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Desa Pakraman and Lembaga Perkreditan Desa in Bali

A study of the relationship between customary governance, customary village development, economic development and LPD development

by

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CONTENTS

List of tables

Abbreviations and acronyms

BKSLPD	Badan Kerjasama LDP, association of LPDs
BPD	Bank Pembangunan Daerah, regional development bank (of Bali)
BPLPDK	Badan Pembina LPD Kabubaten, guidance board of the district administration
KSP	Koperasi simpan pinjam, savings and credit cooperative
LDKP	Lembaga Dana Kredit Pedesaan, rural credit institution (under provincial law)
LPD	Lembaga Perkreditan Desa, village credit institution (in Bali)
LPPLPD	Lembaga Pengembangan & Pelatihan LPD, LPD development and training institution
MSE	Micro and small enterprise
PAR	Portfolio at risk
PLPDK	Pembina LPD Kabupaten, LPD guidance organization at district level
PLPDP	Pembina LPD Propinsi, LPD guidance organization at provincial level (no permanent office or staff, works with PLPDK, LPPLPD)

Glossary

Indonesian (Balinese)	English
Adat	Customary law
Asuransi Kumpulan	Group life insurance for loan protection
Awig-awig (bal.)	Internal regulation, bye-laws of a customary village, since around 1970 increasingly in written form; adoption is a sacred process
Badan pengawas daerah (BAWASDA)	Supervisory body of the district administration (intervening in case of major problems)
Badan pengawas internal	Supervisory board (of LPD)
Banjar (bal.)	Customary community as part of a village
Bapak angkat	Godfather relationship, as between corporations and small enterprises
Bendesa (bal.)	Elected head of the customary village
Dana pembangunan	Development fund (of LPD), 20% of profit
Dana sosial	Social fund (of LPD), 5% of profit
Bendesa (bal.)	Head of customary village, also kelian desa pakraman or pakraman

Dana perlindungan LPD	LPD protection fund (kept in BPD)
Desa adat	Village based on customary law, with three village temples. The desa adat is the owner of the land; the residents are leaseholders.
Desa pakraman (bal.)	Customary village, the village of the krama, gradually replacing the term desa adat in Bali (eg, as in: LPD Pakraman Lepang)
Desa Dinas	Administrative village
Dusun	Administrative community as a subdivision of a village
Karma	Deeds – past, present and future – making a person responsible for his life in this world and in the beyond. Karma-phala are the results of one's action. In reincarnation karma extends through one's past, present and future life.
Kelian (bal.)	Head, elder
Kepala	Head
Krama	Residents of a customary village (in some areas all indigenous adult married people, elsewhere indigenous household heads; in some areas it includes those who have married into the village)
Krama ngarep (bal.)	The native residents of a customary village with full attendance and voting rights in village and banjar assemblies, usually represented by the household heads
Krama tamiyu	"Guest" residents, without full participation rights. They may pay a token fee annually (eg, 20 kg of paddy) for the privilege of living in the village
Pakraman (bal.)	Customary law, also adat
Paruman	Assembly (of desa, banjar)
Pecingkreman (bal.)	Savings and credit association in the banjar; same as seka simpan pinjam
Peniarikan (bal.)	Secretariat of desa or banjar
Pegawai	Staff, employees
Pembina	Support, guidance
Pengawas	Board members
Pengurus	Management
Perarem (bal.)	Appendix to awig-awig, implementation regulation
Perwakilan	Representative (eg, of banjar in prajuru desa)
Prajuru desa	Council of customary village (bendesa and elected councilors)
Seka (bal.) simpan pinjam	Savings and credit association in the banjar; same as pecingkreman

1. Introduction

Lembaga Perkreditan Desa (LPD) is a financial institution with two unique characteristics: (a) as an institution owned and governed by the customary village (desa adat, desa pakraman), it is fully integrated into Balinese culture; (b) like no other financial institution, it is inclusive in outreach, covering almost all customary villages of Bali and the vast majority of its population. Based on an analysis of case studies and secondary data, this study aims to deepen our understanding of the relationship between governance by the customary village, institutional performance and economic development as a basis for designing strategies to strengthen smaller and weaker institutions and manage the risks of larger ones.

More specifically, the study deals with the following questions and issues:

- What are the cultural and religious foundations of the LPDs?
- How were the LPDs established as non-bank financial institutions at the level of the customary village?
- How are the LPDs governed; and what has been the role of the customary village in governance?
- What have been the benefits of the LPDs, what has been their impact on the customary village?
- What are the most critical issues that need to be addressed?
- What are major challenges and areas for further research?

2. Foundations, framework and development of LPDs

2.1 The cultural and religious foundations of the LPD in Bali

Lembaga Perkreditan Desa (LPD) is a network of financial institutions under provincial law in Bali which are owned, financed and governed by the customary village. They function as autonomous village banks, but are not authorized to call themselves banks because they are not licensed and regulated by Bank Indonesia. Their unique character within the Indonesian financial landscape is shaped by a combination of several factors: a regulatory framework issued by the Governor of Bali in 1984, revised in 1988 and amended as the network evolved; a system of self-management and self-governance integrated into the customary village; self-financing through deposit mobilization and retained earnings; and the interdependence of three types of economies within the local community: the households with their rice farms, livestock and microenterprises; the customary village; and the LPD. The common bond holding all these spheres together transcends the world of finance and economics: the religious belief in a uniquely Balinese cultural essence which binds together past, present and future lives and permeates all aspects of life. The LPD is designed as an integral part of Balinese culture. The explicit purpose of establishing a network of LPDs throughout Bali has been the preservation and strengthening of the customary village as the communal space of Balinese economic life, culture and religion.

Bali is comprised of two systems, distinct and overlapping at the same time. One is secular and part of the overall Indonesian political system: a province headed by a governor and structured in an administrative hierarchy of districts (*kabupaten*), sub-districts (*kecamatan*), administrative villages (*desa dinas*) and quarters (*dusun*), each headed by an elected *bupati*, *camat*, *kepala desa* and *kepala dusun*, respectively. The other one is cultural and religious: a Hindu island determined to preserve its identity, headed by the same elected governor who presides over the province, and structured along customary lines of descent and residency in 1433 customary villages with 3945 communities (*banjar*).

