Old and New Worlds of Microfinance in Europe and Asia
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In: Aditya Goenka and David Henley (eds),
Southeast Asia's Credit Revolution: From Moneylenders to Microfinance. London: Routledge 2010 [ISBN 978-0-415-44368-5], pp. 40-57

Excerpt:
Microfinance in Indonesia: the case of linkage banking

Origins of linkage banking

Microfinance has a much longer history in Asia then in Europe, though little is documented about the early history of indigenous institutions like *arisan* in Indonesia, *hui* in China, *chits* in India, or *paluwagan* in the Philippines, to name but a few (Seibel and Damachi 1982). Self-reliance, viability and sustainability have been identified as core institutional principles. Such informal institutions are still exceedingly widespread, but have generally failed to evolve as they did in Europe. Since the early 1900s when Westermann (1934) discovered the *sodyodyo*, a rotating savings and credit association in Togo, many have argued to build a modern financial system on indigenous foundations. At the time this found little interest. This began to change in the 1970s when commercial and development banks as well as cooperatives used as credit channels turned out to have failed delivering to the rural and urban masses. Assuming that poor people were too poor to save, credit NGOs ushered in what came to be known as the *microcredit revolution*; Grameen Banking, the delivery of credit through newly established small groups and standardized delivery schedules, became a model. Development banks and credit NGOs both had in common ignoring savings and financial intermediation, relying instead on capital transfer from abroad: *undermining rural development with cheap credit* (Adams et al. 1984) and *easy money* (Seibel 1994). As a result they lacked self-reliance and institutional sustainability; many still do.

In the early 1980s the poor performance of development finance created a climate of openness for innovations and a paradigm shift. As SHGs as informal financial intermediaries were still found to be ubiquitous, Seibel (University of Cologne) argued for their upgrading; Kropp (GTZ) and Mittendorf (FAO) pointed out they could only work with governmental and formal sector partners. The result was a hybrid model: *linking* formal and informal finance. This was to include *upgrading* of informal, and *downgrading* (*downscaling*) of formal financial institutions (Seibel 1985, 1996, 1997).

In Indonesia Bongartz (1989) had found up to 60 SHGs in a single village – indigenous, self-, government- or NGO-induced (see Holloh 1998: 37-45 for a more differentiated picture). Hence, there was no need to establish new groups. SHGs as local financial intermediaries of various types and sizes were to be brought into business relationships with banks as refinancing agencies. Terms and conditions, including interest rates, were to be determined by the business partners. Technical assistance was to set the process into motion. Capacity-building services were to be provided by NGOs. No capital was to be transferred from abroad; there was enough liquidity in the banking sector.

Three models of institutional links were proposed, in a loose sequence: *Model 1 Indirect Linkages* while banks lacked confidence in informal SHGs: Banks–NGOs–SHGs–Members; *Model 2 Direct Linkages:* Banks–SHGs–Members, including NGOs as capacity-builders; *Model 3 Direct Access*: Banks–Individual clients. Avoiding a bank wagon effect, SHGs were to deposit savings in banks as partial collateral and to obtain repeat loans at an increasing ratio. SHGs would lend to their members on their own terms. All partners involved would cover their costs from the interest rate margin and generate a surplus. Group savings were to be the main source of loanable funds. However, as the SHGs were pre-existing, project emphasis was on access to bank credit, while internal savings were neither promoted nor monitored. (APRACA 1986; Kropp et al. 1989; Seibel and Parhusip 1990).

The development of linkage banking in Indonesia

In Asia linkage banking was taken up by APRACA, an association of agricultural and central banks, as of 1986 and disseminated among its members. Indonesia was first starting a pilot, 1988-91, serving as an experimental field station visited by member countries. The Philippines, Thailand and India followed with own projects. The project was guided by a task force of Bank Indonesia (BI), the central bank; Bank Rakyat Indonesia, a government-owned agricultural development bank; and Bina Swadaya, a leading NGO. Technical assistance was provided by GTZ, 1988-99. (Seibel 1996: 62-71)

Initial linkages were mostly mediated through NGOs, on-lending to the groups. Charging a margin of 5-10%, this greatly increased transaction costs. During the pilot phase, a growing number of banks and SHGs discovered that direct linkages, and direct selection of groups by banks, was more beneficial. As PHBK progressed, the number of NGOs involved greatly increased, while their direct involvement as lenders declined. There is a qualifier: with the passing of the BPR law, PHBK recommended to its NGO partners eager to maintain their own microfinance activities to convert into BPR-type banks, which Bina Swadaya and several others did, carrying out linkages under their new institutional roof.

