Positive Outlook for MSME Loans

Analyst: Adrian Noer

Micro, small, and medium enterprises (MSME) in Indonesia have acquired good momentum for growth in line with the growing economy and support from the government. This support can be seen in some of the existing laws, and regulations issued by Bank Indonesia (BI), to boost MSME loan growth. Despite the high risk profile of the debtors, PEFINDO believes MSME loans will continue to grow positively in the medium term, as the banks are also trying to optimize their revenue profiles by capturing high margin business, including lending to MSMEs.

Regulatory environment supportive to potential growth in MSME loans

Based on Bank Indonesia Regulation (PBI) No.14/22/PBI/2012, the definition of the MSME segment is as follows:

1. Micro enterprises are a productive business belonging to individuals or a company that has a net worth value of up to IDR50 million, or has an annual sales value of up to IDR300 million
2. Small enterprises are a productive business belonging to individuals or a company that has a net worth value of between IDR50 million and IDR500 million, or annual sales of between IDR300 million and IDR2.5 billion
3. Medium enterprises are a productive business belonging to individuals or a company that has a net worth value of between IDR500 million and IDR10 billion, or an annual sales value of between IDR2.5 billion and IDR50 billion.

Rules and regulations issued either by the government, or by BI as the central bank, show a positive signal of support from the government related to the development of the MSME industry. Under PBI, banks in Indonesia are required to increase their MSME loan portfolio starting at 5% in 2015 and rising to 20% in 2018. Other regulations such as Law No. 20/2008 regarding micro, small, and medium enterprises also support MSME development. The regulation is divided into several sections that describe critical factors to support MSME development, including business climate, business development, financing and guarantees, and partnerships.

PEFINDO believes this requirement may result in an increasing penetration of MSME loans in the medium term. As of December 31, 2014 (FY2014), MSME loans in Indonesia had reached IDR707 trillion, up by 10.5% from IDR640 trillion as of FY2013. In terms of percentage, MSME loans contributed 18.7% of the total banking industry loans as of FY2014, slightly down from 18.9% as of FY2013.

MSME loan concentration to major players

Amid positive growth in MSME loan penetration, PEFINDO views the major players as still dominating the segment due to their strong experience, robust infrastructure, and strong risk management capability. As of December 31, 2014, PT Bank Rakyat Indonesia Tbk (Persero) (rated $_{id}$AAA/stable) was the largest MSME lender, with an outstanding balance of IDR153 trillion or 21.6% of total MSME loans in the industry. Other banks that have made a significant contribution to MSME loans included PT Bank Mandiri Tbk (Persero) (rated $_{id}$AAA/stable) of IDR93 trillion as of December 2014 (13.2%) and PT Bank Danamon Indonesia Tbk (rated $_{id}$AAA/stable) of IDR46 trillion (6.5%). In the near to medium term, PEFINDO projects that these banks will continue dominating MSME lending despite an increasing contribution from other banks to comply with PBI that will require a 20% portion of MSME loans by 2018.

BI publication data shows that MSME loans are dominated by major players, including government banks, regional banks and private banks. Based on the bank classification distributing the loans, as of December 31, 2014, government banks were the largest contributor with outstanding loans of IDR341.8 trillion (48.3%), followed by private foreign exchange banks of IDR231.0 trillion (32.7%), regional banks of

IDR50.8 trillion (7.2%), rural banks of IDR35.4 trillion (5.0%), private non-foreign exchange banks of IDR30.4 trillion (4.3%), joint-venture banks of IDR13.5 trillion (1.9%), and foreign banks of IDR4.3 trillion (0.6%). In terms of segmentation, medium enterprise loans held the largest share of MSME loans at 47.5% as of FY2014, followed by small enterprises (29.7%), and micro loans (22.8%).

The disbursement of MSME loans is heavily concentrated on Java Island, as it is the center of business and economic activities in Indonesia. As of December 31, 2014, based on main project locations by provinces, 15.2% of loans were disbursed in Jakarta, followed by 11.8% in East Java, 11.1% in West Java, 13.4% in Central Java, 6.8% in North Sumatra, and the rest in other areas. This is in line with the overall loan composition by region, indicating that business activities are still concentrated in those areas. In the near to medium term, PEFINDO believes that with the government's focus on boosting infrastructure development, other parts of the country will experience growing economic activities resulting in increased loan penetration, including in the MSME segment.

Table 1: MSME loan contribution and number of accounts, 2011-2014

	2011	2012	2013	2014
MSME loans [IDR bn]	479,887	552,226	640,035	707,141
Non MSME loans [IDR bn]	1,779,976	2,226,731	2,742,839	3,072,234
Total bank loans [IDR bn]	2,259,862	2,778,957	3,382,873	3,779,376
MSME loans to total loans [%]	21.2	19.9	18.9	18.7
MSME number of accounts [#]	8,797,888	9,078,322	10,139,606	10,953,682

Source: Bank Indonesia

Table 2: MSME loans based on bank's classification (in IDR billion), 2011–2014

	2011	2012	2013	2014
Government bank	222,645	242,861	304,751	341,804
Private foreign exchange bank	176,925	205,731	217,529	230,998
Private non- foreign exchange bank	17,309	23,260	27,572	30,367
Regional bank	31,314	45,082	46,896	50,837
Joint-venture bank	6,651	8,750	11,379	13,467
Foreign bank	3,320	713	697	4,247
Rural bank	21,723	25,830	31,211	35,420
Total	479,887	552,226	640,035	707,141

