



# Report on Best Practices for Sustainable Models of Pro-Poor Rural Financial Services in INDONESIA





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Report on  
Best Practices for Sustainable Models of  
Pro-Poor Rural Financial Services in INDONESIA

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# Foreword

Promoting pro-poor growth is a pattern of growth that is inclusive and enhances the ability of impoverished people to participate, benefit in, and contribute to the growth process. This is a critical factor for developing countries to achieve a sustainable way out of poverty and to enable achievement of the Sustainable Development Goals.

The causes of poverty are complex and multi-dimensional. They involve, among other things, climate, gender, markets, access to finance and public policy. Likewise, the poor are quite diverse in both the problems they face and the possible solutions to these problems. Poverty remains a predominantly rural problem with a majority of the poor in developing countries living in rural areas. It is estimated that 76 percent of the developing world's poor live in rural areas whereas only about 58 percent of the overall global population lives in rural areas. Because of the complexity of rural poverty, each country needs to evolve its own strategy for addressing the concerns of rural poor that is in tune with its socioeconomic ethos.

APRACA has been in the forefront to lead access to finance in the rural areas through its member institutions in the Asia-Pacific region by providing technical assistance in capacity building, research and knowledge management. We are fortunate enough to receive generous funding from International Fund for Agricultural Development (IFAD), the global leader in development finance for documenting the pro-poor rural finance best practices (RuFBEP project). The knowledge gathered will help APRACA in disseminating the information that promotes innovations, productivity, inclusive growth, self-reliance, and welfare of the rural poor in the region and benefit the member institutions in 21 countries across the region. We are confident that documenting the best practices on sustainable practices of pro-poor financial services in the countries like China, India, Indonesia, Philippines, and Thailand will be extremely useful to the countries in the Asia-Pacific region to draw lessons in evolving suitable strategies for the benefit of their people and will add value to global knowledge resources.

This country report on rural finance best practices in **Indonesia** is a part of the series of country reports being published by APRACA with the financial support from International Fund for Agricultural Development.

**Chamnong Siriwongyotha**

APRACA Secretary General

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**Bintan Badriatul Ummah**  
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# Abbreviations

ABSINDO	Asosiasi BMT Indonesia/Association of BMT Indonesia
AO	Account Officer
APRACA	Asia-Pacific Rural and Agricultural Credit Association
BI	Bank Indonesia/Central Bank of Indonesia
BKD	Badan Kredit Desa/Village Credit Agency
BKK	Badan Kredit Kecamatan/Sub-district Credit Agency
BLM	Bantuan Langsung Masyarakat/Direct Community Grants
BMT	Baitul Maal Wat Tamwil (Islamic Cooperative)
BNI	Bank Negara Indonesia
BP	Badan Pengawas/Board of Supervisors
BPD	Bank Pembangunan Daerah/Regional Development Bank
BPR	Bank Perkreditan Rakyat/Rural Bank
BRI	Bank Rakyat Indonesia
CBOs	Community-Based Organizations
CCDP	Coastal Community Development Project
CFIs	Cooperative Financial Institutions
CFS	Cooperative Field Staffs
CMLF	Community-Managed Loan Fund
CPM	Competitive Profile Matrix
CWG	Country Working Group
DEP	Dana Ekonomi Produktif/Productive Economic Fund
Depdagri	Departemen Dalam Negeri/Ministry of Home Affairs
DFID	Department for International Development
HH	Household
HR	Human Resource
IDR	Indonesian Rupiah
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
INKOPSYAH	Induk Koperasi Syariah/Sharia Federated Cooperatives
IPTW	Insentif Pengembalian Tepat Waktu/Incentive for Timely Repayment
KAU	Kelompok Aneka Usaha/Various Business Group
KJKS	Koperasi Jasa Keuangan Sharia/Islamic Financial Services Cooperatives
KKPE	Kredit Ketahanan Pangan dan Energi (Credit for Food Security and Energy)
KSP	Kelompok Simpan Pinjam/Saving and Loan Group
KUD	Koperasi Unit Desa/Village Cooperative
KUR	Kredit Usaha Rakyat (People's Business Credit)
LEPP-M3	Lembaga Ekonomi Pengembangan Pesisir-Mikromitra Mina (Institute of Coastal Economic Micro Mina Development Partner)
LKMA	Lembaga Keuangan Mikro Agribisnis (Microfinance Institution for Agribusiness)
LPDB	Lembaga Pengelola Dana Bergulir/Management Institution of Revolving Fund
MAD	Musyawarah Antar Desa/Inter-Village Consultative
MDGs	Millennium Development Goals
MFIs	Microfinance Institutions
MoA	Ministry of Agriculture

MoF	Ministry of Finance
MSMEs	Micro, Small and Medium Enterprises
MUB	Modal Usaha Barokah/Business Capital Barokah
MTA	Multiguna Tanpa Agunan/Un-collateral Multipurpose Loan
MW	Mega Watt
M&E	Monitoring and Evaluation
NBFI	Non-Bank Financial Institutions
NGO	Non-Government Organization
NMC	National Management Consultant
NPF	Non-Performing Financing
NPL	Non-Performing Loan
NPWP	Nomor Pokok Wajib Pajak/Tax ID Number
OJK	Otoritas Jasa Keuangan/Financial Services Authority
PEMP	Pemberdayaan Ekonomi Masyarakat Pesisir/Coastal Community Economic Empowerment Programme
Pinbuk	Pusat Inkubasi Bisnis Usaha Kecil/Center of Small Business Incubation
PMK	PMK Peraturan Menteri Keuangan/Ministry of Finance Regulation
PMT	Penyelia Mitra Tani (Supervisor of Farmer Partner)
PNPM	Program Nasional Pemberdayaan Masyarakat/National Program for Community Empowerment
PSBs	Postal Savings Banks
PUAP	Pengembangan Usaha Agribisnis Pedesaan/Rural Agribusiness Development
P4S	Pusat Pelatihan Pertanian dan Pedesaan Swadaya/Agriculture and Rural Training Center
READ	Rural Empowerment and Agricultural Development
RFS	Rural Financial System
RLF	Revolving Loan Fund
RUA	Rencana Usaha Anggota (Member Business Plan)
RUB	Rencana Usaha Bersama (Joint Business Plan)
SHG	Self-Help Group
SIUP	Surat Izin Usaha Perdagangan (Trade Licence Letter)
SKU	Surat Keterangan Usaha (Letter of Business Confirmation)
SMEs	Small and Medium Enterprises
SPDN	Solar Packed Dealer for Fishermen
SPP	Simpan Pinjam Perempuan (Women's Savings and Loans)
SOLID	Smallholder Livelihood Development
SOP	Standard Operating Procedure
STA	Sub Terminal Agribisnis
TDP	Tanda Daftar Perusahaan (Certificate of company registration)
TDUP	Tanda Daftar Usaha Pariwisata (Certificate of tourism registration)
TOR	Term of Reference
UEP	Usaha Ekonomi Produktif (Productive Economic Activities)
UGT	Usaha Gabungan Terpadu (Integrated Joint Business)
UPK	Unit Pengelola Kegiatan (Activity Management Unit)
USP	Usaha Simpan Pinjam (Savings and Loans Unit)

US\$1 = 13,280 Indonesian Rupiah as on 31 August 2015



# Executive Summary

As a common phenomenon in many member countries within the Asia-Pacific region, in Indonesia poverty is still a major problem with 27.2 million out of its total population of about 250 million still live in poverty. Majority of these poor people live in rural areas where agriculture is primary source of employment and livelihood. The low income flow from agriculture forces most of the rural inhabitants to find work in the agricultur as well s other non agriculture sectors, either as laborers or small business operators.

It is now well established that inclusive financial system is a key ingredient for the economy to grow fast and rapid economic growth is a potential source to alleviate poverty. A positive relationship between access to financial services and poverty alleviation will hold only when the provision of financial services makes productive capacity of the poor realised fully. This implies that provision of enhanced access to a range of financial services for these rural poor people is critical to pull them out of poverty. However, many constraints the poor people face in accessing financial services. Accordingly, overcoming these constraints is vital for poverty alleviation and establish an inclusive development path. This is not an easy task since it requires creation of innovative ways to provide financial services to the rural poor.

Recognizing the importance of providing enhanced access to financial services to the rural poor towards pulling them out of poverty and the difficulty associated with its realization, national governments of the Asia-Pacific region have requested the Asia-Pacific Rural and Agriculture Credit Association (APRACA) to support the expansion of access to rural financial services for their rural poor. In response to this demand, APRACA has conducted studies in four distinct-phases across five countries that include PR China, India, Indonesia, the Philippines and Thailand with the overall goal of establishing a sustainable strategy to reduce rural poverty and improve food security for rural communities in the Asia-Pacific region.

This country study of Indonesia was done in the first phase. The goal of this current study was two fold. First, to document the best practices in the provision of financial services to rural poor of Indonesia. Second was to pilot two or three best practices to make its impacts on the target segments and subsequently to scale up its implementations.

To achieve these goals a combined research method is applied. The method included extensive literature review, field visits, indepth interviews and focus group discussions. In documenting the best practices in operation, the consultant worked in close cooperation with Country Working Group (CWG) consisting of the lead institution and other institutions involved in rural finance. To aid the selection of financial service schemes which can be considered as best practice in Indonesia, together with the consultant the CWG, it developed a checklist of best practices indicators. This checklist was adapted from the set of indicators provided by the APRACA attached in the study ToR.

## **Rural Financial Services for Pilot Projects**

The researchers collected information from various sources including CWG to list the cases of rural financial services (RFS) best practices in Indonesia. The discussion among researchers, Bank Indonesia (BI) and the Country Working Group (CWG) selected 8 RFS based on the inclusion criteria. Using primary assessment and inclusion criteria, consultants together with Country Working Group discussed and

selected 5 potential RFSs out of 8 identified RFS to analyze in-depth and comprehensively towards identifying the best practices of rural finance in Indonesia.

As stipulated in the ToR, only two or three schemes are to be proposed as pilot projects. In line with the above stipulation, three rural financial services (the LKMA Pincuran Bonjo, the BMT UGT, and the USP Grameen Pesisir) are chosen for the pilot project. This recommendation is based on the following criteria. The three financial institutions identified were established by local initiative and resources. It has been proven that they are all sustained even without the government's technical and financial support. The USP Grameen Pesisir has a group lending approach directed to serve financial need of small unit business operated by women. Moreover, it appears that this scheme has shown a bright growth of business and outreach. However, its operation is only one year old. It needs more time to prove its viability as good and sustainable scheme.

The preceding discussion does not imply that the three institutions have no weaknesses. In fact there remain no perfect financial institutions to cater to the agriculture and rural sectors. Therefore, these institutions too have some of the weaknesses inbuilt in the system. But, it is believed that these weaknesses can be overcome through pilot project which can be used as a medium for a learning process towards finding solution and to make it replicable by other financial service institutions.

### **The Selected Best Practices**

The study has identified and selected three rural financial services as best practice currently prevailing in Indonesia. It consists of two community-initiated and one government-initiated programs. In the following sections, key features of each of the service that make itself recognized as best practice are outlined briefly.

#### **A. The LKMA Pincuran Bonjo**

This community-initiative based rural financial service scheme is operated in West Sumatra Province. The fund comes from the community and is supported by the government. As the other three schemes, this one is also focused on serving clients operating on small unit businesses who are not eligible to obtain a loan from commercial banks. The schemes offered are individual borrowing whereby loan is provided to individual borrowers. The loan provision requires no asset collateral against the borrowed fund. But, the client has to meet the following requirements—they should be member of the LKMA for at least a period of 1.5 months. In addition to this requirement, the borrower should have an accredited personal guarantor. The personal guarantor is normally a community elder whose good social reputation will be at jeopardy when the guaranteed borrower fails to make the promise that he had made towards the loan repayment. The first loan is up to IDR 3 million with a monthly repayment of up to 10 months. If the repayment of the first loan is completed as scheduled, the borrower can apply for a bigger credit package with a longer period of repayment. Interest is up-front payment, which means that all interest is paid at the start of borrowing period while principal repayment follows payment schedule in accordance with maturity date. Under this scheme, the loan is bundled with compulsory saving by the borrowers. The main purpose is to make the borrowers become self-disciplined in managing their financial affairs so as to enable them to accumulate capital. This eventually will make them able to self-finance their business and to pull them out of poverty.

The other unique feature which is different from other rural financial services is that the LKMA Pincuran Bonjo applies integrated system of rural financial framework. It provides financial and non-financial services to the clients and the community.

## **B. The BMT UGT Sidogiri**

BMT UGT Sidogiri is located in Pasuruan district of East Java Province. This rural financial service scheme follows *sharia* (Islamic) financing norms. As the other schemes, this one is also focused on serving clients operating on small unit businesses who are not eligible to obtain loans from commercial banks. The scheme is an individual borrowing scheme whereby loan is provided to individual borrowers. The loan provision requires no asset collateral against the borrowed fund. The loan size varies by scale of financing scheme. First is for productive poor, relatively small with the maximum amount of IDR 1 million. The loan repayment is gradual (monthly) with the maximum time period of 12 months. Second is to finance individual borrower or micro and small business entity with maximum financing IDR 500 million. The loan repayment is gradual (monthly) with the maximum time period of 36 months.

The loan does not carry any explicit interest since it is not allowed by Islamic law. Instead on UGT MUB, the lender and the borrower use sharia agreement of *Mudharabah/Musyarakah* (based on profit sharing system) and *Murabahah* (based on trading/buy and sell system); profit sharing and trade margin will be agreed by both parties.

Under this scheme, also the loan is bundled with compulsory saving by the borrowers. The main purpose of this is to make the borrowers become self-disciplined in managing their financial affairs so as to enable them to accumulate capital. This eventually will make them able to self-finance their businesses and to pull them out of poverty.

## **C. The USP Grameen Pesisir Loan Scheme Provided by Mina Samudera Cooperative**

This scheme was introduced and implemented in a fisheries cooperative, named KUD Mina Samudera located in the Province of Banten in October 2013. The scheme is envisaged for group lending directed to serve financial need of small unit businesses operated by women. In order to apply for the loan women have to form a group of five or more. They also have to be members of the KUD Mina Samudera. As in the case of the second scheme, the group places no certified asset collateral against the obtained loan. Instead, joint liability is applied for the loan with the consequence that if one of the members fail to meet the agreed repayment schedule, the next loan will not be approved. In addition to this, members of the group together with those of other groups who obtained similar loan conduct once-a-week meeting to discuss a variety of business issues related to the use of loan. This meeting provides an opportunity for the lender (the KUD) to conduct a supervision of use of the loan to ensure that the borrower is capable of making timely repayment.

Under this scheme, also the loan is bundled with compulsory saving by the borrowers. The main purpose is to make the borrowers become self-disciplined in managing their financial affairs so as to enable them to accumulate capital. This eventually will make them able to self-finance their businesses and to pull them out of poverty.



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# CHAPTER 1

## Introduction

### 1.1 Background

Indonesia has the fourth biggest population in the world, after China, India and United States of America. Most of these people live in rural areas. In 2014, the country's population was 253.6 million (Purnomo, 2014). It is estimated that 44 percent of the national population lives in rural areas. Despite the declining rate of its contribution to the Gross Domestic Product (GDP), agriculture sector still remains a major source of employment and income for the country's population, with more than 35 percent of the national labor force working in the agriculture sector (Safrizal, 2013).

Agriculture, which is a major source of employment and income for rural population, has become over crowded with labor after the emergence of the financial crisis in mid-1996. As the crisis had brought down industrial sector, the laid-off workers returned to their rural communities to seek economic subsistence. As unemployment had already been a serious problem, the return of laid-off laborers to their rural communities made the rural economy's unemployment condition worse. The government has tried hard to ameliorate this unemployment problem through implementation of various development programs, but the government's effort has not yet been able to effectively solve this problem. As a consequence, unemployment still remains a serious problem in the rural areas. In August 2013, the rate of unemployment was 6.25 percent.

On an average, rural people are relatively poor. The average size of farmland holding per farmer is relatively small. In 2013, the average farmland holding size was 0.86 hectare per farm household. This size is relatively very small by any Western standard. The existing surplus labor force in agriculture in rural areas together with the small average land holding size implicate unfavorably on the levels of income of farmers.

In addition to the low average income levels, another problem of the rural population of Indonesia is the prevalence of poverty. It is true that poverty is not a new problem to Indonesia. In the Dutch colonial era, poverty had been a major problem and the need to improve the quality of life had been one of underlying factors behind the introduction of transmigration program in 1905 (Pelzers, 1945). The Suharto government had made a great effort to bring it down to the lowest level in 1980s. However, the occurrence of the national financial crisis in the mid-1996 had caused the level of poverty to rise again in the country. Since then there has been a lot of programs designed and implemented with the expenditure of a huge amount of resource to eradicate the poverty and under development, but yet it remains a major problem in the country and rural areas are the main host of poverty. In addition, due to surplus laborers working in agriculture, majority of the rural households have to employ a "multiple job strategy" to generate income to support their family's subsistence. With this strategy, a family's labor force has to work not only in agriculture, but they also have to find jobs out of farms. Thus, the phenomena such as migratory laborers and operators of informal small businesses become more common in rural community of Indonesia.

It is now well accepted that inclusive financial system is a key ingredient for economy to grow well and the rapid economic growth is an avenue to alleviate poverty. Such a positive relationship between financial services and poverty alleviation will hold only when the provision of financial services makes productive capacity of the poor people become fully realized. This implies that access to financial services will be a key for poor people to lift themselves out of poverty.

However, poor people lack access to financial market. Financial institutions often overlook them because of their limited financial capacity. This is a misconception as a recent study has revealed – a great market potential for rural financial services even though the rural population is relatively poor. The study of Banking with the Poor network collaborated with SEEP Network (2009) revealed an Indonesian state owned bank, Bank Rakyat Indonesia (BRI) through its village units in 2006 mobilized savings as much as IDR 38.68 trillion (US\$ 3.87 billion) from more than 30 million rural micro savers. Most of the savings mobilized was lent to 3.44 million rural micro borrowers.

This figure did not reflect yet the full market potential of rural finance in Indonesia, since the BRI was only one out of so many formal and semi-formal finance institutions involved in collecting savings and providing loans to rural population (Banking with the Poor Network collaborated with SEEP Network, 2009; Wardoyo, 2014). In addition, rural finance in this country is not limited to savings and loans. Other forms of rural financial services such as micro-insurances (Nuryartono, 2013) and remittances is just beginning to develop.

Nevertheless, the great market potential of rural finance in this country has not yet fully exploited. This is not simply because of misconception about the extent of market potential itself, but also because of some other factors which constrains development of rural finance. These include high transaction costs, lack of suitable asset collateral, weak legal system and lack of physical and institutional infrastructure. Actually, some of these constraints can be relaxed through either creative innovation in approach and delivery methodology and improvement of regulatory framework.

Delivering small-scale financial services is particularly challenging in rural areas as on the one hand it is expensive to the financial institutions to operate and on the other hand high cost of transaction to the small holder. In addition, there are risks associated with availability of collaterals, natural disasters, low yields, unforeseen decline in prices, etc. Therefore, provision of financial services to poor rural households faces many challenges, including weak infrastructure, the limited capacity of financial service providers and low levels of client education. This has led to the conclusion that agricultural and rural finance is a high risk activity for both the lender and the end borrower. Despite these barriers, innovative ideas are constantly being developed and tested. IFAD's extensive experience in the sector demonstrates, however, that both agriculture and rural finance can be profitable businesses. Furthermore, that the new and innovative approaches should be given both the opportunity and the appropriate resources (fiscal, institutional, political, etc.) to show their true potential to help lift the typical smallholder farmers out of poverty.

The Asia-Pacific Rural and Agriculture Credit Association (APRACA; [www.apraca.org](http://www.apraca.org)) received a grant from the International Fund for Agricultural Development (IFAD) to respond to the specific requests from national governments of the Asia-Pacific region for support in expanding access to rural financial services for the poor.

The basic approach of this grant project is documenting the best practices at the macro, meso and micro levels of the rural finance<sup>1</sup>. The term rural finance refers to the financial transactions related to both agricultural and non-agricultural activities that take place among households and institutions in rural areas. Rural finance institutions refer to both rural finance institutions and rural microfinance institutions.

In a changing global economy and in the context of the widening financial crisis, volatile food and agricultural commodity prices and the perils of climate change, developing inclusive rural financial systems and fostering innovations to increase the access of poor and marginalized women and men to a wide range of financial services including savings, investment and working capital loans, insurance and remittances is central to IFAD's mandate.

<sup>1</sup> As defined in IFAD's Rural Finance Policy, p. 15 (<http://www.ifad.org/pub/basic/finance/eng.pdf>)

In building inclusive financial systems, IFAD applies six guiding principles in its rural finance interventions: (i) support access to a variety of financial services; (ii) promote a wide range of financial institutions, models and delivery channels; (iii) support demand driven and innovative approaches; (iv) encourage – in collaboration with private sector partners – market-based approaches that strengthen rural financial markets, avoid distortions in the financial sector and leverage IFAD's resources; (v) develop and support long-term strategies focusing on sustainability and poverty outreach; and (vi) participate in policy dialogues that promote an enabling environment for rural finance. These binding principles are applied at the micro level, working with retail rural finance institutions and beneficiaries; at the meso level, focusing on financial infrastructure, such as second-tier institutions, and technical service providers; and at the macro level, assessing the policy, legislative, regulatory and supervisory framework.

## 1.2 Objectives and Scope of the Study

The overall objectives of the study are:

- (a) To sustainably reduce rural poverty and improve food security for rural communities in the Asia-Pacific region.
- (b) To assist rural finance providers and governments extend financial services on a sustainable basis, through the application of best practices suitable to their unique operating environments.
- (c) This scoping and mapping study is the Phase-1 of the whole exercise with the immediate objectives to identify and critically review the best practices which are replicable and could be successfully scaled up by the financial institutions, IFAD and other interested parties.

The specific objectives of the study are as follows:

- (a) To undertake an extensive desk review of the available literature, covering one<sup>2</sup> of the five focus countries, on the design, implementation and evaluation of best practices relating to the identified themes. This includes reviewing the results of the Finpower, Finservaccess and Microserv projects (The reports are available in APRACA website [www.apraca.org](http://www.apraca.org)). The details of the broad themes and the matrix are given in Annexure-1 and the consultants need to decide the inclusion criteria after discussing with the lead institution and the country working group.
- (b) To identify, determine and document the innovations, critical rural finance issues, concerns and gaps within the national rural finance condition;
- (c) To conduct field research and targeted interviews with stakeholders in the selected country, including government officials, financial service providers, clients, researchers and donors.
- (d) To review and analyse different types and methodologies of providing rural financial services to the rural poor. This includes researching as to how best practices need to adapt to the local political/economic/social and environmental circumstances in which they operate.
- (e) To identify the various successes and failures in implementing rural finance, and ascertain the reasons and circumstances that affect the outcome.
- (f) To recommend the thematic best practices (minimum 2-3 based on the study) and draft proposals for their implementation.
- (g) To present the paper in the regional workshop to be held during January 2015 and participate in the discussion and finally revising the document.

<sup>2</sup> Each consultant will be appointed to cover the study of one country in collaboration with the lead institution, country working group and IFAD project leaders of that country.

The research intended to capture the rural finance products, service delivery, business models, enabling environment, use of technology etc. Its also sought to include, to the extent possible, a comprehensive analysis of the policies and regulations on micro-insurance, internet banking, remittances, financial intermediation, and financial literacy and risk management and governance, in addition to other traditional topics with emphasis on access to financial services by the rural people.

The research team conducted the study by participating in the regional workshop to discuss the findings of the study. It is expected that the team provides recommendations for piloting the best practices in the focussed countries. The study resorted to recommend the restructuring/reform processes needed for the development and expansion of institutional vehicles to foster access to rural finances.

The comprehensive report provide a presentation of the status of rural finance (including microfinance) related to the existing policies and regulatory framework, latest innovative strategies including lessons learned with in the period that would result to RuFBEP project, APRACA and IFAD in general to support further pursued at the regional and national levels.

### **1.3 Content of the Report**

This report has seven chapters to capture all the information about rural financial services in Indonesia. The structure of the report is as follows: (1) Introduction (Background, Objectives and Scope of the Study, Content of the Report); (2) Methodology (Study design, Inclusion criteria, Geographical Coverage, Sampling Methodology, Field Work and Data Collection and Data Analysis); (3) Review of published and grey Literature; (4) Findings on Rural Financial Services (Key players in Rural Finance Space, Regulatory Framework and Enabling Environment, Typology for Providing Rural Finance, Capacity of the Rural Financial Institution in Indonesia, Challenges related to Rural Finance in Indonesia, Innovative Rural Finance Operation/Schemes in Indonesia); (5) Detailed study of Rural Finance Best Practices (Identified Best Practices, Competitive Profile of the Selected Best Practices, Details of the Best Practices, and Key Success Factors); (6) Pilot Testing of the Best Practices; and (7) Conclusions, Policy Recommendations and Way Forward.



## CHAPTER 2

# Methodology

### 2.1 Study Design

The methodology for this study resorted to a combination of primary and secondary level exploration and analysis. The data collection has been carried out through desk reviews of the available literature from the published sources as well as the grey sources. Additionally workshops, field visits and focused group discussion were held at the field level to document the best practices established and currently in prevalence in the agriculture and farm domains. This has been done in close cooperation with the lead institution and other institutions involved in rural and agriculture finance.

It is to submit that the major part of the work has been done during the desk research phase to review literature and other relevant information concerning the rural financial services particularly the best practices in Indonesia. In order to demonstrate the latest situation and the contemporary relevance of the ideal practices evolved in the rural financial sectors, the secondary data after 2010 only has been used in this analysis. Subsequently the primary level investigations were made to establish the authenticity of the secondary level findings and establish the scope of its replication in wider contexts.

### 2.2 Inclusion criteria

For each rural financial services reviewed, the consultants have a summary assessment using the proposed broad themes and inclusion criteria for selecting rural finance best practices. Then the proposed themes and inclusion criteria is discussed with Bank Indonesia as the lead institution and Country Working Group (CWG) to explore appropriate criteria for condition of rural finance services in Indonesia.

