

A Study on the Performance of Credit Guarantee Schemes for Micro and Small Enterprises
in Indonesia

by

Embun Suryani

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Approved by the Dissertation Committee:

Sanae ITO (Chairperson)

Yuzuru SHIMADA

Christian S. OTCHIA

Naoko SHINKAI (External Examiner)

Approved by the GSID Faculty Council: March, 2020

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LIST OF ABBREVIATIONS

ACCA	: Association of Certified Chartered Accountant
ADB	: Asian Development Bank
AO	: Account Officer
Askrindo	: <i>Asuransi Kredit Indonesia</i> (Indonesian Credit Insurance)
BCA	: <i>Bank Central Asia</i>
BI	: <i>Bank Indonesia</i> (Indonesian Central Bank)
BII	: <i>Bank Internasional Indonesia</i>
BNI	: <i>Bank Negara Indonesia</i>
BPD	: <i>Bank Pembangunan Daerah</i>
BPD NTB	: <i>Bank Pembangunan Daerah Nusa Tenggara Barat</i> (The regional Bank of West Nusa Tenggara)
BPR	: <i>Bank Perkreditan Rakyat</i> (Rural bank)
BPS	: <i>Badan Pusat Statistik</i> (Central Bureau of Statistic)
BRI	: <i>Bank Rakyat Indonesia</i>
BTN	: <i>Bank Tabungan Negara</i>
BTPN	: <i>Bank Tabungan Pensiunan Negara</i>
CAC	: Conditional Automatic Cover
CBC	: Case by Case
CGA	: Certified General Accountant
CGC	: Credit Guarantee Corporation
CGS	: Credit Guarantee Scheme
CGTMSE	: Credit Guarantee Fund Trust for Micro and Small Enterprises
CO	: Chief Officer
CPA	: Certified Public Accountant
CSBFP	: Canadian Small Business Financing Program
Disperin Provinsi NTB	: <i>Dinas Perindustrian Provinsi Nusa Tenggara Barat</i>
EA	: Economic Additionality
ECG	: Emergency Credit Guarantee
FA	: Finance Additionality
FAMPE	: <i>Fundo de Aval à Micro e Pequenas Empresas</i>
FIs	: Financial Institutions
GDP	: Gross domestic product
GRDP	: Gross Regional Domestic Product
IJP	: <i>Imbal Jasa Penjaminan</i> (Guarantee Fee payment)
IPO	: Initial Public Offering
KADIN	: <i>Kamar Dagang dan Industri</i> (Chamber of Trade and Industry),
KGF	: <i>Kredi Garanti Fonu</i> (Credit Guarantee Fund)
KIBO	: Korea Technology Finance Corporation
KODIT	: Korea Credit Guarantee Fund
KUR	: <i>Kredit Usaha Rakyat</i>
LJKK	: <i>Lembaga Jaminan Kredit Koperasi</i> (Co-operation Credit Guarantee

	Corporation
LPG	: Loan Portfolio Guarantee
MEM	: Marginal Effects at the Mean
MOF	: Ministry of Finance
MSE	: Micro and Small Enterprise
MSME	: Micro, Small, and Medium Enterprise
NERA	: National Economic Research Associates
NPGS	: New Principal Guarantee Scheme
NTB	: <i>Nusa Tenggara Barat</i> (West Nusa Tenggara)
OECD	: Organization for Economic Co-operation and Development
Perum Jamkrida	: <i>Perum Jaminan Kredit Daerah</i>
Perum Jamkrindo	: <i>Perusahaan Umum Penjaminan Kredit Indonesia</i> (Indonesian Credit Guarantee, Ltd.)
Perum PKK	: <i>Perusahaan Umum Pengembangan Keuangan dan Koperasi</i> (Finance Cooperative and Development, Ltd.)
Perum SPU	: <i>Perusahaan Umum Sarana Pengembangan Usaha</i>
PGS	: Public Guarantee Scheme
PMK	: <i>Peraturan Menteri Keuangan</i> (Regulation of Ministry of Finance)
PT. ASEI	: <i>Perseroan Terbatas Asuransi Ekspor Indonesia</i>
PT. PKPI	: <i>Perseroan Terbatas Penjaminan Kredit Pengusaha Indonesia</i>
PT. PNM	: <i>Perseroan Terbatas Permodalan Nasional Madani</i>
RCGC	: Regional Credit Guarantee Corporation
SASB	: Sustainability Accounting Standards Board
SBCGC	: Small Business Credit Guarantee Corporation
SBLA	: Small Business Loan Act
SEBI	: Surat Edaran Bank Indonesia
SFLG	: Small Firm Loan Guarantee
SGS	: State-funded Guarantee Scheme
SME	: Small and Medium Enterprise
SOE	: State-Owned Enterprise
SP	: <i>Sertifikat Penjaminan</i> (Guarantee Certificate)
SP3	: <i>Surat Persetujuan Prinsip Penjaminan</i>
USAID LPG	: U.S Agency for International Development Loan Portfolio Guarantee
US SBA	: United States Small Business Administration

CHAPTER 1

Introduction

1.1. Background of the Study

Micro, Small and Medium Enterprises¹ (hereinafter referred to as MSMEs) play a crucial part in economic activities. A study by CGA (Certified General Accountant), ACCA (Association of Certified Chartered Accountant), & CPA (Certified Public Accountant) Australia concluded that 99% of businesses all over the world were Small and Medium Enterprises (hereinafter referred to as SMEs) and these companies also created jobs for more than half of all industries in the OECD (Organization for Economic Co-operation and Development) countries (reported in Samujh et al., 2012). Besides, these businesses enable the establishment of new initiatives and the development of job openings, generate concepts of innovative products, and boost manufacturing capacities (Nitani and Riding, 2005).

Indonesian MSMEs are no exception. The Indonesian Central Bureau of Statistics (BPS, 2015; p. 294 and 305) reported that the proportion of businesses in Indonesia is dominated by micro and small businesses (99.3% of the total businesses), while the number of medium businesses is only 0.7% of the total businesses. It means the number of large businesses only takes a very small portion of the total business. Furthermore, approximately 57.6% of the total

¹ Indonesian Regulation No. 20, 2008 uses two quantitative criteria for defining Micro, Small and Medium Enterprises: total assets in rupiah (IDR) and annual sales in rupiah (IDR) (BPS, 2009; p. 16). Micro businesses have total assets of no more than 50 million IDR (land and building are not included), and total annual sales of no more than 300 million IDR. Small businesses have total assets of more than 50 million IDR but less than 500 million IDR (land and building are not included), and total annual sales of more than 300 million IDR but less than 2,500 million IDR. Medium businesses have total assets of more than 500 million IDR but less than 10,000 million IDR (land and building are not included), and total annual sales of more than 2,500 million IDR but less than 50,000 million IDR. A business must meet at least one financial criterion to be categorized as a micro, small or medium business. These categories will then become the standard for this study in classifying micro, small and medium enterprises.

Indonesian Gross Domestic Product (GDP) was generated by MSMEs (Bappenas, 2016; p. 5). This resulted in the creation of numerous employment opportunities for Indonesian people, about 88.6% of all jobs. Papiashvili and Ciloglu (2012) reported that the number of people employed by Small and Medium Enterprises (hereinafter referred to as SMEs) is nearly as many as those employed by large enterprises. Moreover, they possess a high capacity to endure financial crises because they are able to tackle abrupt economic disruption better than their partners from the bigger corporations.

However, a number of researchers found that SMEs, especially in developing countries, were confronted with more critical financial limitations compared to their counterparts from big companies (Saadani et al., 2011; Beck and Demirguc-Kunt, 2006; Cull et al., 2007; Riding and Haines, 2001). Small businesses received fewer loans compared to bigger companies. In 2015, for example, only about 19.89% of the aggregate of loans from the national and private banks in Indonesia were given to MSMEs (Bank Indonesia, 2015; p. 1). When gaining access to loans from credit markets, MSMEs were also confronted with diverse chances because of asymmetric information issues that exist between lenders and borrowers. This situation was driven by a shortage of information between the two parties. Thus, this implies that one company is given more or preferable information over another. At this point Craig et al. (2007) assert that these information issues seem to be critical and therefore lead to monetary limitations to small-scale lending and the breakdown of the credit market.

Therefore, many governments have created assistance projects to enable MSMEs to cope with these financing constraints. MSMEs' need for assistance in funding has been recognized by governments worldwide, which have introduced a variety of initiatives for increasing financial access for such firms. Insufficient collateral is one of the reasons that the commercial banks are

less willing to provide loans to SMEs (Saadani et al., 2011; Zecchini and Ventura, 2009; Riding et al., 2007; Boocock and Shariff, 2005). Thus, the most efficient way to improve credit availability for such companies is through Credit Guarantee Scheme (hereinafter referred to as CGS), considering the aim of this scheme is to transfer credit risk, due to the probability of default faced by the commercial banks. These schemes may be able to improve loan distribution for MSMEs by establishing a proper design of loan pricing that is not affected by borrower behavior.

Increasing the availability of loans for SMEs is one of the positive impacts of credit guarantee schemes (Cowling, 2010; Uesugi et al., 2010; Oh et al., 2009; Zecchini and Ventura, 2009; Riding et al., 2007). However, Ono et al. (2013) argued that many empirical studies have yet to demonstrate the economic impact of guarantee programs to these firms, although they are widely implemented around the world to help SMEs that face difficulties in accessing loans. From a theoretical point of view, credit rationing caused by asymmetric information problems can be decreased by employing a guarantee program (Stiglitz and Weiss, 1981). In these programs, the profitable projects can be provided with a loan that could not be attained without the existence of a guarantee program, as a government intervenes to support financial development for SMEs (Riding et al., 2007; Boocock and Shariff, 2005). On the other hand, de Meza and Webb (1987) assert that when some non-profitable projects are provided with loans in a free market suffering from asymmetric information problems, a guarantee scheme might intensify the “over-lending” problem and may hinder credit guarantee schemes from reaching their primary objective.

Asymmetric information as the main obstacle to the implementation of the credit guarantee schemes might originate from the borrower’s side. The borrowers who were informed

about the guaranteed loan may be unwilling to repay the loan because they assume that the loan is from public funds. Previous studies referred to the importance of a relationship between lender and borrower that could diminish informational friction and increase loan availability for the SMEs in regular periods or even in a financial crunch (Ono et al., 2013; Cole, 1998; Petersen and Rajan, 1994). In such a relationship, a lender maintains excellent interaction and communication with potential borrowers. This relationship could enhance the effectiveness of the guarantee schemes to provide loans for small-scale and micro-lending. Ono et al. (2013) also argued that in a close relationship, the lender employs the guaranteed loan to help customers in solving a temporary financial problem. The lender might treat the guaranteed loans as a complementary product to non-guaranteed loans delivered by the bank, and then increase the availability of loans guaranteed by a Credit Guarantee Corporation (hereinafter referred to as CGC) as well as non-guaranteed loans.

Indonesia has long been implementing a guarantee scheme, for over 40 years in fact. According to Hiemann and Noorjaya (2001), however, in 1998 approximately 75% of guaranteed loans provided by Indonesian CGCs experienced losses and underwent reforms several times. The first Indonesian state-owned CGC, known initially as *Lembaga Jaminan Kredit Koperasi* (LJKK), was established in 1970. In 2008, the Indonesian government issued Presidential Regulation No. 2/2008 concerning the Guarantee Agency. To implement the regulation, the Ministry of Finance (hereinafter referred to as MOF) released a regulation concerning the CGC and Credit Re-guarantee Corporation. The regulation stated that *Perusahaan Umum Jaminan Kredit Indonesia* (Perum Jamkrindo)², initially known as LJKK, as the latest form of the

² Perum Jamkrindo, previously known as LJKK, was established on July 1, 1970. The business network is composed of 9 regional offices, 1 Jakarta special branch office, 55 branch offices, and 16 service unit offices (KUP) scattered

Indonesian CGC, holds a business license as a Credit Guarantee Company. Furthermore, the MOF issued Decree No. KEP-77/KM.10/2009, formally establishing a license for the guarantee company to Perum Jamkrindo. The annual report of Perum Jamkrindo described its vision of “being a leading CGC that can support the development of the national economy.” This vision is translated into three missions as follows: 1) implementing CGCs and business consulting to encourage the business development of MSMEs and cooperatives; 2) providing wider and qualified services; and 3) creating benefits to stakeholders based on healthy business principles (Perum Jamkrindo, 2015; p. 67).

Among other things, one serious issue concerning the operation of this program is the efficiency of the scheme. A number of researchers have studied the issue of efficiency as well as the effectiveness of guarantee schemes (Boocock and Shariff, 2005; Riding et al., 2007; Zecchini and Ventura, 2009; Cowling, 2010; and Saadani et al., 2011). So far, the studies on the implementation of guarantee schemes mainly focus on developed countries (Meyer and Nagarajan, 1996). On the other hand, in developing countries, a comprehensive evaluation of this subject has not been conducted. The operational effectiveness of such schemes in developing countries has not been proven. The Indonesian CGC faced the same problem as well, and the efficiency and the ability of this corporation to extend the targeted number of groups facing financial restrictions are still doubtful.

