

LUMBUNG KREDIT PEDESAAN (LKP) PROGRAM

Program Description

The province of Nusa Tenggara Barat (NTB) owns a system of semi-formal financial institutions called *Lumbung Kredit Pedesaan* (LKP). The author visited LKP units in Dompu District, and this report reviews only the LKP units located in this district. One unit was established in each of Dompu's four sub-districts between 1989 and 1991. Each unit is located in a sub-district capital and serves most of the villages in that sub-district via approximately weekly field staff visits to the villages. Units have a very similar structure to that of the BKKs.

Three of the units were founded through capital endowment grants (about US\$5,800 to US\$8,400 per unit) from USAID, and the fourth received an initial endowment by the province. The units do not receive fixed or regular subsidies from the government. However, over the last several years, both the provincial and district governments have provided the units with motorcycles, upgraded facilities, and modest additional capital endowment grants. In addition, supervision costs are partially borne by the provincial development bank (BPD). Finally, units do not pay taxes.

In theory, unit profits are divided among stakeholders as follows: 50 percent to the provincial (and sometimes district) government as dividends; 15 percent to general reserves; 15 percent to special reserves; 10 percent to employee bonuses; and 10 percent to an employee welfare fund. In practice, the provincial and district governments' annual dividends and the funds for general and special reserves are added to retained earnings. Thus, the units actually retain 80 percent of their profits.

Program Supervision. The units are supervised by the district branch of the BPD. The BPD makes all policy decisions for the LKP, including the types of savings and lending products units can offer, the terms they can charge on these instruments, how they should provision for bad debt, when they should write off loans, what their underwriting and loan servicing procedures should be, whom they should hire, how they should train staff, etc. The Dompu district branch of the BPD has one full-time supervisor to oversee the four LKPs in its district. Two of these units are within walking distance of the BPD branch. Despite the fact that the supervisor oversees only 4 units, one unit manager was able to effectively bankrupt his unit by making fraudulent loans and embezzling funds.

Loan Product

LKPs have one loan product, a 12 week loan repayable weekly in 12 equal installments. The first installment represents the interest due on the loan, the next a forced savings payment, and the final 10 are repayment of capital. Many other government-owned, semi-formal financial institutions in Indonesia offer the same product with similar repayment terms. The effective interest rate for this product, including a fee of Rp. 2,500 (US\$1.10), is about 8.3 percent per month or 160 percent annually on a declining balance basis. This figure assumes that the forced savings, and the interest earned on this savings, is returned after the loan is repaid, as BPD supervisors claim.

The loan size ranges from Rp. 50,000 (about US\$21) to Rp. 500,000 (about US\$214). Loans above Rp. 200,000 (US\$86) must be approved by the BPD which supervises the LKPs. Loans do not require physical collateral.

Group Lending. LKPs do not offer group loans. NTB's BPD staff who were supervising the LKP system did not believe that this lending modality would be useful for LKP, although the PHBK program was operating in the same area and presumably demonstrating some of the advantages of group lending schemes.

Savings Product

Units have one voluntary savings instrument - a demand deposit with no restrictions on withdrawal. The instrument pays a 10 percent annual return. This rate is almost identical to the rates paid by the other programs reviewed in this report, and is also about the same as the rate BRI Unit Desa pays on small demand deposits. Forced savings also carry a 10 percent annual interest rate.

Staffing

Units are staffed by from 6 to 11 employees. All employees must have at least a high school degree, and unit managers should have a college degree. Staff must pass a test before they are eligible for employment. All staff receive one month of training before they begin work.