**Table 1. Review Checklist of Best Practices Indicators**

No.	Theme	Identified Factors	
		Indicator	Best Practices
Inclusion Criteria			
1	Savings Products	Type of saving	Voluntary
			Compulsory
		Access to savings withdrawals	Open access
			Limited access
		Interest rate	Payable
2	Credit/Financing Products	Type of credits	Short term
			Long term
		Criteria target	Feasible but not bankable
		Loan repayment structures	gradual repayment
			single repayment
		Source of fund	Government
			Commercial
		Interest rate	Commercial
		Subsidized	
		Additional Cost	General fees and charges
		Collateral	Physical/asset Collateral by clients

**Table 1.** (continued)

No.	Theme	Identified Factors	
		Indicator	Best Practices
			Guarantees
			Social collateral
3	The Methodology Used	Rural credit methodologies in use	Group lending
			Individual lending
4	Legal Structures and Regulation	Regulator/Authority	Self Regulated
			Government Regulated (Ministry, Central Bank, OJK, Local Government, ect.
		Regulation	Content of the regulation
			Consumer protection
5	The Appropriate Managerial and Administrative Structure	Guidelines	By Government
			By Non-Government
6	Operational and Outreach Structures- Wholesale and Retail	Approaches to achieve financial inclusion by outreach into un-served rural areas	Direct loan/saving distribution to the clients
			Linkages between wholesale institutions and smaller retail entities (cooperative/ non-cooperative)
7	New Innovations	Product	Bundling between main product and secondary product
			Point of sale outreach
			Linking of Remittances to credit
		System	Incentive for customer discipline
			Collateral (insurance, social collateral, guarantee)
			Customer Protection
			Selection, Recruitment, Monitoring and Supervision
			Technical assistance (training, capacity building, supervising)
		Technology of Delivery	Mobile Phone Banking
			Internet Banking
8	Financial and Management Reporting	Report, Budgeting and planning	Standard and Regular Financial Reporting
			Budgeting and planning
			Financial Report Evaluation
9	Islamic Finance	Procedure	Akad or Agreement
		Collateral	Asset or Trust
		Return	Sharing profit or interest rate
10	Governance	Structure of Organization	The role of the board of directors
			The role of supervisory agency
			The relationship between management and the board
<b>Performance</b>			
1	Saving performance	Outreach	number of customers
			growth of customers number
		Achievement	total saving accumulated
		Sustainability	The Program/Scheme has been running for minimum 3 years with positive growth

**Table 1.** (continued)

No.	Theme	Identified Factors	
		Indicator	Best Practices
2	Loan Performance	Outreach	number of borrower
		Target	total loan
		Achievement	NPL
		Sustainability	The Program/Scheme has been running for minimum 3 years with positive growth

- (a) Savings Products. It is generally recognized that savings is the most sought after financial product by the rural poor, especially by women. Best practices will be identified relating as to whether savings should be voluntary or compulsory, whether there should be open access to savings withdrawals or access should be limited, and the interest rate payable on savings and how it should be set.

- (b) Credit Products. This theme will focus on identifying the most appropriate credit products for the target clientele. What are the correct circumstances for short term and long term credit products, and the appropriateness of balloon and bullet loan repayment structures? Also, how interest rates and general fees and charges should be priced and charged.

The role of collateral in providing rural financial services remains topical. The question as to whether taking physical collateral, or guarantees, should be a legal requirement when extending credit will be explored. Best practices for taking social collateral, as opposed to real assets, and accepting moveable assets compared to immoveable assets, would be critically reviewed.

- (c) The Methodology to be used. This theme will identify the major rural credit methodologies that are in use (village savings and loans, group lending, accumulated savings and credit associations, village banking, individual lending, rotating savings and credit associations, hybrids) and will discuss their strengths and weaknesses. The theme also will identify the most appropriate methodology for a variety of operating circumstances. The goal of general inclusion of the rural poor within a methodology will be one of the driving factors of this theme.
- (d) Legal Structures and Regulation. This theme will examine the various legal structures and the role of regulation. A key question to be answered will be which rural finance modalities should be regulated and the intensity of that regulation and oversight (light touch compared to heavy handed oversight). The various approaches to legal structures and regulation to be reviewed will include unregulated SHGs, self-regulated entities (Apexes), and incorporated entities. The correct intensity of oversight, and which type of institution should be regulating the financial service providers (Central Banks, Departments of Cooperatives, the Securities and Exchange Commissions, the Ministry of Finance, the Ministries of Social Affairs and the Registrars of Companies, amongst others), will be studied.
- (e) The Appropriate Managerial and Administrative Structure. This theme will consider the various alternative managerial and administrative structures, and which ones are appropriate for various sets of circumstances. When is a decentralized approach compared to a centralized management structure more appropriate? When is a flat management structure, as opposed to a pyramid structure, superior? The various strengths and weaknesses of project management units and project implementation units will be reviewed. The issue of allocating responsibility between central governments and provincial and district governments also will be covered. Two key issues that will need to be considered under this theme will be the quality and outreach of communications, and the ease of physical access to the clients. How this will affect the management structure and the role of government policy in determining which structure is finally adopted will be highlighted.

- (f) Operational and Outreach Structures-Wholesale and Retail. This theme will review the various approaches to achieving financial inclusion by outreach into unserved rural areas. This will include studying the establishment of linkages between wholesale institutions and smaller retail entities, either registered financial institutions, NGOs or SHGs. The need for having the appropriate technical and managerial skills at all levels of the outreach structure, but particularly at the end client level, will be highlighted. The strengths and weaknesses of establishing specialized rural finance units within large financial institutions will be discussed. Of considerable importance will be the trade-off between the response rates to the request for services versus the need for control.
- (g) New Innovations. Under this theme a review of innovative products and systems as they relate to rural finance has been studied. Potential areas of study included mobile phone banking, point of sale outreach, the linking of remittances to credit, the provision of insurance (life, health, crop and livestock, index based insurance, and weather insurance), and the bundling of financial services with other support services. A key part of the recommendation under this theme was identifying how the ongoing evolution of innovative ideas could be monitored and disseminated to interested parties after the grant closes.
- (h) Financial and Management Reporting. Best practices in budgeting, planning, analysis and interpretation of data, were identified. The key ratios and key financial records to be kept are determined and accordingly recommendations are made.
- (i) Islamic Finance. A study was undertaken to identify common best practices that apply to both orthodox rural finance and Islamic rural finance.
- (j) Governance. Best practices as they relate to the role of the Board of Directors, the relationship between management and the Board, and the needed professionalism in management could be topics to be studied under this theme.
- (k) Performance. There are two indicators to determine the performance of rural financial institutions dealing in saving and loan products. The criteria of saving performance are the indicators of positive growth as the scheme has been in operation for a minimum of 3 years with positive growth of clients. While the criteria of loan performance has been the number of borrowers, achievement of target lending, Non Performing Loan (NPL), and whether the scheme has been operated for a minimum of 3 years with positive growth of clients.

## 2.3 Geographical Coverage

The scoping and mapping study is expected to cover all key players and stakeholders of rural finance products, last mile service delivery, business models and enabling environment prevailing in Indonesia. The document captures the innovations at the community and the rural financial institutions level in order to achieve and obtain the most relevant issues. Also, it looks at the previous studies and available literatures and undertakes desk reviews of areas or aspects not covered in past reviews and updating activities. Hence the geographical coverage of the report has been representative of the country by selecting the regional clusters.

## 2.4 Sampling Methodology

Researchers collected information from various sources including from CWG to list the cases of RFS best practices in Indonesia. There remains a large number of RFS operating in Indonesia under varying conditions-enabling as well as otherwise. Based on the discussion across stakeholders and key players, BI and the CWG, the following rural finance good practices were selected based on the set inclusion criteria:

1. LKMA Pincuran Bonjo
2. Baytul Ikhtiar Cooperative

3. KUR Micro Loan Program
4. IFAD Program (CCDP, SOLID, READ)
5. Swamitra Mina-PEMP
6. BMT UGT Sidogiri
7. KKPE Program
8. PNPM UPK (SPP)

Towards a comprehensive review, primary assessment criteria were used to ensure the adherence of the inclusion criteria (see Table 1). Following are the primary assessment criteria were applied in this context.

- (a) Sustainable: the rural financial services/program has been operating for at least 3 years and still going on.
- (b) Targeted client: it serves eligible but not bankable customers in rural areas.
- (c) Self sustained: The institution can survive with their own funds; the main source of fund is not from a donor or a grant

## 2.5 Field Work and Data Collection

Using primary assessment and inclusion criteria, consultants together with Country Working Group discussed and selected 5 potential RFSs out of 8 identified RFS cases to be analyzed in-depth and present comprehensively as best practices of rural finance in Indonesia.

- KJKS BMT UGT Sidogiri, Pasuruan-Jawa Timur
- KUD Mina Samudera with Business Unit of Saving and Loans of Swamitra and Grameen Pesisir Loan Scheme in Tangerang-Banten
- PNPM UPK SPP Sidomulyo Lampung Selatan-Lampung
- LKMA Pincuran Bonjo, Payakumbuh Sumatera Barat
- KUR Micro Credit Program, BRI and beneficiaries of KUR Micro Credit Program Cianjur- West Java

**Table 2. The Potential Rural Finance Services for Best Practices**

Institution	Type of RFS	Criteria	Targeted clients	Primary data collection*	Other Remarks
1. KJKS BMT UGT Sidogiri-Pasuruan-Jawa Timur	Cooperative of Sharia Financial Services	Islamic rural financial services	Un-bankable but eligible	<ul style="list-style-type: none"> <li>• BMT UGT Sidogiri-Pasuruan Jawa Timur (head office, branch and debtors)</li> </ul>	
2. KUD Mina Samudera	Village Unit Cooperative	<ol style="list-style-type: none"> <li>1. Linkage program between bank and rural financial institutions</li> <li>2. Solidarity Group Lending using Grameen System</li> </ol>	Productive coastal poor community	<ul style="list-style-type: none"> <li>• Mina Samudera Cooperative and its business units of saving and loans</li> <li>• Directorate of Coastal Community Development, Ministry of Marine and Fisheries</li> </ul>	Sample is selected based on recommendation from the Directorate of Coastal Community Development, Ministry of Marine and Fisheries

**Table 2.** (continued)

Institution	Type of RFS	Criteria	Targeted clients	Primary data collection*	Other Remarks
3. PNPM UPK (SPP)	Poverty Reduction program from Government	Rotating Loan Fund for loan and saving women's group	Eligible but not bankable	<ul style="list-style-type: none"> <li>National Management Consultant (NMC) PNPM-Jakarta</li> <li>UPK SPP Sidomulyo Lampung Selatan</li> </ul>	Sample is selected based on recommendation from National Management Consultant (NMC) of PNPM-Jakarta
4. LKMA	Self-Help Group (supported by government initiative)	Community based rural financial services		<ul style="list-style-type: none"> <li>LKMA Pincuran Bonjo, Payakumbuh</li> <li>Masril Koto (founder of LKMA Prima Tani and Social Entrepreneur)</li> </ul>	
5. KUR Micro Credit Program	Credit Program – Poverty Reduction Program	Commercial Loans with Guarantee scheme from Government	Un-bankable but eligible	<ul style="list-style-type: none"> <li>BRI head office-Jakarta</li> <li>BRI Cianjur</li> <li>Beneficiaries of the KUR program (individual debtor micro and retail, executing institution)</li> </ul>	

Note:

Feasible business: a business that makes a profit so that it has the ability to pay the entire debt and interest within a specified period and uses its profit for business development.

Non-bankable: a business that can not meet the bank's requirements especially the provision of collateral.

To ensure that the work captures the information accurately, and to ensure a fully systematic approach to data collection, interview topic guides have been developed and applied to support the relevant aspects outlined in the study.

## 2.6 Data Analysis

The collected data has been analyzed quantitatively and qualitatively. It involved the following approaches:

- Outreach and trend analysis of various rural financial services provided by different institutions.
- Comparative study based on the inclusion criteria using Competitive Profile Matrix (CPM). The CPM identifies a firm's major competitor and its particular strengths and weaknesses in relation to a sample firm's strategic position (David, 2005). CPM not only creates a powerful visual catch-point but also conveys information about the competitive advantage and is the basis for a company's strategy (Bygrave & Zacharakis, 2011).



Zimmerer, Scarborough, and Wilson (2008) state three steps to construct a CPM for a company. The first step is to find the key success factors (KSFs) for the company and attach weight to those factors according to their relative importance. In the next step, the company needs to identify its major competitors and rate each competitors including company itself on each of the KSFs. KSFs in different ratings have been given from 1 to 4 considering their relative importance to the organization where 1 stands for major weakness, 2 stands for minor weakness, 3 stands for minor strength, and 4 stands for major strength. Same method is applied when rating to the KSFs of competitors. Lastly, the company has to multiply the weight by the rating for each factor to get a weighted score and then adds up each competitor's weighted scores to get a total weighted score. Capps III and Glissmeyer (2012) argue that CPM includes company's KSFs which help the company identify strengths and deficiencies in the significant areas. Analyzing organizations in this manner is an effective way to evaluate many competitors in one framework to support an effective strategic plan.

## CHAPTER 3

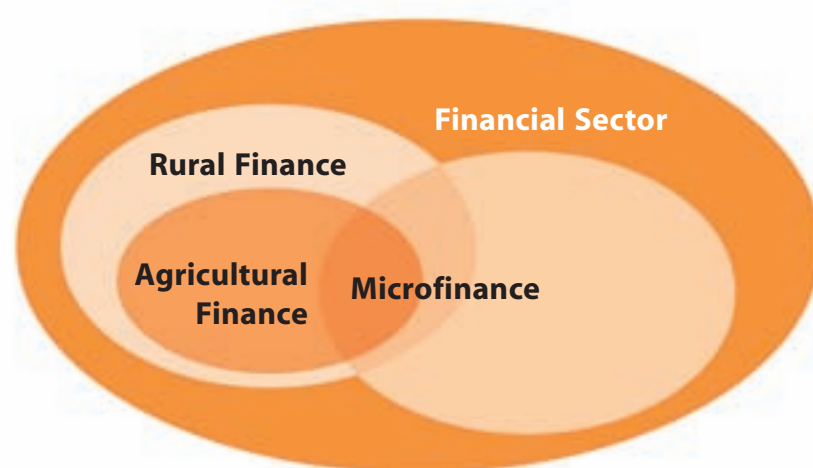
# Review of Literatures<sup>3</sup>

### 3.1 Definition and Scope of Rural Financial Services (RFS)

The term rural financial services implicitly mean the provision of financial services to the rural community. It is true that in rural areas of developing countries, agriculture is the main economic activity from which majority of rural inhabitants generate major share of their family income. Nevertheless, there has been increasing role of non-agricultural sector in providing jobs and income to the rural inhabitants. Accordingly, it is incorrect to claim rural finance as synonym to agricultural finance. It is rather only a subset of the rural finance. Another important aspect of rural finance is the fact that this market serves clients whose demand for financial services generally is relatively small in size. This implies that rural finance is also about microfinance.

Andrew (2006) has depicted this rural finance's complexity in the following diagram. By using this diagram (below), it is possible to draw various definitions and scope of rural financial services. Thus, in the study of IFAD (2009) and DFID (2004), for instance, the term rural finance refers to the financial transactions related to both agricultural and rural business activities that take place among households and institutions in rural areas by people of all income levels. But, this description is far from complete. For instance, it does not explain the types of financial services that RFS provides to members of the rural community. It also needs explanation about institutions which make these services available for them.

**Figure 1. Rural Finance in the Structure of Financial Sector**



Source: Andrew, 2009

A much more comprehensive description of rural financial service is provided by Meyer (2012), DFID (2004), IFAD (2009), Andrew (2006) and the World Bank (2007). They all agree that rural finance encompasses the full range of financial services that farmers and rural households require, not just credit for poor people provided by microfinance, but wider range of services such as savings, money transfer, payments and insurance to rural individuals, households, and enterprises, both farm and non-farm, on a sustainable basis. It includes financing for agriculture and agro processing. These

<sup>3</sup> Chapter 3 is derived from two types of literature; (1) Published Literature such as journal and book and (2) Grey Literature that comes from working paper and report; (see details in references)

products are supplied by providers in rural areas which include commercial and development banks, non-bank financial institutions, cooperatives, microfinance institutions (MFIs) and semi-formal or non-formal organizations – such as savings and credit cooperatives, self-help groups (SHGs), village savings and loan associations, financial service associations as well as input supply traders and agri-processing companies.

### **3.2 Potential Benefits of Rural Financial Services**

Rural finance is of importance for improvement of inhabitants in rural areas of developing countries. It plays a vital roles to reduce poverty, enhance donors' development effectiveness agenda and contribute to achieve the three strategic goals of rural development viz, (i) rural economic growth, (ii) inclusion and enabling participation of all rural people in development process and (iii) reduction of vulnerability to economic, physical, and other shocks (IFAD, 2009). The rural finance can reduce poverty by providing resources that allow the poor to invest and so pursue new economic opportunities through savings and access to credit which help rural households manage seasonal liquidity shortages, and meet planned life events such as marriage and childbirth and unplanned life events such as a health exigency and death (World Bank, 2007). In addition to saving and credit, access to insurance services also helps the poor to mitigate some of their risks.

Moreover, improving rural finance system helps households to receive remittances reliably and at low cost, and raise income particularly for poor families which also contributes to the first MDG on the eradication of extreme poverty (DFID 2004 and World Bank 2007).

Rural finance can help farmers to access financial services. For farmers who do not own land, credit and savings facilities can help establish or expand family enterprises because the family will be able to maintain consumption of basic necessities when household incomes decline temporarily (Zeller and Sharma, 1998).

Rural finance plays a critical role in household strategies to reduce vulnerability. It assists the poor to smoothen consumption and to build up assets greater than the value of the liability. To build up assets, poor people have access to financial services and it allows them to manage their household cash flows through creating saving and credit. Besides, the access to financial services also helps households to start new agricultural activities, set up small businesses or non-farm enterprises (ranging from handicrafts to commerce and telecommunications) and helps small farmers to improve productivity through investment in irrigation, production equipment, inputs or hired labor. It also helps to invest in post-harvest handling, processing, and marketing (Zeller and Sharma, 1998; Nuryartono, 2005, IFAD 2009 and World Bank, 2007).

Particularly for women, rural finance is important and gives potential benefit to control family finance. Rural finance has given interventions that enhance women's direct access to and control over financial resources, which improves their position vis-à-vis their husbands, strengthening their role as decision-makers and enhancing their ability to influence how they allocate resources (World Bank, 2007). Moreover, if before women were at the lowest levels of rural society, once they gain access to the rural financial services, their status at home and in the communities improves. Credit extended to women has a greater positive impact on household food consumption and on the quality of life of children as compared to loans extended to men (IFAD, 2009).

### **3.3 Paradigm Shift of Rural Financial Services**

In much of the developing world, enhancing the livelihoods of rural areas is still a task as it was several decades ago. This is simply due to the fact that these areas are still home for majority of their population and one of the country's major economic sectors. Further, agriculture patterns in rural areas are still a major source of employment and income for majority of the population. Most of them are still

under poverty even though development programs have been implemented in this sector for over the last five decades – to depict its inefficiency or structural defects.

The poverty that rural communities face has been closely linked with lack of their access to right financial services. With the help of international donors and agencies, various financial service schemes have been designed and implemented to assist them in getting out of poverty over the period of the rural development program implementation. All the efforts however do not provide much needed push towards alleviating poverty from rural communities of developing countries. In the following parts of this section, a shift in the underlying paradigm of financial service schemes implementing to support rural development of this region are briefly outlined.

#### **(a) Public Interest Paradigm**

Over the last five decades the developing countries have been struggling to solve the chronic problems of food shortage, unemployment and rural poverty. Since agriculture remains as the major source of employment opportunity and income in rural areas, it makes sense if this economic sector becomes the main target for the implementation of rural development program. Accordingly, agricultural production had to be modernized to enable itself to absorb local labor as well as to raise farming productivity and income so as to lessen the existing rural problems of food shortage, unemployment and deprivation.

Borrowing money from local banks or money lenders was another way to meet the extra farming expenditure to raise farming productivity. But it was commonly observed that small borrowers like poor farmers had been excluded from gaining access to formal financial services. This was not simply because of the potential borrowers' inability to meet the required collateral, but also due to prohibitive credit transaction cost – disabling both lenders and borrowers to engage in a loan contract. Borrowing from local (informal) money lenders attracts heavy interest rates. Therefore, with the support of international agencies and donor countries, the government implemented a subsidized credit program to assist the small farmers in adopting the new farming technology. Subsidized credit was to mean that the loan was charged at an interest rate with a lower magnitude than the market rates. The subsidy was considered important to incentivize the farmers towards adopting new technologies which they might have perceived as riskier than that of the old/prevaling technology.

With the implementation of credit program which was distributed mainly through the government owned banks, the developing countries' government implicitly acknowledged the prevalence of financial accessibility constraints in rural areas and its adverse effects on development of rural-agricultural economy. This problem was a kind of market failure and it costs the economy with inefficiency. This economic inefficiency was social waste that required the government to correct through public policy interventions (Stiglitz, 2000).

Viewing from this perspective, the government interventions in the local credit market could be considered as a correction strategy for the failed credit market to respond to credit needs of the local farmers and it was desirable to improve market efficiency. Therefore, the government's intervention at local credit market through the provision of subsidized credit market could be considered, based on the public interest paradigm whereby the government implements a credit program in order to correct market failures and to improve market efficiency.

While the justification for implementation of the subsidized credit program seems academically sound, the program had been widely criticized not only because of its bad performance, but also due to its failure in recognizing and serving the true financial needs of rural inhabitants. The main cause of its bad performance was related to the fact that the program did not really help small farmers to adopt new production technologies. It was too easy for the rich-large farmers to seize the provided credit by using their political influence and networks, leaving the poor-small farmers who actually were the targeted group with insufficient access to it (Zeller and Sharma 1998). This in turn made the implemented rural

development program a failure to solve problems of food shortage, unemployment and poverty and that make all these problems still major development issues in rural areas of developing countries even today.

### **(b) Market Based Paradigm**

All these problems constrained the credibility of public interest paradigm as basis for development of rural financial service marketlose in popularity. In a positive note this led to the occurrence of paradigm shift in the mid-1980s<sup>4</sup> towards the introduction of a new paradigm. The new paradigm employed market-based approach in dealing with rural population's needs for financial services (Andrews, 2006). It focused on three aspects which previously were ignored in the provision of financial services to rural inhabitants, especially the poor families. First, it is necessary to make the financial service provision match with financial needs and condition of the clients. Second, the provision has to be made on a sustained basis. Third, public policy should not distort the operation of financial market to make sustained provision of financial services possible.

With this entire new paradigm in credit and financial services, it made sense if one claimed the new approach would do much better than the public interest approach in serving financial needs of the rural population, notably the poor families. Accordingly, Nagarajan and Meyer (2005) had claimed this new approach could reach large number of rural clients on a sustained basis. By contrast the government sponsored financial service program reached only a limited number of clients-local powerful and wealthy families who used their political influence and networks to hijack the program to serve their self-interest.

### **(c) Inclusive Financial System Paradigm**

Development of inclusive financial system has recently attracted much attention from both government leaders and academia. Financial inclusion has been viewed as a critical condition for simultaneous achievement of both growth and equity (inclusive growth) which is previously considered impossible. Sarma and Pais (2011) have identified two potential positive effects of financial inclusion for the economy. First, it reduces the cost of using capital through its role in facilitating the allocation of efficient resource so that the economy can grow more rapidly. Secondly, it suppresses the growth of informal sources of credit such as money lenders who charge a high interest rate on loans whose borrowers are mostly poor households. This suppression would bring down interest rate charged on informal loans so that the poor borrowers can make better use of their informal borrowings to improve their income. In short, the development of financial inclusion will promote both economic growth and equity.

There has been emphasising on the importance of financial inclusion for poverty alleviation. Haughton and Khandker (2009) claimed that the lack of capital is a key factor in causing poverty. Providing with better access to financial market through implementing inclusive financial policy would presumably make the poor able to escape poverty that has held up their family's life. Meanwhile, Kelkar (2010) has made even stronger point on the importance of developing inclusive financial system to improve life of poor people. With regard to the case of Indian poor farmers, he points out that financial inclusion can drastically reduce indebtedness of the farmers and that it could reduce farmers' suicide since indebtedness is one of the main causes of farmer's suicide in this country.

Though, financial inclusion involves not only demand side of the credit market but also its supply, scholars have apparently focused their expertise to make the inclusion from the perspective of demand side of the market. This trend probably is a response to what Gardwe and Elizabeth (2011) has claimed-lack of attention to client needs. This lack of attention has, in fact, a major cause of exclusion of low

<sup>4</sup> InfoResources, Focus No. 8/08, September 2008 page 6

income families from the formal financial market. Hence, it looks rational if scholars make client needs become priority in their effort to assist development of inclusive financial system in developing countries.

Financial inclusion is, clearly, helpful for low income families. It can help the poor families not only to avoid falling into indebtedness which can make their family welfare deteriorated, but also to improve their economic activities to raise their family income so that they can escape poverty that has seized their life. However, this benefit can be fully realized only when they have a good knowledge about use of financial services and products. Study conducted by INTERCAFE (2013) shows that financial inclusion will influence habit of financial behavior at the household level. Members of this group generally have low formal education. Their low formal education levels would have hindered them from making acquisition of such good financial knowledge. Thus, making development of inclusive financial system in the developing countries is effective to eradicate poverty but requires the government to promote financial literacy program for this group of poor people.

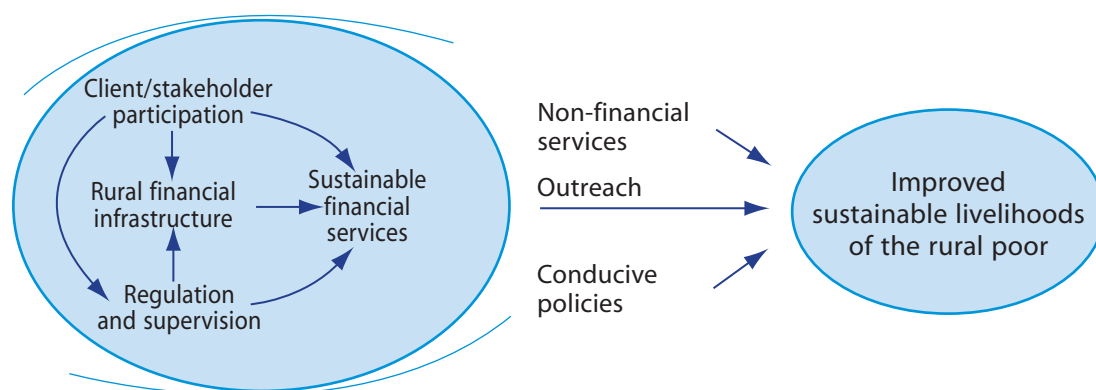
IFAD (2009) has made a further exploration of the issue of development of inclusive financial system in the context of rural development of developing countries to which it provides technical and financial support. It proposed six guiding principles required to be followed in building inclusive financial system for rural areas of developing countries. These include,

- (a) Supporting access to a variety of financial services, including savings, credit, remittances and insurance as the recognition of rural poor people's requirement of a wide range of financial services
- (b) Promoting a wide range of financial institutions, models and delivery channels, tailoring each intervention to the given location and target group,
- (c) Supporting demand-driven and innovative approaches with the potential to expand the frontiers of rural finance,
- (d) Encouraging market based approaches that strengthen rural financial markets and avoiding distortions in the financial sector,
- (e) Developing and supporting long-term strategies that focus on sustainability and poverty outreach, given that rural finance institutions need to be competitive and cost-effective to reach scale and responsibly serve their clients, and
- (f) Participating in policy dialogues that promote an enabling environment for rural finance, recognizing the role of governments in promoting conducive environment for pro-poor rural finance.