The Indonesian CGC still operates as a subsidiary partner for the commercial banks through implementing the bank’s procedure in providing loans for MSMEs, especially for Micro and Small Enterprises (hereinafter referred to as MSEs). Indonesian Regulation No. 20, 2008

throughout Indonesia. Perum Jamkrindo is 100% state-owned, through the Government of the Republic of Indonesia/Ministry of State-owned Enterprises. The state equity participation is 7,639 billion IDR (1 USD = 14,000 IDR). The number of employees is 1,042 people. (http://www.jamkrindo.co.id/dokumen/laporan_tahunan)

uses two quantitative criteria for defining Micro, Small and Medium Enterprises: total assets in rupiah (IDR) and annual sales in rupiah (IDR) (BPS, 2009; p. 16). Micro enterprise is characterized as an entity which has total assets of no more than 50 million IDR, and total annual sales of no more than 300 million IDR. While, small business has total assets of more than 50 million IDR but less than 500 million IDR, and total annual sales of more than 300 million IDR but less than 2,500 million IDR. These micro and small businesses in Indonesia are still facing the restrictions in accessing loans from national and private banks because of inability to provide enough collateral. These enterprises are characterized as risky borrowers by the commercial banks. The formal financial institutions insist on requesting sufficient collateral to give loan approval, although a guarantee from the CGC is available.

Micro and small businesses are 99.3% of the total businesses in Indonesia, the government initiated a credit program to support financial access for these enterprises. This credit program is one of the essential products of Perum Jamkrindo to encourage the access of loans for the MSEs which is known as *Kredit Usaha Rakyat* (hereinafter referred to as KUR)³ loan. The KUR loan comes from an Indonesian commercial bank's funds which are delivered to the micro and small-borrowers and guaranteed by Perum Jamkrindo. The commercial bank employs its own mechanism for delivering KUR loans, and Perum Jamkrindo provides a guarantee of about 80% of the total loan in case of loan default. Therefore, this study aims to evaluate the implementation and performance of the CGS in Indonesia to support financial access, especially for MSEs, mainly focusing on the KUR loans.

³ KUR is a credit scheme for working and/or investment capital to feasible and productive MSEs & cooperatives which are not yet bankable. Perum Jamkrindo guarantees the KUR loans up to 20 million IDR for the Micro KUR category, while for loans of more than 20 million IDR up to 500 million IDR (1 USD = 14,000 IDR) are included in the Retail KUR category.

This objective is accomplished through exploring the dimensions of quantitative and qualitative approaches. Quantitative dimensions were conducted to investigate the benefit of CGS in Indonesia by evaluating the Financial Additionality (FA) and Economic Additionality (EA). The qualitative dimensions were then conducted by measuring the behavioral aspects and attitude in order to explore the existence of relationships between lenders and borrowers to increase the accessibility of guaranteed loans.

1.2. Research Objectives and Questions

1.2.1. Research Objectives

The broad objective of this study is evaluating the implementation performance of CGS in Indonesia. This evaluation is conducted based on: 1) the operational performance of a guarantor, a case study on Perum Jamkrindo (a state-owned CGC in Indonesia), 2) the benefits of guaranteed loans to the borrowers, and 3) the effort of the lender to reduce the default loan through creating relationships between lender and borrower.

1.2.2. Research Questions

1. Is the operation of Perum Jamkrindo effective based on its ability to create profits, maintain claim rates and recover the claims of defaulted loans?
2. To what extent will the guaranteed loans (KUR loans) of Perum Jamkrindo affect their beneficiaries (MSEs) based on FA and EA?
3. To what extent does lender-borrower relationship affect the accessibility and the terms of guaranteed loans (KUR loans) offered to MSEs? Can the lender-borrower relationship be a driver to raise repayment performance of KUR loans by micro and small borrowers?

1.3. Significance of the Study

Most studies about the evaluation performance of credit guarantee schemes are concerned with additionality. However, Saadani et al. (2011) argued that measuring additionality remains technically challenging because of the complexity of selecting a suitable control group consisting of companies that have similar characteristics to those of the guarantee users. However, Boocock and Shariff (2005) argued that making a suitable control group was not feasible for two reasons. First, "...the various motivations, constraints, and uncertainties affecting smaller enterprises create problems in locating appropriate pairs of firms," (Boocock and Shariff, 2005; p. 14). This problem could lead to systematic biases. Moreover, a reliable national database of MSMEs, which could be beneficial in choosing a control group, is not available, because the province of Nusa Tenggara Barat (NTB) does not have such a database. Second, the lenders provided the guaranteed loan to the MSMEs for different reasons, causing some difficulties in identifying a proper control group with the same characteristics. Therefore, as an alternative method, the overall figures for employment in the micro and small sector, which was collected from secondary sources, were employed for standardizing purposes.

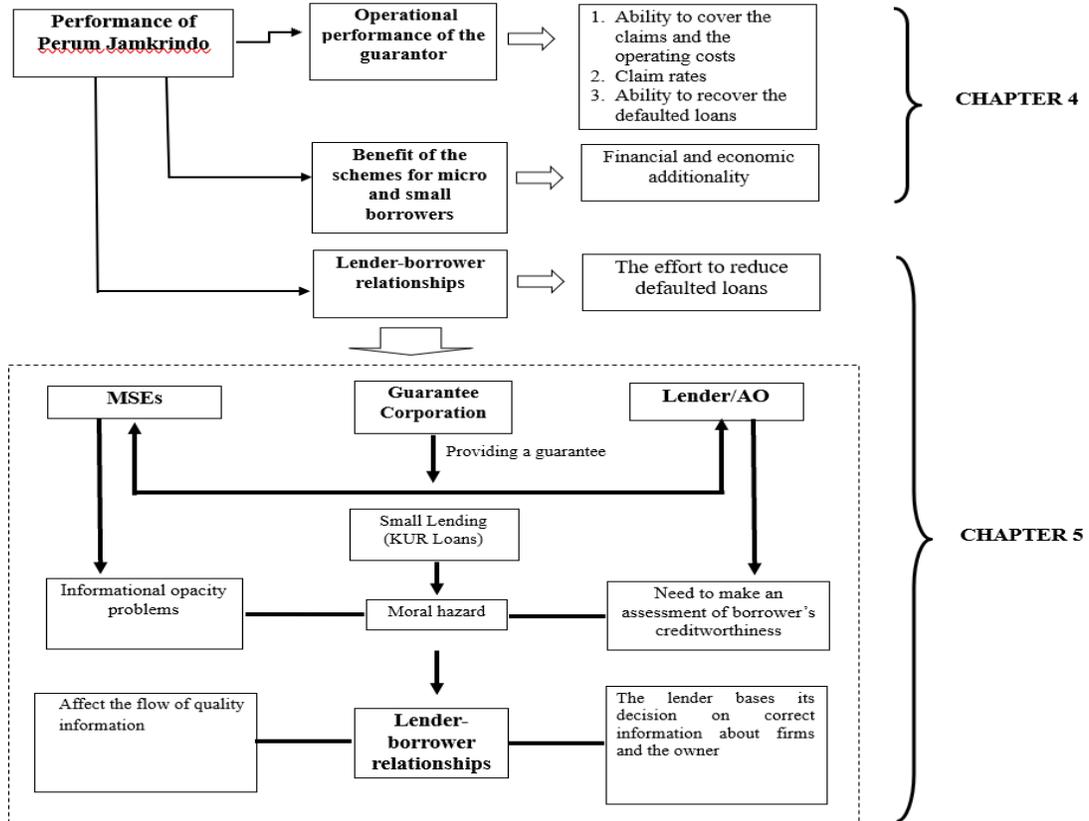
Furthermore, most studies on guarantee programs have not yet employed a comprehensive evaluation of the impact of the programs based on their level of additionality and economic impact. Nonetheless, this assessment is crucial for improving the implementation and effectiveness of the schemes to reach their goals (Saadani et al., 2011). Jonsson (2009) argued that the performance evaluation should consist of monitoring the three parties of credit guarantee schemes, which are the guarantee institution, borrowers (MSMEs) and participating lenders (commercial banks). The implementation of the CGS can be recognized as excess supply for credit provision. When the lenders have authority to choose the firms to be guaranteed, then,

micro, small, and medium business with low creditworthiness can gradually obtain a guaranteed loan due to excessive supply which then finally increases the chances of loan default. Furthermore, it leads these firms to grow to be more dependent on public support, implying that the credit guarantee program, as one of the types of public intervention, has had a negative effect, due to less selective guaranteed loan distribution and an excessively simple mechanism.

Therefore, this study has explored the comprehensive assessment of CGS's performance in Indonesia from the three prospective parties of CGS. Firstly, from the guarantee institution (CGC), this study investigated the effectiveness of the CGC by measuring the ability of the CGC in covering the operational cost and its capacity to manage the claims. Secondly, from the borrower's side, this research examined the benefits of the scheme for MSEs to encourage their business by measuring financial and economic additionality. Lastly, from the participant lenders (banks), a descriptive qualitative study was conducted by exploring the lender-borrower relationship. This relationship is crucial in overcoming the negative effects of the guarantee scheme related to a moral hazard problem.

1.4. Research Framework

Figure 1.1 Research Framework



Source: Author

The research framework above summarizes the broad objective of this study, which is to evaluate the performance of the CGS. These performance evaluations are conducted based on three aspects of the credit guarantee schemes. First, they evaluate operational performance of the guarantor from ability to cover the claims and the operating costs, the rate of defaulted loans, and the ability to recover the defaulted loans. In this part, this study conducted a case study on Perum Jamkrindo as the state-owned CGC in Indonesia. Second, the benefits of guaranteed loans to the borrowers were investigated through FA and EA. Then, the final aspect is exploring the efforts of the lender to reduce loan default through creating lender-borrower relationships.

1.5. Research Methodology

The previous studies of credit guarantee schemes have not been focused on a comprehensive evaluation of this subject, especially in developing countries. These studies only focused on one aspect of the three parties of credit guarantee schemes, most of them only focused on the borrowers, such as Riding et al. (2007), Boocock and Shariff (2005), and Saadani et al. (2011). Thus, this study conducted both quantitative and qualitative study to investigate the three essential parties of the credit guarantee schemes, which are the guarantor, lender, and borrower. The quantitative study was conducted to examine the effectiveness of Perum Jamkrindo's implementation by examining its costs and benefits for micro and small businesses. Effective operation refers to the capacity of the premium fee of the guarantee to deal with claims and all operating costs of the guarantor. This indicator was measured by exploring the secondary data that was collected from the annual reports of Perum Jamkrindo (2006-2013).

Meanwhile, the investigation of the benefits of the guarantee scheme especially for borrowers is explored through examining EA and FA. This investigation is focused on the micro and small borrowers who are the clients of Perum Jamkrindo in NTB. A small survey was conducted from September to December 2014 for collecting related data. It was done in a certain sector and area in order to obtain similar feedback. The research object of this study was the tourism sector in the city of Mataram and the regency of West Lombok. This sector was chosen since it is one of the most important sectors in Lombok, one of the two main islands in NTB.

A sample of 300 clients of Perum Jamkrindo NTB branch office in the city of Mataram and West Lombok was chosen to represent the selected population. The researchers received usable responses from 109 respondents. The interviews with the respondents utilized a closed/open-ended questionnaire. The instruments in the questionnaire (Appendix 2) were

adapted from Boocock and Shariff (2005). Then, the information from the key informants, such as CGC director and lender (bank), was collected as well through in-depth interviews to reinforce the finding.

The calculation of FA is based on the formula used in National Economic Research Associates (NERA) (Boocock and Shariff, 2005). Subsequently, the effect of the enterprise characteristics on FA was predicted by conducting a logistic regression analysis. FA is identified as a dichotomous dependent variable, which is measured using an ordinal scale, scoring 1 when the respondent can obtain benefit (FA) of the guaranteed loan, and zero if they cannot. Variables of analysis were divided into continuous and categorical data. Additionally, to investigate whether the borrowers of Perum Jamkrindo generate significant EA, this study utilized the overall figures for employment in the micro and small business sector, which was collected from secondary sources for standardizing purposes.

The descriptive qualitative approach was used for further investigation related to the implementation of the CGS in supplying additional loans for MSEs. This qualitative dimension is explored by focusing on the lender in the relationship between lender and borrower, and how this relationship influences the capacity of MSEs to access guaranteed loans, the term of lending, and loan repayment performance. The analysis was directed toward the description of the related actors in micro and small lending, resources, and relationships by focusing on the KUR loan. As a credit program from the Indonesian government, the KUR loan comes from the partner banks of Perum Jamkrindo and is guaranteed by Perum Jamkrindo.

In the implementation of the CGS, Perum Jamkrindo works with national banks, regional development banks, national private banks, and non-bank institutions. Among the partner banks of Perum Jamkrindo, Bank Rakyat Indonesia (BRI) is the most significant national

bank in Indonesia and one of Perum Jamkrindo's essential partner banks in delivering the KUR loan. Therefore, BRI was chosen as a sample for this study to examine the role of the lender in maintaining the performance of the KUR loan. This loan is one of Perum Jamkrindo's products. BRI shows high performance in delivering the KUR loans. By 2017, it had reached 64,401 micro and small businesses which were offered working and investment capital, totaling 1.11 trillion IDR⁴ (KUR Ekon, 2017).

This study focuses on the lender-borrower relationship. The account officers (hereinafter referred to as AO) of the lenders were explicitly interviewed, since the AOs are the bank personnel who trace creditworthiness of borrowers and deal directly with borrowers. The AOs also have the best access to the source of information related to the business, manager/owner, and community. Through the organizational structure, this information is difficult to access and measure. They make the judgment about a client's loan eligibility and consequently can explain how social and network ties affect their lending decisions. The study examined BRI (Bank Rakyat Indonesia) Unit Narmada and BRI Unit Kebon Roek, which are both small branch offices of BRI. To get a broader picture of the lender-borrower relationship, the AOs of Bank Tabungan Negara (BTN), Bank Mandiri and the regional bank of West Nusa Tenggara (BPD NTB/Bank Pembangunan Daerah Nusa Tenggara Barat) were also interviewed.

