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FINAL REPORT

EVALUATION OF BPR ACCESS TO FINANCE FROM COMMERCIAL BANKS IN INDONESIA

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I. General Approach and Background

1.1. Background and Rationale of The Study

In these last two years, one of the strategies promoted by the Government and Bank Indonesia in order to improve access of micro, small, and medium enterprise (MSME)`to commercial banks are through cooperation between commercial banks and rural banks (BPR) in a so-called "linkage program". This cooperation is in forms, namely: (i) the commercial banks are lending to the BPR and the BPR will redistribute the loan to the debtors, and (ii) joint financing between the commercial banks and the BPRs for lending to MSME. The background of linkage program that BPR face liquidity problems in credit lending to their clients which is indication with height of Loan to Deposit Ratio (LDR), i.e. one of the BPR in Jogyakarta in September 2003 have LDR until 101,9% [1], and on the other side the commercial banks face the problem of intermediary function, which is indication with LDR ratio around 40 – 50%. The other objective that with existence of defrayal of commercial banks, expected for credit lending of BPR become cheaper and in turn can degrade imposed interest rate to micro, small, and medium enterprise.

In its implementation stage, the linkage program between commercial banks and BPRs is going in a snail pace[2]. Up until March 2004 the commercial banks involved in the business are only 29 banks and BPR & saving and loan cooperatives (KSP) which involved are 945 unit. In the year of 2003, the total disbursed fund reached to Rp. 696.8 billions. One of the survey result conducted by BI Regional Office in Surabaya[3], towards the linkage program reveals that only 16 BPR have engaged themselves in cooperating with commercial banks from the 103 BPR respondents. It was also from the same survey which shows that those BPR which do not engage in cooperation with the commercial banks do not mean that they don't have access, but only about 81.6% claimed that they never have problem with liquidity.

Based on the aforementioned illustration, although progressing slowly, evidently there are a number of commercial banks which have beforehand engage on an agreement with the BPR to distribute credits to the micro, small and medium enterprise. The big question that lies here is what are factors which commercial banks put into account in credit lending to the BPR? It is to this question that this study is put into place.

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[1] See in Business Indonesia, January 5, 2004. Nevertheless, on average LDR of BPR per March 2004 around 76,94%. Source Central Bank in Business Indonesia, July, 10 2004

[2] See in Bisnis Indonesia, July 14, 2004

[3] See in Bisnis Indonesia, July 28, 2004

1.2. Objective of the Study

The main objective of this study is to identify the factors which commercial banks put into account in credit lending to the BPR. Other than from the mentioned objectives, this study shall provide least information that the commercial banks may require in implementing its rating mechanism in order to increase credit lending to the BPR.

1.3. Expected Output

1. What factors which determine the credit lending from the commercial banks to the BPR
2. The nature of information needed by the commercial banks in implementing its rating mechanism for BPR assessment.
3. Factors that BPR put into account to request loan from the commercial banks
4. Bank Indonesia regulations that potentially impede the improvement of access of BPR to commercial banking.

II. Methodology

2.1. Method of Data Analysis

A. Logical Framework

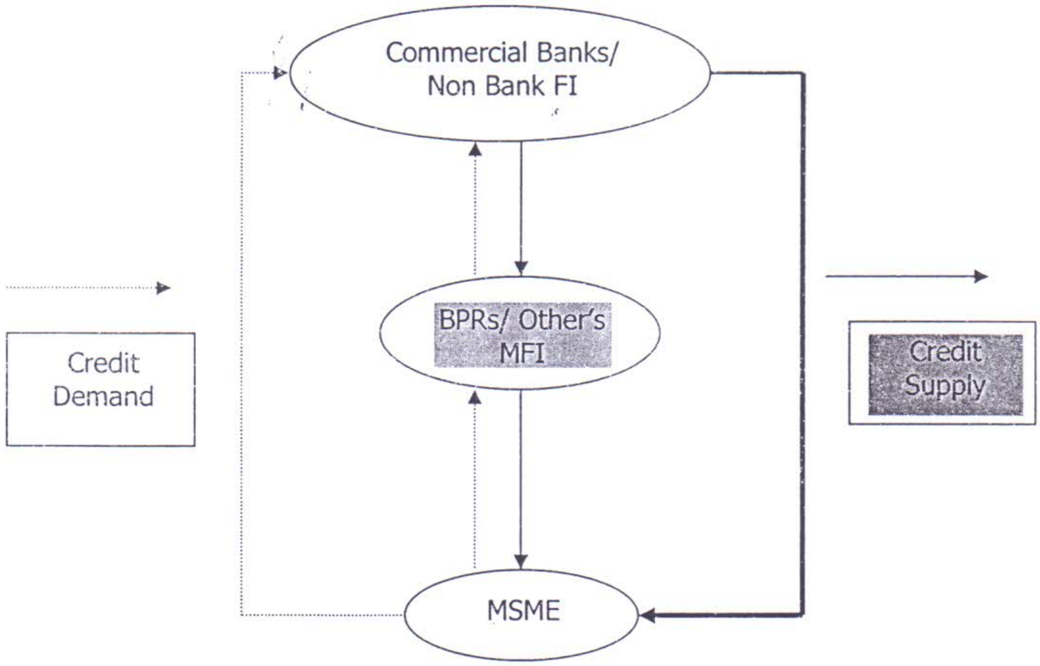


Figure 1. The Logical Framework

B. Analysis of Factors That Determine Decisions of Commercial Banks on The Channeling of Credits to Rural Banks

In order to have adequate knowledge about the factors taken into account by commercial banks in the channeling of credits to BPR, three phases of analysis will be undertaken:

Firstly, analysis of the valuation of the level of BPR's health that uses the method of CAMEL (Capital Adequacy, Asset Quality, Management Capability, Earnings and Liquidity) at Bank Indonesia. Bank Indonesia requires commercial banks to lend their credits only to BPR that have maintained their healthiness over the past consecutive years. For this, Bank Indonesia provides commercial banks with information on the level of BPR's healthiness using the CAMEL method, which is based on monthly reports submitted by BPR to Bank Indonesia. Despite the availability of information on the health of BPR, questions arise as to whether the CAMEL method, which was basically designed to support Bank Indonesia's supervision activities, can be used by commercial banks as a reference for assessing the level of risks of credit lending to BPR. How about the capability of CAMEL Method to provide comprehensive information for commercial banks to assess past performances of BPR, formulate BPR's plans for its future, and decide its targets? If several BPR banks actively came to commercial banks to apply for credits, can CAMEL Method help commercial banks rate the healthiness of BPR, which can be given priority to be further assessed? How far commercial banks can get updated information from CAMEL Method?

Secondly, analyses of policies design by the Head Offices of commercial banks. Empirical experiences show that commercial banks' decision on potential debtors (including BPR) always use policies decided by the central office of commercial banks. As explained in the early pat of this paper, decision on credit provision by commercial banks at least takes into account 6 factors namely (i) risk level (ii) collateral (iii) competitive rate (iv) ROE target (V) future potential, and (vi) cross subsidization. In relation to the assessment of BPR, the question arises is what policies issued by the head office, regardless of whether they are internal policies or Bank Indonesia's regulations being used as a reference. Among the factors considered by commercial banks in channeling credits to BPR, what considerations taken into account by the head office to make those factors its priority? How about the priority given to the using of CAMEL Method for designing policies on credit provision to BPR as decided by the head office of BPR? Are the mechanisms of monitoring policies decided by the head office?

Thirdly, analyses of decision making by the braches office of commercial bank. Differences in economic development between regions, geographical condition and so on have caused the process of decision making by the branches office of Commercial Bank in credit lending to debtors (including BPR) had to be adjusted compared with policies design from the head office of Commercial Bank. In assessing BPR, the question arises is what factors and information are needed for making assessment. How the priority given by the branch office to those factors? From where did the information come from? How about the using of CAMEL Method?

C. Analysis of Factors Determining BPR's Demand for Commercial Bank Credits

In order to know factors decisive to BPR's credit demand to Commercial Bank, four phases of analysis need to be conducted.

Firstly, analysis of BPR's internal condition, in relation to financial and management performance. Four factors will be analyzed namely those related to BPR's financial sources, its capital, its liquidity and outreach (types of activities financed, types of financing, amount of financing and the time period of financing). Among those factors, which ones are given priority consideration by BPR to borrow from Commercial Bank? How about the interaction between those factors in influencing BPR's decision to apply for Commercial bank credits? How about the factor of BPR's financial management? Is financial management another factor considered by BPR in applying for Commercial Bank loans?

Secondly, analyses of competition between commercial banks those develop micro financing as their new product in cooperation with BPR to deliver credits to micro and small enterprises? In increasing commercial banks' credit expansion to micro and small entrepreneurs, at least 2 strategies are adopted by commercial banks. The first strategy is the opening of unit office that can be accessed by micro and small entrepreneurs with credit procedures and requirements not different from those practiced by BPR. The second strategy is using BPR as an intermediation institution, in the form of direct loan to BPR or joint financing between commercial banks and BPR. The question is that, from the aspect of transaction costs, what strategy will be adopted by Commercial Bank. From the micro and small enterprise point of view, how about the comparison regarding the cost of borrowing between the unit office established by Commercial Bank and BPR? With Commercial Bank's openness to implement the two strategies in order to reach micro and small enterprises, how about its implication on BPR applying for Commercial Bank loans?

Thirdly, analysis of the issue of access or interest rate as an option of policies in increasing BPR's applications for Commercial Bank credits. Different studies show that, for micro and small entrepreneurs, the issue of access (number, type and time) to financing sources is more important than the issue of interest rate. On the other hand, in using BPR, which is Commercial Bank's strategic choice of credit lending to micro and small entrepreneurs, borrowers will compare interest rates of loans channeled to them through BPR directly channeled to the interest rates of credits directly going to them. Taking this mater into consideration, does BPR takes into account the issue of easy access and interest rate in applying for loans to Commercial Bank? This is against the fact that, on the other hand, collateral, as shown by the results of several studies, has always become the main issue accessing Commercial Bank credits.

Fourthly, analysis of Bank Indonesia regulations those are not conducive to BPR in improving its access to Commercial Bank Credit. The costs of channeling Commercial Bank credits to BPR are influenced by several factors including Bank Indonesia regulations. There are two regulations of Bank Indonesia that can be less conducive to efforts of encouraging BPR to apply for Commercial Bank loans.

The regulations are directed to commercial banks lending and BPR operations. The question is which regulations are not conducive to the channeling of commercial bank loans to BPR, in relation to the channeling of commercial bank credits and the operation of BPR?

2.2. Method of Data Collection

A. In-depth Interview

In-depth interview will be undertaken in relation to the scope of the study with an aim to analyze factors considered by Commercial Bank in lending credits to BPR. For this, in-depth interviews will be held with officials of the Directorate of BPR Supervision and Bank Indonesia, regarding the using of CAMEL Method. As for commercial banks, in-depth interviews will be conducted at two levels namely interviews with the staff of Commercial Bank's head office related to the drafting of policies on the channeling of credits to BPR, and interviews workers of Commercial Bank's branch offices who are in charge of evaluating credits and making policies on the channeling of loans. In-depth interviews with Bank Indonesia and Commercial Bank officials will use leading questions as guidelines.

B. Quantitative and Qualitative Survey

Quantitative and Qualitative Survey will be conducted in elated to the scope of the study with an aim to carry out analysis of factors considered by BPR in applying for Commercial Bank loans. Using questionnaires, some quantitative data will be collected from BPR management. In addition, interviews with BPR management, and representatives of the BPR association will be conduct, at the national level and in Surabaya and Denpasar with an aim to get information on (i) competition between commercial banks that develop micro finance as a new product and BPR in the channeling of credits to micro and small enterprises (ii) the issue of access or interest rate as a policy option in increasing BPR's application for Commercial Bank loans, and (iii) Bank Indonesia regulations not conducive to BPR's endeavor of improving its access to Commercial Bank credits.