It is also suggested that these principles need to be implemented at all the three levels of intervention, namely micro level, meso level and macro level. The micro level involves retail rural financial institutions and the ultimate beneficiaries of IFAD supported projects and programs, including poor rural households, women, young people and indigenous people. The meso level involves financial infrastructure, including second-tier institutions and technical services. The macro level involves policy, legislative, regulatory and supervisory framework. Meanwhile, in supporting development of inclusive financial system in rural areas where IFAD operates, this international agency has the strategy of supporting its partners at different levels to build the sustainability of institutions and models, increase outreach to remote rural areas and marginalized poor people.

IFAD (2009) has also provided some insight as to how the implementation of the six principles at all the three levels of intervention will eventually result in improvement of the rural poor's welfare as depicted in the following figure below. Implementation of the principles at all level of intervention will lead to promotion of sustainable financial services. This will increase outreach of rural financial services (RFS). Together with the support of provision of non-financial services and implementation of supportive public policies, the increased outreach will bring about improved sustainable livelihoods of the rural poor.



**Figure 2. Interlinkages among Micro-Meso dan Macro Level of Rural Financial Stakeholders**

Source: IFAD Rural Financial Policy

### 3.4 Some Important Lessons Learnt

There are some lessons learnt from past schemes of financial services implemented in rural areas of developing countries. They can be organized into three segments, namely (a) demand-side segment, (b) supply-side segment and (c) public-side segment.

#### (a) Demand-side Segment

For livelihood, rural families rely not only on agricultural activities, but also on other economic activities including working as migrating laborers. In addition, their income is relatively small and less stable. These attributes are embodied in their demand for financial services. Accordingly, types of financial products that they want are diverse and small in size. Their demand includes such financial products as small loans, savings, remittances and insurances (Info Resources, 2008).

Another important aspect of their demand for financial service is about contractual terms of the demanded product itself. Their limited financial capacity and insecurity of income make them unable to meet the conventional terms for financial service provision which the providing institution sets to suit their best interest. If access of these rural poor families to financial services to be secured contractual terms of service provision should be designed not simply for the purpose of serving the interest of the provider. Instead, contractual terms should be designed to match the financial condition of these poor clients (Nagarajan and Meyer, 2005).

#### (b) Supply-side Segment

Service provider institutions must match the rural demand if they want to exist and grow and be able to provide their service on a sustainable basis. Accordingly, they have to offer various financial products which the rural poor need. In addition, these products have to be made available for these poor clients at the terms that suit their financial conditions.

A major challenge for these institutions is the extent of transaction cost and commitment of the clients to comply with the agreed contractual terms. Transaction cost involves the cost of process of making a contract and that of its execution. With regard to transaction of financial products such as loan, it is observed that the transaction cost exhibits a phenomenon of economies of scale. This discourages clients with a small quantity of demand for financial service to participate in formal financial market.

The question of moral commitment of the clients to comply with the agreed contractual terms is especially relevant in the case of loan provision. This is because the loan provision is very vulnerable to

a hold-up strategy. This is the reason why a bank as the provider of loan asks its clients to place collateral against the provided loan. By doing this, both the parties become involved in exchange of hostages so that the clients become self-disciplined to comply to their promise of making loan repayment (Williamson, 1975). Because they are poor, the clients certainly cannot afford to meet this requirement. This is another constraint for them to participate in formal financial market.

All these constraints must be removed from design of financial services delivered to poor clients. But, this action is feasible for providing institutions only if it does not do harm to the continuation of their business. This implies that financial institutions need to innovative in order to reduce the costs and to replace the use of material collateral with social collateral (Info Resources 2008). Such innovation is quite possible to carry out as the case of Grameen Bank scheme has demonstrated. However, the Grameen Bank scheme needs not be copied as it is. The institutions must consider factors unique to their areas of operation, since what works well in one area may not work in other (Info Resources 2008).

### **(c) The Public-side Segment**

For any kind of business, a conducive business environment is crucial. Same is applicable for rural finance services. The government has the responsibility to establish and sustain this environment. In this context, the government needs to perform the following tasks (Info Resources 2008). First, the government should create a stable political and macro-economic environment which is a pre-condition for development of rural financial system. Second, improvement of rural legal environment which includes land tenure system and property rights regimes. Market transaction will be costly to carry out if system of rights and ownership is unclear and not enforceable. Third, legal and regulatory framework should be clear and transparent to facilitate fair competition among financial service provider institutions to better serve the rural poor clients. Fourth, to reduce the cost of transactions of rural financial services and to promote trade linkage between rural and urban economy, improvement of road infrastructure and telecommunication systems are vital.

## **3.5 Rural Financial Services-Country Contexts**

Finding of RFS in country contexts based on source of fund, rural financial services can be categorized into three types viz, (1) Government program, (2) Community-based financial organization, and (3) rural financial services developed by private sector. Each of this is briefly explained on the next paragraphs.

### **1. Government program**

In developing countries, poverty is the main problem that has to be solved yet, especially in the rural areas where agriculture is the source of income for the majority of population. The poor people in the rural areas also does not have access to formal financial services due to the failure of commercial banking to provide financial services to the poor. This is the major rationale of the call for intervention in the market for financial services at the micro level. Therefore, governments created policy framework as an intervention tool to provide financial services access to the poor.

Conning and Udry (2007) elaborated some of the government interventions that can clearly serve the useful purpose of promoting financial market-trade between private parties. For example, transaction costs between private parties may be reduced if the state is able to provide impartial and accessible legal mechanisms for the arbitration and enforcement of contracts. Similarly, the prudential regulation and supervision of deposit-taking financial intermediaries may promote deposit mobilization and encourage efficiency-enhancing market competition between banks. Even some forms of more direct government intervention, including direct loans and government loan guarantees, may arguably at times help crowd-in private sector financial intermediation or provide efficiency enhancing financial services in contexts where private sector actors may have otherwise been reluctant to operate.

For example in South Africa, the latest version of a rural development policy differentiates between rural women, children, farm workers, the disabled and small farmers as specific groups that warrant support (Coetzee, 1998). Thailand, after the economic crisis in 1998, the government attempted to improve the financial services to rural areas and promote community or non-commercial financial institutions. The policy allow farmers to adopt more capital-intensive methods of production. For example, to purchase more machinery and market inputs. Furthermore, to the extent that credit access is linked with the provision of technical assistance by credit organizations, credit can also raise allocative efficiency by allowing farmers to substitute non-market inputs with market inputs and increasing farmer's ability to bear risk. Similarly, the conventional policy approach to overcome the adoption-discouraging effects of financial market inefficiency in Ethiopia is subsidization of agricultural credit, mainly through state-owned development banks (Abate et al., 2015).

## **2. Community-based Financial Organization**

Community-based financial services became a solution to overcome the finance problem of the rural poor due to lack of access to informal financial services. Rural community initiated to manage their finances together informally through social gathering, group savings and loans. Money lenders or semi-formal microfinance systems, for example the Grameen Bank system is now widely available in many countries (with appropriate system adjustments). In some areas rural people still set up rotating savings and credit associations (ROSCAs) as a method of interest-free financial self-help. This is mainly to provide mutual support in meeting the needs of local people for ceremonial events, such as weddings and funerals or during household crises – e.g. supplementing income during the illness of a family member, as opposed to investment in diverse livelihood activities and entrepreneurial ventures (Hu 2003 and Tsai 2004 on Zhang and Loubere 2013).

World Bank has developed community-based financial organizations as semi-formal institutions to provide financial services in rural areas (Ritchie 2007). A community-based financial organization can be defined as *autonomous* organization owned and managed by members of a particular community. They differ from the "village banks" in Latin America and the "solidarity groups" in Bangladesh. Such groups are usually not autonomous; they have been set up by MFIs as a cost-effective way to provide services to the poor. Although such entities may manage their own affairs to a certain extent, they receive technical support, as well as funding, from the parent MFI and thus may not be subject to the same governance and management issues as fully autonomous groups. The membership of this organization varies from small groups with as few as five members to entities with hundreds, or even thousands, of members. They maybe informal, registered as associations or cooperatives, or part of a largervillage organization, such as a company or women's organization. The central characteristics of these entities, which drive their governance and management, are their financial and institutional independence, and mobilization and management of their own resources.

## **3. Rural Financial Services by Private Sector**

Private sector has developed financial services to poor people in rural areas through some innovations. Innovations were in new products and methodologies as well as refinements to existing practices that are created in response to market inefficiencies and changing demands of a target clientele (Llanto and Lavina 2006). Essentially, innovations by financial institutions are not only a means to reach the large unserved poor households but also to provide more and better products and services that contribute to increasing profitability of the institutions adopting them.

Kenya has successfully managed to innovate by combining telecommunications with financial services such as M-PESA (Kloeppinger-Todd and Sharma 2010). In March 2007, M-PESA in partnership with Safaricom, Kenya's leading mobile telecommunications company launched the innovation. The cell-phone-based, money-transfer business was a welcome commercial opportunity across Africa and elsewhere. M-PESA allowed customers to send money home and make a variety of other payments

without a bank account. People began using the system simply by registering for free at certified M-PESA agents, which included retailers, supermarkets, gas stations, and shops that sell prepaid airtime cards. In fact, several banks have even become M-PESA agents. Customers could use cash to “buy” electronic money (e-money) from an agent, use their phones to perform financial transactions (for example, to send money to another person or buy additional airtime). The e-money could also be converted into cash by selling it back to an agent. Agents were paid a commission for providing cash-in and cash-out services and for registering customers. Those method also has been developed in Brazil by Caixa Econômica Federal, Africa by WIZZIT and South African Bank of Athens, in Philippines by Globe Telecom and SMART13 called G-Cash (CGAP 2006).

## CHAPTER 4

# Findings on Rural Financial Services in Indonesia

### 4.1 Key Players in Rural Finance Space

Rural financial service market in Indonesia is complex with different type of financial institutions operate to serve rural poor with a variety of financial products. To help better understand this complexity, it is desirable to discuss some concepts commonly used to assess structure of rural financial system (RFS).

In most developing countries, like in Indonesia, majority of members of rural community rely on agricultural activities for living. Nevertheless, because of small size of the farming operations as well as low productivity and weak market bargaining power, they cannot simply rely on income generated from these activities to support their family lives. Generally, they have to complement their agricultural income with that generated from non-agricultural activities such as petty traders and small-scale home industry to fulfill their family's basic needs. As they are poor they need financial support from outside their household to enable operating not only the farm, but also the complementary economic activities. Accordingly, the rural finance system serves not only agriculture but also other rural economic activities.

Since rural finance system includes both microfinance and agricultural finance, IMF (2005) has suggested it is necessary to differentiate the concept of microfinance and small and medium enterprises (SME) finance. With the recognition of the different types of financial institutions serving different segments, such differentiation of concept of finance is useful for the assessment of the adequacy of access and the effect of regulation. Lenders normally distinguish between microfinance and SME finance. The first one refers to credit provided to poor households and to informal, unregistered microenterprises. Meanwhile, the second one refers to credit given to enterprises registered as microenterprises, small businesses, and medium-size enterprises.

According to IMF (2005) the difference between the two finance institutions can be observed not only from the perspective of lenders, but It can also be observed from the perspective of borrowers. From the borrowers' perspective the fundamental differences are as follows:

#### (a) Microfinance's characteristics:

- Most often provided by non-bank institutions;
- Often based on the group-lending approach (although numerous microfinance loans may consist of loans to individuals rather than to groups);
- Various membership based financial cooperatives and mutual-assistance associations;
- Almost never formally secured, although informal security (i.e., not legally binding) in the form of collateral interest over household goods and tools is commonly used.

#### (b) SME Finance's characteristics:

- Mainly by banks, building societies, and non-bank financial institutions (NBFIs);
- Do not use a group-lending approach, but individual approach;
- Usually allows a firm's assets or personal guarantees to legally secure small business loans.

By adopting the IMF (2005)'s points of view, one can divide key players in rural financial service market into several categories depending on the scope of regulation, type of ownership, and type of services offered. Therefore, they can be differentiated in the following manners:

- Whether it is required to obtain a license to carry out financial intermediation activities, registered with some central agency (but not required to obtain a license) that will provide non-deposit credit-only services, or registered as a legal entity;
- Organizational format, including ownership and governance aspects; and
- Type of financial services permitted and provided.

Applying this tool of differentiation of finance providing institutions, the RFS can then be divided into seven principal categories, namely:

- government programs or agencies for rural finance, microfinance, or SME finance
- non-bank, nonprofit NGO-MFIs
- membership-based cooperative financial institutions (CFIs)
- postal savings banks (PSBs) or institutions
- development finance institutions
- specialized banking institutions (usually licensed for limited operations, activities, or services to differentiate them from full-service commercial banks) such as rural banks, microfinance banks, and non-bank finance companies
- commercial banks

They are different not only in organizational format and ownership, but also in regulatory status and types of financial services they offered. More detailed information about the differences is provided in Table 3 below.

**Table 3. Institutional Providers of Financial Services**

<b>Institutional Provider</b>	<b>Organizational format</b>	<b>Ownership</b>	<b>Regulatory status and how regulated</b>	<b>Financial services permitted to be offered</b>
Government rural or micro or SME finance programs or agencies	Trust fund or agency	Government	Not regulated by banking authority	Wholesale or onlending funds to participating institutions
Non-bank/nonprofit/ NGO MFIs	Nonprofit foundation, trust, or association	Private sector entities or organizations	Not regulated by banking authority	Microfinance loans only; no voluntary deposits
Membership-based cooperative financial institutions (CFIs)	Savings and credit cooperative organization (SACCO) or credit union	Members	Not regulated by banking authority, but may be regulated by department of cooperative	Savings and time deposits and loans to members only
Postal savings banks (PSBs)	State-chartered institution	Government	Not regulated by banking authority	Savings and time (fixed) deposits only and money transfers
Development Finance Institutions	State-chartered institution	Government	May or may not be regulated by banking authority	Wholesale certificates of deposits, loans, and credits

**Table 3.** (continued)

Institutional Provider	Organizational format	Ownership	Regulatory status and how regulated	Financial services permitted to be offered
<b>Specialized banking institutions</b>				
Rural banks	Limited liability company	Private sector investors or shareholders	Licensed or supervised by banking authority	Savings and time deposits, loans, and money transfers
Microfinance banks	Limited liability company	Private sector investors or shareholders	Licensed or supervised by banking authority	Savings deposits, microfinance loans, and money transfers
Non-bank finance companies	Limited liability company	Private sector investors or shareholders	Licensed but not necessarily supervised by banking authority	Wholesale certificates of deposits, loans, and credits
Commercial banks	Limited liability company	Private sector investors or shareholders	Licensed or supervised by banking authority	Demand and savings and time deposits, loans, money transfers, and foreign exchange; full banking services

Source: IMF (2005)

However, the current status of rural and microfinance institutions in Indonesia is slightly different from the above discussion. The main categories of rural and microfinance institutions in Indonesia are as follows (please also refer Table 4 and Figure 3):

- Commercial banks;
- Specialized banking institutions (usually licensed for limited operations, activities, or services to differentiate those from full-service commercial banks) such as rural banks-people credit bank (Bank Perkreditan Rakyat/BPR) and non-bank finance companies;
- Membership-based cooperative financial institutions (CFIs);
- Non-bank, nonprofit NGO, MFIs;
- Government programs or agencies for rural finance, microfinance, or SME finance.

### Commercial Banks

Some commercial banks serve microfinance segment such as Bank Rakyat Indonesia (BRI), Regional Development Bank (BPD) at provincial level, Unit Mikro Mandiri-Bank Mandiri, Danamon Simpan Pinjam, Bukopin Swamitra, BTPN, and other microfinance programs from commercial banks. In July 2015, there are 118 commercial banks with 12 commercial sharia banks registered in the OJK (OJK, 2015). However, the outreach of microfinance programs provided by commercial banks is relatively limited to reach rural and remote areas.

The commercial banks usually have micro and retail units to manage micro segments with network infrastructure. Following are some examples of MFI service units managed by commercial banks. The most prominent microfinance provider among the commercial banks is the public bank of BRI and its pervasive Unit Desa (Village bank).



- Bank Rakyat Indonesia (state owned bank)

In 2014, for improving its micro business network, BRI has 5.293BRI Unit (Desa), 2.457 Teras BRI (usually located in traditional market) and 610BRI Teras Keliling (mobile). In addition, since mid-2014, BRI also began to develop Branchless Banking using agency system. By using this system, it is expected that the public and in particular BRI customers gain more easy access to the banking services provided by the BRI. At the end of 2014, the BRI has more than 20,000 agents spread all over Indonesia.

Up to 2014 total deposits from customers of BRI micro reached IDR 166.2 trillion, which makes micro business a self-funded business. In addition, to support micro-lending, the bank has “matri” as a marketing force in the BRI units with per BRI ratio of 4.32 in 2014.

To participate in microfinance in a larger scale, BRI has a global corporate social responsibility program namely Microfinance International Cooperation (MIC). The purpose of MIC-BRI program is to develop leading microfinance business in the world. Through the MIC-BRI consistently run Microfinance Training and Study Visit (MTSV), business captures, as well as technical assistance in the field of microfinance. BRI-MIC has also been cooperating with various international microfinance institutions such as Asia-Pacific Rural and Agricultural Credit Association (APRACA), the Microfinance Network (MFN), the Microcredit Summit, Banking with the Poor (BWTP), Woman World Banking, APEC, and others. United Nations (UN) has also been set BRI as a world microfinance laboratory (BRI Annual Report, 2014).

- Bank Mandiri (state owned bank)

In 2014 Bank Mandiri extended its services to micro customers through a network expansion bringing the total number to 1,127 micro units, 897 micro branches and 706 micro outlets across Indonesia (Mandiri Annual Report, 2014).

- Bukopin (foreign exchange commercial bank)

Swamitra – Bukopin is the name of a form of cooperation or partnership between Bank Bukopin and cooperatives to develop and modernize Savings and Loan Businesses/Usaha Simpan Pinjam (USP) through utilization of network technology and support of management system. Thus the USP have broader financial transaction service capabilities with due observance of applicable statutory regulations. In 2014, there were 678 units of Swamitra-Bukopin (Bukopin Annual Report, 2014)

- Danamon (foreign exchange commercial bank)

Danamon micro banking is also known as Danamon Simpan Pinjam (DSP). DSP’s main targets are individual entrepreneurs of micro and small businesses. Focusing on customers in micro business activities, who are mainly located in traditional markets, DSP services emphasize on community based approach and offers unique value proposition of secure, quick, and convenient nature. Most of DSP units are in the middle of the community. Hence customers can easily access DSP’s services. DSP’s transaction services are supported by Danamon’s technology and network that ensures its security. DSP also provides quick services for customers with the commitment of 3-day credit application processing after receiving the complete documents. In 2014, DSP offices and units were found across all parts of Indonesia in 34 provinces covering 834 locations (Danamon Annual Report, 2014).

- **Specialized Banking Institutions**

Specialized banking institutions by definition has limited license for its operations, activities, or services to differentiate it from full-service commercial banks. It consists of rural banks-people credit bank (Bank Perkreditan Rakyat/BPR) and non-bank finance companies. In July 2015, there were 1644 rural banks/BPRs with 161 sharia rural banks registered in the OJK (OJK, 2015).



- **Membership-Based Cooperative Financial Institutions (CFIs)**

Ministry of cooperatives as well as micro small and medium enterprise released its data on June 2014 with the following numbers:

**Table 4. Cooperative Financial Institution in Indonesia**

Cooperative/Unit	Number	Member
Saving and Loan Cooperative (Kopdit/KSP)	19,838	3,052,641
Saving and Loan Unit of Cooperative (USP-Kop)	95,881	15,409,283
Sharia Cooperative (KJKS)	1,197	136,710
Sharia Unit of Cooperative (UJKS-Kop)	2,163	333,282
	110,079	18,931,916

However, besides KJKS/UJKS there is also Baitul Maal Wat Tamwil (BMT) which has not yet officially registered as KJKS. According to BMT practices, in 2014, there were around 4,000 BMTs in Indonesia. These BMTs are organized themselves to an association-Asosiasi BMT seuruh Indonesia, Perhimpunan BMT Seluruh Indonesia, Inkopsyah BMT etc.

Examples of membership based cooperative in this study are Microfinance Institutions for Agribusiness (LKMA), Pincuran Bonjo (with cooperative as its legal business entity), KJKS/BMT UGT Sidogiri and KUD Mina Samudera.

- **Government Programs or Agencies for Rural Finance, Microfinance and/or SME Finance**

There are plenty of programs to support rural and microfinance provided by government through its ministries. Following are few of such government program for rural micro finance,

- **Kredit Ketahanan Pangan dan Energi (KKPE) – Credit for Food Security and Energy**  
 KKPE is a subsidized credit scheme launched in 2008 as replacement of previous KKP program. The purpose of the program is to support Food Security and Energy. Profile of the KKPE is as follows,
  - Distribute by commercial banks (11) and BPDs (12)
  - Target clients: Bankable but not feasible for commercial loan
  - Commodities/products to be financed: Food crops, Horticulture, Livestock, Fisheries, Agricultural equipment
  - Credit disbursed through farmers' groups/cooperatives from where the funds are disbursed to the individual group/cooperative members
  - Collateral is required, but interest rate is subsidized
- **Kredit Pengembangan Energi Nabati dan Revitalisasi Perkebunan (Credit for Agricultural-based Energy Development and Estate Revitalization)**  
 KPEN-RP is subsidized credit scheme to support the revitalization of estate crops and energy. The scheme intends to facilitate rehabilitation and development of plantations through the provision of concessionary loans directly to farmers (in case of cocoa). The program was implemented in 2010-2014.
- **Kredit Usaha Rakyat People's Business Credit (KUR)**  
 KUR micro credit program is part of holistic program under 3<sup>rd</sup> cluster of poverty reduction national program. Profiles of the KUR are as follows,
  - Credit methodology is a direct loan from bank to the borrowers. The eligible KUR borrowers are a Micro, Small and Medium enterprise, Cooperative and Group of SMEs. The

KUR can be indirectly disbursed through linkage institutions by an executing or channeling mechanism.

- Collateral is not required but guaranteed by government
  - Interest rate is commercial rate
  - From 2007 to 2014, the KUR is distributed by 7 commercial banks and 13 BPDs in 33 provinces with 11,691,851 number of borrowers and a loan size of IDR 14.1 million.
  - Targeted clients: Feasible but not bankable business units
  - Officially launched on 5 November 2007
- Saving and Loan for Women Group (SPP-Simpan Pinjam Kelompok Perempuan) managed by Activity Management Unit (UPK) under the Umbrella Program Nasional Pemberdayaan Masyarakat Mandiri-Perdesaan PNPM (National Program for Community Empowerment-in Rural Areas)
- SPP is a Revolving Loan Fund (RLF) for woman group savings and loan managed by UPK. The loan is made available to woman saving and loan's groups from where the funds are disbursed to the individual group members. This RLF was implemented in 2008/2009-2015. As per January 2012 the program covered 5,100 sub-districts in 393 district/regency covering 32 provinces.
- Warehouse Receipt Program (Skema Sistem Resi Gudang; S-SRG): Warehouse Receipt Scheme is a loan granted by the bank to Farmers, Farmers Groups, Joint Farmers groups and Cooperatives with Warehouse Receipt as guarantee (off farm).

However, the above-mentioned classification does not yet fully reflect the complexity of provision of financial services in rural areas of developing countries. It fails not only in covering the whole variation of financial providers, but also in accommodating the variation of authority that provides business permit (license) and supervises its use. In many developing countries the national financial authority is not the only institution that has the authority to issue licenses for the operation of a financial institution. Other institutions such as local government and government ministry can also issue such a permit for operating financial business within their own legal jurisdiction. This has implications on the operation of rural financial market. Different regulations are applied by different regulators as their concerns are different. In addition, supervision for a financial institution will not be always by the national financial authority, but it can be from an institution other than this authority.

Another problem with the IMF classification above is that it does not cover those financial service providers without business license such as money lenders, trader-cum-creditors, ROSCA (rotating saving and credit association) and self-help groups. In terms of outreach this type of financial service suppliers is probably the most important one in rural sectors of developing countries.

Adams and Fitchett (1992) have tried to solve these problems by classifying rural financial institutions into three categories, namely (a) formal finance institutions, (b) semi formal finance institutions and (c) informal finance institutions. They defined each category as the following:

- Formal financial institutions are those ones which are licensed, regulated and supervised by the financial authority
- Semi-formal financial institutions are situated between formal and informal. Semi-formal institutions are those institutions that have a formal registration and business license obtained not from the financial authority, but from other institutions such as local government. These institutions are not supervised by the financial authority but by the one which provides the business license
- Informal financial institutions are the ones which have no formal registration and business license so that no supervision is sought for these institutions

Feng et al. (2013) has used this classification to explain reform of rural financial services in China. As found in other developing countries, in Indonesia also the government directly involves in expanding access of rural community to financial market through implementation of special financial programs delivered to a certain target groups. The programs may be stand alone one or just complementary to other program such as food self-sufficiency program. In addition, in implementing the program, the government often cooperates with local financial institutions. This kind of provision of rural financial products does not, however, include in Adams and Fitchett's classification. It is desirable to extend the Adams and Fitchett classification to include government sponsored financial program when applied it to explain structure of rural financial system of developing countries, like Indonesia. Thus, it may add one more into Adams and Fitchett classification- the government sponsored financial program.

In order to have a clear understanding of the rural financial market space in Indonesia, we also used a framework developed by the Consultative Group to Assist the Poor (CGAP) which also has been used by IFAD to assess rural financial market. Using this framework, the rural financial market of Indonesia can be divided into three tiers-micro, meso and macro as indicated in Figure 3.

The micro level of the financial system consists of rural financial services (RFS) and their clients. The clients served by RFSs include households, individuals and micro/small enterprises in the rural areas. It represents the demand side of the rural financial market. On the supply side, it consists of various types of rural financial services spread across Indonesia.

As indicated in the Figure 3, there are functions performed by the supply side of the micro level of rural financial market such as funding management, providing products and services for their clients in the rural areas, delivery channels and coverage area of their serving activities. Funding management contains the source of funds for daily operations of the RFSs. For the formal RFS, the main source of fund is third party funds. For semi-formal RFS, source of funds are more varied. Since semi-formal RFSs are mainly member based institutions, membership savings are one of necessary source of fund. Other important sources of fund are third party fund, which is basically collected through voluntary saving products. For some semi-formal RFS, source of fund is received from linkage program with banks-either as executing or channeling agencies. Some semi-formal RFS could also receive grants or soft loans from government at the central or regional levels.

Product and services provided by formal RFS are financial services. Semi-formal RFS provides more product and services diversification. It comprises financial and non-financial services. Moreover, some semi-formal RFS use integrated approach in their operational framework.

