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MICROFINANCE FOR MICROENTERPRISES: SOME PRACTICAL EXPERIENCES OF LINKAGES BETWEEN FORMAL AND INFORMAL FINANCIAL INSTITUTIONS IN INDONESIA

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Introduction: an agenda for small and microenterprise finance

This paper is based on the assumption that women's and men's enterprises are best served by an **unrepressed financial system**. No amount of donor support and external debt can substitute for the right policy environment: one which encourages domestic resource mobilization and the proper functioning of financial intermediaries. (Chapter 1.1)

Only a **deregulated policy environment** will offer real returns on savings deposits, create positive incentives for both customers and banks to engage in mutually beneficial business relations and induce banks to develop innovative financial technologies of savings mobilization and credit delivery. Indonesia is perhaps the most successful recent example (Chapter 1.2). Not only has deregulation, after 1983, led to unprecedented levels of savings mobilization and economic growth; at the same time it has boosted poverty alleviation from an already high 2.1 percent annual reduction (1970-1984) to a phenomenal 3.7 percent reduction p.a. (1984-1987).[1] In a country where the large majority of the poor are self-employed microentrepreneurs in farming and nonfarming occupations, such a policy is of course of direct benefit to poor men and women.[2]

Yet, despite the phenomenal growth of the financial system and the achievements in poverty alleviation, **lack of access to finance** will remain the most severe obstacle to small and microenterprise growth. Saver, borrower and lender **transaction costs** are the core problem. (Chapter 1.3) There are four principal avenues to the solution of the transaction cost problem:

(1) **Self-finance** based on own savings, possibly in conjunction with financial self-help groups as local depository institutions

(2) **Upgrading financial self-help groups** as pre-cooperative informal financial institutions

(3) **Downgrading banks** to local institutions at grassroots level but with formal status

(4) **Linking informal and formal financial institutions**, or self-help groups and banks.

Self-finance is the forgotten half in development theory and practice, just as savings were the forgotten half of development finance. Informal sector enterprises invariably start with informal finance, of which self-finance is fundamental. Its mobilization and utilization can be greatly facilitated by small local financial self-help groups. They may confine their activities to savings mobilization, as in the case of the ubiquitous rotating savings associations; or they may include lending activities from internally generated funds, as in the case of the equally ubiquitous nonrotating savings and credit associations. As a rule they do not tie into the circles of formal finance. Unlike self-finance, formal institutional finance has frequently been a factor of underdevelopment, rather than development. Self-finance should be a topic of first priority in development thinking during the 1990s.

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1. World Development Report 1990: Poverty, Oxford University Press, 1990, pp. 40-45

2. In 1987, self-employed households in farming in Indonesia accounted for 58 percent of the poor and 41 percent of the total population (ib. p. 33). In addition, most poor households - particularly women - are engaged in off-farm non-farm income-generating activities.

Financial self-help groups are exceedingly widespread in the developing world. Most of them are of indigenous origin. But in recent years governmental and nongovernmental organizations have increasingly embarked on their upgrading. Nonprofessional interventions á e.g. through generous grants, credit guarantees, debt releave and laxity in financial management á have sometimes eliminated the spirit of self-help and its technical complement, saving. **Professional upgrading,** which always starts with savings, can have a tremendous impact on the quality of group organization and of their savings and lending activities. Some credit unions in Indonesia are a case in point: within periods of two to three years, training and consultancy inputs have multiplied the internal funds of pre-existing indigenous groups up to tenfold and above. Because of their proximity, sociocultural adaptation and low saver-borrower transaction costs, financial self-help groups can greatly improve the self-financing potential of small and microentrepreneurs. Upgrading through technical, not financial, assistance can be the key to the full mobilization of their potential as informal financial institutions. As the legal framework permits, as in Indonesia since October 1988, such institutions may eventually evolve into rural banks (BPR).

Downgrading formal financial institutions, i.e., adapting banks to the environment of the informal urban and rural sector, can result in appropriate financial technologies for small and microenterpreneurs. Some of these technologies may have been adapted from informal financial institutions. As this may be costly and risky, particularly during the start-up phase, banks will only be inclined toward downgrading if permitted to cover their costs from the margin. Selected examples from Indonesia are Bank Rakyat Indonesia which has set up some 3600 rural offices with innovative savings and credit programs; provincial development banks (BPD) with their small semiformal financial institutions (BKK in Central Java, LPD in Bali, LPN in West Sumatra) which offered uncollateralized loans at market rates even before deregulation; Bank Dagang Bali, Bank Seri Partha and others with daily savings collection and doorstep services, etc.

Linking banks and self-help groups is an approach designed to utilize the potential of both formal and informal financial institutions. It gives self-help groups of micro- and small entrepreneurs access to bank finance; it gives banks cost-effective access to the poorer segments of the population. Initiated by regional associations of central banks and major rural banks (APRACA for Asia and the Pacific, presently under discussion in AFRACA for African countries), it fosters a policy climate in which banks, self-help groups and Non-Governmental Organizations as well as Governmental Organizations may freely determine new modes of cooperation. The central bank as the project holder, as in Indonesia, only acts as a facilitator; all terms and conditions are negotiated between banks, self-help groups and self-help promoting institutions, such as NGOs. Indirectly, the linkage approach may lead to processes of downgrading banks and of upgrading informal financial institutions. By transferring technologies of savings mobilization through self-help groups, it may also strengthen the self-financing of small and microentrepreneurs. An example are daily savings collection techniques in accordance with income patterns in the informal sector, which are typically daily, rather than monthly. Unlike the upgrading approach, which solely relies on savings mobilized by self-help groups, the linkage approach favors a dynamic multiplier ratio between groups savings and bank credit, thus augmenting over time the funds available for enterprise finance. (Chapter 2)