Source: Bank Indonesia

Table 3: Top 3 MSME loan banks (in IDR trillion), 2011-2014

	2011	2012	2013	2014
MSME loans	480	552	640	707
BRI MSME loans	98	115	142	153
Mandiri MSME loans	42	57	74	93
Danamon MSME loans	31	36	41	46

Source: Bank Indonesia and PEFINDO

According to a Bank Indonesia report based on economic sectors, the trading and retail trading sector was the largest sector for MSME loans at 52.7% during FY2014, followed by the processing industry (9.7%) and agriculture and forestry (8.4%). Based on economic sectors for the overall banking industry's loans, the trading sector is also the largest contributing sector over all. The increasing bank loans to the trading sector will indirectly have a positive impact on the growth of MSME loans. PEFINDO expects the trading sector will deal with the slowing down of economic conditions given that the margin in this segment is quite high and the products sold can be adjusted following current market trends.

High credit risk compensated by high margin

The non-performing loan (NPL) ratio for MSME loans as of December 31, 2014 rose to 3.9% from 3.4% in 2012 and 2013. This was partly due to the slowing down of the national economy. Although it is still below 5%, the ratio is considered high compared to a 2% NPL for overall loans. For banks that dominate MSME loans, only Bank BRI maintained its NPL in micro loans due to its long history and expertise in the segment, while other major players such as Bank Mandiri and Bank Danamon have higher NPL figures. As most MSME debtors engage in informal sectors and have limited management capability to record their business and financial activities, as well as strategies to overcome the economic downturn, PEFINDO believes MSME loans bear a higher credit risk profile compared to other loan segments.

Table 4: NPL of micro loans from BBRI, BMRI, and BDMN

	Latest	2013	2012
[%] BBRI (FY2014)	1.1%	1.0%	1.1%
[%] BMRI (1H2014)	3.3%	3.0%	3.2%
[%] BDMN (1H2014)	6.5%	5.9%	5.3%

Source: PEFINDO

PEFINDO believes the high credit risk of MSME loans can be mitigated by implementing several strategies. The first step to mitigate the credit risk is by applying a prudent loan underwriting policy. This strategy includes assessment of the debtor's business profile and character. The track record of the debtor, supplier relationships, buyer relationships, how long the business has been operating, are essential information that a bank should gain from the debtors. Collateral assessment is another important factor when reviewing MSME loans. As the last resort and last way out when a loan is in default or has a problem, a bank needs to know the current condition of the collateral. The bank needs to appraise the collateral using an internal appraisal or an independent appraisal to discover information such as, the current market price of the collateral, the current liquidation price of the collateral, ownership status, the marketability and accessibility of the collateral. The bank must also have an internal policy related to the collateral coverage ratio. The bank has to make sure that the collateral coverage ratio is sufficient to pay out the loan when it defaults. Another important strategy relates to monitoring and collection. MSMEs have a quick turnaround in terms of transactions and funds, which can be done several times within one day. To anticipate this fast movement, a bank that disburses a loan to this segment needs to monitor and collect from its MSME debtors on a daily basis. Daily collection will also make it easier for the debtors to repay their loans, rather than on a monthly basis. By applying and executing these strategies, PEFINDO expects that a bank engaged in MSME loans will have optimum profit and benefit without sacrificing its credit quality performance.

The high-risk profile of MSME loans is compensated by a high lending rate, resulting in a high margin. This has attracted many banks to secure maximum profit from MSME loans. Looking at Bank BRI, Bank Mandiri, and Bank Danamon as the dominant banks in the MSME segment, we can see that from BI prime lending rate data as of December 2014, these banks charged a higher lending rate for micro loans compared to other loan segments. PEFINDO projects that the banks will continue their high margin business model despite tightening competition, as the high margin is required as a buffer to support potential credit risk and resources allocation for the MSME segment.

Table 5: Lending rate for micro loans compared to other loans as of FY2014 (in % per annum)

	Micro loan	Retail loan	Corporate loan
BBRI	19.25	11.75	11.00
BMRI	19.25	12.25	10.50
BDMN	20.81	13.25	12.30

Source: PEFINDO

Another condition that could affect MSME loan growth is tight liquidity conditions that end with a high cost of funds. The tight liquidity profile can be seen from the high loan to deposit ratio (LDR) from banks in Indonesia of 89.7% in 2013 and 88.9% in FY2014, much higher than 83.6% in 2012. This high LDR was caused by the high cost of funds following the increase in the BI rate at the end of 2013 to 7.5% and to 7.75% in December 2014. This condition resulted in higher cost of funds and PEFINDO believes it will still exist in the near to medium term. With a higher cost of funds, most banks in Indonesia tend to increase their loans to the MSME segment, where they can charge a higher rate and get a higher profit.

Table 6: MSME loans compared to BI rate, NIM, NPL, 2011-2014

	2011	2012	2013	2014
BI Rate [%]	6.00	5.75	7.50	7.75
NIM [%]	5.91	5.49	4.89	4.23
MSME loans [IDR bn]	479,887	552,226	640,035	707,141
Non MSME loans [IDR bn]	1,779,976	2,226,731	2,742,839	3,072,234
MSME NPLs [%]	3.63	3.40	3.40	3.94

Source: Bank Indonesia