**From Self-Help Groups to Village Financial Institutions in Bali: How Culture Determines Finance and Finance Determines Culture**

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## Cultural and religious foundations of customary financial institutions

Preservation of cultural and religious identity is a key concern in Bali. Finance is one of the spheres in which this identity has been challenged. However, this identity will not easily be undermined. Its roots were planted some 500 years ago by Hindu princes who fled Java and established a culture of Dharma Hinduism on Bali while incorporating elements of ancient Balinese culture. The result has been an ever-evolving blend of religion and ritual, temple architecture, arts and crafts, music and dance, family life and community associations, irrigated rice cultivation and cross-cutting water user groups, none of which fit into a single fixed pattern. A fundamental characteristic of Balinese society is its structural fluidity and diversity.[2] Customary law regulates propriety, but not formal patterns of behavior.

Bali is comprised of two systems. One is secular and part of the overall Indonesian administrative system. The other is based on customary law. The highest authority of the village is the assembly of customary residents, which elects the village council and village head. Communal activities are arranged around the *banjar*, or customary community, with its temples and assembly hall, where religious and life-cycle ceremonies take place.[3] [4]

## Financial institutions at the *banjar* level

Every *banjar* has a large variety of groups. [6], and among them are savings and credit groups.[7] Into the 1970s these groups were ubiquitous, but quite relaxed about financial discipline. As Holloh noted in Lodtunduh, Gianyar district, "borrowers had to pay monthly interest but were only required to repay the loan principal when the *banjar* had to finance religious rites or public expenses. Thus, borrowers often did not know when they had to repay their debts and faced difficulties in repaying the principal in a lump sum when they were asked to do so."[8]

Lodtunduh is an administrative village comprising two customary villages with ten *banjar*. Many of its residents specialize in wood-carving and handicrafts. As their business expanded, so did their demand for credit. Without financial discipline, the savings and credit groups began facing serious difficulties. Help came from two quarters. The first was the Credit Union Coordinating Office in Jakarta, which offered guidance. Credit unions could have become a model for the modernization of informal groups, but were considered a foreign element. Another intervention came from Bali itself: building financial institutions similar to the groups, but operating at the level of the customary village, rather than that of the *banjar*, the larger customary community

## Financial institutions at the customary village level

The initiative to establish *Lembaga Perkreditan Desa* (LPDs), customary village-level financial institutions, was taken by the Governor of Bali in 1984, with the intention of setting up institutions capable of competing with the rapidly expanding banking sector, but integrated into Balinese culture. The village appeared more suitable than the *banjar* to guarantee the economies of scale required. In 1984, the Government of Bali passed a decree, and in 1988 a provincial law, defining the customary village as the owner and operational area.

In 1988, the central government also enacted a law on rural banks regulated by the central bank. Existing institutions, including LPDs, were to be converted into rural banks. This would have greatly reduced the number of LPDs, many of which would have been far too small to qualify as a bank. The Government of Bali thus objected, and in 1999 the central bank finally exempted the LPDs.[9]

### The power of *krama* and *karma*

The owner of the LPD is the customary village, more specifically, the indigenous residents, *krama ngarep*. Users are comprised of *krama ngarep,* other residents, the village and customary community as corporate bodies, and community associations. Non-residents are excluded.

Governance is the responsibility of the customary village, which elects a board of supervisors. Ultimate authority lies with the village and constituent *banjar* assemblies as the owner of the LPD. The chair-person regularly reports to the village council; the customary community heads report to their assemblies. Intimate knowledge of all resident families enables the board to arrive at sound credit decisions and to enforce repayment. The strongest threat in case of default is to call the name of before the community at the assembly. This action would so greatly shame the family of the delinquent that it is virtually never invoked.

There is yet another, even stronger sanctioning power, representing the spiritual dimension of governance: *karma*. Good as well as bad deeds affect a person's *karma*, in this life and, through reincarnation, in the next. Saving, investing one's savings or loans to the benefit of the family, and repaying one's loans positively impact one's *karma;* wasting one's resources and failing to settle one's debts has a negative impact. It is these two factors – social control by the *krama* and spiritual control by one's *karma* – which explain why the board can be so successful enforcing repayment, and why physical collateral is rarely if ever seized.

**If governance fails: the role of the board in the fall and rise of an LPD**

The reality of good governance is most evident where good governance has broken down, and the re-establishment of cooperation between board, management and customary village has subsequently turned the LPD around. The following case studies are instructive.