The highest authority of the village is the assembly (*paruman desa*) of the customary residents, which elects the village council, *prajuru desa,* and the head of the village, *bendesa*, who presides over the village council. In the execution of his customary duties the *bendesa* is assisted by a secretariat, *peniarikan*. The basic community in Balinese society is the *banjar,* headed by the *kelian*, an elected elder presiding over the assembly of the banjar residents. Each banjar comprises numerous associations, among them an orchestra and dance association, *seka gong*, a savings and credit association, *seka simpan pinja*m or *pecingkreman*, and a youth association, *seka taruna*.

The political system of the customary village is a mixture of direct and representative democracy. Krama are the residents of the banjar and the customary village. While there is some local variation, there is a basic distinction between krama ngarep, the native residents of original descent within the community, with full attendance and voting rights at assemblies; and krama tamiyu, "guest" residents without full participation rights. In the banjar the krama ngarep, usually represented by the heads of household, participate in the monthly banjar assemblies (paruman) held at the assembly hall, bale banjar. In small villages all krama ngarep participate in village assemblies (paruman). In larger villages, the krama ngarep elect their representatives (perwakilan) at the banjar assembly, who then form the council of the cstomary village (prajuru desa).[1]

2.2 Establishing the framework

The initiative to establish a network of LPDs in Bali was taken by Governor Prof. Dr. Ida Bagus Mantra. The regulatory framework for the pilot phase, March 1985 to March 1988, was laid down by Governor Decree No. 972/1984 and finalized by Provincial Government Regulation No. 2/1988, which defined the *desa pakraman* as the owner and are of operation of the LPD. Each LPD received a start-up capital, initially amounting to Rp2m (equivalent to US$1780 in 1985). Attempts of converting the LPDs into rural banks (BPR) regulated by BI were resisted, as this would have been incompatible with the notion of large numbers of small village-based institutions too small to be supervised by BI. Finally, in a letter dated Feb 17, 1999, BI gave its approval to LPDs as non-bank financial institutions in Bali.

2.3 Development of LPDs

The number of LPDs increased steadily during the first ten years, reaching 849 in 1995. During the next four years their number stagnated. In 2000 growth resumed, reaching 1356 LPDs as of June 2008, covering 95% of the 1433 customary villages. By excluding 71 LPDs which are unsound (*tidak sehat*) and 99 which are non-performing (*macet*), the number of reasonably well performing LPDs is reduced to 1186; of these 984 are sound, 144 fairly sound and 58 less sound. A total of 372 LPDs, or 27%, thus require attention from the guidance agencies. 88.2% of the portfolio is classified as standard, which means that 11.8% is technically at risk, comprising 6.5% substandard, 3.0% doubtful and 2.3% loss. 83.9% of the clients are classified as standard; the loans of 4.4% are classified as loss.

Borrower and depositor outreach of the 1356 LPDs is given below. Statistically, LPD outreach is virtually universal. On average every family, out of a total of 834,000 families[2], holds 1.4 savings and term deposit accounts; and almost every other family (44%) has a loan outstanding. Assuming that every borrower as well as every holder of a term deposit account also holds a savings account, net outreach is 1.12m.

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

[2] Population size: 3.4m

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

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

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

Table 2: Depth of financial services of LPDs, June 2008

All LPDs:	Rupiah	US$
Loans outstanding	2.0 trillion	217 million
Savings & fixed deposits	2.4 trillion	261 million
Savings *Fixed deposits*	*1.3 trillion* *1.1 trillion*	*138.8 million* *122.7 million*
Total equity	0.5 trillion	57 million
Average amount per LPD:		
Loans outstanding	1.5 billion	160,000
Savings & fixed deposits	1.8 billion	193,000
Equity	0.4 billion	42,000
Average amount per client:		
Loans outstanding	5.5 million	594
Savings & fixed deposits	2.0 million	217
Savings *Fixed deposits*	*1.1 million* *13.6 million*	*$124* *$1,478*

More detailed information about the growth and outreach of LPDs for the period from 1999 to June 2008 is given below in **Error! Reference source not found.**, pertaining to all licensed LPDs. From 1999 to June 2008 the number of borrowers increased from around 205,000 to 365,000. The number of depositors (comprising both savings and deposit accounts) doubled from around 612,000 to 1.2 million. Borrower outreach per LPD grew from an average of 225 to 269, depositor outreach from 671 to 889. During the same period the loan portfolio and total client deposits grew more than 9-fold. In US$ terms, average loans outstanding per LPD increased from $33,323 to $159,864, the average deposit balance per LPD from $39,858 to $192,841. Average loans outstanding per borrower grew from $148 to $594, the average deposit balance per depositor from $59 to $217.

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

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

Table 3: Basic LPD data, 1999 - June 2008

Amounts in million Rupiah:	**1999**	**2001**	**2003**	**2005**	**2007**	**Jun-08**
No of desa pakraman	1371	1380	1407	1414	1433	1433
No of licensed LPDs	912	953	1208	1304	1351	1356
No of borrowers	204,842	233,990	301,328	333,798	359,507	365,044
Average no borrowers per LPD	225	246	249	256	266	269
Average loan outst'g per LPD	237	537	628	968	1309	1469
Av. loan outst'g per borrower	1.1	2.2	2.5	3.8	4.9	5.5
No of savers & depositors	611,531	743,636	885,325	1,021,799	1,193,469	1,204,982
Av. no per LPD	671	780	733	784	883	889
Av. deposits per LPD	283	567	674	1032	1515	1772
Av. deposits per depositor	0.4	0.7	0.9	1.3	1.7	2.0
Total assets per LPD	371	730	889	1,337	1,938	2,217
Total equity per LPD	83	150	199	285	396	412
Amounts in US$:	**1999**	**2001**	**2003**	**2005**	**2007**	**Jun-08**
Average loan out'g per LPD	33,323	51,667	74,595	98,455	138,997	159,864
Av. loan outst'g per borrower	148	210	299	385	522	594
Av. deposits per LPD	39,858	54,497	80,022	104,972	160,827	192,841
Av. deposits per depositor	59	70	109	134	182	217
US$ exchange rate	7100	10400	8425	9830	9419	9189
Balance sheet, in billion Rp.	**1999**	**2001**	**2003**	**2005**	**2007**	**Jun-08**
Cash	8.4	19.2	32.9	39.4	65.0	66.5
Deposits in banks	111.2	156.0	259.5	406.9	720.5	864.6
Gross loans outstanding	215.8	512.1	759.2	1262.0	1768.7	1992.0
Loan loss reserve	-4.7	-8.9	-15.5	-27.2	-41.1	-43.6
Net fixed and other assets	7.9	17.1	37.4	62.0	105.2	126.4
Total Assets	338.7	695.6	1073.4	1743.1	2618.3	3005.9
Client savings & deposits	258.1	540.1	814.4	1345.6	2046.5	2402.9
Borrowings & other liabilities	5.3	12.2	18.6	25.9	36.1	44.2
Equity (incl. profit of the year)	75.3	143.3	240.4	371.6	535.7	558.8
Total Liabilities	338.7	695.6	1073.4	1743.1	2618.3	3005.9
Profit of the year	27.1	54.4	71.0	106.3	131.1	77.5
Total assets in million US$	47.7	66.9	127.4	177.3	278.0	327.1
CAR (*excl. profit of the year*)	14.2	12.8	15.8	15.2	15.4	16.0
Return on average assets		9.1	7.4	6.7	5.7	