Three factors contribute to the success of a program of small and microenterprise finance: the right policy environment, the right approach and á the right technical details based on experience. The latter may not take the form of a scheme, which would be too inflexible for the multitude of local and branch-specific environments, but of **procedural recommendations.** In their present form they are based on only two years of experience in the field, and to an experience which is limited to rural areas. (Chapter 3)

Recommendations may change with experience. E.g., one large government bank with a rural mandate was only prepared to join what was then considered the linkage experiment if **credit guarantees** were provided. Reluctantly (credit guarantees are tempting and may create moral hazard), a self-help development cum credit guarantee fund was set aside for that purpose. Private banks let themselves be convinced by the impeccable repayment record of the pre-existing self-help groups and joined the experiment without credit guarantees. When after 18 months the arrears ratio of the government bank was still 0 percent, the management accepted that indeed credit guarantees were superfluous. The expansion phase will do without credit guarantees. The fund is now being utilized for self-help development activities such as training and consultancies.

Enterprise finance without collateral was considered one of the innovative features of the linkage program. How could the poor provide collateral? Until closer scrutiny of internal lending practices preceding cooperation with the linkage project indicated that many self-help groups do demand collateral. A goat, a bicycle, a radio and a plot of land may be listed in the loan contract between self-help group and member as collateral. Some banks also showed reluctance to lend without collateral beyond a pilot phase, particularly when lending to self-help groups continues to grow. Some banks have argued that collateral is important: for psychological reasons (foreclosure being a rare occurence). We are now exploring forms of **nonformal collateral** which enter into loan contracts but do not require costly official certification.
Some **government organizations** had an abysmal record with group lending in pre-deregulation days. Large volumes of subsidized targeted funds had been channeled by banks on behalf of the government through groups created for that purpose by government organizations. The repayment record was 40 %. The banks were not willing to repeat this experience. The linkage program was therefore started in cooperation with local nongovernment organizations (NGOs) as self-help promoting institutions. The resulting performance was excellent, with arrears below 1 %. But then we made two observations: Firstly, a number of government-initiated and sponsored women's groups which participated in the linkage program in North Sumatra had an equally impeccable repayment record. Secondly, large numbers of self-help groups in the linkage program are family planning and family welfare women's groups under government organizations (BKKBN and PKK) which had contracted group guidance and training to NGOs. Two major success factors emerge from that experience: one is proper guidance and training of self-help groups, the other one is the application of nonpreferential proper banking practices. To this one may add a third one: women's groups.[1] The feasibility of a close cooperation on these terms with government organizations is now under examination. Given the limited potential of NGOs, the linkage approach will only continue to expand if all institutional resources are utilized: of NGOs, GOs and banks.

Due to its APRACA origin, the linkage program has a rural bias. However, the **urban informal sector of small and microenterprises** has great potential for linking banks and self-help groups. In urban areas, there is a wider spectrum of self-help groups which may act as financial intermediaries between banks and entrepreneurs. In addition to the ubiquitous rotating and nonrotating savings and credit associations (RoSCAs), business associations, interest associations and other forms of voluntary associations abound. In West Africa for example, craftsmen and craftswomen may be organized in unions or guilds while market women are prominent in product-based market organizations. All these associations incorporate financial activities.

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1. UNDP Jakarta and Bank Rakyat Indonesia report a similarly successful experience (1 % arrears) with their working capital credit program for women's joint business groups (KUB). They attribute this to four main factors: adherence to proper banking procedures, limitation to women borrowers, savings component and group approach.

As in many other countries, **women in Indonesia** are excellent savers, reliable self-help group participants and active microentrepreneurs. Nondiscriminatory microenterprise development, upgrading or linkage programs will automatically include large numbers of women. Any financial program with a strong savings component is likely to come out with strong women's participation. It is not charity what women entrepreneurs need: not in the forms of grants and not in the forms of financial subsidies. What they need is access to savings deposit facilities, real returns on savings deposits, access to credit at market terms and technical assistance to their self-help groups. The latter may include training and consultancy services concerning savings mobilization, fund management, appropriate technology, marketing, upgrading of self-help organizations and linkages of self-help groups to banks. Training and consultancy may be subsidized, financial services must not.

Two others fields need to be mentioned for more direct interventions. One is appropriate **technology transfer** for women's small and microenterprises. This may be combined with approaches to self-help group development. The other is the **opening up of access to finance and to income-generating activities in closed societies** where such access is not normally granted. Here closed self-help groups of women may be a first step of making available both finance and microenterprise opportunities to women.

1. The policy framework

1.1. Repressing the financial system through regulation

Several decades of experimentation with development have taught a powerful lesson: rigid regulation of the economy by the government leads to underdevelopment. It stifles the growth of money, production, income and employment.

The system of production á particularly agriculture, trade and industry á is the motor of the economy, finance is its fuel. Unless there is a functioning fuel injection system which supplies that fuel, the motor will not run. The faster the motor is to run, the more fuel it needs.

It is the financial system which has to pump the money into the economy: it has to mobilize savings, provide credit and assure an adequate growth of the money supply. An undersupply of money will stall the engine, thus halting the economy; an oversupply will lead to inflation, thus choking the engine.