Furthermore, to strengthen the interview results, the author interviewed BRI's chief officer (CO) of small branch offices, who makes the final and legal lending decision based on the AO's recommendation. In-depth interviews were undertaken and observations were made to obtain an exhaustive view of the lender-borrower ties. The first phase interviews were conducted from June to July 2015 and the second phase took place from February to March 2016. Table 1.1

⁴ 1 USD equivalent to 14,000 IDR

presents a summary of the research methodology of the dissertation.

Table 1.1 Summary of Research Methodology

	Object	Data collection method	Type of data	Variable analysis	Type of data analysis
Guarantee corporation	Perum Jamkrindo	Case study	Quantitative data	<ul style="list-style-type: none"> • Guarantee fee • Operational cost • Default/claim rate • Subrogation income • Claims recovery 	Quantitative analysis
Borrower	MSEs that received a KUR loan	Small survey	Quantitative and qualitative data	<ul style="list-style-type: none"> • Financial and economic additionality • Borrower perception of guaranteed loan • Respondent's characteristics 	<ul style="list-style-type: none"> • Quantitative analysis (Logistic regression analysis) • Qualitative analysis (based on in-depth interviews)
Lender: the partner banks of Perum Jamkrindo	BRI, BTN, Bank Mandiri and BPD NTB	In-depth interviews	Qualitative data	Aspects of social relation between lender and borrower	Qualitative analysis (based on in-depth interviews)

Source: Author

Chapter 2

Conceptual Background

2.1. Background of Credit Guarantee Schemes

2.1.1. Rationale of Credit Guarantee Schemes

The difficulties of Micro, Small, and Medium Enterprises (MSMEs) in accessing loans have become the concern of development finance. The proposed solution to overcome this financial constraint focuses on two aspects. The first aspect concerns in creating conducive business environment to encourage people to begin and run businesses. This can only be realized if the market failures have been corrected since they impede the success of enterprises, investment activity, and business development. Then, the second concern falls into the implementation of credit guarantee schemes.

A Credit Guarantee Scheme (hereinafter referred to as CGS) is a kind of public financing assistance that has emerged as an instrument to promote private sector growth. Because the capital market had not been competitive or efficient, it would not have been possible to finance all profitable businesses with private loans. Therefore, public financing assistance is necessary. The asymmetric information problem has led banks to impose a rate of interest that reflects the associated financial risk. However, financial markets are not perfect due to asymmetric information problems, transaction costs, bankruptcy costs and regulatory restrictions (Craig et al., 2007). Furthermore, they also reported that the asymmetric information problems could signify the breakdown of the loan market, and then in turn financial constraints for small-scale lending can occur. These imperfections increase the cost of financing for profitable projects and may hinder their funding altogether.

The credit guarantee schemes are designed to overcome the failure in the capital market by minimizing the financial loss endured by the financial institutions due to defaulted loans. Further, finance professionals have recommended credit guarantee schemes to solve difficulties encountered by micro, small, and medium firms, and also other credit rationed groups (women, poor and very poor people), especially in developing countries, to obtain financial assistance from banks. When they do get such credit, then the loan is mostly on unsatisfactory terms. Furthermore, participating in a CGS, assessing individual loans can exacerbate the lender-borrower relationship since it represents an ex-ante positive signal of borrower's creditworthiness to the bank (OECD, 2013). Then, Honohon (2010) also argued that a longer-term relationship could be created through involvement in a CGS, thereby alleviating the existence of information asymmetries.

2.1.2. Justification for Credit Guarantee Schemes

Theoretical evidence concludes that the incidence of asymmetric information problems, which cause adverse selection and moral hazard, trigger credit rationing, especially for small-scale lending (Stiglitz and Weiss, 1981). When the adverse selection appears, the demand for the loans is higher than the loan supply by the bank lenders, the interest rate will increase. Many other authors also suggest that asymmetric information is the primary explanation for the credit rationing of Small and Medium Enterprises (SMEs) (Cowling, 2010; Zecchini and Ventura, 2009; Riding et al., 2007). The lenders are never provided with exhaustive information about the borrowers' ability and willingness to pay back the loan. Hence, the allocation of credit for small enterprises is lower than that of larger firms; even though these small enterprises could represent significant economic development (Deelen and Molenaar, 2004).

Further, the banks may utilize a variety of selection tools to catalyze an effective repayment performance that leads to an increasing expected return (Craig et al., 2005). They also express that a borrower agrees to pay an interest rate, which can then be used as one of the selection instruments. A higher interest rate is probably due to a higher risk because it expresses the perception that the borrower's willingness to pay back the loan is low. Meanwhile, SMEs seem to be less able to develop because they are relatively inexperienced and lack enough resources. Without sufficient collateral, it finally creates a negative response by the lender to the loan supplied to SMEs. Hence, lenders perceive that micro and small businesses are inherently higher risk clients, and it might reduce the prospective return of lenders from investing in small-scale lending.

Therefore, guarantee schemes subsidized by public loans are believed to be a problem-solving device to overcome these difficulties (Levitsky, 1997). Business growth and the success of enterprises seem to be hampered because of market failures, which can be addressed through the implementation of credit guarantee schemes. These guarantee schemes could be the 'substitute collateral' which can be viewed as a replacement for sufficient physical collateral that SMEs are not able to provide to secure a loan; then the barriers faced by these companies in accessing and gathering formal loans due to a lack of collateral can be overcome. The guarantors supply a guarantee to encourage the bank/lender to provide a loan. The guarantee also makes the banks feeling confident that the loan will be covered in case of loan default. Credit guarantee schemes employ a risk transfer instrument to address these constraints, thereby diminishing lenders' perception of risk and the lender's exposure to loss due to loan default.

2.1.3. Contrary Arguments to Credit Guarantee Schemes

From a theoretical framework, commercial banks and microfinance institutions have to be able to provide necessary loans for micro and small borrowers; thus, the credit guarantee funds are no longer needed (Deelan and Molenaar, 2004). In a competitive market, the financial institutions have high motivation to overcome financial constraints of SMEs (OECD, 2006). Small-scale lending is perceived as an attractive area of business by banks, especially in most OECD countries, so it is important to develop an effective monitoring technique. Furthermore, a better evaluation is employed by the lenders than the Credit Guarantee Corporation (CGC) because the lenders have better experience and information about clients. It is improbable that the guarantors will have superior experience in analyzing loans than lenders, as their decisions have been based on fewer criteria (Jonsson, 2009). This means that if lenders employ the same standards, they should also refuse loan applications by micro and small-borrowers (Navajas, 2001).

The critics of credit guarantee schemes emphasize that asymmetric information problems, which are moral hazard and adverse selection, are frequently connected to the guarantee scheme. When the customers know that their debts are backed by a guarantor, they tend to be less willing to repay the loan. Likewise, Navajas (2001) argued that the loan insured by the guarantor could lead to the possibility of lenders not performing an appropriate evaluation to ensure the repayment loan by the borrowers, which can then lead to lenders approving high-risk loans.

Moreover, running credit guarantee schemes are costly and not always suitable since they tend to spend their capital quickly and could not always cover the operational costs of the schemes. Navajas (2001) also argued that CGC is confronted with a trade-off between charging

an appropriate premium fee that could enable scheme to maintain its operational expense, and selling its products at an affordable price. Hence, the questions associated with credit guarantee schemes are mainly about their sustainability and ability to produce additionality especially for the MSMEs.

2.2. Costs and Benefits of Guarantee Schemes

Assessing the costs of guarantee schemes is essential because there are usually additional transaction costs that are incurred by lenders (and borrowers) when a guarantee is initiated and if a claim is subsequently made. The costs related to risk sharing are not necessarily recovered through setting fees or adjusting interest rate spreads. They have to be added to any continuing operational or administrative subsidies to the guarantee organization. A public CGC is usually subsidized by government with a specific amount that is used as the initial capital for running the CGS.

On the contrary, the importance of guarantee schemes is typically measured based on their ability to produce additionality especially for MSMEs as the targeted groups. The economic gain will be reflected in the higher income of the borrowers and through any additional employment and taxes paid by their firms. However, in the future, the development capacity of guarantee institutions to provide the guarantee for micro and small-scale lending seems to be more crucial and valuable to describe the benefit of guarantee schemes. The creation of guarantee funds enables micro and small-borrowers to access loans, whereas without the existence of the guarantee program, it would not be possible. Furthermore, an excellent guarantee scheme is the one that enables the creation of an invention mode of gradually changing the risk boundary of the lenders from an entirely risk-averse point of view against micro and small-borrowers.

2.3. Overview of Credit Guarantee Schemes from the Legal and Regulatory Framework

Credit guarantee schemes are specific non-profit organizations where particular regulatory systems are applied. Profit-oriented organizations are usually private-public schemes that exist in some countries, where only the public shareholders of the organization accept the revenue generated. The guarantee corporations are recognized by the legal and regulatory framework for supporting SME development by easing the access to finance, delivering valuable information to the banking system, and providing a resource for public loans (Leone and Vento, 2012).

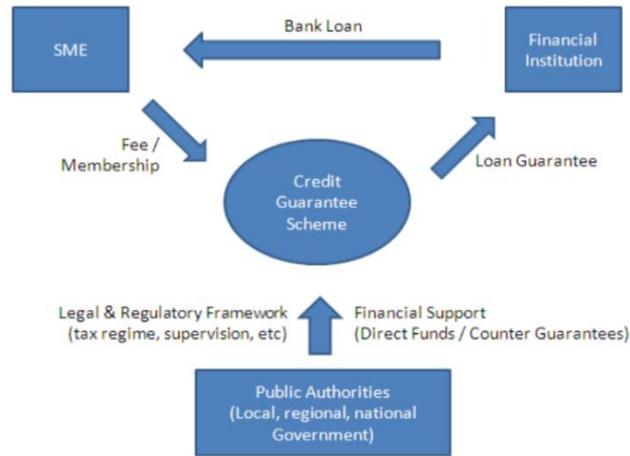
Every country's CGC is characterized by typical CGC funding and management. Nevertheless, as the financial intermediaries, aspects of a CGC's operations are arranged by a particular regulatory framework. The operational aspects of credit guarantee schemes are showed by the solvency ratio, minimum capital requirements, and transparency criteria. Supervision over credit guarantee schemes should be employed at many levels, including by a country's central bank and other public bodies. The oversight of a public scheme is conducted by central government ministries. For example, in Korea, the related government department (the Ministry of Strategy and Finance) observes and evaluates the Korea Credit Guarantee Fund (KODIT). Mainly, because its CGC is at a comparatively early phase of operation, it might not be regulated by specific regulations; thus, the managing and controlling task related to the entire financial system of the CGC may be conducted by the authorities (Leone and Vento, 2012).

2.4. Ownership and Management of Credit Guarantee Schemes

The OECD (2013) broadly identified three types of guarantee schemes namely public guarantee schemes, private schemes, and public-private (or mixed) guarantee schemes.⁵ These types of guarantee schemes determine the relationships between CGCs, banks/lenders, and borrowers. D'Ignazio and Menon (2013) broadly identified two main categories of guarantee schemes: public guarantee and mutual guarantee schemes. The mutual guarantee association is defined as a private society initiated by the related organization that shares the debt risk of the borrowers who face a difficulty in accessing bank loans. Meanwhile, to reduce financial constraint on MSMEs, a Public Guarantee Scheme (PGS) is initiated as an effective policy tool of government support. Generally, among all types of credit guarantee schemes, essential subjects in the guarantee scheme include three members that have different purposes, which are the guarantors, the lenders, and the borrowers (Figure 2.1).

⁵ Public credit guarantee schemes are initiated by the government as an effective policy instrument to overcome financial constraint faced by SMEs. A public credit guarantee scheme is commonly operated by related government departments. In some cases, the sponsor and management of the guarantee scheme are given by institutions with the contribution of the private sector, an organization of SMEs, and banks. In a private CGS, the role of the government is mostly finite related to the framework of legal and regulatory aspects. The allocation of financial assistance, in either in the form of direct funding or counter-guarantees, is also limited. While, for the mixed guarantee schemes, the government is the sponsor for the CGC but the management aspects are carried out by lending institutions (OECD, 2013).

Figure 2.1. Important Players of CGS



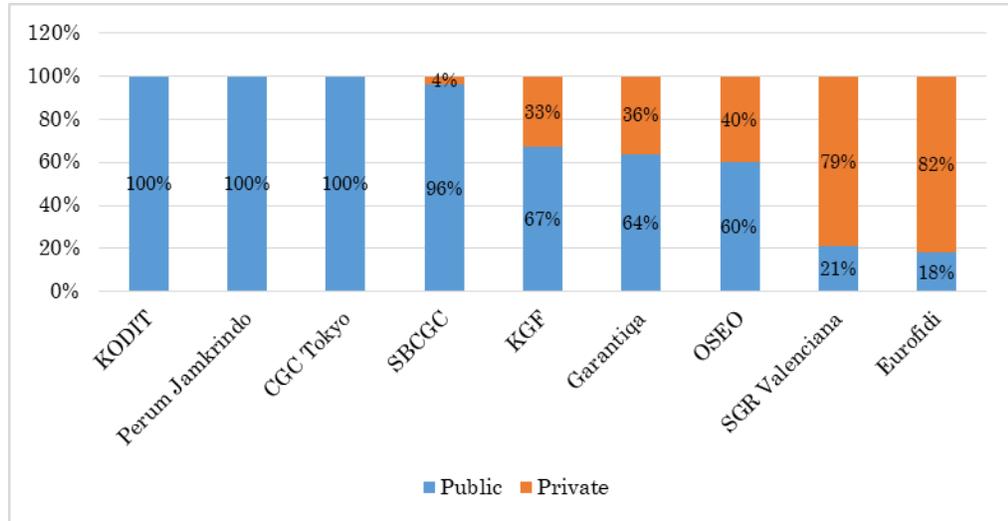
Source: OECD (2013; p. 11)

The borrower could be identified as a micro, small, and medium enterprise looking for a loan from a bank. The lender is frequently a formal financial institution, such as a conventional bank, rural bank, cooperative, or a finance company that is seeking to profit from lending. Due to their role and motivation, the lender is faced with asymmetric information when assessing the creditworthiness of borrowers. The guarantor mainly consists of a group made up of a government body, a private organization, and a trade organization. This group aims to ease financial access by providing a guarantee for some portion of the debt capital of the borrowers.