GTZ-ProFI (2007) reports that since its inception PHBK facilitated linkages of 351 commercial bank branches and 998 People's Credit Banks (BPR) with 6,582 SHGs and 31,636 channelling groups who received 74,111 loans; 240 NGOs were involved. These are cumulative data; data at four points in time, between 1992 and 2003, are given in Table 1.

Table 1: Linkage banking in Indonesia, 1992-2003

	3/1992	3/1997	**3/1999**	6/2003
Commercial bank branches	33	211	**218**	111
People's Credit Banks (BPR)	11	225	**667**	552
NGOs	23	130	**131**	53
Savings & credit groups (SHGs)	698	2,016	**1,312**	647
Channelling groups	-	3,065	**12,137**	10,599
Group savings in banks (Rp bn)	0.3	3.7	**10.8**	20
Group savings in banks (US$ mn)	0.15	1.54	**1.23**	2.42
Group loans outstanding (Rp bn)	1.9	24.3	**71.7**	70.5
Group loan outstanding (US$ mn)	0.95	10.1	**8.2**	8.5
Bank savings to loans ratio	0.16	0.15	**0.15**	0.28
Long-term loss ratio (in percent)	6	4	3	2

Source: GTZ-ProFI 2007

During the pilot phase, the size of SHGs varied from 10 to 200, averaginge around 45, but declined with a shift to channelling groups. Around 30,000 group members were involved as of 1992, and probably less than 400,000 as of 1999 (a fraction of the outreach of BRI's 4,000 BRI village units). Some BPR reportedly embraced linkage banking wholeheartedly. Eg, in Yogyakarta Province, as of Dec. 2005, 18 BPR served 1,051 SHGs with loans outstanding of US$ 1.05m; 8 BPR, with an NPL ratio of 2%, accounted for 90% of the loan balance. Yet, as banks consider linkages their private business and are neither compelled nor particularly motivated to engage in voluntary reporting, actual outreach is likely to be greater. Moreover, transitions to Model 3, direct access of members to banking services, have not been monitored.

Critical perspectives

Several factors have to take into account when assessing PHBK. First, the program benefited from a conducive policy environment, starting with interest rate deregulation in 1983; the passing of a legal framework for microbanks (BPR) as regulated financial institutions in 1988, later the main partners in PHBK; banking deregulation in 1992 which facilitated branching; and the phasing-out of 30 out of 34 subsidized credit programs in 1990 (Seibel 1996: 17-23). Second, given the dismal performance of cooperatives (KUD), groups have suffered from the lack of an appropriate legal framework and remained informal; the draft microfinance law of 2001 seemed to offer a solution, but has been put on hold by the Ministry of Finance. Third, the Asian Financial Crisis affected the mandate of BI, the champion of PHBK, of engaging in activities other than monetary policy.

The most important factor, however, was internal: a change in policy from SHGs as self-reliant financial intermediaries to channelling groups as an outreach strategy of banks. In the eyes of this author, who is partial as he designed and implemented the original approach, this almost meant a return to a government program (BIMAS) of the 1970s. The new channelling approach differs from the old in some essential respects – the emphasis on market rates of interest, and the commercial interest of banks in group linkages; but it is similar in others – the neglect of savings mobilization and financial intermediation by the groups. Project documents say there were good reasons for the change: a declining interest of SHGs in bank linkages after a couple of cycles. I only doubt that the program would have been started by APRACA and the Indonesian task force in the 1980s as a channelling approach.

Crunching the numbers of data collected by PHBK during 1989-93, Holloh (1998) examined the internal dynamics of groups. He concluded: (1) Savings-driven groups outperform all other groups; when there is an unmet demand of members for credit, there are lasting effects of access to bank credit on the growth of these groups, also in terms of additional savings mobilization. (2) Equity-driven groups, funded through initial and compulsory regular savings, are substantially smaller, their growth is slow; benefits from access to bank credit are only temporary. (3) Groups without a solid equity or savings base either benefit little, or are even damaged, by bank credit.

Maurer (1998:223) offers a more general explanation of inconsistencies – correctly so, in my view –, pointing to an inherent conflict of objectives: between impact on target groups through credit disbursement, and institution building of SHGs as financial intermediaries. Indeed, one may either aim at a “linkage product… designed in a way that would attract banks… successful in facilitating finance to low-income-microentrepreneurs” (Steinwand 1997:63-64); or at strengthening SHGs as financial institutions in a systems perspective (Seibel 1996). In the original APRACA/GTZ design document, the two perspectives are reduced to a question of practicality: “It is the ultimate and long-range objective of such linkages to make the individual small enterprise bankable. In this case the individual may eventually gain direct access to a formal financial institution.” (Kropp et al., 1989:55).

Through dissemination, the Indonesian linkage banking pilot has entered the history of rural microfinance in a number of countries. It achieved its greatest depth and breadth of outreached in India.

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