*LPD Kayu Kapas*

LPD Kayu Kapas in Bangli district is a tiny institution established in 2002 which broke down early in its history. The village, located in a remote area, consists of a single customary community with 138 families. The LPD worked reasonably well during the first year, 2003. But the board of three farmers was inexperienced and unaware of its responsibilities. Problems started in 2004 when the manager had used a substantial amount of the funds for his own purposes. Savers could not withdraw their money, no new loans were issued, and borrowers refused to repay. The district guidance agency, established by the Government of Bali, kept visiting the LPD, but failed to revive it.

The turn-around came in May of 2007 when the guidance agency invited a well-functioning neighboring LPD to instruct the board about its responsibilities. Without changes in composition, the board convinced the manager and the borrowers to repay their debts. With the help of a six-month loan from another LPD, Kayu Kapas resumed operations. By August 2008, total assets had increased by 85% over even December levels, savings had more than doubled, there were no arrears, and net profit had risen from Rp2.4m to Rp4.6m.

The case of LPD Kayu Kapas shows first how a young LPD breaks down if the board is not aware of its responsibilities. It also shows that, with proper guidance and instruction, a non-functioning board can be turned around, revitalizing a non-performing LPD, restoring confidence, achieving full repayment of arrears despite an extended period during which the LPD was practically closed, and returning to profitability – all this in a very small and remote village normally considered unsuitable for a financial institution of its own. The initiative to revitalize the LPD had come from the guidance agency, but only after a delay of three years. The key instrument in bringing about change was the mobilization of assistance by a well-functioning neighboring LPD.

*LPD Kapal Mengui*

LPD Kapal Mengui in Badung district is one of the larger LPDs in Bali, serving a village of 18 customary communities with 2,275 families. Established in 1990, the LPD functioned well for several years, but four years later it ran into problems. Manual book-keeping led to errors and eventually to fraud. The board failed to step in, and the village lacked experience running an LPD. The guidance agencies lacked clearly defined tasks and failed to intervene. By 1996 the LPD had accumulated losses of Rp75m.

In October 1997 a new board was elected, including two board members with financial experience.  Immediately the new board acted to revitalize the LPD. It mobilized technical assistance from the guidance agency and development bank and brought in the customary administration of the village and the customary community. These local authoritative bodies defined the responsibilities of the board members and re-introduced adherence to the regulation: "We took a social approach, because the problem was in the community, and we addressed the *krama* at the *banjar* meetings." With full support from the leadership throughout the village, they solved the delinquency problem and recapitalized the LPD through savings mobilization. By the end of 1997, the LPD was again turning a profit, and has remained profitable ever since. In 2002 the LPD modernized its operations through computerization, adopted an operational handbook and moved to a new building.

The case of LPD Kapal Mengui shows that even in a village with good potential and several years of good performance, an LPD can be brought down through fraud and delinquency if the board does not function, the village authorities do not step in, and external supervision is ineffective. The crucial factor in failure was poor governance, just as good governance was decisive in bringing the LPD back to life. Once a new board with a high level of competence and motivation was elected, revitalization took place at an amazing speed – several years before the establishment of computers and new operational procedures. Assistance from the guidance agency and development bank also played a role, but only after the board took strong steps to secure recovery. It so happened that the turn-around took place at the time of the monetary crisis of 1997/98, when the banking sector collapsed. LPD Kapal Mengui, like other LPDs, reported no significant negative effects of the crisis.

*LPD Gelgel*

LPD Gelgel in Klungkung serves a village of 28 *banjar* with 2,441 families. Besides agriculture and livestock, there is a multitude of home industries. The LPD was established in 1988 and functioned well for ten years. The situation changed rather abruptly in 1999. 80% of the portfolio fell into arrears; losses amounted to Rp0.9m. The downfall of the LPD is attributed to a lack of communication and coordination between management and staff; but it is not clear what led to it.

The management did not insist rigorously on repayment; and there were cases of fraud. The board did not intervene.

The initiative to take action came from two people who had retired from a bank and returned to the village. One became a board member, the other one a manager. The board and management took “a family approach to solve the problem of nonperforming loans,” attending *banjar* meetings and convincing defaulters to repay their loans. Everyone repaid, sometimes after rescheduling, and collateral was never confiscated. In revamping the LPD staff, the board and the manager also took a family approach: retaining the staff, insisting on hard work and discipline, introducing good banking practices and tightening the rules. The board also established a close relationship with two well-performing LPDs, which served as role models and acted as consultants and trainers. The board of LPD Gelgel succeeded in restoring trust, turning the losses into profits, which continued to grow every year through 2007. A beautiful new building is currently under construction, fully financed from the group’s own resources, right next to the market and the largest temple of Gelgel. The case of LPD Gelgel demonstrates how a committed new governance team can restore trust and achieve full repayment of overdue loans using a soft approach, and without ever taking recourse to seizing collateral.