Usually, provincial or national authorities provide initial funding for public guarantee schemes, which are then operated either by a unit of a local government or by an independent formal credit guarantee corporation and are widely implemented in low-income and emerging economies. The players, who qualify as this type of guarantee scheme, are all Asian Credit Guarantee Schemes, such as the Japanese CGC (CGC Tokyo), KODIT, Perum Jamkrindo, and

Thai Small Business Credit Guarantee Corporation (SBCGC) (Figure 2.2).

Figure 2.2 Capital Funds Composition (Public/Private)



Source: KPMG (2011, p. 21)

Public guarantee corporations are mainly characterized as publicly-owned. OECD (2013) explains that the critical role in the development of public-private guarantee corporations is identified as that of financial institutions that consist of commercial and development banks, or also small and medium business boards, in which the public board seems to hold a majority stake. On the other hand, it is recognized that the private sector (trade organizations and banks) has a central role in the funding and management of the private guarantee organizations. The participation of the private sector in the regulatory and legal framework is limited.

2.5. Design Feature of Credit Guarantee Schemes

2.5.1. Firm Eligibility

Most guarantee schemes aim to increase access to formal finance for a target group of MSMEs. The type of identification of eligible clients, the terms of lending, and other funding

criteria are broadly characterized. The eligibility criteria could be based on a firm's size, which is referred to as the level of asset turnover, even though some schemes have relatively broad eligibility categories (Jonsson, 2009). Furthermore, there are also some credit guarantee schemes with specific eligibility criteria. For instance, some guarantee schemes are executed based on a very limited qualifying industry, or carried out in only one industry. Then, the other schemes are characterized the target market of guarantee clients with a focus on the specific MSMEs.

Bannock (1997) identified the other definitions of eligible firms for guarantees based on three features, which are the number of employees, capital invested in fixed assets, and value of sales turnover. The amount of employee is the easiest to determine, while sales turnover is probably somewhat more difficult to determine as is capital invested in fixed assets. The accuracy of the assessment criteria influences the validity of determining the size and the character of the business. Hence, most guarantee schemes need a relatively simple approach to assess eligibility, so the number of employees is one of the simple indicators to assess the eligibility of business.

International experience shows a variety of eligibility criteria. For instance, OECD (2013) reported that applications for funding to back up a necessity of working capital do not obtain guarantees from the Canadian Business Financing Program (CSBFP). Further, the study of OECD found that in some schemes, a lack of collateral that leads to rejection of a loan application is one of the characteristics to qualify, for example in the case of Credit Guarantee Fund (KGF) in Turkey, FAMPE in Brazil, and the US SBA Loan Program. To achieve the broader policy goals, as a policy instrument, some public guarantee schemes focus on particular types of companies, such as for start-ups or innovative firms. A guarantee corporation which assists tech-oriented ventures is Korea Technology Finance Corporation (KIBO), which is willing to provide up to 100% of guarantees for loans proposed by tech-oriented firms (OECD, 2013).

2.5.2. Guarantee Mechanism

The delivery mechanism of a CGS is based on contractual and procedural arrangements between the three parties, which are the guarantee organization, the lender, and the borrower. The guarantee assignment process of the credit guarantee schemes can be used to distinguish their role, which can be broadly divided into retail, portfolio, and large-scale guarantee systems (Saadani et al., 2011). However, in mutual schemes, the more common guarantees are for retail.

The guarantee approval process for retail guarantee systems mainly evaluates the eligibility of firms and measures the risk of loans on a case by case basis. Furthermore, this guarantee approval process has high administrative costs due to utilizing qualified personnel. In some instances, both the guarantors and lenders employ the credit risk assessment, in which detailed information about the borrowers known to credit guarantee schemes is transferred to the bank.

On the other hand, in portfolio guarantees, the approval process to provide a guarantee is not appraised on an individual base. It means that customers do not have to apply directly for a credit guarantee. Likewise, the approval decision is made depending on the general features of the loans, such as the amount and the purpose of the loan, and also the location of the firm that applied for the loan. This kind of CGS involves a simple proficiency, explicitly on the part of the CGS; it has low operational costs. This approach is more flexible than the retail guarantee approach since it enables lenders to extend guarantees without a guarantor's verification; thus, every lender has a guarantee allocation that can be provided for eligible business.

While, the large-scale guarantee systems are identified by the absence of a direct relationship between the CGC and the other parties, namely the borrower and lender. Mainly, the non-bank intermediaries are offered a counter-guarantee by the CGS, frequently for micro-credit

institutions. Therefore, the capital costs incurred by retail or portfolio systems seem to be considered relatively high, especially for micro-credit.

The ability to control credit risk better is the primary benefit of the individual approach, which then ensures financial sustainability. The other significant value added to the individual approach is the exchanges of private sources, such as information and technical support, between the guarantor and the lender during the decision-making process. Thus, it can overcome the issue of less experience of banks with small-scale lending. On the contrary, those that favor the portfolio method suggest that the guarantee schemes may deal with higher default risks but significantly minimized operating and transaction costs.

2.5.3. Coverage Ratios and Pricing of Guarantees

The coverage ratio refers to the level to which a loan is guaranteed against loan default. Coverage ratios should be employed as a tool for effective loan evaluation and monitoring potential borrowers, while also supplementing the proper protection to negate the risk of default. In principle, if a guarantee scheme provides 100% coverage so that banks/lenders have zero risk exposure, it would be unreasonable to expect them to carry out a risk assessment with due diligence. The higher the coverage, the higher the probability of the risk of moral hazard's appearance, due to the possibility that borrowers may be less willing to pay back the loan because of the perception that they are well covered by the guarantee institution.⁶ Additionally, the motivation of lenders for conducting precise loan screening will plummet, since lenders realize

⁶ The Japanese credit guarantee scheme increased the coverage ratio up to 100% to overcome the credit constraint during the financial crisis in Asian in the late 1990s. However, because of this policy, the profitability of firms which received guarantees was lower than those firms which did not obtain guarantees. Therefore, Uesugi et al. (2010) concluded that moral hazard problems occur because of the coverage ratio is exceptionally high.

they are party to a guaranteed loan; so they have relatively low exposure (Deelen and Molenaar, 2004; p.100). Beck et al. (2010; p. 15) noted that there are 76 schemes worldwide that employ a median coverage ratio of 80%. The implementation of 100% guarantee coverage is also significant, and is confined mainly to more developed countries, e.g., Japan, Luxembourg, and Spain. The risk portion of various schemes ranges from 20% to 100%.

Regarding incentives for both of banks and borrowers, proper fee or pricing is a crucial aspect of a guarantee scheme. Therefore, the guarantee fee should be calculated in relation to the risk exposure since it influences the sustainability of the guarantee scheme as well. Bannock (1997) argues that in assigning the size of the fees, the balance between viability of the scheme and the compliance of lenders and borrowers to take part should be considered. A guarantee fee is allocated as a percentage of the amount of guaranteed loan.

Furthermore, the guarantee fee determines two crucial rules. Firstly, the fee sets a crucial source of income for the credit guarantee schemes that covers the cost of defaults. Secondly, the fee should ensure that only credit rationed firms, which are unable to access loans in the capital market under typical conditions, would consider applying for a loan under the guarantee of a CGS. Bannock (1997) argues that the premium fee of a guarantee is not only a crucial source of income for guarantee scheme, but it also plays a significant part in creating additionality. If the fees are high enough, banks will avoid employing the guarantee for eligible customers who can feasibly get loans without additional guarantees.

Table 2.1 presents the arranged fee by the guarantee scheme that might be associated with the allocation of risk between the lender and the guarantor (Deelen and Molenaar, 2004; p.99). A fundamental principle of insurance, which should be employed by the guarantor, is connecting the guarantee fee to the risk exposure. This is supported by Saadani et al. (2011), who found that

most schemes, in their benchmark, link guarantee fees to risk exposure. On the contrary, Beck et al. (2008) found that only 21% of guarantee schemes around the world implement risk-based analysis to set the guarantee fees.

Table 2.1 Structures Fee Set by the Guarantee Schemes

Coverage ratio	Guarantee fee	Addition for loans 3 to 5 years	Addition for loans 5 to 8 years
< 20%	0.80%	0.10%	0.25%
21 – 40%	1.20%	0.25%	0.50%
41 – 50%	1.50%	0.50%	0.75%
51 – 60%	2.00%	1.00%	1.50%
61 – 70%	2.50%	1.50%	2.50%
71 – 80%	3.00%	1.50%	2.50%

Source: Deelen and Molenaar (2004; p. 99)

Most countries apply a guarantee fee of around 2% of the amount of the guaranteed loan per year. Deelen and Molenaar (2004) argued that the fee should not be higher than 2% because the client must give this guarantee fee on top of the interest rate of the loan. Saadani et al. (2011; p. 15) reported that the level of fees around the world ranges from 0.8% to 2.3% per annum with an average of 1.5% per annum. In the Netherlands, riskier types of firms are charged with higher fees, such as young enterprises or tech-oriented firms. Whilst in Chile, the performance of the bank’s portfolio as measured by the default rate is utilized as the basis for creating the level of fees.

2.5.4. Risk Management

Banks that lend money are used to managing risk since it is crucial for the success of banking. The attention given to risk assessment is undoubtedly based on the perceived amount of loss to which the bank is exposed. Due to an asymmetry of information on the creditworthiness of small firm borrowers, reliable data is difficult and costly to obtain. In such cases, the bank will

eventually amass the skill to make appropriate lending decisions only through repeated and frequent exposure to transactions with small clients that leads to a “learning process” of assessing risk.

Empirical studies argue that guarantee schemes might induce moral hazard between lenders and borrowers. Nevertheless, through a sound system and operation of the scheme, this problem could be significantly minimized. Various tools are in place for credit guarantee schemes to control the risk of a loan, which are used to varying degrees among different types of schemes. The management of risk is highly essential for the viability, performance, and role of the guarantee programs. In which, coverage ratio, the system of the guarantee and pricing are the essential elements in guarantee risk management.

Setting risk sharing proportions between the guarantor and the lenders in a scheme will ultimately depend on many factors. The previous performance of the creditor’s SME loan portfolio will be the significant element in the decision. The total amount of guarantee will also need to be taken into account to ensure the fund can meet its potential guarantee claim commitments. In some cases, the guarantee coverage has been adjusted upwards after a few years of operation, to encourage greater participation, or to extend the risk frontier (Bannock, 1997; p. 32). For example, the UK’s coverage for established firms was increased from 70% to 85% in 1993. Sometimes the primary factor is neither of the above but rather the degree of prevalence of loan delinquency within the financial system of the country.

In principle, if a guarantee scheme provides 100% coverage so that banks have zero risk exposure, it would be unreasonable to expect them to carry out the risk assessment with the same degree of due diligence. However, only a few schemes provide very high coverage, 90% or more often 100%. Some schemes work in this way, for example, those in the USA, Japan, Korea and

Spain, where the credit guarantee organization is large, extensively staffed, and decentralized with an extensive branch network (Bannock, 1997; p. 31). It is also significant that 100% guarantee coverage is confined mainly to more developed countries, where the financial sector and banking system is far more developed, both with regards to management and fiscal soundness (Bannock, 1997; p. 31).

Most schemes around the world, however, follow a different logic, based on it being inadvisable to take away entirely from the bank the role of risk assessment for the loan and the borrower. Thus, it implies that the lending institution should assume some of the risks. The OECD survey of schemes (2013) concludes that there are two main risk-sharing approaches. Some schemes provide guarantees at a level of 50%, and the other schemes are in the range of 65% to 85% (Bannock, 1997; p. 32). Many schemes have different windows for particular categories of firms where the guarantee percentage is raised from the base level to encourage younger entrepreneurs, start-ups, business creation, and development in more deprived areas or a particular sector.

Lower guarantee percentages are often associated with the portfolio model where risk assessment is delegated to the bank. The lenders do not have to obtain prior approval from the guarantee corporation before issuing a guarantee which only has 75% coverage compared to 90% for individual guarantee contracts, for example, SBA in the US (Bannock, 1997; p. 32). Most of the 50% coverage schemes are in fact based on the automatic delivery system, in which all loans within the size and sector eligibility limits are covered, irrespective of their risk profile or collateral status. In addition, the scheme is associated with directed lending policies towards the micro, small, and medium sector. This scheme is applied in India, Indonesia, and Pakistan.

Although not formally included in the percentage distribution of risk sharing, the

borrower is the third agent in the transaction. An important design feature is to organize the scheme to retain the borrower's commitment to repay the loan so that those who solely wish to obtain credit and not to repay it will be excluded as much as possible. This step can be achieved by requiring a personal guarantee, a third-party surety from a family member or friend, or the equivalent covering some significant personal assets. The value of personal assets may be far below the usual collateral standard required by banks; nonetheless, it signals the borrower's willingness to have something of value at risk. The recovery of these pledges must, of course, be pursued in the event of a default and post-claim. Also, a method should be designed to ensure as far as possible that borrowers, who default, are blacklisted and cut off from receiving any further loans from all lending institutions in the future.

