

Optimal Financing System For Indonesian SMEs

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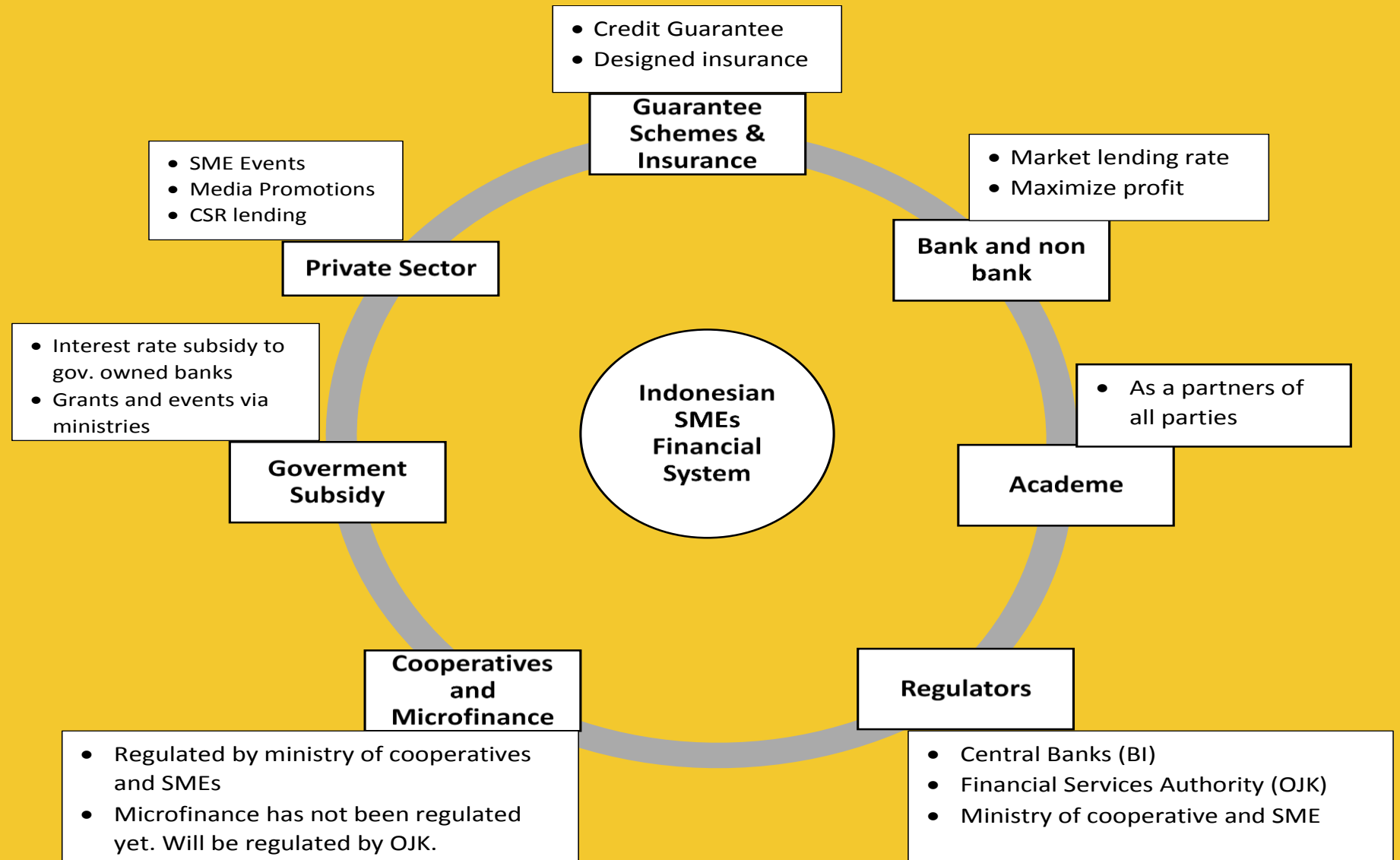
Motivation