C. Study Locations and Sampling Design

This study applied in three locations, which is Jakarta, East Java, and Bali Province. The location chosen should be due to where the Commercial Bank and BPR (BPR) analyzed. These four units of analysis are (1) BPR, (2) Commercial Bank, (3) Bank Indonesia, and (4) Debtor of BPR. Table 1 below will shows the sampling design organized.

Table 1. Study Location's and Sample

Locations and Sample	Jabodetabek (Jakarta, Bogor, Depok, Tangerang, Bekasi)	East Java Province (Surabaya, Sidoarjo, Pasuruan, Malang)	Bali Province (Denpasar, Badung, Tabanan, Singaraja)
BPR		15 unit	15 unit
Commercial Bank	5 unit	3 unit	2 unit
Central Bank (Head and Regional Office)	1 unit	1 unit	1 unit
Debtor of BPR	5 persons	5 persons	5 persons

D. Criteria

The criteria's were use for sampling selection, namely:

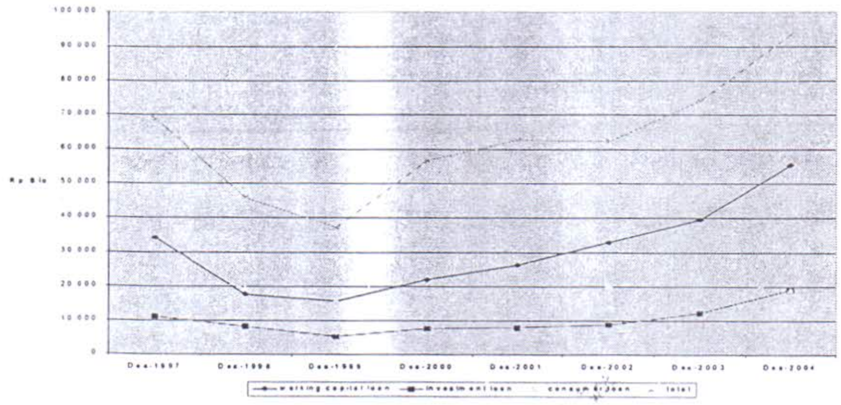
- Commercial banks were chosen based on their realization of loans channeled to BPR; one local bank each was chosen in East Java and Bali
- BPR were divided into three categories based on value of assets:
  - Category 1: Rp 5 billion or less
  - Category 2: over Rp 5 billion up to Rp 10 billion
  - Category 3: over Rp 10 billion
- Each category consists of:
  - Ones that have obtained credit from commercial banks/ non-bank financial institutions and ones that have not
  - Level of soundness: some sound, some reasonably sound
  - Located in both suburban and rural areas
  - Debtors to BPR and to commercial banks

III. Commercial Bank's Financing for Micro and Small Business

3.1. Overview on Commercial Bank's Financing for Micro and Small Business

The information on growth of loans from commercial banks for micro and small businesses can identify from small business loans figure. According to Bank Indonesia regulation, small business loan is credit from commercial banks with plafond up to Rp500million. Compared with the condition prior economic crisis, outstanding loans from commercial banks for micro and small businesses by December 2003 exceeded the ones of December 1997. In December 2004, the figure increased to Rp93.6trillion, or 27% increase of the figure in December 2003. The proportion of these loan s has not changed much, however the growth of outstanding loans for micro and small businesses by the end of 2004 indicated that the loan for micro and small businesses in the future would be a significant point to consider in the business plan of commercial banks. Another thing to take into account is that 80% of loans for micro and small businesses were allocated for working capital and investment. The detail on the progress of the outstanding small bus iness loan within 1997 – 2004 is elaborated in the Figure 2.

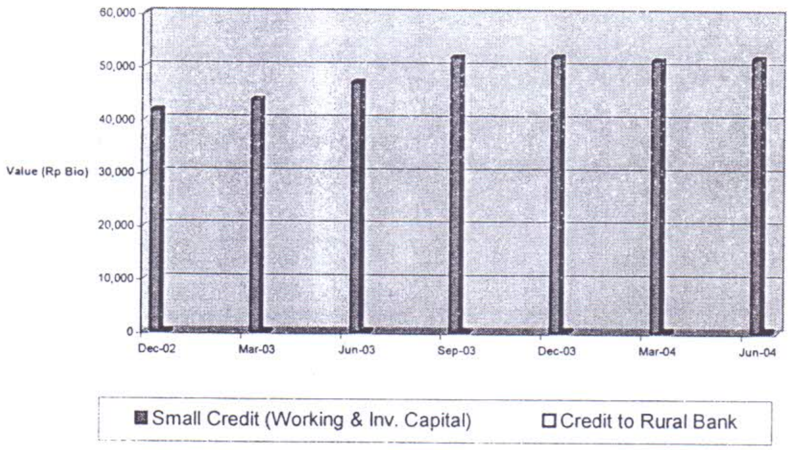
Figure 2. The Outstanding of Small Business Loan within 1997-2004



Source: Processed from Bank Indonesia Data

The interviews with 5 commercial banks in Jakarta and 2 commercial banks in Surabaya and Denpasar shows that commercial banks have two strategies in channeling the loans to micro and small businesses, namely: (i) delivering the loan directly to micro and small businesses as the end users, and (ii) initiating a linkage to BPRs, which would deliver the loan to micro and small businesses. Within the period when the linkage program was implemented (December 2002 – June 2004), the outstanding loan from commercial banks for micro and small businesses delivered through BPR only 1% compared to the working and investment capital outstanding loan from commercial banks delivered directly to micro and small businesses as the end users. This fact illustrates that commercial banks generally deliver the loan directly to end users, and this is their main strategy. The comparison between outstanding of working and investment loan and outstanding of commercial bank's financing to BPRs within December 2002 – June 2004 is illustrated in the Figure 3.

Figure 3. The Outstanding of Working and Investment Loan and Outstanding of Commercial Bank's Financing to BPRs within December 2002-June 2004



Source: Processed from Bank Indonesia Data

Financing from Commercial Banks through BPRs Minor Compared with Directly Lending of Commercial Banks to *End Users*

Five commercial banks having the biggest share in funding through BPR (hundreds of BPR with outstanding loan worth hundreds of billions rupiah) deliver loan through BPR at 10% of their outstanding loan delivered directly to micro and small businesses.

One of Surabaya based commercial banks that has a relatively big proportion of loan for micro and small businesses has in fact never initiated a linkage with. This commercial bank considers delivering the loan directly to end users more comfortable than having any other financial institution acting as the liaison.

One of Denpasar based commercial banks has a limited number of 3 BPRs to deliver its loan to micro and small businesses. Its understanding on micro and small businesses as its main target to fund and its experience in delivering the loan directly have made them come to a decision not to have BPR as its strategy in reaching micro and small businesses

There are 4 contributing factors commercial banks put into consideration when deciding a strategy in funding micro and small businesses, namely: (i) the existence of branch offices, (ii) the number of Account Officers, (iii) management policy, and (iv) experience in financing micro and small businesses.

The existence of commercial banks' branch offices. Commercial banks which nature is "corporate banking" do not usually have a wide range of branch offices, unlike the ones of "retail banking." These "corporate banking" commercial banks have branch offices in urban areas, capitals of provinces and certain regencies. To expand the business to funding micro and small businesses undeniably needs a wider spread of branch offices, but this requires high investment. Branch offices would help identify potential businesses and monitor them to intensify the connection with micro and small businesses. Initiating a linkage with BPR is the strategy to minimize the transaction cost in delivering the loan to micro and small businesses. However, to apply the prudential banking principles, cooperation could only be done with BPR within the monitoring range of the branch offices. Limited number of branch offices means limited network with BPR.

The Number of Account Officers. To expand the business to reach micro and small businesses, a high number of Account Officers is needed, because prudential banking principles require Risk Units to monitor the financed units. The commercial bank internal policy to monitor the financed units, even by sampling, results in high expenses. Initiating a linkage with BPR is a strategy to use in order to minimize the expenses in delivering the loan to micro and small businesses. However, the number of Account Officers in the branch offices also determines the extent of cooperation between commercial banks and BPR.

Management Policy. With the change in the management of commercial banks, their orientation towards financing micro and small businesses is also altered. Referring to the definition of micro and small credit stipulated by Bank Indonesia, there is a wide range of target groups for commercial banks to fund. Should commercial banks decide to focus on financing micro and small businesses (Rp100million to Rp250million loan), the strategy to have BPR distribute the loan would be a necessity. However there was a survey to 45 BPRs showing the range of loan for the current debtors is between Rp3.5million to Rp12million. If BPR target group of this loan is not considered apposite because of the amount of loan this group is having, the strategy to cooperate with BPR is no longer considered primary in extending the coverage of loan to micro and small businesses.

The Change in the Management of Commercial Banks Resulting in the Change of Strategy to Provide Loans for Micro and Small Businesses

One of the commercial banks oriented to corporate banking has now been having an intense cooperation with BPR in providing loans for micro and small businesses. This change of business plan was materialized after the change in the management. According to definition on small business loan stipulated by Bank Indonesia, the new management defines that their target group is micro and small businesses with a credit limit more than Rp250million. With the change of the business plan, a linkage with BPR is not an option strategic as all funding by BPR has a lower credit limit.

A commercial bank has tried funding loan directly to micro and small businesses at a traditional market, and at the same time it coordinated with BPR. After the change, the new management considered the direct funding a disappointment, then reduced providing loan for micro and small businesses in 2004 even before any result came in. As the consequence, there was not any new loan through BPR. Only after the evaluation and problem mapping, it was decided in 2005 that business expansion by providing loan for micro and small business through BPR is in order

Experience in Financing Micro and Small Businesses. The experiences in credit lending for micro and small businesses shows that an intense relationship and monitoring are the key factors of repayment. Commercial banks that have a portfolio in funding micro and small businesses would prefer delivering the loan directly to the target units than doing it through other parties or BPR. Commercial banks that do not have such an experience would need higher cost to do the same.

The in depth interview with a commercial bank oriented to corporate banking shows that the incomplete understanding on the nature of funding micro and small businesses is one of the constraints in providing the loan to those units. BPR is one of the possible solutions to overcome those constraints. However, some of the commercial banks oriented to corporate banking have already started providing directly loans to micro and small businesses, even only for micro and small business located at traditional market, and trading center.

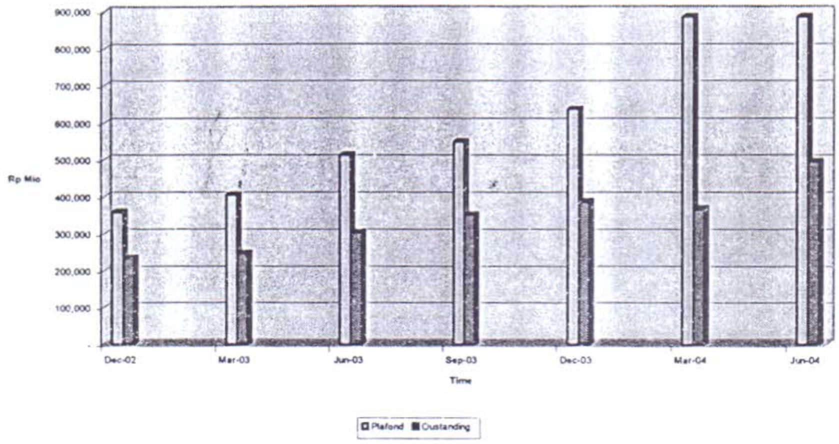
3.2. Commercial Bank's Financing for Micro and Small Business through BPR

3.2.1. Overview on Financing from Commercial Bank's to BPR

From June 2002 to June 2004, 28 commercial banks cooperated with BPR to gain better access to providing loans for micro and small businesses. With the fund from Government Bonds, a non-banking financial institution could have cooperation with BPR in delivering loans to micro and small businesses. According to Bank Indonesia in June 2004, 924 BPR already linkage with commercial banks with outstanding loan of RP536 billion in total (781 BPR cooperated with commercial banks and resulted in RP496 billion of loan, and 143 BPR collaborated with non-banking financial institutions and resulted in Rp40.4

billion of loan). The growth of plafond and outstanding loan delivered through BPR within December 2002 – June 2004 is exhibited in the Figure 4.

