BADAN KREDIT DESA (BKD) PROGRAM

Program Description[50]

The *Badan Kredit Desas* (BKD) is a system of village-owned financial institutions located in West, Central, and East Java, and Yogyakarta. BKD units were first established in 1898 and have existed in their present form since 1952. The BKD concept is based on a Dutch system of village banks. Each BKD unit is owned by an individual village, and operated by three residents of the village. Units generally transact business only one day per week. They operate from a village public building or the home of one of the village leaders. There are 5,345 BKD units, of which 4,806 were active at the end of 1996.

BKDs were established with small capital grants from provincial governments. Their loan capital is derived primarily from this initial grant, retained earnings, and required and voluntary savings. BKD units sometimes also borrow from BRI, other BKD units, local governments, and other parties. In practice however, most BKDs keep large deposits with BRI branches or Unit Desa and have little need of loans.

BKD earnings are used for commissions to their staffs and fees to an accountant and BRI. The profits remaining after these deductions stay with the unit in the form of retained earnings.

Supervision. BRI managers at regional and head offices define the business of BKDs. BKD records are prepared weekly by an accountant hired by the unit. BKDs are supervised by BRI staff or contract workers. BKDs generally receive at least one supervision visit per month. Supervisors review the units' bookkeeping, cash handling, and portfolio quality. They arrange for excess BKD funds to be deposited with BRI branches, organize BRI loans to BKDs, and facilitate BKD units' lending to each other. Supervisors can dismiss unit staff. BRI staff who act as supervisors are paid Rp. 9.6 million (US$4,110) annually for their service. This is equivalent to about 4.3 times annual per capital GDP. Supervisors hired as contractors are paid less but are part of a BRI pension plan. All BKDs within a district share responsibility for payment of the district's supervision fee. The fee is allocated across BKDs based on the volume of their lending activities. Thus, BKDs with a relatively high annual loan volume pay a larger share of the supervision cost than BKDs with a low volume.

Loan Products

Loan of 10 to 12 weeks account for about 65 percent of BKDs' loan volume. These loans have an interest rate and payment terms almost identical to that of the LKPs in NTB. The loan is repaid in 10 to 12 equal installments. The first installment represents the interest due on the loan, the next a forced savings payment, and the final 8 to 10 are repayment of capital. Seasonal/agricultural loans account for about 20 percent of BKDs' loan volume, and 35 day loans account for 15 percent. Loans of 20 to 22 weeks account for about 0.2 percent of loan volume.

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[50] The author did not collect detailed data for the BKD program. The following annex contains some general information.

In theory borrowers can reclaim their forced savings after they have repaid their loan. In practice, borrowers' ability to withdraw their required savings varies by BKD office. Many BKDs allow withdrawals only for religious holidays or do not allow withdrawals at all, such that the forced savings becomes a fee.

The interest rate for the BKD 12 week loan product is equal to 7.2 percent per month or 131 percent per year on a declining balance basis assuming that the forced savings is returned without interest after the loan is repaid. The monthly interest rate is 9.5 percent and the yearly rate 347 percent if the forced savings payment is never returned.

In 1995, loans generally ranged in size from a minimum of Rp. 25,000 (US$11) to a maximum of Rp. 600,000 (US$257). However, seasonal credits could reach Rp. 1 million (US$428).

Savings Products

BKDs have accepted voluntary savings deposits since 1991. These accounts earn interest at a rate of 9 percent per year. This rate is about equal to inflation and the rates paid by BKKs, LKPs, and BRI on small deposits. Rural banks (BPRs) often pay rates almost twice as high. Forced savings do not earn interest.

Staffing

Each unit is staffed on a part-time basis by three village inhabitants. Staff is appointed by the village chief but must be approved by BRI supervisors. Staff can by dismissed by the village chief acting on advise from the supervisors. Staff compensation consists of a commission equal to 2.5 percent of the principal payments collected which is divided between the staff members. Staff receive no other compensation.

Underwriting and Loan Servicing

For each unit, loans are underwritten and serviced by the three BKD staff members. Because the staff members live in the villages they serve, they generally have good information about individuals' creditworthiness. Staff members have an incentive to perform these functions prudently because their compensation is based on collections.

Program Performance

The author did not collect detailed information on BKD program performance. The following represents the available data concerning program sustainability and outreach.

Sustainability. Data on default and arrears are problematic because BKDs only write off loans in default if the borrower moves, or if the loan is more than 5 years overdue. Table 31 estimates default and arrears rates for the program by simulating the program writing off all loans in default each year.[51] Using this approach, annual default rates ranged from 2 percent to 6 percent in the mid-1990s. Loans in default accounted for approximately 4.9 percent of loans in 1996, up from 2.6 percent in 1995. The loan volume in arrears was equal to 16 to 23 percent of outstanding credits during the mid-1990s. The volume of loans in arrears in 1996 was 21 percent of outstanding loans, up from 16 percent in 1994.