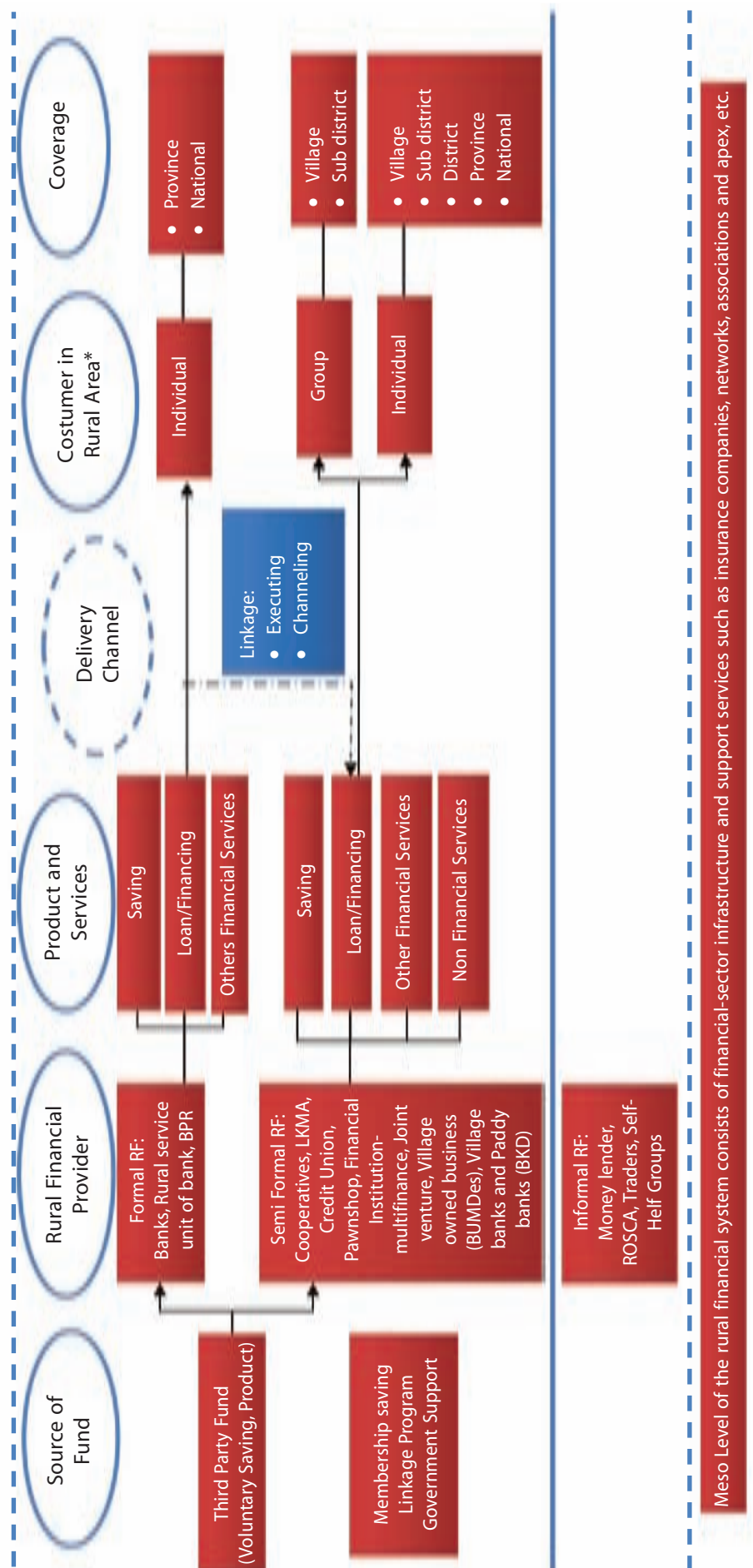
All RFSs have direct delivery channel for their own products. It means that they serve the customers in rural areas directly. The formal RFS can have direct and indirect delivery channels in serving clients in the rural areas. Indirect delivery channel is applied when semi-formal RFSs act as linkage agencies of the formal RFSs.

The clients served can be grouped into two main classes-group or individual. Most RFSs serve individual clients, particularly formal RFSs. Some semi-formal RFSs provide individual and group lending approaches.

The coverage area of a formal RFS is larger compared to that of a semi-formal RFS. By regulation, formal RFS may have coverage area at provincial or national level. Different to semi-formal RFS, the coverage area served depends on the legal entity they hold. If they are classified as microfinance, by regulation they are allowed to serve only limited coverage. From customer served classification, the coverage area of a group based lending RFS is limited. However, for the individual based lending RFS, the coverage area is more diverse. It depends on legal entity and their financial capacity to enlarge their business development.

**Figure 3. Rural Finance Structure and Framework**

**Macro Level of Rural Financial System: Regulation and Supervision to Provide Enabling Environment and Ensure Customer Protection**



Since the study focus on formal and semi formal RF, informal RF is not be discussed

\*Focus study: Feasible but unbankable customer in rural area. Sometimes, there is linkage fund from formal to semi formal

The meso level of rural finance market consists of financial-sector infrastructure and support services such as insurance companies, technical support and training services, networks, associations and apex deposit insurance company, audit firms, etc. Their function is to facilitate activities in the rural financial sector, but do not themselves provide retail financial services. Networks, associations and apex organizations of retail financial services are institutional infrastructure engaged in advocacy and information dissemination.

The macro layer of rural finance market consists of regulation and supervision to provide enabling environment, maintain sustainability of (rural) financial market and to ensure customer protection. Financial Service Authority (FSA), Bank Indonesia (BI), ministry of finance (MoF), and other technical ministries related to the rural financial market in Indonesia such as ministries of cooperative and small micro and medium enterprises, agriculture, fishing and marine affairs, home affairs are part of the macro level. The macro level provides the (rural) financial market with the financial laws/regulations/policies, supervise financial institutions and enforce compliance. The main institutions such as FSA, BI and MoF affect the overall economic conditions of Indonesia particularly through the financial system.

## 4.2 Regulatory Framework and Enabling Environment

As summarized from Mushosho (2008), regulatory framework includes laws, regulations, guidelines, rules and codes that the entities are required to comply with and the institution or structure for enforcing compliance. Regulatory structure is an institutional form which carries out supervision of the regulated entities. The aim of a supportive regulatory framework is to build strong regulated and unregulated institutions of all types (IMF, 2005):

- (a) to provide services on a sustainable basis under uniform, common, shared performance standards; and
- (b) to encourage the regulatory authority to develop appropriate prudential regulations and staff capacity that are tailored to the institutions' operational and risk profiles

Supervision has broadly been defined as a process of enforcing the regulatory framework. It includes the interaction between the regulatory authority and the regulated institutions that enables the regulatory authority to:

- Monitor the financial soundness of the regulated intermediaries
- Proactively identify and respond to emerging trends and problems in the industry and at specific institutions.
- Enforce compliance with regulations
- Manage the exit of failed institutions from the financial system with the aim of preventing financial system instability and losses to small, unsophisticated depositors

As the rural finance and microfinance sector grows, different degrees of regulatory requirements that permit MFIs to legally mobilize savings and other commercial sources of funds can encourage capacity building and innovation that are aimed at self-sufficiency and greater outreach. The requirements could vary from:

- (a) Simply registering as legal entities,
- (b) Preparing and publishing periodic reports on operations and financial results,
- (c) Observing non-prudential rules of conduct in business operations,
- (d) Securing a proper license and being subject to prudential regulation by a regulatory authority, prudential supervision, or by a central supervisory authority. Lower-tier institutions serving the lower end of the market can enable non-bank micro lenders to seek greater formalization without actual licensing.

Since rural financial institutions reviewed in this study are diverse in terms of registered business entity, it influences the implemented regulatory and supervisory framework. There is no single framework to accommodate all rural financial institutions, the same as in previous discussion.

As discussed previously, regulatory framework provides the (rural) financial market the financial laws/regulations/policies, supervise financial institutions and enforce compliance. The latest law on (rural) microfinance institutions in Indonesia is Law on Microfinance Institution No.1 year 2013, which is enacted in January 2013. Two types of MFI legal business entities recognized by the law are cooperative and limited liability company (PT). The law also require all microfinance institutions to have legal business license as “microfinance institution”. Therefore, “un-registered microfinance institutions” must obtain business license as microfinance institution to the FSA/OJK at the latest on January 8, 2016. This rule applies to:

- Bank Desa
- Lumbung Desa
- Bank Pasar
- Bank Pegawai
- Badan Kredit Desa (BKD)
- Badan Kredit Kecamatan (BKK)
- Kredit Usaha Rakyat Kecil (KURK)
- Lembaga Perkreditan Kecamatan (LPK)
- Bank Karya Produksi (BKPD)
- Badan Usaha Kredit Pedesaan (BUKP)
- Baitul Maal Wat Tamwil (BMT)
- Baitul Tamwil Muhammadiyah (BTM)
- And/or other institutions equivalent to those

Following are the regulations related to microfinance institutions:

- Government regulation PP No. 89 year 2014 on Interest rate or Profit sharing of financing and business coverage area of microfinance institution.
- OJK regulation POJK No. 12/POJK.05/2014 on Business licensing and institutional of microfinance institutions
- OJK regulation POJK No. 13/POJK.05/2014 on Business implementation of microfinance institutions businesses
- OJK regulation POJK No. 14/POJK.05/2014 on Supervision of microfinance institutions



Table 5. Regulatory Framework for Rural and Microfinance Institutions (RMFI) in Indonesia

Type of RMFI	Ownership	Form of Organization	Established under Law of Republic of Indonesia No.	Authorized Activities	Government Agency of Jurisdiction	Regulated by	Supervised by
<b>Formal MFIs</b>							
Commercial Banks (conventional system)	Private/State	Limited Liability Company	Law No. 7/1992 on Banking as amended by Law No. 10/1998	Full service bank	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK)	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK)	<ul style="list-style-type: none"> <li>As of the date of 31 December 2013, supervision of individual banks (micro prudential) is conducted by OJK.</li> <li>Supervision of macro prudential remain conducted by Bank Indonesia, in coordination with OJK.</li> </ul>
Commercial Banks (sharia system)	Private/State	Limited Liability Company	Law No. 21/2008 on Sharia Banking	Full service bank	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK)	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK)	<ul style="list-style-type: none"> <li>As of the date of 31 December 2013, supervision of individual banks (micro prudential) is conducted by OJK.</li> <li>Supervision of macro prudential is conducted by Bank Indonesia, in coordination with OJK.</li> </ul>

**Table 5. (continued)**

Type of RMFI	Ownership	Form of Organization	Established under Law of Republic of Indonesia No.	Authorized Activities	Government Agency of Jurisdiction	Regulated by	Supervised by
MFI Service Unit	Micro banking division	Operating division, e.g.: BRI Unit Desa, Mandiri Mitra Usaha, Danamon Simpan Pinjam, Niaga Mkro, Warung BJB.		micro-loans and/or savings deposits	Micro Banking Division	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK) (as part of banking division)	<ul style="list-style-type: none"> <li>As of the date of 31 December 2013, supervision of individual banks (micro prudential) is conducted by OJK.</li> <li>Supervision of macro prudential is conducted by Bank Indonesia, in coordination with OJK.</li> </ul>
Bank Perkreditan Rakyat (BPR)/ Rural Banks	Private parties; Local Government	Limited Liability Co. or Cooperative or Government Enterprise	Law No.10/1998	Saving and time deposits; microfinance loans	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK)	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK)	As of the date of 31 December 2013 by Financial Services Authority (FSA/OJK)
<b>Semi-Formal MFIs</b>							
Sharia Financial Cooperative	Private sector	Sharia Financial Cooperative	Law No. 25/1992 on Cooperative	Saving deposits, micro loans, payment point and agents of other financial services	Ministry of Cooperative and Micro-Small-Medium Enterprise	Ministry of Cooperative and Micro-Small-Medium Enterprise	Ministry of Cooperative and Micro-Small-Medium Enterprise at local offices
Saving and Loan Unit of Village Cooperative (USP and Grameen* Group Lending)	Community initiative or government sponsored	Saving and Loan Unit of Village Cooperative	Law No. 25/1992 on Cooperative	Saving deposits, micro loans, payment point and agents of other financial services	Ministry of Cooperative and Micro-Small-Medium Enterprise	Ministry of Cooperative and Micro-Small-Medium Enterprise	Ministry of Cooperative and Micro-Small-Medium Enterprise at local offices



Table 5. (continued)

Type of RMFI	Ownership	Form of Organization	Established under Law of Republic of Indonesia No	Authorized Activities	Government Agency of Jurisdiction	Regulated by	Supervised by
KSP-Savings and Loan Cooperative	Government sponsored	Financial Cooperative	Law No. 25/1992 on Cooperative	Savings deposits and micro-loans (member only)	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise
Agribusiness Microfinance Institution (LKMA)	Community initiative or government sponsored	Financial Cooperative	Law No. 25/1992 on Cooperative	Savings deposits for community, micro-loans only for members	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise
Credit Union	Private sector individual	Financial Cooperative	Government Ordinance No. 9/1995 Regulation No. 1/2013	Savings deposits and micro-loans (member only)	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise
Pawnshop	State-owned	Government enterprise	Regulation No. 103/2000 Regulation No. 10/1990 Staatblad No. 81/1928	Pawn loans	Ministry of Finance	Ministry of Finance	Supervision Agency
Financial Institution – multifinance	Stated-owned	Limited Liability Co. or Cooperative	Ministry of Finance Regulation No. 84/PMK. 012/2006 Presidential decree No. 61/1988 Presidential regulation No. 9/2009 Regulation No. 1/2013	Leasing, factoring, consumer finance, credit card	Ministry of Finance	Ministry of Finance	<ul style="list-style-type: none"> <li>Ministry of Finance</li> <li>Financial Services Authority</li> </ul>

**Table 5.** (continued)

Type of RMFI	Ownership	Form of Organization	Established under Law of Republic of Indonesia No.	Authorized Activities	Government Agency of Jurisdiction	Regulated by	Supervised by
Joint-Venture	Stated-owned	Limited Liability Co. or Cooperative	Ministry of Finance Regulation No. 84/PMK. 012/2006 Presidential decree No. 61/1988 Presidential regulation No. 9/2009 Regulation No. 1/2013	Leasing, factoring, consumer finance, credit card	Ministry of Finance	Ministry of Finance	<ul style="list-style-type: none"> <li>Ministry of Finance</li> <li>Financial Services Authority</li> </ul>
Village-owned Business – Badan Usaha Milik Desa (BUMDes)	Village government	Village enterprise	Ministry of Home Affairs Regulation No. 39/2010	Rural economy services such as business services, distribution of daily necessities, agricultural trade, and home industry	Ministry of Home Affairs, District/city government	Sub-district and District/city government	<ul style="list-style-type: none"> <li>Badan Permusyawaratan Desa (BPD) – Village Consultative Agency and/or internal supervision</li> <li>Inspectorate of district/city</li> </ul>
Badan Kredit Desa (BKD) – Village Banks and Paddy Banks	Village-owned and village-managed	Staatsblad	Staatsblad 1929 Village Credit Institution Act	Micro credit only	Finance Ministry; BRI; OJK	Finance Ministry; BRI; OJK	BRI Branch on behalf of OJK
Unit Ekonomi Desa – Simpan Pinjam (UED-SP)	Village government	Village enterprise	Ministry of Home Affairs Instructions No. 412/440/SJ 1998	Micro credit and savings	Ministry of Home Affairs; village head and LKMD	Sub-district and district PMDs, National PMD	Sub-district and district PMDs, National PMD

Table 5. (continued)

Type of RMFI	Ownership	Form of Organization	Established under Law of Republic of Indonesia No.	Authorized Activities	Government Agency of Jurisdiction	Regulated by	Supervised by
Lembaga Dana Kredit Pedesaan (LDKP) – Village Rural Fund and Credit Institutions	Local and provincial government administration	Government enterprise (NBFi)	Provincial Government Decrees; Ministry of Finance, 1984	Micro-loans only	Provincial government	Provincial BPD	Provincial BPD
<b>Government Program</b>							
Government Program on Micro Credit (example KUR Micro Credit Program)	Facilitated by government	Micro loan product offered in several banks	Decree of Deputy for Macro and Finance; Coordinating Ministry for Economic Affairs as Chairman of Executive Committee of Credit/Financing Guarantee for Micro, Small, Medium, and Cooperatives No. KEP – 01/ D.I.M. EKON/01/ 2010 on the Standard Operating Procedures and Implementation of KUR Micro Credit Program	Credit Guarantee scheme. Source of loan is from banks and guarantee provided by government	Coordinating Ministry for Economic Affairs	Coordinating Ministry for Economic Affairs	Coordinating Ministry for Economic Affairs

**Table 5. (continued)**

Type of RMFI	Ownership	Form of Organization	Established under Law of Republic of Indonesia No.	Authorized Activities	Government Agency of Jurisdiction	Regulated by	Supervised by
Government Program on Rotating Loan Fund (example SPP UPK PNPM Mpd)	Facilitated by government	Rotating Loan Funds managed by Women's Group Saving and Loan in the Activity Management Unit (UPK) under the Umbrella of Program Nasional Pemberdayaan Masyarakat Mandiri-Perdesaan/PNPM (National Program for Community Empowerment in Rural Areas)	Operational instructions issued by the Ministry of Home Affairs in the implementation of PNPM Rural	Rotating Loan Funds provided by government	Directorate General of Village and Community Empowerment, Ministry of Home Affairs	Directorate General of Village and Community Empowerment, Ministry of Home Affairs	Directorate General of Village and Community Empowerment, Ministry of Home Affairs
<b>Informal MFIs (Not yet regulated)</b>							
<ul style="list-style-type: none"> <li>• <b>ROSCA</b></li> <li>• <b>Money lender</b></li> <li>• <b>Landlord-cum-creditor</b></li> <li>• <b>Trader-cum-creditor</b></li> </ul>							

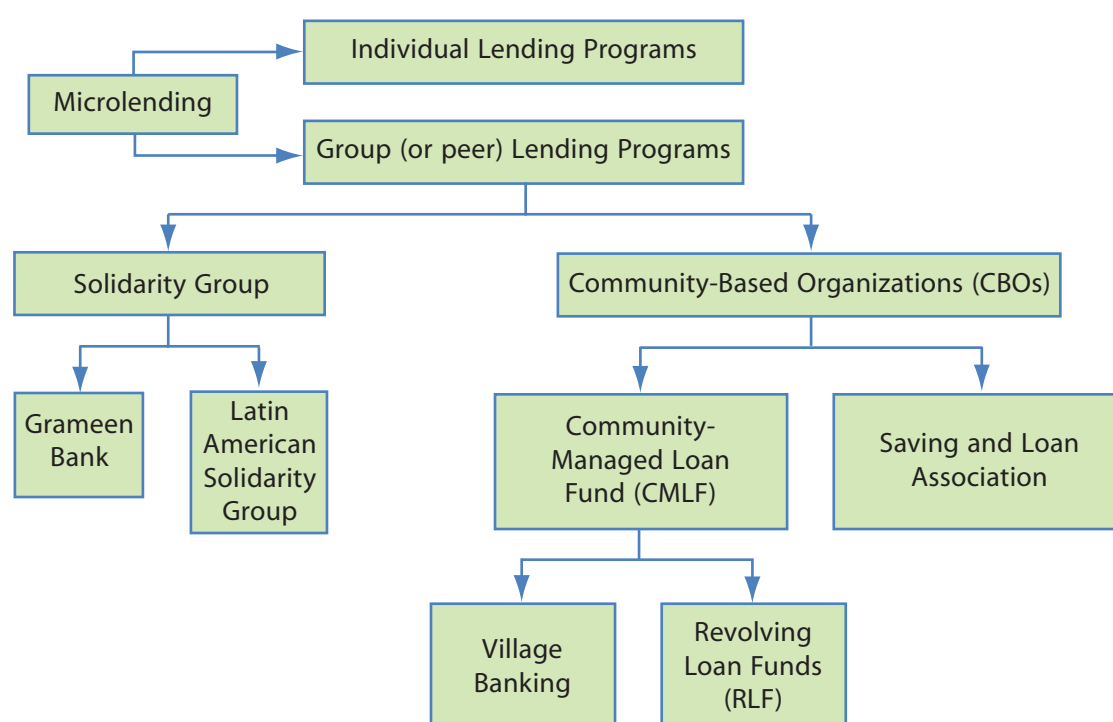
\* Grameen is one of savings and loans unit scheme

### 4.3 Typology for Providing Rural Finance

There are two general lending programs providing rural finance: individual lending programs and group (or peer) lending programs. Technically, in its implementation, all programs are adapted with the needs of the target client group, conditions in the local environment (economic, social, political, and legal), and goals of the program.

Individual lending is the loans that are directly disbursed to the individual borrowers. The RFS performs a thorough analysis of every potentially funded business. Borrowers receive loans based on past performance, credit histories, viability of business propositions, and references. To encourage repayment, borrowers provide collateral and co-signers. Collateral needed could be in the form of land (proven by certificate, deed of sale and purchase and the copy of land/building tax) or vehicle (proven by letter of vehicle ownership/BPKB of car or motorcycle, Copy of vehicle registration certificate/STNK). This collateral generally should be at least 60 percent of the loan value, although it is open for negotiation. Individual loans mostly have bigger loan size (mostly more than IDR 1,000,000).

**Figure 4. Type of Group Lending**



Source: Brandt, L., Epifanova, N. and Klepikova, T. (2002)

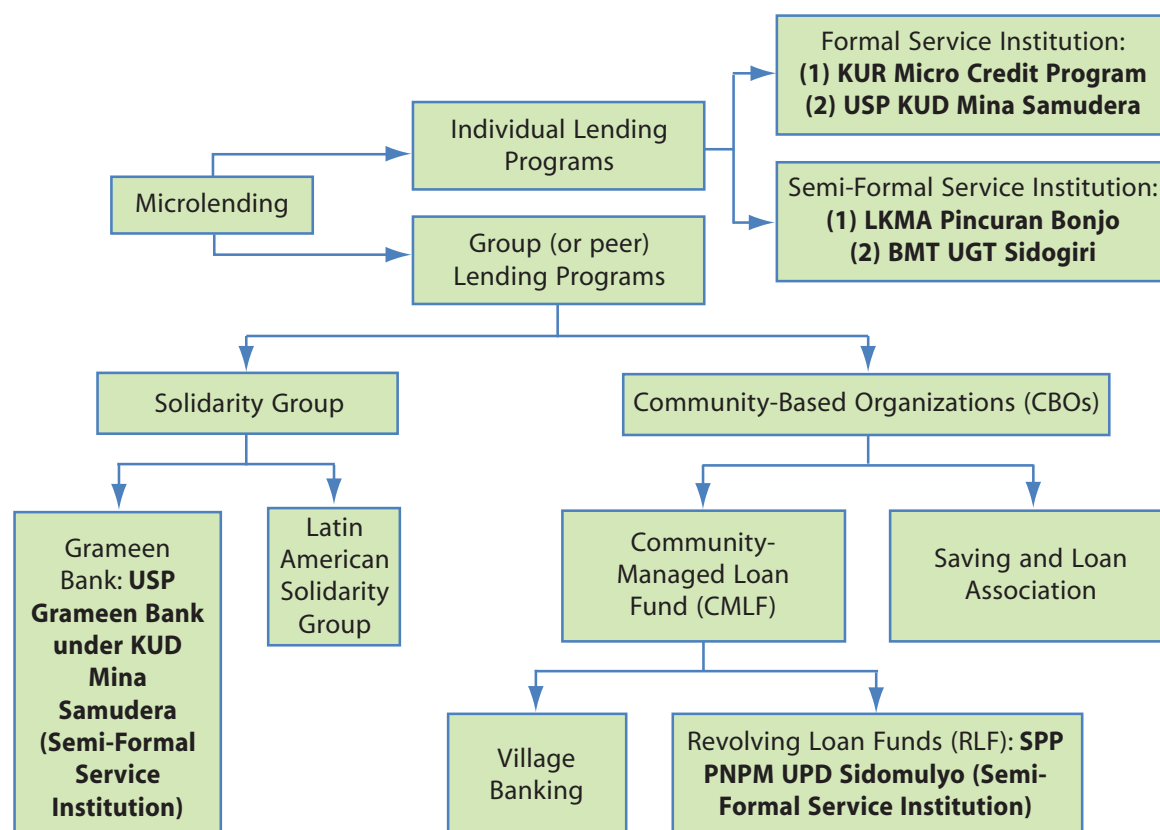
In the individual lending scheme, prior to loan disbursement lending institution requires careful analysis of 5C aspects (Character, Capacity, Capital, Collateral, and Conditions) of the prospective debtors. Evaluating the loan application and defining the terms for each particular client, may take around 7 working days. Managing and supervising the debtors depends on the mechanism applied by the lending institutions and it influences the cost structure of the financial institutions. Repayment is made monthly and it can be by auto-debit from saving account or account officer of the financial institution.

Group lending programs disburse loans through groups. Maximum size of the first loan to a member is IDR 1,000,000. There will be progressive size of loans for each member if they show good performance in repayment and follow the rules particularly in attending and doing all transactions in the weekly/center meeting. The loans are distributed among the members using the pattern of 2-2-1 or

3-2 (the poorest members get the first chance in receiving the loans and the leaders is the last ones who get the loans).

Group lending do not need collateral but group members guarantee the repayment of each other's loans. It means there is a mechanism for peer pressure and collective responsibility generated by the group. In addition, functions typically performed by the account officer of financial institution staff are delegated to the borrower group- peers screening of clients and determining who can join and accept into their group.

**Figure 5. Financing Schemes in Indonesia**



In Indonesia, schemes of individual lending and group lending are diverse depending on features of the financial institutions as formal or semi-formal ones. Among the 5 rural finance institutions, KUR Micro credit Program and USP KUD Mina Samudera are formal service institutions whereas KUR program is regulated under commercial banks and USP KUD Mina Samudera is regulated under rural and MFI services unit of one commercial bank. Two other credit programs are saving and loan from semi-formal institutions (LKMA Pincuran Bonjo and BMT UGT Sidogiri). These semi-formal institutions are regulated under Cooperative structure.

Brandt, L. et al. (2002) in Lending Methodology Module mention that generally in individual lending program, borrowers have to provide collateral. However, some RFSs in Indonesia have different features. Their requirement to provide the physical collateral depends on the type of service institution. Formal service institutions are regulated by commercial banks such as KUR and USP KUD Mina Samudera which require borrowers to provide physical/asset collateral. Whereas, individual lending by semi formal service institutions is regulated by cooperative. Through this the borrower need to provide physical/asset collateral or just guarantor such as BMT UGT Sidogiri. Moreover, the institution could decide social collateral as a requirement for the borrower.

The typology of group lending program can be observed from USP Grameen bank under the program of KUD Mina Samudera and SPP PNPM UPK Sidomulyo. USP Grameen Bank is a solidarity group model. In this scheme, staff of KUD Mina Samudera could identify a potential village and conduct training course to explain the philosophy, rules and procedures of the program. The members of the group would be chosen by members because it could influence the group to have a good performance. This scheme uses joint liability (any group member defaults a loan, the other member must cover the loan) as social collateral. The loan in this scheme is mostly bundled with saving. In case of default, the member could use saving to cover the default.