3. Case studies

The case studies reported below focus on three aspects indicative of the comparative strength of the LPD. The first aspect pertains to the crucial importance of good governance and the role played by the board of supervisors, first in the fall of an LPD due to neglect by the board, and then in the rise of an LPD revitalized by a resuscitated board. The second aspect relates to the comparative advantage of well-governed LPDs in the face of strong banking competition. The third aspect pertains to the economic and social impact of the LPD on the desa pakraman.

3.1 If governance fails: the role of the board in the fall and rise of an LPD – The experience of four LPDs –

The importance of good governance is most evident in those cases where cooperation between board, management and customary village has broken down; and where the re-establishment of good cooperation has subsequently revitalized the LPD. Three of the case studies presented below deal with past experience and the successful turn-around of an LPD; the fourth presents the ongoing experience of an LPD yet to be rescued:

- The first is LPD Kayu Kapas, a very small LPD where an inexperienced board learned only after a crisis what its obligations were; and which is now running smoothly despite its minimal size and remote location.
- The second is LPD Kapal Mengui, one of the larger LPDs, which was brought down by fraud and delinquency after several years of good performance, but brought back to life by a new board with a high level of competence and motivation.
- The third is LPD Gelgel, one of the larger LPDs, which fell into disarray after ten years and was turned into a model LPD by a committed new governance team including a professional manager.
- The fourth is LPD Satra, a small LPD which has been ailing for years while everyone has been watching its downfall without taking action, including the manager, the old and the new board and the various guidance agencies, raising serious questions concerning the effectiveness of the system of guidance and supervision.

LPD Kayu Kapas in Bangli district is a tiny LPD which broke down early in its history and could easily have been given up for lack of feasibility. The village, located in a remote area, consists of a single banjar, with 138 families. The manager of the LPD reports that it was established in 2002, even though it is listed by PLPDK as having been licensed in 1997. Bookkeeping is done manually; and there is no telephone connection. The LPD worked reasonably well during the first year, 2003. But the board, comprising three farmers, one of them also a small entrepreneur, was inexperienced and unaware of its responsibilities. Bookkeeping was manual; there was no internal control; nor was external oversight effective. Problems started in 2004, when savers could not withdraw their money, and no new loans were issued. It turned out that the manager of the LPD had used a substantial amount of the funds for his own purposes.

As he did not repay, the borrowers also refused to repay. The guidance agency, PLDPK Kintamani, kept visiting the LPD, but was unable to revive the LPD, which became dormant for two years. No records were kept during that period.

The turn-around came in May 2007 when the PLPDK invited LPD Batur, a well-functioning neighboring LPD, to instruct the board about its responsibilities and motivate everyone to revitalize the LPD. The bendesa and the manager of the LPD also visited several other LPDs. Without any changes in its composition, the board succeeded convincing the LPD manager and the borrowers to repay their old debts in full. With the help of a six-month loan of Rp3m from LPD Batur, which was repaid on time, it resumed operations.

By December 2007 the LPD had 110 savings and 81 loan accounts from among the 138 families of Kayu Kapas. Total assets amounted to Rp 42.1m, loans outstanding to Rp35.1m (averaging Rp 433,000 per loan), savings to Rp20.0m and net profit to Rp 2.4m. The LPD adjusted its risk management to its human and financial capacities, limiting loan sizes to a maximum of Rp5m and loan periods to 10 months[3]. As a result there were no arrears. The LPD was classified as healthy (*sehat*). By August 2008 total assets had increased by 85% to Rp77.8m, loans outstanding had declined to Rp31.1m. Savings had soared to Rp52.0m – an increase of 160% and a strong indication of restored confidence. Rp20.1m of surplus funds were deposited in BPD. Again, there were no arrears, and the LPD was classified as healthy. Interest income (including income from penalties and fees) amounted to Rp9.4m during the first eight months of the year; salaries of Rp3.35m were the biggest expense item, constituting 74% of expenditure; and net profit amounted to Rp4.6m. Return on average assets was an impressive 7.7%.

However, the large share of salary expenditure raises the issue of adjusting the size of employment to its business volume. According to regulation an LPD has a minimum staff of three, which is beyond the requirements of a small village. A small LPD may do very well with a single staff member, ie, the manager, and still adhere to the four-eye principle[4]. More accurately, one should say it adheres to an eight-eye principle, as it includes three board members watching over it. At the same time the opening days and hours of very small LPDs may be reduced. This would increase their profits substantially, including the size of its development and social funds. Differentiation of regulation by size of LPD is a policy issue that needs further attention.

The case of LPD Kayu Kapas district shows first how a young LPD breaks down if the board is not made aware of its responsibilities. But in a second phase it also shows that, with proper guidance, a non-functioning board can be turned around, revitalizing a non-performing LPD, restoring confidence, achieving full repayment of arrears despite an extended period during which the LPD was practically closed, and returning to

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3 This is in contrast to another relatively small LPD visited (LPD Satra, Klungkung), with total assets of Rp800m, loan sizes of Rp0.5m-25m and loan periods of 1-5 years, far beyond its management capacity. Not surprisingly that LPD is in serious trouble.