- SMEs are Indonesian economy's back bone.
- Financing SMEs is still scattered. There is no systematics scenario of Government as well as private sector.
- Abandon foreign capital inflow to SMEs sector.
- The involvement of Academe and
- APEN challenge for Indonesian SMEs
 - *By creating integrating and comprehensive system.*
 - *By educating people.*
 - *By using/creating innovative technology.*

Outline

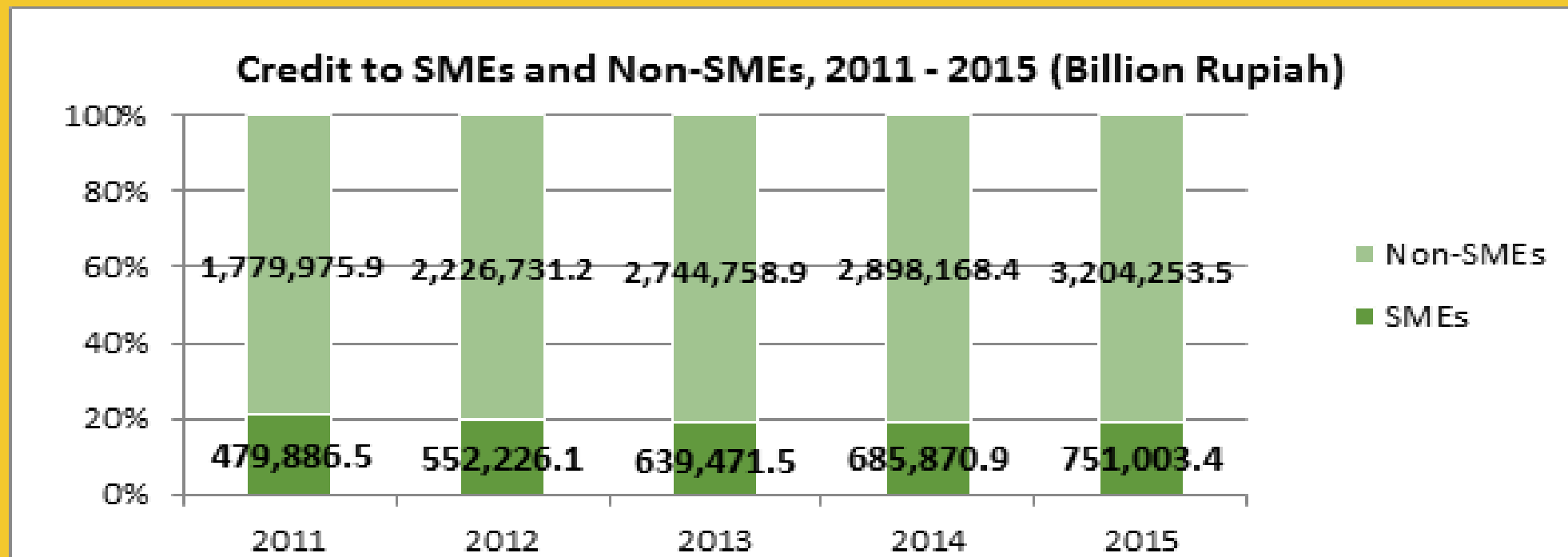
- Financial system for Indonesian SMEs
- Current condition of SMEs financing
- The government role
- Credit guarantee scheme
- Credit rating system
- Foreign participation
- Optimal financing for SMEs
- Conclusion

