OPTIMAL FINANCING SYSTEM FOR INDONESIAN SMES

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Faculty of Economics and Business, University of Indonesia 2015

ABSTRACT

Indonesian SMEs have become the main target of investment worldwide due to its massive 57 million units operating in economy that contribute in the making of 60% of Indonesia GDP and absorption of 98% of the nation labor force. Rate of return of SMEs is above the average banks interest rate, thus results in a higher rate of return for direct investment to SMEs compared to investment in banks and/or other financial institutions. From banks perspective, credit to SMEs is considered to be risky due to the high risk nature embedded in SMEs itself, thus results in a higher interest rate charged to credit to SMEs compared to other credit arrangement forms. SMEs, however, have other option in financing the needs of fund from cooperatives, microfinance institutions, and government subsidy. Another important source of fund for SMEs comes from private sector via CSR initiatives. The study describes current condition of financial system in the context of SMEs in Indonesia, analyzes the gap, and suggests solution in realizing the optimum financial system for SMEs financing in Indonesia. We conclude that the optimal financing for SMEs requires a structured and integrated data base, so that all parties, both borrowers and lenders, should access to the system before executing the finance. Therefore very intense IT involvement in building the data base system is a must.

Keywords: *SMEs, financial system, IT involvement*

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BACKGROUND

The availability of external finance for small and medium enterprises (SMEs) is a topic of interest to academics and an important issue to policy makers around the globe. Indonesia's external finance for SMEs is one of major obstacle to the SMEs development. The involvement of the Indonesian in financial sector is still low, due to lack of knowledge about financial sector. Most people, especially in the rural area, do not have a bank account, and doing cash transact. On the other hand, SMEs are the business units that are managed by people who are not attached so much in the financial sector. In other words, financial inclusion for SMEs is still low.

SMEs play significant role in the Indonesian economy. 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. Therefore, the increase of access to SMEs is obligatory since it brings benefits, not only to SMEs but to financial institutions as well. For instance, from banks perspective, access of finance to SMEs increase the speed of circulation of fund in banks, therefore increases liquidity as well as business activity of banks, the condition applies to cooperatives as well. While in the case of microfinance institutions, such as leasing company and other microfinance institutions, the increase of SMEs participation in financial system will improve business capacity of microfinance institutions.

From the perspective of government, the upscale of SMEs is regarded as the main contributor of national economy growth. Currently, on average, per unit of SMEs in Indonesia absorb 2 employees. Mardanugraha et. al., (2015) shows that to achieve optimum level of 6% GDP growth with 2% unemployment rate SMEs growth in Indonesia must be at the level of 42% p.a. High growth SMEs absorb labor, therefore emphasize its importance in promoting economy growth. In assisting SMEs in terms of financing, government has implemented several policies, one of which is through direct star- up financing and credit lending to non-bankable SMEs while the other is via subsidy through credit guarantee and insurance scheme to SMEs. Interest rate subsidy among banks enables banks to run business normally due to particular margin which maximizes profit while insurance scheme for farmers, in which the premium insurance is covered by the government, allows private insurance companies to participate in guarantee scheme for SME.

Insurance and credit guarantee, both are crucial in the financing of SMEs, since they provide certainty in investing to SMEs. However, the high-risk characteristics of SMEs results in low participation of private sector in the credit guarantee scheme, thus leaving government, in the current time, being the main player in developing credit guarantee schemes in the economy.

The study identified sources of fund that are accessible to SMEs, reveals the current condition of SMEs financing and the alternative source of fund in the future, as well as suggest policy recommendation regarding the optimum financing system for SMEs in Indonesia.

1. CURRENT CONDITION OF SMEs FINANCING

1.1. Financial system for SMEs

Berger & Udell (2006) categorized financing scheme for SMEs into two types namely: transactions lending that is based primarily on ‘‘hard’’ quantitative data and relationship lending, which is based significantly on ‘‘soft’’ qualitative information. “hard” lending system is formal financial system in which SMEs must complete obligatory documents such as financial report and legal documents. In Indonesia, the current operating financial system is bank-based system in which there is no understanding regarding capital market and/or financial market. In general, there is no SMEs in Indonesia that already issue shares or bonds in formal financial market. “Hard” lending system occurs when there is no access of SMEs to formal financial sector, namely banks. “Soft” lending system occurs in informal financial sector where financial activities practiced between individual or informal financial institutions with the absence of legal documents such as document of business establishments or financial statement.

Diagram below summarize the financial system for SMEs in Indonesia:

