PROGRAM HUBUNGAN BANK DAN KSM (PHBK) PROGRAM

Program Description

Program Hubungan Bank dan KSM (PHBK) is a group lending program sponsored by the Central Bank of Indonesia (BI) and the German government's Agency for Technical Cooperation (GTZ). The program has been in existence since 1989. It currently operates in Bali, Java, North Sumatra, Lombok, South Sulawesi, and Nusa Tenggara Barat (NTB). Operations will shortly begin in Irian Jaya, North Sulawesi, and South Kalimantan. In each province, the program is managed from BI's branch offices. The program provides technical assistance to banks, NGOs, and borrower groups to help them develop group lending skills. Banks and NGOs lend to borrower groups. Since 1992, the program has provided no liquidity support for these loans.

Lending Models. The program operates along three basic models. In the first model, borrower groups function as financial intermediaries (KSP). Banks provide them with a group loan that they on-lend to their members. NGOs train groups in record-keeping and financial intermediation skills and provide general support to the group for a period of up to 9 months. The PHBK program pays the NGOs for their training and guidance activities. The program also trains (but does not compensate) the banks.

Model 2 functions similarly to model 1 with the exception that banks lend to NGOs which then lend to groups acting as financial intermediaries. Thus, NGOs act as financial intermediaries, and also train groups.

In Model 3, the bank lends to a channeling group (KPM). Each individual within the group receives a portion of each loan made. In practice, loans are almost always divided equally among group members. Each member is responsible for repaying his or her share of the loan. If a member does not repay, then the remaining members are liable for the unpaid segment of the loan. Banks generally recruit groups to participate in these loans in one of two ways. Banks encourage good customers who have some status in their market segment or community to form their own groups. Also, banks identify groups by working with formal or informal village or religious leaders. Generally, each group has a well-respected leader who is known to the bank prior to the issuance of the group credit. This leader may also provide collateral for the credit. The bank or members may pay the group leader a commission, or the leader may undertake the task without remuneration. Individuals are often willing to assume this responsibility without monetary compensation because of the status they receive from performing the role. Under this model, the program trains only the banks. It is up to the banks to organize and train groups.

This model is much cheaper for the program to support than the other two. Further, because the training investment is made in banks rather than in groups, and banks have a lower dropout rate than groups, it is less likely that resources will be wasted. However, this model can have higher costs for banks than the other two. NGOs are not involved in this model.

In practice, many banks, NGOs, and borrower groups are engaged in lending activities that combine various aspects of the three models. For example, some banks use NGOs almost as financial intermediaries (along the lines of Model 2), and pay them a fee for their services. However, they do not require the NGOs to assume credit risk. Some borrowers band together in a channeling group that divides all loans evenly among members (along the lines of Model 3), but charge members a spread that is retained by the group, and that may later be used to make additional loans to members (thereby simulating aspects of Model 1).

Evolution of Lending Models. PHBK now discourages banks from lending to NGOs with the purpose of their serving as financial intermediaries (Model 2) as this was found to be difficult to implement in practice. Under this mode, defaults were high as few NGOs had the capability to function as viable financial intermediaries.

In provinces that have attained a relatively high concentration of banking facilities, PHBK is also phasing out, or has phased out, support for groups as financial intermediaries (KSPs in Model 1). The program has found Model 1 expensive to implement and slow to expand because the role of the group as financial intermediary requires very significant training and support. Furthermore, Model 1 is only necessary when low population density creates high transaction costs for borrowers and banks. Thus, in areas like Java and Bali that have achieved significant coverage by financial intermediaries, the project now focuses exclusively on promoting Model 3 - direct links between banks and channeling groups of borrowers.

However, the program continues to support NGOs and groups as financial intermediaries (Models 1 and 2) in provinces such as NTB, North Sulawesi and South Kalimantan, where, program managers believe, the low density of financial intermediaries makes it impossible for the direct bank/borrower links under Model 3 to reach most rural inhabitants.