Two lessons emerge from these case examples, one pertaining to governance, the other one to supervision. While any LPD risks falling into disarray, a motivated and committed board, whether newly elected or reoriented, can revitalize an LPD in an amazingly short period of time. Good governance, with effective control over management, is absolutely crucial.

In none of the case studies has information about poor performance been followed by instantaneous action. While monitoring and reporting are effective, supervision is not. There is no coordination among the various agencies, and there are no instruments of enforcement of regulation. The family approach works well under conditions of good governance. But once governance fails, a similarly soft approach to supervision does not work. Evidently, as in any modern financial system, there are limits to the effectiveness of internal control by *krama* and *karma*. These factors must be supplemented by external supervision and the power of enforcement. Finding a Balinese way of achieving effective external supervision continues to be a challenge to the stakeholders.

**Growth and outreach of LPDs lead to economic and social impact**

By June 2008 LPDs were present in about 95% of customary villages.  Statistically, outreach to the 834,000 families of Bali is virtually universal, though there are regional disparities.

Such massive diffusion has led to changes in Balinese society. There is agreement among the LPD board members and managers that the LPD has a pronounced economic impact. There is now virtually total access to financial services for the whole population of the village – including the poor – at minimal client transaction costs. With regard to impact on women, the LPD provides a case of equitable service provision, without any discrimination on the basis of gender. The majority of depositors, and many of the borrowers, are women. In many cases, men borrow the money and their wives put it to use.

Additionally, the accumulation of savings and access to credit at competitive interest rates has contributed to income smoothing and the purchase of household durables. The LPD has also had a significant impact on local business by increasing the self-financing capacity of small and microenterprises, and increasing access to credit. This access has facilitated self- and debt-financed business start-ups; it has also led to the expansion of existing businesses and to new innovation.

Income and employment have increased. Direct employment by the LPDs amounts to 7,000, or 5 per LPD. There are indirect income and employment effects through farm and non-farm micro- and small enterprises financed through the LPD. This is a field which requires further study.

In addition to direct contributions from profits into a village development fund and a social fund, the LPD has offered the village and community administrations – non-formal entities with little access to formal financial institutions – accounts permitting them to accumulate resources, pay their staff and finance public investments. With regard to social impact, the LPD has improved the welfare of the families in various ways: families are able to acquire more livestock; more families are now in a position to pay for higher education of their children; housing has been improved; access to finance has created new opportunities for the less-fortunate generally. Also, in case of emergencies, families are either able to finance resulting shortfalls and expenses from their savings, or they have access to emergency credit.

## Conclusion

The LPD has emerged as a microfinance institution of superior efficiency. It has almost fully replaced the former indigenous savings and credit groups that operated at the *banjar* level. Yet, financial institutions at the customary community level have not disappeared. Registered savings and credit cooperatives have been spreading in recent years. In addition there are a good number of rotating savings and credit associations established by the Family Planning Board. Large numbers of voluntary associations continue to exist in the customary communities. In all villages visited, these associations are reported to save in, and borrow from, the LPD. This finding also applies to the cooperatives and many of the rotating savings and credit associations.

Access to financial services for all, as a human right, has become reality in Bali. The LPD has made a substantial contribution to this achievement, bringing financial services within reach of everyone. At the same time, other, smaller types of financial institutions have come into existence, indicating that there is still a need for self-organized financial services on a very small scale which are not adequately fulfilled by larger institutions, not even those at village level.

The LPD has given new strength to the customary village. The LPD gives support to the village temples and ceremonies as the center of religious and cultural life in Bali. Large LPDs have directly contributed to the economic development of the village, particularly by supporting selected infrastructure projects. The LPD enables everyone to make use of the opportunities created by the economic development of Bali. Yet, as village-level institutions, there are limits to the loan demands to which they can respond. Addressing these limitations may require linkages with banks, which may extend larger loans to customers based on their track record at the LPD.

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***Notes and References***

1. This paper is based on field work in October 2008 as part of a study requested by Promotion of Small Financial Institutions (ProFI), a joint project of Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, Bank Indonesia and Bank Pembangunan Daerah (BPD) Bali; their support is gratefully acknowledged.
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