Conditions for Access of the Poor to Microfinance Services: the Views of the Rural Financial Institution Officers in Lombok, Indonesia

Kondisi Keterjangkauan Masyarakat Miskin Terhadap Pelayanan Pembiayaan Mikro: Pandangan Pengurus Lembaga Keuangan Pedesaan di Lombok, Indonesia

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Abstract

This paper discusses main issues useful for the provision of financial services to the poor. The discussion is based on the view of 23 officers of major Rural Financial Institutions (RFIs) in Lombok, Indonesia. Data collected through in-depth interviews using an open-ended questionnaire in 2007. It was found that providing rural-micro financial services can be financially feasible, cost-effective if three fundamental issues are dealt properly: These issues are: the poor had insufficient physical collateral; the poor had very limited knowledge and experience in banking; and the poor generally do not have permanent businesses. Suggested strategies are, as follows. Rural financial institutions (RFIs) should lend loans to those who have good characters and businesses; and implement adaptive and convenient service policy and mechanism. Contract enforcement is in=effective for group lending. Frequent visits, supervision and monitoring, good applicant screening and field officer incentives were among the instruments considered able to increase loan repayment of the poor. Fair regulatory and market environment is necessary for RFIs to sustain their services.

Key Words: Rural Financial Institution, Condition for Sustainable Access, Microfinance, and Lombok

Abstrak

Paper ini mendiskusikan beberapa isu-isu penting untuk penyediaan jasa keuangan untuk si miskin secara berkelanjutan. Diskusi didasarkan pada pendapat 23 pengurus Lembaga Keuangan Pedesaan di Lombok, yang dikumpulkan dengan tehnik interview mendalam pada tahun 2007. Respondent dipilih berdasarkan kesediaan mereka untuk diwawancarai. Ditemukan bahwa penyediaan jasa keuangan mikro dapat secara financial layak dan menguntungkan jika tiga isu-isu dasar dapat disiasati dengan baik. Ketiga isu-isu dasar tersebut adalah: si misin tidak punya jaminan yang memadai; si miskin memiliki pengetahuan dan pengalaman urusan bank yang terbatas; dan kebanyakan si miskin tidak memiliki usaha yang permanen. Strategi penanganan isu-isu tersebut adalah sebagai berikut. Lembaga keuangan pedesaan hendaknya memberikan pinjaman pada yang memiliki karakter dan usaha yang layak. Lembaga keuangan pedesaan hendanya menerapkan kebijakan dan meanisme pelayanan yang sederhana, mudah dan sesuai dengan karakter si miskin. Pinjaman secara kelompok adalah tidak effektip dalam penegakan perjanjian kredit. Kunjungan sering, pengawasan dan monitoring, seleksi nasabah yang baik, dan insentip tenaga lapangan merupakan instrumen untuk meningkatkan pengembalian kredit. Regulasi and lingungan pasar yang adil diperlukan oleh lembaga keuangan pedesaan untuk dapat memberikan pelayanan secara berkelanjutan.

Key Words: Lembaga kuangan pedesaan, Prasyarat akses berkelanjutan, Keuangan mikro dan Lombok

Introduction

This paper discusses several key issues useful for the provision of financial services to the poor in Lombok, Indonesia. The discussion is based on the views of 23 officers of major Rural Financial Institutions (RFIs) in Lombok, collected through in-depth interviews in November, 2007. The officers are representatives of 5 units of a national government bank (BRI Units), 6 private rural banks (*Bank Perkreditan Ra*kyat, BPR), 6 local government rural banks (*Lembaga Kredit Pedesaan*, BPR-LKP), and 6 rural credit cooperatives (*Koperasi Simpan Pinjam*, KSP). Their selection is based on their willingness to cooperate with the study. The issues include the conditions for profitable microfinance, credit access and repayment, and threats of new entries.

Conditions to Profitably Provide Financial Services to the Poor

There are three key issues to be dealt carefully in serving financial services to the poor. First, the poor have insufficient physical collateral to secure the loans. Therefore, measures other than physical collateral such as frequent visits, monitoring and personal relationships, which can serve as social-physiological collateral, should be implemented to reduce the lending risks to an acceptable level. Second, the poor have very limited knowledge and experience in getting institutional financial services and hence it requires more time and staff to serving them properly. Third, the poor generally do not have permanent businesses, or earned seasonal incomes so that they may not be able to pay several credit instalments during bad time, but normally they fully repay the loans in latter time. Consequently, the costs of fund recovery may be higher than expected.