The credit program from SPP PNPM UPK Sidomulyo is different. This credit program is one of community-based organization (CBOs). One of CBO's aims is to develop a mini bank, independent of the lending institution, and manage it entirely by the poor. The SPP PNPM UPK Sidomulyo received initial funding from government grant with approaches of Revolving Loan Funds (RLF) as community-managed loan funds.

The credit program in SPP PNPM UPK Sidomulyo is a part of group lending, but the form of group lending is quite different from group lending of Grameen Bank. It is individual loan repayment terms but set by the group. So the group is a requirement to get the credit or as peer pressure to guarantee repayment, but installment repayment is the responsibility of every member. Although the financial service institutions do not require any collateral, RLF groups may require some collateral from the group members.

Credit analysis by the financial institution is simple enough because peer assessments is carried out by the group and supervised by Account Officer (AO). Following are examples of processes conducted in Grameen Group Lending in Village Unit Cooperative:

- AOs conduct location survey to observe the potential and feasibility of the location before the program started
- AOs conduct general meeting with the community or prospective members
- Group forming. Group members are selected by the group leader; they should live in the neighborhood. This is important for discipline among the members during repayment period. Each group consists of 5 persons (leader, co-leader and members). In one center there are at least 3 groups to carry out all activities
- AOs conduct feasibility test to observe socio-economic condition of the prospective members including their household business
- Prospective members should follow 4 days of mandatory training exercises
- At the end of the training (on the 5<sup>th</sup> day), the groups will have validation test
- If they pass the test, they can apply for the loans

However, managing and supervising the groups requires additional efforts after preparing all administrative requirements before conducting weekly/center meeting.

## **4.4 Capacity of the Rural Financial Institutions**

In general, institutional capacity can be defined as the ability of an institution to perform tasks and produce outputs, to define and solve problems, and make informed choices or manage their affairs successfully and sustainably. In this case, capacity of the rural financial institutions can be assessed by inputs and resources to produce sustainable performances.

It should be ensured that financial institutions or government intervention are sustainable in terms of financial performances and to reach sufficient number of clients to optimize the outreach and maximize impacts. Sustainability can be observed by financial performance indicators and number of members/



clients. These indicators should be well tailored to the conditions of rural financial institutions; therefore it should be easy to understand and to calculate. The minimum indicators that should be available for assessment/evaluation are indicators of assets (savings accumulated and loans disbursed), loan to deposit ratio, non-performing loans, profitability and efficiency.

To be a sustainable rural financial institution, necessary requirements are as follows:

- **Institutional Capacity**
  - **Financial Capacity**

Capability of rural financial institutions to offer financial services particularly loan/financing depends on their ability to get and to maintain their source of funds. Financial capacity is represented by financial performance such as assets and capital accumulated in the financial reports. One important source of fund is saving accumulation. In relation with loans, savings can be used as: (1) tool of regular repayment; (2) hold/freeze deposit during the period of loan repayment; (3) resource for low income debtors to improve their financial capacity; (4) self-sufficiency as well as reducing dependence on other institutions (donor or government supports).

Financial capacity can be improved by linkage with wholesale financial institutions and maintain those sources of funds. As an example, Koperasi Mina Samudera and BMT UGT Sidogiri are executing agencies of other larger financial institutions. However, linkage and partnership with the wholesale financial institutions depends on aspects such as: (1) performance of the rural financial institution; (2) type of legal/registered business entity of the rural financial institutions and 3) capacity to provide collateral.
  - **Lending Methodology**

Since the community served by rural financial institutions are unique in their socio economic characteristics, lending methodology applied should be tailored to the financial needs and preferences of the clients (and potential clients). The financial institutions should not be replicating/copying methodology from other institutions directly. The terms and conditions should be adjusted to the conditions of their clients.
  - **Sufficient Working Facilities**

Working facilities have significant contribution to staff performances. Since there are daily financial transactions either for saving or repayment, in the office or door to door services, daily monitoring and follow up of prospective clients, financial institutions and its clients need adequate physical infrastructure such as office supplies up to road network and supply of transportations.
- **Management Capacity and Governance**

Management Capacity should ensure that the daily activities of rural financial institutions can support achievements in financial, operational matters and its sustainability.
- **Management practices (accountability and transparency)**
  - Use of annual work plans viz, planning of budget and revenue, business plans etc
  - Updated operational manual/standard operating procedure
  - Use of regular reports such as daily, weekly, monthly, annual financial and management reports

- Implement appropriate risk management/monitoring and evaluation systems
  - Risk management such as internal audit or M&E system
  - Information flow and regular meeting to make decisions and motivate staff performance
  - Appropriate MIS (accounting or simple book keeping, auditing, budgeting and loan tracking) established and implemented with regular reviews and upgrades
- Recruit and retain qualified staff at all levels of management and operations.
  - Recruitment process
  - HR policies and procedures to have business and social skills (including performance reviews and staff development plans)
  - Staff retention rate

## 4.5 Challenges related to Rural Finance in Indonesia

While potential benefits obtained from successful RFS are enormous, development of RFS needs extra efforts. Some scholars have identified major obstacles to develop RFS (DFID, 2004; Zeller and Sharma, 1998, Nuryartono 2005, Nuryartono, et al., 2012 and IFAD, 2009). These include: (a) information asymmetries between market participants, (b) lack of suitable collateral, (c) high transaction costs, (d) high risk, (e) contract enforcement problems, (f) high operating costs, (g) formal banking procedures and physical access difficulties, (h) weak institutional capacity, (i) lack of enabling policy environment, and (j) remote areas-mountainous and scattered geography making service delivery expensive.

These factors are often compounded with limitations on women's role which is justified by religious customs and traditions. Many communities observe strict Islamic prohibitions against interest-based lending makes activity in the region difficult for the formal banking sector and the solution is introducing an Islamic microfinance (IFAD, 2009).

Other obstacles are related to a peculiar borrowing behavior of farmers. Since most of the farmers derive their incomes from agriculture, they all tend to borrow at the same time, and to save immediately after the harvest. This makes it difficult for the financial institutions to diversify their portfolios (Zeller and Sharma, 1998).

Besides the identified obstacles, rural finance services also face with a number of challenges. These challenges reinforce and compound one another, and are not only faced by the community but also by the institutions. These challenges can be divided into external, client and provider/government related.

### (a) External challenges

Infrastructure for transport, communication and information dissemination is less developed in rural areas (IFAD, 2009). This condition makes the cost of delivering services to the poor high. The situation is similar if clients live in remote areas or are in geographical isolation (Andrew, 2006; Info Resources, 2008). Moreover, the revenues of rural households, whose incomes mostly depend on seasonal agricultural and livestock production, are volatile due to fluctuating weather (rainfall patterns) conditions, pests or animal diseases affects the output of crops (Yaron, 2004). This leads to high risk, high rate of agricultural finance default amplified by commodity price fluctuation (Info Resources, 2008).

### (b) Client/Household challenges

Rural areas have low population density and limited level of client education leading to lack of bankable investments. Poorly educated people face difficulty to analyze credit risks and the profitability of a loan or savings scheme, to provide all documents and information (such as a business plan) required to apply for a loan, and to understand conditions and contracts (Info Resources, 2008). Other challenges are faced

by women who have no access to due judicial process and lack property rights or secure land tenure, and therefore cannot offer the typical kinds of loan collateral (IFAD, 2009). Besides that, cultural challenges are also faced by providers, who also face the challenge of poor repayment culture. Many farmers repay the credit by final payment at harvest time, which is a problem for providers.

### **(c) Provider/government challenges**

Financial service providers in rural markets are not able to choose which challenges they will face (Andrew, 2006). Limited capacity of financial service providers may be distorted from subsidized, targeted lending, lack of flow of funds which can delay program expansion (IFAD, 2009). The providers are also hesitant to serve the agricultural sector, given its seasonality and the inherent risks of farming.

The challenges also come from issues related to human resources and staff capacity. Adapting to a quickly changing operating and regulatory environment is little bit difficult for providers (Andrew, 2006).

A gap in the supply of financial services to the rural population is a challenge faced by providers, especially regarding investing in the agricultural sector. One of the main reasons is that governments, financial intermediaries and donors have concentrated on supply-side interventions while undertaking reforms and innovations. They have paid insufficient attention towards improving access to rural finance through reducing risks in the rural financial environment (DFID, 2004).

Taken together, these challenges increase the transaction costs for provision of financial services in rural areas, with high unit costs both for institutions and for their clients. Serving rural areas requires continuous attention and innovation. With these challenges, there is a need for institutions to look at all aspect of their own organization and operating environment. Also, providers need to acknowledge that community's chances of accessing finance can be improved by giving them the opportunity to manage and reduce the risks to which they are exposed (Andrew, 2006; DFID, 2004; Info Resources, 2008; Yaron, 2004).

As in other developing countries, the provision of financial services to rural population is also a real challenge in Indonesia. One of the major challenges is that formal banking procedures cannot be applied when dealing with the provision of financial services to this group. In Indonesia, credit is the most important financial service demanded by rural people. Standard banking procedure requires that a borrower has to pledge some asset collateral against their loans. In order to make the borrower become self-disciplined to fulfill his obligation to repay the loan and the statutory interest rate, the accepted collateral has to match the monetary value above that of the borrowed fund.

While the reason behind this banking practice is academically sound, unfortunately it makes majority of the rural people unable to access this formal financial service. There are two main factors responsible for this problem to emerge. First of all, as explained previously, most of the rural population of Indonesia lives under poverty line or close to it. Since they are poor, they simply cannot meet this requirement. Another problem regarding this collateral requirement is the fact that the bank accepts property as collateral only if its ownership title is legally certified by the government. As Soto (2000) has correctly pointed out property certification is not common in developing countries. This is especially true of rural areas of Indonesia. Even though farmland is the most valuable property asset for majority of rural residents, farmland certification is not common in this country. Most of rural farmland here is still with no legal ownership certificate. This implies that even if they possess a small size of farmland, they still do not have access to the formal banking loan because their small land is not legally certificated. Study conducted by Nuryartono 2005, Nuryartono et al., 2012 shows the poor interlinkage between credit market and land market in the rural areas of Indonesia.

The government has actually responded to these problems and tried to manage them to enhance the access of the poor people to formal credit market. An important response of the government to this access problem is the implementation of government guaranteed credit scheme such as KUR credit scheme in 2007. As previously explained, this scheme is a government guaranteed scheme so that potential borrowers can apply for loans to commercial banks without pledging asset collateral. In addition, the scheme has involved not only central and provincial government owned banks but also private banks and is quite successful in improving the poor people's access to formal credit market.

Land certification has been a national program for more than three decades. The program is known as *Program Agraria Nasional (Prona)*. Despite the efforts of the government for decades, farmland certification is still a major issue in this country. According to the head of *Badan Pertanahan Nasional* (National Land Agency), Hendarman Supandji, out of 85 units of land to be certificated, only 43 units of land have been certificated until very recently (Triyono, 2014)<sup>5</sup>.

It is also doubtful as to what extent this program can help to improve credit accessibility of owners of small-size farmland whose population are millions in this country. Actually, this program charges no monetary fees for certification of the small farmland that poor farmers own. But, this does not mean the process is not costly for small landowners. The program requires landowners to follow an administrative procedure such as providing and presenting administrative documents, interviews, mapping of the land site. This implies that the procedure is a time consuming process for the land owner. The process can be quite time-consuming as it has to be carried out with some degree of credibility to avoid a false certification. For poor land owners whose income is normally not fully obtained from farming operation but partly also from working for others, this time consumption can be so expensive even though the magnitude of its monetary value may be only small. This is because the loss of this small income could make their family become poorly fed.

High cost of transaction is another hindrance for rural finance to operate effectively and efficiently to reach rural population of this country. The main root of this problem is the presence of asymmetric information between market participants whereby one party possesses much better information about the transaction than the other partners. This opens up opportunity for the better informed party to exploit the transaction to its own benefit at the cost of the other party (Hoff and Stiglitz, 1996). The fact that law enforcement is relatively weak in Indonesia makes a moral hazard problem for even more serious. This is because the legal system cannot be used as an effective instrument to manage misconduct of business partners.

All these make screening of applicants for financial services become important for the suppliers. By screening applicants, the supplier can sort out bad borrowers. Screening process is a costly activity as it consumes working time from both parties and monetary expenditures such as expenditure on making credit application and transportation. However, the screening process is more costly when dealing with small size applicants than large ones. This cost perspective is true for both sides of the transaction, the supplier and the borrower of the financial services. Consequently, the financial service provider prefers not to serve a borrower with a small loan demand, while the small borrower prefers not to borrow money from this formal financial institution because of high transaction cost.

This situation is akin to that of rural financial service in Indonesia where, as previously explained, majority of rural people who need credit service are operators of small businesses who are also struggling to get out of poverty. As their business is relatively small, they demand only small-size credit which is sufficient to finance the operation of their small business. However, the expensive cost of borrowing a small size loan makes the rural business operators discouraged to borrow money from these formal creditors. When they are in desperate need for a small loan, they would like to apply for the loan from informal creditor who makes it available to them at almost at no processing cost. But, this

<sup>5</sup> Agus Triyono (2014) BPN Kesulitan Jalankan Program Sertifikasi Tanah. <http://nasional.kontan.co.id/news/bpn-kesulitan-jalankan-program-sertifikasi-tanah> downloaded 17 Dec 2014.

easiness of loan process is not without cost. The informal lenders would ask their clients to pay a much higher interest rate than what they would have to pay if they got the loan from a formal rural finance institution.

As discussed below, the government has tried to overcome this problem by promoting use of group lending approach when providing loan to poor borrowers, including the ones living in rural areas. This new lending approach has gained global recognition after the Grameen bank scheme's success in delivering a package of very small amounts of loans to millions of poor families of Bangladesh by implementing a group lending approach which makes the peer group as focal point in processing, supervising and administering a loan to small borrowers (Braverman and Guasch, 1996). The government's promotion of using group lending approach looks quite successful. Now, it is widely used not only by the government sponsored credit programs such as KUR scheme, but also by private banking when offering loans to clients with a small financial demand.

Provision of infrastructure is critical for development of economy as they function to facilitate economic transactions. Sufficient supply of infrastructure is required if the economy is to perform well. However, lack of infrastructure is a national problem in this country. The problem is, nevertheless, more pronounced in rural areas than in urban areas.

Insufficient supply of electricity is still a major issue in rural areas of Indonesia. Many parts of rural areas, especially the remote ones are either without supply of electric power or with unreliable power supplies. This short supply of electric power is a real challenge for development of rural finance services. Today, financial transactions are reliant much on use of computer facilities whose operation requires reliable electric supply. It is true that it is possible for the financial service providers to produce its own power by operating a personal electric generator set. But, using electric power from own generator will make its business operation become much more expensive than one in which its business is operated by using electric power supplied by the government owned company, named PT Perusahaan Listrik Negara (PT PLN), whose business operation is highly subsidized by the government<sup>6</sup>.

Recently, the government has responded to the current problem of power supply shortage which is actually a nation-wide problem by announcing that it plans to build some new power suppliers with the total capacity of 30,000 mega watt (MW) in the near future<sup>7</sup>. However, it is not yet so clear as to whether this extra supply of power will be used to fill the current short supply of electricity in rural areas or just simply to use all of the extra supply to serve to urban areas of the country. It is very likely that the government will allocate mostly of it to the urban areas. The main reason is Indonesia now focuses to push the economy to grow at a more rapid rate and the main engine for this rapid economic growth is industry which is located mostly in urban areas. Better supply of electric power is required to support this growth engine to enable itself to generate a higher economic growth rate which the newly elected government has determined to achieve.

Poor supply of electricity is only a part of the infrastructure problem which hinders the development of rural economy in this country. Relatively bad condition of roads is common to rural areas of Indonesia. This condition makes transportation of people and goods not only a time consuming activity and but also costly. Transportation becomes even more costly when small vehicles are involved in rural areas of this country. This is simply because transportation exhibits a phenomenon of economies of scale.

The extent of transportation cost is crucial for rural business since generally its products have to be exported to markets located at a distance from the rural areas where production activity is conducted. The negative effect of quality of transportation system becomes even more worse when the transported

<sup>6</sup> In Indonesia, provision of electric power is monopolized by this company. This is because electric power is considered as a basic need for Indonesia whose supply cannot be handed to private companies.

<sup>7</sup> McKinsey & Company (2014): Ten ideas to reshape Indonesia's energy sector. Available on file:///C:/user/Downloads/Ten ideas to reshape Indonesias energy sector.pdf



products are bulky and perishable. The higher is transportation cost, the less would be the profit. The extent of profitability of rural business is a critical factor for its ability to pay the loan that the business operator has used to finance its operation.

There is still another way by which this relatively bad condition of rural transportation system adversely affects the business of rural finance in this country. Both rural financial providers' staff and their clients have to meet not only when loan application is processed, but also after the application is successful. In this context, either the provider comes to visit their clients or the clients come to visit the provider's office. It is important to keep in mind, in Indonesia rural poor people generally live at remote parts of the rural area. What this implies is that potential poor clients will be rather less enthusiastic to come to the finance provider's office to hand over their application for financial products because their visit will be too costly for them relative to the size of financial transaction they will involve in. Instead of waiting for the poor potential clients to come, the finance institution will have to send its staff to visit potential clients to promote their financial products, to monitor and supervise its usage. With such a situation of transportation, these visits will become costly. Since the clients are relatively poor with a small amount of finance transaction demand, it looks impossible to impose this expensive transportation cost to the poor clients through the payment of a higher interest rate. Making this business becomes profitable for the finance institution would therefore requires this institution to develop innovative ways to manage this high cost of transportation.

Agricultural production is a major activity in rural areas that provides employment and income to majority of rural inhabitants of Indonesia. Small farmers do not use high technology to control production process to ensure that it produces outputs as the operators have planned. Instead, their farm production tends to rely on natural environment and climate so that the production process confronts with high uncertainty. However, this is only one kind of risk that the farmers face. Another source of uncertainty that relates to the farming operation is a price uncertainty. Agricultural production in Indonesia is seasonal since it relies on climate and nature. This makes agricultural products' price having a tendency to fluctuate over the course of production season. Thus, at the harvest season, the prices tend to drop significantly while in the lean season the prices go up. The small farmers would be better off if they can delay the selling of their products until the market prices are sufficiently high. However, they cannot do that way, since they need cash to repay their previous loan, to pay their daily expenditure and to finance their next cultivation.

The presence of these farming risks would not have been a serious constraint for development of rural finance in this country if market for farming risk mitigation had existed here. The farmers can buy farming insurance against the loss of farming income due to the occurrence of production or marketing risks. As such, lenders would need not to worry about the repayment of the fund that it lent to the farmers since the insurance company will cover the farming income loss when crop production fails or its price drops. On the other hand, when market for farming risks does not exist, the supplier of loan has much reason to worry about the loan repayment. This is because the small borrower has no alternative source of fund to make the loan repayment when farming income becomes much lower than the expected one due to the presence of farming risks. Despite the presence of some good reasons to support its existence, market for agricultural insurance has not yet developed in this country.

Structure of market for agricultural products and inputs is another factor that constrains development of rural finance in this country. In this market farmers are generally in the weak position. As previously explained, on average, agricultural production in this country is relatively small in size. In addition, the farmers produce generic outputs with insufficient post-harvest processing. Also, the producers generally conduct their agricultural business individually without the support of other farmers through a collective action institution such as farmer cooperative so that they cannot follow a collective bargaining process when selling their products or buying farm inputs. All these characteristics put the small farmers in a weak position when dealing with the buyers of their products as well as with the suppliers of agricultural inputs. This makes the lack capability to generate profit from farming operation, which in turn makes lending a risky business.

## 4.6 Innovative Rural Finance Operations/Schemes in Indonesia

A financial innovation can be defined as something new that resulted from a deliberate change to an existing financial product, process or delivery system (Apraca, 2007). An innovation will be considered a “good practice” if such innovation has produced positive outcomes in terms of financial sustainability and improved client outreach and “best practice” is defined as the outstanding practice in the particular process or function.

Indonesia has significant experiences of diverse rural financial services. It ranges from informal institutions initiated by local community to formal institutions at national level as government initiatives program or part of retail banking business. A number of rural financial services have unique characteristics/features that come from local values or adapted with socio-economic dimensions of rural community. A number of rural financial innovations in Indonesia have been recognized as having been successful in reaching the rural poor as well as providing sustainable financial services. Following are some examples of rural financial innovation in Indonesia:

The most recognized best practice worldwide for rural financial services and operated in Indonesia is BRI Village Banking (Unit Desa). BRI village banking approach is the best practice in financial services delivery by government agricultural development bank (Apraca, 2007). The feature of BRI village banking is that the units operate as profit centers with deposit and loan services. It provides retail lending (individual lending) which is innovative with flexible loan term adapted to local social, economic and cultural circumstances. The targeted clients of BRI are low-income clients. Outstanding elements of the BRI village banking is high outreach on saving mobilization and high deposit to loan ration. The BRI individual lending model is a success in Indonesia and the best practices for retail banking targeting the low-income clients but it has not been widely replicated by other countries.

There are local based rural (micro) finance which is recognized as successful in providing sustainable rural financial services such as Lembaga Perkreditan Desa (LPD) in Province of Bali and Lumbung Pitih Nagari in Province of Sumatera Barat. One of important factors for LPD to be successful is its unique characteristic. The LPD is a non-bank financial institution with a village development focus, owned by customary village (desa adat). Conceptually, the customary laws can be a powerful framework of social integration and control, including loyalty of member to LPDs (Budastra, 2007) as indicated previously by Holloh (1994) that

*“the unique character of the LPD lies in the fact that it is not related to the official village administration but is an institutional element of the custom village. The character of the desa adat as a democratic system regulated by customary law provides strong socio cultural bonds and effective mechanism”.*

Microfinance Institution for Agribusiness (LKMA) is one of the innovative approaches in rural (micro) finance services. It is a combination between community based organization and government initiative. Ministry of Agriculture promotes the establishment of LKMA through the establishment of farmer group association. With supported by Agricultural regional offices of Province Sumatera Barat, some LKMAs in this provinces show innovations in their operations to reach the rural poor and make them sustainable. The LKMAs are registered as cooperative for their legal businesses. To improve the sense of belonging of the LKMA members, besides obligation to have principal and compulsory saving for being cooperative member, the members should be also shareholders. The sense of belonging creates a common understanding among members to be together in developing their LKMA.

The other innovation practices in the rural finance services are what is called “a mixed model”. Most of the rural finance services use this mixed model as a mixture of features of two or more models under one approach. Following are some examples in this study:



- a. Some cooperatives in the coastal areas under the technical supervision of Ministry of Marine Affairs and Fisheries have applied this mixed model. One of the cooperatives proposed by the ministry is included in this study-the KUD Mina Samudera. This cooperative has mixed features as the following.
  - Individual lending through Loan and Saving Unit (USP) which has partnership with commercial banks in the program of Swamitra-Bukopin. In lieu of the costs incurred in the partnership with Bukopin, the cooperative receive some benefits such as: (1) receives Swamitra technology and management system which can improve the sense of trust of members of Cooperatives; (2) conducts online financial transactions in all Swamitra Offices throughout Indonesia; (3) Business information and communications support making it able to well-conduct production and marketing; (4) Correct and accurate present financial statements. This unit provides variety of savings products and loan for the public (not limited to the cooperative members).
  - Group-based lending through loan and saving unit-replicates and modifies Grameen model namely Grameen Pesisir. By paying compulsory saving, the members of the Grameen Pesisir become members of the cooperative and receive benefits as cooperative member. Grameen approach is one of the most popular microfinance methodologies, that has been successfully adopted, replicated or modified to suit the Indonesian local context. The Grameen model applied is relatively modified by the local social, economic and cultural circumstances. The essential features of Grameen model applied locally are:
    - poor people's access to credit, with women as a priority
    - small loans repaid in weekly instalments
    - eligibility for higher loan amount for succeeding loans
    - loans for income-generating activities
    - financing activities chosen by borrowers themselves
    - forming solidarity groups
    - Serve as linkage institution with commercial banks
- b. Sharia financial services also apply a mix model of rural (micro) finance. In this study BMT UGT Sidogiri provides individual financing systems with sharia agreement and the service patterns with the linkage institution and sharia commercial banks. This BMT has legal entity as Islamic Financial Services Cooperative (KJKS) and follows the standard features of cooperative. However, in addition to the standard features of cooperative of principal and compulsory saving, the BMT applies some modifications in order to improve their capital capacity.

## CHAPTER 5

# Detailed Study of Rural Finance Best Practices

### 5.1 Identified Best Practices

This section explains five cases of rural financial services that are recognized as best practices. To complement the desk review, field work has been carried out to investigate the real condition and to ascertain the RFSs capacity for best practices which are likely to be scaled up and replicated.

The comparison of financial inclusion criteria from the selected rural financial institutions are shown in Table 5. The data in this table reveal that all RFSs provide saving and credit products to their clients except KUR micro credit program. It is also shown that saving products are compulsory and voluntary. Compulsory saving is a requirement for membership. It is also required that when borrower takes a loan they are to minimize default. The compulsory saving can be withdrawn by the saver only after his membership in the financial institution is terminated. The amount of compulsory saving is different among RFS because it is specified by their own management. This compulsory saving receives no interest, but a share on the business surplus earned by the financial institution is disbursed to the members once a year.

These institutions also encourage their borrowers to make a voluntary saving. The amount is not specified, but depends on the willingness of the borrowers. LKMA Pincuran Bonjo doesn't give interest for all saving products. BMT Sidogiri also doesn't give interest because they use Sharia financial agreement. Access to withdraw for saving is relatively open for voluntary saving but limited for compulsory saving.

All the institutions also have diverse credit schemes. Their target group is relatively similar – the ones who are not bankable, but economically feasible. Loan repayment structure is also similar-gradual repayment. Different to other RFS, LKMA Pincuran Bonjo has a credit scheme with single repayment after harvest. Commercial interest rate is charged on the loans, except for the financing provided by the BMT UGT Sidogiri since BMT UGT applies sharia agreement. All RFSs also charge additional fees on loans they provide. However, the amount and type of additional cost for credit/financing product varies for each RFS.

Regarding the use of asset collateral against loan, physical collateral is applied by BMT UGT Sidogiri for "matured clients", USP scheme of the KUD Mina Samudera and KUR credit program. Meanwhile, in the case of KUR scheme, only the borrower of KUR Micro provides no collateral, but guaranteed by the government. The Grameen scheme of KUD Mina Samudera and SPP-UPK Sidomulyo apply joint liability group as social collateral. Moreover, LKMA Pincuran Bonjo does not require collateral but when the borrower takes a loan it should be guaranteed by the community elder.