Participating Banks. As of March, 1996, 323 banks and bank branches were participating in PHBK. This figure increased from 148 in 1995. Participating banks include private rural banks or *Bank Perkreditan Rakyat* (BPRs); provincial development banks (BPDs); public and private commercial banks; and provincial and village-owned financial facilities (LDKPs and BKDs). However, different types of banks participate with varying degrees of enthusiasm. BPRs currently account for 56 percent of participating banks; state-owned commercial banks, 23 percent; private commercial banks, 11 percent; and regional development banks, 10 percent. Program managers have found that BPRs are the most eager to participate. The number of BPRs involved in the program has more than tripled in the last 18 months since PHBK began targeting marketing efforts to them. The program has been least successful in attracting private commercial banks. Five private commercial banks have signed Memorandums of Understanding to participate in PHBK, and two additional banks are preparing to. However, only two of these banks are actually making PHBK loans and even they are doing so on only a very modest basis. Furthermore, they are lending to NGOs for these to on-lend to groups (Model 2), a model that the program no longer supports due to NGOs' poor performance as financial intermediaries.

Program Supervision. Banks and NGOs are supervised by Bank of Indonesia staff and consultants. Groups that function as financial intermediaries are supervised by NGOs; and groups

that simply channel credits to members are supervised by banks. This supervision is very expensive for the more complicated lending models and in remote areas.

Loan Products

Banks, NGOs, and credit groups are free to choose the terms under which they will make loans. Loan products vary from one BPR which made loans for 10 weeks with daily repayments, to other banks making 12 month loans with monthly repayments. The PHBK program encourages financial intermediaries to require a 20 percent forced savings deposit in lieu of collateral. In practice, individual banks differ in the extent to which they require this forced savings component.

Given that the three types of lending intermediaries set their own loan terms, interest rates vary widely across participating institutions. In general, the larger the number of financial intermediaries between the originating institution and the end user, the higher the interest rate paid by the end user. Thus Model 3 (in which loans pass from banks to "channeling groups") usually has the lowest rates to the end user, and Model 2 (in which loans pass from banks, to NGOs, to borrower group financial intermediaries, to end users) has the highest. Rates also tend to be higher in more remote areas and for loans with daily repayments. In Sumbawa, most banks were lending at a 2.5 to 3.0 percent flat rate per month; NGOs that on-lent to groups were lending at a 5.0 to 5.5 percent flat rate per month; and credit groups were lending to members at a flat rate of 5.5 to 7.5 percent per month (including a 1.5 percent flat rate required savings component). On a declining balance basis, and including fees and forced savings requirements, rates generally ranged from about 3 to 15 percent per month or 100 to 450 percent per year for end users. However in less remote locations, banks lending to channeling groups may charge rates as low as 1.9 percent per month on a declining balance basis. This rate, including fees and forced savings requirements, can translate into interest rates as low as about 46 percent per year for end users.

Savings Products

All participating banks offer groups the opportunity to hold voluntary saving accounts. The interest rate paid on these accounts varies by bank. In Sumbawa, private rural banks (BPRs) were paying an interest rate of 12 to 16 percent per year on demand deposit accounts. These rates are positive in real terms, although generally below the level paid by BPRs in more competitive markets. They are somewhat higher than the rates paid by the other programs reviewed in this report and than those paid under BRI's SIMPEDES program. Forced savings accounts paid the same interest rate as voluntary accounts. The interest rate charged on time deposits range from 16 to 22 percent per year for a 1 year deposit. Bankers believed that for these small depositors, convenient access to savings was far more important than earning a high interest rate. They therefore did not think that raising the interest rate paid on deposits would increase the volume of savings they could mobilize.

Generally, NGOs functioning as financial intermediaries and credit groups (KSPs) also accept voluntary savings deposits. These funds may be recycled in the form of loans to groups or members, or they may simply be deposited on the saver's behalf with a bank.

Staffing

Staffing for the PHBK program is heavy and includes Bank of Indonesia (BI) employees and consultants at the national level and in BI's branch offices. Further, the work of training credit groups is contracted out to NGOs. Staffing costs are primarily responsible for the high total program costs discussed below.

Staffing of BPRs is also very heavy compared to staffing of the province-owned financial institutions (BKKs and LKPs) reviewed in this report, and compared to Bank Rakyat Indonesia (BRI's) Unit Desas. One BPR interviewed reported a staff of 23. This compares to staffs of 3 to 11 for BKKs, LKPs, and Unit Desas. However, BPRs tend to have larger lending programs than BKKs and LKPs. This BPR made 2,000 loans in 1995. An average BKK in South Kalimantan made 314 loans in the same year; and the average LKP made about 1,000.