2.6. Claims Handling

For a guarantee scheme to be effective, the aspect of loan defaults (claims and claims validation) needs to be well implemented since it could generate a failure of the scheme. The settlement of claims must be fast and predictable to create the credibility of the guarantor, and at the same time to keep encouraging loan collection. The banks will be persuaded if the guarantors have a high capacity to pay the claims correctly.

However, sometimes the procedures of claim payments were not defective but operated improperly to delay claim payouts when the fund was undercapitalized and could not meet its commitments. Implementing the guarantee procedures appropriately by employing sufficient staff for handling claim payment of the guarantee tend to be avoided mainly by some guarantee schemes in developing countries. Procedures were designed, dealing with when and how such claims could be made and would be paid out, but tended to be somewhat vague and imprecise.

The full confidence and mutual trust that exist between the bank and guarantor may indicate a ready agreement on both sides. On the other hand, when such confidence is lacking, as in the early years of the development of a scheme, it can lead to disputes and delays, thereby undermining the lender's trust in the reliability of the guarantee agreement. The key is to have well-defined terms, but this does not imply that there is only one desirable model.

The practicality and time-scale of legal recovery processes are crucial in the administration process of a claim. Since about 1990, the effective completion of claims through implementing strictly defined processes has been recognized by most guarantee schemes as the essential element in gaining and maintaining the trust of the lenders (Bannock, 1997). Commonly, the claims on the credit guarantee due to loan default can be made after arrears have reached three months or 90 days. In that time, the consumers have been adequately reminded, the outstanding loan has been 'called in', legal processes have been conducted to impound collateral, and the loan has been recovered.

In general, four kinds of payment rules can be considered (Saadani et al., 2011). They comprise of a one-time settlement after default is authorized, a sole settlement after legal processes are started, a partial settlement at the time of default, then, the residing settlement after judiciary processes are completed, and an individual settlement if court proceedings are finished. Beck et al. (2010; p. 16) show that about 66% of CGSs around the world place responsibility on the lenders/banks for the recovery process of defaulted loans. Also, they reveal that the claim recovery was conducted by 34% of the sample schemes due to loan default of customers. Moreover, in 42% of the sample schemes, the claim settlement happens after the bank begins legal processes, and in just 14% of the sample schemes, after the bank abolishes the loan, then the claim's settlement could be conducted.

The choice of payment procedure should take into consideration the efficiency of the judicial system. In a country with efficient judicial proceedings, the settlement of claims can be made when all trials are completed. However, the attractiveness of the guarantee scheme may be tarnished because of the claim payment procedure, where the system has been less efficient, when claims are completed at the end of the legal process, which leads to an extended waiting periods and losses for banks/lenders.

2.7. Performance of Credit Guarantee Schemes

The performance of CGS implementations depends on the three players of credit guarantee schemes (credit guarantee corporations, lenders, and borrowers). Due to the significant objective of a CGS, each player has to maintain the sustainability of this scheme. The increasing number of studies on partial credit guarantee schemes indicates the growing concern about this policy intervention, aimed at encouraging SMEs' financial access. Saadani et al. (2011) divided these studies into three types. Firstly, there are surveys of multiple countries that investigate the significant characteristics of guarantee schemes (Beck et al., 2009). Secondly, there are also individual country studies, including an effort to assess additionality (Cowling, 2010; Cowan et al., 2009; Riding et al., 2007; Boocock and Shariff, 2005; Riding and Haines, 2001). Lastly, there are also studies focusing on the best experiences in terms of design issues and describing the practices of credit guarantee schemes throughout the world (Deelen and Molenaar, 2004; Green, 2003).

One of the critical issues regarding the debate about this program is the effectiveness of loan guarantee schemes for SMEs, which is studied by many scholars. For instance, Cowling and Mitchell (1997) found that the UK's guarantee scheme was able to assist a significant number of

marginally employed people to become self-employed. Riding and Haines (2001) reported an essential role of loan guarantee program in Canada (SBLA), which was identified as effectiveness in creating job opportunity and also supporting small and medium firms to survive and grow. The recent studies by Zecchini and Ventura (2009) proposed a new approach to investigate the effect of credit guarantee schemes on SMEs by using an econometric approach. Their study proved that Italy's CGS might raise loan availability for SMEs by reducing their borrowing costs without diminishing the ability to be financially sustained.

2.7.1. Performance Indicators of Credit Guarantee Schemes

2.7.1.1. Guarantors

One of the core indicators of CGC performance is financial sustainability, which could be measured by the equity ratio. Financial viability describes the ability of CGC's to manage losses, and its continuity in providing enough equity based on expected liabilities. The guarantor is able to cover its costs, which consist of operating expenses and the cost of defaults, through asking a premium fee from its customers, direct subsidies from public institutions or other donor agencies, or also from the investment income of the guaranteed loan itself. This capacity to cover all costs significantly influences the financial sustainability of the guarantee program (Jonsson, 2009). Covering the costs of defaulted loans is the primary cost charges by credit guarantee schemes (Cowling, 2010; Riding and Haines, 2001). A good guarantee scheme should continue to have an equity ratio below a certain level that would be influenced by the risk of the portfolio. The equity ratio of guarantee schemes varies from 5 to 10, representing the government policies, management of risk, and also the maturity of the system.

Furthermore, Saadani et al. (2011) argued that the ability of the scheme to provide guarantees for eligible SMEs reflects the outreach of the scheme. Moreover, in theory, outreach may be measured based on SME's financial gap, which is referred to as the distinction between the demand and supply of bank loans for these enterprises. The increasing number of credible companies that faced difficulty in accessing bank loans may reveal a higher potential market for the guarantee. The standard indicator for measuring the outreach is the amount of issued guaranteed loans or outstanding guarantees scaled by GDP (Saadani et al., 2011).

Meanwhile, the level of default could be used as an indicator to evaluate the performance of a CGS; Green (2003) concluded that a restricted working and the perceived high-risk aversion is indicated by a minimal default rate of credit guarantee schemes. However, a high level of default generates the question as to whether the scheme is inefficient because of applying a poor credit evaluation. Cowling (2010) reported three main factors that affect the rates of default; a higher interest rate charged on loans, development of GDP (higher GDP growth may imply more small business were able to access the guaranteed loans), and the eligibility test for using a guaranteed loan being based on working capital rather than investment capital. Moreover, Riding and Haines (2001) concluded that a high percentage of guaranteed is connected to a high rate of loan default. It indicates that the frequency of defaults in the guaranteed portfolio is generated by the percentage of a guarantee set by the guarantor.

2.7.1.2. Borrowers

The additionality of a loan, identified as FA and EA, is the most critical parameter of a guarantee scheme's performance. The ability of a borrower to access loans that would not have been available without the existence of a scheme is the indicator of FA. Furthermore, the output

created by a customer because of the ability to access loan for running his business is the indicator of EA (Boocock and Shariff, 2005). EA is divided into two types, direct EA, and indirect EA. Direct EA describes the effect of the guaranteed loans on the companies themselves; thus, it is assessed as the growth of employment, profit, and turnover. Whereas, indirect EA refers to rising profits from the activities of guarantee recipients. The benefit created by indirect EA could be in encouraging exports that increases the business effect in the national economy which then develops the national wealth (Gibb, 1999).

2.7.2.3. Lenders (Banks)

Among lender and guarantor, an agency relationship exists, which could harm the successful implementation of a guarantee scheme. The position of the lender as a delivery agent can generate the problem of moral hazard. Riding and Haines (2001) argued that the guarantor might create a parameter for the scheme to be able to match the objectives of the schemes with the objective of the lenders (making profitable loans). Thus, the guarantee scheme may accomplish its aims. It implies that the performance of a guarantee scheme also depends on the performance of the lender in the participating guarantee scheme. The behavior and attitude towards micro, small, and medium companies of the participating lenders are the critical aspects of their performance (Jonsson, 2009). The lenders are also concerned with their performance in distributing the guaranteed loan.

As commercial banks, the lenders have to maintain the standards of performance issued by the authorized institution. For instance, the Sustainability Accounting Standards Board (SASB) provides sustainability accounting standards for Commercial Banks in the US through identifying five measures of sustainability. These measures are 1) financial inclusion and capacity building, 2)

customer privacy and data security, 3) management of the legal and regulatory environment, 4) systemic risk management, and 5) integration of environmental, social, and governance risk factors into credit risk analysis. Furthermore, the commercial banks in Indonesia also have to follow the standard procedure for performance established by the Bank Indonesia (Indonesian Central Bank). The Bank Indonesia has a crucial role in managing the sound performance of financial institutions, particularly in the banking sector. The performance of banking institutions is promoted through the supervisory and regulatory mechanism. The performance standard of the Bank Indonesia is also based on the international standard of performance assessment for a commercial bank authorized by the Decree of Directors of the Bank Indonesia No.30/12/KEP/DIR and *Surat Edaran Bank Indonesia* (SEBI) No. 6/10/PBU/2004. The regulations identified the following procedure of performance assessment for commercial banks in Indonesia: 1) capital, 2) asset quality, 3) management, 4) earnings, and 5) liquidity.

2.7.2. Previous Researches: Performance Evaluation of Credit Guarantee Schemes

There is a growing amount of literature on partial credit guarantee schemes which indicates an increasing interest in this type of policy intervention, aimed at encouraging MSMEs' financial access. Saadani et al. (2011) divided these studies into three categories. The first category consists of surveys across multiple countries investigating the common characteristics of credit guarantee schemes (Beck et al., 2009). The second category consists of individual country studies, including the effort to assess additionality (Cowling, 2010; Cowan et al., 2009; Riding et al., 2007; Boocock and Shariff, 2005; Riding and Haines, 2001)⁷. The last group

⁷ The performance evaluation of CGS is identified based on three concepts, which are financial sustainability, financial additionality, and economic additionality (OECD, 2013). Even though, the boundary between the three concepts is not always clear-cut. Financial sustainability relates to the ability of a guarantee program to cover its

concentrates on the best practices and design issues of the implementation of credit guarantee schemes around the world (Deelen and Molenaar, 2004; Green, 2003).

One of the critical issues regarding the debate about this program is the effectiveness of loan guarantee schemes in supporting the financial development of MSMEs. Many scholars have studied this issue. Nevertheless, many of them are mostly qualitative criticisms about the policy scheme from a macroscopic viewpoint (Oh et al., 2009). For instance, Riding and Haines (2001) reported that the loan guarantee program in Canada (SBLA) could create many job opportunities and increase the ability of small enterprises to survive and grow. The SBLA creates job opportunities with a lower cost than that of any other program of the Canadian government. Additionally, Cowling and Mitchell (1997) provide evidence that the guarantee scheme in the UK allowed a substantial number of marginally employed people to become self-employed.

A recent study (Zecchini and Ventura, 2009) proposed a new approach to investigate the effect of credit guarantee schemes to SMEs by using an econometric approach. Their study proved that Italy's CGS could increase credit availability for SMEs by reducing their borrowing costs without being financially unsustainable. Meanwhile, most studies have focused on investigating whether credit guarantee schemes have been able to generate FA and EA as their primary objective, and then whether a CGS is a robust method of encouraging lending to SMEs based on its ability to reduce the cost of default. Many researchers have reported that a comparison between the client's present condition with some prior baseline data is used to measure additionality (Riding et al., 2007; Cowan et al., 2009; Riding and Haines, 2001;

total operating costs and loan defaults. Financial additionality refers to incremental loan access to SMEs and improvement of the term and conditions of loans. This concept of financial additionality relates to intermediate outcomes. The economic additionality refers to the economic impacts, such as employment, turnover, and sales, which might have been influenced causally by the credit guarantee. This definition deals with policy outcomes.

Boocock and Shariff, 2005; Oh et al., 2009; Cowling, 2010). Otherwise, the performance of borrowers, who obtained guaranteed loans, the treatment group, is compared with non-borrowers who were not provided with any guaranteed loans. However, studies that focused on additionality could not present any significant explanation about the causality relationship between credit guarantees and additionality, and their influence on the borrowing cost of the guaranteed loan for SMEs. Therefore, only limited evidence can be found that can be used by policymakers in considering the effectiveness of credit guarantee schemes to reduce the financial constraints of SMEs. The summary of the literature on the effectiveness on partial credit guarantee schemes is presented in Table 2.2 below.

Table 2.2 Performance Evaluation Country Studies

Country/Study	Objective	Methodology	Finding
UK: Cowling (2010)	To measure the economic effect of the Small Firm Loan Guarantee (SFLG) scheme in supporting access to loans for small and medium enterprises that they would have otherwise not have had	Propensity score matching	Significant additionality
Italy: Zecchini and Ventura (2009)	To investigate the effectiveness of the Italian state-funded guarantee scheme related to credit additionality and cost reduction	An econometric approach (a Difference-in-Difference approach)	Cost reduction is in the range of 16-20%, while the additionality is estimated at 12.4% at the median
Canada: Ridding, Madill and Haines (2007)	To measure the incrementality of the Canadian loan guarantee program, Canada Small Business Financing (CSBF)	Propensity score matching	Significant additionality (75% of FA)
Korea: Oh <i>et.al.</i> (2006)	To investigate whether the credit guarantee scheme influences the growth of the enterprise, its investment, productivity, ability to survive in post-economic crisis.	Propensity score matching	Significant additionality
Malaysia: Boocock and Shariff (2005)	To investigate the level of baseline FA and the factors associated with FA, and to establish the degree of EA and assess the sustainability of New Principal Guarantee Scheme (NPGS)	Interviews of guarantee users	Additionality

Sources: Literature Review

Based on Table 2.2 above, it can be summarized that most of the evaluation studies are about the effectiveness of credit guarantee schemes based on additionality. However, Saadani et al. (2011) argued that measuring additionality remains technically challenging. Moreover, he said that identifying a proper control group, which consists of firms with the same features as the guarantee users, is the primary challenge. No thorough evaluation studies of the degree of additionality and economic impact of the guarantee schemes have been conducted, especially in developing countries because the schemes are not mature enough. Nonetheless, this is a drawback that should be overcome, since this evaluation is very important for improvement in the implementation and effectiveness of the schemes to reach their goals (Saadani et al., 2011). While Jonsson (2009) argued that the performance evaluation should consist of monitoring the three players of credit guarantee schemes, which are the guarantee institution, borrower and participating lender (bank).