With regard to rural credit methodology, group lending is applied in the case of loans provided by Grameen Scheme of KUD Mina Samudera and SPP UPK Sidomulyo. The other RFSs use individual lending method. Unfortunately, almost all institutions are not supported by appropriate regulation for consumer protection such as non-availability of Deposit Insurance for their saving products. In terms of loans or financing, some RFSs started to be protected by micro-insurance.

Table 6. Inclusion Criteria Checklist for the Candidates of Rural Financial Services Best Practices

No.	Theme	Identified Factors		BMT UGT Sidogiri	LKMA Pincuran Bonjo	KUD Mina Samudera		SPP UPK Sidomulyo		KUR	
		Indicator	Best Practices			USP	Grameen	UPK	SPP		
Inclusion Criteria											
1	Savings Products	Type of saving	Voluntary	✓	✓	✓	✓	No	✓	No	
			Compulsory	✓	✓	No	✓	No	✓	No <sup>8</sup>	
		Access to savings withdrawals	Open access	✓	✓	✓	✓	No	✓	No	
			Limited access	✓*	✓*	No	✓*	No	✓*	No	
2	Credit/Financing Products	Interest rate	Payable	Not applicable	No	✓	✓	No	No <sup>9</sup>	No	
		Type of credits	Short term	✓	✓	✓	✓	✓	✓	✓	
			Long term	No	No	No	No	No	No	No	
		Criteria target	Feasible but not bankable	✓	✓	✓	✓	✓	✓	✓ <sup>10</sup>	
			Loan repayment structures	✓	✓	✓	✓	✓	✓	✓	
		Source of fund	Single repayment	No	✓*	No	No	No	No	No	
			Government	No	✓	✓	✓	✓	✓	✓	
		Interest rate	Public/private	✓	✓	✓	✓	No	No	No <sup>11</sup>	
			Commercial	Not applicable	No	✓	✓	No	No	No	No <sup>12</sup>
		3	The Methodology Used	Additional Cost	Subsidized	Not applicable	No	No	No	No	✓
General fees and charges	✓*				✓*	✓*	✓*	No	✓*	✓*	
Collateral	Physical/asset Collateral by clients			✓	No	✓	No	No	No*	No*	
	Guarantees			✓	✓	No	No	No	No	No	No
Rural credit methodology in use	Social collateral			No	No	No	✓	No	No	✓	No
	Group lending			No	No	No	✓	✓	✓	✓	No
Individual lending	✓			✓	✓	No	No	No	✓*	✓*	

<sup>8</sup> Required to open saving account (Simpedes). It is important to manage repayment from the debtors.

<sup>9</sup> Some of SPP does not provide interest rate

<sup>10</sup> Unbankable based on banking perspective, in this case Bank Rakyat Indonesia (BRI)

<sup>11</sup> Some SPP received fund from another banks

<sup>12</sup> Interest rate is determined by government

Table 6. (continued)

No.	Theme	Identified Factors		BMT UGT Sidogiri	LKMA Pincuran Bonjo	KUD Mina Samudera		SPP UPK Sidomulyo		KUR	
		Indicator	Best Practices			USP	Grameen	UPK	SPP		
Inclusion Criteria											
4	Legal Structures and Regulation	Regulator/Authority	Self-Regulated	No	✓	No	No	No	✓	No	
			Government Regulated Ministry, Central Bank, OJK, Local Government, etc.	✓	✓	✓	✓	✓	✓	✓	
		Regulation	Content of the regulation	✓	✓	✓	✓	✓	✓	✓	✓
5	The Appropriate Managerial and Administrative Structure	Guidelines	Consumer protection	No	No	No	No	No	No	✓	
			By Government	✓	✓	✓	✓	✓	✓	✓	✓
			By Non-Government	✓	✓	✓	✓	No	No	✓	✓
6	Operational and Outreach Structures- Wholesale and Retail	Approaches to achieve financial inclusion by outreach into un-served rural areas	Direct loan/saving distribution to the clients	✓	✓	✓	✓	✓	✓	✓*	
			Linkages between wholesale institutions and smaller retail entities (cooperative/ non-cooperative)	✓	No	✓	✓	No	✓	✓	✓
7	New Innovations	Product	Bundling between main product and secondary product	✓	✓	✓	✓	No	✓	✓	
			Point of sale outreach	✓	No	✓	✓	✓	✓*	✓	✓
			Linking of Remittances to credit	No	No	No	No	No	No	No	No

Table 6. (continued)

No.	Theme	Identified Factors		BMT UGT Sidogiri	LKMA Pincuran Bonjo	KUD Mina Samudera		SPP UPK Sidomulyo		KUR
		Indicator	Best Practices			USP	Grameen	UPK	SPP	
Inclusion Criteria										
		System	Incentive for customer discipline	✓	✓	No	✓	✓	No*	No
			Collateral (insurance, social collateral, guarantee)	✓	✓	No	✓	No	No	
			Customer Protection	✓	No*	✓	✓	No	✓	
			Selection, Recruitment, Monitoring and Supervision	✓	✓	✓	✓	✓	✓	
			Technical assistance (training, capacity building, supervising)	✓	✓	No	No	✓	No	
8	Financial and Management Reporting	Technology of Delivery	Mobile Phone Banking	No	No	No	No	No	No	No
			Internet Banking	No	No	No	No	No	No	
			Standard and Regular Financial Reporting	✓	✓	✓	✓	✓	✓	
			Budgeting and planning	✓	✓	✓	✓	No*	✓	
			Financial Report Evaluation	✓	✓	✓	✓	✓	✓	
9	Islamic Finance	Procedure	✓	No	No	No	No	No	No	
		Collateral	✓	No	No	No	No	No		
		Return	✓	No	No	No	No	No		
10	Governance	Structure of Organization	The role of the board of directors	✓	✓	✓	✓	✓	✓	
			The role of supervisory agency	✓	✓	✓	✓	✓	✓	
			The relationship between management and the board	✓	✓	✓	✓	✓	✓	

Regarding product innovations, all RFSs use bundling between loans and saving. None tries to link remittance to credit. Incentive for motivating customer discipline is provided by the BMT Sidogiri, LKMA Pincuran Bonjo, and Grameen Scheme of KUD Mina Samudera. Technical assistance for clients is provided by some RFS, except KUD Mina Samudera and KUR micro credit program. In addition, financial management reporting (although in a simple method) and governance is common practices to all the financial institutions.

Some of the inclusion criteria has asterisk (\*) marks. It is intended to indicate that although the institution has similar inclusion criteria, the application is technically different. Inclusion criteria from each institution will be elaborated in the following part.

## 5.2 Competitive Profile of the Selected Best Practices

The differences between the proposed five best practices is assessed and best RFSs are recommended to be up scaled or replicated. We use Competitive Profile Matrix to assess the profile of each proposed RFS.

The critical success factors in this analysis include nine indicators of inclusion criteria from the design for selecting best practices. The indicators are Saving Product Quality, Credit/Financing Product Quality, Methodologies Used, Legal Structure and Regulation, Appropriate Managerial and Administrative Structure, Operational and Outreach Structure – Wholesale and retail, New Innovations in Financial and Management Reporting and the Governance structure. We added two critical success factors that have not been included in the inclusion criteria viz, (1) human resources as part of institutional capacity and (2) Quality of non-financial services.

To develop the matrix, after selecting the critical success factors to be included in the assessment, we set weight for each of the factors. The most important factors have been given the highest weight and the lowest weight is used for the least important factors to be considered as critical success factors. The rating scales are from 1 to 4, 1 = the major weakness, 2 = the minor weakness, 3 = the minor strength, 4 = the major strength. Following is the explanation for the critical success factors.

- (a) Saving Product Quality consists of several indicators such as whether savings should be voluntary or compulsory, whether there should be open access to savings withdrawals or access should be limited, and the interest rate payable on savings and how it should be set.
- (b) Credit/Financing Product Quality consists of several indicators that represent the most appropriate credit products for the target clientele. It comprises some indicators such as type of credit (short term and long term credit products), criteria of the targeted clients, loan repayment structures (gradual or single repayment), and source of fund, collateral (physical collateral, guarantees or social collateral), interest rate, general fees and charges.
- (c) Major rural credit methodologies that are in use (village savings and loans, group lending, accumulated savings and credit associations, village banking, individual lending, rotating savings and credit associations, hybrids).
- (d) Legal Structure and Regulation examine the various legal structures and the role of regulation.
- (e) The Appropriate Managerial and Administrative Structure
- (f) Operational and Outreach Structure – Wholesale and retail are the various approaches to achieving financial inclusion by outreach into unserved rural areas. It consists of several indicators such as establishment of linkages between wholesale institutions and smaller retail entities and direct distribution of loan products.
- (g) New Innovations consists of several indicators that represent innovative products, systems and technology of delivery.
- (h) Financial and Management Reporting consist of several indicators such as budgeting, planning, and analysis and interpretation of data.

Table 7. Competitive Profile Matrix of the Selected RFS

Critical Success Factor	Weight	BMT UGT Sidogiri		LKMA Pincuran Bonjo		KUD Mina Samudera		SPP UPK Sidomulyo		KUR	
		Rating	Score	Rating	Score	Rating	Score	Rating	Score	Rating	Score
Saving Product Quality	0.125	4	0.5	4	0.5	3	0.375	2	0.25	2	0.25
Credit/Financing Product Quality	0.125	4	0.5	4	0.5	3	0.375	2.5	0.3125	3	0.375
Methodology Used	0.05	3	0.15	4	0.2	3	0.15	3	0.15	3	0.15
Legal Structure and Regulation	0.1	3.5	0.35	3.5	0.35	3	0.3	2.5	0.25	3	0.3
The Appropriate Managerial and Administrative Structure	0.05	3	0.15	3	0.15	3	0.15	2.5	0.125	4	0.2
Operational and Outreach Structure – Wholesale and retail	0.1	4	0.4	3	0.3	4	0.4	2	0.2	3	0.3
New Innovations	0.15	3	0.45	4	0.6	2.5	0.375	2.5	0.375	2	0.3
Financial and Management Reporting	0.05	3	0.15	3	0.15	3	0.15	3.5	0.175	4	0.2
Governance	0.05	3	0.15	3	0.15	3	0.15	3	0.15	3	0.15
Human Resource	0.1	4	0.4	3	0.3	2	0.2	1	0.1	4	0.4
Quality of non-financial services	0.1	3	0.3	4	0.4	3	0.3	3	0.3	1	0.1
TOTAL	1		3.5		3.6		2.93		2.39		2.73



- (i) Governance consists of several indicators such as relation to the role of the Board of Directors, the relationship between management and the Board, and the needed professionalism in management.
- (j) Human Resource consists of several indicators such as quantity and quality of the human resources available, policy related to the development of human resources.
- (k) Quality of non-financial services mostly explain the type of non-financial services provided. As rural financial services, economic activities in the rural area such as agriculture should be taken into account. Availability of marketing station, agricultural inputs and technical assistance on production or marketing of agriculture commodity seems to be important to improve capacity of the clients.

This table portrays the competitive scenarios of each RFS. Following are the results

- (1) The LKMA Pincuran Bonjo scores better (strengths) in Saving Product Quality, Credit/Financing Product Quality, Methodology Used, New Innovations and Quality of non-financial services. It assumes minor strengths in Legal Structure and Regulation, The Appropriate Managerial and Administrative Structure, Operational and Outreach Structure – Wholesale and retail, Financial and Management Reporting, Governance and Human Resource. As a whole, its total score is 3.6.
- (2) The BMT UGT Sidogiri scores better (strengths) in Saving Product Quality, Credit/Financing Product Quality, Operational and Outreach Structure – Wholesale and retail, Human Resource and assumes minor strength in New Innovations, Methodology Used, Legal Structure and Regulation, The Appropriate Managerial and Administrative Structure, Operational and Outreach Structure – Wholesale and retail, Financial and Management Reporting, Governance and Quality of non-financial services. As a whole, its total score is 3.5.
- (3) KUD Mina Samudera has major strength in Operational and Outreach Structure – Wholesale and retail and major weakness in human resources. Other critical factors are assessed to be minor strength. The total score is 2.93.
- (4) KUR Micro Credit Program has major strength in Appropriate Managerial and Administrative Structure, Financial and Management Reporting and human resources. However, it has weakness in saving product. The KUR does not require any saving accounts from the debtors, but the implementing banks require it to manage the debtor willingness and ability to repay the loan. The total score is 2.73.
- (5) SPP UPK Sidomulyo has minor strength in Financial and Management Reporting, governance and quality of non-financial services. However, it has major weakness in human resource aspect. Since it is part of the government program with limited period of implementation, the human resource policy does not provide any career opportunity, thus influencing the quality of human resources involved in the SPP UPK management. In terms of legal structure, one important issue in SPP UPK is that it is not a legal entity for the UPK, which influences its capacity to grow further.

From this competitive profile matrix, it is revealed that LKMA Pincuran Bonjo enjoys slightly higher competitive advantages than the BMT UGT Sidogiri while KUD Mina Samudera, SPP UPK Sidomulyo and KUR credit program are lagging behind by 0.68, 1.21 and 0.88 than LKMA Pincuran Bonjo.

## 5.3 Details of the Best Practices

### 5.3.1 LKMA Pincuran Bonjo, Payakumbuh, Sumatera Barat

Microfinance Institution for Agribusiness (LKMA) Pincuran Bonjo is established by the village community. In other villages the LKMAs are facilitated or initiated by the Agriculture Provincial Office, mainly by PUAP/Rural Agribusiness Development Grant to support farmers in dealing with capital problems. LKMA Pincuran Bonjo is managed by the community to serve the community. It means LKMA belongs to the community, from the community, by the community and for the community. Following are some principles of LKMA:

- LKMA is an independent MFI. There is no relation among 900 units of LKMAs in Sumatera Barat.
- Legal entity of LKMA is Cooperative but its operational system follows the banking system (in a simple way)
- Different from the conventional cooperative with principal, compulsory and voluntary savings as membership based savings, as a part to improve capital capacity of LKMA and sense of belonging of the members, all prospective members should buy at least one stock.
- Number of stock ownership does not influence their rights, all members have the same right “one man one vote.”
- LKMA designs products, services and their own regulations based on the community needs. Therefore, products, services and regulations among LKMAs are different from each other.

At the beginning of LKMA's establishment, it was supported by Agriculture Office of Sumatera Barat Province. The Government of West Sumatra Province used PUAP grants (enacted by a Decree of Minister of Agriculture (Kepmentan) No. 545/Kpts/OT.160/9/2007) as a way to strengthen the capital or start-up funds for the growth of LKMA from the existing Gapoktan (Association of Farmers Group) throughout Kanagarian (village level) in West Sumatra. LKMA is under supervision of Agriculture Regional Office particularly after receiving PUAP grant. LKMA should submit their grant allocation to the PMT (Penyelia Mitra Tani/Supervisor of Farmer Partner) at Agriculture Regional Office. PMT is a professional recruited by the Ministry of Agriculture which has primary responsibility to supervise and advocate Counseling Assistance and Gapoktan/Poktan PUAP receiver. Standard and regular financial reporting of LKMA follows guidelines from agriculture regional office. Moreover, LKMA prepares annual planning and budget and it is evaluated by its members during the annual member's meeting. The Financial Report Evaluation (in a simple form) is carried out by the members in two weekly meetings.

LKMA is expected to be a productive and efficient institution in managing funds for farming or poor people in rural areas (Agriculture Office of West Sumatera, 2009: 9-11). Through the decision of the Governor of West Sumatra, PUAP grants can only be disbursed to Gapoktan through LKMA. Therefore in Sumatera Barat, PUAP grants is managed through LKMA that is formed by several existing Gapoktan. All products provided by LKMAs are designed and regulations formulated according to the community needs and through a community consensus.

Establishment of LKMA Pincuran Bonjo was motivated by marketing problems of agricultural products, especially for rice and vegetables. Some community members (horticulture farmers) who live in the village of Padang Alai, Sub-District of Payakumbuh Timur in November 2007 held a meeting with the extension/agricultural officer, forming Baliak Mayang Farmers Group, following the name of their area in the village. Then, the members of Baliak Mayang Farmers Group started to think about how to sell their agricultural products at a profitable price for farmers, and they formed Sub Terminal Agribisnis (STA) Baliak Mayang. This STA is managed by Farmers Group of Baliak Mayang.

Coupled with the growing business of production and marketing of agricultural products, they began to manage the cropping pattern so that there was no excess production of certain commodities and the cropping pattern was tailored to the needs of the market. Sub Terminal Agribisnis (STA) is continuously growing in partnership with vegetable traders in Singapore and Pekanbaru in Riau.

Along with the increasing market demand, the problem of capital arises. As a result, the farmer group members agreed to establish a financial institution managed by own members. They formed the Capital Accumulation Institution (Lembaga Pemupukan Modal). After joining the participatory training held by Dipertabunhut Payakumbuh (Agricultural Office at Payakumbuh district) they formed LKMA named Pincuran Bonjo.

The LKMA Pincuran Bonjo was formally launched on June 17, 2008 by Mayor of Kota Payakumbuh Mr. Capt. H. Josrizal Zain, SE.MM with the Legal Entity No. 29/BH/KUMK-Pyk/VI/2008 dated June 3, 2008. Legal entity of LKMA Pincuran Bonjo is cooperative and it is regulated and supervised by Cooperative Regional Office. LKMA submits Annual Report to the Cooperative Regional Office.

The institution of LKMA Pincuran Bonjo is a self regulated organization since it was established based on their members and community's needs. Managerial and administrative structures of the LKMA generally follow the system developed by community consensus. LKMA management is under the supervision of the supervisory board. The management (the head of LKMA and the managers) has main functions to manage daily activity of LKMA and its business units. In the role of supervisory agency, the cooperative submits Report of Annual Member Meeting to the Cooperative of District Office. Source of fund of this institution is from government and commercial sources. The LKMA has strong asset base. From government, the LKMA received PUAP grant in 2009. The commercial source of fund is member's accumulated stocks and saving accounts from the community (see Table 7). Every member has a minimum of 1 exemplar of the stock (1 exemplar stock = IDR 100,000) and stock ownership does not determine member rights. Each member has the same right in the LKMA although number of stock ownership for each member is different.

The number of customers in LKMA Pincuran Bonjo is growing positively. The number of customers was 425 customers in December 2012 and increased to 580 customers in December 2013 and to 675 customers by December 2014. The positive growth in the number of customers implies growing total saving accumulation (Table 7).

**Table 8. Total Savings Accumulated from December 2012–December 2014**

<b>Saving</b>	<b>Dec 2012 (IDR)</b>	<b>Dec 2013 (IDR)</b>	<b>Dec 2014 (IDR)</b>
Principal Saving	21,980,000	28,780,000	32,800,000
Special Compulsory Saving (stock)	11,300,000	14,700,000	16,700,000
Compulsory Saving	28,043,000	40,208,000	56,788,000
Voluntary saving	280,090,171	387,049,871	579,418,641

Source: LKMA Pincuran Bonjo (2014)

Table 7 shows that all types of savings are increasing over time. The voluntary saving doubled from 2012 to 2014. Table 8 shows that from 2012 to 2014, the number of borrowers increased from 84 to 138, with prospective debtors on a waiting list. While the NPL or bad debt rate of LKMA Pincuran Bonjo from 2012 to 2014 at the rate of 1-2 percent.

**Table 9. Loan Performance of LKMA Pincuran Bonjo**

<b>Loan Performance</b>	<b>December 2012</b>	<b>December 2013</b>	<b>December 2014</b>
Number of Borrowers	84	115	138
Total Loan disbursed	IDR 865,720,000	IDR 903,684,000	IDR 896,400,000

Source: LKMA Pincuran Bonjo (2014)

## Innovative Approaches and Practices

The LKMA Pincuran Bonjo is selected as best practice of financial institution in consideration of several unique features and innovative approaches as explained below.

### *a. Product*

LKMA Pincuran Bonjo has both saving and credit products for its members. Credit is directly disbursed to the clients as individual lending.

#### *(i) Saving*

Since the legal entity of LKMA is as a cooperative, it should follow the regulation as cooperative to have several types of savings as membership based saving. Principal and Compulsory savings are requirements for membership. Principal saving is paid once during registration to be a cooperative member. Compulsory saving is done on regular basis as long as being the cooperative member.

- Principal saving is mandatory saving as cooperative member. It is paid once at the beginning of membership with the amount of IDR 200,000
- Compulsory saving is collected at every meeting (2 times a month at 2<sup>nd</sup> week and 4<sup>th</sup> week) with amount IDR 5,000/time

As a requirement to be a member of LKMA, it is an obligation to buy at least one piece of stock (@ IDR 100,000 per stock) at registration. There are other requirements to be a member (a) honesty, discipline, good historical record on loan and saving elsewhere, (b) possession of resident ID card, Family ID Card, and (c) ownership of business or land. The amount of compulsory saving is specified by the lending institution. This saving receives no interest, but a share of membership based saving will be calculated on the surplus of business earned at the end of the year (but it is delivered before Iedul Fitri). The dividend is around 4 percent per year for stockholders.

Second type of saving is voluntary saving. Type of voluntary saving are community saving (bundled with the credit to facilitate the repayment), education saving, Iedul Fitri saving, qurban saving, (time) deposit saving, pawning saving, maternity saving and marriage saving. Community saving can be withdrawn anytime but the compulsory saving can be withdrawn by the saver only after his membership in the financial institution is terminated. Access for saving withdrawn is open for the voluntary saving. The education saving can be withdrawn every 6 months (at school opening season); Iedul Fitri saving can be withdrawn two weeks before Iedul Fitri; qurban saving can be withdrawn two weeks before Iedul qurban; pawning saving can be withdrawn until the saving amount is enough to repay the pawned asset; (Time) deposit saving can be withdrawn depending on the time schedule agreement; and maternity saving can be withdrawn a week before the birth of a child. On saving product, every member should pay administration fee of IDR 5,000.

#### *(ii) Credit*

LKMA Pincuran Bonjo bundles the credit and saving. LKMA Pincuran Bonjo provides short term credit with several schemes. First loan is limited up to IDR 3 million in a 12 month repayment period. There are several features of financing; (1) 5 months credit with a maximum loan size of IDR 5 million; (2) 10 months credit with a loan size of more than IDR 5-20 million; (3) 12 months credit with a loan size of more than IDR 5-20 million; (4) 24 months credit with a loan size of more than IDR 5-20 million; and (5) agriculture financing scheme by profit sharing mechanism with percentages of 80:20 and 50:50, depending on what kind of the input that the institution shares for agriculture activities. This kind of financing is without any interest.

LKMA Pincuran Bonjo provides credit for farmer without any physical or asset collateral. This financial institution could be representative for community driven and self-sustaining institutions. Their target group is members who are not bankable, but economically feasible and eligible for individual lending. The LKMA has the following requirements to be a borrower: (a) being a member for a minimum of 1.5 months and having paid compulsory savings for three times, (b) business surveyed by management and (c) the nominal amount for first credit is IDR 3,000,000 with a repayment period of 12 months.

Loan repayment structure can be single or gradual repayment. The single repayment is for loan size of up to IDR 5 million with 5 months period and can be paid after harvest. Repayment varies by type of scheme:

*(1) 10 months credit*

- Installment is paid every month for 10 months
- When borrower receives the loan, he/she receives only 90 percent of the loan and the remaining 10 percent is for: 6 percent for provision, 3 percent for administration fee, 1 percent for ledul fitri saving

*(2) 24 months credit*

- Installment is paid every month for 24 months
- When borrower receives the loan, he/she receives only 80 percent of the loan and the remaining 20 percent is distributed across-18 percent for provision, 1 percent for administration fee, 1 percent for ledul fitri saving

*(3) 12 months credit*

Borrower will receives 100 percent of the loan and installment payment is every month for 12 months with the following details:

- 1<sup>st</sup> month (10% of the loan size) is paid for provision
- 2<sup>st</sup> month (10% of the loan size) paid for: (5%) ledul fitri saving and (5%) deposit saving
- 3<sup>rd</sup> – 12<sup>nd</sup> installment (10% of the loan size) is paid for principal installment

*(4) Profit Sharing Credit*

- a) Profit Sharing 80:20
  - Requirement: should have a business for a minimum of 1 year and should pass the evaluation.
  - Process: labor cost, equipment cost and material production (input cost) charged to the LKMA as a capital. All sales/harvest revenue will be shared with this composition
    - 50 percent from the product sales will be used for payback of the capital
    - Rest 50 percent will be used for profit sharing – divided into (1) 80 percent for borrower and (2) 20 percent for the LKMA
  - Financing period is 1-2 years
- b) Profit Sharing at 50: 50
  - Requirement: in business for a minimum of 1 year and should pass the evaluation.
  - Cost to buy mulch plastic, pest control materials, marker and rope – are charged to the LKMA
  - Labor cost charged to the borrower
  - All sales/harvest revenue shared with this composition:
    - 50 percent from the product sales for the borrower
    - 50 percent from the product sales for the LKMA
  - The loan can be rescheduled except in case if the default is caused by the negligence of the borrower

LKMA Pincuran Bonjo does not require physical collateral but when the borrower takes a loan it should be guaranteed by the elder person/chief of the clans as a guarantor. Incentive for motivating customer discipline is provided by LKMA Pincuran Bonjo. Provision of technical assistance for clients, financial management reporting and governance is common practices by the institution.

*b. Bundling of main product and secondary product*

The unique feature of LKMA Pincuran Bonjo is the bundling of a loan with saving products such as compulsory savings, Iedul Fitri savings and the loan. Moreover, the LKMA also provides stocks to its members. The ownership of stock could foster the sense of belonging.

Another unique feature is marketing and agriculture inputs facilitation. The members of LKMA are mostly horticulture farmers who face problems of agricultural product marketing, especially for rice and vegetables. The group formed Sub Terminal Agribisnis (STA) to sell commodities at profitable prices. With growing business of production and marketing of agricultural products, they manage the cropping pattern so that there is no excess production of certain commodities. STA continuously grows in partnership with vegetable traders in Singapore and Pekanbaru in Riau. With STA, members could sell their products and buy production inputs from LKMA business unit. The STA showed that LKMA is a financial institution which has integrated loan and saving products, and also manages the inputs and marketing needs of members. This allows members and institution to grow in mutually reinforcing framework.

*c. Institutional Capacity*

LKMA Pincuran Bonjo is an integrated financial institution which is community driven. In the beginning, even though this institution did not have any support or subsidy from the government or other institution, it could self-sustain.

*d. Point of sale outreach*

LKMA mainly operates at the village level, but clients can be from other locations such as local residents who live in other villages or other cities.

*e. Incentive for customer discipline*

There are several incentives for customers who are disciplined as members:

- Members could ask the LKMA staff to collect their savings every day;
- Each member should pay compulsory saving of IDR 5,000 in two meetings in a month and it will be accumulated as surplus/profit sharing at the end of the year.
- Borrowers are scheduled to pay Iedul Fitri saving while they borrow the money. The members will receive the saving a week before Iedul Fitri.
- Members will receive a parcel/gift from the LKMA every Iedul Fitri
- LKMA provides several types of savings and it gives advantages for members to be more disciplined with their family finance, because some types of savings cannot be withdrawn.
- Installment payment could be adjusted from community saving

*f. Technical Assistance*

LKMA has a P4S (Agriculture and Rural Training Center) for training and capacity building. The knowledge can be transferred from farmers to farmers, management to farmers, agriculture regional office and any other institutional to farmer/group of farmers.