4 In Germany, where local financial institutions had come under the banking law in 1934, the four-eye principle as a regulatory requirement for small village banks was only introduced in 1974, when they had attained a considerable size and started being merged into larger entities comprising several villages.

profitability – all this in a very small and remote village normally considered unsuitable for a financial institution of its own. The initiative to revitalize the LPD had come from the PLPDK, but only after a delay of three years. The key instrument used by the PLPDK was the mobilization of both technical and financial assistance by a well-functioning neighboring LPD.

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

The LPD now has 8,270 savings & deposit accounts and 843 loan accounts. The total number of management and staff is 22, including 13 collectors. By December 2007 total assets amounted to Rp16.8bn, loans outstanding to Rp 11.7bn. Savings and deposits amounted to Rp 14.85bn. Rp4.2bn in excess liquidity were deposited at BPD. Total equity stood at Rp1.9bn, including Rp0.6bn in profits of the year. Portfolio growth seems to have reached a certain limit, reaching Rp12.3 as of August 2008; savings and deposits stood at Rp16.9bn. However, its profitability is still growing; at Rp0.6bn, profits by August 2008 the LPD have already attained the amount of the whole of 2007. Loan sizes range from Rp 500,000 to Rp250m; the maximum loan period is 5 years. The LPD seems to be managing the risks of an excessively long maximum loan period rather well: defaults, accumulated since inception since there is no write-off, are below 1% of loans outstanding.

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

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

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

0.3% of the portfolio is overdue, and another 0.3% is classified as bad debts, but are still expected to be recovered.

The board succeeded to restore trust, turning the loss of Rp0.9m of 1999 into a profit of Rp41m in 2000 and Rp125m in 2002. Profits have continued to grow every year, up to Rp515m in 2007.[6] As of August 2008 total assets amounted to Rp13.5bn, loans outstanding to Rp9.7bn, savings and deposits to Rp10.8bn, total equity to Rp1.6bn and profits during the first 8 months of the year to Rp0.37bn. LPD Gelgel is also involved in liquidity exchange with other LPDs in the area. A beautiful new building is under construction, fully financed from its own resources: a public display of success, next to the market and the *pura desa*, the largest temple of Gelgel.

The case of LPD Gelgel demonstrates how a committed new governance team together with a professional manager is able to restore trust and achieve full repayment of overdue loans, using a soft approach without ever taking recourse to the seizing of collateral. As in Kayu Kapas, well-performing LPDs in the area played a supporting role. In contrast to LPD Kapal Mengui, with maximum loan periods of five years, the manager of LPD Gelgel felt that loans for more than two years would be too risky; both LPDs have fared well with their different policies; but LPD Gelgel is probably better prepared for systemic risks comparable to the one which at present has afflicted the global economy.

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

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

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

Table 4: Loan portfolio classification of two neighboring LPDs (in percent)

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

*Error due to rounding

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

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

3.2 The comparative advantage of the LPD in a competitive environment – The experience of six LPDs –

Bali has a differentiated financial landscape, comprising a variety of formal, semiformal and informal financial institutions. Commercial and rural banks are the main competitors of the LPDs. In all the villages visited we found one or several formal financial institutions in the vicinity, most often a rural bank (BPR) and a BRI microbanking unit, but also commercial bank branches or cash offices. Among the banks is the provincial development bank BPD with its branches, where all government employees hold accounts and receive their salaries. Downstream the LPD competes with many semiformal financial institutions, such as savings and credit cooperatives (KSP) and for informal institutions, such as rotating savings and credit associations (a*risan*, or *selisian*, and *arisan PKK*) and the formerly ubiquitous *seka simpan pinjam*, or *pecingkreman*, which has now been largely replaced by the LPD. For many of these the LPD acts as a local banker, accepting their deposits and providing loans. How does the LPD fare in the face of such competition? Here are six case studies which describe the competitive situation of LPDs:

Near **Padang Luwih** are two commercial bank branches, which lend larger amounts for longer periods than the LPD; there is a BPD branch, with simple procedures for government employees; there is a rural bank branch at a distance, with more cumbersome procedures and no payment services; there are four savings and credit cooperatives in the village, with the added attraction of profit-sharing; and there are six arisan PKK. LPD Padang Luwih estimates that it holds about 60% of the deposit and loan accounts of its residents; its market share of the amount of deposits is estimated at 20%, and its share of credit at 40%.

In **Cemagis** there is a rural bank in the neighborhood, with very similar terms, but fewer clients because the LPD is much faster in its service. The nearest BRI unit is in Kapal, 6 km from Cemagis. Its staff is more professional, but service is slower. There are three competing savings and credit cooperatives, with terms similar to those of the LPD. LPD Cemagis holds the majority of deposit accounts in the village, but only about 40% of the amount. The share of credit accounts is estimated at 60%, the amount outstanding at 40% or less.

In **Kapal** there are two bank offices nearby, one of them with ATM; a BPD branch which has slow credit procedures, but accepts deposits from LPD collectors after hours; a BRI unit which is not online; and two rural banks which use the payment services of the LPD. There are also ten savings and credit cooperatives, which are good clients of the LPD. The share of savings accounts in the LPD is estimated at 90%; other estimates are not available.

LPD Bedha doesn't report any banking offices in the vicinity, except a BPD branch where government employees hold their accounts. Perhaps because of the absence of banks there are 18 savings and credit cooperatives, 40 arisan PKK, and 15 other arisan with deposit accounts at the LPD.

LPD Pecatu is facing fierce competition from commercial and rural banks. Yet with total assets of Rp80bn, a portfolio of Rp61bn, deposits of Rp63bn, a ROA of 5.4%, a ROE of 26.1% and a write-off for bad debts of 0.05% in 2007 (*MIX data*) it is doing very well. With regard to savings the LPD does not win the overall price competition in Pecatu, paying only 5% on savings and 6% on term deposits, close to what the BRI unit pays; in contrast, the BPR pays 14% and the KSPs pay 12%. Together with the BRI unit is wins the competition of confidence; and with regard to all three it wins the competition of convenience and low depositor transaction costs. With regard to loans the LPD is competitive, charging around 15% (16% on commercial, 15% on consumption and 12% on loans guaranteed by deposits). By comparison the BPR and the KSP reportedly charge 24%-30%, the BRI unit around 26%.