Table 31
Incremental Annual Default and Arrears Rates for BKD

	1992	1993	1994	1995	1996
Loan volume in default percent of outstanding loans	6.0	4.4	2.0	2.6	4.9
Loan volume in arrears percent of outstanding loans	22.9	17.8	15.9	17.6	21.2

BKDs do not adequately provision for bad debt. To partially adjust for the reporting inaccuracies that this creates, BRI reported the BKD system's profitability if the units wrote off 100 percent of their loans in arrears past the final due date each year. If calculated in this way, the system had a return on assets of 8.7 percent and a return on equity of 11.0 percent in 1996. These rates translate into a real return on assets of 0.7 percent and a real return on equity of 2.8 percent. Nominal returns have declined slightly over the last three years, but real returns rebounded slightly in 1996 (Table 32). The author did not collect the data required to estimate the BKDs' unsubsidized profitability. However, the major inaccuracy in BKD reporting is the fact that the units do not adequately provision for bad debt. Thus, it is likely that the figures presented above which partially compensate for this do not greatly over-state the units' performance.

Table 32
Adjusted BKD Profitability as Reported by BRI[a]

Profitability Measure	1993	1994	1995	1996
ROA (percent)	11.4	9.2	9.2	8.7
Real ROA (percent)	1.6	0.6	0.2	0.7
ROE (percent)	14.4	11.7	11.7	11.0
Real ROE (percent)	4.3	2.9	2.0	2.8

a/ These figures simulate the BKD system's profitability if the units wrote off 100 percent of their loans in arrears past the final due date each year.

Outreach Scope. Active BKDs are located in 4,806 villages on Java. In Eastern Java and the island of Madura, BKD units are located in about 20 percent of all villages (Christian, 1995).

[51] Loans in default are assumed to be loans that are in arrears by more than 6 months past the loan's final due date.

Information on total annual lending was not available. The data in Table 33 above are estimates of annual lending derived by multiplying lending during the month of December of each year by 12. Using this rough approximation, lending grew from Rp. 232 million (US$111 million) in 1993 to Rp. 305 million (US$131 million) in 1996. The program issued approximately 1,760,000 loans in 1996, up slightly from 1,713,000 in 1993. The real volume of lending grew in each year except 1995.

Table 33
BKD Estimated Annual Lending[a]

	1993	1994	1995	1996
Nominal lending volume (Rp. million)	232,312	256,847	258,589	305,330
Growth in real lending volume (percent)	8	2	-8	9
Nominal lending volume (US$)	110,624,920	117,819,793	113,416,153	130,698,739
Number of loans issued	1,713,336	1,639,104	1,606,884	1,757,028
Growth in number of loans issued (percent)	3	-4	-2	9

a/ Estimates are derived by multiplying the lending volume in December of each year by 12.

Total savings under the program stood at Rp. 23 billion (US$9.8 million) at the end of 1996. In real terms, savings have grown slowly but consistently since 1993. The volume of outstanding savings was equal to about 26 percent of total outstanding loans net of likely default in 1996. That figure has been constant over the last four years. BKD units have offered voluntary savings products since 1991. Since 1993, voluntary savings have been equal to about 5 percent of outstanding loans net of likely defaults and net of required savings.[52] The voluntary of voluntary savings declined in real terms in 1995 and 1996 (Table 34).

Table 34
BKD Required and Voluntary Savings

	1993	1994	1995	1996
Total nominal savings (Rp. million)	16,053	18,239	20,070	22,827
Growth in real savings (percent)	4	5	1	5
Total nominal savings (US$)	7,644,063	8,366,488	8,802,677	9,771,259
Total savings percent of total outstanding loans	25.1	25.2	24.6	25.7
Voluntary savings percent of net loans[a]	5.4	5.3	4.8	4.9
Voluntary savings real growth rate (percent)	3.2	1.6	-6.2	-0.5

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. BKDs had an average loan size of Rp. 173,776 (US$74) in 1996. This is equivalent to about 6.5 percent of GDP-per-capita.

Productivity. BKDs have extremely low fixed costs. Units operate out of existing village facilities, and staff are paid entirely on commission. Even the cost of BRI supervision is tied to the units' annual loan volume. This cost structure makes BKDs uniquely suitable for delivering financial services in very remote, low-density areas. However, because their loan portfolio is entirely concentrated in a single village, units are very vulnerable to systemic credit risk. Furthermore, most units lack dynamism as discussed below.