As explained before LKMA Pincuran Bonjo was established through local initiative and resources and it has been proven that it is sustainable with limited technical and financial support from the government. With the existing products, LKMA Pincuran Bonjo can up grade and add more features. The LKMA also provides financing for horticulture sector. It can also finance other sectors such as food crop or fishing sector with customized features. LKMA also has credit insurance particularly when LKMA finances agricultural sector, which has high risk of failure.

### **Lesson Learnt**

In order to improve or to replicate LKMA Pincuran Bonjo, following are the challenges to be addressed for solutions.

- The point of sale of LKMA Pincuran Bonjo is only one village. LKMA staff goes to customers to collect savings every day. So when the point of sale widens, it will be costly to collect savings. The system should be more efficiently adjusted.
- The LKMA was established to meet the local needs and is driven by the community. The management should include local people who really know the characteristics of the community and this could minimize moral hazards. However, the local management must be equipped with ability to manage the operations including marketing skill.
- In LKMA the local elder is the guarantor, who facilitates installment repayment. If the scheme is implemented in other places, there should be a community elder (or other similar position) to guarantee the financing, who is really respected by the community.
- Implementation scheme introduced from elsewhere must be adapted to the local culture because communities culture and characteristics are different and it could affect the implementation of financing scheme. The scheme also could be adjusted with the communities' needs.
- Portfolio credit should be enlarged to reduce the seasonal risks because the revenue cycle of LKMA is highly affected by seasonal patterns of agricultural activities.

### **5.3.2 BMT UGT Sidogiri**

BMT UGT Sidogiri is a financial institution based on Islamic/sharia system. BMT UGT Sidogiri was established on 5 Rabiul Awal 1421 H or 6 June 2000 which was approved by Head Office of Cooperative and Micro Small Enterprises at Jawa Timur Province. The legal structure and regulation of BMT UGT Sidogiri are authorized by Government Regulation (Ministry, Central Bank, OJK, local government, etc). As an Islamic Financial Services Cooperatives (Koperasi Jasa Keuangan Sharia/KJKS), BMT UGT is supervised by Cooperative Offices at province and district levels. The BMT UGT Sidogiri is regulated under regulations such as:

- the Act of Cooperative No. 25 year 1992
- Permenegkop and UKM No. 35.2/PER/M.KUKM/X/2007 on the Standard Operating Guidelines for Management of Islamic Financial Services Cooperatives (KJKS) and Sharia Financial Services Cooperative Unit (UJKS)
- Permenegkop and UKM No. 5 year 2007 on the health guidelines of the KJKS & UJKS
- Permenegkop and UKM No. 39 year 2007 on the supervision guidelines of KJKS and UJKS

In general, the managerial and administrative structure of BMT UGT Sidogiri follows the rules/guidelines from the Ministry of Cooperative about KJKS and it adopts some managerial and administrative structures based on internal needs.





contract called sharia contract/agreements. There are various sharia contract agreements (based on trading, profit sharing, rental, charity systems and others), which can be applied depending on the needs of the clients. Based on the aqad/sharia contract agreement, the returns may be in the form of trading margin, profit sharing, rental fee, guarantee fee and others. Following are the terms of aqad/contract for some financial products:

- Bai'Bitsamanil Ajil = deferred payment sale
- Hiwalah = contract of debt assignment
- Ijarah = lease contract
- Istisna' = manufacturing contract
- Kafalah = contract of guarantee
- Mudharabah = trust investment partnership
- Murabahah = cost-plus financing
- Qard hasan = benevolent loan
- Rahn = collateral or mortgage
- Syirkah = partnership
- Wakalah = contract of agency

The products offered by BMT UGT Sidogiri are shown in table below.

**Table 10. Financial Products Offered to Members, Prospective Members and Public**

<b>Savings</b>	<b>Financing based on Profit Sharing Agreement</b>	<b>Financing based on Trade Agreement</b>	<b>Services/ Consumer Financing</b>	<b>Other Services (Fee base Income)</b>
1. Umum Syariah (general saving)*	1. Mudharabah or Qirad	1. Murabahah	1. Ijarah/Sewa Beli/Leasing	1. Remittances (now online)
2. Simpanan MDA Berjangka (time deposit)	1. Mudharabah atau Syirkah	2. Bai'Bitsamanil Ajil	2. Rahn/Gadai Emas Syariah/ Sharia Gold Pawning	2. Monthly payments for electricity, telephone, and internet
3. Haji Al-Haromain (Pilgrim)		3. Bai' Al-Salam/ Istishna'	3. Hawalah/Anjak Piutang/Factoring	3. Sharia insurance
4. Umrah Al-Hasanah			4. Kafalah/ Penjaminan/ Guarantee	4. Financing for Hajj & Umrah
5. Lembaga Peduli Siswa (Scholarship)			5. Wakalah/ Perwakilan	5. Facilitating administrative of Hajj & Umrah
6. Iedul Fitri				6. Ticketing
7. Qurban				
8. Walimah (Merriage)				
9. Ziarah Wisata				
10. Aqiqah				

\* This Savings is bundled for financing and time deposits.

Source: BMT UGT Sidogiri (2014)

Since 1 October 2012, all office networks use on-line system. The on-line transaction is used for

- (1) cash deposits
- (2) cash withdrawals
- (3) Remittances between accounts
- (4) Printing customer's account statements

Similar to other financial institutions, BMT UGT Sidogiri also had potential problem of Non-Performing Financing (NPF). BMT UGT Sidogiri attempts to avoid NPF through various ways. Financing application should be acknowledged by the family members of the prospective borrowers. The borrowers and BMT officer pray together just before financing is disbursed. BMT UGT also has repayment schedule/recording system to control NPF. Performance of the BMT UGT Sidogiri is shown in table below.

**Table 11. Financial Performance of BMT UGT Sidogiri in 2012 and 2013**

	2013	2012
Capital		
CAR	27.1%	23.6%
Total equity/Total Asset	22.2%	19.1%
Liquidity		
Cash Ratio	30.5%	26.9%
Current Ratio	122.4%	117.5%
FDR (Financing to Deposit Ratio)	94.6%	81.4%
Asset Quality		
Total Financing/Total Asset	58.8%	65.4%
NBF Brutto	9.7%	8.6%
NBF Netto	2.9%	2.5%
Ratio PPAP (Allowance for Earning Assets)/PPAPWD	42.4%	59.8%
Rentability/Earnings		
BOPO (Operational Cost/Operational Revenue)	61.4	67.5%
Ratio Labor Cost/Total Cost	30%	28.2%
ROE	36.7	38.1
ROA	6.2	5.4
ROI	42.2	4.9
GPM	24.8%	23.2%
Number of branch office & co-branch offices	228 unit	191 unit
Staff	1.130	911
Members	8,872	5,552 orang
Savers	415,771	298,456
Debtors	98,128	76,212
Asset	IDR 1,068,232,262,652	IDR 662,771,142,563

Source: BMT UGT Sidogiri (2014)

The establishment of BMT UGT Sidogiri was supported by 3 types of capital. These are:

#### **I. Own Capital (Total IDR 164,434,550,000)**

1. Principlal savings of IDR 1,000,000 x 8,871 member of BMT = IDR 8,871,000,000
2. Membership based savings of IDR 130,000 x 8,871 member of BMT = IDR 1,153,230,000
3. Exclusive savings of IDR 154,410,320,000

## II. Loan Capital (loan from other banks received at 2013, Total IDR 119,000,000,000)

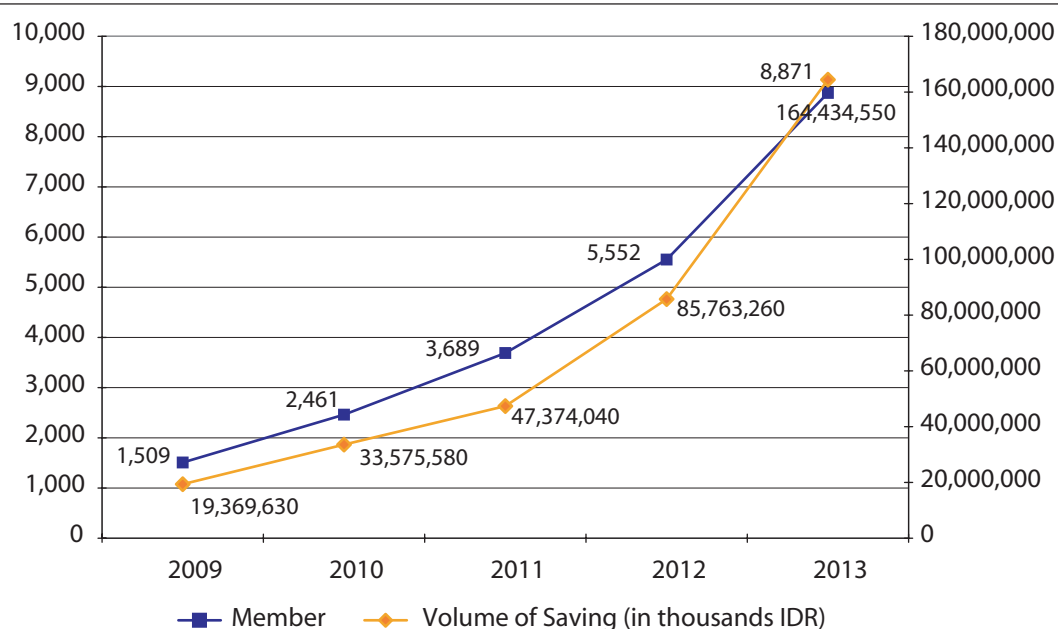
1. BSM branch Sidoarjo IDR 49,500,000,000
2. BRIS Malang IDR 30,000,000,000
3. BCA Syariah IDR 30,000,000,000
4. Bukopin Syariah IDR 10,000,000,000

## III. Third Party Fund (Total IDR 664,465,294,636)

1. Simpanan Umum Syariah (Saving) IDR 453,114,130,977
2. Simpanan Umum Berjangka (equal to Time Deposit) IDR 64,955,710,250
3. Simpanan MDA Berjangka IDR 146,395,453,409

From 2009 until 2013, the number of members and volume of savings have always showed a positive growth which can be seen from the figure below.

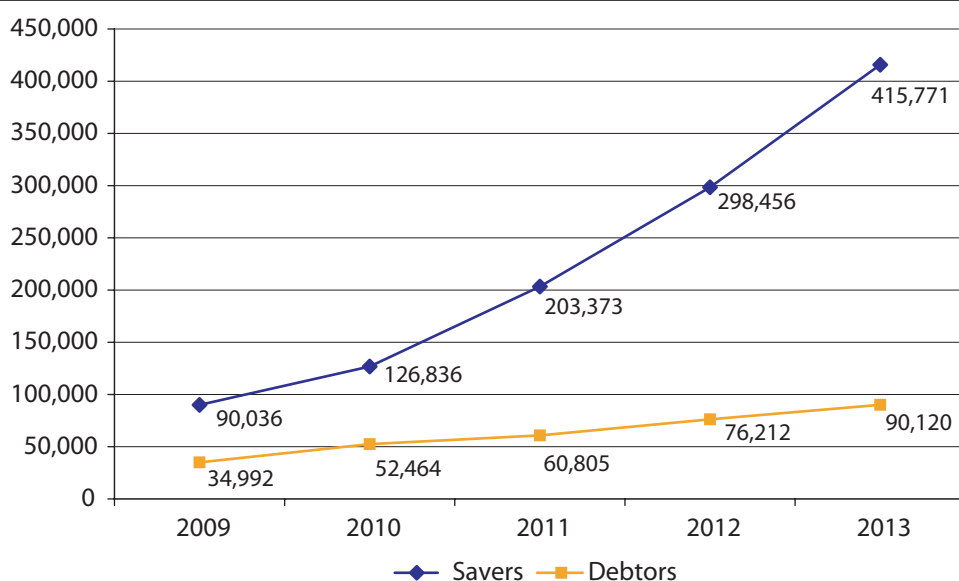
**Figure 7. Number of Members and Volume of Savings at BMT UGT Sidogiri**



Source: BMT UGT Sidogiri (2014)

Moreover, a positive growth of number of members was accompanied by a positive growth of savers. The figure below shows that the number of savers increased significantly than the debtors.

The performance of BMT UGT Sidogiri has been impressive. The table below shows that the total capital and savings of the members, number of debtors, financing and asset have shown a positive growth. In 2007 BMT UGT Sidogiri had an asset base of only Rp. 51,672,554,641. In a period of 6 years the asset grew by 20 times to Rp. 1,068,232,262,652. That is an amazing performance for a financial institution which does not charge any interest.

**Figure 8. Number of Savers and Debtors at BMT UGT Sidogiri**

Source: BMT UGT Sidogiri (2014)

**Table 12. Performance of BMT UGT Sidogiri**

Year	Own capital	Saving of the member	Number of Debtors	Financing	ASSET	ROE (%)	FDR (%)
2007	6,747,450,000	31,176,547,352	18,441	30,317,556,057	51,672,554,641		
2008	12,035,480,000	62,602,493,556	24,092	59,019,170,973	89,380,278,098	38.15	88.26
2009	19,423,830,000	92,249,688,674	34,992	88,478,783,550	133,242,408,136	39.49	85.43
2010	33,575,680,000	150,947,479,950	54,593	148,034,140,674	226,319,513,647	34.5	82.79
2011	47,374,040,000	265,221,225,244	80,805	266,586,707,336	406,198,718,754	38.02	79.81
2012	85,352,500,000	450,193,495,567	76,212	433,699,261,203	622,771,142,563	38.15	91.39
2013	164,434,550,000	664,465,294,636	98,128	628,274,226,519	1,068,232,262,652	36.68	94.55

Source: BMT UGT Sidogiri (2014)

To reach institutional targets, BMT UGT Sidogiri has developed reporting, budgeting and planning systems. For budgeting and planning, annual budget and work plan are prepared. These plans are evaluated in the first and second semesters and at the end of the year. Standard and regular financial reports are of two types; (a) for financial reports, BMT UGT follows the reporting scheme as guided by the Ministry of Cooperatives and Micro/Small Enterprises and (b) for internal users, BMT UGT reports are adjusted based on their internal needs. This BMT also has financial report evaluation. This financial report is prepared regularly for (1) internal management (monthly, quarterly, semester and annually), (2) government supervisory institutions (quarterly and annually), (3) audited by external independent auditor.

### Innovative Approaches and Practices

The BMT UGT Sidogiri is selected as a best practice of financial institution in consideration of several unique features and innovative approaches as explained below:

#### a. Product

- (i) Savings; BMT UGT Sidogiri has two types of savings—voluntary saving for public and membership based saving (principal and compulsory savings). To improve capital capacity of the BMT, there is an option for the members of BMT UGT to contribute more than membership

based savings (principal and compulsory savings. There is a special savings scheme (only for members), which is voluntary.

Principal savings is paid once at membership registration with an amount of IDR 1,000,000. Membership based savings is paid annually in multiples of IDR 10,000. Membership savings (principal savings & membership based savings) cannot be withdrawn as long as they are members of the BMT UGT. Additional deposit and withdrawal from special savings scheme of the membership saving can be done only at certain periods.

Tabungan Umum Syariah savings is a pre-requisite (bundling) to receive financing services. The minimum first/initial deposit is IDR 10,000 and the same for the next deposits. Tabungan Umum Syariah can be withdrawn anytime using saving book or internal card. Administration fee is IDR 2,000 per transaction. For administrative fee, members pay IDR 5,000 when opening the account & there is no monthly administrative fee.

Starting in 2014, BMT UGT has partnership with BRI (co-branding with BRI) launched a scheme to provide card that can be used as ATM and debit card. Withdrawal limit is IDR 1,000,000 per day. Administration fee is IDR 7,000/transaction.

Savings in BMT UGT Sidogiri uses sharia system, which charges no interest. Sharia agreement used for Tabungan Umum Syariah is mudharabah musytarakah with the ratio of 30 percent customer and 70 percent BMT UGT. Membership saving includes special savings, which will earn a share of surplus/profit annually.

- (ii) Financing: There are two productive financing schemes, namely UGT Modal Usaha Barakah (MUB) & UGT Multiguna Tanpa Agunan (UGT MTA) both are covered by insurance. Both types of financing charge no interest (based on sharia system). This financing is disbursed directly to individual/micro small business entity and Sharia agreements are used for UGT MUB—Sharia Agreement of Mudharabah/Musyarakah (based on profit sharing system) and Murabahah (based on trading/buy and sell system), profit sharing and trade margin are agreed by both parties.
- UGT MTA is a multipurpose financing scheme without collateral whose target is to finance individual borrowers and this is a type of charity financing for productive poor. Financing period for UGT MTA is up to 12 months with a maximum financing of IDR 1,000,000. The target group of this financing is people who are productive but not bankable. The process of selection, recruitment, monitoring and supervision is carried out by BMT UGT staff (AOs and their supervisors).
  - UGT MUB is used mainly for working capital which target is to finance individual borrowers or micro and small business entity. Financing period for UGT MUB is up to 36 months with maximum financing of IDR 500,000,000. UGT MUB can be used to finance individual borrowers or micro and small business entities and financing is disbursed directly to the clients. The required documents for applying to UGT MUB are:
    - Copy of applicant's ID cards & of his/her spouse
    - Copy of Marriage certificate
    - Copy of HH card
    - Copy of the last 3 months' savings account
    - Copy of the last 3 months' electricity payment/government's pipe water payment
    - Copy of Collateral ownership
    - Copy of Business Legality (NPWP, TDP & SIUP). This requirement is more flexible to be fulfilled compared to bank

The required documents for applying UGT MTA are:

- Copy of applicant's ID cards
- Copy of ID card of the couple & his/her letter of financing approval

- Copy of Marriage certificate
- Copy of HH card
- Copy of the last 3 months' electricity payment/government's pipe water payment

Sharia agreement used for UGT MUB are Sharia Agreement of Mudharabah/Musyarakah (based on profit sharing system) and Murabahah (based on trading/buy and sell system); profit sharing and trade margin are agreed by both parties. Sharia agreements used for UGT MTA are:

- Murabahah (based on trading/buy and sell system) for working capital financing.
- Qardul Hasan is such of charity financing for working capital financing. Repayment value is exactly the same as the value of financing. Customers may provide the BMT their business profits but not binding & not yet determined in the contract.
- Ijarah, Kafalah & Hiwalah (based on rental based system) for consumer financing.
- Hiwalah is sharia agreement used for debt financing

The repayment of loan is gradual. For debtors in the market areas, deposit money for savings is collected every day and financing repayment can be deducted from their savings account or cash paid monthly to the Account Officer (AO). The role of this type of AO is funding and financing. For debtors outside the market areas there is a policy to do saving every day, but the Account Officer will collect their repayments monthly. The role of this type of AO is financing and maintains the non-performing financing (NPF). The incentive for customer discipline is that, if debtors pay off their financing sooner than scheduled, the margin that should be paid will be deducted.

In BMT UGT Sidogiri does not have additional administrative fee for funding and financing paid by the clients. For financing products there is around 1 percent of the financing value for administrative fee, but it is already calculated in the margin. To propose the financing in BMT UGT Sidogiri, there is collateral which should be fulfilled by client. There are 2 types of collateral—physical/asset collateral and guarantees.

- Collateral in form of land or vehicle is needed when prospective debtors apply for UGT MUB:
- Land (proven by certificate of ownership and certificate right of use), It is calculated as 70-80 percent of the financing value;
- Vehicle (proved by letter of vehicle ownership). It is calculated as 60-70 percent of the financing value
- Guarantees: UGT MTA (particularly with Qardul Hasan agreement) does not require any collateral but it needs personal guarantee particularly from religious leader

## **b. Credit Insurance**

BMT UGT Sidogiri has financing which bundled with savings and credit insurance which provided by sharia national insurance company. This product gives advantages for customer protection because the debtor is protected with financing insurance.

## **c. Point of sale outreach**

BMT UGT Sidogiri also has branches in remote and very remote areas. The presence of branches allows BMT UGT Sidogiri to have products such as remittances whereas other cooperatives rarely have such products. Through remittance, customer in one branch can send money to other customers in another branch. Before BMT UGT Sidogiri had an online service, internal management was done using mobile phone technology by SMS for the remittance services. The remittances use an internal mechanism for deposits across branches.



**d. Guarantee as collateral**

Besides physical/asset collateral in the form of land and vehicle, in BMT UGT there is a product of UGT MTA, which only needs personal guarantee from religious leader. Personal guarantee from religious leader can reduce moral hazard of the debtor.

**e. Institutional Capacity**

BMT UGT Sidogiri has strong institutional capacity. As a cooperative, this institution is successful and has good performance. BMT has 228 branch offices and co-branch offices spread in 10 provinces in 2013. As Islamic financial institution, BMT has a big opportunity to grow and attract many customers. Aside from being a profit institution (Baitul Tamwil) BMT UGT also serve the social objectives (Baitul Mal).

The growth in membership can also be observed. The diversity of products give opportunity to increase savings accumulated, which allows BMT to develop further. Moreover BMT UGT Sidogiri has a special scheme for membership savings. In this scheme, members can save their money up to the amount of IDR 2 billion. This membership savings is calculated in the profit or surplus sharing. Other institutional capacity of BMT UGT Sidogiri can be seen from management practices particularly in financial report evaluation. Financial reports are prepared regularly for internal management monitoring every month, quarter, semester and annually, whereas for government supervision reports are prepared at every quarter and annually. The financial reports are audited by external independent auditor. From the scheme of financial reports it is clear that the management of BMT UGT Sidogiri has accountability and transparent management practices.

BMT UGT Sidogiri also achieves financial inclusion by outreach into un-served rural areas. The BMT has linkages between wholesale institutions and smaller retail entities (cooperative/non-cooperative). BMT UGT is an executing agency for sharia banks. BMT UGT also receives gold as collateral for sharia pawning gold, and this gold is stored in sharia bank. This gold can be used for refinancing scheme by the bank. Moreover, BMT UGT becomes members of some institutions such as INKOPSYAH & ABSINDO. Benefits from being members of these organizations are:

- Financial-source of financing
- Non-financial-relationship with other financial institutions and prestige

**f. Mode of Operation**

Financing schemes in BMT UGT Sidogiri are of two types—one for working capital and another for multipurpose financing without collateral but with guarantor. Advantages for customers from financing in BMT UGT include not only the financing but also members can have savings account and get profit or surplus sharing annually. The financing period is up to 36 months with a maximum financing of IDR 5,000 million. This is not much different from financing from commercial banks and can serve customers who need large amounts. Another advantage from BMT, which is rarely the case with banks is financing up to 12 months with a maximum financing of IDR 1 million without any collateral but with guarantee from the religious leader.

**5.3.3 Grameen Pesisir in KUD Mina Samudera Tangerang**

The Ministry of Marine Affairs and Fisheries formulated the Coastal Community Economic Empowerment Programme (PEMP). This program aims to reduce poverty in coastal communities, particularly for fishing workers to increase their livelihood. To improve the welfare of the coastal community, the program focuses on the revolving fund by Productive Economic Funds (DEP/Dana Ekonomi Produktif). The fund is managed by the Institute of Coastal Economic Micro Mina Development Partners (LEPP-M3) which has been established as a holding company of the coastal communities.

Under the Ministry Decree of Marine and Fisheries (Number.Kep.18/MEN/2004) with general guidelines for the implementation of the PEMP program, there are five stakeholders involved in this program: (1) the government institutions-marine and fisheries departments and provincial government agencies are responsible in the field of marine and fisheries; (2) management consultants-county or city consisting of non-government organizations, universities, or consulting firms; (3) village facilitators; (4) cooperative of LEPP-M3 or fisheries cooperative as recipients of Productive Economic Funds (DEP/Dana Ekonomi Produktif) cooperative capital and (5) Executing Bank which distributes a DEP to LEPP-M3.

Related to those government programs, this study focuses on fisheries cooperatives of KUD Mina Samudera as recipients of DEP funding. KUD Mina Samudera has four business units, consisting of

1. Loan and Savings Unit of Swamitra Mina Samudera (USP Swamitra Mina Samudera)
2. Loan and Saving Unit Grameen Pesisir (USP Grameen Pesisir)
3. *Solar Packed Dealer* for Fishermen (SPDN)
4. Kedai Pesisir Unit (Store for Fishermen)

From the 4 unit businesses of the KUD Mina Samudera, this study focuses only 2 units, USP Swamitra Mina Samudera and USP Grameen Pesisir.

### ***USP Swamitra Mina Samudera***

KUD Mina Samudera collaborated with one commercial bank in running USP Swamitra Mina Samudera. The operational fund comes from the KUD but the management uses system developed by the bank. Swamitra as a business unit of the KUD is regulated under the Act of Cooperative No. 25 in 1992 and Government Regulation No. 9 in 1995 for Saving and Loan Business.

USP Swamitra Mina Samudera provides basic financial products such as savings and credit. These units also provide financial services such as payments for electricity, water, and phone. Financial products offered by USP Swamitra Mina Samudera are:

1. Swamitra savings. This product is a voluntary savings, open access and unlimited so that customers can deposit and withdraw their money any time without limitation on the unit office, as long as the balance is sufficient, using the savings book. The interest rate on savings is 5 percent per annum (PA). This savings product is also a requirement for getting the loan as a tool for auto debit installment payments.
2. Loan bears interest rate of 1.75 percent per month or 21 percent per annum. This is the only loan provided by Swamitra Mina. This loan can be used for productive (investment and capital) and consumptive purposes. This product can be accessed not only by members but also non members of cooperative as long as they can fulfill the administrative requirement, collateral, and other requirements. Loan will be disbursed through their savings account. Some portion of the savings account cannot be withdrawn and the value is accounted in the 5 percent administration fee/charges at the time of credit disbursement. These held/frozen savings will be returned after the debtors repay all their debt (interest and principal).
3. The loan is only for the short term. It's only for 3, 6, 10, 12, 18, 24 months with loan size generally from IDR 1,000,000 to IDR 50,000,000. However, in some cases, the larger loan can be approved up to IDR 150,000,000 and the loan payment period can be extended up to 36 months. This loan is provided not only to bankable people but also unbankable ones who have feasible business. Swamitra Mina Samudera also collaborates with Jiwasraya Insurance (one of national insurance company) to provide credit insurance to protect the borrowers and their families.
4. Swamitra time deposit. This product is the same as the product of deposits in bank with maturity of 1 month, 3 months, 6 months, and 12 months. The interest rate on savings is 8 percent PA.
5. SMS for electricity and telephone payment services.