This review did not systematically collect salary information for either PHBK workers or BPR staff. However, one BPR manager reported paying credit agents/field staff a base salary of Rp. 95,000 per month (US$41), and a bonus of 15 percent of the interest he or she collected. The BPR manager stated that a good credit agent could make as much as Rp. 250,000 (US$107) per month including this bonus. This base salary is extremely low when compared to base salaries of BKK and LKP workers. Further, if the field worker earned one-half of this theoretical maximum bonus, then his total compensation would still rank at the bottom of the compensation scale for BKK units. However, this compensation would be roughly in line with that received by LKP employees. While bonuses represent an important part of total compensation for BKK and LKP workers, they were unlikely to account for more than 50 percent of total income for these employees. In contrast, bonus pay could be equal to well over 100 percent of a credit agent's base pay at this BPR.

Underwriting and Loan Servicing

Underwriting and loan servicing techniques are left to the discretion of individual banks, NGOs, and credit groups. Furthermore, they depend on the type of lending model employed.

Model 1. When banks lend to savings groups and rely on an NGO to train and support the groups (Model 1), banks generally also depend on the NGO to assist in underwriting and loan servicing. In this model, NGOs identify and screen groups. The banks retain the credit risk however, and so bank staff generally undertake their own appraisal. Banks review the repayment history the group has experienced in lending out its own funds. Banks usually also require that groups submit the names of all group members who may receive part of the loan and a description of their businesses. Banks may select businesses from the list, and visit them on a random basis. Banks also generally start groups off with small, short-term loans, and allow these loans to grow in size and repayment term as groups demonstrate repayment capacity. In theory, groups should also demonstrate savings capacity by saving a fixed amount each month for a period of several months prior to receiving their first loans. In practice however, many groups collect the total required savings amount from members at one time and deposit these funds in a lump sum in the bank.

In Sumbawa, where the lending bank was located an hour or more away by car from the credit groups, the bank relied on an NGO to collect payments from groups. The bank paid the NGO

0.25 percent of the initial loan balance per month for performing this collections function. However, the NGO was not happy with this arrangement and maintained that the fee was insufficient to cover its costs. One BPR also allowed borrowers to make repayments to the local BRI Unit Desa outlet. The Unit Desa then transferred these payments to the bank.

In theory, credit groups also appraise loan requests from their members. This probably occurs in mature groups functioning like real credit institutions. The groups visited however were located in Sumbawa, where implementation of the program is still relatively new. Groups on this island did not receive a loan from a bank and then review loan applications from members to determine how funds would be disbursed, rather they simply divided the loan evenly among all members.

Given the amount of time it takes to train groups and fulfill program requirements, groups first enrolling in the program can wait six months or more to obtain their first loan. This contrasts with several days or weeks for BKK and LKP borrowers, but is similar to the wait required under the P4K program.

Model 2. In Model 2, banks make loans to NGOs that make loans to groups, that make loans or pass funds to their members. Under this model, NGOs assume the full credit risk for the loans they make to groups. In theory of course, banks should be concerned about the credit-worthiness of the end-users of the loans, since their repayment record will largely determine whether the NGO will be able to repay the loan to the bank. In practice in Model 2, banks do not concern themselves much with the creditworthiness of end-users. NGOs undertake many of the credit review practices banks engage in in Model 1. However, NGOs also generally know the groups they work with quite well, and so may not be as structured in their formal credit analysis.

Model 2, like model 1, requires a significant level of sophistication on the part of the credit group. Furthermore, forming links between groups, NGOs and banks can be very time-consuming. Thus, groups first enrolling in the program under Model 2 can also wait six months or more to obtain their first loan.

Model 3. In Model 3, once a group has been assembled, underwriting proceeds as described under Model 1 above.

Under Model 3, the group leader assumes responsibility for collecting the payments of group members. Banks then collect payments from group leaders. One BPR reported that they had invested significant resources in training channeling groups in bookkeeping, management, and other business skills. However, another BPR said that they provided no training support to channeling groups. BPRs also differ in the extent to which they require forced savings as collateral from channeling groups. As in Models 1 and 2, lenders usually start groups off with small, short-term loans and increase their size and term over time as groups demonstrate repayment capacity.