Reasons for Evolution in Program Performance. Most BKD units lack dynamism; and over time, many slowly decapitalized. While there were initially 5,345 units; by 1992, only about 3,000 active units remained. BRI recapitalized an additional 1,000 units in 1992. Units are managed on a part-time basis by people with other business activities. In practice, most units lend to the same small group of customers over time, and often make little effort to expand the volume of their business or broaden their customer base. This lack of dynamism is reflected in the system's very low loan to assets ratio. Loans accounted for 48 to 49 percent of assets from 1993 though 1996. This compares to the South Kalimantan BKK system in which loans account for 84 percent of assets. BKD units have very few fixed assets and no investments. Thus, during the mid 1990s, 36 to 39 percent of their assets were held as demand deposits in BRI branches and Unit Desa.

In the early 1990s, BRI undertook an information and promotion campaign to encourage fund managers to expand their customer base. However, this initiative met with little success. Further, BRI's enthusiasm for the project was diminished when the 1992 Banking Law prohibited the expansion of the BKD system and the BKDs were instructed not to compete with KUD savings and loan initiatives.

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

Most BKD units are too small to qualify to become BPRs according to the 1992 Banking Regulation. However, the regulation makes an exception for institutions already in existence prior to 1992 and possessing a license from the Ministry of Finance. BKDs fall into this classification. BI is currently determining how it will deal with BKD units that are too small to become BPRs. It appears likely that these units will be allowed to continue to operate but will no longer be able to take deposits from people outside the village in which they are located. Further, the Regulation prevents the creation of new BKDs.

To allow for growth in the number of BKD type institutions, the government has created 975 similar institutions spread across 24 of Indonesia's 27 provinces since 1994. These new institutions are called *Tempat Pelayanan Simpan Pinjam* (TPSP). They are almost identical to existing BKDs in their structure and function except that they come under the umbrella of the *Koperasi Unit Desa* (KUD) village cooperative system. These institutions do not violate the Regulation because financial institutions under the cooperative system are exempt from the minimum capital requirements that threaten the existence of other small financial institutions.

These new institutions have been funded by grants from the National Development Planning Agency (BAPPENAS) to KUD. As of 1996, BAPPENAS had provided a total of approximately Rp. 18 billion (US$7.9 million) to the KUD system to establish 975 TPSP units. Thus, it costs approximately Rp. 18.5 million (US$8,000) to establish each new TPSP. This grant is used as follow: Each TPSP unit receives a one-time sum of Rp. 8 million (US$3,500) as seed loan capital and an additional one-time grant of Rp. 500,000 (US$220) to purchase equipment and supplies. BRI receives approximately Rp. 3.1 million (US$1,300) per unit to train three unit staff members and the KUD and BRI supervisors. KUDs receive almost Rp. 6.9 million (US$3,000) to provide technical support and project monitoring, and to print materials. Thus, new TPSP units retain 46 percent of the funds spent to establish them, the KUD system keeps 37 percent of these funds, and BRI, 17 percent (Table 35).

Table 35
Approximate Costs to Establish New TPSP Units

Input	Cost (US$)	Percent of Total Costs
Total	7,958	100
Start-up capital endowment grant (retained by TPSP unit)	3,448	43
Start-up grant for fixed assets (retained by TPSP unit)	216	3
Technical support, project monitoring and materials printing (retained by KUD)	2,968	37
Training for staff and KUD and BRI supervisors (paid to BRI)	1,326	17

In contrast to BKDs, TPSPs are supervised by BRI and by the KUD system. Unlike BRI's BKD supervisors, BRI's TPSP supervisors are paid entirely on commission. They receive 15 percent of the interest collected by the TPSP branches they supervise. Each supervisor is responsible for 18 TPSPs. TPSPs are also overseen by a KUD technical administrator who receives a salary of Rp. 120,000 (US$53) per month. KUD technical administrators each oversee 6 TPSPs.

Thus, the 1992 Presidential Regulation has forced new BKD-type institutions to fall under the auspices of the KUD system. This has resulted in a start up cost of about US$3,000 per unit to cover KUD expenses and an ongoing cost of about US$53 per unit per month for KUD supervision. It is not yet clear whether these costs will be justified in terms of improved unit performance. However, the KUD system has a very inauspicious history of managing financial institutions, and appears to be pressuring the units to make loans at subsidized rates.

Competition

BKDs' relatively low maximum loan size and high interest rates ensure that they do not compete with BRI's Unit Desa branches. BKDs may have difficulty competing with BKKs and other provincial-owned financial institutions in villages served by both types of facilities, because BKKs also provide small, non-collateralized loans and village-level service. Further, they charge a substantially lower interest rate than do BKDs.