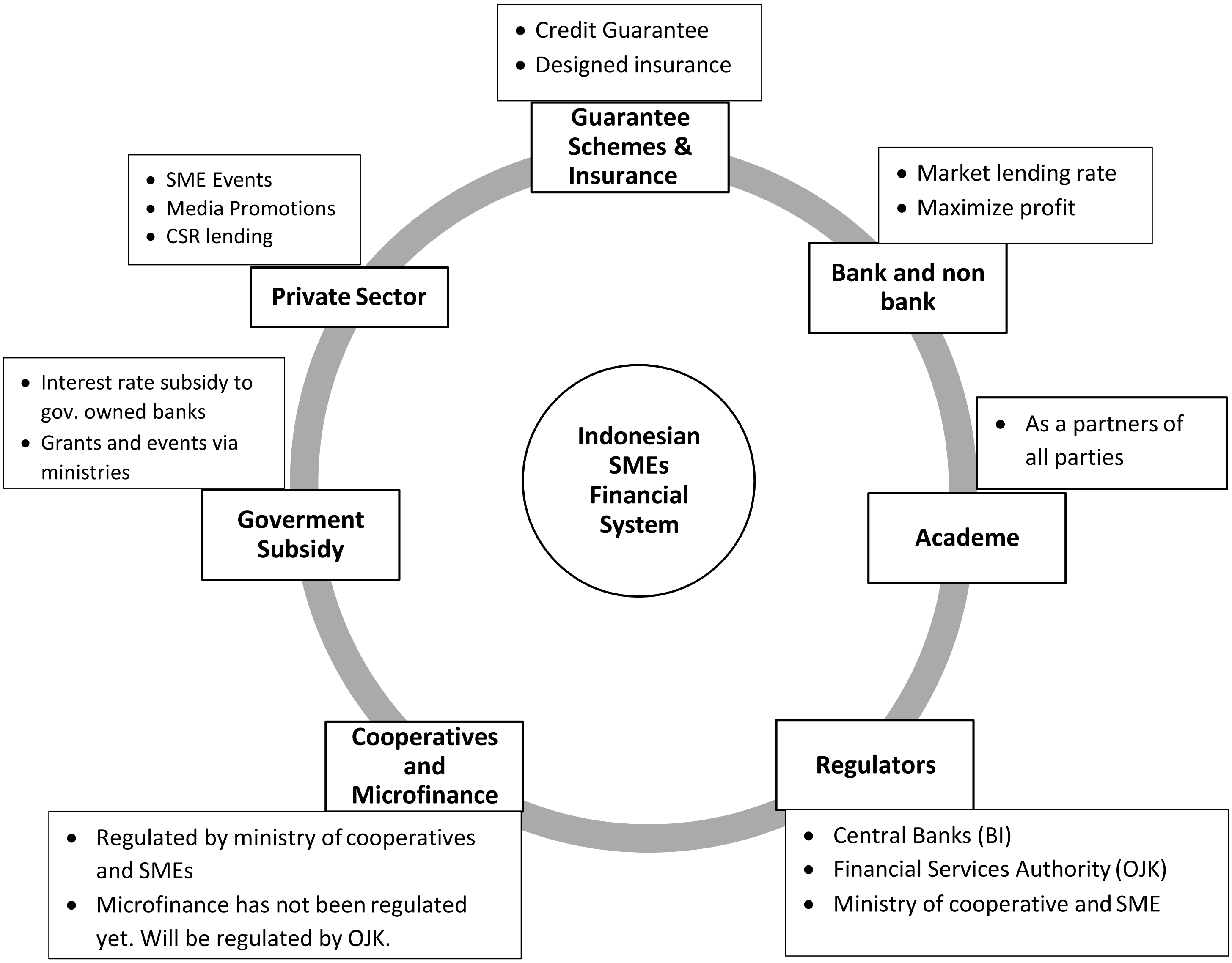


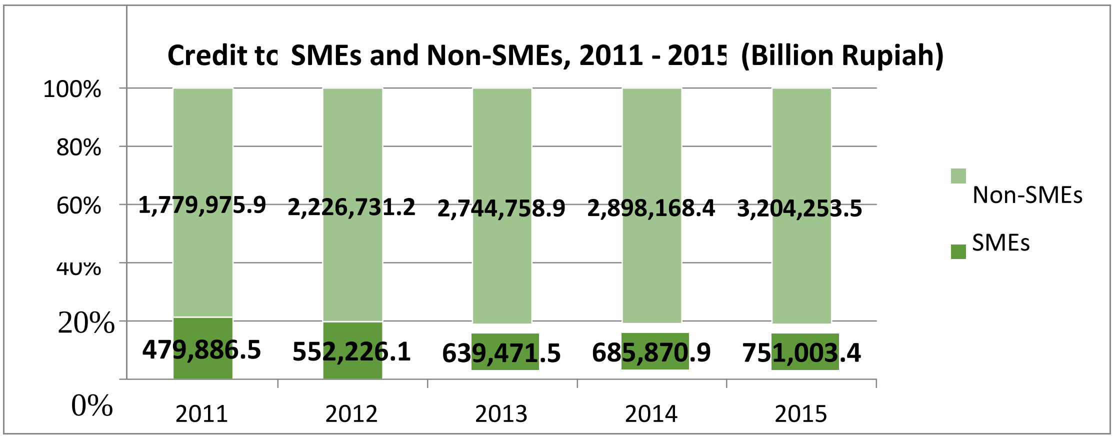
Figure 1. Financial System for SMEs

1.2. Bank and Non-Bank Financing

1.2.1. Bank Financing to SMEs in Indonesia

The importance of banking in accessing finance applies to any kind of businesses, including the Small and Medium Enterprises in Indonesia. As graph 2.2.1.1 shows, the nominal amount of credit to SMEs increases over time, however, its proportion is small compared to credit to non-SMEs. The more intriguing fact is that the proportion seems to have a downside trend along 2011 – 2015. In 2011,
21.24 percent of credit is allocated to SMEs, however, in 2015, it is only 18.99% of credit that is allocated to SMEs. The proportion decreases over time from 2011 to 2015 with only a slight increase from 18.90% in 2013 to 19.14% in 2014.

Figure 2.1.1.1

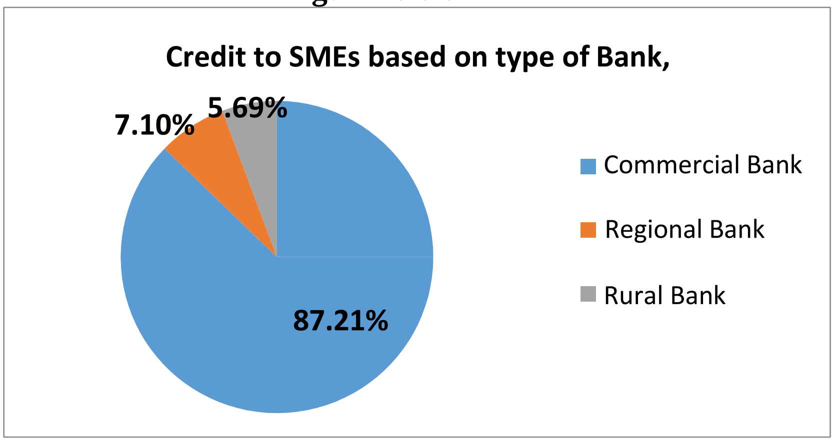


Source: Bank Indonesia, 2015

The channeling of credit to SMEs in Indonesia is dominated by commercial banks. As graph

2.2.1.2 indicates, in 2015, 87.21% of credit to SMEs is channeled by the commercial banks. The contribution of both Regional Banks and Rural Banks has not been significant with only 12.79% contribution to national credit channeled to SMEs. However, Regional Banks are slightly more contributive in national credit to SMEs scheme in 2015, with 7.10 % of contribution compared to Rural Banks, which only contribute 5.69% in national credit to SMEs scheme.