Tight regulation has repressed the growth of the financial system. The main instruments of financial repression were interest rate controls, credit targeting and interest rate subsidies. Low or negative real returns on deposits discouraged savers. Ceilings on interest rates prevented banks from covering their transaction costs; this made banking unprofitable. Subsidized credit channeled on behalf of the government led to inappropriate and unintended borrower selection and insufficient borrower scrutiny. Credit targeting induced borrowers to divert loans to other purposes. Generous credit guarantees led to moral hazard among both lenders and borrowers. Low recovery rates and program decapitalization as well as market distortions were some of the immediate results. While agriculture was usually the beneficiary of some subsidized targeted credit, the informal sector of production and service activities in both urban and rural areas was the most neglected: its savings went uncollected, its credit needs unfulfilled.

While the government adopted the role of a donor, the banks were unable, or restricted, to act as financial intermediaries between savers and borrowers. The financial system remained repressed, in many cases inoperative. Finally, foreign debts replaced domestic savings.

During the 1950s and 60s, the role of the financial system in economic development was virtually ignored. The theory of the day was modernization through technology transfer with external capital. Domestic capital formation and national resource mobilization did not enter into that theory. Well into the 1980s, many developing countries were held in the grip of that theory.

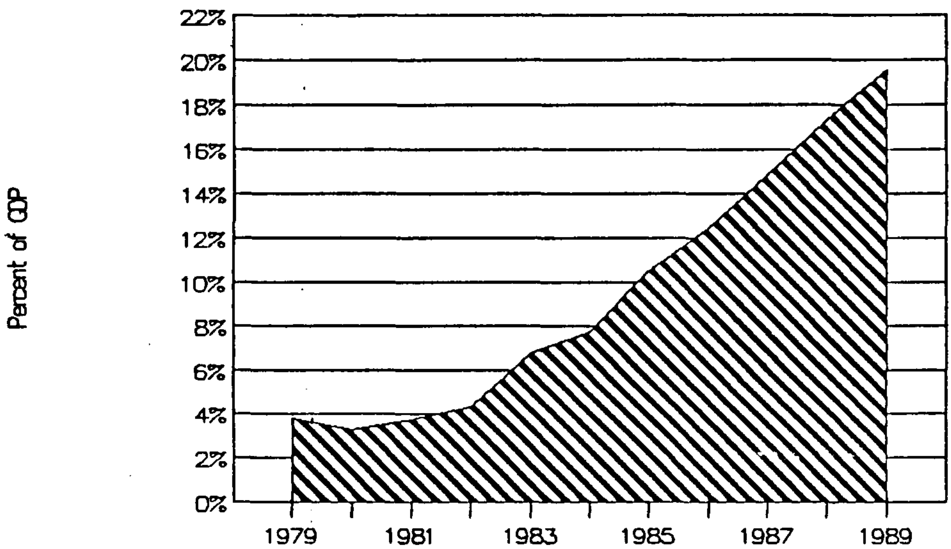
In the 1960s and 70s, Indonesia suffered from many of the ills of a regulated policy environment. As elsewhere, this resulted in a repressed financial system. At the beginning of the 1980s, savings, including time deposits, as a proportion of GNP was below 4 %, money supply (M_2) below 15 %.

1.2. Developing the financial system through deregulation

Since 1983 the financial system of Indonesia has been gradually and prudentially deregulated. Banks in Indonesia are free to set their own interest rates, depending on costs, risks and profit expectations. Sound banks may engage in foreign exchange at floating rates. Since the deregulation act PAKTO 27 of October 1988, it is relatively easy to set up new banks and bank branches, also in rural areas. As of February 1990, most subsidized credit programs with their high default rates were dismantled.

The financial system has responded vigorously: banks have embarked on innovative approaches to urban and rural finance; they have increased in numbers and size; and they have embarked on vigorous campaigns of domestic savings mobilization and credit delivery at market rates. The outflow of capital has been reversed. Financial savings grew from below 4 % to almost 20 % of GNP, M_2/GNP from below 15 % to 37%: the level from which industrialized countries have usually entered into the phase of economic take-off and rapid development. (Graph 1)

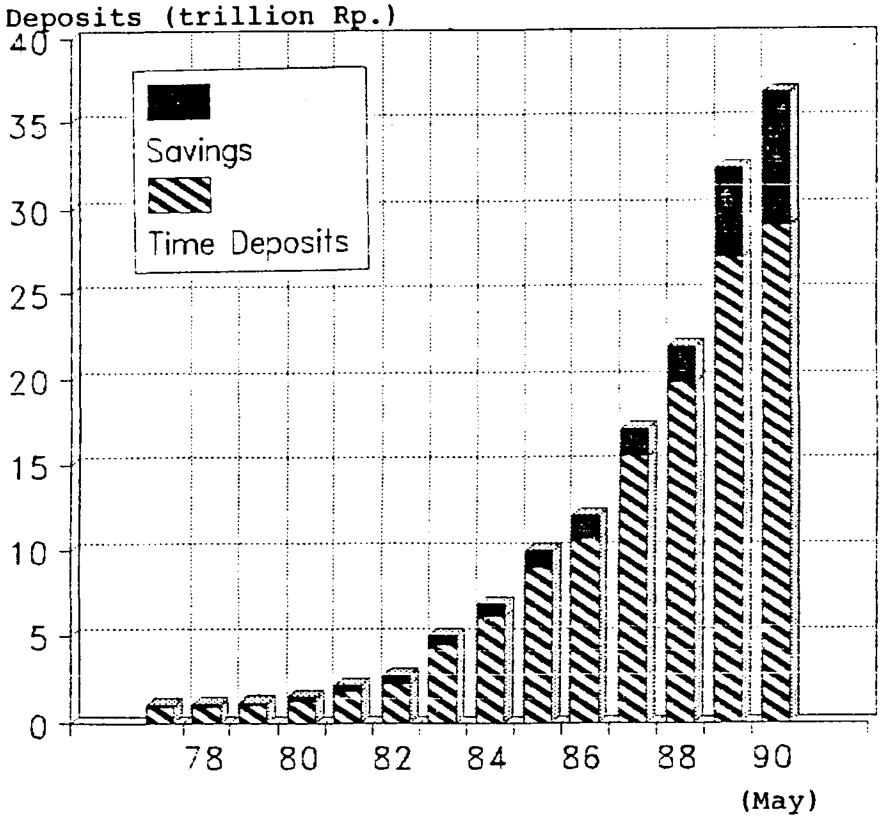
Graph 1: Ratios of Financial Savings to GDP in Indonesia, 1979-89