Requirements for channeling groups under this model are much less than the requirements for credit groups under Models 1 and 2. Further, individuals are linked more closely to banks under

this model than the other two. Thus, the time from group formation to first loan disbursal can be as little as a few days to a few weeks.

Program Performance

This section reviews program performance as measured by sustainability and outreach. Sustainability is measured by the program's arrears rate, its cost per unit outputs, 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. PHBK experienced early problems with high arrears. However, recent repayment performance has been sound. Information on the share of the PHBK portfolio at risk was not available. However, the program's ratio of number of credits overdue to number of credits outstanding[41] climbed sharply over the two years from fiscal 1990/91 (April 1990 to March 1991) to fiscal 1992/93. By the end of fiscal 1992/93, loans in arrears accounted for 29 percent of outstanding loans. This figure has since declined, and stood at 13 percent in 1995/96 (Table 21).[42] The volume of late payments as a share of the volume of outstanding loans rose from fiscal 1990/91 to 1993/94 and then declined. This rate was 5.7 percent in fiscal 1995/96. Data do not allow for a calculation of the program's annual default rate. However, program organizers report the cumulative default rate as being below 2.8 percent.[43] Further, their figures show this rate declining slightly over the last two years. The program's arrears rate and default rate would likely be judged sound by international microcredit standards.[44]

Table 21
Arrears Rates for PHBK Program

	Fiscal Year					
	1990/91	**1991/92**	**1992/93**	**1993/94**	**1994/95**	**1995/96**
Number of credits overdue percent of number of credits outstanding	17.2	21.1	29.0	19.9	11.5	12.9
Volume of payments overdue percent of volume of loans outstanding[a]	5.0	14.2	13.3	16.5	8.7	5.7

a/ Overdue payment is defined as a payment that is one day late or more.

[41] Where credits overdue is defined as credits whose payments are one day late or more.

[42] Actual annual arrears rates may be below the figures presented here because many participating banks do not write off loans. Thus, current annual arrears rates reflect some bad debts incurred in previous years.

[43] In the absence of data on default rates, the maximum possible cumulative default rate is assumed to be the inverse of the cumulative repayment rate. In fact, the cumulative default rate will be below this figure since at least some of the loans for which repayments are currently late will eventually be repaid. The cumulative repayment rate is defined as: total cumulative repayments / (cumulative repayments + cumulative arrears).

[44] For example, 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, and lenders should have annual losses from defaults of 4 percent or less of outstanding loan volume. PHBK's arrears rate is slightly above the 10 percent level but includes loans in arrears by one day or more. The program's default rate is likely below 4 percent.

PHBK program costs are high. Further, according to data provided by Bank of Indonesia, 70 percent of total costs are, BI's "in-kind" costs (salary and allowance expenses of regular BI staff working on the project and rent for project office space).[45] It is therefore useful to examine program cost ratios considering total costs and "cash outlay" expenses only (all costs incurred by GTZ and BI that are in excess of regular BI staff salaries and rent for office space in BI buildings).

Even when only cash outlay costs are considered, the ratio of annual program costs to annual lending is high in 1995/96, but has declined rapidly in the last two years. In fiscal 1992/93, the program's ratio of total costs to funds lent was approximately 304 percent (or 86 percent if BI's in-kind costs are excluded from the calculation). This figure declined to approximately 94 percent by 1995/96 (or 28 percent if BI's in-kind costs are excluded). The cost per group receiving a loan was about US$11,654 in 1992/93, (US$3,304 excluding in-kind costs) and had declined to US$1,764 (US$522 excluding in-kind costs) in 1995/96. Finally, if it is assumed that most program expenses are incurred for groups receiving their first loan, it is useful to compare annual program costs to the number of first loans received per year. The program spent an estimated US$16,856 per first loan received (US$4,729 excluding in-kind costs) in 1992/93, and about US$2,079 per first loan (US$615 excluding in-kind costs) in 1995/96 (Table 22).