Figure 4. The Growth of Plafond and Outstanding Commercial Bank Loans Delivered to BPR within December 2002 – June 2004



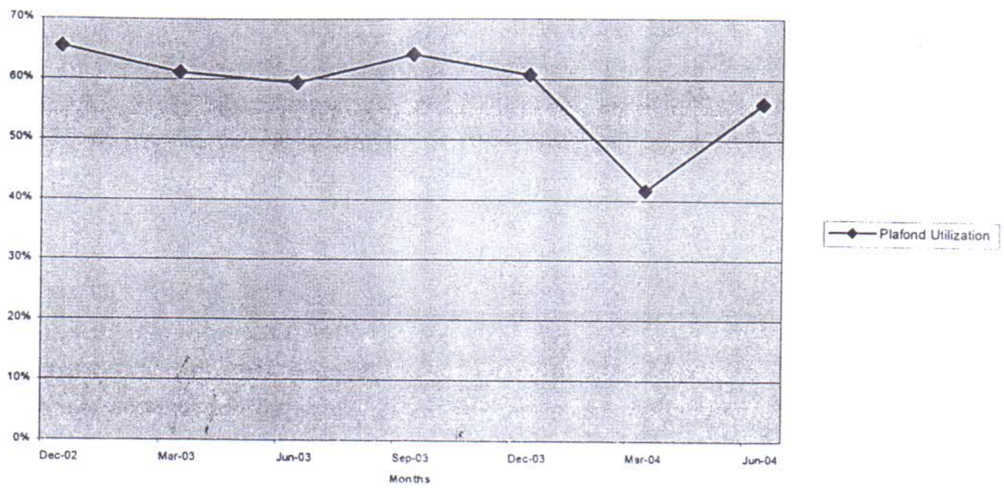
Source: Processed from Bank Indonesia Data

Data provided by Bank Indonesia in October 2004 shows a total of 2,153 BPRs with 1,873 BPRs (approx. 87%) in a sound condition. An interview with 5 dominant commercial banks has it that only BPR in sound condition[1] can get the funding. A survey to 45 BPRs in Jabodetabek, East Java and Bali illustrated that every BPR gets funding from 2-3 commercial banks in average. It was concluded that only 250-300 BPRs have received funding from commercial banks or about 15% of BPR in sound condition has done so. Commercial banks declared that they have only cooperated with 250-300 BPRs which are considered "the best 250-300."

One of the factors why only "the best 250-300 BPRs" had been considered is because the facilities provided by commercial banks have not been optimally utilized. By June 2004, the outstanding loan from commercial banks through BPR has only reached 56% of total plafond. The utilization rate of BPR to credit plafond from commercial banks within December 2002 – June 2004 is illustrated in Figure 5.

Figure 5. The BPR Utilization to Commercial Banks Plafond

[1] Bank Indonesia categorized BPR in 4 levels of condition: (1) sound, (2) fairly sound (3) less sound, and (4) unsound



Source: Processed from Bank Indonesia Data

Of 45 BPRs being the sample of the survey, 30 BPR already linkage with commercial banks show that there are different amount of loans average delivered by BPR based on assets. There is no difference in interest rate[2], term of loan, and cooperation scheme. The details of the characteristic of financing by commercial banks through BPR are exhibited in the Table 2.

Table 2. The Characteristic of Financing by Commercial Banks to BPR

Items	BPR's with Asset < Rp 5 Bio	BPR's with Asset Rp 5 - 10 Bio	BPR's with Asset > Rp 10 Bio
Linkage with number of commercial bank	2	2-3	3
Loan Average (Rp Bio)	1.5	2.2	5.2
Interest Rate (% p.a)	15	15	15
Duration (Years)	1-3	1-3	1-3
Scheme	Executing (Installment)	Executing (Installment)	Executing (Installment)

Source: Processed from primary data

[2] The interest rate for BPR varies between 12-19% p.a.

3.2.2. Factors that Affect Commercial Bank's Channeling of Loans to BPR

From the interview with commercial banks and information from 30 BPRs obtaining the loan from commercial banks, it was mentioned that there are 7 factors affect the commercial banks to provide loans:
(i) BPR level of soundness
(ii) CAR > 8%
(iii) NPL < 5%
(iv) Ratio of its capital to total loan from commercial banks
(v) BPR's shareholder and management
(vi) Business plan
(vii)Additional collateral.

BPR level of soundness. To get funding from commercial banks, BPR should have been in a sound condition for the last two years. This requirement is a necessary condition. Some commercial banks might have leniency on some certain components (for instance, the result of assessment on BPR management might be satisfactory), but funding is only provided for BPR in an absolutely sound condition. Non-banking financial institutions have a somehow different perspective: not only that BPR has to be in a sound condition, but fairly sound also have a potential to obtain funding. Commercial banks policy is based on the fact that commercial banks currently are not capable of developing all potentials of 1,873 BPRs which are in a sound condition according to Bank Indonesia. This explains why the cooperation so far has not reached BPR which is in a fairly sound condition.

Ratio of capital to total loan from commercial banks. This ratio varies between 2-10 times. BPR who has RP250 million worth of capital can get a total loan of between Rp500 million to Rp2.5 billion. As long as BPR keeps this ratio, commercial banks could always provide loans to BPR. This explains why every BPR could have an average of 2-3 commercial banks providing loans, and there is a possibility that BPR received a loan from non-banking financial institutions at the same time.

BPR Shareholders and Management. The characters of shareholders and management also play an important role on the assessment by commercial banks. The reasons to keep it into consideration are: (i) there can be only a qualitative assessment, and it requires a tremendous effort in verifying the characters of shareholders and management, (ii) the management tends to be representatives of shareholders, therefore unable to deny shareholder's request.

An interview with commercial banks (and reconfirmed by the information from the association of local BPR) reveals that most BPR which get the funding have inexperienced shareholders who do not have a background in banking. The owners of BPR are usually people who have a background in a certain kind of business and have enough funds to put as the initial investment to found BPR. A commercial bank mentioned in the interview that it once declined the request on loan solely due to the character of BPR shareholders.

Additional Collateral. In the interview, commercial banks reveal two reasons for requiring additional collateral in the form of fixed assets for BPR to have its request on loan granted. Firstly, with this additional collateral BPR shows a moral obligation and clear intention to return the loan. Secondly, this additional collateral is needed for loans in amount of more than Rp500 million. The more amount of the loan requested, the more percentage of additional collateral required. There is only one commercial bank that requires additional collateral in the form of BPR account receivable (not in the form of fixed assets).

3.2.3. Commercial Bank Procedures to Deliver Loan through BPR

Source of information. Two BPRs which have received loan from commercial banks stated two mechanisms that took them to getting the loan. First, commercial banks launch the opportunity to get the loan to BPR. After getting the information about this from DPD Perbarindo, any other BPR, colleagues, or the staff of commercial banks, BPR makes a request to commercial banks. To reach potential BPR, commercial banks usually contacted DPD Perbarindo to have their plan to provide loans socialized. During the process of socialization, credit application form has been prepared for BPR to fill out.

Assessment on feasibility and terms of realization of loan to BPR. In the interview, commercial banks mention two methods to do assessment on feasibility of BPR. The first one is having the Account Officer in charge of the whole process (upon receiving credit application form, up to having it analyzed by a credit committee). The second one, commercial banks distinguish marketing activities carried out by Sales Officers from the activity of making the decision whether to grant the loan. Sales Officers only identify potential units to fund, preparing basic information needed by other units analyzing and making the decision. Based on the basic information prepared by Sales Officer and putting other information from assessing unit into consideration, decision will be made whether the request would be granted. With this system, the decision can be made in a shorter time, in a more focused and independent way.

The decision to grant the loan to BPR is also determined by the amount requested. Generally, the loan up to Rp500 million is under the authority of the particular branch office. For loans more than Rp500 million, the decision would be made by the head office or regional office.

The combination of the authority of branch office and the assessment on feasibility results in different time of realization of the loan. BPR stated that funding from commercial banks would need approximately 30 days until it can be realized. However, some BPRs have proved to be able to get it in a shorter time (7-14 days) or in a longer time (60-90 days). Shorter time to make a realization of the loan might happen on commercial banks which have separated the duties of assessing the feasibility (marketing unit and analyzing unit).

3.2.4. Commercial Bank Problems in Delivering Loan through BPR

Data on potential of the BPR that could be financing by commercial banks is not available. One of the requirements, which is also a necessary condition for commercial banks to deliver a loan through BPR, is some information on the level of condition of the particular BPR. This information is the result of an assessment by Bank Indonesia. In the interview, commercial banks reveal that such information is confidential therefore Bank Indonesia cannot produce it. The information on the level of condition can be issued only if the particular BPR has applied for some loan, because it should reveal its level of condition as assessed by Bank Indonesia, and the original form (not copy) should be attached. This is one of the reasons why commercial banks would cooperate with only 250-300 BPRs, or only 15% of all BPRs in a good level of condition. In some cases, a commercial bank actively approaches BPR, and it turns out that the level of condition of BPR does not meet the requirement. Had the information on the level of condition of BPR been provided, in the form of total assessment or assessment per CAMEL component, it would not have been as difficult.

The high cost of pre screening in identifying potential BPR. There are two mechanisms in delivering loans from commercial banks through BPR: (i) a commercial banks approaches BPR, and (ii) BPR, after gaining some information from many sources, comes to a commercial bank.

In the experience of commercial banks, information in the form of quantitative data provided by BPR needs to go through some stages of verification and analysis to determine that the information is true and valid. The same goes to qualitative data, such as the characters of BPR shareholders and management, and a more complicated verification process is applied. For some commercial banks, the infrastructure is not yet proper for pre screening the information given by BPR. Even quantitative data provided by BPR is not up to the standard of commercial banks.

There is a wide span of "Good Level of Condition" criteria set by Bank Indonesia. The total assessment on the level of condition of BPR is based on CAMEL. Every component has its own value and proportion. The component which is the main concern of commercial banks is the management which was assessed and considered good or satisfactory. The result of assessment by commercial banks is in fact different, as it shows that the management is less than satisfactory. Non-banking financial institutions use a specific rating method, and it usually shows the similar result. The thing is that the assessment on BPR level of condition does not automatically shows the same outcome of the assessment on total components (CAMEL), and the latter determines the final assessment.

Commercial banks have an internal policy of Risk Unit to monitor a certain number of units funded by BPR. With the prudential banking principles applied by commercial bank Risk Unit, there is an internal policy to monitor a certain number of units funded by BPR. The scheme of loan from commercial banks through BPR is generally executing (BPR bears the risks), but BPR needs to attach the list of units funded to its credit application form. With this internal policy of Risk Unit, it is required to do monitoring. Some commercial banks require that 25% of debtors funded by BPR be regularly examined. Commercial banks with limited number of branch office have the Account Officer in charge of the whole process, from the beginning to the monitoring of delivering loans through BPR. The Account Officer would find this unfavorable. With the set target to deliver loan up to a certain amount, the Account Officer would find it more favorable to deliver credit to debtor individual (personal or micro, small and medium businesses).

The management policy of commercial banks puts micro and small businesses in the priority to fund. The definition of Loan for Small Businesses setting credit limit up to Rp500 million implies a wide range of micro and small businesses to receive loans from commercial banks. Bank Indonesia June 2004 data shows an average loan of BPR debtor approximately Rp5 million. A survey to 45 BPRs reveals that BPR with less than Rp10 billion worth of assets can distribute a maximum credit of Rp500 million. Since commercial banks prioritize loans for small businesses of Rp250 million credit, they have only BPR with Rp10 billion worth of assets as their target. Experience shows that to make a deal between a commercial bank and a Rp10 billion asset BPR would be more complicated, because each party has points to consider before deciding to cooperate.