Acknowledging these basic problems and the previous performance of their financial institutions, the majority (84%) of the RFI officers were confident that providing financial services to the poor could be financially feasible (profitable). Their reasons were, as follow. Many of the poor have 'good' personal characters and businesses; the poor are their principal clients; the poor only borrow when they assure that they can repay; and the poor borrow small loans so that they could always find the ways to repay.

So there is an opportunity for cost-effectively providing financial services to the poor. This confirms the commercial microfinance vision supported by key international donors (World bank and others) that financial services should be provided on financially sustainable basis, or independent from subsidy (Vogel and Adams 1997; Robinson 2001).

The officers generally viewed that lending to the poor can only be financially feasible if the financial institutions lend to those who have good characters and businesses, despite of relatively high interest rate. High interest rate results from high transaction costs, which is typical for microfinance due to the problems of lending to the poor (noted above).

The view about the problem and conditions to profitably provide financial services to poor households largely influences the RFIs' service policy and mechanism where credit size is negatively correlated to interest rate and repayment system but positively to credit terms. The rural bank (BPR) and credit cooperative (KSP) that advance small loans without collateral charging higher interest rate with daily/weekly repayment and shorter terms to small entrepreneurs (the poor) with good characters. On the other hand, BRI Units that offer larger credits with collateral changing lower interest rate with monthly repayment, longer terms and collateral to the less poor.

Since the small credit is not secured by physical collateral, the lenders minimise the potential losses resulting from non-performing loans by frequent visits (for screening, monitoring, supervising, repayments and relationship building, among others), and disguises the high transaction costs (interest rate) by frequent instalments. This is a sound microfinance practice, from the prudential banking view.

However, such a microfinance practice may lead to imbalance access among the poor. Most of the RFIs' borrowers (53-89%) are small traders and industries, leaving those outside the occupation sectors (such as agriculture) and those without businesses (but willing to start ones) under serviced. This result supports the argument put forward by Morduch (2000) to the limited roles of commercial microfinance institutions can play in poverty alleviation. He argues that such financial institutions have to charge high interest rates on loans, to be profitable. Therefore, only those with high-margin and quick turnaround businesses can borrow while others can not. This suggests that a reasonable interest rate subsidy may be necessary for the provision of financial services to the latter group of the poor.

Alternative lending strategies that could reduce lending costs and eventually interest rates on loans should also be considered if extension of credit outreach and access to the poor were to be achieved. Considering the primary lending strategy adopted by the RFIs in the study areas, which is primarily individual lending[1], a group lending may be an alternative because it can reduce the lending transaction costs, and increase repayment rate resulting from the peer pressure (Hoff, Braverman et al. 1993).

However, there is a little support for the group lending strategy from the key officers of the RFIs in Lombok. This is clearly shown by their responses to the question: *If they think that there are differences in credit repayment between lending in a group and lending in individuals*.

Their responses were ‘no differences’ (23%), the individual lending strategy better (59%), and the group lending strategy better (18%). There were four reasons of those in favour of individual lending, namely: group leader often dishonest, good individuals easier to identify than good group, enforcement in a group lending more difficult, and members often waiting the others to repay.

The unpopularity of group lending resulted from the fear of the well-known non-performance of the group lending in the past mass rice intensification program, BIMAS. One possible cause of the non-performance of group lending in the program was that one or more of the necessary requirements for good repayment performance of group lending were violated. For instance, the formation of the groups was ‘top-down’, set up by the authority and others, not by the members. Such a group formation gave rise to unequal incentives among the group members to participate and share responsibility to fulfil the obligations. Another possible cause was that the recipients and parties involved in the delivery system (NGOs, and the village cooperative officers) might see the credits given under the program as government grants - they had got wrong massages as they had not seen the importance of the program as much as the government did.

Other factors that might also cause the undesired outcomes of the credit program included social, economic, and political characteristics of the population. Failures to consider the non-homogenous characteristics of the target groups and the participating parties in the delivery system result in program failure (Floro and Yotopoulos 1991; Dury, Vicosqui et al. 1996; Sharma and Chamala 1998).

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[1] Of the RFIS, only LKPs practiced group lending, on limited basis.