Formal financial system of Indonesian SMEs



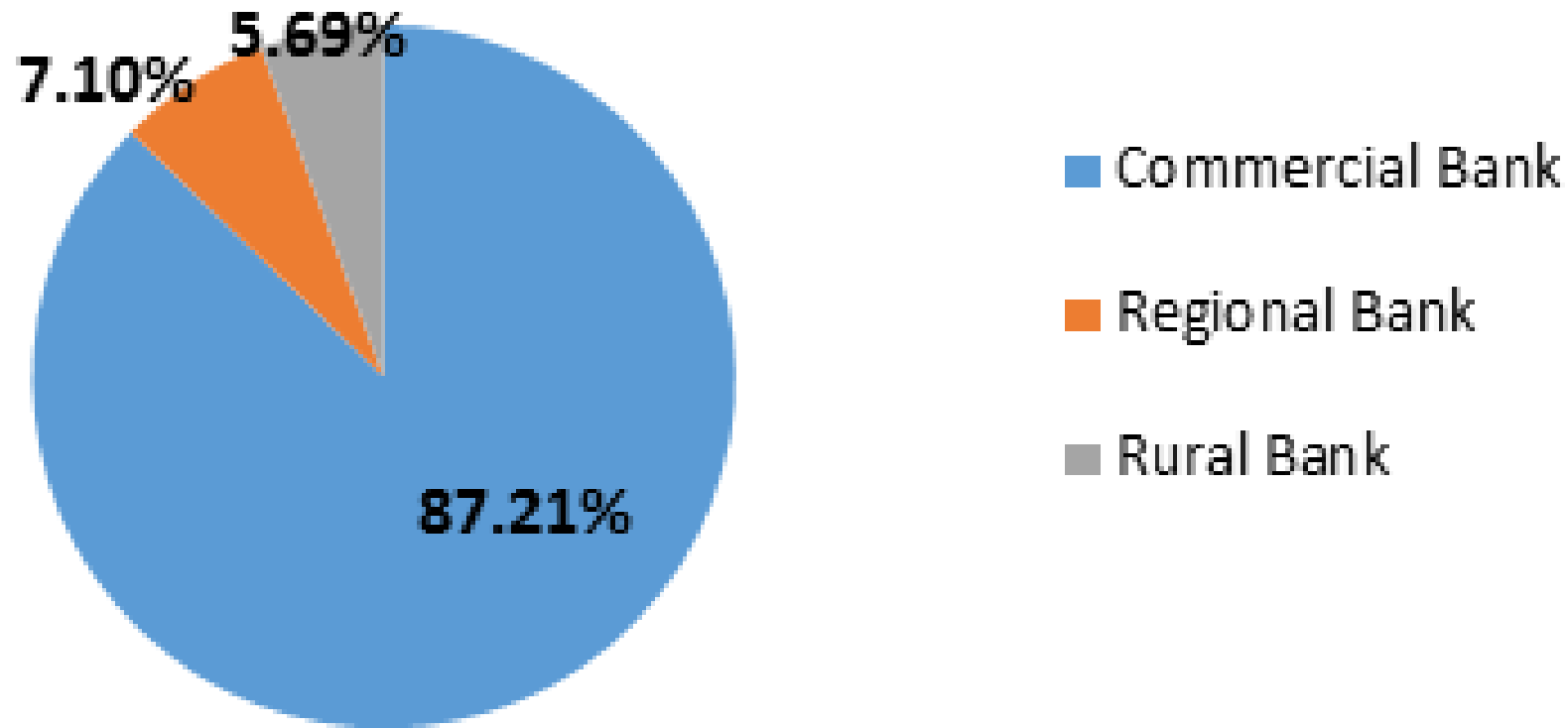
Current Condition of SMEs financing

- Since 1997, the contribution of SMEs to formation of GDP has always been higher than 50%. In 2013, there are 57 million units of SMEs in Indonesia that responsible in the absorption of 114 million of labor force. But only less than 20% for financing.