2.8. Managing Guarantor-Lender Relations

It cannot be repeated too often that the effectiveness of a guarantee scheme relies first and foremost on getting the cooperation and participation of the partner banks, because many failures of younger guarantee schemes have occurred since the banks were unwilling to take part. Their fears, which were often well founded, were that guarantees would not be approved without delays, and claims would not be paid out quickly without prolonged bureaucratic processes in the event of losses. The guarantor would argue that the lender had not made a proper evaluation of the loan request, had not appropriately supervised the borrower, or had failed to pursue debt collection vigorously. This condition would justify initial rejections, long delays and costly disputes in settling claims.

The necessity to grow the trust of lenders in CGC's has been more emphasized by new guarantee organizations. Further, the guarantee organizations have also produced more specific conditions and procedures for expressing their respective roles and conditions under which they can provide a solid guarantee. Also, the guarantor should create a system that enables the participant banks to have a voice in their operational arrangements. Hopefully, this relationship is always fruitful even if conflicts of interest between the guarantor and the banks arise, which may sometimes emerge on an individual transaction basis.

Better schemes have also clearly specified detailed procedures in written agreements and have tried to adhere to them. There are, however, some situations where it is abundantly clear that the bank has been significantly remiss and the guarantee should not be paid out in these cases. A full explanation as to why this step is being taken should be given relatively promptly to the claimant, and it should be a rare occurrence, assuming the guarantor takes joint responsibility with the lender in prior approval or post-approval monitoring of guarantee issue procedures.

One of the key advantages of a multi-bank scheme is that it allows comparative monitoring of individual lender performance in the use of, and claims under, the guarantee. When requests concerning commitments are running at an exceptionally high level for a particular lender, the guarantor can take steps to draw the bank's attention to this and jointly examine the reasons. It may be that some aspect of lending behavior is different without it in any way falling below agreed standards or breaking any eligibility conditions. This condition may require an adjustment in coverage or fees for that particular bank. While the problem is evaluated, in other cases, accreditation rights or even extensive cooperation should be decreased at least temporarily. When managing relations between guarantor and lender it should be assessed whether the bank has behaved correctly and responsibly in particular cases.

It is essential for the banks to have the capacity to benefit commercially, directly and indirectly, from their participation in the guarantee scheme. That ability is a crucial issue that the guarantor might have in mind in arranging the relationship. Essential items here are any further transactions costs arising from the use of the guarantee scheme which the bank cannot recover.

2.9. Overview of Lender-Borrower Relationships

The relationships between lender and borrower have extensively been discussed in the financial intermediation theory. It is contended that through such relationships, the lenders produce significant information about borrowers that could not be accessed in financial markets. This information is known as “soft” information and is difficult to be observed and verified by others or transmitted to others since it is difficult to quantify and communicate such information through the organization structure (Berger and Udell, 2002). These authors additionally remarked that banks appear to generate intensive relationships with borrowers to manage the presence of asymmetric information concerning small-scale loans. This relationship has become a highly intriguing area for financial institutions particularly related to small-scale lending. The prior relationship between lenders and borrowers becomes valuable information for the bank to determine the creditworthiness of the borrowers over a substantial period of time. It is essential for prudent lenders to search for creditworthy borrowers, where the establishment of the long-term relationship between lenders and borrowers is recognized as an appropriate method to get this information, particularly for opaque businesses.

The capacity to gather soft information is strengthened by regularly doing business with a given customer. The expense for collecting information is most likely high when the lender and borrower execute just once transaction. The cost may be reduced when repeated transactions have

been made. At this point, the lender-borrower relations may impact the costs of borrowing. The more information on borrowers the lenders can collect, the less the lenders have to exacerbate borrower's motivations by setting loan conditions, related to interest rate and collateral requirements. The ongoing relationship between lender and borrower in rendering numerous financial services can create important data for the lender, helping to inform the lender in making decisions as to whether it broadens credits, setting up the term of loans, requirements of collateral or other conditions to the loan. Thus, the long-standing barrier of anxiety and skepticism could be reduced through such relationships, which can also strengthen the lender-borrower relationship, thereby encouraging future transactions. The strength of a relationship can be described by the term of a loan, deposit, or other service products provided to the borrower. The World Bank concluded that:

“The formation and maintenance of social capital between staff and borrowers is crucial to: identify and train borrowers; select and approve loan proposals; negotiate solutions when problems emerge (e.g. the death of a group member, crop failure following a cyclone, etc.); and fend off criticism - even hostility - from skeptics, moneylender, and some religious leaders” (reported in Ito, 2003; p. 237).

With a greater lender-borrower relationship, a small-scale firm could obtain a loan with a lower rate of interest, and may not have to give collateral because a positive past relationship prompts a lender to anticipate less loan risk. The accrued information, which was gathered throughout the lender-borrower relationship, is utilized to refine the contract terms of a loan. Financial institutions, as a financial intermediary, are concerned with assisting SMEs to deal with credit rationing issues. The degree of credit rationing may rely upon the quality of the existing relationships between lender and borrower. Some researchers concluded that the strength of a relationship can be described by the period that the lender has given credit, deposit, or other service products to the borrowers. Thus, it affects the firm's value and credit availability (Cole,

1998; Ono et al., 2013; Ono and Uesugi, 2009; Berger and Udell, 2002).

The dynamic interaction between lenders and borrowers requires a positive offering from both of them. The lender can only realize a client's need if the borrower gives precise and timely information. In strong relations, the bank (Account Officer/AO) understands the operational characteristic of a specific business of a borrower and receives signals relating to managerial aspects and business prospects, which then lead to the best understanding of customer needs and resources. Strong lender-borrower relations are so effective that the interaction between both parties creates a better understanding of both of them, then decreases monitoring costs and also loan rates. This conclusion is consistent with the framework of social interaction in a business-to-business relationship (Blois, 1999).

Some researchers found some empirical facts related to the relationship between bank and borrower. Ono et al. (2013), for example, contended that the relationship between lender and borrower could lessen the friction of information and improve credit accessibility for small businesses. Additionally, this relationship is also primarily associated with the credit accessibility and loan terms, for example, the collateral conditions and the interest rates of a loan (Berger and Udell, 2002; Lehmann and Neuberger, 2001; Cole, 1998; Petersen and Rajan, 1994). Besides, the improvement of the lender and borrower relationship is formed through the critical role of trust, confidence, and satisfaction (Uzzi, 1999; Ganesan, 1994). Trust may have been built through prior transactions that could decrease moral hazard. In this way, it could lessen the cost of monitoring.

Henceforth, the characteristics of relationships bring about a remarkable effect on the quality and amount of information given to the lender. Uzzi (1999) explored how the strength of the lender-borrower relationship and social connections affect the capacity of a SME customer to

get loans and lessen the expense of borrowing. This relation will build a cooperation that gives rise to an ongoing relationship, in which the two parties develop a mutual trust. Fisman and Khanna (1999) concluded that in the absence of certainty, people are inclined to search for more information and consider the significance of monitoring to diminish opportunism. At this point, the better the flow of information is, the more trust and understanding of each other's conduct will be.

2.10. Lender-Borrower Relationships in the Context of Credit Guarantee Schemes

As described earlier, empirical studies have concluded that the close lender-borrower relationship reduces information disputes between a borrower and lender. It also improves loan accessibility and the terms of the loan for micro, small, and new companies, in particular, which are informationally more obscure companies (Berger and Udell, 2002; Lehmann and Neuberger, 2001; Cole, 1998; Petersen and Rajan, 1994). Establishing relationships may be more costly for SMEs than to big business, and a lack of interaction could lead to credit rationing for SME's credit market.

Craig et al. (2005) and Menkhoff et al. (2012) concluded that relationship lending may solve physical collateral problems. It means that credit guarantee schemes diminish collateral necessity, where the lender-borrower relationship serves as a form of substitute for small business collateral. Further, Craig et al. (2005) also stated that the guarantee program could reduce the risk by creating lender-borrower relationships. Hence, loan guarantees may decrease probability of loan default, and improve credit allocation for MSMEs by applying a procedure for loan pricing which is not affected by borrower behavior.

Also, the close relationship between lenders and borrowers may create a quick and easy

approval process for guaranteed loans since this relationship is based on trust between both parties. The lenders do not need to face a high evaluation cost to approve a loan for a borrower since the lender already knows about the creditworthiness of the borrower. Therefore, lenders/banks start to consider the importance of maintaining a relationship with borrowers.

The credit guarantee increases the expected return of the lender without increasing the lending cost and tends to enhance the willingness of a bank to provide loans. Finally, the loan guarantee program could increase the intermediary function of the lenders by lowering the risk to extend longer-term loans needed by small business for capital investment. However, the ways that the relationship between lender and borrower affects the performance of credit guarantee schemes have not received much attention in the literature.

Ono et al. (2013) arrived at a contrary conclusion related to this relationship in the context of credit guaranteed loans. They argued that in a close relationship, a lender might employ guarantee schemes to supplement its effort to support customers in temporary financial crisis. The improvement of ex-post performance of small firm borrowers is likely to increase the arrangement of guaranteed loans through the relationship between lender and borrower. On the other hand, Vogel and Adams (1996) concluded that banks may want to replace existing loans with guaranteed loans. Hence, the intimate relationships between lender and borrower may damage the performance of credit guarantee schemes since the banks/lenders might exploit their informational advantages to identify unprofitable businesses, changing non-guaranteed loans to guaranteed loans, and delivering loans with worse default risks to the public credit guarantee corporation. Credit existence and an enterprise's ex-post performance increase if the lender employs the guaranteed loan to enlarge its efforts to support firms, in particular for micro and small firms, and also young firms.

Chapter 3

Guarantee Corporations, Regulatory Framework, and Provision of Guaranteed Loans for Micro and Small Enterprises in Indonesia

3.1. Introduction

This chapter describes the existing Credit Guarantee Corporations (CGCs) in Indonesia, their regulatory framework, and the government's role in supporting the implementation of CGCs. This chapter starts with the history of CGCs in Indonesia that presents the overview of CGCs with the regulatory guarantee in Indonesia. The second part describes the delivery networks for guarantee schemes in Indonesia. This section describes the delivery mechanism and the role of the financial institutions as the partner banks of CGCs in providing guaranteed loans for Micro, Small, and Medium Enterprises (MSMEs) and then evaluates the outreach of CGCs to reach these companies.

3.2. History of Credit Guarantee Corporations in Indonesia and Regulatory Framework

3.2.1. Overview of Credit Guarantee Corporations in Indonesia

The public policies on the guarantee industry from the Indonesian Government are mainly guarantee loans provided for all sectors and MSMEs. Minimizing the barriers of these businesses to access loans due to not having enough collateral is expected to be overcome by the guarantee mechanism which can then be identified as an effective tool to support government programs for MSMEs development. The history of the guarantee corporation in Indonesia began in 1970 when the Government established LJKK (*Lembaga Jaminan Kredit Koperasi*), an institution covering loans for cooperatives.

One year later the government also established another tool to implement government

policies known as Askrindo (*Asuransi Kredit Indonesia/Indonesian Insurance Credit*), an insurance company for bank loans, also an instrument to implement government policies. These guarantee/insurance institutions had to cover government-supported credit schemes at regulated premiums. This insurance institution faced massive losses, which were finally covered by the government budget.

LJKK became Perum PKK (*Perum Pengembangan Keuangan Koperasi/Finance Cooperative and Development*), a company with the same mission. In 1990, the Indonesian government stopped several credit schemes, and Askrindo experienced another financial crisis. Then, Indonesia's Ministry of Finance (MOF) introduced a private credit guarantee company in 1996, known as PT. PKPI (*Perseroan Terbatas, Penjaminan Kredit Pengusaha Indonesia*). This company is active but does not play a significant role in the market. PT. ASEI (*Perseroan Terbatas, Asuransi Ekspor Indonesia*) is another government company, created in 1985, and engaged in credit insurance and guarantees. PT. ASEI is connected, in particular, with financing imports and exports.

