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POLICY MEMO

Optimizing Financial Access for Growth-Oriented MSMEs in Indonesia

Indonesia has over 64 million micro, small, and medium enterprises (MSMEs), which account for 61 percent of the country's GDP (National Team for the Acceleration of Poverty Reduction 2020). Acknowledging the potential of MSMEs in driving economic growth, numerous government programs and services offered by private sectors exist to expand financial accessibility. Nevertheless, there are untapped opportunities to optimize financial access to MSMEs that need assistance in achieving their growth aspirations.

KEY RECOMMENDATION

Both financial institutions and the government can benefit from better data integration and utilization. Creating models based on information from loan officers or psychometric measures from pre-loan surveys can increase the efficiency of the loan approval process and monitoring costs, allowing financial institutions more time to assist new clients. For the government, integrating available data allows the opportunity to evaluate the influence of services on business outcomes and household welfare. To improve microcredit programs, modifying its models to allow flexible repayment options can improve business outcomes. Lastly, collaborations to conduct pilot and rigorous impact evaluations have the potential to inform the innovation of financial products aimed to widen financial access.

BACKGROUND

The Government of Indonesia aims to increase the production of value-added goods, the number of people employed, investment, exports, and economic competitiveness in The National Medium-Term Development Plan (RPJMN) 2020 – 2024. To achieve this, the government is widening financial access for MSMEs through multiple programs, such as People Business Credit (KUR), Ultra-micro Credit Financing (UMi), and group loans for underprivileged women by PT. Pemodalan Nasional (PNM) (Cai et al. 2024).

Despite these efforts, many entrepreneurs still face constraints in accessing credit. From the supply perspective, most government-backed credit programs are concentrated in Java. Outside of the three major state-owned banks with many regional branches, banks have little interest in expanding their clients to micro and small enterprises due to limited capacity and risks of non-performing loans (Cai et al. 2024).

From the perspective of MSMEs, the lack of demand is due to several reasons. First, specifically for KUR, the interest rate is still deemed high by micro and small enterprises and documentary prerequisites, such as business registration, is deemed arduous with no guarantee of approval. Second, many entrepreneurs do not know the available loan options. Third, credit products that banks offer do not take into account the constraints that women-led enterprises face. With limited information and perceived risks, many entrepreneurs prefer to borrow from family and friends or through informal means despite their high interest (Cai et al. 2024).

POLICY INSIGHTS

Past evaluations conducted in several developing countries provide insights into innovations that can identify growth-oriented businesses and widen financial access for MSMEs.

1. Using available data Information from loan officers or collecting additional psychometric data can assist in identifying firms with potential growth.

Based on several evaluations related to microfinance, targeting high-potential entrepreneurs increases the impact of microcredit on measures such as profit and household incomes (J-PAL Policy Insights 2023). To effectively identify firms with growth potential, creating a model using the entrepreneur's characteristics (e.g., gender, age, number of years in business) and qualitative measures (e.g., business income stability judged by loan officers) can increase the efficiency of loan approval. **The mixed method was found to reduce the number of undecided loans by 41.8 percent, reduce the probability of collecting additional information by 27 percent and reduce the probability of default by 12 percent** (Paravisini and Schoar 2013). Alternatively, the use **of machine learning that mixes past financial information and psychometric data** (e.g., personal initiative, preference for flexible schedule) taken from a survey that applicants fill out pre-loan **can assist in identifying high-performing loans and reduce misidentification made by loan officers** (Bryan, Karlan, and Osman 2023).

Using available financial data and collecting additional information through surveys can benefit the government and financial institutions. For financial institutions, using information from field loan officers or collecting additional surveys can create models that increase the efficiency of the loan approval process and reduce the cost and time spent screening and monitoring clients. An increase in efficiency allows more time for loan officers to find and assist new clients. The growing application of artificial intelligence in loan screening and monitoring are under-explored areas, conducting pilot and rigorous evaluations in this area can improve bank management schemes and provide insights on how to target firms with high potential growth.

The data collected by private and state-owned financial institutions can also benefit the government program designs. Currently, banks send data of KUR recipients to the Ministry of Finance (SIKP), while a general credit data registry to the Financial Information Service System (SLIK) hosted by the Financial Service Authority (OJK). If the two databases are integrated with national IDs as unique identifiers in the upcoming MSME database,[1] this information can be utilized by the government to improve the targeting and evaluate the impacts of programs that are designed to promote firms' growth (Kredit Usaha Rakyat Kementerian Koordinator Bidang Perekonomian Republik Indonesia n.d.). For example, banks delivering KUR can confirm if applicants have previously received non-subsidized loans using SLIK. Additionally, the collection of national IDs allows the government to regularly monitor the condition of firms using national surveys, such as the National Socioeconomic Survey (SUSENAS) and the National Labor Force Survey (SAKERNAS).

2. Modifying the traditional microcredit model, such as grace periods and flexible repayment options, can improve business outcomes.