In 1995, staff salaries range from Rp. 90,000 (US\$39) to Rp. 150,000 (US\$64) per month. On an annualized basis, this is equivalent to a range of 49 to 79 percent of per-capita GDP. In addition, all employees of a given unit share a total of about 20 percent of nominal unit profits in the form of bonuses and a welfare fund. For the most successful unit, this bonus and welfare fund would have amounted to an average of about Rp. 400,000 per employee - equivalent to from 2.5 to 4.5 months' salary. Employees are eligible for an additional bonus if 94 percent or more of total payments due during a 3 month period have been collected by the end of that period. However, none of the units have been able to achieve this collection rate for the last several years.³²

Underwriting and Loan Servicing

Prospective borrowers must obtain a written recommendation from their village headman and have a functioning business. Unit personnel visit the business site of each prospective borrower to verify business viability before issuing the loan. If the borrower is married, his or her spouse must also sign the promissory note. Loans are disbursed within two weeks of the unit receiving the borrower's application. Each borrower is visited weekly to solicit his or her repayment installment. Borrowers who do not repay are also visited weekly to attempt to collect past due funds. The staff attempt to find out why repayments are delayed and encourage partial repayments for delinquent borrowers.

³² This is not surprising given that the units carry loans on their books which have defaulted some time ago and should be written off.

Program Performance

This section reviews program performance as measured by sustainability and outreach. Sustainability is measured by the program's arrears rate, its profitability, and the size of the subsidy required to sustain operations. Outreach is measured by the volume of annual lending and savings activities (scope) and the population it serves (depth of market penetration).

Sustainability. This analysis estimates arrears rates assuming that units wrote off 100 percent of their loans in default each year.³³ If the arrears rate is recalculated in this way, the volume of loans in arrears is equal to 20 percent of net outstanding loans in 1995 for the system as a whole (excluding one unit for which data are not available). In all, one unit has maintained consistently low arrears rates since 1992.

The other three units had loans in arrears equal to 18 percent of total loans over the period. For Hu'u, loans in arrears reached 78 percent of total loans in 1993. The program did not have arrears data for the unit thereafter (Table 16). The program's arrears rate is significantly higher than that which would be considered sound by international microcredit standards.³⁴

Table 16
Adjusted Annual Arrears Rates^a for LKP Units in Dompu District (Percent)

Units	1992	1993	1994	1995
Total	16	30	NA	20 ^b
Hu'u	20	78	NA	NA
Montabaru	4	4	NA	7
Sariutu	23	23	NA	37
Bada	18	22	NA	22

a/ $(\text{Volume of Loans in Arrears in Year 1} - \text{Volume of Loans in Default in Year 0}) / (\text{Outstanding Loan Volume in Year 1} - \text{Loan Volume in Default in Year 0})$.

b/ Excludes the Hu'u unit for which 1995 data were not available.

³³ The LKP system defines loans in default as being more than 90 days late in payment.

³⁴ The Committee of Donor Agencies for Small Enterprise Development (1995) set as an acceptable standard for microenterprise lending, that 10 percent or less of total loans should have late payments of 30 days or more. BKK's arrears rate in 1995 includes loans that are one day late or more, so it is not directly comparable. However, it is twice as high as the standard, and did not include arrears information for the program's most troubled unit.

Simulating the units' default rates if LKP wrote off 100 percent of its loans in default each year, the volume of loans in default is equal to 5.5 percent of net outstanding loans in 1995 for the system as a whole (excluding one unit for which data is not available). Two units have maintained consistently low default rates over the last three years. One unit had low default rates in 1993 and 1994, but experienced a significant upsurge in 1995, and one unit experienced default rates in excess of 30 percent for the two years for which information was available (Table 17). The program's default rate is somewhat higher than that which would be considered sound by international microcredit standards.³⁵

Table 17
Adjusted Annual Default Rates^a for LKP Units in Dompu District (Percent)

Units	1993	1994	1995
Total	11.5	3.8	5.5 ^b
Hu'u	45.8	31.0	NA
Montabaru	1.7	0.3	1.1
Sariutu	2.4	3.6	0.6
Bada	2.2	1.6	12.6

a/ (Volume of Loans in Arrears by 90 Days or More in Year 1 - Volume of Loans in Arrears by 90 Days or More in Year 0)/ (Outstanding Loan Volume in Year 1 - Loan Volume in Arrears by 90 Days or Mores in Year 0).

b/ Excludes the Hu'u unit for which 1995 data were not available.