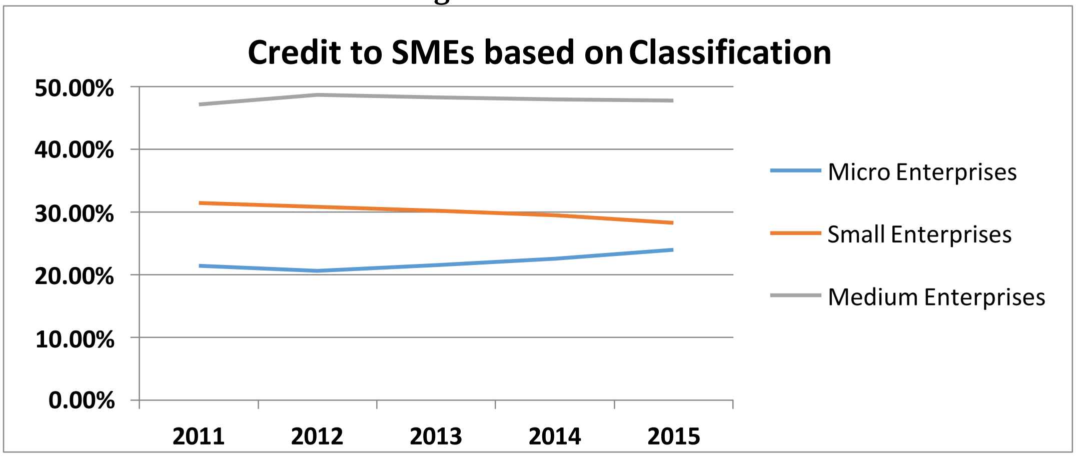
Figure 2.1.1.2



Source: Bank Indonesia, 2015

Based on the size of business, credit channeled to SMEs is more concentrated among the Medium Enterprises. In the period of 2011-2015, credit channeled to Medium Enterprises has never been lower than 45%, with average of 47.69%. The lowest proportion of credit channeled to Medium Enterprises occurred in 2011 (47.11%) while the highest was on 2012 (48.64%). The proportion of credit to Micro and Small Enterprises in Indonesia remains the same in the period of 2011-2015, with only 51%-52% national credit absorption rate. However, there is an increasing absorption of credit among the Micro Enterprises since 2012. In 2012, Micro Enterprises absorb only 20.60% of national credit to SMEs, however, in 2015 the absorption rate increases to 24.00%. The increase in the absorption rate of credit among Micro Businesses is followed by the consequences of decrease in the absorption rate of credit among Small Businesses, which sees a downward slope trend from 31.45% of absorption rate in 2011 to 28.22% in 2015. The graph in overall shows that Medium Enterprises remain the most favorable in receiving credit compared to Micro and Small Enterprises. However, there seems to be a changing pattern of SMEs credit channeling in Indonesia, in which Micro Enterprises are seems to be more favorable compared to Small Enterprises in receiving credit.

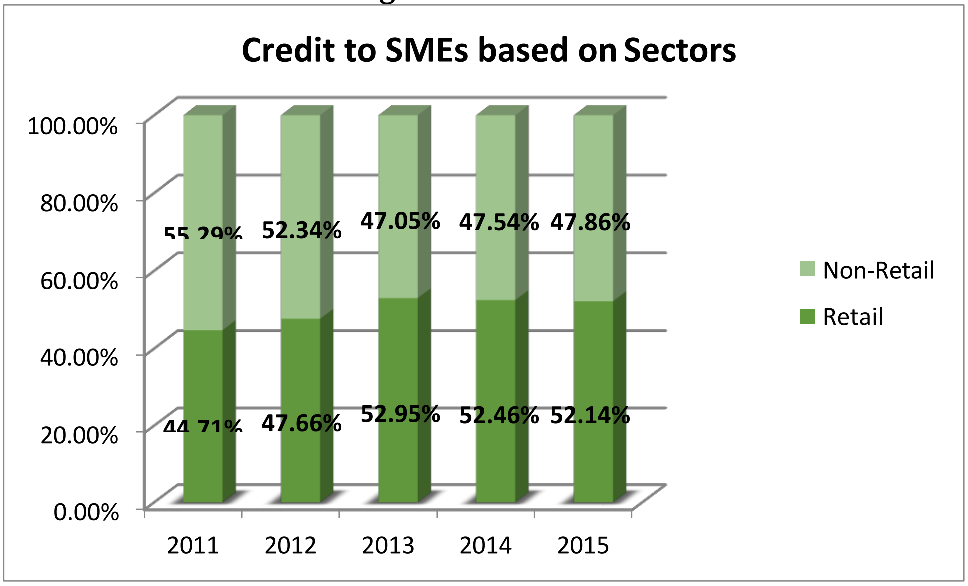
Figure 2.1.1.3



Source: Bank Indonesia, 2015

Credit to SMEs in Indonesia is heavily concentrated on Retail Sector, with absorption rate of credit channeled of 52.14% in 2015. The trend on credit channeled to retail sector increases significantly during the period of 2011-2013, with only a small decrease in 2014 (0.49%) as well as in 2015 (0.31%). The second biggest sector to receive credit is Processing Industry with 10.03% absorption rate of national credit to SMEs in 2015, followed by Agriculture, Hunting, and Forestry sector, which absorb 8.44% of credit to SMEs in 2015, and Social Services, with 6.10% absorption of national credit to SMEs rate in 2015. The 4 sectors absorb 76.71% of national credit to SMEs in 2015, which left each of the other 14 sectors, absorb less than 5% of national credit to SMEs.

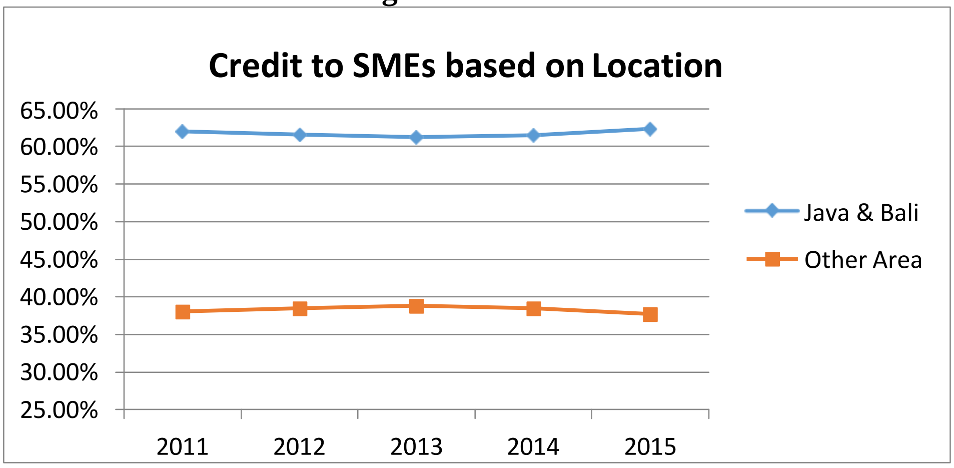
Figure 2.1.1.4



Source: Bank Indonesia, 2015

Not only concentrated based on the size and type of business, credit channeled to SMEs is also concentrated based on location. SMEs located inside the region of Java and Bali are more likely to receive credit from bank than other area as indicated by graph 2.2.1.5., that shows that during 2011- 2015, bank credit to SMEs has never been lower than 61.20% (2013).