3.3. Financing for Micro and Small Business through Micro Banking Unit

Compared with funding micro and small businesses directly as the end users, financing through BPR is not significant (only 1% of the loan from commercial banks is used as working capital and investment). In the mean time, within March 2004 – March 2005, some commercial banks have developed micro banking unit, and its purpose is to provide service penetration directly to micro and small businesses, a service to which has not been optimally rendered by Micro Financial Institutions.

An interview with a commercial bank that has successfully developed a Micro Banking Unit reveals its two reasons to improve access to micro and small businesses for funding by developing Micro Banking Unit. *First*, data on outstanding credit from 28 commercial banks to BPR shows that only 60% of credit provided by commercial banks has been used. Some commercial banks achieve only 50% of plafond. With the range of credit used 50-60%, the commercial bank sees the importance to deliver the idle fund directly to micro and small businesses which have had no access to funding from commercial banks.

Second, quoting the research by Bank Indonesia and Center of Bureau Statistic[3], commercial banks notice there are 42 million micro and small businesses in the need of totally Rp110 trillion credits. Some micro banking units, like BRI and BPR, can reach only 16 million customers with total Rp 35 trillion credits. The study by Bank Indonesia and Center of Bureau Statistic shows financial service to micro businesses, and that the service is not yet optimized. This study is relevant to the other two studies[4]. A study by World Bank and Center of Bureau Statistic illustrates 36% of micro and small businesses have access to banking services. A survey conducted by Bank Danamon in 2003 proves that of 1,000 micro and small business respondents in 8 major cities, most of them choose BRI units and commercial banks to fulfill the need in funding. Only 5% choose BPR and the rest of them would borrow some money from relatives, family, friends, cooperatives, and creditors.

3.3.1. Financing Characteristics of Micro Banking Unit

Having gone through the brochure published by micro banking unit and based on the interview with the key person, we can see the characteristics of the service of unit micro banking:

- **Funding target.** The target groups are generally micro and small businesses in trading and/or located at a traditional market or shopping centers. With this target, micro banking units are mainly located in urban areas, such as in the capital of the province or the capital of the regency.

- **Business requirement.** Micro and small businesses to get loan are the ones who have their own business and have been around for 1-2 years. The proof of ownership is Trade license (SIUP) or Company registration (TDP).

[3] See KONTAN tabloid, January 31, 2005
[4] See REPUBLIKA news paper, February 12, 2005 and Bisnis Indonesia news paper, March 9, 2005

- **Collateral requirement.** This usually applies for a certain amount of credit, the ones more than Rp5 million or more than Rp10 million. The kinds of collateral accepted are land certificates, house certificates, vehicles (cars, motorcycles), and time deposit account.

- **Service coverage.** Micro banking unit is usually handled by 2-3 people, and the service coverage is between 2-3 kilometers of the micro banking unit location. Personal approach and a good monitoring system in managing micro credit services are important.

- **Time range of loan.** The dominant business sector funded by Micro Banking Unit is trading, and it is also the target group. The loan could be given for up to 3 years.

- **Credit limit.** Micro business is the priority of the micro banking unit. However credit limit could possibly exceed what Bank Indonesia stipulates about micro credit (maximum credit limit of Rp50 million). So far, the credit limit varies between Rp1 million to Rp 200 million.

- **Rate of interest.** Rate of interest set by micro banking unit varies between 12-24% per annum.

3.3.2. Potential Problems of Micro Banking Unit

As a unit of a commercial bank, the decision on providing loans for micro businesses should refer to prudential banking principles. Some studies on the issues of micro and small business access to funding from commercial banks show two major problems faced by micro and small businesses: (i) business authenticity and (ii) collateral. Of those two problems, business authenticity would be the more potential problem due to the characteristics of micro banking unit. For instance, micro banking units do not oblige collateral for a maximum credit limit of Rp10 million.

With the growing number of businesses funded by micro banking units, a matter of human resources and its availability emerge. Currently, prioritizing efficiency, a micro banking unit is handled by 2-3 people. The accomplishment of a micro banking unit in rendering service to micro and small businesses is mostly determined by personal approach and being actively connected. These things would create loyalty and minimize bad debts. The service coverage of micro banking unit is within the range of 2-3 km. When the number of micro and small businesses receiving loan increases, the more number of human resources is needed, especially for monitoring.

IV. Funding Micro and Small Businesses by Rural Bank's

4.1. Overview on Funding Micro and Small Businesses by BPR

The performance of BPR has been increasing from time to time, and it is proved by macro indicators of BPR performance in providing services to micro and small businesses. The following table illustrates the improvement within June 2003 – June 2004.

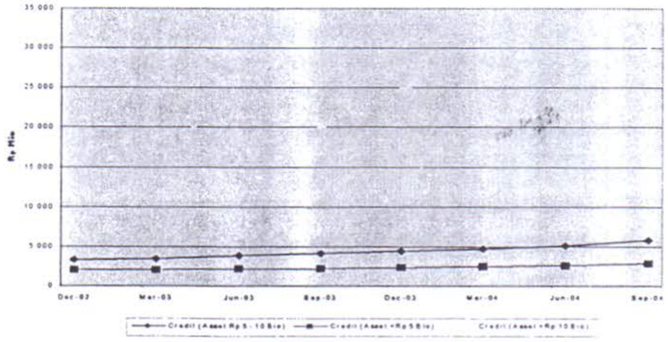
Table 3. The BPR Performance in Providing Service to Micro and Small Business within June 2003-2004

Indicators	June 2003	June 2004	Increase
1. Fund from the third parties (in trillion Rp)	7,2	9,9	38%
2. Credit Volume (in trillion Rp)	7,7	10	30%
3. NPL (percent)	9,1	8,4	(0,7%)

Source: Bank Indonesia

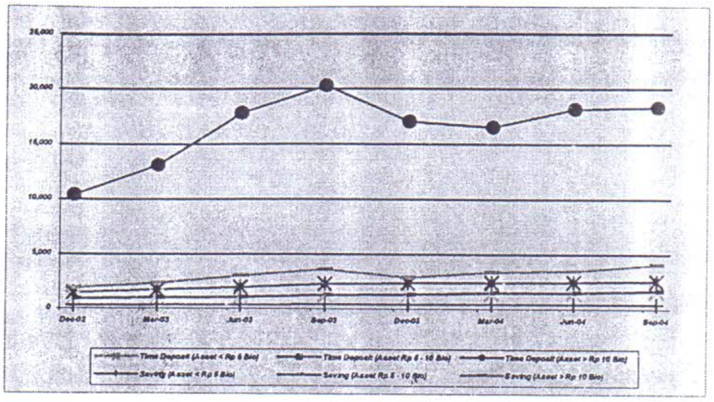
On a smaller scale, the survey on 30 BPRs getting funds from commercial banks shows no significant change in general. However, grouping BPR based on the assets, we can see the improvement on the performance of BPR which have assets more than Rp10 billion. The December 2002 – September 2004 analysis reveals that BPR with less than Rp5 billion assets do not have much change in performance (credit volume, number of debtors, and saving and time deposit mobilization). BPR with Rp5 billion – Rp10 billion assets has a slight increase in performance, yet it is not significant. The details of BPR performance grouped with their assets within the period of December 2002 – September 2004 is illustrated in the Figure 6, Figure 7, and Figure 8.

Figure 6. The Credit Volume of BPR with 3 Asset Categories



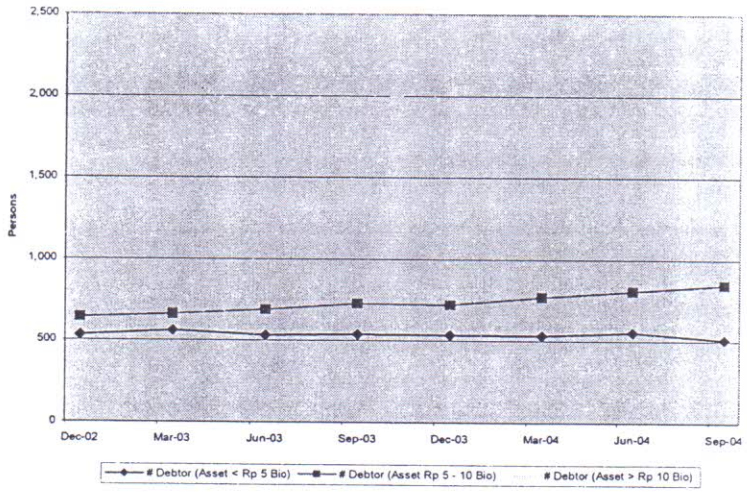
Source: Processed from primary data

Figure 7. The Saving and Time Deposit of BPR with 3 Asset Categories



Source: Processed from primary data

Figure 8. Number of Debtors of BPR with 3 Asset Categories



Source: Processed from primary data

The strategies applied by the surveyed BPR on every group of assets do not differ. Speed of service, simplification of requirements, and being actively approaching customers are their main strategies. BPR with more than Rp10 billion of assets have started developing the market, not only to micro and small business, but also to private companies and government institutions, by providing credit on consumptions (targeting at customers with fixed income).

BPR of all group of assets have relatively the same source of information, tools, and methods in assessing the feasibility of debtors. Unlike commercial banks who have means of checking bad debts and difficult debtors, BPR rely on parties connecting with potential customers, such as prominent figures and government administrators of all levels, as sources of information. BPR generally carry out surveys and interviews in collecting information to assess the feasibility. To see a potential customer's capability in paying back the loan, BPR go through the financial reports: its return on investment and its business income level. Without supporting documents to forecast potential customer's capability in paying back the loan, interviewing would be the only supporting method used by BPR.

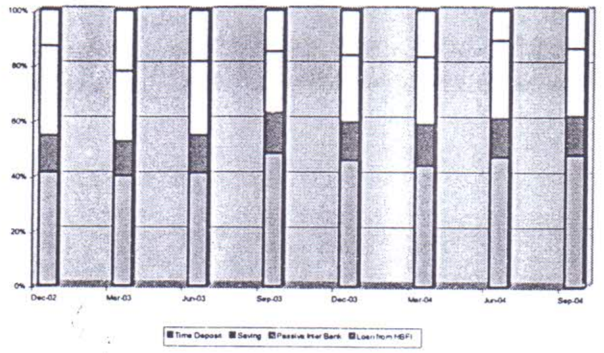
4.2. Sources of BPR Fund for Micro and Small Business Credit

Besides the capital stored by the owners, BPR have 4 sources of fund for micro and small business credit: (i) savings account, (ii) time deposit, (iii) inter-bank liabilities (include commercial bank loan), and (iv) non-banking financial institutions loans.

The survey on 30 BPRs with loan from commercial banks shows that by September 2004 savings account and time deposit collected from the citizens have contributed 55-60% in funding from BPR. Inter-bank liabilities (include commercial bank loan), is 10-25% and loan from non-banking financial institutions reaches 15-30%. Compared with the situation in December 2003, although not too significant, the increase in contribution of savings account and time deposit only occurs to BPR with assets less than Rp5 billion. The decrease in contribution of savings account and time deposit as the main source of fund happens to BPR with assets more than Rp10 billion, it is about 35%.