Source: Klaus Maurer

Since PAKTO 27, the mobilization of financial savings has skyrocketed, including to an increasing extent savings from the poorer sections of the population. Savings deposits, which are the form of money-holding of the poor, have grown even faster than time deposits in which the rich usually hold their money. (Graph 2)

Graph 2: Increase of Time and Savings Deposits, 1977-May 1990 (in trillion Rupiah, nominal)



Source: Klaus Maurer

In rural finance, government-owned Bank Rakyat Indonesia (BRI) bank with its rural mandate is perhaps the most impressive illustration of the impact of financial deregulation. In only seven years, it changed from an agency channeling government funds at a loss to a profitable commercial bank. While its rural lending scheme expanded at a phenomenal rate, its savings mobilization grew even faster, proving beyond doubt that rural savings exist! In December 1989, it passed the 100 % mark of fund mobilization for rural credit. Rural savings at that point amounted to Rp. 850 bn in BRI, outstandings to Rp. 846 bn. In 1989, 1.64 million borrowers had loans averaging Rp. 777,000. At present (Nov. 1990), the number stands at 1.9 million. The long term loss ratio was 3.26 %. BRI has now started to move into urban finance, mobilizing savings and extending credit to urban informal sector enterprises.

BRI has also proven that credit at market rates is more effective: Under the subsidized BIMAS credit program, Rp 2.55 trillion (in 1989 prices) were lend over a 14 year period (Rp. 182 billion per year); under BRI's nonsubsidized KUPEDES scheme, Rp. 3.75 trillion in 6 years (625 billion per year).

1.3. Transaction costs: the core problem of microfinance

Yet, despite a favorable policy environment in Indonesia and a rapid pace of expansion of the financial system, formal finance has not reached more than between 5 and 30 % of rural households and of urban informal sector households, with wide variations between different parts of the country. What keeps the banks from effectively reaching the poorer sections of the population is the core problem of microfinance: **transaction costs.**

Both savings mobilization and credit delivery involve transaction costs: for both banks and their customers. They comprise interest, noninterest and opportunity costs. Given the small size of savings, loans and installments, both the people and the banks find their transaction costs too high. A microentrepreneur will not deposit Rp. 1000 in a bank if he has to spend Rp 1200 on transportation; and a bank will not lend him Rp. 200,000 at 24 % p.a. if its fixed costs per loan are Rp. 50,000.

Exhibit 1: Cost components of financial intermediation

Cost incurred by	Cost Category	Cost Item
Savers	Cost of Deposits	Inflation
		Transaction Costs
Financial Intermediary	Cost of Mobilizing Funds	Interest Costs
		Administration Cost
	Lending Cost	Transaction Costs - Information Costs - Administration Costs
		Cost of Risk/Default
		Opportunity Cost of Capital
Borrowers	Borrowing Cost	Interest Costs
		Transaction Costs

Source:
Klaus Maurer

There is thus a vicious circle of microfinance: banks cannot mobilize savings and disburse credit if their transaction costs are not covered; without access to financial services, such as savings and credit, the microenterprises of the poor stagnate; stagnating microenterprises do not generate enough income for deposits, loans and installments above the break-even point. Hence, banks and the poor continue to stay apart.

2. Linking banks and self-help groups: an innovative solution to the transaction cost problem

2.1. Prerequisites

Two prerequisites must be met if microentrepreneurs should gain adequate access to financial services:

(a) Financial institutions must be permitted to cover their costs from the margin. This prerequisite is fulfilled since banks in Indonesia are free to set their own interest rates on savings and credit. Each bank can differentiate its margin and adjust it to the cost and risk structure of different groups of customers.

(b) The transaction costs of formal finance are too high for the banks to reach the poor; self-help groups reach the poor but their funds are insufficient for the growing financial needs of microentrepreneurs. A solution is provided by a link between banks and SHGs.

2.2. Background and history

The linkage approach was initiated in 1986 by **APRACA**, an association of central and rural banks in Asia and the Pacific. Together with Bank Rakyat Indonesia and Bina Swadaya, Bank Indonesia (BI) as the central bank started the first pilot program of the region in September 1988. Policy guidance is provided by a **national task force** comprising banks and NGOs. Technical assistance is rendered by Deutsche Gesellschaft fuer Technische Zusammenarbeit (**GTZ**) GmbH.

Training of bank, NGO and SHG staff began in Febr. 1989. The first bank-SHG linkage occurred on 31 May 1989. In mid-1990, **institutionalization** became the core strategy of **self-sustained linkages**: through linkage units in banks and NGOs, financial management training by the bank training institute LPPI and Survey, Training and Consultancy units in major NGOs. Project staff are now in the process of gradually transferring their functions to these institutions. With the support of BI, they will become instrumental in **intensification, expansion** and **national implementation.**

The program has been operative in four pilot project areas. BI and the National Task Force are presently making preparations for expansion into five additional provinces.