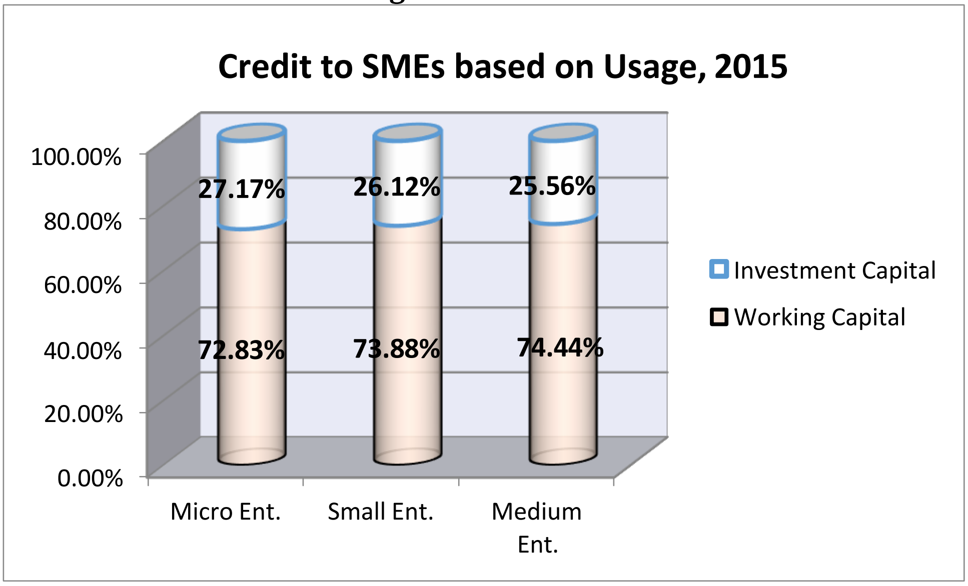
Figure 2.1.1.5



Source: Bank Indonesia, 2015

Financing for working capital is more needed by SMEs in Indonesia regarding the size of business. As figure 2.2.1.6 below indicates, for every group of SMEs based on size, whether Micro, Small, or Medium, more than 70% of credit channeled is used to finance the needs of working capital. The condition indicates that credit to SMEs is most likely to be used to finance routine business activity (short-term financing). The low proportion of credit channeled used to finance investment capital indicates that SMEs in Indonesia are still having difficulties in expanding their business. The interesting fact is that the relative amount of credit channeled used to fund investment capital needs is highest among the Micro Enterprises and lowest among the Medium Enterprises. The main hypothesis is that among Micro Enterprises, credit granted by Banks are needed the most to purchase equipment to produce goods/services, however, as the size of business increases, SMEs are more likely to focus on daily business routine with little intention on expanding their business.

Figure 2.1.1.5

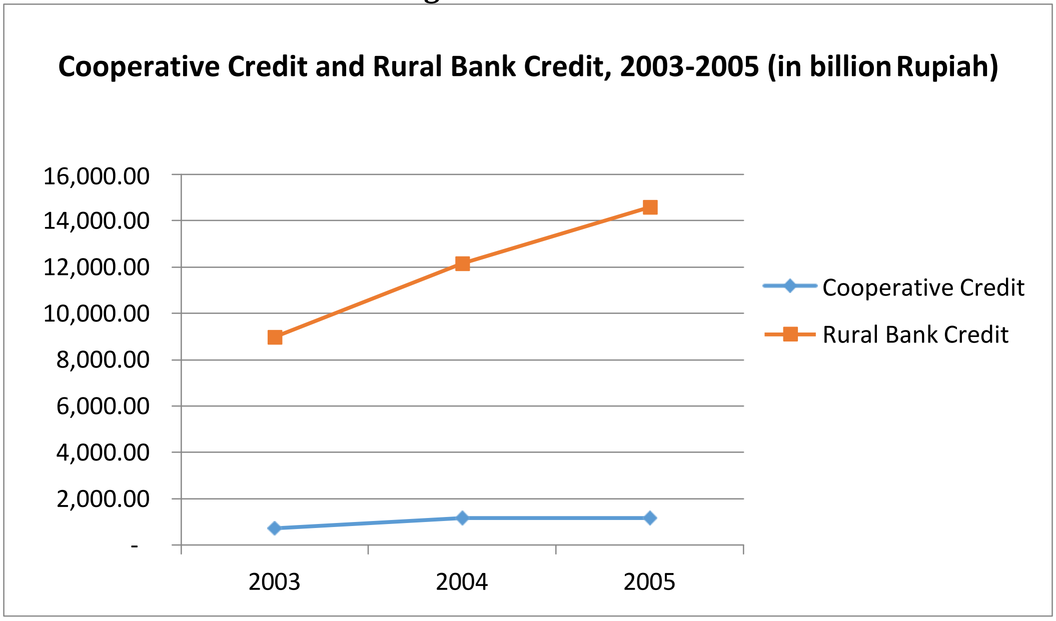


Source: Bank Indonesia, 2015

1.2.2. Non-Bank Financing in Indonesia: The Case of Cooperatives

One of the most common institutions in channeling credit beside banks in Indonesia is cooperative. Cooperative in Indonesia which specializes in financial activities is categorized as *Koperasi Simpan Pinjam* (KSU, Cooperatives of Deposit and Lending). As the name suggests, KSU is allowed, only, to collect and lending funds to its members which must be redistributed among its members at the end of the year as *Sisa Hasil Usaha* (SHU, Benefit of Cooperatives). There is no data available regarding the amount of credit channeled by KSU, or other form of cooperatives, in Indonesia since 2006. The latest available data is in the year 2005 in which KSU, nationwide, channeled credit of only Rp 1,154.82 billion Rupiahs. The amount of credit is tiny compared to banking credit channeled in the same period. For comparison, Rural Banks, which normally focus on channeling credit to the same market segment as cooperatives, managed to channel credit in total of 14,598.00 billion Rupiah in the same year. The previous performance of cooperative has not been effective in term of credit channeling, in which it managed to channeled only 720 billion of Rupiah in 2002 and 1,156.69 billion Rupiah in 2003. By comparison, rural bank outnumbered this amount by more than 10 times in 2002 and 2003, with total credit channeled of 8,985.00 (2002) and 12,149.00 (2003).

Figure 2.1.1.6



Source: Combined from Depkop.go.id and Bank Indonesia

1.3. Microfinance in Indonesia

Microfinance has been proven to be one of the most effective ways to achieve financial inclusion among the poor, informal sectors, as well as Small and Medium Enterprises. The success story of Grameen Bank which enables more than 100 million people worldwide to access sum of credit of more than US$ 25 billion had arouse interest on how microfinance can actually reaches those regarded as unreachable by commercial banks. The case also applies to Indonesia.

The development of microfinance in Indonesia has been started since New Order Regime through Cooperatives, Rural Banks, and several NGOs focusing on microfinance. However, there has not been any official rules and definition in Indonesia regarding the scope of work, responsibilities, rules of game, and other boundaries of these units. The absence of practical definition of microfinance institutions in Indonesia thus results in few literatures on the particular subject since there is no reliable data in analyzing microfinance institutions in Indonesia.

In 2013, Indonesia Financial Services Authority (OJK) ratified Law No. 1/2013 on Microfinance Institutions. The law defines Microfinance Institution (MFI) as financial institution that is especially established to provide services in business development and society empowerment by giving loans or financing for micro-scaled business of MFI members and society, providing deposit management, or giving consultancy services in business development that is conducted not merely for profit. In terms of mission, microfinance institution, as obliged by OJK must participate in financial inclusion in order to increase the well-being of society through financial services.

In terms of form, Microfinance Institutions are limited into two options which are Cooperatives-LKM or Limited Liability Company. However, in Limited Liability Company, there is an obligation of 60% of ownership by the local government and 20% maximum of share for individual. Microfinance Institutions as regulated by OJK must also state its 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.