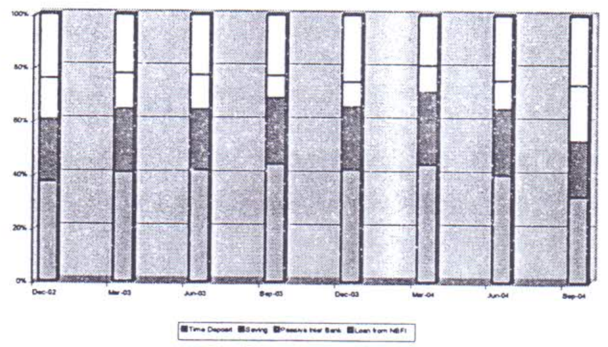
The inter-bank liabilities, including loan from commercial banks, as the source of fund gives contribution of 10% of loan from BPR with more than Rp 10 billion of assets. Those BPR rely 30% of their sources of fund on loan from non-banking financial institutions for credit lending to micro and small enterprises. The source of fund from a non-banking financial institution for BPR is Government Bond, which rate of interest applied to BPR is SBI rate-of-interest + 4%. For BPR, that rate of interest is considered more favorable than the rate of interest from commercial banks, which is 15% per annum. The detail of the growth of BPR sources of fund for micro and small businesses according to the group of assets within the period of December 2002 – September 2004 is illustrated by the Figure 9, Figure 10, and Figure 11.

Figure 9 The Source of Fund for BPR with Asset Less Than Rp 5 Bio



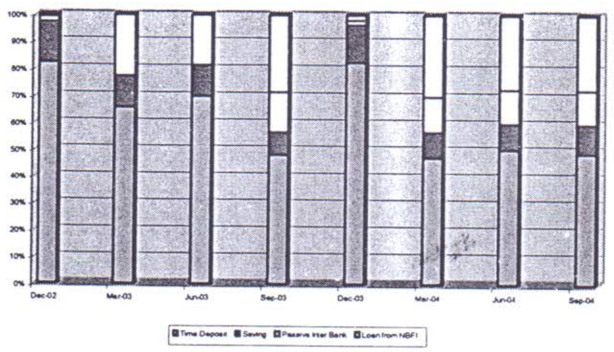
Source: Processed from primary data

Figure 10. The Source of Fund fo BPR with Asset Rp 5 – 10 Bio



Source: Processed from primary data

Figure 11. The Source of Fund for BPR with Asset More Than Rp 10 Bio



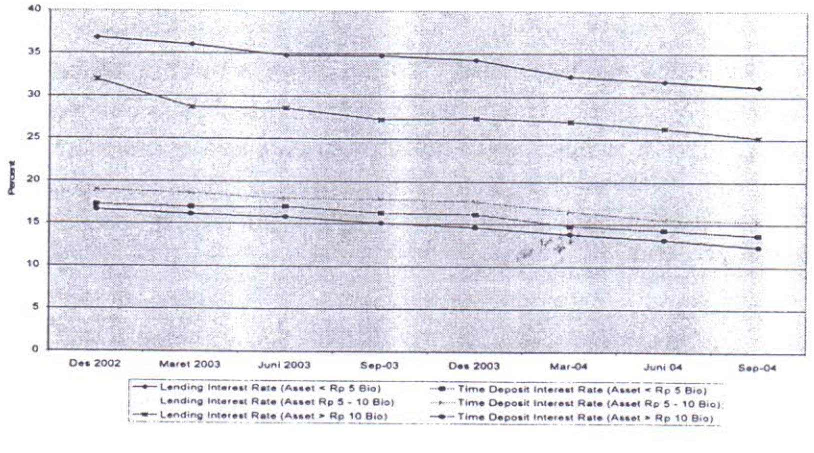
Source: Processed from primary data

4.3. The Impact of Funding from Commercial Banks through BPR towards Improvement on Micro and Small Business Access

With a cooperation between commercial banks and BPR[1], it is expected that the cooperation improve micro and small business access to funding from commercial banks, in a wider scope (higher number of debtors), and a lower credit interest rate. With inter-bank liabilities (include commercial bank loan as BPR source of fund, it is illustrated that BPR with assets less than Rp5 billion and the ones with Rp5 billion – Rp 10 billion of assets have the highest contribution, which is 25-30%. Is funding from commercial banks with linkage program of almost two years able to improve micro and small business access?

- **Credit interest rate for micro and small businesses.** Compared with the condition in December 2002, the trend of credit interest rate decreases about 25-31% each year. Only BPR with assets more than Rp10 billion is able to set credit interest rate at 25%. Ratio of credit interest rate to time deposit interest rate is approximately twice, with average time deposit interest rate as BPR proxy of fund. BPR with assets less than Rp5 billion have the ratio of more than twice. With the trend not changing, funding from commercial banks is assumed unable to improve efficiency in BPR funding. The average of commercial bank credit interest rate set to BPR is 15% per annum, so the cost of fund is lower on BPR with assets less than Rp5 billion and BPR with assets more than Rp10 billion. The detail of comparison between time deposit and credit interest rate within the period of December 2002 – September 2004 according to the group of assets is illustrated Figure 12.

Figure 12. The Comparison between Time Deposit and Credit Interest Rate of BPR with 3 Asset Categories within the Period of December 2002 –September 2004

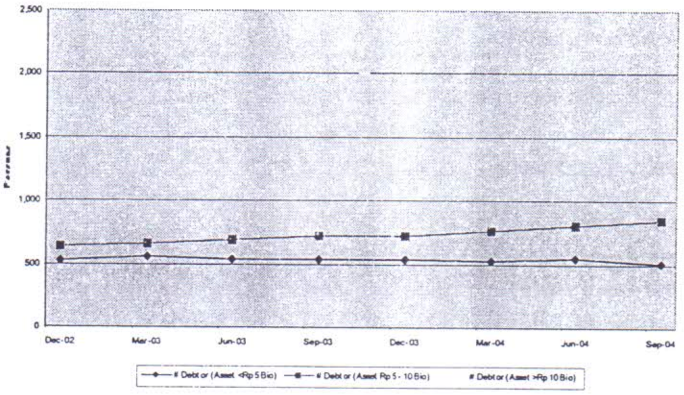


[1] See the Memorandum of Understanding between the Government and The Governor of Bank Indonesia on Poverty Reduction Strategy, 2002

Source: Processed from primary data

- **Number of micro and small businesses to become debtors.** Up to September 2004, the increase of number of debtors reached as a proxy of the growth of BPR outreach only occurs to BPR with Rp5 billion – Rp 10 billion of assets (32%), and BPR with assets more than Rp 10 billion (37%). BPR with assets less than Rp5 billion have no increase in number of debtors; the trend is almost a decrease. The growth of number of BPR debtors within the period of December 2002 – September 2004 is detailed in the Figure 13.

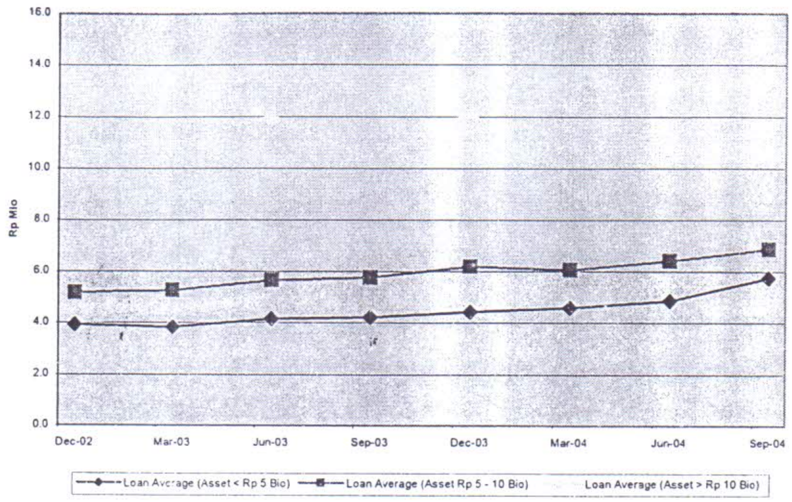
Figure 13. The Growth of Number of Debtors of BPR with 3 Asset Categories within the Period of December 2002 –September 2004



Source: Processed from primary data

If the contribution of inter-bank liabilities, including loan from commercial banks, is 25% of sources of credit fund from BPR with assets less than Rp5 billion, therefore the assumption that commercial bank credit improves the reach coverage of BPR is not proved. It is presumptive that BPR with assets less than Rp5 billion use credit from commercial banks to increase the credit limit of their debtors, not to develop new debtors. The December 2002 analysis shows that average amount of loan from BPR with less than Rp5 billion of assets is Rp4 million. The figure increases to Rp6 million in September 2004. The growth of loan average within the period of December 2002 – September 2004 is detailed in the Figure 14.

Figure 14. The Growth of Loan Average of BPR with 3 Asset Categories within the Period of December 2002 –September 2004



Source: Processed from primary data

- **Is liquidity the main reason of BPR cooperation with commercial banks?** When cooperation between commercial banks and BPR started, the argument that BPR had a problem of liquidity was forwarded. Credit from commercial banks was expected to solve that problem. The interview with BPR cooperating with commercial banks shows that liquidity is actually not the main reason to have cooperation with commercial banks. The main reason is to increase credit volume to micro and small businesses. The Table 4 shows the reasons of BPR of group of assets to cooperation with commercial banks.

Table 4. The Reasons why BPR enter into Financing Cooperation with Commercial Banks

Reasons of Linkage	BPR (Assets < Rp 5 Bio)	BPR (Assets Rp 5 – 10 Bio)	BPR (Assets > Rp 10 Bio)
1. Increasing credit volume to micro and small enterprise	75%	60%	66%
2. Increasing Liquidity	25%	30%	17%
3. Increasing Customers' Level of Trust		10%	17%

Source: Processed from primary data

4.4. BPR Problems in Financing Cooperation with Commercial Banks

The interview with BPR have linkage with commercial banks shows that problem of credit interest rate of commercial banks is the main problem of BPR, especially for BPR with Rp5 billion – Rp 10 billion of assets. However, the BPR with assets more than Rp10 billion see problems of commercial bank credit interest rate and the possibility of losing their customers (especially the ones with good characters), both at the same proportion.

Table 5. BPR Problems in Financing Cooperation with Commercial Banks

Constraints in cooperating with commercial banks	BPR (Assets < Rp 5 Bio)	BPR (Assets Rp 5 – 10 Bio)	BPR (Assets > Rp 10 Bio)
1. Credit interest rate	50%	80%	40%
2. Providing collateral	12.5%	20%	20%
3. Concern of losing customers to commercial banks	25%		40%
4. others	12.5%		

Source: Processed from primary data

4.5. Constraints from Bank Indonesia Regulation and Government Regulation

The interview with BPR operator's that there are some constraints in implementing BPR strategies to reach micro and small businesses. A summary of constrains felt by BPRs' operators can be seen in the Table 6.

Table 6. The Constraints from Bank Indonesia Regulation and Government Regulation

Source of regulations	BPR (Assets < Rp 5 Bio)	BPR (Assets Rp 5 – 10 Bio)	BPR (Assets > Rp 10 Bio)
1. BI Regulation	• Paid up capital • Prohibite for payment service • Open of Branch Office • LLL is 20% of capital • Collectibility order (for agriculture sector) • Operational jurisdiction within the subdistrict • Less than Rp10 million loan from micro banking unit is possibly without collateral, but for BPR needs collateral	• Open of cash office • Prohibite for payment service • Inventory and fixed capital is 50% of paid up capital • There is no guarantee for BPR to withdraw assets when experiencing bad debts	• LLL is 20% of paid up capital • BPR inventory should not exceed 50% of capital • Open of cash office
2. Government Regulation	• Tax Accounting System of BPR is not compatible with the one of tax bureau • Taxing on savings > 7.5 million • Fiducia issues	• Tax on dividend of stored capital • Tax on other MFI is not applied	• Taxation • Local government levies

V. BPRs' Competition with Commercial Banks in Serving Micro and Small Enterprises Over The Next Three Years

5.1. Overview of BPRs' Competition with Commercial Banks in Serving Micro and Small Enterprises: Existing Condition

A study conducted by one commercial bank in eight large cities in Indonesia showed that the sources of financing for micro and small enterprises derive not only from BPRs, but also from commercial banks, the micro banking units of commercial banks, and other sources (friends, families, loan sharks, and cooperatives). The results of interviews with 15 borrowers from BPRs in Jabodetabek (Greater Jakarta), Bali, and East Java indicated the same thing: these borrowers had, at the same time, also obtained loans from commercial banks and/or micro banking units of commercial banks.