LPD Kayu Kapas is facing the competition from a BRI unit and a rural bank just two kilometers away. Yet, despite recent difficulties and its very small size almost everyone in the village holds a savings account in the LPD, which is expanding its business and making a profit since its revitalization in May 2007. One may have serious doubts whether such small LPDs are feasible. But they do apparently have a function in deposit-taking and the provision of small loans, and can make a profit – provided they have the trust of the village and a functioning board.

Overall, the LPD has a number of core strengths: it is self-financed, self-managed and self-governed; it is an integral part of the desa pakraman as the center of life; and it is able to bank on karma as an effective collateral substitute. From the experience of its board members and management, the LPD has a number of **competitive advantages:**

- Proximity, direct and easy access for everyone
- Personal contact and a sense of belonging
- Convenient services, doorstep collection of savings & repayments
- Simple procedures
- Rapid service
- Payment services for electricity, water and phone billings (only by larger LPDs)
- Tax-free deposits
- Low borrower and saver transaction costs
- Profit benefits the community
- Desa pakraman, banjar and banjar associations have savings and credit accounts at LPD.

But compared to other financial institutions it also has competitive disadvantages: There is no feasibility examination when establishing a new LPD; the LPD is restricted to one village, which limits staff selection and business growth; it is restricted to investments of surplus liquidity in BPD, with negative net interest margins of deposits; and external controls are weak.

3.3 The economic and social impact of the LPD – Six cases –

There are three main avenues of impact of the LPD: (a) self- and debt-financing of start-up and expansion of micro and small enterprises (MSEs), from accumulated savings and loans; (b) a development fund amounting to 20% of the profit of an LPD; and (c) a social fund of 5% of profit, both allocated to the desa pakraman. Here are some examples of the impact of LPD on MSEs:

In **Kapal** almost all households with MSEs reportedly borrow from the LPD for their working capital; 75% of start-up are estimated to borrow from LPD, followed by larger repeat loans. This in turn establishes a track record for subsequent larger borrowings from other financial institutions. In addition, successful MSEs reportedly open businesses outside Kapal.

In **Bedha**, in the past most loans from the LPD were obtained for consumption purposes; but this is now shifting to loans for productive purposes, income and employment generation. This is greatly helped by a doorstep daily collection and repayment scheme. Seven collectors are involved in deposit and four in loan repayment collection. The payment collectors also analyze and monitor loans and provide technical guidance. Local business promotion in Bedha has also included the distribution of 38 heads of improved breeding cattle in 2007 from LPD funds. This was combined with technical guidance and, by October 2008, had produced 41 calves.

In **Lepang**, a small village of 274 families in Klungkung district, it is reported that the LPD has evolved into a source of funds for new businesses and the expansion of existing small enterprises, which in turn has led to higher sales, incomes and savings – and to trust in the LPD as the village's own financial intermediary. Livestock is also included in the new business operations financed by the LPD.

In remote **Kayu Kapas**, the recently revived tiny LPD has reportedly contributed to the growth of woodcarving, small stores, livestock and other income-generating activities.

The main use by the desa pakraman of the development fund consists of the financing of temple renovations and festivals. In addition in larger villages with big LPDs the desa pakraman may also decide to use part of the funds for economic purposes. The social fund is generally used for social, and to a lesser extent for religious, purposes.

Here are some examples:

In **Luwih**, over a three-year period (2005-07) a total of Rp297m were paid into the account of the desa pakraman. The desa pakraman and the six banjar jointly decided to use the funds for the renovation of the three village temples, to repair the road and build a bridge to the holy springs of the village, and to build a kindergarten. This was later moved to a new location while the old premises were converted into an office building for the administration of the desa desa pakraman. The social fund during that period amounted to a total of Rp74m. The village and banjar assemblies had decided to use the funds for scholarships, funeral contributions, support of priests and contributions to a pilgrimage to Hindu temples on Java.

In **Bedha** the development fund during 2005-07 amounted to Rp280m. 40% of that amount were distributed among the 38 banjar. The remaining 60% were used for the development of the village, comprising three major projects: buying land for public facilities; financing the establishment of a social development foundation supporting education, a kindergarten building and the social affairs of the youth "to improve their spirituality"; and the distribution of 38 heads of improved breeding cattle among the banjar, one per banjar. The social fund, amounting to Rp70m, has been used for scholarships and youth programs, support of the priests in all 38 banjar as well as for temple festivals.

In **Pecatu** the development fund, amounting to Rp2.3bn over the period 2005-07, has been used for the renovation of the village temples and the banjar assembly halls, a village market, a kindergarten, a security guard for the cemetery, and incentive payments for the 35 members of the administrative staff of the desa pakraman. The social fund, amounting to Rp575m, has been been used for various purposes, including the financing of a free health check in each banjar every *galungan*, one of the principal Balinese festivals.

In tiny **Kayu Kapas**, which had been dormant for several years and just recovered, the development fund was too small for anything of significance and was credited to the account of the village to be accumulated in the following years. Despite its very small profit, Kayu Kapas used the amount of Rp 122,169 allocated to the social fund in 2007 to meet social obligations at weddings and funerals.

4. The relationship between desa pakraman and LPD in practice

4.1 Good governance and the need for effective supervision

4.1.1 Owners, users and governors of the LPD in the customary village

Owner of the LPD is the customary village. In most villages this means that the original indigenous residents, *krama ngarep*, are the ultimate owners.

Users include several categories: the original indigenous residents, *krama ngarep;* other residents, *krama tamiyu;* the customary village and the banjar as non-formal corporate entities; the various banjar associations; and registered local savings & credit cooperatives (KSP). LPDs may strictly follow the regulation and categorically exclude non-residents; but some accept deposits from outsiders, particularly in villages which function as economic centers. Lending to outsiders is much rarer, and normally requires a personal guarantee from a resident of the village where the LPD is located.