[45] Program costs considered here include all costs that Bank of Indonesia and donors attribute to the program. These costs do not include the costs that banks incur in making program related loans. Banks' costs are excluded because information regarding these costs was not available. Further, it is assumed that banks are fully compensated for the costs they incur through the revenues they earn on program loans. Because banks receive no special incentive to participate in the program, it is unlikely that they would continue to do so if they were not recouping their full costs. Similarly, NGOs' costs are not included in this section because NGOs are compensated by the program for their services. Thus, their costs should already be captured in expenditures by BI and donors.

Table 22
Approximate PHBK Program Costs in Comparison to Program Outputs:
Fiscal 1990/91 to Fiscal 1995/96

Total Cost Per Program Output						
	1990/91	**1991/92**	**1992/93**	**1993/94**	**1994/95**	**1995/96**
Annual cost (US$)	3,687,167	3,994,965	4,253,810	4,647,182	5,164,454	5,231,503
Cost percent of annual loan volume	357	227	304	292	168	95
Cost per group credit (US$)	8,821	7,412	11,654	6,012	3,699	1,785
Cost per new group credit	14,574	16,856	16,682	10,169	6,134	2,103
Cash Outlay Cost Per Program Output (US$)[a]						
	1990/91	**1991/92**	**1992/93**	**1993/94**	**1994/95**	**1995/96**
Annual cash cost (US$)	954,434	1,124,984	1,205,954	1,379,258	1,697,107	1,589,218
Cost percent of annual loan volume	92	64	86	87	55	29
Cost per group credit (US$)	2,283	2,087	3,304	1,784	1,216	542
Cost per new group credit (US$)	3,772	4,747	4,729	3,018	2,016	639

a/ Costs exclude BI in-kind expenditures on the program.

The costs detailed above effectively translate into very large subsidies for borrowers. To gauge the magnitude of this subsidy, this section provides rough estimates of the percent increase in the interest rate that banks would have to charge their PHBK clients if the banks were to maintain their current level of profits while fully funding this program. This percent increase in the required interest rate is a lower-bound estimate of the Subsidy Dependency Index (SDI).[46] As Table 23 indicates, the program's subsidy dependency index follows trends in program costs. In fiscal 1990/91, banks would have had to increase their interest rate by approximately 628 percent to pay for the full cost of the program. Over the following 5 years, this figure declined sharply, and stood at 158 percent in fiscal 1995/96. While a 158 percent increase in the interest rate is still very high, it is impressive that this figure declined by almost one-half from fiscal 1994/95 to 1995/96 alone. To fund direct program costs, banks would have had to increase their interest rate

[46] SDI figures presented here are only rough estimates of actual figures because the author was required to make a number of significant estimations and assumptions. Because this program operates through private banks, we assume that the total program subsidy is equal to the cost of running the PHBK program, that is, that banks are not subsidizing these loans in other ways. The SDI calculation also requires an estimate of the total interest collected annually on program loans. This information is not available. An estimate for this figure was calculated based on the average interest rate charged on loans, the program's annual average outstanding loan volume, and the program's annual arrears rate. The average interest rate charged on loans is assumed to be 107 percent per year on a declining balance basis including all interest charges, fees, and forced savings requirements.

Further, the SDI is calculated assuming a market return for equity holders. Since information on participating banks' current returns to equity holders was not available, we assume here that these rates are acceptable at their current level. If banks' actual returns on their loans under this program are below the market level, then the figures presented here underestimate the actual SDI.

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

by 163 percent in fiscal 1990/91, and by 48 percent in 1995/96. Table 23 also provides rough estimates of the interest rate banks would have had to charge clients to maintain their current level of profitability and cover program costs. In fiscal 1990/91, banks would have had to charge an annual interest rate of approximately 781 percent. By fiscal 1995/96, this figure had declined to 277 percent. To fund the direct costs of the program and maintain profitability in fiscal 1995/96, banks would have had to charge an interest rate estimated at 159 percent.