2.3. Guiding principles

Through a set of interrelated guiding principles, **factors of institutional viability and sustainability** were systematically built into the program design:

- o Working through existing institutions
- o Respecting the autonomy of participating institutions
- o Recognizing SHGs and NGOs as financial intermediaries
- o Promoting savings mobilization
- o Linking savings and credit
- o Using group savings as partial collateral
- o Advocating group liability
- o Granting financial incentives for timely repayment
- o Ensuring fast services through simple procedures
- o Achieving financial viability through market rates
- o Encouraging banks to assume the credit risk
- o Ensuring institutional viability of banks, SHGs and NGOs through cost coverage from the interest margin

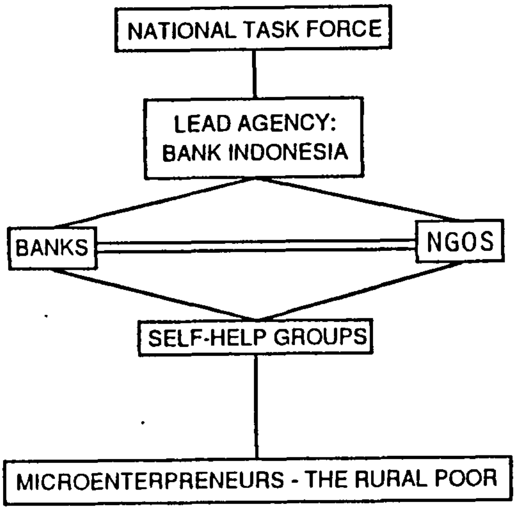
2.4. Program design

BI acts as a **facilitator** between banks, SHGs and NGOs (Graph 3). It only provides recommendations, no compulsory scheme. Its **objectives** are,

- o to improve access to financial services
- o for the poorer sections of the rural population
- o by linking SHGs and banks,
- o thus minimizing transaction costs.

By bringing the three partners together, business relations ensue in their own self-interest. No direct subsidies are provided as they would prevent viability and sustainability.

Graph 3: Project Design



The target group comprises **self-help groups** of,

- o rural microentrepreneurs in the informal sector
- o small farmers and tenants
- o the rural poor
- o women and men in villages and rural towns.

2.5. The role of self-help groups

Self-help groups are local organizations which are near their members. They may be of indigenous origin, or they may have been initiated by governmental or non-governmental organizations. On the local level, the distinctions by origin are frequently only of analytical relevance; in reality, they overlap. For instance, an arisan may come under the guidance of a government organizations, which in turn enlists the training and consultancy services of an NGO.

As a result of proximity, the transaction costs in SHGs are minimal: for the group and for the members, i.e. for savers, borrowers and lenders. Their main functions are:

- o providing guidance in all matters
- o collecting savings from the members
- o building up an internal loan fund
- o examining the credit worthiness of borrowers
- o providing financial consultancy services to members

- o arranging for informal collateral or guarantees
- o granting loans to members
- o collecting installments
- o applying social control mechanisms to enforce repayment
- o acting as a credit guarantee group
- o acting as a financial intermediary between members and outside agencies (such as government agencies, donors, NGOs, banks)

Prerequisites for effective financial intermediation are that the SHGs possess,

- o good organization
- o adequate savings activities
- o internal lending activities with satisfactory performance
- o good book-keeping
- o income-generating activities of members with absorptive capacity for additional credit.

2.6. The role of NGOs

NGOs working with financial SHGs may have two basic functions with regard to SHGs:

- o guidance, training and consultancy in financial and non-financial matters
- o acting as a financial intermediary between SHGs and donors or banks.

If NGOs act as financial intermediaries, their activities may include any of the following:

- o financial extension services
- o training in bookkeeping
- o training in financial management
- o promoting innovative savings schemes, e.g. daily savings collection in the informal sector
- o mediating contacts with a bank
- o depositing savings of SHGs in a bank
- o examining the credit worthiness of SHGs
- o negotiating bank loans for SHGs
- o entering into a loan contract with a bank as the legal borrower
- o onlending to SHGs
- o collecting installments from SHGs
- o bearing the credit risk
- o repaying the loan.

NGOs not acting as financial intermediaries may still carry out several of these activities, except entering into a loan contract and bearing the credit risk. The extent to which financial transactions, such as collecting savings and repayments, are carried out by NGO or bank personnel depends on the individual case.

Prerequisites are that the NGO possesses,

- o concerning training and consultancy (T&C): the necessary T&C competence

- o concerning linkages with banks: financial management skills

- o concerning financial intermediation between SHGs and banks: financial reserves to absorb arrears and bear the risk.

2.7. Linkage Models

Two models are suggested to participating institutions: a model of direct linkages between banks and SHGs, which may or may not include NGOs in an advisory function, and a model of indirect linkages which works through NGOs an additinal intermediary.

LINKAGE MODEL I: DIRECT LINKAGES

MEMBERS — SHG — BANK

LINKAGE MODEL II: INDIRECT LINKAGES

MEMBERS — SHG — NGOS — BANK

5.5. Performance

During the first 18 months of linkage implementation in the field, i.e. until 30 September 1990, 20 banks or bank branches, 13 NGOs and 355 SHGs actively participated in the linkages. During that period the 355 SHGs deposited savings of Rp. 355 million in banks. They obtained 427 bank loans of Rp. 1.77 bn. (US$ 950,000). Outstandings were 1.34 bn. 49.6 % were lent directly to SHGs (model I), 50.4 % through NGOs as intermediaries (model II). Close to 6500 members received loans averaging Rp. 272,000: 98.6 % of them for income-generating activities. The arrears ratio between banks and SHGs (Model I) was below 0.5 %; between banks and NGOs (Model II) all payments were on time. The arrears ratio between SHGs and NGOs as well as banks was 1.2 %.