It is very difficult to estimate unit profitability as income statements and balance sheets provided by the BPD contain some apparent errors, omissions, and inconsistencies. Further, basic earnings measures, such as return on equity and return on assets, are problematic given that the LKPs receive endowment grants and in-kind gifts including supervision by the BPD at a subsidized cost. The units receive an additional implicit subsidy in that they do not pay taxes on income. Finally, the units do not adequately provision for bad debt.

If all of these factors are ignored, the three units for which information is available showed a combined real (above inflation) return on assets of 1 to 6 percent over the last three years. However, if rough estimates of expenses for depreciation of fixed assets, adequate loan loss provisioning, taxes, reserve requirements, and full supervision costs are made,³⁶ and the units'

³⁵ The Committee of Donor Agencies for Small Enterprise Development (1995) set as an acceptable standard for microenterprise lending, that lenders should have annual losses from defaults of 4 percent or less of outstanding loan volume. LKP's 1995 rate is above this level and did not include defaults for its most troubled branch.

³⁶ There is no need to impute additional interest to LKP liabilities because LKP pays market interest rates on liabilities. For a number of years the LKP system had loans from the provincial BPD for which it paid below-market "interest rates" which also served as fees for supervision. However, these loans were converted to equity in 1995. For the purposes of this analysis, these loans are treated as equity for all years and the interest expense/supervision fee is treated as a supervision fee.

The LKP system also funds part of its portfolio from savings accounts required from borrowers. These required savings accounts earn an interest rate below that which the program would have to pay to obtain marginal additional resources from another source. For the purposes of this analysis, this practice is

average outstanding assets are adjusted to take into account adequate loan loss provisioning,³⁷ then the units' adjusted real return on average assets was -22.3 percent in 1993, -8.8 percent in 1994, and -5.2 percent in 1995 (Table 18). Taking into account the above additional expenses, the units' adjusted real return on average equity was -33.3 percent in 1993, -9.7 percent in 1995, and -2.8 percent in 1995.

Assuming that equity holders earned an interest rate equivalent to the average 3 month time deposit rate plus a 4 percentage point spread, the units' Subsidy Dependency Index (the percent increase in the interest rate that is required if the unit were to be fully self-supporting including paying a market rate of return to liability and equity holders)³⁸ would have improved sharply from 104 percent in 1993 to 24 percent in 1995.³⁹ The program's equity to assets ratio was 68 to 73 percent from 1993 to 1995. Reducing this ratio to a level more in line with that of commercial banks and replacing equity with liabilities would have reduced the program's Subsidy Dependency Index. However, the program could not have achieved full self sustainability through this approach.

considered to be equivalent to generating additional fee income from loans and is not counted as a subsidy. However, footnote 39 on page 47 examines what the program's total subsidy would have been if access to these required savings were treated as a subsidy.

³⁷ This analysis did not have information concerning when gifts of assets and equipment were received. Therefore, it was not possible to adjust equity and assets to reflect owners' initial contributions and to then depreciate these assets over their life. The estimated depreciation expense is subtracted from annual profits, but its value is not deducted from assets or from equity.

³⁸ See Annex 7 for a description of how the SDI is calculated.

³⁹ LKP, like the other programs reviewed here, funds part of its portfolios from savings accounts required from borrowers. If this forced savings policy were considered a subsidy, the amount of the subsidy would be equal to the difference between the interest paid on the required savings and the interest the institution would have had to pay on marginal additional liabilities. When the SDI is recalculated to incorporate this additional subsidy, it increases from 104 to 107 percent in 1993, and from 24 to 27 percent in 1995.