The management team comprises three members: the manager of the LPD, the secretary and the treasurer, who are appointed by the board. Larger LPDs may have functional divisions, a middle management of division heads and a larger number of staff, totaling more than 50 in the largest LPD. According to LPD regulation, management and staff are required to come from the customary village. This can impose serious constraints on an LPD, both in small villages with an overall shortage of qualified personnel and in large villages where banking qualifications are required. In some cases such positions are filled by bank retirees originating from the village. The management team receives training from LPD training and guidance agencies and, in recent years, from Certif, a national bankers training and certification agency for rural banks (BPR) and non-banks including LPDs. LPD staff is trained by the management team and sometimes by LPD training agencies.

Governance is the responsibility of the customary village, which elects a board of supervisors, *pengawas*. The minimum number of board members is three. The maximum rarely exceeds seven. This it not necessarily related to the size of a village or an LPD; there are many large LPDs with the minimum number of three board members only. The board is chaired by the head of the customary village, the *bendesa*. Elections are held every three to five years, depending on the village. Normally board members are elected by the assembly of the customary village; in some villages, every banjar elects a board member. Confidence and reputation are usually the decisive criteria of selection. In some villages retired bankers, university lecturers and other highly skilled residents of the village are found on the board; but finding competent board members can be a problem, particularly in smaller villages. Training and guidance of board members, estimated at around 6,000, represents a future challenge.

The board appoints the management, determines the operational terms and procedures of the LPD and has full authority of internal supervision. The board routinely meets weekly or monthly as well as in-between as need arises. In smaller LPDs all credit decisions require the approval of the board; non-involvement of the board would be a danger signal. However, loans below a certain limit may be approved by the manager and signed afterwards by the bendesa at the next meeting. Large LPDs have a credit committee and a differentiated system of lending authority.

Internal control is the responsibility of the board. Large LPDs may establish a unit of internal audit, which may comprise board members and staff of the LPD. Auditing is not compulsory; but virtually all big LPDs are audited by a chartered accountant. PLPDK and BPD are involved in monthly reporting of LPDs, but are not in auditing. It has been suggested that auditing mandatory for LPDs with total assets above Rp5bn.

Ultimate authority lies with the village and banjar assemblies. Normally there is close communication between the board, the customary village and the banjar. The bendesa regularly reports to the council (prajuru) of the customary village; the heads of the banjar, who are members of the village council, report to the monthly banjar assemblies. Alternatively, in villages where the board comprises representatives of the banjar, these report directly to the banjar assemblies. In case of defaulting, board members communicate directly with borrowers, together with the head of the banjar if deemed necessary.

The strength and the weakness of the LPD lies in its system of governance. Good governance brings together all customary authorities in the village: the bendesa as head of the village and of the board, the other board members, the customary village administration and council, and the banjar heads and assemblies. Intimate knowledge of all resident families with their past and present situations enables the board to arrive at sound credit decisions and to enforce repayment. If necessary the board members involve the other authorities, among them the heads of the banjar in particular, to induce loan delinquents to repay. However, in the absence of effective external supervision, the LPD may break down if the board members are not aware of their responsibilities and the krama do not insist on good governance.

In contrast to the sanctioning power of the *krama*, which would so greatly shame the family of the defaulter if called upon that it is virtually never invoked, there is another, even stronger sanctioning power, which represents the spiritual dimension of governance and does not need to be invoked by any worldly authority: *karma*. Good as well as bad deeds affect a person's *karma*, positively or negatively: in this world, in the beyond and, through reincarnation, in the next life. Saving, investing one's savings or loans to the benefit of the family, and repaying one's loans positively impacts one's karma. Wasting one's resources and failing to settle one's debts has a negative impact. As one of the board members put it: "If you die as a defaulter, you will enter the beyond as a defaulter." It is these two factors, social control by the *krama* and spiritual control by one's *karma,* which explain why the board can be so successful in inducing defaulters to repay their loans and why there are so few LPDs in which physical collateral is ever seized.

4.1.2 In support of good governance: the need for effective supervision

Out of ten LPDs visited, four have undergone a major crisis. Had they been banks under the supervision of BI, they would have been closed. There is no information on how many LPDs have lived through similar crises and recovered. However, we do know that 372 LPDs, or 27% of the total number, are not in good heath (*sehat*). Two conclusions may be drawn from our case studies, which apply to all LPDs:

- While any LPD risks falling into disarray, a motivated and committed board, whether newly elected or reoriented, can revitalize an LPD within a short period of time, regain the trust of the customary village, apply a soft approach by convincing the defaulters to fully repay their overdues, and lead the LPD to continual growth and profitability. The unequivocal conclusion is that good governance, with effective control over management, is absolutely crucial.
- While all LPDs were closely monitored and their poor performance was well known to all agencies involved in guidance and supervision, in none of the cases has instantaneous information been followed by instantaneous action. Adherence, or lack of adherence, to regulation was well documented by monthly reports, but no steps were taken to enforce standards. In two cases the guidance agency PLPDK has played a decisive role in reviving the LPD, but only after considerable delays. In two cases, a strong LPD in the area has given a helping hand; this is an instrument that could be used far more systematically. Province-level agencies have not been involved in the process of revitalization.

The overall conclusion is that while monitoring and reporting are effective, supervision is not. There is no coordination among the various agencies, and there are no instruments of enforcement of good performance. In fact there is no evidence that the political will to enforce regulation exists. The soft or family approach of the customary village works exceedingly well under conditions of good governance. But once governance fails, a similarly soft approach to supervision does not work.

A total of 228 LPDs in Bali are not functioning properly, comprising 99 classified as non-performing, 71 as unsound and 58 as less sound. Another 144 LPDs are only fairly sound (cukup sehat); they, too, require attention to prevent a further decline as it happened in some of our case studies. Together with all the families in the respective villages whose savings are at risk, all LPDs deserve a more effective system of supervision. As our case studies of past failures show, we also have to assume that on principle all LPDs are at risk and require a system of effective supervision and immediate action at the first sign of weakness.

4.2 Benefits and impact

4.2.1 Impact on the desa pakraman

There is agreement among the board members and LPD managers visited that the LPD has given the desa pakraman a new strength. It appears that before the advent of the LPD the village was mainly an assembly of banjar where most of the religious, cultural, social and economic life took place. While the banjar has not lost any of its significance, the desa pakraman has emerged as an entity continuing to encompass the banjar, but with a new life of its own.