Banks have gained new confidence in rural microentrepreneurs from the poorer sections of the population. They were found to be good savers, prudential investors and reliable borrowers.

Self-help groups in the informal sector have gained access to bank finance at market rates. Credit supply is no longer limited by scarce subsidies. It is only the capacity of microentrepreneurs to save, invest and repay which may limit their effective demand for credit.

3. How to guarantee a high standard of quality of linkages between self-help groups and banks: Some practical experiences

The following basic conclusions have been drawn from the project experience during 1989 and 1990:

- o Deregulation of the financial system has provided the policy environment in which linkages between banks and self-help groups can freely develop

- o Rural savings exist and can provide a solid basis to the rural financial system

- o Market rates of interest ensure the feasibility and viability of microcredit to microentrepreneurs

- o The application of solid financial management principles by both banks and NGOs leads to excellent loan performance in the informal sector

- o The cooperation of banks, self-help groups and NGOs works effectively and strengthens the system of rural finance

- o Inclusion of self-help groups and NGOs as financial intermediaries benefits the poorer sections of the population and stimulates the growth of microenterprises

- o Women participate as savers and borrowers in large numbers.

These conclusions provide the framework for the following more practical experiences which are given in the form of

RECOMMENDATIONS TO BANKS AND NGOs IN INDONESIA.

(1) Linking Banks and Self-Help Groups (LBS) is your own program

1.1. Treat LBS as your own program or scheme.

1.2. Work out your own terms and conditions. They may be based on Bank Indonesia's recommendations; but they should not be blindly followed.

1.3. Adjust terms and conditions to the local situation so that there is a balance between your own interests and those of your target groups. This may imply a differentiation of terms and conditions by area, type of target group, costs, risks, etc.

1.4. Produce your own leaflet and information materials. Of course you can use Bank Indonesia's leaflet as a source; but make sure you adjust it to your own needs.

1.5. Examine Bank Indonesia's recommendations carefully. There are several which should not be disregarded without good reason (e.g., recommendations concerning selection criteria of SHGs and training requirements).

1.6. Take your own initative. Find your own bank, NGO or SHGs. Bank Indonesia staff will do its best to assist you; but don't just wait for them.

(2) Prepare your organization for the linkage program

2.1. Bank and NGO management may participate in exposure programs

2.2. Assign staff full-time or part-time to LBS. With the growth of LBS, you may eventually consider establishing a LBS unit.

2.3. Train your staff (bank loan officers, NGO supervisors or field workers) adequately. They may participate in LBS information training and special training courses.

(3) Select participating NGOs prudentially

3.1. Any participating NGO should be capable of providing adequate guidance to financial SHGs.

3.2. An NGO participating as a financial intermediary (model II) should meet the following requirements:
- a proper auditable book-keeping system and annual audits
- basic financial management capability
- reserves to provide for arrears or nonfulfillment of financial obligations of SHGs

3.3. If one of these conditions is not met, several alternatives are possible:
- applying model I with direct loans from banks to SHGs, shifting all financial intermediation to the bank
- direct loan contracts between banks and SHGs, but leaving some financial intermediation activities (e.g., savings and repayment collection, loan negotiation) with the NGO
- cooperation with another NGO in certain fields
- remedying the situation, e.g. through special training or consultancy activities.

(4) Select participating SHGs prudentially

4.1. SHGs participating in LBS should fulfill the following criteria:
- good organization, which includes capable staff or board members, proper elections of board members; village authorities should normally not be represented among the board
- local autonomy, no interference from local authorities
- good financial standing vis-a-vis NGO or bank (no repayment failures)
- satisfactory internal savings and credit activities (no bad debts of members, no excessive arrears) for at least 6 months
- proper book-keeping system and financial procedures

4.2. If any of these criteria are not fulfilled, steps should be taken to remedy the situation through special training and consultancy activities. Normally, these will be provided by an NGO.
4.3. Banks and NGOs are advised to select SHGs only from within a close geographical area in which effective guidance and supervision are possible

4.4. In cases where SHGs are guided by other organizations (such as religious bodies, government cooperatives, etc.) special clearance may be required.

(5) Assure adequate training of SHG staff or board members

5.1. Adequate training of SHG staff or board members should be assured, particularly in the fields of,
- book-keeping
- basic training
- LBS information.

5.2. A training plan should be worked out by the guiding NGO concerning such fields as
- financial management
- income-generating activities and household economy

5.3. Upon request, LBS offers a book-keeping system specifically developed for SHGs

5.4. Training first: No credit without preceding training!

(6) Stimulate savings mobilization by SHGs

6.1. Internal savings mobilization is the core of self-help.

6.2. External finance must not replace adequate self-financing and internal savings.

6.3. Through proper guidance and consultancy, internal savings mobilization can be greatly stimulated. In addition to the three usual types of savings á equity, compulsory monthly and voluntary monthly savings á, innovative forms of savings mobilization which are more adequate to the informal sector should be promoted, such as
- doorstep financial services
- daily (or weekly) savings collection.

6.4. Savings first: all credit must be preceded by savings.

(7) Set interest rates at market level

7.1. Every participating institution is autonomous in its interest rate determination. It is recommended that each should cover its costs from the margin:
- banks
- NGOs and
- SHGs.

This is the basis of their institutional viability. However, the costs of training may have to be borne from outside sources.