Microcredit has expanded around the world to assist low-income borrowers. Multiple evaluations have been conducted on traditional microcredit models and found it only holds a significant impact among entrepreneurs with experience (J-PAL Policy Insights 2023). A study in Mongolia, the Philippines, and Bosnia and Herzegovina, found that the demand for microfinance was higher among borrowers who had already expressed interest or applied for loans (Karlan and Zinman 2011; Attanasio et al. 2015; Augsburg et al. 2015). The findings are consistent with the landscape in Indonesia, as the Coordinating Ministry of Economic Affairs highlights several applicants of the KUR program have previously received unsubsidized loans from regional and private banks.

Modifying the traditional microcredit model may be necessary to expand and increase the demand for microcredit among small-scale business owners. Traditional microcredits are often characterized by high repayment frequency, biweekly or weekly payments, immediately after loan disbursement. While some borrowers may prefer this mechanism to promote discipline, the stringent requirements may also create barriers for small-scale businesses with irregular cash flows. By offering microcredit products with grace periods or flexible repayment options, firm owners may be able to withstand negative shocks and invest in riskier higher-return investments.

Four studies evaluated the impact of flexible loans (Aragón, Karaivanov, and Krishnaswamy 2020, Barboni and Agarwal 2023, Battaglia, Gulesci, Madestam 2023, Brune, Giné, and Karlan 2024). In India, a flexible microcredit product that allowed borrowing and repayment at any time increased profits by 15 percent, and borrowers were no more likely to default after four months (Aragón, Karaivanov, and Krishnaswamy 2020). A second study in India also found that **allowing borrowers to defer payments at a time of their choosing also increased monthly profit and sales** (Barboni and Agarwal 2023). **The likelihood of borrowers repaying the full loan early also increased by 33 percent after three years.** However, a study conducted by Brune, Giné, and Karlan (2024) revealed that the impact of flexible payments limited when given to first-time borrowers, as their default rates increased when given flexible options by 5 percent, with no changes in profit. Clients who opted for flexible schedules are faced with volatile sales and those who were more willing to take on business risks such as investing in tools and machines. A similar model can be piloted by private financial and non-financial institutions that may have limited field officers but are looking to expand their market among micro and small enterprises.

3. Identifying key barriers faced by female-led firms and piloting interventions to reduce such barriers has the potential to increase female access to credit.

Evaluations on microcredit products and cash or in-kind transfers have showed little to modest impact for the average borrower. High returns among micro-enterprises were largely found only among experienced firms and male-led firms. To explain the gendered differences, several studies point to intra household dynamics, women being more likely to invest in non-business activities, or women's tendency to self-select into less profitable sectors due to the preference for flexibility (Fafchamps et al. 2014, Berge, Bjorvatn, Tungodden 2015, Fiala 2018). However, these impacts may not hold true for small enterprise and loan products which do not follow the traditional microcredit model.

1 The national MSME database is currently being developed by the Ministry for Cooperative, Small and Medium Enterprise.

In the context of Indonesia, while bank account ownership and intrahousehold dynamics may not be a barrier for women, the average women-owned firm remains to have significantly less profit, sales, and employees compared to the average male-owned firms. Indonesia possesses a high number of female entrepreneurs, which mostly work in trade (50 percent), and manufacturing, specifically the home-based industry (24 percent), and service industry (13 percent) (World Bank 2016). **Based on the 2018 Financial Inclusion Insight Survey (FII) there is a small gender gap in account ownership and strong norms around women managing household finances** (Moorena et al. 2020). Despite having supportive spouses and equal decision-making in their households, based on interviews with female business associations and a survey conducted by the World Bank in 2016 women entrepreneurs still have limited access to assets that can secure loans (World Bank 2016). Furthermore, a focus group discussion among female-led businesses operating in rural areas identified additional challenges due to cultural and societal norms. The discussion found women in rural areas face harder times accessing government offices and services that are not close to their communities, they also faced discomfort when dealing with officials who are mostly men (International Finance Corporation 2016).

Female-led firms, especially those with aspirations to grow, are a largely untapped market. According to a 2022 survey conducted by the National Statistics Bureau (BPS), more than 70 percent of micro and small firms are led by women (BPS 2022). By identifying key barriers faced by female-led firms and piloting interventions to reduce such barriers, both financial and non-financial institutions can play a role in unlocking the potential of female-led firms to grow and contribute to Indonesia's economic development.

4. The recent rise of digital lending has the potential to optimize financial access, however more evaluations are needed to assess how features of these products can benefit MSMEs.

The digital lending sector is a growing but relatively new market both in Indonesia and many other low- and middle-income countries. There are multiple business models that exist in Indonesia, including banks and fintech companies who digitized loan products and fintech companies that channel loans through peer-to-peer (P2P) lending. Digital lending offers the opportunity to reduce the limitation of conventional lending by simplifying the application process, ease repayment, and using digital footprints (e.g. e-commerce transactions, internet use) to define eligibility and remove collateral.