To illustrate the competition that exists between BPRs and commercial banks and micro banking units of commercial bank from the perspective of BPRs' debtors who are also debtors of commercial banks and micro banking units of commercial banks, a comparison was made on four indicators: (i) credit amount, (ii) loan interest rate, (iii) transaction cost, and (iv) loan termination time. The comparison for these four indicators can be seen in the Table 7.

Table 7. The Comparisons of Credit Lending from Commercial Banks and BPR's to Micro and Small Enterprises

Items	BPR	BRI Unit	Danamon Saving and Loan	Commercial Banks
Credit Amount (Rp Mio)	4-250	2-100	15	10-300
Interest Rate (average p.a)	26	17	24	18
Transaction Cost (%)	2.6	2.8	2	3.9
Decision Time (days)	4	19	2	25

More specifically, the competition between BPRs and commercial banks' micro banking units can be seen from a number of financing characteristics, as shown in the following Table 8.

Table 8. Competition between BPRs and Commercial Banks' Micro Banking Units

Item	Mandiri Micro Banking	Danamon Saving and Loan	BRI Unit	BPR
Business Requirement	Have own business for at least 2 years (proven with SIUP or TDP)	Have own business	Have own business for one year	Have own business that is considered to have good prospects (flexible regarding TDP and SIUP)
Type of Collateral	Collateral in form of land certificate, house, car or motorcycle, or time deposit for loan of over Rp 5 million	Collateral in form of land and building certificate, motorcycle, or car, for loan of over Rp 10 million	Collateral in form of house and land ownership certificate, provisional ownership deed (*girik*) or sale deed, certificate, certificate that collateral is not in dispute, most recent PBB receipt	Collateral in form of motor vehicle certificate (usually), certificate, land or house documents
Interest Rate	12% per year	2% per month for under 50 million, and 1.5% per month for 50-200 million.	18% per year	2-3% per month
Credit Ceiling	1- 100 million	1- 200 million	1- 50 million	500,000 – 250 million (maximum 20% of paid-up capital)
Decision Time	1-2 days	1-2 days	7-14 days	2-5 days
Loan period	Maximum 36 months	1-50 million, maximum 24 months; 50-200 million, maximum 36 months	Maximum 36 months	Averages 12-24 months
Other Requirements	Photocopy of KTP, proof of ownership of collateral for over 5 million	Photocopy of KTP/ KK/ marriage certificate, electricity/ telephone bills, proof of ownership of collateral, pay slips (for employees), bank account	Photocopy of KTP/ KK, passport photo, proof of ownership of collateral, lives in a permanent house	Photocopy of KTP/ KK/ marriage certificate, Proof of ownership of collateral, Owns permanent home/ Has credible references
Facilities	Savings/ payments can be collected, and pay daily/ weekly	DSP membership card, telephone and electricity payments, collect customer's savings	• Payments can be made fro savings account or through autodebit • Transfer services, online with all branches/ units	Pick up service for savings account, or collection savings or credit payment (depending on customer's request)
Withdrawal from savings	Must be at office	Must be at office	Must be at office	Can be delivered
Participant's obligation	Open an account	Open an account	Open an account	Open an account

Source: Interviews with managements

*) SIUP: *Surat Izin Usaha Perdagangan*, Trading Business Permit

*) TDP: *Tanda Daftar Perusahaan*, Company Registration

*) PBB: *Pajak Bumi dan Bangunan*, Land and Building Tax

*) KTP: *Kartu Tanda Penduduk*, Identity Card

*) KK: *Kartu Keluarga*, Family Registry Card

Motor Vehicles are BPRs' most favored type of primary collateral

For new customers, BPRs prefer to require motor vehicles as the primary collateral. Only old customers (with 5 repeat loans) can use land certificates as additional collateral, if the value of the primary collateral is inadequate.The prospective customer can use another form of collateral, such as land or buildings. This is because using a land title as collateral requires higher costs (notary fees) and the execution process (in case of default) is long and difficult.

In other regions (cf. the case of BPR in Bogor), motor vehicles are preferred as collateral because the loan processing is quicker. If a land certificate is used as the loan guarantee, it takes longer because the handling at the National Land Agency alone takes two to three days. This then affects the length of time needed to release the loan to the BPR's customer.

From Table 9, several matters can be concluded regarding the strengths and weaknesses of BPRs in channeling loans to micro and small enterprises for the future, as follows:

- The issue of loan interest rates is still the main problem for BPRs in competing with commercial banks and their micro banking units in channeling credit to micro and small enterprises. This phenomenon is relevant to the results of the previous analysis, which indicated that the existence of cooperation between commercial banks and BPRs does not provide any improvement to the cost efficiency of the BPRs' funds.

Why BPRs' Interest Rates Are High

One serious weakness for BPRs at present is their high interest rates, which make it harder for them to compete with commercial banks. These high interest rates are related to the high overhead costs faced by BPRs. This problem is felt particularly by BPRs with a small business scale. It is often perceived that the small scale of these BPRs also causes their operational activities to be inefficient, in terms of both manpower and funds.

Another reason given as the cause of high interest rates from BPRs to micro and small enterprises is the limited availability of sources of cheap funds to be channeled by the BPRs. The high cost of money received by the BPRs from the commercial banks means that the interest rates on the money they lend are also high.

Yet another reason why it is so difficult to lower the interest rates is the high profit targets from the owners. This makes it difficult to bring the rates down. This constraint has been experienced by one BPR X in Jakarta in carrying out a strategy to reduce interest rates so as to be able to compete with commercial banks.

- Compared with the micro banking units of commercial banks, transaction costs and loan termination times at BPRs are actually higher. This situation indicates that in channeling loans to micro and small enterprises in the future, BPRs' main competitors will be the micro banking units that have recently been established by several commercial banks. Using the same indicators, compared with other Micro Finance Institutions (Banks), BPRs are still superior.

- Aside from high loan interest rates, the high administrative costs at BPRs are a problem mentioned by their borrowers, compared with the services received from commercial banks' micro banking units.
- In terms of provision of collateral, commercial banks' micro banking units do not require collateral for loans of certain amounts (under Rp 5 million or under Rp 10 million), whereas BPRs could not do this.
- Compared with commercial banks' micro banking units, which already have specific ceilings for channeling loans to micro and small enterprises, the credit ceilings at BPRs are set at 20% of paid-up capital.
- The one advantage of BPRs compared with the micro banking units of commercial banks is the ease provided by BPRs in providing a pick-up and delivery service for micro and small enterprises' savings deposits.

Convenient service is BPRs' best point in their competition with commercial banks

The main strength that BPRs rely on to win in their competition with commercial banks is their quick and easy service, in which they come to the customer. These BPRs can process a credit application from a micro or small business in as little as two days.

In one case, when checking the required identification documents, the BPR found that the prospective borrower's identity card (KTP) had expired. The BPR went ahead and processed the loan, even though it needed to have a valid KTP when the loan was released. Cases such as this show that in dealing with their borrowers, BPRs emphasize the element of trust – something that would be impossible to find at a commercial bank.

The competition between BPRs and commercial banks can also be analyzed by comparing the Banking Law (UU Number 7/1992 and UU Number 10/1998) applicable to commercial banks and to BPRs with regard to their institutional structures and the business activities that they may and may not conduct, as shown in the Table 9.

Table 9. The Banking Laws Applicable to Commercial Banks and to BPRs

Item	Commercial bank	BPR
Establishment of Bank	1) Bank may only be established and conduct business activities with a permit from the Directors of Bank Indonesia 2) Bank may only be established by: a. Indonesian citizen(s) and/or Indonesian legal entity/ies, or b. Indonesian citizen(s) and/or Indonesian legal entity/ies with foreign citizen(s) and/or foreign legal entity/ies in partnership	BPR may only be established and owned by a. Indonesian citizen(s); b. Indonesian legal entity owned entirely by Indonesiancitizen(s); c. Regional government; or d. Two or more parties as mentioned in letters a), b), and c).
Paid-up Capital	• Paid-up capital to establish a Bank is set at a minimum of Rp 3.000.000.000.000.00 (three trillion Rupiah) • Paid-up capital for a bank with the legal form of a cooperative is the basic contributions, compulsory contributions, and grants as regulated in the Law on Cooperatives	a) Paid-up capital to establish a BPR is set at a minimum of: 1) Rp. 2.000.000.000.00 (two billion Rupiah) for a BPR established in the territory of Greater Jakarta Special Capital District (DKI Jakarta Raya) and regencies/ municipalities of Tangerang, Bogor, Bekasi and Karawang 2) Rp. 1.000.000.000.00 (one billion Rupiah) for a BPR established in the territory of a provincial capital outside the region mentioned in number 1); 3) Rp 500.000.000,00 (five hundred million Rupiah) for a BPR established outside the territories mentioned in numbers 1) and 2). b) The portion of the BPR's paid-up capital that is used for working capital must be a minimum of 50% (fifty percent)
Opening of branch offices	• Domestic branch offices of the Bank may only be opened with permission from the Directors of Bank Indonesia • Plans to open Branch Offices as mentioned in clause (1) must be set out in the Bank's annual work plan • Approval or rejection of requests as mentioned in clause (3) shall be provided within 30 (thirty) days from receipt of properly completed request document	A People's Credit Bank (*Bank Perkreditan Rakyat*, BPR) may only open a branch office under the following conditions: a. In the territory of the same province as its head office; b. Only with the permission of the management of Bank Indonesia; c. Plans to open branches must be set forth in the BPR's annual work plan; d. Must comply with soundness requirement: categorized as sound for the previous 12 (twelve) months; e. Required to increase paid-up capital by at least the amount stipulated in sub-chapter 3.2.01 letter c for each new branch office opened.

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Item	Commercial bank	BPR
Opening of cashier services	• Banks may conduct cashier services outside bank offices in the form of mobile cashiers, floating cashiers, payment points, Automated Teller Machines (ATM), or other equivalent activities • Bank is required to set out its plans for cashier activities outside offices as mentioned in clause (1) in its annual work plan • Bank is required to submit report on plans for cashier activities outside offices as mentioned in clause (1) in writing to Bank Indonesia no later than 30 (thirty) days before the activities are conducted	Requirements for opening Cashier Services a. Plans for opening Cashier Services must be set out in the BPR's annual work plan b. BPR may open Cashier Services only within the territory of the same regency/ municipality as the BPR office that supervises it, which fulfils the soundness requirement of being categorized as at least reasonably sound for the previous 12 (twelve) months c. Required to consolidate the financial report of the Cashier Services with the financial report of the BPR branch that supervises it. • Opening procedure: BPR is required to submit plans for opening Cashier Services in writing to Bank Indonesia no later than 30 (thirty) days before opening the Cashier Services
Prohibited activities	Commercial banks are not allowed to: a. engage in capital participation, except as mentioned in Article 7 letters b and c b. engage in insurance enterprises c. conduct other enterprises outside the business activities as mentioned in Article 6 and Article 7.	a. The Rural Banks are not allowed to: b. accept savings in the form of demand deposits or take part in transfers of payment c. engage in business activities in foreign currency d. engage in capital participation e. engage in insurance enterprises f. engage in business enterprises other than those mentioned in Article 13.
Opening of offices below branch level	• Bank is required to present plans for opening of offices below Branch Office level in writing to Bank Indonesia no later than 30 (thirty) days before opening the office, accompanied by results of a feasibility study that contains level of saturation of number of banks • Offices below Branch Office level as mentioned in clause (1) include Subsidiary Branch Offices, Cash Offices, or the equivalent • Opening of offices as mentioned in clause (2) may be done: Only within the same clearing region as the supervising Branch Office, except with the approval of Bank Indonesia; With due attention to the results of the feasibility study that analyzes bank saturation level • Financial reports of offices below a Branch Office must be consolidated with the financial report of the supervising Branch Office for the same days	