Action taken by OJK thus has resulted in a more comprehensive framework of Microfinance in Indonesia. However, there are still many loopholes to overcome in the future. Firstly, there is no official regulation regarding the maximum or minimum amount of credit channeled by MFI in Indonesia. The absence of this regulation might enable MFI to channel credit in massive amount to one and/or several parties only, thus counterproductive with the goal of promoting access to finance among the poor, informal, and SMEs. Secondly, there is no official guide regarding the interest rate of credit among the MFIs thus allowing MFIs in Indonesia to charge higher interest rate to the poor, informal, as well as SMEs compared to conventional banks since the poor, informal, and SMEs has no other option of financing. Lastly, there is no formal guidance to MFIs in the law ratified by OJK regarding the target of MFIs in term of financial inclusion, credit channeling, and many other financial institution indicators. This might leave MFIs to be inefficient in pursuing the goal of MFI in the economy.

2.2. The Government Role

Financing of SMEs become one of the major concern of the central government to support development of SMEs in Indonesia. Through ministries and financial institutions, the central government channels various forms of financing for example grants, loans, and investment credit.

2.2.1. National Entrepreneurship Movement

Motivated by the low number of entrepreneurs in Indonesia, the Ministry of Cooperatives and SMEs initiated National Entrepreneurship Movement program since 2011. According to Ministry of Cooperatives and SMEs, in 2011 the percentage of entrepreneurship in Indonesia was 0.24%, still far from ideal conditions at 2% of total population. Meanwhile when compared to other ASEAN countries, the percentage rate of entrepreneurship in Indonesia are far behind, especially with Malaysia, Singapore, and Thailand. Through the National Entrepreneurship Movement, the government provides grants for prospective entrepreneurs and entrepreneurs who already have a business to business development. The program is open to the public with no age limit, which means it can be accessed by all part of society. Before obtaining the grants, National Entrepreneurship Movement participants are required to attend training and workshops to make a business proposal. Business proposals will be collected and selected as the basis for determining how many grants were given to each participant in accordance with their business needs. Although the success rate has not been measured because there is no monitoring and evaluation process, the program is attracting a lot of interest from entrepreneurs and aspiring entrepreneurs to participate.

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

Most of the Micro and Small Enterprises (MSEs) with the status of informal experienced problems when trying to apply a loan to bank. Requirements to get loan from bank is considered difficult for Micro and Small Enterprises. It had them to provide collateral and complete legality to get the loan. Complexity credit application process is what inhibits SMEs in accessing venture capital to the bank. On the other hand, as the intermediary institution that channels funding from creditor to the debitor, the bank must be careful to avoid the risk of default. To improve capital access for SMEs, the government seeks to remove these barriers by simplify the requirements given to businesses through the Kredit Usaha Rakyat (KUR). The main objective of this program is to improve financial access for micro and small enterprises to accelerate the development of the real sector. In implementation, the government appointed and given authority over certain banks to channel Kredit Usaha Rakyat (KUR). Currently there are three national banks are appointed by the government to channel KUR namely : Bank Rakyat Indonesia, Bank Mandiri, Bank Nasional Indonesia.

Micro and small entrepreneurs in Indonesia could apply for a loan in the form of working capital loan or investment loan with a credit limit of 5 million to 500 million. For entrepreneurs who wish to apply for micro KUR have to fulfill simple requirements such as operating business for at least 6 months and some form of administrative completeness like resident card, driving license, and family registration letter (Kartu Keluarga). For retail KUR with more than 100 million loan are required to submit Trading License (SIUP), Company Registration (TDP), and the Location Permit License (SITU). Based on the report of the Ministry of Cooperatives and SMEs, since mid-August to October 2015, the credit has been channeled to SMEs amount to 4.35 trillion rupiah to 267.686 SMEs with 12% of interest rate per year, lower than the earlier (22%) per year.

There are other types of credit that the central government provide for specific enterprise such as Food and Energy Security Loan (Kredit Ketahanan Pangan dan Energi) for SMEs in agricultural sector, Energy Development and Plantation Revitalization Loan (Kredit Pengembangan Energi dan Nabati Revitalisasi Perkebunan) for SMEs in plantation sector, and Cattle Breeding Business Loan (Kredit Ketahanan Pangan dan Energi) for SMEs in livestock sectors. The three types of loans are getting interest subsidies from government. Food and Energy Security Loan (KKPE) is the investment credit or working capital loans granted to farmers, ranchers, fishermen, and groups (peasants, farmers, fishermen and fish farmers) in order to support the intensification of rice, corn, soybeans, cassava and sweet, peanut and or sorghum, sugarcane cultivation, cattle breeders, domestic poultry, fishery to support food security. Maximum credit limit is Rp. 100 million with a term corresponding business cycle with a maximum maturity of 5 years. Energy Development and Plantation Revitalization Loan (KPEN-RP) is a credit marked for Micro and Small Enterprise engaged in plantation sectors. This credit aims is to accelerate the development of the community's plantation through the expansion, renovation, and rehabilitation of plantation crops. Cattle Breeding Loan (KUPS) is the investment credit Micro and Small Enterprises in livestock sectors in order to seed the production of beef cattle or dairy cattle.

Central government through the Ministry of Cooperatives and SMEs also initiated LPDB (Lembaga Pengelola Dana Bergulir) or Revolving Fund Management Institution for Cooperatives and SMEs in charge of managing the revolving fund for MSME financing. LPDB KUMKM has channeled a total funding of 5.70 trillion rupiah to 3,975 partners across Indonesia since 2008 until 2015.

2.3. Roles of Private Sector

The private sector also plays a role in supporting the financing of SMEs. Some private sectors support the development of micro, small, and medium enterprises through its CSR program. There are some private sector programs that have been implemented for several years to support the development of SMEs in Indonesia, some of which Wirausaha Mandiri program and Citi Microentrepreneurship Awards.

2.3.1. Wirausaha Mandiri

One contribution of Bank Mandiri in supporting entrepreneurship in Indonesia is organized Wirausaha Mandiri program. Background of program implementation is motivated by the large amount rate of unemployment in Indonesia, especially young generation. This program has been ongoing since 2007 by giving awards and grants to entrepreneurs who are selected as a winner in the competition. The main purpose of the activities is to invite young people to become independent generation so they are not only become job seekers but become job creators. Wirausaha Mandiri program received tremendous enthusiasm from public, especially young generation. As evidence, the number of applicants who participate in this activity is increasing from year to year. It can be seen that the enthusiasm of young people to become entrepreneurs continue to grow. In addition, Wirausaha Mandiri Program not only gives awards and grants but also organizes coaching for the winner through workshops and business coaching, as well as providing access to the market through exhibition program.

2.3.2. Citi Microentrepreneurship Awards

Citi Microentrepreneurship Awards (CMA) held by Citi Bank as a form of appreciation to micro entrepreneurs who actively participate to drive regional economy. CMA has been implemented in more than 30 countries and has been awarded to 5,900 entrepreneurs. In Indonesia, this program is an annual program conducted by the Citi Foundation through Citi Peka that works together with UKM Center FEB UI. In order to participate in program, the participant required to meet selection criteria, such as having a maximum turnover 200 million per year, operating at the grassroots level, having potential to grow, and providing benefits to the community and the surrounding environment. Through CMA, the selected winner are expected to develop their business and inspire other micro entrepreneurs, especially those in remote and underdeveloped regions in Indonesia. Until now, there were more than 4,500 micro businesses Indonesia who have participated and have at least 92 micro- entrepreneurs choose the best from all over Indonesia. Winners of this program obtain grants as additional capital for business management.