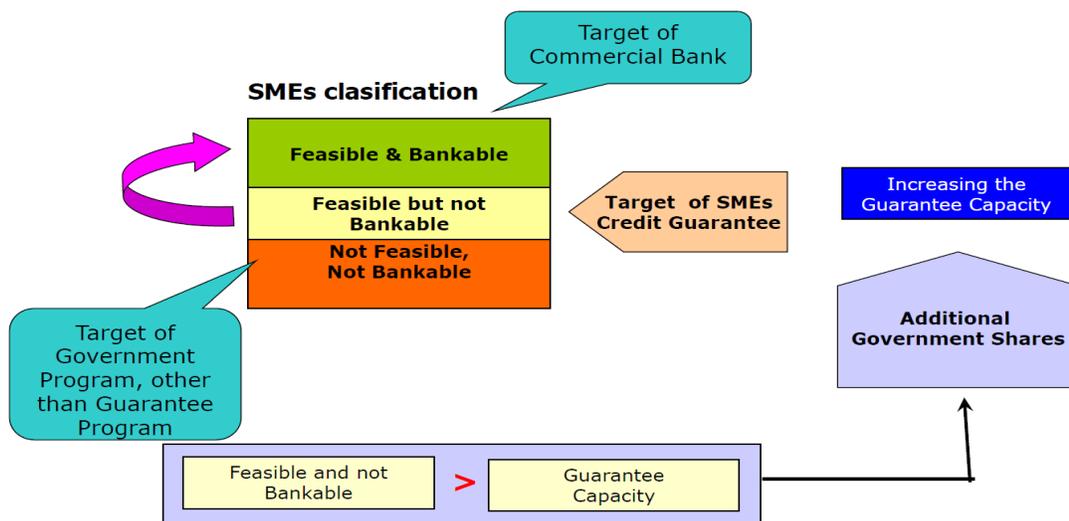
Perum PKK's services were restricted only to cooperatives. Thus, Indonesia Government changed this Perum PKK into *Perum Sarana Pengembangan Usaha* (Perum SPU). Perum SPU had served not only cooperatives but to also serve micro, small, and medium businesses. Then, since 1999, after reforming Perum PKK to become Perum SPU, the government companies left their established market segments and infringed on each other's fields of competence. At that time, their primary task was to create profit for the government. They were lost their development orientation as indicated by the fact that they did not develop particular guarantee schemes.

In 2008, the Indonesian government created Perum Jamkrindo (*Perusahaan Umum Jaminan Kredit Indonesia*) as the transformation of Perum SPU. This transformation is related to

the transformation in a line of business activities of the guarantee corporation. Now it is only concentrated on running a credit guarantee business for MSMEs instead of providing direct credit to these sectors through profit and loss sharing. Perum Jamkrindo was required to hold a permission as a CGC to meet the regulation; thus, the MOF declared that Perum Jamkrindo has a business license as a Credit Guarantee Company.

The vision of Perum Jamkrindo is “being a leading CGC that can support the development of the national economy.” This vision is translated into three missions as follows: 1) implementing credit guarantee corporations and business consulting to encourage the business development of MSMEs and cooperatives; 2) providing wider and qualified services; and 3) creating benefits to stakeholders based on the healthy business principles (Perum Jamkrindo, 2015; p. 67). The target of this government guarantee program in Indonesia is based on the Figure 3.1 below.

Figure 3.1 Targets of Indonesian Public Guarantee Programs



Source: Perum Jamkrindo (2011a; p. 28)

3.2.2. Guarantee Regulation of Credit Guarantee Corporations in Indonesia

The Indonesian Government established the main state-owned CGC, known as the LJKK in 1970. Further, LJKK was transformed into Perum PKK (*Perum Pengembangan Keuangan Koperasi*) based on regulation No. 51 in December 1981 which was then revised by Government Regulation No. 27 in May 1985. In 1996, MOF issued Government Decision No. 486/KMK.017/1996 regulating CGCs with a task of supporting enterprises in obtaining funds from a wider variety of sources. According to this regulation Perum PKK should only provide a guarantee for credits delivered by banks, leasing or factoring companies, consumer finance enterprises, and venture capital providers as well as companies offering other kinds of installment purchases. Then, guarantee certificates will be issued to those entitled to ask for the licenses. The regulation allows banks to request loan guarantees without the knowledge of the borrower. Under this regulation, the minimum statutory equity is 10 billion IDR, and 3 billion IDR is required to start a business. This regulation also allows a CGC to be jointly established by private investors and state-owned firms.

The government enlarged the range of Perum PKK's services through PP. 95 in November 2000, and then Perum PKK became Perum SPU. Moreover, through the Government Regulation No. 41 in 2008; the name of Perum SPU was changed to Perum Jamkrindo. Perum displayed a transformation in the company's way of doing business, in that it does not provide loans directly to MSMEs that employ a term of revenue sharing, it instead focuses on delivering credit guarantee to these enterprises.

The Indonesian government issued Presidential Regulation No. 2 in 2008 about Perum Jamkrindo. To implement the regulation, the MOF released the Regulation of MOF in 2008, issuing Perum Jamkrindo a license as a CGC. Furthermore, the MOF issued Decree No. KEP-

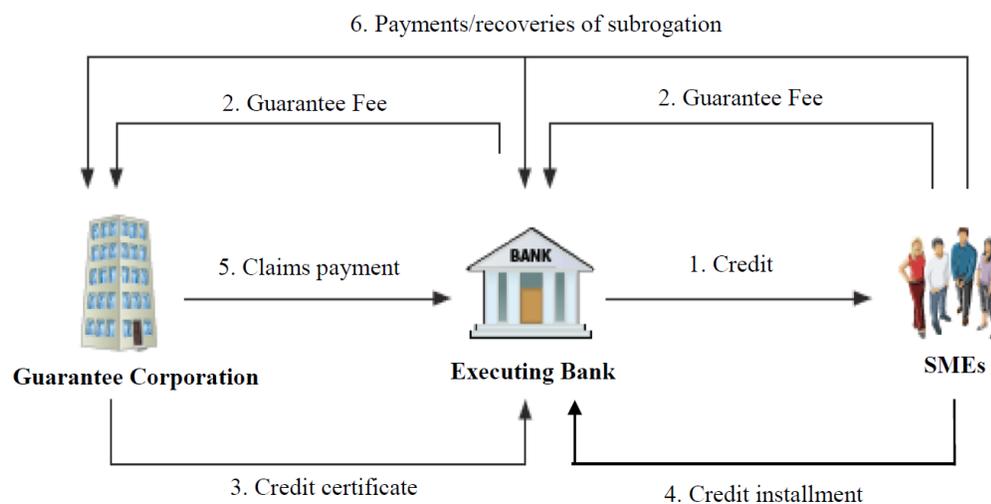
77/KM.10/2009 April 22 which formally established a permit for corporation guarantees to Perum Jamkrindo.

3.3. Operational Characteristics of the Indonesian State-owned Credit Guarantee Corporations

3.3.1. Regulatory and Delivery Mechanism

The fundamental principle of the credit guarantee mechanism is to take over the credit risks (credit failure) to meet the financial obligations of the borrower. However, it does not eliminate the financial obligation of the borrower/guaranteed to the lender/guarantee recipients until the lender/guarantee recipients convey that the loan is settled. A credit guarantee is required by the lender at the time of loan application submitted by the borrower, if the borrower could not fulfill the credit requirement, especially that of adequate collateral. The credit guarantee process is implemented following the terms and conditions agreed upon between the guarantor and the guarantee recipients (banks) and documented in the credit guarantee agreement (Figure 3.2).

Figure 3.2 Guarantee Mechanism of Perum Jamkrindo



Source: Modified from Perum Jamkrindo (2015; p. 237)

There are two kinds of guarantee mechanisms: Case by Case (CBC) and Conditional Automatic Cover (CAC) basis. The CBC mechanism is a guarantee approval process based on a case by case basis of the credits granted by the guarantor. The guarantee of a case by case basis is applied to commercial loans, micro credit, construction and procurement of goods/services credit, counter bank guarantee, distribution of goods and certain types of multipurpose credit.

The guarantee credit approval steps using the CBC mechanism are as follows. Firstly, the guarantee recipient or partner bank applies for a credit guarantee by submitting several documents, which are business proposal, ID card and business license of the applicant. Secondly, after analyzing the feasibility of the guarantee application, the guarantor issues a letter called SP3 (*Surat Persetujuan Prinsip Penjaminan*) to the guarantee recipient that contains the guarantee terms and conditions, or issues a refusal letter when the credit guarantee application is not approved by the guarantor. Thirdly, the guarantee recipient submits a letter of consent, agreeing to all the terms contained in the SP3 when they agree to its terms. Fourthly, the credit agreement is signed by the guarantee recipient or partner bank/non-bank and the loan for the MSME client and cooperative is approved. Fifthly, the guarantee recipient submits the proposal for the issuance of Guarantee Certificate (*Sertifikat Penjaminan/SP*) to the guarantee company by submitting several documents, including a copy of the credit agreement and its addendum, and the receipt of Fee Payment Guarantee (*Imbal Jasa Penjaminan/IJP*). Finally, the guarantee recipient receives a guarantee certificate issued by the guarantor.

The CAC, on the other hand, operates without informing the borrower that their loan is subject to a guarantee that can eliminate one source of moral hazard. CAC is a guarantee provided automatically by the guarantee corporation for the credit application of clients in the partner banks of the CGC. In this model, the guarantor will evaluate the feasibility of the

guarantee application in advance before the issuance of guarantee approval. The CAC is given to all credit guarantee products within the limits of a certain amount of credit. This CAC is given to all credit guarantee products including *Kredit Usaha Rakyat* (KUR) loans and micro credits.

3.3.2. Types of Guarantees

Indonesian CGCs run two types of guarantees that are classified as credit guarantee programs and existing (corporate) credit guarantees. In Indonesia, the credit guarantee program was established around 1960 and was intended to provide financial support for the productive sectors of the economy to be able to develop their business. The Ministry of Cooperatives and Micro, Small, and Medium Business stated that the credit program is a financing system for a bank's credit which is focused on the interests of national economic development.

One of the activities conducted by Indonesian CGCs is running a credit guarantee program that aims to support the credit program established by the government in order to increase credit access especially to MSEs. KUR loan is one of credit guarantee programs currently undertaken by Indonesian CGCs. The CGCs create the existing guarantee directly or indirectly. Direct lending is provided by guarantee recipients to MSEs and cooperatives, while for indirect lending, the guarantee recipient cooperates with the linkage institutions with the patterns of executing and channeling.

3.4. Strengthening Participation for Credit Guarantee Schemes

The guarantee scheme is a tool to support government policy to encourage financial access especially for MSMEs. The implementation of the schemes needs the participation of some parties, such as local banks, regional governments, donors, and the central bank.

3.4.1. Participation of Commercial Banks

Financial institutions (FIs) are an essential channel for supplying the loans for MSMEs since they have an established institutional framework. FIs are often commercial banks, which have experience in evaluating and screening credit proposals, which can reduce loan default and claims. The FIs provide a loan for MSMEs by using the CGC services; hence it is proposed that the FIs should participate in the equity of this company. The role of local banks could be as a sign of commitment to support the guarantor institution and as supervisors to prevent inefficient use of funds and engagement in excessively risky business or business contracts not based on purely commercial terms.

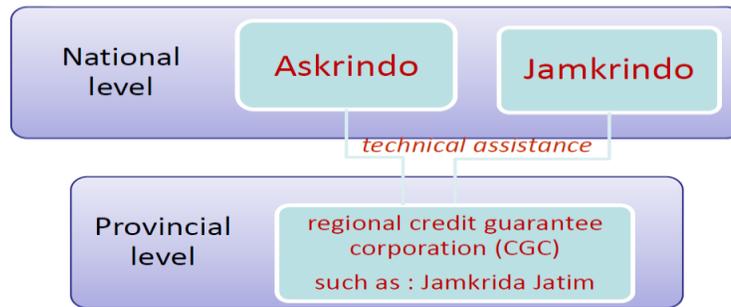
3.4.2. Participation of Regional Governments

A credit guarantee facility is a political tool by which the decentralization process makes provinces and district governments more powerful. Therefore, the CGC's success or failure also depends very much on the support of local authorities. However, not all provincial governments may wish to invest 10 billion IDR in establishing a local bank loan guarantee company. These provinces might acquire shares in the consolidated company, a trust fund, a kind of profit center on the local level.

3.5. Public Credit Guarantee Corporations

Indonesia, as one of nine “Big Players” in the guarantee market (KPMG, 2011), has significant experience in implementing guarantee and insurance programs. The public credit guarantee schemes in Indonesia are divided into state-owned and regionally-owned guarantee corporations. The structure of credit guarantee schemes in Indonesia is demonstrated in Figure 3.3.

Figure 3.3 Credit Guarantee Schemes in Indonesia



Source: Bank Indonesia (2010; p. 2)

3.5.1. State-owned Credit Guarantee Corporations

Perum Jamkrindo is a State-Owned Enterprise (SOE) in the format of a Public Corporation. Therefore, the company has not conducted an Initial Public Offering (IPO), hence, the government of the Republic of Indonesia has 100% ownership of Perum Jamkrindo. Delivering a credit guarantee for MSMEs and cooperatives for all sectors is the objective of the Perum Jamkrindo. The state-owned CGC was created under the Department of Co-operatives, but now it is under the MOF. This company has been transformed several times. By the regulation of the Indonesian Government No. 41 of 2008 dated May 19, 2008, of Perum Jamkrindo. The Government set the aim of establishing Perum Jamkrindo which is to employ and encourage government policies and programs for national economic development. To achieve the goals and objectives of the company as referred to, Perum Jamkrindo conducted the following business:

- Providing credit guarantees both cash and non-cash provided by partner banks or other financial institutions to MSMEs and cooperatives;
- Providing guarantees for lease financing, factoring, consumer finance, and funding patterns furnished by the financial institution to MSMEs;
- Providing guarantees to purchase goods by installments made by small and medium enterprises;
- Providing Islamic guarantees for financing both cash and non-cash provided by a sharia bank or sharia banking unit for micro, small, and medium businesses;
- Providing guarantees for contract services performed by MSMEs;

- Performing other business activities, including providing advisory and management consultants to MSMEs and co-operatives following the aims and objectives of Perum Jamkrindo.