Ways to Increase Credit Access and Credit Repayment of the Poor

Improving access to financial services of the poor is one of the main challenges of microfinance development in developing countries, as so in Indonesia. In this regard, the officers suggest five ways. First, the poor should be well informed about various credit services available. Second, the RFIs should adopt easy procedure and requirements. Third, the RFI should build family-type relationships with borrowers. Forth, the government credit schemes targeting the poor should be disbursed through the existing RFIs. Lastly, the poor (prospective borrowers) should be given training in management and marketing

The first implies that there are many potential borrowers (from the poor population) who do not attempt to borrow because they do not know or have wrong perceptions about the credits offered by RFIs (for instance, required too much paper works). Therefore, making this group of the poor well informed about micro credit services available for them may increase their access and deepen the service outreach of the existing financial institutions.

The second and the third ways are understandable because the poor are used to 'informality' in their daily life (characterised with flexible and personal relationships). Simple procedures and requirements (from the views of banking standard) are often still too much for them. Formal relationships are not suitable for them.

The fourth implies that the RFI officers view that the implementation of credit schemes is inappropriate and participating in credit schemes is an opportunity to gain earnings. The credit schemes refer to government/donor sponsored credit programs. The credits under the schemes are generally channelled through non-financial institutions, which do not really concern with the future of the schemes. As a result, low credit repayment, miss-targeting and corruptions are common problems of the schemes.

If the schemes were not channelled through the existing financial institutions, many of their clients might not borrow from them because cheaper loans available from other sources, which in turn could force them out of business. This threatened the future availability of micro credits from the RFIs, which just evolved in few years. Therefore, channelling the government schemes through the RFIs may be strategic from the perspective of institution building. The rural banks can be regarded as valuable assets when the provision of financial services to low income households concerned. Their performance, relative to other RFIs, proven that they are able to provide financial services to vast number of rural population (mainly the poor).

The fifth and sixth are straightforward. In spite of its unpopularity, several advantages of group lending over individual lending (such as lower transaction costs and peer pressure) would allow group lending to admit many poor borrowers who, otherwise, would be denied under the individual lending. Training would help many of the poor capable to have good business, which in turn would make them qualify for credits of the existing financial institutions.

Non repayment is another challenge of micro and rural financial development in developing countries. In this regard, the performance analysis of the RFIs shows that their average non-repayment rate was quite high (7-19%), although they could profitably run their operations. This suggests that there is still a room for a profitability improvement by implementing measures to increase the repayment rate of the poor. Among the ways to reduce non-repayment rate of the poor suggested by the officers include: frequent visits (38%), business and management supervision and monitoring (33%), third party helps in credit recovery (12%), legal contract (5%), good applicant screening (5%), field officer incentives (3%) and good services (4%)

Frequently visits, supervision and monitoring may help the borrowers to sustain their income flows so that they are able to repay the loans. In the same time, they may help the lenders kept informed about the state of the borrowers' income earning business so that on time actions can be taken to minimize losses resulting from non-performing loans. The third party helps (to collect repayment) and legal contracts force the borrowers to repay their loans. Good screening protects the lender from lending to bad borrowers. Good service satisfies borrowers so that they fell bad for not repaying their loans.

The Need for Fair Regulatory and Market Environment

In depth interviews with several stakeholders, including bankers and researchers revealed that threats from new financial institutions to pre-existing rural financial institutions exist. Selected cases providing evidences of such threats are, as follows.

Case 1: Threats of private rural bank to government rural banks

A director a government rural bank (LKP) stated that before the private rural bank (BPR) came into the market we faced over demand for loans, but now we had to look for borrowers as many of our previous clients captured by BPR. This was because have much fewer officers than a BPR; and the salaries of our officers were fixed and not linked to performances as in the BPR where the officers earned between 2-3 % of the loan interest incomes, in addition to their monthly salaries.

Case 2: Threats of the rural credit cooperatives to the rural banks

A director a BPR observed that our business grew well before many credit cooperatives joined the market in rural areas. The reasons are as follows. Many of the managers of the rural credit cooperatives were previous workers of the rural banks; therefore, their management and operation relatively similar to the rural banks where they previously worked. The operational costs of cooperatives were generally much lower than rural banks since the cooperatives were not required to deposit security funds in the central bank. There were not much regulation controlling operations of cooperatives, as compared to rural banks. Lastly, there were several arrangements made by the government to support them, e.g., cheap loanable funds.