2.4. Credit Guarantee Scheme

Credit Guarantee Schemes (CGS) are designed as multilateral agreements where lenders, guarantors and borrowers interact witheach other. guarantors may be private or public in nature with borrowerstypically seen as being underserved clients by the formal credit markets. Credit Guarantee Scheme basically serves as substitute of collateral, which in the case of SMEs has always been the most common obstacles to access external source of fund, especially from banks. Boschi, et al. (2014) analyzes the case of partial credit guarantee among SMEs in Italy. As in the case of Indonesia, SMEs in Italy are dominating the economy of the nation. The growth of SMEs strengthens national economy as a whole. The study shows that banks carefully consider the quality of the collateral in credit lending to SMEs, therefore, CGS, which replaces the function of collateral, is highly effective in fostering credit channeling by banks to SMEs. In the study, a threshold of the percentage of credit guaranteed by the government is taken into account, which reveals that credit given above threshold will effectively increase business capacity of the SMEs, while credit below the threshold is not effective in increasing the business capacity of SMEs. The study concludes that the critical threshold is 25%, meaning that credit guarantee below 25% is not effective to induce banks in channeling credit (to SMEs).

In the case of Indonesia, the government guarantees Credit of People Enterprises (*Kredit Usaha Rakyat*, KUR) based on the Regulation of Minister of Finance (PP) No. 10/PMK.05/2009. The percentage of the guarantee accounted to 70% of the total Credit/Funds channeled to SMEs by the banks, with the 30% residual guaranteed by the corresponding bank. The percentage of credit/funds guaranteed by the government in Indonesia thus is much higher compared to the ideal threshold as suggested in the case of Italy by Boschi, et. al. (2014). Another policy implemented by the government of the Republic of Indonesia aside from CGS is the subsidy of interest rate based on the Regulation of Ministry of Finance No. 146/PMK.05/2015. The regulation states that subsidy of interest rate of which the government responsible to are as follows: a. 7% p.a. for Micro Credit; 3% p.a. for Retail

Credit; and c. 12% p.a. for Indonesia Labor Credit. Both policies are categorized as CGS since there is a diversion of risk from banks to government.

Recently, there has not been any study that measure whether the enormous guarantee by the government significantly increase the amount of credit channeled to SMEs by bank or whether banks still prefer to lend credit to big enterprises, considering several indicators such as economies of scale of business as well as the high risk characteristic of credit lending to SMEs. However, it is hypothesized that the 70% guarantee scheme has not been optimal, since, either the percentage is too high, or ineffective (since the guarantee should be increased to 100%, in other words, non-partial). Further study must be conducted to measure the optimum percentage of credit guarantee. It should also be noted that, government credit guarantee and subsidy of interest rate, both are actions implemented by the government to influence how banks operate directly from the paradigm of the banks. Banks are given a risk-free fund channeling portfolio privilege, in the form of credit guarantee by the government. Moreover, banks still enjoy high interest rate margin, since the credit channeled by banks to SMEs are subsidized by the government. In the government side, the scheme might put pressure in the government expenditure. Therefore, in guaranteeing credit and subsidizing interest rate, it is wise for the government to carefully examine the capability of both the government itself as well as the guaranteeing company.

2.5. Credit Rating System

The increasing involvement of the formal financial sector in financing the needs of fund of SMEs makes the role of credit rating agencies increasingly important. The Government of Indonesia, through the Financial Services Authority (OJK), conducts financial education to the people of Indonesia, where SMEs become one of the main targets. Educational programs and the development of financial infrastructure intensively conducted with several purposes, among others, so that SMEs have a greater attachment to the formal financial sector and that economic transactions made in cash in the economy decrease over time.

Ratings on small and medium enterprises (SMEs) reflect the rated entities' overall creditworthiness, adjudged in relation to other SMEs. The company will be analyzed internally and awarded rating according to the particular company's credit worthiness, its management team, and effective relationship with customers and suppliers. The SME sector has its own unique features: unlike the large corporate, the SME sector has no organized information on industries, their functional details, market shares, competition dynamics, and promoter or management track record. The creditworthiness of entities in the sector, therefore, needs to be assessed using tools and methods that are different from those traditionally used for large corporate.

The special characters of SMEs which makes it differs from normal enterprises results in the different design of credit rating for SMEs among countries. One of the example is found in Subramanian & Nehru (2012), who explains Credit Rating in India. SME Ratings agencies in India have evolved a very unique and new tool in rating the sector. This rating reflects the rated entities' overall credit worthiness, adjudged in relation to other SMEs. These ratings are entity-specific, and not specific to debt issuances. The company will be rated according to the strength and weakness of that company only and will be compared to the sector as whole, which will give increased leverage for the company to work on better platform.

For SME A good rating can help SME gain faster and better credit term for the business as it provides information to the lenders about lower risk of default. Banks could offer preferential rate based on rating. A good rating could also be used to approach other financial institution to get better rate bargain than the one provided. Better business opportunities: A risk evaluation by an independent and unbiased rating agency lends credibility to SME and opens up an opportunity for them when dealing with its business partners (e.g. MNCs and large corporate). For instance, a good credit rating SME can participate for tender procurement and makes it more credible to gain bigger orders. It also provides easier access to other sources of finance to obtain additional funding. It even helps the SME retain customers and suppliers and negotiate better terms with them.

Credit rating is also a tool for self-improvement for SMEs. It highlights the strengths and weaknesses of the company and acts as a trigger for selfcorrection. It is like a report card for SME. SME are usually constrained by the strictness of rating discipline and fear of low rating, but the latter may not necessarily be the result of weak financials and can be attributed to various reasons. The issues can be easily pointed out in the rating report. The SME that want to run a sustainable business take the feedback positively and try to improve the business. It is an opportunity to adopt and implement best business practices. Moreover, a regular renewal of ratings not only helps improve performance and build a firm's track record but also builds confidence within the trading partner.

For Lenders, a credit rating takes a significant portion of the perceived uncertainty out of their lending decisions, and reduces time and transaction costs in the system. The ratings from an independent agency, based on high standards, can provide greater confidence, objective and reliable opinion to lenders, and consequently broaden the range of financial resources available to SME. As rating reports provide most of the information banks need for approving loans, it can also serve as an additional input in the credit decision making process. Additionally, as the number of rated players in the SME sector increases, there will be greater transparency in financial service, as more and more information is made available. Overall, the ratings can help provide an important momentum in raising standards through better financial discipline, disclosure and governance practices. Lastly, this in turn, will help lenders reducing their NPL.