7.2. Interest rates should be market rates reflecting,
- cost of funds,
- administrative costs and risks.

7.3. Interest rates may be calculated and expressed as,
- effective rates per year
- effective rates on the remaining balance per month (menurun per bulan)
- flat rates per month on the original loan amount disbursed (tetap per bulan)
- effective or flat rates on 35-day periods
- effective or flat rates on other time periods.

(8) Include margins for banks and NGOs

8.1. Interest rates of banks may be differentiated according to the service provided, reflecting for example,
- the costs of doorstep services
- the costs of servicing remote or inaccessible areas.

If interest rates are not differentiated, there is a danger that the bank will only serve customers who can be reached at low costs.

8.2. The margin of NGOs may be differentiated according to services provided, particularly
- financial intermediation services (savings collection, borrowing and relending, repayment collection, loan negotiation, creditworthiness examination of SHGs)
- guidance and training
- consultancy
- loan supervision.

(9) Assist SHGs in interest rate determination

9.1. Without access to external finance, most SHGs choose a high rate of interest on loans to members reflecting,
- their intention to build up an internal loan fund not only from savings but also from interest income
- scarcity of, and high demand for, credit

9.2. With access to external finance, SHGs should be assisted in discussing interest rate determination with their members to find a balance between two opposing considerations:
- SHGs may choose a high interest rate if they want to build up their internal loan fund quickly
- SHGs may choose a low interest rate if they want their members' microenterprises and incomes to grow quickly
- SHGs have to evaluate the impact of the loans on members incomes and savings behavior; low interest rates might enable members to save more from higher incomes
- The group is autonomous and has to decide on its priorities.

(10) Work out appropriate joint liability arrangements

10.1. Group lending implies joint liability, i.e., the group is responsible for arrears and nonrepayments of individual members.

10.2. There are several alternatives which have to be examined in each individual case:
- liability of the board members on behalf of the group
- liability of the actual borrowers
- liability of all group members.

(11) Advise SHGs on nonformal collateral

11.1. Collateral between SHG and members may not be required if social cohesion is strong and local social controls function well.

11.2. In all other cases, the SHG may be well advised to protect itself against the risk of nonrepayment,
- either through nonformal collateral, i.e. a list of items such as radio, bicycle, house, land which is signed by the borrower and witnessed by the board but without notary public
- or through guarantors who in turn may submit collateral.

A person who is not able to produce either one may not be considered trustworthy by his family and friends.

(12) Work out appropriate collateral arrangements with SHGs

12.1. The basic collateral are the blocked savings of the group deposited in the bank (usually about 20-25 % of the nominal principal)

12.2. The joint liability of the group is a substitute for physical collateral (agunan), but forms an essential element of the group's creditworthiness (jaminan).

12.3. NGOs and banks may examine whether the pledges of nonformal collateral collected by the SHG should stay with the group or be signed over to the NGO or the bank as part of their security.

12.4. In case of group loans to individuals exceeding a certain amount (e.g., one million Rupiah), formal collateral may be required.

(13) Join the loan protection scheme

13.1. Groups may join a loan protection scheme which ensures the group against the risk of loan defaults resulting from the death of a member

13.2. A special loan protection scheme, DAPERMA, is offered by the Federation of credit unions in Indonesia, BK3I.

(14) Cooperate with your partners in loan examination

14.1. Direct bank loans to NGOs or SHGs are examined by the bank.

14.1. Loans to KSM through NGOs are examined by the NGO; banks may carry out spotchecks, particularly at the beginning of the cooperation with an NGO. NGOs and banks are encouraged to make use of information provided by the Monitoring System of the project.

14.2. The examination of loans to members is carried out by the board of the SHG; NGOs and banks may carry out spotchecks, particularly in the initial phase. The PPLBS mMnitoring System may provide useful information.

(15) Encourage productive loan usage by microentrepreneurs

15.1. Loans from banks or NGOs to SHGs are expected to be onlent to members.

15.2. Loans to SHGs for group enterprises are strongly discouraged as they have usually failed. Exceptions should be very carefully examined and supervised.

15.3. The usage of loans from SHGs to members is determined by the SHGs and their members.

15.4. SHGs are strongly encouraged to emphasize productive uses of the loans. Loan at the present level of interest rates should normally not be used for nonproductive purposes.

(16) Determine adequate loan ceilings

16.1. There is no general recommendation concerning loan ceilings to SHGs.

16.2. On principle, loan ceilings should be derived from estimated absorptive capacities, which includes the capacity to save, invest and repay

16.3. During the first cycle of loans, it is recommended to to set a ceiling of Rp. 1 million for loans from SHGs to individual members.

16.4 Banks may adjust loan ceilings case by case.

(17) Determine adequate ratios of savings to credit

17.1. It is recommended to request a deposit of blocked savings before a loan is granted.

17.2. In a first cycle of loans, it is recommended to start with a conservative ratio of savings to credit, e.g., 1:3 or 1:4, reflecting the bank's assessment of risks involved.

17.3. If repayment has been satisfactory, the ratio may be increased after each cycle, until the absorptive capacity of the group and its members has been reached.

17.4. The blocked savings should be genuine savings of the group and its members; they should not have been borrowed from external sources.

(18) Determine appropriate maturities

18.1. Banks, NGOs and SHGs should base maturities on four factors:
- financial needs of the borrower
- previous savings and credit record
- financial management capacity of borrower
- creditworthiness and confidence

Maturities which exceed the financial needs and the handling capacity of the borrowers are very risky.

18.2. Maturities should thus be differentiated and not uniform. Particularly, loans should not all be at the recommended maximum maturity.