Table 23
Estimate of Subsidy Dependency Index[a] and
Required Interest Rates to Cover Program Costs for PHBK Program

	Fiscal Year					
	1990/91	**1991/92**	**1992/93**	**1993/94**	**1994/95**	**1995/96**
Lower bound estimate for SDI with full program costs (percent)	628	515	574	471	298	158
Lower bound estimate for SDI with direct costs only (percent)	163	145	163	140	98	48
Lower bound estimated average current interest rate (percent) [b]	107	107	107	107	107	107
Estimated average interest rate required to fund full program cost (percent)	781	659	723	613	427	277
Estimated average interest rate required to fund direct program cost (percent)	282	263	282	257	212	159

a/ The percent increase in the interest rate that is required if the program were to operate without subsidies.
b/ Annual average interest rate calculated on declining balance basis including all fees and forced savings requirements. An estimated average of the rates commonly charged by rural banks and commercial banks to channeling groups.

Outreach Scope. PHBK experienced significant difficulties from fiscal 1991/92 to fiscal 1993/94. Since 1994 however, the program has grown rapidly. In real terms, PHBK volume declined by 24 percent in fiscal 1992/93, and then grew by 7 percent in fiscal 1993/94; 84 percent in 1994/95; and an estimated 73 percent in 1995/96 (Table 24). Total loan volume was Rp. 12.8 billion (US$5.5 million) in fiscal

Table 24
PHBK Program Lending Volume

	Fiscal Year				
	1991/92	**1992/93**	**1993/94**	**1994/95**	**1995/96**
Nominal loan volume (Rp. million)	3,534	2,915	3,406	6,813	12,821
Growth in real loan volume (percent)	64	-24	7	84	73
Nominal loan volume (US$)	1,757,384	1,399,328	1,593,589	3,075,107	5,526,422
Number of group loans issued	539	365	773	1,396	2,931
Growth in number of group loans issued	29	-32	112	81	110

1995/96. This represents approximately Rp. 40 million (US$17,000) per participating bank branch. PHBK disbursements in fiscal 1995/96 were approximately 55 percent as large as the P4K program's. Nevertheless, PHBK has expanded very rapidly over the last several years, whereas P4K's lending declined in 1995/96.

Table 25
PHBK Required Savings

	Fiscal Year			
	1992/93	**1993/94**	**1994/95**	**1995/96**
Nominal outstanding savings (Rp. million)	424	651	1,263	2,077
Real growth in savings (percent)	NA	41	79	51
Nominal outstanding savings (US$)	203,313	304,399	570,165	895,345
Savings percent of outstanding loans	20	24	24	19

PHBK management does not keep track of the volume of voluntary savings generated under this program. The real volume of required savings deposits grew by 79 percent in 1994 and 51 percent in 1995. By the end of fiscal 1995/96, required savings stood at Rp. 2.1 billion (about US$900,000), and equaled 19 percent of outstanding loans (Table 25).

Outreach Depth. This program's objective is to deepen rural financial markets. The program defines its target group as households that have not previously received a commercial bank credit. According to the program's 1993 Impact Study carried out in Yogyakarta and Central Java, 93 percent of beneficiaries in those provinces met this criteria.

Although the program does not target a specific income group, it is nevertheless interesting to obtain some indication of the income of program beneficiaries. The program's monitoring system does not track beneficiaries' incomes. The 1993 Impact Study found that among surveyed participants in two provinces, less than 20 percent had monthly household expenditures below the poverty line. More than 40 percent of respondents had household expenditures more than twice as high as the poverty line. Furthermore, about 11 percent of households were in the highest 13 percent of the income distribution. If these findings are representative of borrowers under the program today, then this program cannot be considered to be primarily reaching the low-income population, although some low-income households are being served. It is likely that virtually all of P4K's loan recipients have incomes as low or lower than the poorest one-third of PHBK participants.

The program does not keep track of the number of borrowers per group, and estimates for this figure are based on old data that no longer accurately reflect the makeup of participating groups. Thus, it is difficult to estimate the average loan size per individual borrower. One program manager's estimate of the average loan size per group member results in loans per person equal to 13 percent of GDP per capita. However, management estimates of the number of members in each borrower group results in loans per individual being equal to about 7 percent of per capital GDP. If the program's actual average loan size to end users is in the middle to higher end of this range, then this program has the largest average loan size of the 5 programs reviewed here. Nevertheless, this figure is much lower than the loan size-to-GDP-per capita figure for 9 of the most respected microcredit programs in the world (Christen et al., 1995).