Table 18
Estimated LKP Earnings Adjusted for Subsidies and Bad Debt Expenses

Units	Earnings Measure	1993	1994	1995
Three of four units				
	Adjusted real ROA (percent)	-22.3	-8.8	-5.2
	Adjusted real ROE (percent)	-33.3	-9.7	-2.8
	Subsidy Dependency Index ^a (percent)	104	41	24
	Current interest rate (percent)	160	160	160
	Required interest rate to cover all costs including market return on equity (percent)	325	225	198
Best performing unit				
	Adjusted real ROA (percent)	-0.2	-0.9	4.9
	Adjusted real ROE (percent)	5.6	3.1	11.9
	Subsidy Dependency Index ^a (percent)	0	10	-4
	Current interest rate	160	160	160
	Required interest rate to cover all costs including market return on equity (percent)	160	176	154

a/ The percent increase in the interest rate that is required if the units were to be fully self-supporting including paying a market rate of return to equity holders.

In 1995, the program would have had to charge a 198 percent annual interest rate to completely eliminate all program subsidies and pay liability and equity holders a market return on their investments. This rate is higher than the rate required for BKK and P4K, but below the rate required for PHBK. It is about 24 percent higher than the rate the units currently charge.

Again taking into account the additional expenses above, the best performing LKP unit could have provided an adjusted real return to equity holders of from 3 to 12 percent since 1993 . This unit's subsidy dependency index would have varied from 10 to -4 percent over the last three years (Table 18). The interest rate required to eliminate all of the unit's subsidies ranged from 154 to 176 percent.

Outreach Scope. The district of Dompou has four LKP units for its six sub-districts. When the units were founded, the district had only 4 sub-districts. District leaders hope to be able to create new units for the new sub-districts, but have no firm plans for doing so. Units serve 34 of the 45 villages (76 percent of villages) in the sub-districts where they are located.

In 1995, total lending for the four units was about Rp. 714 million (US\$313,000). This is equivalent to an average loan volume of Rp. 178 million (US\$78,000) per unit. However, loan volume is not divided equally among units. The unit with the largest volume

Table 19
LKP Annual Loan Volume

	1991	1992	1993	1994	1995
Nominal loan volume (Rp. million)	485,722	527,539	459,889	510,269	713,555
Growth in real loan volume (percent)	NA	3	-16	5	23
Loan volume (US\$)	246,559	258,598	218,995	234,068	312,963
Number of loans issued	6,409	4,689	3,079	3,122	4,148
Growth in number of loans issued (percent)	23	-27	-34	1	33

accounted for 47 percent of all loans, and the unit with the smallest volume accounted for 4 percent. Over the last five years, combined lending for the four units has increased slightly in real terms in every year except 1993. However, this pattern belies important differences across units. Specifically, one unit grew at a real compound annual rate of about 32 percent, while lending volume in each of the other three units declined in real terms by an annual average compound rate of from 1 to 28 percent. The number of loans issued by the four units in 1994 was less than one-half of the number issued in 1991. Lending rebounded somewhat in 1995, when the number of loans issued approached two thirds of the number in 1991 (Table 19).

Savings deposits grew rapidly between 1991 and 1993 (Table 20). However, savings declined at a real annual rate of 21 in 1994 and 12 percent 1995. Trends in savings for individual units approximately followed this general pattern. By the end of 1993, voluntary savings were equal to 35 percent of units' outstanding loans net of bad debt and required savings, but declined to 18 percent by 1995.⁴⁰ In 1995, total savings for the four units stood at Rp. 64 million (about US\$28,000).

Table 20
LKP Required and Voluntary Savings

	1991	1992	1993	1994	1995
Total nominal savings (Rp. million)	43.2	57.3	77.9	67.1	64.4
Real growth in savings (percent)	NA	23	24	-21	-12
Total nominal savings (US\$)	21,953	28,106	37,093	30,758	28,249
Total savings percent of total outstanding loans	36	39	50	38	30
Voluntary savings percent of net outstanding loans ^a	21	22	35	22	18
Real growth in voluntary savings (percent)		15	50	-31	-6

a/ The volume of voluntary savings is compared to that of outstanding loans net of required savings because in practice, savings required to obtain a loan are equivalent to borrowers receiving a smaller loan. Thus, comparing voluntary savings to loans net of required savings allows an analysis of the importance of voluntary savings in funding loans.