Customers can pay the installment or deposit their money directly in Swamitra Mina Samudera office. Moreover, an officer (AO) also comes to centers of economic activity (market, TPI, etc.) to collect the fund from customers. Sometimes, customers can ask the officer to collect the money from their home/business place without any charges.

The requirement of savings and loan products are relatively flexible and the process is relatively fast. The administrative requirements that must be fulfilled are not complicated. These include a copy of ID card, cost for saving book, and IDR 10,000 for first minimum deposit. However, loan application is not as easy as savings requirement. There are collateral and administrative requirements. The collateral can be in the form of land certificate, deed of sale or purchase, and copy of land-building tax. If the borrower does not have land certificate they also can hand over letter of vehicle ownership/BPKB of car or motorcycle and copy of vehicle registration certificate/STNK. This collateral generally should cover at least 60 percent of the loan value, although it is opens to negotiation.

Besides giving the collateral, the borrowers should submit the application and other requirements to the officer. Then the officer will analyze how much loan can be obtained by the borrowers. The applications are sent to the bank for disbursement authorization. It needs 5-7 working days to process the document starting from completed requirements until disbursement. The loan fund is directly disbursed to borrowers.

As part of cooperative, one source of initial fund is cash collateral from government (Ministry of Marine Affairs and Fisheries) but the KUD can raise the funds from many sources such as other government programs, soft loans and commercial sources. The government program such as LPDB program from Ministry of Cooperative and KUR micro credit program from BNI are some examples of funding sources for the KUD. The government programs deliver the funds to the KUD, and KUD as an executing institution, the fund is delivered through the USP. Other sources of funds for USP are Third Party Fund (DPK) and monthly interest income.

The USP is supervised by the bank and KUD Mina Samudera. KUD Mina Samudera also has responsibility to help USP improving its performance. Because USP is part of KUD, it affects KUD performance. Manager of USP should report the USP performance (follows the reporting scheme from the bank) to the bank and also to KUD Mina Samudera.

Managerial and administrative structures of the cooperative generally follow the Act of Cooperative and the managerial and administrative structures of the USP generally follow the system developed by the bank. This partnership is represented by name "Swamitra (USP Swamitra Mina Samudera)". In this partnership (in order to use management & IT system of the partner bank), the cooperative pay a management fee of IDR 25 million for the first five years. For the 2<sup>nd</sup> five years it pays IDR 15 million. The cost for IT system is the maximum of IDR 4 million/month. It is costly but it provides a trust for the community and customers.

### **USP Grameen Pesisir**

Grameen Pesisir is a business unit of the cooperative and is regulated under the Act of Cooperative No. 25 in 1992 (contents: Establishment of the cooperative including all requirements). The managerial and administrative structure of the Grameen generally follows the system developed by Ministry of Marine Affairs and Fisheries.

USP Grameen Pesisir in KUD Mina Samudera was formed in October 2013. Until November 2014, number of members serviced by this unit was 1,910 women, coming from 78 Centres and 383 Groups, with one group consisting of 5 women. Majority of the groups in one center are located in the same area. This makes it easy for the group to conduct weekly meetings.

The products of USP Grameen Pesisir include loan and savings. The loan is a group lending so this loan can be given if the borrowers are included into the group. It is distributed among the members using the pattern of 2-2-1 or 3-2 (the poorest members get the first chance in receiving the loans and the leaders are the last ones to get the loan).

This loan is only for a short term – 25 weeks (6 months) or 50 weeks (12 months). The first loan for each member is IDR 1 million or IDR 5 million for a group. If they show good performance in repayment and obey the rules, they can apply for the second loan and the value can be doubled. There are 5 phases and each phase has different IDR 1 million of loan for every member and it cannot exceed the maximum limit for each phase. The total loans as of November 2014 was IDR 2,409 billion with return rate of IDR 1,203 billion and Bad Debt Ratio of 0 percent. This loan need to be repaid gradually during the weekly meetings or at the center meeting to the Cooperative staff. There is additional cost when the member gets the loan. It is 5 percent from the loan, 2 percent for first compulsory saving (record in the saving book), 2 percent for administrative fee and 1 percent for insurance. This credit insurance is managed by the cooperative.

The target of loan is poor families especially women who have potential business or will develop a business or need additional money to support her husband in running household business activities. The required document is only a copy of ID card and borrowers should be organized into groups. There is no physical collateral but each member has a responsibility to supervise other members in the group. So, if one member can not make the repayment, other members should cover it or it become a joint liability of the group members. This also makes the loan to be easily accessed by the poor.

There is an incentive to increase the repayment rate and minimize moral hazard. If a member pays more than one installment, for example, two installments in every weekly/center meetings (the loan is paid off in 10 meetings), this member will have the waiver of the last installment as an incentive. The rule of weekly installment in center meeting is also strict. Praying together (kind of promise to God to fulfill the debt) in the opening and closing of the center/weekly meeting provides members a stronger motivation to pay weekly installment.

This business unit has 2 types of savings, compulsory savings (1 percent from the loan) and voluntary savings. The compulsory savings cannot be withdrawn at any time. It is a pre-requisite (bundling) for credit and this savings is mandatory as cooperative member. Compulsory savings is also collected once at the time of credit disbursement at about 2 percent of credit value or 0.1 percent of credit value if it is collected weekly (or IDR 1,000 if the loans is IDR 1,000,000, IDR 2,000 if the loan is >IDR 1,000,000-IDR 2,000,000, and so forth up to maximum loan as much as IDR 5,000,000). This savings has no interest, but groups will get share of the "cooperative's surplus" every year. This surplus will be given in the form of door prize due to the small amount of compulsory savings accumulated. Then, in each group this door prize will be given in rotation for each member or it can be sold and the money can be distributed among them.

The voluntary savings has open access and it is collected by cooperative staff at weekly/center meeting without minimum value of transaction. For voluntary savings, members can withdraw at the weekly meeting in the center meeting using their savings book and also does not earn interest.

The activity – both savings and borrowing – is conducted at the center. This center could be a home of a member, or another place near the members' home. The management structure of the center is very simple- it consists of head of the center, leader of the group, vice leader and members. The responsibility of the head of the center is to control the entire membership. Group leader controls the members and makes sure that all the members attend the weekly meeting, vice leader collects installments and savings money and writes down in the passbook, which is confirmed by Grameen Pesisir officer in front of all members.

There are some processes to be fulfilled to be a member of the Grameen. Following are the processes carried out either by the prospective members or by the Cooperative Field Staffs (CFS).

- CFSs conduct location survey to observe the potential and feasibility of the location before the program starts.
- CFSs conduct general meeting with the community or prospective members.
- Group formation. Selection of members is carried out by the group leader. They should live in the neighborhood. This is an important step because of joint liability of the members during the repayment period.
- Each group consists of 5 persons (leader, co-leader and members).
- At least 3 groups form a center meeting as a place to carry out all activities.
- CFSs conduct feasibility test to assess socio economic condition of the prospective members including their household business.
- Prospective members should follow 4 days of mandatory training exercises and at the end of the training (on the 5<sup>th</sup> day), there is a group validation test. If they pass the test, they can apply for the loans.
- Credit application process is about 7-14 days.
- To monitor all transactions & activities, CFSs prepare all administrative requirements before conducting weekly/center meeting.

**Table 13. Performance of Savings Unit KUD Mina Samudera**

Indicator	USP Swamitra Mina		Grameen*
	Dec-2013	Oct-2014	Nov-2014
<b>Total saving (IDR)</b>	6,725,385,955	7,125,061,993	Compulsory saving: 99,748,000 Voluntary saving: 68,629,500
<b>Savers</b>	1,978	2,700	Gourp: 382 Members: 1,910
<b>Total Loan (IDR)</b>	7,744,612,399	8,289,386,256	2,409,000,000
<b>Borrowers</b>	652	666	Gourp: 382 Members: 1,910
<b>NPL/BDR (%)</b>		4	0

\* established at October 2013

Source: KUD Mina Samudera (2014)

## 5.4 Key Success Factors

From the competitive profile matrix (CPM) of five selected RFSs, which explains the reasons and circumstances that affect the outcome, best practices on sustainable models of pro-poor rural finance services are LKMA Pincuran Bonjo, BMT UGT Sidogiri and Grameen Pesisir scheme of KUD Mina Samudera. The other two RFSs, KUR micro credit program and SPP UPK could not be categorized as best practices since both RFSs were established mainly through a top-down approach. Although the two RFSs seem to be prospective, their existence are much more dependent on the key implement actors such as central or local governments or commercial bank's technical and financial support. If the supports are suspended or not prolonged, the stability and performance of RFSs will be directly or indirectly affected.

The apparent success of the LKMA Pincuran Bonjo may be attributed to a number of factors, internal and external such as (1) community initiative and resources to establish the LKMA received support from the government through technical and financial supports, (2) The community values and needs are embedded in conducting their activities and providing services, (3) The management mostly from local community who really know the characteristics of the community, so it minimizes moral hazards,



(4) Physical collateral is substituted by guarantee from community elder, (5) The distinctive feature of LKMA Pincuran Bonjo is integrated financial services with facilitating agricultural inputs, marketing station and education for improving capacity of farmers, (6) The LKMA provides innovative saving products, all savings are designed based on the community needs, (7) The LKMA provides innovative loan products with flexible loan term and various repayment options. All loan products are designed based on the community needs, (8) Linking saving (compulsory saving, ledul Fitri saving as incentive) with loan services, (9) good monitoring of LKMA activities and its performances by the member through member's bi-weekly meeting and (10) sense of belonging of members supports the performance of the LKMA.

The success of BMT UGT Sidogiri was attributed to the following factors. (1) BMT UGT were established by the teachers of Islamic boarding school to respond to their needs on working capital and get positive responses from their community, (2) To improve their capital capacity, the BMT designed a special scheme for membership based savings but voluntary in nature, (3) Linking saving with loan services, (4) The BMT provides innovative saving and financing products based on community needs in particular for Islamic financial system, (5) All savings and financing methodology are designed based on the community needs, (6) To protect the loan and its borrowers, micro insurance is taken place, (7) Management mostly alumni from Sidogiri boarding school or have knowledge on sharia financial services, (8) The BMT uses of ICT in improving financial service delivery through on-line transactions, co-branding with BRI; (9) Serve as linkage institutions with Sharia commercial banks; (10) Good monitoring of BMT activities and its performance by regular members meetings, (11) Indonesia is highly potential market for Sharia financial services, (12) sense of belonging of members supports the performance of the BMT.

The success of Grameen Pesisir was attributed to the following factors: (1) The concept of Grameen Pesisir is initiated by government and implemented fully by the resources of KUD Mina Samudera; (2) During preparation and implementation of the Grameen Pesisir concept, the KUD received technical assistance from the government; (3) The common features of implemented Grameen Pesisir program are: small loans and frequent repayment by weekly meeting, self-chosen income generating activities by borrowers, incentives for good payers, Interest rate to cover operational, financial and return, (4) To protect the loan, micro insurance is taken place, (5) Linking saving (compulsory saving) with loan services, (6) Loan terms short and can be selected either 6 months or 12 months, (7) group lending mechanism to overcome collateral problems, (8) Following Gibbons (2006), among essential condition for successful replication of Grameen model are: (a) poverty density and (b) freedom to create self-employment and (9) As part of cooperative business unit, monitoring is implemented in regular basis.

#### **5.4.1 Considerations to Replicate or Upscale the Best Practices**

The experiences of rural finance best practices show that internal management and socio-economic environment will be optimized to reach their success.

- It shows that “top down approach” should be reduced in developing appropriate rural finance services and community driven institution is more recommended.
- Community culture and social values should be embedded in the practices of rural finance services. Implementation schemes elsewhere must be adapted to the local culture because culture and characteristic of communities are definitely different.
- Sense of belonging to the RFS should grow in order to achieve the community mutual goals.
- Community capacity through saving accumulation is therefore saving mobilization from rural community is encouraged.
- Improving the capacity of institutions into sustainable financial institutions
- Providing low cost and tailor-made delivery system

- Products and services should be flexible and vary according to the needs, preferences, daily life and the social economic circumstances of the community served. In other words, demand driven products and services to be delivered. For example, repayment schedule follows the cashflow of the client's activity.
- Innovations in products and systems (such as bundling savings with loans, incentives to repay, substitution of physical collateral by personal guarantee or social collateral)
- Providing low cost mobile services (with limited financial services offered).

Therefore, before replicate or upscale the appropriate best practices, baseline study should be carried out to gather information on the following aspects:

1. Rural poor characteristics including their saving behavior and features of suitable financial product should be collected.
  - Rural poor characteristics; this should be more than demographic and economic information related to the rural poor conditions. It should also cover information on the unique characteristics of rural community which should be embedded in developing rural finance services.
  - Community saving behavior; This is vital since saving mobilization is an important aspect to improve capacity the rural finance services and the community
  - The features of saving, loan and other financial products that fits the community needs to be ascertained
2. Examine the policy and regulatory environment related to rural finance services.
3. Specify financial system and availability of rural finance infrastructures.

#### **5.4.2 Integrated System Framework for Rural Financial Services (case of LKMA Pincuran Bonjo)**

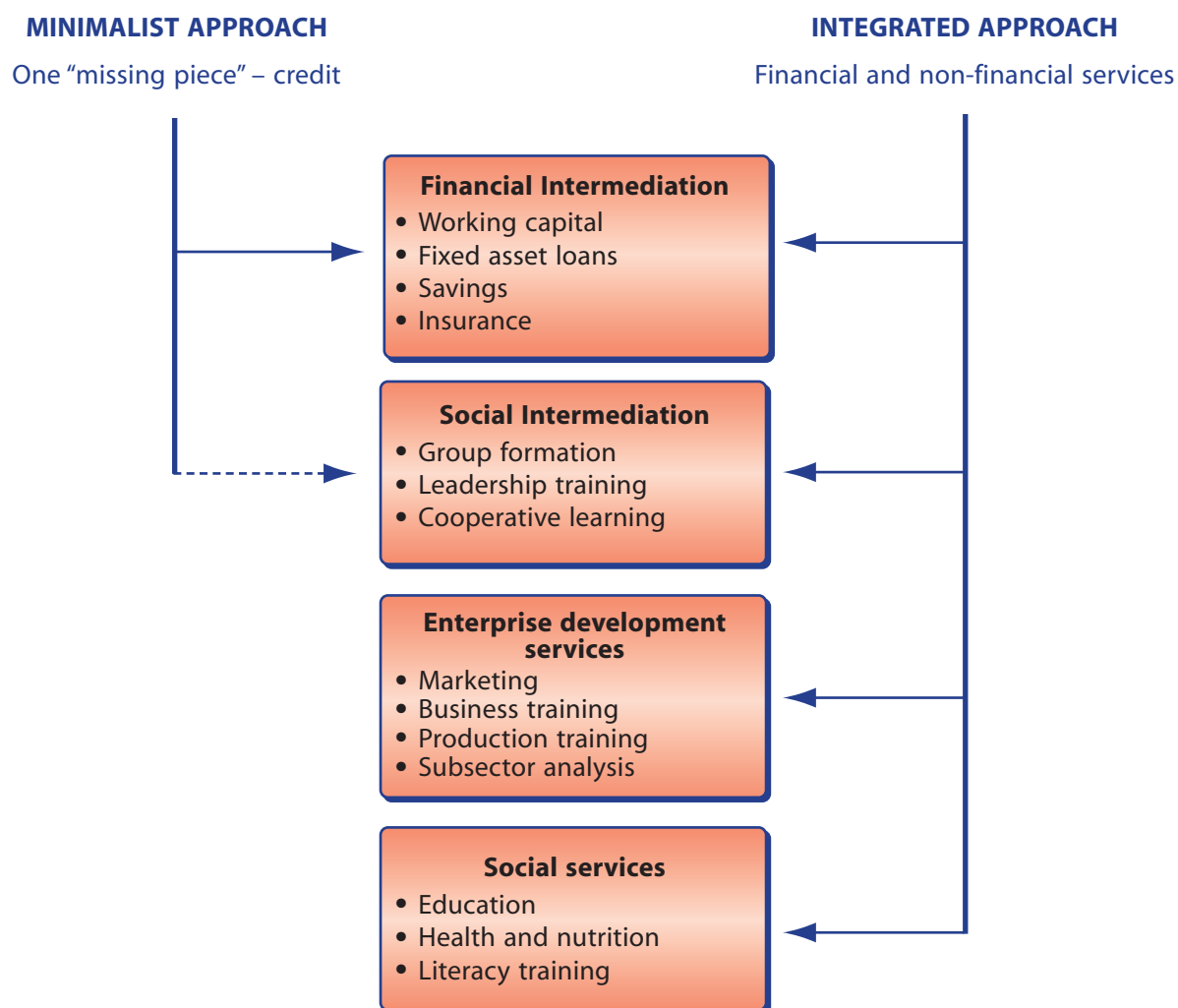
Social and economic activities of rural community are important factors to find appropriate rural financial services. The needs of inputs, production and marketing services for their agricultural activities and their social life circumstances are closely related. Therefore the concept of integrated approaches of financial and non-financial services is proposed to be replicated or upscaled.

Following the concept of integrated approaches (financial and non-financial services needed) vs minimalist approaches (credit as a policy *per se*) by Ledgerwood (1999), integrated approaches provide comprehensive framework for rural financial services. Integrated systems framework provides four broad categories of services that may be provided to the clients:

- Financial intermediation  
The provision of financial products and services are savings, credit, insurance and payment systems.
- Social intermediation  
The process of building the human and social capital is required for sustainable financial intermediation for the poor.
- Enterprise development services  
Non-financial services to assist rural microentrepreneurs such as business training, marketing and technology services.
- Social services  
Non-financial services that focus on improving the well-being of rural microentrepreneurs such as education and literacy training.



**Figure 9. Minimalist and Integrated Approaches to Rural Microfinance**



Source: Ledgerwood, 1999

## CHAPTER 6

# Conclusions, Policy Recommendations and Way Forward

## 6.1 Conclusions

From the literature review and field work carried out, the following conclusions are drawn,

1. The study confirms that the rural poor need not only small loans, but also other types of rural financial products, notably savings. The rural financial institutions have to design their products in line with these poor clients' needs if they want to see their operation to grow sustainably. Their products are acceptable for the poor clients only if they are made available to them at the terms that suit their financial conditions.
2. The rural financial institutions need to deliver these products in innovative ways. High cost of transaction and use of certified asset as collateral are the main standing blocks that prevent the rural poor from gaining access to financial services offered by the commercial banking system. The rural financial institutions have to be innovative in overcoming these standing blocks if they want the poor to access their products.
3. After the conducting the field work, the Country Working Group (CWG) has agreed that only three out of the five identified best practices have a good prospect for replication and up-scaling in other part of Indonesia and in other countries. These selected schemes are (a) LKMA Pincuran Bonjo, (b) BMT UGT Sidogiri, and (c) Grameen Scheme of KUD Mina Samudera. The first and second financial institutions are all established by local initiative. The third is initiated by government for growing micro finance institutions to provide group lending scheme but funding basically from the micro finance institutions. They have been able to tailor their products to meet the needs of the rural poor clients and to develop innovative ways to make local poor accessible to these products. While both BMT UGT Sidogiri and LKMA Pincuran Bonjo have been tested over time, the Grameen Scheme of KUD Mina Samudera has not yet been fully tested. This scheme has been in operation for only one year.

## 6.2 Policy Recommendations

The preceding discussion does not imply that the BMT UGT Sidogiri, LKMA Pincuran Bonjo and Grameen Scheme of KUD Mina Samudera have no weaknesses. It is also not yet clear as to what extent these institutions can be adapted to different socio-economic environments. All these issues can be learned through a pilot project, which can be used as a medium for learning process to find answers. Therefore, the pilot project is expected to produce several outputs.

1. Improved access of rural community to financial services/increased outreach  
The proposed three schemes can be replicated in other areas with two important principles:
  - General features can be directly implemented such as savings mobilization process
  - Specific features require some adaptations to the local political/economic/social and environmental circumstances.
2. Enlarged functions of rural financial services  
The proposed system framework for rural financial services is an integrated approach to be gradually provided for the rural community-financial intermediation, social intermediation, enterprises development services and social services.

### 3. Financial services diversification

The range of products commonly provided includes credit/financing, savings, micro-insurance, payment services. Development of financial services focused on rural areas should meet some key principles:

- To respond effectively to the *demand (the needs)* and preferences of clients
- *simple products* in order to be easily understood by the clients and easily managed by the institutions
- Accessibility, affordable price and the quality of the products

Following Ledgerwood (1999) and findings from the fields confirm that providing lending/financing products should follow principles such as:

- a. Offer services that fit the preferences of poor entrepreneurs.
- b. Streamline operations to reduce unit cost
- c. Motivate clients to repay loans
- d. Ensure the sustainability, interest/fee through subsidies. It should cover full-cost interest rates and fees.

### 4. Availability of supporting facilities for the effective working of rural financial institutions

## 6.3 Way Forward: Pilot Testing of Good Practices

- 1) This study proposes three rural finance best practices-LKMA Pincuran Bonjo (Individual Lending from Community driven institution)
- 2) BMT UGT Sidogiri (Individual Lending using Sharia system)
- 3) Grameen Bank of KUD Mina Samudera (Group Lending methodology in coastal areas)

To replicate or scale up the three rural finance best practices, they need some adjustment and adaptation to the local political/economic/social and environmental circumstances of the areas where they are introduced/replicated. Geographic and regional diversity with its unique culture, social and economic values should be considered in implementing the replicated schemes.

This pilot project is expected to produce several outputs:

### 1. Improved access of rural community to financial services/increased outreach

The three proposed rural finance best practices have unique features in their operational and daily activities. The lending methodologies offered by the three institutions represent individual and group lending methodology, with sharia and conventional system. These schemes can be replicated in other areas with two important principles viz,

- General features can be directly implemented such as savings mobilization process, improving access to the rural community by door to door services, etc.
- Specific features require some adaptations to the local political/economic/social and environmental circumstances. One example is physical collateral requirement. This type of collateral can be substituted by personal guarantee or social collateral depending on the community's culture.

### 2. Enlarged functions of rural financial services

The proposed system framework for rural financial services is an integrated one. With integrated approach, rural financial institutions serve more than just financial services. The institutions provide other important services to the rural community such as social intermediation, enterprises development services and social services. All these services can be gradually implemented.

### 3. Financial services diversification

The range of products commonly provided includes credit/financing, savings, and micro-insurance and payment services. Development of financial services focused on rural areas should meet some of the following key principles:

- To respond effectively to the *demand (the needs)* and preferences of clients (and prospective clients) in the rural areas
- Design *simple products* in order to be easily understood by the clients and easily managed by the institutions
- Accessibility, affordable price and quality of the products

Following Ledgerwood (1999) and findings from the field confirm that providing lending/financing products should follow principles such as,

- a. Offer services that fit the preferences of poor entrepreneurs.
  - Short loan terms, compatible with enterprise/business cycle and income patterns
  - Repeat and potentially be gradual loans
  - Start with small loan size
  - Relatively unrestrict use of loans
  - Customer friendly approach to be adopted
- b. Streamline operations to reduce unit cost
  - Applications to be very simple and approved on the basis of easily verifiable criteria, such as the existence of a going enterprise.
  - Decentralize loan approval.
  - Maintain inexpensive offices
  - Select staff from local communities, including people with lower levels of formal education (hence lower salary expectations but have strong motivation)
- c. Motivate clients to repay loans
  - Incentives
  - Joint liability groups
- d. To ensure their sustainability, interest/fee should not be subsidized. It should cover full-cost interest rates and fees.

### 4. Availability of supporting facilities for the effective working of rural financial institutions

The proposed modalities for the Pilot Project are as follows:

- Base Line and End Line Studies
- Reviews of several aspects related to improvement of RFI capacities
- Workshop to introduce and provide a channel for brief discussion about policies, research or survey results and other similar activities;
- Workshop-training
- Training and capacity building
- Modules and standard operating procedures (SOP) development;
- Focus Group Discussions
- Provision of Technical assistance for RFIs in conducting activities that have been previously practiced during training, or provide assistance for testing a system/mechanism/tool that has previously been developed.
- Provision of supporting facilities for effective working environment of RFI

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## Annex 1

**Table 1. Summary table of References/documents/source of information for desk review**

Themes	Documents/Source of information to be reviewed
Theoretical overview on rural financial services	<ul style="list-style-type: none"> <li>• Andrew, M. 2006. Micro credit and Agriculture: How to make it Work. MEDA, Canada.</li> <li>• DFID. 2004. Making Rural Finance Count for the Poor</li> <li>• FOCUS. 2008. Accessing Financial Services in Rural Areas. Inforesources FOCUS No. 2/8.</li> <li>• GTZ. 2005. Reforming Agricultural Development Banks. Federal Ministry for Economic Cooperation and Development</li> <li>• IFAD. 2009. Rural Finance Policy. Rome.</li> <li>• IFAD. 2009. Rural Finance; small Amounts Making a Big Difference. Italy.</li> <li>• Meyer, Richard L. Micro credit and Agriculture: Challenges, Success and Prospects.</li> <li>• Pederson, G. 2002. Rural Finance Institutions, Market and Policies in Africa.</li> <li>• The World Bank. 2007. Providing Financial Services in Rural Areas; a Fresh Look at Financial Cooperatives. Agriculture and Rural Development Department, World Bank. Report No. 40043-GLB. Washington, DC.</li> <li>• Yaron, J., Benjamin, Mc D., Charotnenko, S. 1889. Promoting Efficient Rural Financial Intermediation. The World Bank Research Observer Vol. 13 No. 2, pp. 147-70.</li> <li>• Yaron, 2004. J. Rural Microfinance: The Challenge and Best Practices. Tanzania</li> <li>• Zeller, M. and Sharma, N. 1998. Rural Finance and Poverty Alleviation. IFPRI. Washington, DC.</li> </ul>
Policies, Regulatory framework and Strategies of Rural Financial Services in Indonesia	Law and regulation on microfinance, for example Act No. 1/2013 of microfinance institution; Publications from BI (Central Bank of Indonesia), OJK (Indonesian Financial Service Governing Authority) and other related institutions
Review of Regulations on Credit Scheme Programmes of Indonesia such as credit for food security and energy (KKP-E), KUR, and/or other commercial schemes.	<p>Reports of the ministries</p> <p>Reports of the Donors</p> <p>Reports of public and private financial institutions</p> <p>Previous related studies</p>
Reports of Rural Financial services implemented in Indonesia managed by different institutions	<p>Reports of the ministries</p> <p>Reports of the Donors</p> <p>Reports of public and private financial institutions</p> <p>Previous related studies</p>
The Asia-Pacific Rural and Agricultural Credit Association (APRACA)	Finpower, Fiservaccess, Microserv projects

<p>Inclusion criteria IFAD Program</p>	<p>Inclusion criteria from various sources Rural Empowerment and Agricultural Development Programme in Central Sulawesi (READ) Supervision report 2013 Smallholder Livelihood Development Project in Eastern Indonesia (SOLID) Supervision Report 2012 Coastal Community Development Project Design Completion Report 2012</p>
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