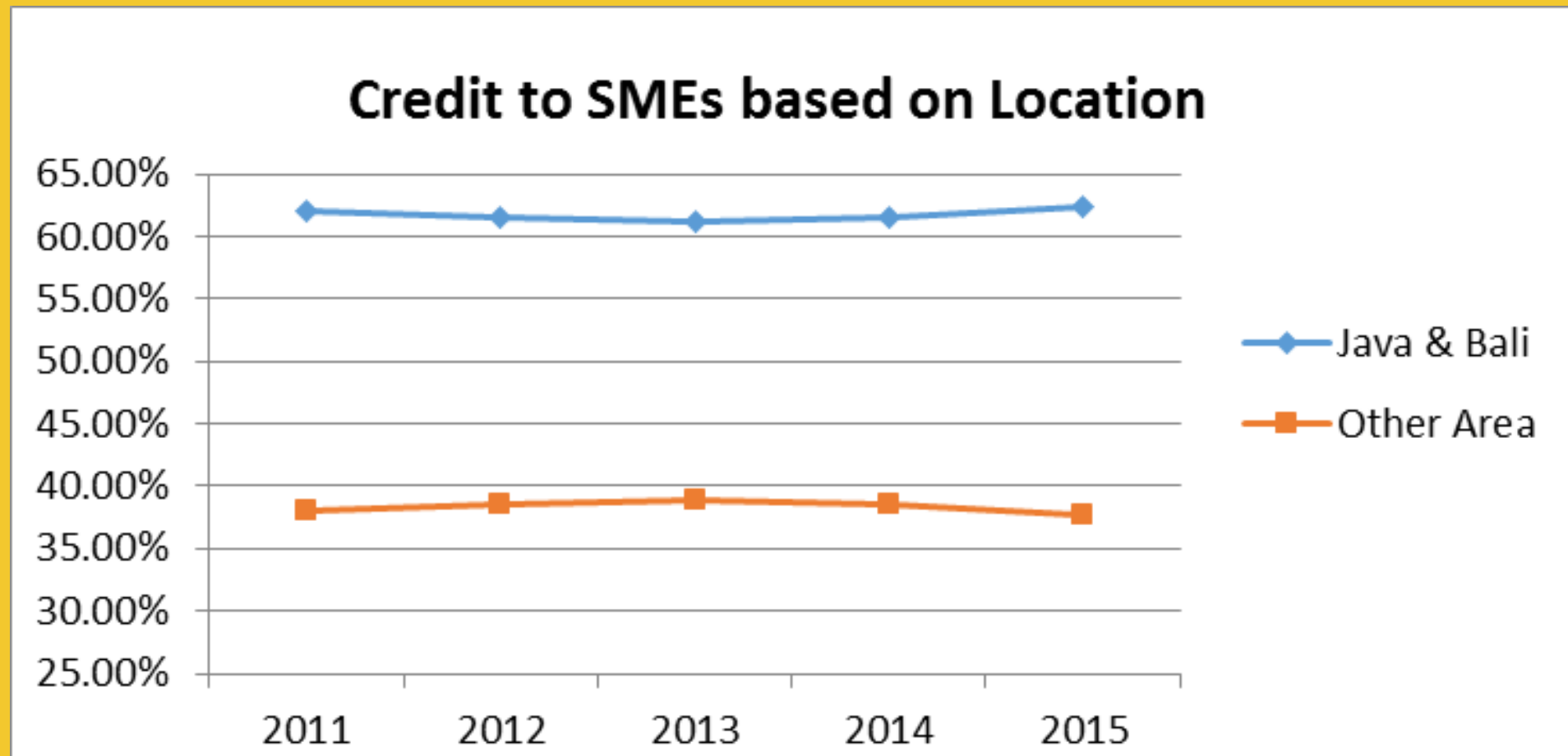


Regional and rural banks take significant part

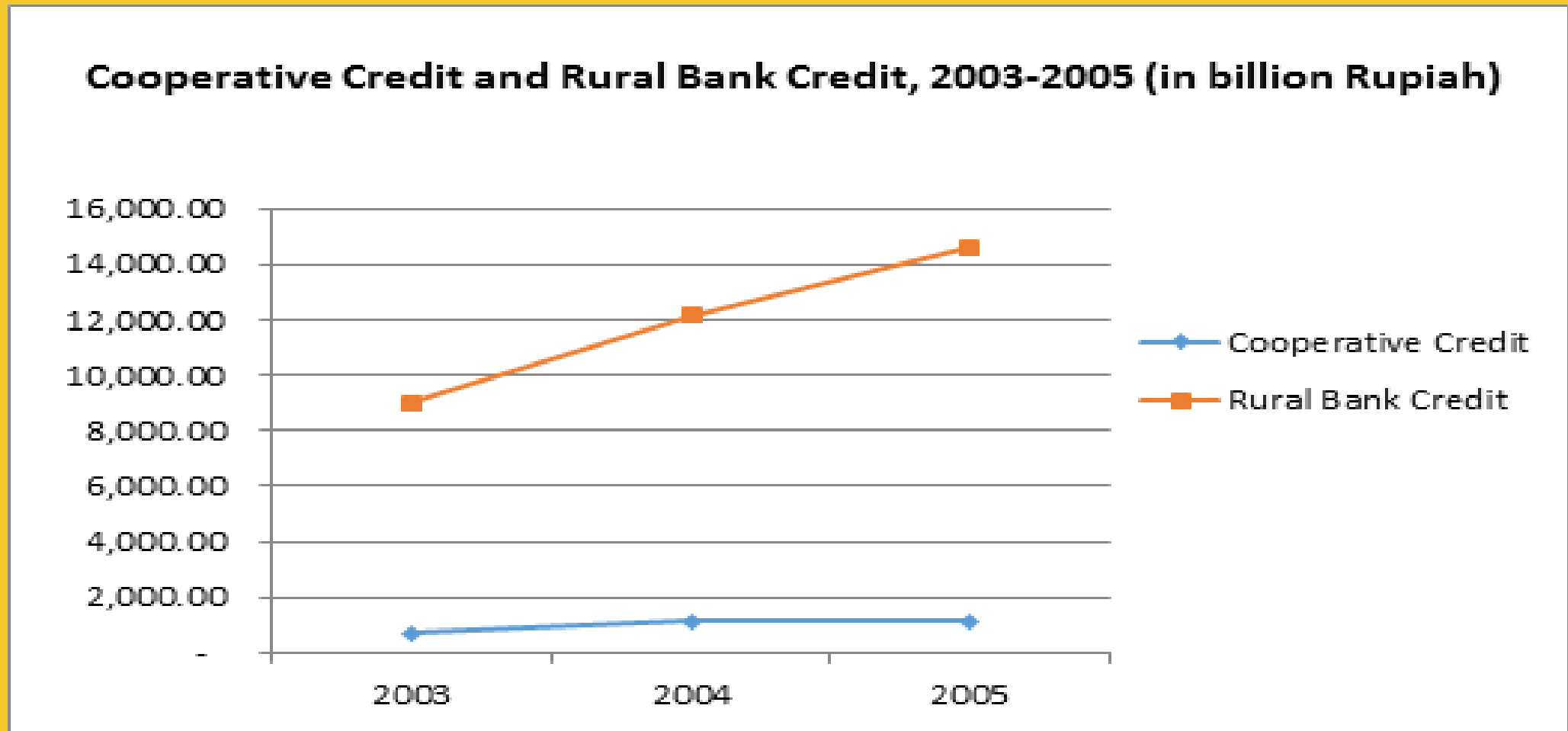
Credit to SMEs based on type of Bank,



Still concentrated in Java & Bali



Cooperatives that regulate by ministry of cooperatives and SMEs



Microfinance in Indonesia

- In 2013, Indonesia Financial Services Authority (OJK) based on Law No. 1/2013 about Microfinance Institutions.
- The area of work which can only be classified into 3 groups (i) Village Coverage, (ii) Sub-District Coverage, and (iii) Regency/City Coverage, all of which must submit 4-monthly report to OJK annually.
- No official regulation regarding amount of credit.
- No official guide regarding the interest rate of credit
- No formal guidance to MFIs regarding the target of MFIs in term of financial inclusion, credit channeling, and many other financial institution indicators.

The Government Role

- Financing SMEs in various forms grants, loans, and investment credit.
- **National Entrepreneurship Movement (*Gerakan Kewirausahaan Nasional*):**
 - *Motivated by the percentage of entrepreneur in Indonesia is still very low 0.24% compared to other ASEAN countries or theoretical believes 2% of total population..*
 - *Government provides grants for prospective entrepreneurs.*
 - *Business proposals will be selected for determining how much cash grants to be given.*

Kredit Usaha Rakyat (Soft Loan for Micro and Small Entrepreneurs)

- Credit limit is 5 million to 500 million.
- Until mid-August to October 2015, the credit has been channeled to SMEs amount to 4.35 trillion rupiah to 267.686 SMEs.
- The interest rate is 12% while the market interest rate is about 22%. The interest rate is subsidized by the government, under the credit guarantee scheme.