The shift in emphasis is most pronounced in the area of local financial institutions. Traditionally, the seka simpan pinjam was the only local financial institution, one in each banjar, owned by the krama of the banjar. But they had the character of isolated self-help groups, without a network or other forms of interaction, and without a support structure. Savings and credit activities of the seka simpan pinjam had been on a minor scale; for larger deposits or loans people had to turn to other financial institutions mostly outside the village, usually at the subdistrict administrative town. Establishing an LPD in each desa pakraman has turned the villagers away from a more cumbersome, less reliable and frequently frustrating orientation to outside financial institutions and back to the desa pakraman as the only place where everyone without exception has access to financial services at minimal saver and borrower transaction costs. The financial functions of the seka simpan pinjam banjar have thus shifted to the desa pakraman, but only as a result of the superior strength of the LPD, which has generally replaced the seka simpan pinjam. Only in a single one out the villages visited did we find seka simpan pinjam still in existence.

Choosing the desa pakraman over the desa dinas as the place for the new financial institution has given the desa pakraman an official recognition which it otherwise does not possess in the overall political and administrative system of Indonesia. The village in turn has honored this decision by offering the best location to the new LPD, normally near the biggest temple and the market place. This in turn has contributed to the strength of the LPD.

This new official recognition of the desa pakraman is also reflected in the fact that the LPD has become the (quasi-) *bank* of the desa pakraman and the banjar as non-formal corporate bodies, which do not have access to financial services by the formal banking sector. The desa pakraman as well as the banjar deposit their fund in the LPD and obtain loans for community projects from the LPD. This implies a shift of responsibilities for local development in Bali from the desa dinas to the desa pakraman.

In the spiritual and religious domain, the desa pakraman has also gained in reputation in the eyes of its original residents, the *krama*, because of the new capacity of the LPD and the village to invest in the renovation of the village temples and the temple festivals. All this has given the residents a new pride in their village, its strength, its development and its temple festivals which matter so much in Bali.

4.2.2 The use of the development and the social fund

The most immediate instruments of support to the desa pakraman by the LPD are the development fund and the social fund, at a rate of 20% and 5%, respectively, of annual profit. They are paid into the account of the desa pakraman held by the LPD. The use of the funds is decided by the village and banjar assembly.

From 1999 to June 2008[7] total profits of the LPDs amounted to Rp775bn, or $84m. At a rate of 20% and 5%, respectively, the development fund amounted Rp155bn or $16.8m and the social fund to Rp39bn or $4.2m over the 9.5-year period. During the three-year period 2005-07, the total development fund amounted to Rp71bn or $7.5m and the total social fund to Rp18bn or $1.9m.

[7] Figures will be revised after the end of the year, to cover a full period of ten years.

Table 5: Net profit, development and social fund, 1999-June 2008

Year	Profit in billion Rp.	Profit in million $	Exchange rate
1999	27.1	3.8	7,100
2000	36.6	3.8	9,595
2001	54.4	5.2	10,400
2002	66.9	7.5	8,940
2003	71.0	8.4	8,425
2004	85.0	9.2	9,285
2005	106.3	10.8	9,830
2006	118.8	12.7	9,393
2007	131.1	13.9	9,419
Jun-08	77.5	8.4	9,189
Total profit	**774.8**	**83.8**	
Total development fund	**155.0**	**16.8**	
Total social fund	**38.7**	**4.2**	

The use of the development fund is focused on the renovation of the village temples and the financing of temple festivals; in most of the smaller villages this is the almost exclusive use of the development fund. It is pointed out that with LPD support and the additional income generated, these investments are now carried out on a much larger scale than before, and that the temples are grander and the festivals more generous than before. The families are relieved of their obligation to pay, and thus benefit indirectly. This is of particular importance to those in the village who would have difficulty paying their share; having the LPD meeting their obligations is seen as avoiding a negative impact on their karma. In big LPDs the development fund is also invested in infrastructure such as roads, sidewalks, bridges and markets, the purchase of land, the construction of stalls and shops for rent and a kindergarten. Part of fund may be passed on to the banjar.

The use of the social fund includes contributions to temple ceremonies, but is mainly focused on social welfare of the needy and on social assistance. This includes contributions to health expenditures, school fees and scholarships, donations at funerals, cremation, wedding and tooth-filing ceremonies, assistance to youth groups and support of youth employment, and support of temple priests and pilgrimages. As with the development fund, the social fund relieves families of their customary obligation to contribute for those purposes from their own resources.

4.3 Economic and social impact

There is agreement among the LPD board and management visited that the LPD has a pronounced economic impact. First, there is now virtually total access to financial services for the whole population of the village at minimal transaction costs to the clients, including low-income people. With regard to impact on women, the LPD is a clear case of gender mainstreaming without any discrimination on the basis of sex. The majority of depositors, and many of the borrowers, are women. In addition it was pointed out that in many cases it is the men who borrow, and the wives who use the money.

Second, the LPD has emerged as a microfinance institution of superior efficiency. It has replaced the moneylenders, who used to charge 10%-25% interest per month. This has substantially lowered borrowing costs and completely abolished financial exploitation, as any profit is channeled back into the community. Furthermore it has fully replaced the former *bank of the banjar*, the seka simpan pinjam, as well as linkages between banks and the various self-help groups (*seka*) in the village. Such linkages – hubungan bank dengan kelompok swadaya maskyarakat (HBK) – had been promoted since 1988 by a joint program (PHBK) of Bank Indonesia and GTZ. During the pilot phase, Bali excelled in terms of outreach and performance among the four pilot provinces. But as the LPDs spread, the groups have been spontaneously taken over by the LPD, without any particular program or promotion. All SHGs, or seka, now hold their accounts with the LPD, at greater convenience and much lower cost.

Third, the LPD has had a significant impact on local business, by increasing the self-financing capacity of small and microenterprises from savings and by increasing access to credit. This has facilitated self- and debt-financed business start-ups, which would find it difficult to obtain finance from other sources; it has led to the expansion of existing businesses; and it has led to business innovations, such as new handicrafts and the introduction of improved breeding cattle financed by an LPD on a village-wide scale.