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Outreach Depth. The LKPs do not keep data on borrower income. Borrowers are primarily petty traders. Approximately 60 percent are women. The average loan size for the four LKP units in Dompu in 1995 was about Rp. 170,000 (US\$75). This is lower than the likely average loan size for the BKK and PHBK programs, and only slightly higher than the average loan size per individual under the P4K program. It is equivalent to about 7 percent of per capita GDP.

The BPD claims that units may serve villages as far as 100 kilometers away via bus trips that might take up to 3 to 4 hours each way. In practice, the reach of individual units varies. One unit said that it did not visit any villages further than one hour away from the sub-district capital by motorcycle. In practice, this meant that its range was limited to less than 30 kilometers. This range excluded the unit from serving one of the villages in its sub-district.

Productivity. While most units are recording at least a small annual profit on paper, their real, unsubsidized returns are generally negative. Furthermore, the units are not being managed with a keen regard to efficiency. The provincial BPD is responsible for staffing the units, and is using the LKPs as a means of employment generation without regard to unit needs. For example, one unit had from 6 to 8 staff members in the unit office (not including field staff) on any given day to handle from 10 to 30 transactions. The district branch of the BPD had one full-time employee to supervise the four units, a task that should have taken no more than 25 percent of his time. Excessive staffing creates unnecessary costs for the units, thereby depressing profits. Furthermore, it dampens employees' motivation to perform well. As indicated above, at a successful unit the annual bonus based on unit profits can contribute very significantly to employees' total compensations. However, the BPD increases unit staff sizes when the units are earning enough money to support additional salaries. The addition of each new employee reduces the bonus available for the current employees since the same total bonus and welfare fund (20 percent of profits) is divided between a larger number of people.

Unit policies also did not appear to be designed with productivity and client needs in mind. For example, LKP policy required borrowers to visit the unit office at least three times to obtain a loan. A private BPR serving the same clientele in the same district which also made use of field staff required borrowers to visit the office only once. LKP customers can give savings to field staff, but must go to the unit to withdraw funds from their savings account.

Reasons for Evolution in Program Performance. The units are heavily influenced by the expertise and honesty of their management. For example, one unit was driven to the brink of insolvency through corrupt management practices. Units are also influenced by the natural endowments (in terms of income, population density, and infrastructure) of their sub-districts. Further, as indicated above, the units are owned by the NTB provincial government and controlled by the provincial development bank. It appears likely that both of these entities have objectives for the units beyond profitability, growth, and client service.

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Response to Regulation No.71/1992 Supporting the 1992 Banking Law

The supporting Presidential Regulation for Indonesia's 1992 Banking Law does not permit informal financial institutions like LKPs to accept deposits unless they become BPRs or cooperatives. Informal financial institutions in existence before 1992 can become BPRs without meeting the minimum capital requirement that institutions created after 1992 must obtain. All four of the Dompu LKP units were established before 1992. However, Dompu's BPD planned to convert only two of the four units into BPRs. For the other two, they plan to comply with the letter of the law by nominally declaring the units to be cooperatives and redefining voluntary savings as "required members' savings." They plan to open new LKP units also nominally declared cooperatives in the two sub-districts that currently do not have these facilities

Competition

LKPs report virtually no competition for borrowers. Few LKP customers could qualify for BRI loans. There are virtually no BPRs in the area, and the PHBK program operates on too small a scale to erode their customer base. Like BKKs, LKPs report that cooperative leaders use their position in the cooperative system to function as private moneylenders charging a 20 percent flat monthly interest rate (equivalent to 1,600 percent per year on a declining balance basis). This rate is well above the LKP rate of about 160 percent. Thus, these individuals do not compete with the LKP units.

Units do compete with Unit Desas for deposits. LKP units pay an interest rate on deposits similar to the rate paid by the Unit Desas. LKPs can be more convenient than Unit Desas in that field staff visit villages on a regular basis and accept deposits. Nevertheless, the recent decline in the volume of outstanding savings indicates that the units are having trouble mobilizing funds in this way.