18.3. Shorter maturities have two advantages which should be strongly emphasized in consultancies to NGOs, SHGs and members:
- they are easier to handle and thus less risky
- they permit a more dynamic growth of the loan portfolio.

E.g., a loan of Rp. 10 million for 18 months binds the borrower for that period and makes additional increases in bank loans difficult. With 6-month maturities, the loan may increase during the same period from a first loan of Rp. 6 million to a second loan of Rp. 10 million and a third loan of Rp. 15 million, each for 6 months.

18.4. First loans under LBS to NGOs, SHGs or members should have shorter maturities. Subsequent loans may have longer maturities if justified.

(19) Choose short maturities for first loans under the linkage program

19.1. First loans from banks to NGOs should not exceed 12 months, varying between 6 and 12 months. The recommended maximum for second loans is 18 months.

19.2. First loans from banks or NGOs to SHGs may vary between 3 and 12 months but should normally not exceed 6 months. Only mature SHGs (e.g., certain credit unions) should obtain first loans up to 12 months and second loans, if justified, up to 18 months.

19.3. The greatest need in the informal sector is for short-term working capital loans. Loans from SHGs to members should be well adjusted to their needs and capacities. Loans may vary from 1 to 6 months. First loans to members should definitely not exceed 12 months.

19.4. Loans received and onlent by a financial intermediary may have to undergo a term transformation, e.g. from 12 to 6 months or from 6 to 4 or 3 or 1 months. This implies that repayments may have to be lent out again to assure that there is no idle money.

19.5. If NGOs or SHGs are not capable of transformation of terms (e.g., transforming a credit received for 12 months into credit onlent for 6 months), the bank should lend at the same short terms at which the final borrower is expected to obtain the loan.

19.6. SHGs with very weak financial management capabilities should only handle loans of short maturities.

(20) In first loans, lend without a grace period

20.1. First loans from banks or NGOs to SHGs and from SHGs to members should be without a grace period.

20.2. Exceptions should be carefully examined. Even if a loan is used for agricultural purposes, borrowers usually have income from various sources which permit monthly repayments.

20.3. If short grace periods (e.g., one, two or three months), the loan amount should be kept small.

(21) Insist on timely repayment

21.1. Banks, NGOs and SHGs must insist on timely repayments. This is to be strongly emphasized in loan negotiations and in all training and consultancies.

21.2. Loans from banks or NGOs to SHGs and from SHGs to members must be repaid in regular installments.

(22) Determine appropriate terms of loan repayment

22.1. Loans from banks to NGOs may be repaid in regular instalments (e.g., monthly or quarterly), or there may be a credit line. Only mature NGOs which good financial management should be accorded a credit line.

22.2. Banks and NGOs should adjust to customary instalment cycles, such as 35 days (selapan, a common traditional time period). It can be disruptive if SHGs or members are forced to switch from 35 days to monthly repayment, particular when the group has its meetings every 35 days.

22.3. Loans from banks and NGOs to SHGs should be repaid in regular instalments, usually monthly or perhaps in 35-day periods.

22.4. Loans from SHGs to members should be repaid in appropriate instalment periods, which may be daily, weekly, at market days, monthly, in 35-day periods, etc.

(23) Work out repayment schedules for all levels of onlending

23.1 A bank or LPSM lending to SHGs must give the borrower a written repayment plan as part of the loan contract which clearly states the dates and amounts of installments.

23.2. A SHG must give each borrower an individual repayment plan as part of the loan contract with clearly specified due dates and amounts.

23.3. The bank or NGO is responsible for assiting the SHG in setting up the individual repayment plans and handing them over to the members. An illiterate member may be assisted by a literate member whose name may be indicated on the repayment plan.

(24) Select appropriate signatories of SHG loan contracts

24.1. Loan contracts are normally made with the board of a SHG acting on behalf of the group.

24.2. In special cases, the loan contract may be made with all final borrowers whose names and signatures appear on the loan contract which may then be cosigned by the board of the SHG.

(25) Deliver credit publicly

25.1. If possible, credit delivery to SHGs and members should be simultaneous and in public, i.e. during the regular meeting of the SHG.

25.2. If this is not possible, credit delivery to a SHG should always be in the presence of several board members and selected members, at least one or two of the major borrowers. A loan must never be handed over to a single representative of the group.

(26) Use incentives for timely repayment (IPTW)

26.1. It is recommended to include a rebate for timely repayment (Insentif Pengembalian Tepat Waktu) by SHGs in the interest rate calculation.

26.2. It is recommended to charge 10 % of total interest paid
as IPTW (e.g., 10 % out of an interest rate of 29 % would be equivalent to an IPTW of 2.9 % on each interest payment to be refunded to the SHG).

26.3. In the case of loans with relatively short maturities (up to 6 months), the IPTW should paid back at the end of the lending period. In the case of longer maturities, the bank or NGO may consider partial repayment of IPTW at certain intervals, i.e. in 6 months periods.

26.4. In case of direct loans from banks to SHGs (model I), the IPTW is kept by the bank until repaid; in case of loans from NGOs to SHGs (model II), the IPTW is kept by the NGO.

(27) Select appropriate penalties for delays in payment

27.1. Penalties for late payment are normally an alternative to IPTW.

27.1. Penalties for late payment may be imposed:
- by the bank or NGO on arrears of KSM
- by the KSM on arrears of members.

27.2. The two systems may be combined, e.g.,
- IPTW on loans between banks or NGOs and SHGs and
- penalties on loans between SHGs and members.

27.3. Penalties are normally calculated as an increase of the interest rate on the remaining balance for each month during which payments are in arrears.

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