For Regulator (Government), The presence of SME credit rating system is not only improving access to finance for SME but to a larger extent also improving the financial inclusion in the country. As more and more SME are included in the financial system, the SME development is becoming more advanced. This will not only have contribution to generate more employment but also more income to the people, which in turn may reduce income gap and poverty. Furthermore, as growingly banks adopt and use this rating mechanism as part of their lending practices, a healthier competition will be created in the banking industry, especially related to SME banking. In the end, this will also bring along prudential and stable financial industry in the country. Yoshino (2015) studied credit rating of SMEs using Asian data. The component of the rating is simpler, it just consist of (i) Sales, (ii) Assets, (iii) Liquidity (Cash), (iv) Total Debt. In Asia countries Credit Rating is only applicable to large companies. He built Credit Rating for SMEs based on SME Data, using three ranking of SMEs for Asian country and five ranking of SMEs for Japan. The credit rating is useful to produce risk ratio and risk based interest rate.

Bank Indonesia central bank of Republic Indonesia in 2014 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. The study proposes to apply 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). In principle the highest scale (e.g. 1, AA or SME1A) represents SME with the lowest probability of default or highest quality of credit and the lowest scale (e.g. 8, D or SME4B) correspond to SME with the highest probability of default or lowest credit quality. Owing to the variations among ASEAN countries, the study proposes a cluster approach in adopting and applying the methodology depending on the development of financial system and hence, SME credit rating infrastructure in the country. There are three clusters proposed: 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. The proposed methodology and weight for different indicators in each cluster. The proposed weights for ASEAN SME Credit Rating Indicators Weights are as follows: I. Non- Financial Aspects 60% consist of a. Business Aspect: Industry or business sector 9%, Business condition/sales condition 10%, Government policy 2%; b. Management Aspect: 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% consist of 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%.

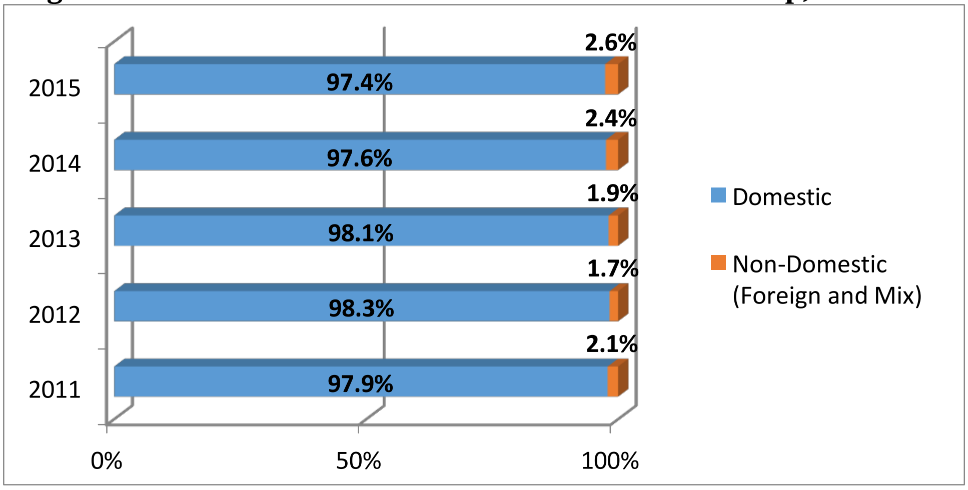
Development of infrastructure is an absolute need in preparing the Credit Rating, in which the existence of Credit Rating Agency becomes crucial. Credit Rating Agency is formed by the government/regulator of financial services, in this particular case are the OJK and BI, which serve to assess SMEs, whether those who access the formal financial sector already or those who has not. Survey and intensive study regarding the access to finance of SMEs needs to be done and improved continuously, in which the involvement of academics might play significant role in achieving this goal.

SMEs Rating agencies assess a firm's financial viability by way of taking all the necessary documents about the company, its management team and the business model etc, analyze the same in terms of their capability to repay the debt in case of going for borrowing from the banking sector and capability to honour business obligations, provides an insight into its sales, operational and financial composition, there by assessing the risk element, and highlights the overall health of the enterprise. They also benchmark its performance within the industry. The company will be rated according to their industry and how they are positioned in the peer group, how comfortable their business model to make the company to repay the borrowing etc. According to Subramanian & Nehru (2012) in India there are more than 5-6 rating agencies who are now actively involving in to the rating of SMEs. CARE, ICRA, SMERA, CRISIL are some of the agencies who are in to the rating of SMEs.

2.6. Foreign Participation

Foreign participating in the financial market for SMEs is shown by, firstly, the amount of credit channeled to SMEs by foreign banks as well as joint-venture banks. Domestic Banks (Persero, National Private Foreign Exchange, National Private Non-Foreign Exhange, Regional, and Rural Banks) dominate credit channeling to SMEs in Indonesia in the period of 2011-2015. As the graph indicates, Domestic Banks contribute by more than 97% of national bank credit to SMEs since 2011, gigantic compared to Non-Domestic Banks that normally contribute by less than 3% per year. However, non-domestic bank are more aggressive in reaching SMEs since 2012. Analysis on data reveals the fact that the growth of credit to SMEs by non-domestic banks has always been higher than its domestic counterpart. In the period of 2013-2015, the average growth rate of credit to SMEs by non-domestic banks is 27.45% with its highest on 2014 (37.23%) while the growth rate of credit to SMEs by domestic banks is only 10.52% with its highest on 2013 (15.60%). Although it can be stated that the fact is due to the low initial credit channeled to SMEs by non-domestic banks, thus increasing its marginal growth rate higher than domestic banks, the fact that non-domestic banks improve its services to SMEs at a faster rate than domestic banks must be taken seriously by domestic banks, as well as the government.

Figure 2.2.1.3. Credit to SMEs based on Bank Ownership, 2011-2015



Source: Bank Indonesia, 2015

The other channel in which foreign parties participate in financing for SMEs is through the development of non-banks credit instruments, in particular, instruments which accommodates foreign investment to SMEs. As known, capital in the economy of Indonesia flows freely, which enable any party to invest to SMEs in Indonesia. Moreover, the participation of Indonesia in the ASEAN Economic Community brings consequences in the form of the agreement to liberalize financial sector among ASEAN economies, thus increase the probability of foreign capital inflow to SMEs in Indonesia. In the ASEAN level, preparations are currently being conducted to facilitate the flow of capital among ASEAN countries. The Initiative of SME Regional Fund is one example of measure taken to facilitate free flow of capital among SMEs in ASEAN countries.

The goal of the fund shall be to increase SME competitiveness, prepare SMEs for the ASEAN Economic Community, and promote regional economic collaboration and equitable economic development among the member countries through expanded trade and investment. The basic concept of the fund is a regional organization with country branches that work closely with local financial intermediaries and SME agencies capable of providing financial support, knowledge sharing, and skill development suitable to the specific needs of each country. One key mechanism will be the required re-payment of financial assistance to enable the Fund to sustain its support for SMEs over the long term. It is proposed that the initial duration for the Fund be set at five years but with a provision for extension if evaluated as successful. There should be a formal evaluation every two years and at the end of the first five years.