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Item	Commercial bank	BPR
Ownership	A commercial bank may only be established by: a. Indonesian citizen(s) and/or Indonesian legal entity/ies; or b. Indonesian citizen(s) and/or Indonesian legal entity/ies together with foreign citizen(s) or foreign legal entity/ies in a partnership	The Rural Banks may only be established and owned by Indonesian citizen(s), Indonesian legal entity/ies entirely owned by Indonesian citizen(s), regional government, or may be owned jointly among these three.
Business activities	a. accumulating funds from the public in the form of savings in the form of demand deposits, time deposits, deposit certificates, savings accounts, and/or or other equivalent forms; b. providing credit c. issuing promissory notes d. buying, selling, and guaranteeing on its own risk or for the interest of and on the order of its customers, bills of exchange, promissory notes, and other commercial papers, state treasury bills, and government surety bonds e. transferring funds, both for its own interest and for the interest of its customers f. placing funds in, borrowing funds from, or lending funds to other banks, whether through letter, telecommunication facilities, sight drafts, check, or other means; g. receiving payments of invoices for negotiable instruments, and making calculations with or among third parties; h. providing places to safely keep valuable goods and documents; i. conducting safekeeping activities for the interests of other parties on the basis of a contract; j. conducting placements of funds from one customer to another customer in the form of negotiable instruments that are not registered on the stock exchange; k. conducting activities of factoring, credit card businesses, and trustee activities; l. providing financing and/or conducting other activities under Syariah Principles, in accordance with the provisions stipulated by Bank Indonesia. In addition, a bank may also: a. conduct activities in foreign currencies, complying with the provisions stipulated by Bank Indonesia; b. conduct activities of capital participation in banks or other companies in the financial sector, such as leasing, venture capital, securities, insurance, and institutions for clearing of settlements and deposits, complying with the provisions stipulated by Bank Indonesia; c. conducting activities of capital participation temporarily to help overcome failure of credits of failures of financing under Syariah Principles, with the requirement that it must later withdraw its participation, complying with the provisions stipulated by Bank Indonesia;	**The activities of a Rural Bank include:** b. accumulating funds from the public in the form of savings in the form of time deposits, savings accounts, and/or other equivalent forms c. granting loans d. placing its funds in the form of Bank Indonesia Certificates (SBI), time deposits, deposit certificates, and/or savings accounts at other banks

A summary of the weaknesses and strengths of BPRs in facing competition with commercial banks in channeling credit to micro and small enterprises can be seen in Table 10.

Table 10. The Weaknesses and The Strengths BPR Facing Competition With Commercial Banks

BPR's Weaknesses	BPR's Strengths
• High loan interest rates	• Personal approach
• High cost of funds	• Easy requirements
• High overhead costs	• Immediate, speedy, and easy service
• High administration costs	• Understanding of Local Market segment
• Limited sources of funds	
• IT, management, and human resources	
• Limited line of credit	
• Unavailability of black list information	
• Limited reach	

5.2. Weaknesses of BPRs in Competition with Other BPRs and other Micro Finance Institutions

The results of interviews with operators of BPRs indicate that in competition with other BPRs they mostly emphasize the aspects of sources of funds and interest rates. In contrast, in their competition with other micro finance institutions, the BPRs feel that the provisions for micro finance institutions are extremely lax (for example in the reporting aspect, which is not the same as BPRs' reporting to Bank Indonesia), the tax regulations that are not the same as those borne by BPRs, and the community's sense of ownership toward micro finance institutions owned by villages (cf. the case of LPD in Bali). The implications of the laxity of the regulations applying to other micro finance Institutions is felt by BPRs as steadily increasing their competition in channeling credit to micro and small enterprises. Even so, operators of BPRs still feel that the competition from commercial banks' micro banking units is heavier than that from other BPRs or from other micro finance institutions.

A summary of the weaknesses felt by BPRs' operators in their competition with other BPRs or other Micro Finance Institutions can be seen in the Table 11.

Table 11. The Weakness BPR's operators in Their Competition with Other BPRs other Micro Finance

BPRs with assets < Rp 5 billion	BPRs with assets between Rp 5 billion and Rp 10 Billion	BPR with assets > Rp 10 billion
• No exchange of information • Interest rates • Limited sources of funds • Channeling of funds limited • Human resources • Technology • Operational efficiency	• Main competition is with Savings and Loan Cooperatives, because of: o Reporting system o Tax on dividends • Competition with MFIs owned by traditional villages/ groups	• Human resources • Operational efficiency • Loan termination periods longer than for other MFIs

Source: Results of interviews with BPR operators

5.3. Strategies For BPRs In Facing Competition With Commercial Banks

To face the competition with commercial banks in serving micro and small enterprises over the coming three years, in addition to BPRs' undertaking a number of internal adjustments, it is also necessary to have simplification or revision of the Bank Indonesia Regulations and Government Regulations related to BPRs' institutional structures and business activities.

5.3.1. BPRs' Internal Strategies In Facing Competition With Commercial Banks

1. Maintain personal approach in seeking new customers
2. Cooperate with large companies/ government agencies in channeling consumer credits and payment of empioyees' salaries
3. Strengthen human resources to control the market and choose local Account Officers
4. Map out potential markets through cooperation with local community leaders

BPRs' Strategies for Minimizing Risk and Increasing Outreach to Micro and Small Enterprises

Fund distribution with a greater emphasis on expanding the number of borrowers than on the amount of credit granted. *This strategy is based on the consideration of security for the BPR's funds; the safety level is higher if the risk is spread out.*

Approach to prominent community figures or other influential persons, particularly in reaching out to prospective potential customers. *This strategy is mostly a mechanism to actualize the potential of prospective customers in a given area. By using people already well known to the public in an area, it is easier for the community to accept the presence of the BPR.*

Building a personal approach, with both existing and potential customers. *This personal approach to customers is developed through service based on the customers' needs, and by fostering relationships.*

Speed and ease of service is also a top priority. *Speed of service is achieved by applying simple but accurate procedures. The customers' need for speedy, easy, and relatively informal service is accommodated by this BPR, and is one of its main strengths in facing the competition coming from commercial banks.*

5. Expand the market through land certification program

Improving access of micro and small enterprise to rural bank's financing through land certification program

The strategies employed by this BPR are generally the same as those used by other BPRs: To develop credit service with a speedy, easy process for the customer, while not neglecting the principles of caution in lending; to develop a variety of products adapted to needs and changes in the market; and to use its old, loyal customers as an entry point for expansion of its customer base.

One quite interesting strategy of this BPR was opening up the market by conducting a mass land certification program for the public as a means to open up opportunities for the public to gain access to credit services. This mass certification was done because many residents in Pujon District did not have proper legal status for the land or buildings that they owned, while these same people were trying to obtain sources of financing for their businesses.

6. Identify cheap sources of funds
7. Conduct efficiency (administration costs and interest rates)

5.3.2. Simplification/ Revision of Bank Indonesia Regulations and Government Policies

Bank Indonesia Regulations:

1. Evaluation of BPRs' collectibility

Bank Indonesia provisions on collectibility do not support BPRs' financing of the agriculture sector

The sector for which the most financing is provided is trade, even though BPRs, given their locations, have great potential in the agricultural sector. In connection with lending to the agricultural sector, the collectibility standards create a problem for BPRs when they are dealing with farmers. A collectibility calculation based solely on timely repayment tends to place BPR Pujon Jaya Makmur as facing a low collectibility rate. In fact, the customers in question have no problems repaying; but because the availability of their funds is so closely tied to the marketing of their agricultural produce, these customers sometimes have to defer their payments for a few days. Such cases as this are extremely common in BPRs' relations with the agricultural sector.

BI should therefore start to reconsider the regulations on calculation of collectibility. The calculations should also take into consideration the sector being financed and the customer's ease in repayment. Similar cases occur in many places, particularly for BPRs located in regions with an agriculture-based economy.

2. Regulation regarding BPRs' paid-up capital (time period)
3. BPR can open only one branch in a year
4. A BPR can open a payment office in a same regency/city of main office
5. Provisions on identification to open an account (set an age limit)
6. "BPR may not engage in other enterprises" to be relaxed or permitted in participation related to its industry

7. BPR may buy collateral goods from debtors, like commercial banks

Government Policy:

1. Tax not to be assessed on dividends provided as paid-up capital of BPR
2. Fiduciary issues must be reported to provincial capital
3. Speed up time for checking land certificates with BPN

VI. The Potential of Independent Ratings to Provoke Change

6.1. The Rationale behind Independent Ratings in Indonesia

Independent ratings could be a potential means of increasing the flow of funds to BPRs not only from commercial banks but also from other sources. However, given current market developments, as outlined in this study, the potential impact is uncertain. At the same time, independent ratings could also serve as a tool to improve the quality of individual BPRs as explained below. The rationale behind the concept of independent ratings for BPRs is much the same as that which underpins the role of the traditional rating agencies vis-à-vis the formal commercial banking and investment community with the exception that BPRs are not yet allowed to receive direct investments or loans from foreign sources. A more detailed analysis concerning potential impact of independent ratings on the provision of funding to BPRs is set out below:

First, independent ratings would provide a much needed additional source of information for regulators and investors/lenders as well as for the management of BPRs themselves. A rating carried out by a professional rating agency would provide more detailed information to the interested parties than does the present Bank Indonesia CAMEL system which measures seven ratios related to capital adequacy, quality of performing assets, profitability and liquidity and relies on answers to 25 questions used to assess general and risk management. Based on the results of these indicators, BPRs are broadly classified by Bank Indonesia as Sound, Fairly Sound, Less Sound, or Unsound. Details of the Bank Indonesia BPR supervision system have been analyzed previously by GTZ/ProFI. The ProFI baseline survey pointed out certain shortcomings of the present system including: too much tolerance to short-term loans in arrears, too little weight to asset quality and loan loss provisioning, and overstatement of profitability when full costs of loans are not accounted for in income statements. In addition, the BPR supervision staff has not grown in accordance with the rapid growth in the number of BPRs; the ProFI baseline survey showed that only half of the BPRs were inspected during the year and that the frequency of on-site supervision did not correlate with BPR performance. In fact, GTZ found that BPR managers themselves were asking for more in-depth involvement of the supervisors in assisting them to comply with supervision requirements. In any event, it should not be the responsibility of the Central Bank to provide information concerning specific institutions to the investment community as is presently the case.

In contrast to the Bank Indonesia CAMEL system, a rating by a professional rating agency would be based on the in-depth knowledge and experience of analysts specifically dedicated to this task. Furthermore, the reports compiled by an independent rating agency, contrary to BI's CAMEL rating reports, could be made public to interested parties provided that the rated institution is in agreement and that the appropriate fee for this service (if any) is paid. An independent rating would also provide Bank Indonesia with a source of comparison for its own internal ratings.

With regard to investors/lenders, as confirmed by the results of this study, in the case of many of the Indonesian commercial banks which lend to BPRs, it may not be cost effective to perform the necessary depth of analysis internally given the relatively small average size of the loans made to BPRs. An independent rating service – provided that the financial community can rely on the quality of its reports - would allow the cost of such in-depth professional analysis to be shared by a number of commercial banks and other interested parties. At the same time, it would address the problem of the present lack of qualified professional analysts within the Indonesian commercial banking industry and the financial sector in general, especially those dedicated to this particular market (the most qualified analysts are likely to be involved in the provision of larger loans).