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Early learnings have shown mixed results when transitioning microcredit to a digitized product. A study in Uganda found converting to e-money disbursement significantly increased the profits for female entrepreneurs (Riley 2022). While a study in the Philippines revealed digitizing microfinance loans led to decreased savings and increased exposure to transaction fees (Harigaya 2020). In the context of Uganda, the repayment policies had to still be done in person through group meetings, while in the Philippines women had the ability to repay digitally outside group meetings. These different results suggest the impact of digital credit on borrowers can vary depending on the design of the product and the context in which it is used.

More evaluations are needed to understand how these products can benefit MSMEs. While digital lending holds a valuable tool to widen financial access, there are also risks of costly debt cycles given the interest rates tend to be higher compared to conventional loan products. Collaborations between banks, fintech companies and researchers to measure the welfare impact from digital loans can provide valuable insights to inform upcoming innovations and regulations in this growing sector.

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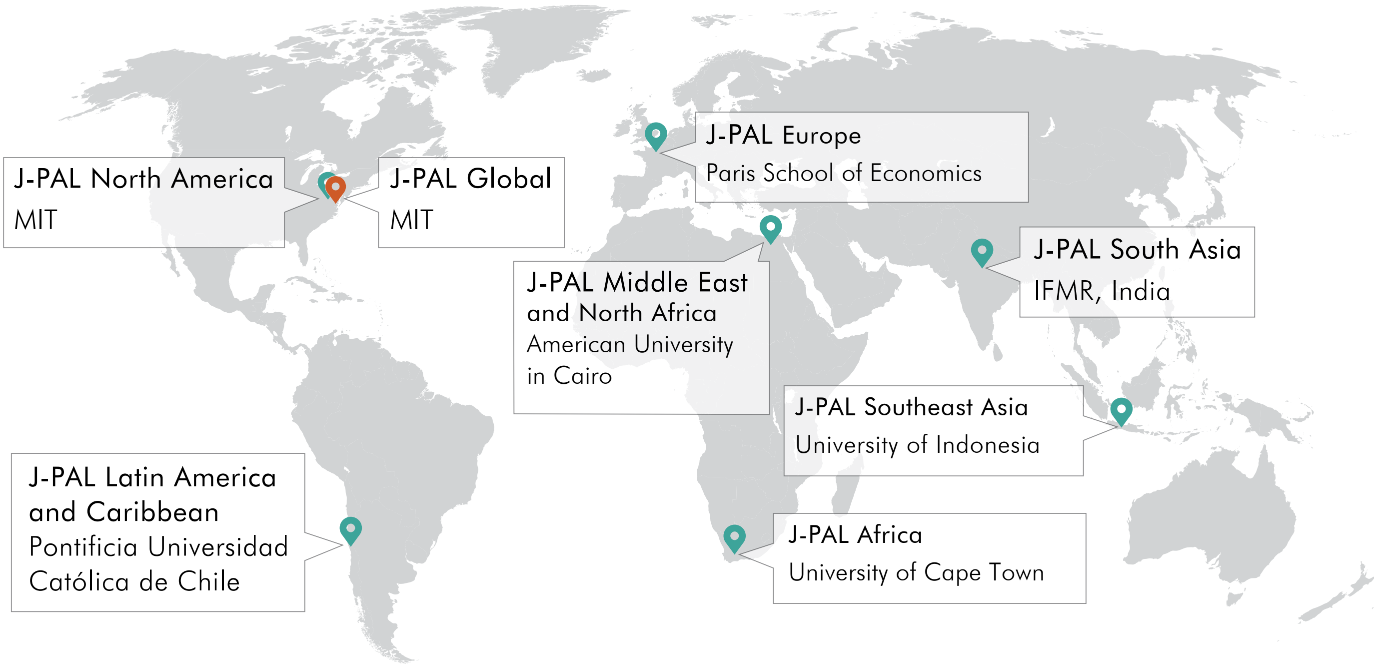

ABOUT J-PAL AND J-PAL SOUTHEAST ASIA

The Abdul Latif Jameel Poverty Action Lab (J-PAL) was established in 2003 as a research institute within the Economics Department of the Massachusetts Institute of Technology (MIT), Cambridge. J-PAL believes that development can be more effective if policymakers and implementers have access to rigorous evidence of what programs and policies work or not, and why. Currently, J-PAL has over 750 affiliated researchers who have more than 1,600 completed and ongoing evaluations in more than 80 countries. These projects rigorously test the effectiveness of programs in areas including health, education, finance, labor markets, environment, governance, and agriculture.

In 2013, then-Indonesian President Susilo Bambang Yudhoyono launched the Abdul Latif Jameel Poverty Action Lab Southeast Asia Regional Office (J-PAL SEA) in Jakarta under the Faculty of Economic and Business, Universitas Indonesia. J-PAL SEA's mission is to equip policymakers with rigorous evidence to inform the design of social programs that will make a lasting contribution to poverty reduction in Indonesia and the Southeast Asia region.

For more information: https://www.povertyactionlab.org/southeast-asia