Besides bank financing foreign could also participate in non-bank financial institutions, venture capital, capital markets, and MFI. Shinozaki (2012) suggest the following areas should be addressed to support an environment for SME growth and development: (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. Currently, many foreign nongovernmental organizations (NGOs) that provides small credit to adopt the pattern that has been succeed in their countries. There are many success stories of microfinance reaching the poor all over the world that demonstrate its effectiveness, including Grameen Bank in Bangladesh, Banco Solidario in Bolivia, and CVECA (Savings and Loan Village Bank) in Mali. Foreigner that has been success building MFI in other countries could come to Indonesia for replicating. MFIs should be sustainable entities that constantly provide financial services for the poor. To this end, it is crucial to foster grassroots MFIs with a proper regulatory framework so that they can reach out to the poor. In general, fragile management systems and insufficient numbers of skilled workers are serious factors impeding the development of a sustainable MFI industry.

The securities market for SMEs has not developed yet at all in Indonesia while some countries have pursued a trial and error approach for creating a well-functioning equity financing venue for growth-oriented SMEs, which can beroughly classified into four types: (i) organized market specially designed for SMEs (e.g., SME Board and ChiNext [venture board] under the Shenzhen Stock Exchange);
(ii) over-the-counter (OTC) market modeled on the NASDAQ (e.g., KOSDAQ); (iii) alternative investment market (AIM) modeled on the United Kingdom’s AIM (e.g., CATALIST under the Singapore Exchange and Tokyo AIM under the Tokyo Stock Exchange); and (iv) issuing and trading venue for unlisted stocks modeled on the US-Pink Sheets (non-exchange market) (e.g., Green Sheet in Japan). In most middle income Asian countries, the SME equity market has yet to be developed, but there are signs that SMEs are seeking a funding alternative to banks. These could be examples for Indonesia to build capital market for SMEs.

Shinozaki (2012) conducted a survey in Indonesia indicated that SMEs were willing to tap an equity market designed specifically for SMEs, with more than 78% of all surveyed firms expressing interest. This finding showed high possibility of building capital market for SMEs in Indonesia. Indonesian SMEs had the intention to grow further through access to safe money, especially long- term funds of more than 5 years, by means of formal finance or diversified funding instruments. Although they still tended to have negative preconceptions of equity finance due to its stringent requirements, demand for such finance seems to be increasing.

Also, the surging trend of personal computer penetration for average households and SMEs will enable policymakers and market organizers to develop cost-effective market infrastructure for SMEs. The creation of a special equity market for SMEs is worth examination among middle income countries. However, in these cases, the market design should be scrutinized in terms of the real needs of SMEs, with a mechanism to support their capacity to tap equity markets (supporting infrastructure) and to attract investors, considering which type of market infrastructure would be the best fit for SMEs in the country context. Shinozaki (2012) suggest that the creation of a Green Sheet-type market may be effective as an―exercise market for smaller but growing SMEs, especially among lower middle income Asian countries. This will provide a chance for them to learn more market rules and obligations, such as disclosure, before tapping the organized market. However, such an exercise market should have functions of both demand creation and liquidity enhancement, with accompanying policy support measures.

The venture capital industry is an issue related to creating and vitalizing a special equity market for SMEs. Again the venture capital is foreign financing model that has been success in many countries. The venture capital company is expected to be an initial risk capital provider for SMEs through active capital participation, but the lack of appropriate securities markets for SMEs and their lack of familiarity with direct finance under the dominance of indirect finance impede the development of a venture capital industry. Policymakers and market organizers are hesitant to launch an SME capital market due to the preconception that it would be a risky market with cost inefficiencies as well as a lack of demand for equity finance from SMEs. Meanwhile, SMEs have little familiarity with equity finance due to a lack of information on capital markets (e.g., benefits and obligations) under the bank-centered financial system. However, information technology will make the development of a cost-efficient SME market possible. Also, the government's socialization program on financial and capital markets can widen funding options for high-end SMEs.

2. OPTIMAL FINANCING FOR SMEs

Optimal Financing Scheme for Indonesian SMEs lies in characteristics as follows:

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 to optimize financing for SMEs are as follows:

1. The pursue of formalization of financial institutions by all involving parties, thus allowing SMEs to access financing from formal financial institutions
2. Develop Credit Rating Agencies that responsible in formulating methodology and criteria. Analyzing characteristics, as well as conducting intensive survey regarding financial sector to which SMEs adhere to. For the first time, Credit Rating Agency is best to be part of the regulator of financial sector, in Indonesia which is OJK (*Otoritas Jasa Keuangan*)
3. Evaluate the credit guarantee scheme, in the particular case is the optimum amount of guarantee. Full Guarantee Scheme in which 100% guarantee exists might not be the optimum practice due to the moral hazard and/or adverse selection it promotes. Moral hazard problem might flourishes since creditor knows the 100% guarantee by the government in its credit, not only so, banks might also be less gentle in insisting payment of credit compared to non- guaranteed creditor
4. Regulate the flow of foreign fund and/or the establishment of foreign institutions that participate in channeling credit to SMEs in Indonesia. Currently, comprehensive rules regarding foreign financing for SMEs applies only in the banking sector. The regulation should be expanded as the supply of foreign fund to SMEs credit in Indonesia is increasing over time
5. Develop mentoring system which involves academics. Intensive mentoring is accompanied by an agent per SMEs to the extent that the particular SMEs is granted credit by formal financial institutions. In the process of mentoring, financial education and other financial inclusions programs, conducted either by government or private sectors, are promoted, therefore emphasize the importance of involvement of academics in the process
6. Apply reward (incentive) and punishment (disincentive) to SMEs in accessing formal financial institutions and non-formal financial institutions nationwide.

CONCLUSION

Financial Education as well as Financial Inclusion is the main conditions in optimizing financing for SMEs. Therefore, the importance of academics is inevitable in developing such financial system which enables SME in accessing credit. The participation of academic are as follow: (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.

Information regarding source of fund accessible to SMEs is best to be integrated within a single institution and socialized through one-door scheme, which will facilitate SMEs in accessing as well as selecting the best loan with lowest interest rate. Interest rate serves as the most important instrument in achieving the fluency in the credit market for SMEs. For these reasons, it is most urgent to develop Credit Rating Agencies institutions and Official Credit Rating System. Credit rating agency serves as the forum in which banks and non-bank financial institutions may access SMEs data, therefore promoting healthy competition among them in developing the best financial product for SMEs.

Credit guarantee scheme as implemented by the government of Indonesia is not operating at the optimum level as to date, due to the high risk embedded in asymmetric information in the scheme, which is seen from its non-proven impact in increasing the access to finance among SMEs. Credit guarantee schemes as well as financial start-up grants implemented by the government are best to be implemented alongside with financial education and financial inclusion program. Official certificate to recipient of credit as well as creditor in the stated two programs above might be considered by official regulator of financial system. Lastly, formulation of regulation regarding foreign participation in credit lending to SMEs should be initiated in the near future. Networking between educator and professional who specialize in the topic of SME must be facilitated by partnership with the regulator of financial system.

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