In fact, not only would this paradigm lead to reduced costs in terms of internal savings to commercial banks, but it would also enable the increased professionalization of the industry in at least two ways. *First*, commercial banks would be able to learn from the analysis provided by the rating agency and to thus increase the quality of their own internal analysis. *Second*, the management of the rated BPRs themselves would be able to benefit from the rating experience which in many cases resembles the analysis which would be carried out by a management consultant.

This potential benefit is confirmed by the experience of CGAP (the Consultative Group to Assist the Poorest which is housed within the World Bank) which, through a fund dedicated to co-financing the expense of ratings for microfinance institutions (MFIs) throughout the world and making these ratings publicly available, is summarized as follows on their website:

Transparency is essential if the microfinance industry is to expand significantly in scale. Investors, donors, and most importantly, domestic savers, will only place their funds where they can reliably assess risk and return on the basis of standardized, comparable information. In addition, transparency makes it easier for auditors and supervisors to oversee the safety of the financial system, which in turn gives additional confidence to investors. Institutions that provide financial services also need clear, standardized information to help them determine where they stand in relation to their peers, or on a global basis. MFI managers that can benchmark their performance against other MFIs are better able to improve performance and more interested and motivated to do so.

6.2. The Reaction of BPRs, Commercial Banks, and PNM to the Idea of Independent Ratings

BPRs and Commercial strongly support the establishment of an independent rating institution in Indonesia. However, the commercial banks voiced some concerns which would require further analysis including:

- Legal Issues: Sharing of BPRs' data with other institutions (other than Bank Indonesia) and bank secrecy (Bank Indonesia law and other legal regulations);
- Credibility, accuracy and validity of the rating provided;
- Impact of publication of ratings on public's level of trust in BPRs;
- Ownership structure of the proposed rating agency; and
- Cost of ratings.

The Reaction of Bank Indonesia to Idea of Independent Ratings

Based on a meeting in December 2004 with Bank Indonesia (also attended by a representative of IFC), Bank Indonesia would view the establishment of an independent rating agency in a favorable manner and appeared to have already been involved in studying this possibility. However, based on additional meetings with CESS, the establishment of an independent rating agency is not a priority for Bank Indonesia at this time.

6.3. Identification of Potential Owners of an Independent Rating Agency

The challenge to establishing an independent rating agency in Indonesia dedicated to BPRs and perhaps other types of MFIs as well lies in ensuring and maintaining its professionalism and independence from the large number of parties with a potential interest in such an institution. This is no easy task in a country such as Indonesia. It is assumed that such an agency would be formed as a privately held, for-profit company as is the case with other rating agencies around the world, both mainstream and those dedicated to the analysis of MFIs.

First, with regard to professionalism, it would appear to make sense to involve an established rating agency with an international reputation. This would be of particular importance depending upon the intended users of the ratings service. If it is to be expected that foreign institutions will eventually be allowed to invest in and/or lend to BPRs, then the importance of an international linkage increases. It is also uncertain whether there is adequate depth and knowledge in the domestic industry to ensure the sufficient professionalism required of an independent rating agency vis-à-vis the foreign investment community. Furthermore, foreign donors, microfinance investment funds, and multilateral and bilateral funding institutions have built up significant experience with the established microfinance rating institutions such as M-CRIL and PlaNet Finance. It would make considerable sense to build upon the knowledge, experience, and international reputation of such organizations, especially in the case of Indonesia where there are so many vested interests pottentially at stake.

Second, as learned during the course of this study, there is an increasing trend on the part of domestic commercial banks to enter into the business of providing small and micro loans to clients directly, thus bypassing the BPRs, in their capacity as intermediaries, to reach this segment of borrowers. This trend, depending upon its development and whether it will have a significant negative impact on the business of particular BPRs and the industry as a whole, will also determine the identity of the most appropriate owners of the rating agency. It is not impossible to imagine a scenario in which BPRs (at least those active in urban areas where commercial banks believe they can compete on a profitable basis) will lose a significant share of their business to commercial banks. In this case, it is likely that the microfinance activities of the commercial banks will be incorporated in ratings provided by mainstream rating agencies such as Moody's and Standard & Poors. To this end, Moody's has already rated at least one commercial bank which focuses predominately on microfinance lending, namely Acleda bank in Cambodia. While the structure of the microfinance business in Indonesia is quite different from that in Cambodia and is considerably more developed and complex, such a scenario should be taken into account when considering the establishment of an additional independent rating agency in Indonesia given present developments in the commercial banking market. Contrary to many other countries, Indonesia does not have a history of significant involvement of NGOs in the provision of microcredit. Therefore, it is important to carefully monitor the impact on the BPR industry of the developing interest of commercial banks in this sector when considering the parties best placed to provide rating services in the Indonesian context.

The identity of potential owners of a microfinance rating agency is also likely to depend upon the volume of funds expected to be attracted into the microfinance sector. Again, the greater the volume of funds, sourced both domestically (individual depositors, banks, insurance companies and other non-bank financial institutions) and from foreign investors, the greater would be the necessity to ensure that a party with an international reputation is involved in providing ratings. It is unlikely that a purely domestic player with no prior reputation of providing ratings would be able to ensure the expertise and impartiality necessary to underpin significant investment in the microfinance sector in Indonesia.

6.4. Cost Estimate of the Establishment and Operation of a Rating Agency

Based on a past exercise, M-CRIL has estimated the cost of providing a rating of a BPR at between $2000-3000. It has not been possible to conduct further analysis concerning cost estimates in the framework of this study. However, it is likely that the full cost of providing an individual rating would be somewhat higher depending primarily on the volume of BPRs and other MFIs to be rated and the composition of the personnel (local vs. international) to be employed by the rating agency.

6.5. Potential Sources of Payment for Ratings/Establishment of a Rating Agency

There are several potential sources of payment for ratings themselves as well as for the establishment (if ultimately necessary) of a dedicated microfinance rating agency. First, as mentioned above, CGAP/IDB provide partial financing for ratings of microfinance institutions and could conceivably provide financing for BPRs to be rated. However, given the significant number of BPRs which could potentially be rated (approximately 1500-2000), it would appear unrealistic to depend on CGAP to provide financing for more than a small share of such institutions.

Depending on the evolution of the market and assuming the continuation of lending by commercial banks to BPRs, it might be possible to share the cost of individual ratings between a number of commercial banks. As these banks would benefit from the cost savings associated with outsourcing the analysis of individual BPRs, they might be willing to pay for this service. One idea to consider would be the payment of an ongoing monthly retainer by each commercial bank or other service subscriber plus an additional fee per individual rating requested.

Yet another source of payment for ratings could be the more traditional model whereby payment is made by the rated BPRs themselves or alternatively by the specific institutions (banks, donors, investors, etc.) requesting ratings on case by case basis.

Based on similar logic, a group of commercial banks active in lending to BPRs could become shareholders and/or provide debt to the newly formed independent rating agency. In the case of equity stakes, care must be taken to ensure a fair and wide distribution of shares which would not allow any one commercial bank to gain disproportional influence over the rating agency. Another source of debt and/or equity in such a rating agency could be the IFC (as long as the rating agency is privately held) or the ADB as well as a number of bilateral development institutions such as KfW or FMO for example. Finally, the institution providing the industry expertise (M-CRIL, PlaNet Finance or even Moody's or Standard & Poors) should hold a stake in the newly formed special purpose company. While this discussion is intended to provide food for thought, the overriding idea to keep in mind is that the composition of ownership in any newly formed rating agency should ensure the preservation of its independence and its ability to provide confidence in terms of quality of its analysis to investors purchasing its services.

6.6. Conclusion and Possible Way Forward

In conclusion, based on discussions with commercial banks, BPRs, PNM, Bank Indonesia, and other industry players, the establishment of an independent rating agency to rate BPRs could be a welcome development in the industry. However, given the present Indonesian context in which commercial banks are beginning to devote considerable effort and expense to reaching the small and micro customers directly without using the BPR system as an intermediary, before establishing a new rating agency, care must be taken to further understand this trend and its resulting impact on the existing and future universe of BPRs. In addition to the accurate definition of its customer base (commercial banks vs. BPRs, donors vs. professional investors), any newly formed rating agency should, above all, be structured in a way so as to ensure its independence from vested interests and the quality of its professional reputation and analysis.

VII. Recommendation: Strategies to Increase Commercial Banks' Financing to Rural Bank's

Strategy 1: Provision of incentives to commercial banks

a. Bank Indonesia to provide data on BPR with potential to obtain financing from commercial banks (BI's soundness ratings: Sound and Reasonably Sound)
b. Bank Indonesia to provide "Early Warning Signal" to BPRs that obtain financing from commercial banks and then experience problems, especially with management
c. Definition of commercial banks' Small Business Loans to be expanded to include their channeling of credit to BPR
d. Revision of Bank Indonesia Regulation on PPAP [Loan Loss Reserve] and ATMR [Risk-Weighted Assets], in connection with Collateral
e. Channeling of loans to sound BPR: ATMR to be calculated at 25%.

Strategy 2: Revise of Bank Indonesia and Government Regulations relate to BPR's operation

a. Bank Indonesia Regulations should be revise
   - Evaluation of BPR's collectibility
   - BPR's paid-up capital (relate to time period)
   - BPR can open only one branch in a year
   - A BPR can open a payment office in a same regency/city of main office
   - "BPR may not engage in other enterprises" to be relaxed or permitted in participation related to its industry (referred to UU Number 7/1992 on Banking, Article 7b)
   - BPR may buy collateral goods from debtors, like commercial banks (referred to UU Number 10/1998, Article 12A on Amendment of UU Number 7/1992 on Banking)
   - Provisions on identification to open an account (set an age limit)

b. Government Policies should be revise
   - Tax not to be assessed on dividends provided as paid-up capital of BPR

- Fiduciary issues must be reported to provincial capital Speed up time for checking land certificates with National Land Agency

Strategy 3: Technical Assistance to BPR

a. Outcome: BPR ready to enter into linkages in line with the requirements of commercial banks

b. Technical Assistance required:
   - Standard Operating Procedures (including for BPRs' management administration)
   - Human resource development (including management training and special training for Account Officers)
   - Development of IT (including standard reporting software for reporting to Bank Indonesia)

Technical assistance needed by BPR in connection with upgrading the quality of human resources and information technology

The technical assistance needed to upgrade BPRs' human resources has to do mostly with computerization, information technology and marketing (Account Officers). Having upgraded skills in technology and computerization, they say, would create greater efficiency for the BPR. In one example, by increasing the computer capabilities of its administrative staff, the BPR succeeded in reducing its overhead costs by reducing the number of employees the administrative section from two or three persons to only one.

In another BPR in East Java, the loan operations system, both for determining and recording loans, which is still done manually, is felt to be a major weakness in competing with commercial banks. This is especially important with regard to the accuracy of the data and the efficiency (speed) of its management.

Strategy 4: Commercial Bank – Rural Bank cooperation scheme for the next three years

a. The commercial bank loan pattern is executing, with a proportion of executing current account to executing on the installment pattern of 50%:50% or 40%:60%.

b. Term of loans to BPR to be increased to 3-5 years, to allow for a change in the allocation of BPRs' financing, specifically to support development in the industrial sector.

c. Proportion of commercial bank financing in the form of joint financing to be expanded

d. Provision of collateral by BPRs to be made possible in various forms (collateral substitutes), not necessarily only fixed assets

Strategy 5: Establishment of an Independent Rating Institution

a. Outcome: Commercial banks obtain information on the BPR to be financed and their financing prospects
b. Commercial banks and BPR strongly support the establishment of an independent rating institution in Indonesia
c. However, the Commercial banks voiced some concerns which would require further analysis including:
    - Legal Issues: Sharing of BPRs' data with other institutions (other than Bank Indonesia) and bank secrecy (Bank Indonesia law and other legal regulations);
    - Credibility, accuracy and validity of the rating provided;
    - Impact of publication of ratings on public's level of trust in BPRs;
    - Ownership structure of the proposed rating agency; and
    - Cost of ratings.