Fourth, the accumulation of safe savings and access to credit at reasonable interest rates have contributed to income smoothing, consumption and the purchase of household durables.

Fifth, in addition to direct contributions through the development fund, the LPD has offered the village and the banjar accounts which permit them to accumulate resources, pay their staff and finance public investments from their savings and from loans.

Sixth, income and employment have increased. Direct employment by the LPDs amounts to 7,000, or 5 per LPD. In addition, there are indirect income and employment effects through farm and non-farm micro- and small enterprises financed through the services of the LPD. This however is a field where quantitative data are lacking and which requires further investigation, particularly through a small and microenterprise survey.

Seventh, with regard to social impact, the LPD has improved the welfare of the families in various ways; it has enabled the families to acquire more livestock and take better care of it; more families are now in a position to pay for higher education of their children; housing has been improved; access to finance has created new opportunities for the less-fortunate. In case of emergencies families are either able to finance them from their savings, or they have access to emergency credit instead of having to turn to the notorious moneylender. Quantitative data about social impact do not exist. Due to the difficulty of attributing changes in welfare to a single cause such as LPD finance, it would in fact be difficult to generate such data through surveys. Qualitative evidence will have to suffice.

5. Conclusions and recommendations

5.1 The LPD has provided inclusive access to financial services for everyone in the desa pakraman

- Access to financial services for all, as a human right, has become a reality in Bali. This has included the right of choice; virtually everyone has opted for savings, only every other has opted for credit in addition to savings.
- The LPD has made a substantial contribution to inclusive access, bringing finance in reach of everyone: households and individuals, MSEs, informal associations in the banjar, local cooperatives, and the administration of the desa pakraman and the banjar – all at minimal client transaction costs.

5.2 The LPD has given new strength to the desa pakraman

- As the area of operation of a financial institution of its own, the desa pakraman has gained a new life which it did not have before. Almost everywhere the LPD has replaced the seka simpan pinjam, or pecingkreman, the formerly ubiquitous informal *banjar bank*.
- It is the LPD which also provides banking services as well as financial support to the administration of the desa pakraman. This has enabled the desa pakraman to carry out community development activities and acquire public recognition as a genuinely Balinese community institution, separate from that of the desa dinas.
- The LPD has given strong support to the village temples and ceremonies as the center of religious and cultural life in Bali.
- Large LPDs have directly contributed to the economic development of the village, particularly by supporting selected infrastructure projects.
- The LPD enables everyone to make use of the opportunities created by the economic development of Bali, establishing, expanding and modernizing their MSEs. This impacts their karma.

5.3 The desa pakraman has given the LPD a powerful framework for managing risks; but an equally powerful framework of external supervision is lacking

- The close cooperation between the krama and elected authorities of the desa pakraman with the board of supervisors and the management of the LPD has been generally very effective in managing risks, both in small and in large LPDs.
- Even after periods of inner crisis and operational breakdown of an LPD, the re-establishment of this cooperation has led to the revitalization of the LPD including the full recovery of overdue loans, the growth of savings deposits as a sign of confidence and the expansion of the loan portfolio.
- However, there are large numbers of LPDs where weaknesses in governance have been detected through a very effective reporting system; but due to inefficiency in the guidance and supervision system no action has been taken, or action has been greatly delayed.

- Effective external supervision and enforcement of prudential standards comparable to that provided by BI for commercial and rural banks is absent.
- External supervision, together with instantaneous guidance in case of need, needs to be professionalized, presumably in BPD or an BPD auxiliary:
  - with the power to enforce recommendations in close cooperation with the Bendesa and board of internal supervisors, to maintain (among sound LPDs) or improve (among fairly sound LPDs) performance;
  - initiating special action (by PLPDK) on poorly performing (less sound and unsound) LPDs to restore good performance;
  - taking action on nonperforming (*macet*) LPDs: *closing them or reforming them*
  - training, guiding and supervising the supervisors through a strong province-level central agency;
  - strengthening the collaboration with guiding agencies and BKLPDK, an association of LPDs.

5.4 The role of BPD needs to be redefined.

BPD has effectively focused on the consolidation of LPD reports and the timely production of reports at district and provincial level. There are three major shortcomings in the functions of BPD:

- BPD has not been able to build up a central data base and a related capacity for data analysis.
- BPD has not been given a clear mandate to act as a financial apex institution of the LPDs.
- BPD has not been given a clear mandate as a supervisor of LPD, nor has it been empowered to enforce banking standards among the LPD; it has not been given the necessary human and financial resources for effective supervision, using information gathered in the reporting system as a basis for timely intervention.

The following options need to be examined, taking into consideration possible conflicts of interest; for each option chosen the required financial and human resources would have to be put in place:

- Establishment of a central LPD data base and data analysis capacity, presumably in BPD:
- designating, or re-enforcing, a financial institution as the bank of the LPD, presumably by strengthening the role of BPD with competitive services;
- clarifying the role of BPD in the supervision of LPDs, possibly differentiated for small and large LPDs.

5.5 The LPD regulation needs to be adjusted

The existing regulation is an excellent model for the majority of LPDs, but needs to be adjusted to the requirements of:

- a small number of big LPDs, to be regulated and supervised like local banks and banking units.8 In particular, the strengthening of LPD supervision may benefit from the experience of external supervision of rural banks (BPR) by BI and the experience of internal supervision of its units by BRI. In this respect more constructive use may be made of the experience of retired bank managers who are serving on the board and management of a number of LPDs.
- a large number of small LPDs, which cannot cost-effectively fulfill the standard LPD regulation, or cannot find the staff among the village population to cope with the regulation and the requirements of managing a financial institution. Amalgamation of smaller LPDs is not accepted as an option. Training of board members may contribute to the solution, but would be a huge task. Institutional cooperation with a strong LPD in the vicinity as a partner (bapak angkat) might also provide a practical solution to the management problem; if institutionalized this would require authorization to use part of the profit allocated to payment for services.

[8] This may include a clarification of the tax status of big LPDs. Note should be taken the deduction of a development and a social fund, together 25% of the profit, may be considered as a form local taxation, directly allocated to the desa pakraman.