Credit Guarantee Scheme

- Full (100%) guaranteed scheme KUR based on the Regulation of Minister of Finance (PP) No. 10/PMK.05/2009.
 - *Government guarantee 70% of the total Credit/Funds*
 - *30% is guaranteed by the corresponding bank → it doesn't clear the rule about collateral.*
 - *The percentage of credit/funds guaranteed by the government in Indonesia is much higher compared to the ideal threshold as suggested in the case of Italy by Boschi, et. al. (2014) → 25%.*
- Subsidy of interest rate based on the Regulation of Ministry of Finance No. 146/PMK.05/2015.
 - *Subsidy of interest rate of which the government responsible to : a. 7% p.a. for Micro Credit; 3% p.a. for Retail Credit; and c. 12% p.a. for Indonesia Labor Credit.*

Credit Rating System

- Development of infrastructure is an absolute need in preparing the Credit Rating, the existence of Credit Rating Agency is crucial.
- Initiatives:
 - *In 2014 Bank Indonesia together with all ASEAN member countries developed an ASEAN Benchmark for SME Credit Rating Methodology.*
 - *LPEM FEB UI is the institution that doing the study.*
- 8 rating Scales:
 - *The scale could be in the form of number (e.g. 1 to 8), letter (e.g. AA to D) or combination of both (SME1A to SME4B).*
 - *The highest scale (e.g. 1, AA or SME1A) represents SME with the lowest probability of default or highest quality of credit*

Credit Rating System

■ 3 Clusters:

- a) cluster 1, a well-developed SME credit rating system like in Singapore and Malaysia;
- b) cluster 2, a fractional SME credit rating system as in Thailand, Indonesia, and Philippines; and finally,
- c) cluster 3, the least developed infrastructure including: Brunei Darussalam, Cambodia, Myanmar, Laos PDR, and Vietnam.