Case 3: Threats of multiple sources of financing and market competition

A key public officer responsible for credit cooperative supervision informed that, as there were various financing sources available to the people, majority of the financial institutions' clients (the traders in markets) borrowed from more than one source. He explained that if we observed a market for a couple of hours we could see 2-3 officers of different RFI visited a trader. This was confirmed by several RFI officers.

While Case-1 shows positive effects of the resulting competition from participation of the new institution in the market, Case 2 and Case 3 indicate negative effects of the resulting competition from participation of the new institution in the market and might endanger the formal market.

A private rural banks could capture large proportions of the clients previously served by the government rural bank because they could provide better services (using mobile service mechanism), and charge positive market price (interest). This is a right incentive for the market to increase its efficiency as it forces the government rural bank to improve the quality of their services. In the same time, the private rural banks also deepens the penetration of the formal financial services to cover those are unlikely reached by government rural banks.

On the other hand, the credit cooperatives (case 2) capture a part of the clients previously served by the rural banks by taking advantages of the regulatory weaknesses and the financial supports of the government. Since the cooperatives are not subject to prudential banking requirements (such as minimum capital requirements, and capital reserves in the central bank) as the rural banks and many cooperatives are run by previous employees of the rural banks, the cooperatives can offer the same quality of credit services but with lower costs.

As the government more opts to cooperatives in dealing with the poor, the government provides financial supports (cheap revolving funds) to cooperatives engaging in financial services to small enterprises (the poor). This provides the opportunity for some people to make uses the government funds for their own benefits, by opening cooperatives. For example, the study observed that there were several credit cooperatives whose funds mainly came from the government financial supports.. Advantages such as these are unsustainable (as the subsidy can be lifted any time).

Similarly, the instances of borrowing from multiple sources also can ruin the market, if the borrowers borrow more than they can afford to repay for (Case 3). In worst case, the borrowers may end up out of businesses, paying interest higher than their earning capacities. If non-repayments were many, the institution lenders' incomes deteriorated. This may lead to lender bankruptcy, which in turn endangers the future supply of formal financial services.

The cases of multiple financing sources imply that the credit officers are incapable to screen out loan applicants who have taken loans from other sources, or to hamper the borrowers from borrowing from another source. Instances of multiple financing sources may be hampered through establishing information sharing among credit officers operating in the same areas. In worst case, the incidences of multiple financing sources are stimulated by the credit officers' desires to maximize their incentive incomes, by lending as much as possible through relaxing the screening for loan applicants. So, the performance base economic incentives given to credit officers (noted above) can also lead to moral hazard of dishonest officers. The moral hazard behaviours of the credit officers may be reduced by better supervision, for instance, frequent field visits by the directors.

Conclusion

Providing rural-micro financial services can be financially feasible, cost-effective or profitable but three fundamental problems need to be dealt carefully. First, the poor had insufficient physical collateral to secure the loans, meaning un-collateralised credit service. Second, the poor had very limited knowledge and experience in banks' services, meaning more time and staff to serving them properly. Lastly, large parts of the poor generally did not have permanent businesses (or earned seasonal incomes) so that they might not be able to pay several credit instalments during bad time, meaning higher costs of fund recovery.

Lending to the poor can only be financially feasible if the financial institutions lend to those who have good characters and businesses, despite of relatively high interest rate. This can be realised by adapting service policy and mechanism, e.g., smaller loans charge higher interest rate and require more frequent repayment instalments. In this regard, the OVC mechanism, which is implemented by the private RFIs appears superior to the conventional banking mechanism, the CVO mechanism.

Although, conceptually group lending has potential to solve the fundamental problems of microfinance, there is little support for it emerging in microfinance practice in Indonesia because of the fear of the well known non performance of the group lending implemented in the previous government program.

Socialisation of the financial services available, easy credit procedure and requirements, building family-type relationships with the poor, and business training were among the strategy to improve access of the poor to financial services.

Frequent visits, supervision and monitoring, good applicant screening and field officer incentives were among the instruments considered able to reduce non-repayment of the poor.

To operate effectively and efficiently, RFIs need regulatory and market environment which ensure fair competition. Subsidized credit schemes, and unfair regulatory requirements among different types of RFIs created unfair competition, threaten the sustainability of RFIs and their services.

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