The program does not keep track of the number of beneficiaries who are women. One program impact survey found that approximately 50 percent of surveyed borrowers were women. The program attracts many women because loans with relatively short terms, frequent repayments, and high interest rates are most appropriate for petty traders. In Indonesia, women make up a large share of the people engaged in this occupation.

For banks participating in this program, geographic outreach varies significantly. Some banks engage only in lending to channeling groups (Model 3), and service clients who are no more than 6 kilometers from one of their branches. Other banks serve groups much further away by relying on the more indirect lending to credit groups (Model 1), or to NGOs that onlend to credit groups (Model 2). As indicated above, one BPR was using Model 2 to serve clients located one hour or more away from the bank by car.

Productivity. The PHBK program has very high overhead costs, as reflected in its high unit costs and subsidy dependency index. PHBK's national-level staff is large and spends a very significant amount of time and money supporting regional initiatives. Similarly, regional staff spend a large amount of time working with NGOs and banks. However, the program is rapidly becoming more cost effective as it is increasingly able to benefit from economies of scale, and as the shift to the relatively simple model of banks' lending to channeling groups (Model 3) reduces ongoing support requirements.

Reasons for Evolution in Program Performance. Program managers attribute PHBK's troubled start and improved performance to financial sector and program-specific circumstances. The program experienced particular difficulties in 1991/92 and 1992/93. This was a troubled period for the entire Indonesian financial sector, which experienced significant liquidity problems and escalating arrears rates. Program volume was also adversely affected and took some time to recover after the program stopped providing subsidized liquidity credits to participating banks in 1992.

Program managers attribute initial, high program costs and arrears rates to inadequate screening of participating NGOs and groups, and to high reliance on the program's Model 2. Model 2 provides financing to credit users through banks making loans to NGOs that lend to credit groups that lend to members. Alternative program models are simpler and more direct with banks lending directly to credit groups which lend to members (Model 1), or banks lending directly to end-users loosely organized as a channeling group (Model 3). Model 2 was found to require the most intense program support and to have the highest program costs. It also suffers from the highest arrears problems because many NGOs are poorly motivated and trained to make market-based loans. For the last several years, the program has been phasing out this model wherever possible, and its share of total program volume has declined from 60 percent in 1993/94 to 17 percent in 1995/96. However, as indicated above, this Model is sometimes the only way that the program can function in remote areas. The program must screen NGOs carefully to ascertain that they have the commitment to follow sound banking practices. Further, it must provide them with training that will enable them to perform these functions effectively.

Program managers anticipate that PHBK will continue to improve its productivity as the program redirects its technical assistance in high density areas from Model 1 (lending to credit groups) to Model 3 (lending to end users loosely organized as a channeling group). As discussed above, Model 3 is the most cost effective of the three models, and the easiest and quickest to propagate. While the program will continue to support the slower and more expensive Models 1 and 2 in more remote regions, organizers anticipate that the ever increasing volume of loans undertaken under Model 3 will rapidly drive down unit costs.

Also, program volume has increased in recent years partially due to the program's aggressive marketing to rural banks (BPRs). BPRs are small, local banks that are usually privately owned and have few, if any, branches. They are much closer to PHBK's target market than many of the larger commercial banks. Also, they have little, if any, bureaucracy and therefore possess the flexibility to adopt the PHBK group lending approach quickly.

Finally, this program is still expanding its geographic coverage. Thus, a significant share of the program's subsidy can be attributed to start up costs in new regions and to reach new groups. Once the program has ceased to expand geographically and has slowed its coverage of new groups within regions, it is likely that its required subsidy level will decline still further.

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

Because the PHBK program relies primarily on BPRs, provincial banks, and commercial banks, it has not been impacted significantly by the Presidential Regulation supporting the 1992 Banking Law. The Regulation discouraged the program from an early goal of upgrading credit groups to semi-formal financial institutions. However, this idea would almost surely have been abandoned even if the Regulation had not been promulgated. The upgrading process was extremely difficult and costly, and the results were poor.

Competition

PHBK, like P4K, complains of "unfair" competition from the new and highly-subsidized TAKESRA/KUKESRA group-based lending program for poor families. PHBK also mentions the P4K program as a source of competition since P4K provides loans to groups at approximately one-fifth of the effective rate charged by banks in the PHBK program.