Credit Rating System

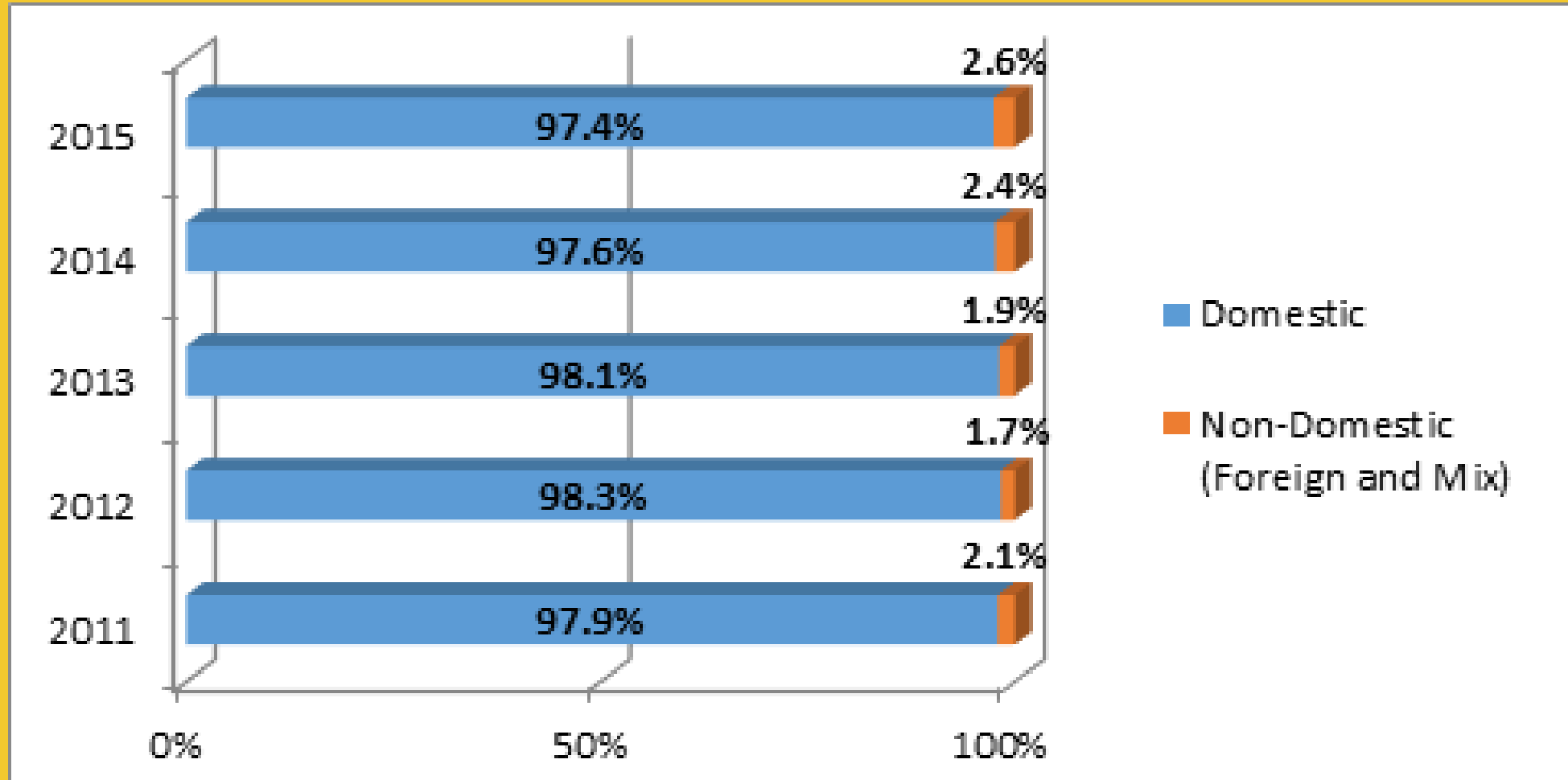
I. Non- Financial Aspects 60%

- Industry or business sector 9%,
- Business condition/sales condition 10%,
- Government policy 2%;
- Management character and experiences 10 %,
- History of the company 3%,
- Age of company 3%,
- Innovation initiative 5%,
- Payment habits (frequency, experiences of delays/defaults) 18%.

II. Financial Aspect 40%

- Profitability (net profit margin, ROA) 4%,
- solvency ratio and stable financial debt (debt to equity ratio, debt to total asset) 8%,
- Liquidity and cash flow (current ratio, quick ratio) 10%,
- Asset or collateral 10%,
- Average balance in financial institution (e.g. bank, non-bank) 8%.

Foreign Participation: Credit to SMEs based on Bank Ownership, 2011-2015



Foreign Participation

- The Initiative of SME Regional Fund is to facilitate free flow of capital among SMEs in ASEAN countries.
- Shinozaki (2012) suggest:
 - *(i) non-bank financing schemes to supplement bank financing for SMEs,*
 - *(ii) capital markets for high-end SMEs and support for the venture capital industry,*
 - *(iii) the base of professionals needed to promote SMEs' access to finance, and (iv) financial education.*
 - *More than 78% of all surveyed firms expressing interest to tap an equity market designed specifically for SMEs.*

Characteristics of optimal financing for SMEs

1. Funded by Registered/Formal Financial Institutions.
2. Competitive credit interest rate among financial institutions thus allowing SMEs in accessing credit to financial institutions with the lowest interest rate
3. Partial Credit Guarantee from the government
4. Intensive business mentoring and business coaching to SMEs whom access credit from formal financial institutions.

Recommendations for Optimal Financing

- Formalization of lender institutions, thus SMEs can ONLY access to formal financial institutions
- Develop Credit Rating Agencies
 - *For the first time, to be part of OJK (Otoritas Jasa Keuangan)*
- Evaluate the credit guarantee scheme
- Regulate the flow of foreign fund and/or the establishment of foreign lender institutions
- Develop mentoring system which involves academics.
- Apply reward (incentive) nationwide to SMEs which accessing formal financial institutions.

Conclusion

- The participation of academic :
 - *(i) research to determine the optimal guarantee percentage for SMEs loan, optimal regulations, etc. (ii) Conducting surveys regarding credit rating implementation for SMEs. The survey should be longitudinal survey since it evaluate the condition of SMEs before and after intervention; (iii) Business mentoring and coaching for the SMEs; (iv) Educate banks/financial institution agents that will engage with SMEs along the period of loan; (v) Research to explore new instrument/model for financing SMEs, especially to absorb foreign capital.*
- Networking between educator and professional who specialize in SME, partnership with the regulator of financial system.