In 2013, the total assets of Perum Jamkrindo totaled 8.29 trillion IDR⁸ compared to its total assets in 2012 which totaled 6.66 trillion IDR an increase of 24.47%, while its total assets in 2014 reached 10.02 trillion IDR (Perum Jamkrindo, 2013; p. 107). Perum Jamkrindo has initiated many branch offices around the nation to reach the large number of MSMEs, especially MSEs that faced financial constraints. The branch offices of Perum Jamkrindo are presented in Table 3.1.

Table 3.1 Network Services of Perum Jamkrindo

Offices	Region
Head Office	DKI Jakarta
Branch Offices (22)	DKI Jakarta, Denpasar, Medan, Pekanbaru, Samarinda, Semarang, Jayapura, Mataram, Palangkaraya, Yogyakarta, Bandung, Makassar, Palembang, Pontianak, Surabaya, Banjarmasin, Kupang, Manado, Jambi, Bandar Lampung, Palu, Tanjung Pinang, Padang, Banda Aceh, Serang, Bengkulu, Kendari, Mamuju, Gorontalo, Tarakan, Ternate, Pangkal Pinang, Manokwari, Ambon
Special Branch Office	DKI Jakarta

Source : Perum Jamkrindo (2015)

Perum Jamkrindo has more than 32 years of experience in the guarantee sector and has cooperated with more than 70 partners, both banking and non-banking institutions, consisting of state-owned banks, Regional Development Banks-*Bank Pembangunan Daerah* (BPD), national private banks and non-bank institutions (Table 3.2).

⁸ 1 USD equivalent to 14,000 IDR

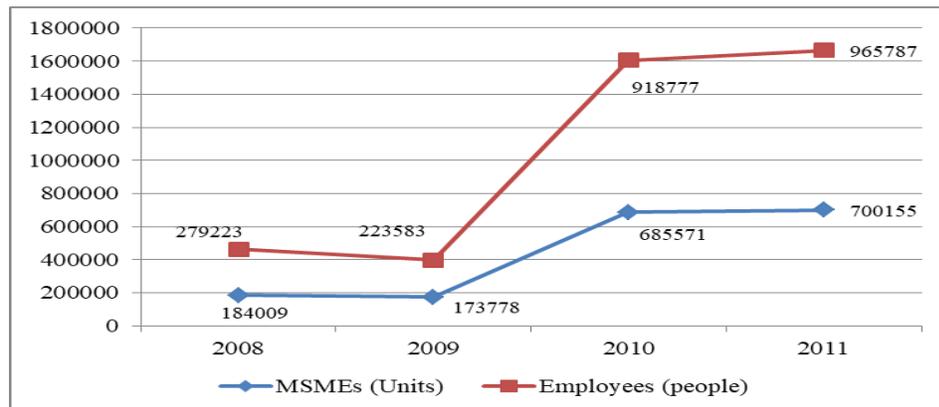
Table 3.2 Partner Banks of Perum Jamkrindo

Type of Banks	Banks
State-Owned Banks	<i>Bank Negara Indonesia (BNI), Bank Rakyat Indonesia (BRI), Bank Tabungan Negara (BTN), and Bank Mandiri</i>
Regional Development Banks (<i>Bank Pembangunan Indonesia /BPD</i>)	26 BPDs throughout Indonesia
National Private Banks	Bank Bukopin, Bank Persyarikatan, Bank CIMB Niaga, Bank Kesejahteraan Ekonomi, Bank Danamon, Bank Permata, Bank Sriparta, Bank Agroniaga, Bank Artos Indonesia, Bank Bumiputra, Bank Yudha Bhakti, Bank International Indonesia (BII); and non-bank institutions: PT. Pegadaian, PT Garuda Indonesia, PT. Hutama Karya, PT. Semen Indonesia, PT Semen Bosowa, PT. Pos Indonesia, PT. Indofarma, PT. Inti, PT Len, KOPEBI, KWSG, Indonesia Exim bank (LPEI), Tripilar Beton Mas, Perumnas, PT. PNM, Propernas, PT. Sahid Dinamika, Asosiasi Logisti Forwarder Indonesia, Brantas Abipraya, BOSTIK, YKKBI

Source: Perum Jamkrindo (2015)

By making many partnerships, Perum Jamkrindo can enlarge its outreach among eligible MSMEs around the nation (Figure 3.4)

Figure 3.4 Outreach of Perum Jamkrindo



Source: Data Processed (Perum Jamkrindo, 2011a; p. 29)

3.5.2. Regional Credit Guarantee Corporations (RCGCs)

A Regional Credit Guarantee Corporation (RCGC) known as Perum Jamkrinda (*Perum Jaminan Kredit Daerah*) is a regionally-owned entity. The establishment of Perum Jamkrinda

originates from a lack of sufficient access to finance for MSEs, as these businesses play a crucial role in encouraging the development of the local economy. An RCGC is owned and funded by a provincial government and seems to be more effective guarantee corporations than state-owned CGCs since it operates in its own region and knows the characteristics of the target clients very well. Therefore, provincial governments are encouraged to create their own RCGC.

The stakeholders in the establishment of an RCGC are the central government, regional government, and regional parliament. The roles of the central government in the creation of an RCGC are as a regulator for local government budgeting, as a regulator to establish a sustainable credit guarantee institution, as a regulator to support the operation of the credit guarantee institution, and as a facilitator to promote human resource capacity building. Meanwhile, the roles of regional governments are to build the supporting financial infrastructure, to provide the initial investment for the establishment of the RCGC, to provide a partial subsidy of the premium fee, especially for microenterprises, and to facilitate education for MSEs in managing credit. Lastly, the roles of the regional parliament are to grant approval for the establishment of the RCGC and to give approval to the regional government for investment in the RCGC.

By the end of 2014, there were 16 RCGCs in 16 provinces, including Perum Jamkrida Jatim and Perum Jamkrida Bali Mandara, which are the longest established RCGCs. Currently regional development banks provide the most significant portfolios for micro and small-credit of RCGCs, since these banks are situated in regional areas. Therefore, these banks are more easily accessed by MSMEs, and they can serve these businesses promptly.

Perum Jamkrida Jatim is located in the province of East Java and owned by the regional government of East Java. The local government invested 150 billion IDR as an additional share (equity) in Perum Jamkrida Jatim. Perum Jamkrida Bali Mandara is located in the province of

Bali and owned by the regional government in Bali, where the government has invested 50 billion IDR as an additional share (equity) in its RCGC.

3.6. Private Credit Guarantee Corporations

3.6.1. PT. PKPI (*Perseroan Terbatas, Penjaminan Kredit Pengusaha Indonesia*)

PT. PKPI is one of several private companies that provide guarantee to MSME loans. Incorporated in 1996 and in operation since 1997, PT. PKPI was backed by KADIN (*Kamar Dagang Indonesia/Chamber of Trade and Industry*), several politicians and with the encouragement of Bank Indonesia, the company was allowed to start its business under the MOF Decree No. 486 from the same year. PT. PKPI provides loan guarantees, which typically cover higher percentages (up to 75%) of the loan. Potential borrowers have to permit the bank and also the credit guarantee company to look at the enterprise and its books on-the-spot. PT. PKPI will do some desk research and appraisal, but in principle, PT. PKPI allows banks to approve the guaranteed contracts.

PT. PKPI's proponents aimed at raising a guarantee fund of 120 million USD to be contributed by private persons, participating banks, and big business. The supporters lowered the target to 20 billion IDR but were only able to mobilize 10 billion IDR⁹. The economic crisis that started shortly afterward prevented this company from playing a role in the market. Individual loans up to 500 million IDR are guaranteed up to 75%. The total exposure is about 100 billion IDR without the risks being reinsured. PT. PKPI does not receive government support. The company covers loans during the grace period, a guarantee without risk, and does not fulfill its obligation to publish its financial figures.

⁹ 1 USD equivalent to 14,000 IDR

3.6.2. USAID LPG (Loan Portfolio Guarantee)

USAID LPG (Loan Portfolio Guarantee) is a remotely run Washington-based loan guarantee scheme cooperating with banks in many countries, including six Indonesian institutions, and has been in operation since 1996. One small private national bank with a focus on MSMEs continues to use this particular cover on a modest level. By mid-2001, less than 40 loans were backed up by this guarantee. The claim rate is zero. The public relations value of the scheme (cooperation with the USA) and the offer of technical assistance are the main reasons for engaging in this venture.

However, banks have also two reasons for not using this facility. It is considered more costly, and under present circumstances, banks do not want to engage in loans that need to be guaranteed in the first place. USAID LPG and PT. PKPI trust the banks to decide on whether criteria are fulfilled to obtain the guarantee and any claims that arise without reviewing internal bank procedures. However, the companies agree that their product ranges overlap and that they compete in the same market. Today, their significant distinction is only their different history.

3.7. Comparison with the Best Practices

The guarantee corporations around the world are mostly owned by the state and initiated mainly by public funds. The guarantee schemes in Asia are primarily identified as PGSs as well. PGSs are initiated by the government as a useful policy tool to decrease the financial constraints of MSMEs, and they are frequently implemented in low-income and emerging economies. Asian Credit Guarantee Schemes have a broader objective to encourage access to finance for MSMEs that lack adequate collateral. The main features of Asian Guarantee Schemes are presented in Table 3.3.

Table 3.3 Main Features of Asian Guarantee Schemes

Country	Main Guarantee Scheme	Operational Characteristic
Japan	There are 52 CGCs, one for each prefecture and one in each of the cities of Osaka, Nagoya, Yokohama, Kawasaki, and Gifu.	<ul style="list-style-type: none"> • They reflect a supplementary economic policy tool supervised by the central government under the Ministry of Finance, the Ministry of Economy, Trade and Industry and regional governments. • Non-profit public financial boards. • 100% of the loans are usually covered by the CGC.
South Korea	State-owned guarantee schemes are operating at the national level and also regional level (Korea Credit Guarantee Fund - KODIT)	<ul style="list-style-type: none"> • KODIT (initiated in 1974) is a non-profit guarantee corporation controlled by the Ministry of Economy, Finance and the Budget and by parliament. • The government and the banks provide a regular grant for guarantee institutions. • KODIT delivers a credit guarantee for SMEs, which operate in the traditional industries, such as wholesale & retail, and manufacturing. • The guarantee coverage is from 60% to 80% of the total loan.
India	State-owned guarantee schemes (Credit Guarantee Fund Trust for Micro and Small Enterprises - CGTMSE)	<ul style="list-style-type: none"> • The Indian government and Small Industries Development Bank of India set up a Credit Guarantee Scheme known as the CGTMSE, which was launched in August 2000 • This scheme stopped the implementation of the Deposit Insurance and CGC.

Source: International Survey on Guarantee Market Players (KPMG, 2011)

3.8. Overview of *Kredit Usaha Rakyat* (KUR) Loans

After the economic crisis in 2007, the Indonesian government encouraged micro, small, and medium business in accessing banks. This program was established based on Presidential Instruction No. 6 June 8, 2007, about the acceleration of real sector development and the empowerment of MSMEs, especially MSEs since these enterprises are 99% of total enterprises in Indonesia. This program aims to enhance the guarantee companies by increasing capital and expanding service reach. In this program, a sum of the state capital is supplemented by the government as additional government capital to strengthen the guarantee companies. KUR is a credit scheme for working and investment capital to MSEs and cooperatives in productive and

feasible business lines, but is not bankable yet, partially guaranteed by the Perum Jamkrindo.

The decision to grant KUR is entirely the authority of the implementing bank. There are two pieces of collateral in the provision of KUR. First, the principal collateral is the business feasibility and the object being financed. The second type of collateral is additional collateral in accordance with the provisions of the implementing bank. The general requirements for MSEs and cooperatives to receive a KUR loan are stated in the Deputy Decree of Macroeconomic and Financial Coordination of Coordinating Ministry of Economic Affairs as Chairman of Implementation Team of the Policy Committee of the Guarantee Credit/Financing to MSMEs and Cooperative Number: KEP-01 /D.I.M.EKON/01/2010.

A KUR loan is funding for working capital and investment to MSEs and cooperatives in productive and feasible business lines, but is not bankable yet, partially guaranteed by the Perum Jamkrindo. There are two types of KUR loans: Micro KUR and Retail KUR. Micro KUR is identified with a limit of up to 20 million IDR¹⁰ per debtor, and with an interest rate of 9% per year. The Retail KUR has a credit range of 20 million to 500 million IDR with a maximum interest rate of 13% per year.

The Indonesian Government, guarantee corporations, and distribution banks are the three parties that have a significant role in the application of KUR programs. The government, namely the technical department of the Indonesian government, plays an essential role in supporting and providing the implementation of the KUR program. The function of guarantee corporations is to guarantee the loans distributed by banks. Some guarantees for KUR loans are 80% of the total loan, for agricultural, marine, fishing, forestry, small industries, and Indonesian workers; and 70% for other sectors. Meanwhile, the role of banks is to distribute loans for MSEs and

¹⁰ 1 USD equivalent to 14,000 IDR

cooperatives. The executing banks of KUR include 26 BPDs, as well as BRI, Bank Mandiri, BTN, BNI, Bank Bukopin, BNI Syariah, and Bank Syariah Mandiri.

The realization of KUR loan based on executing bank is presented in Table 3.4. The distribution of KUR loans by executing banks is dominated by BRI with the total amount of outstanding KUR loan per 31 January 2017 is 1,108 billion IDR and 64,129 debtors. From the total outstanding KUR loan per 31 January 2017 (1,162 billion IDR), 48.59% is categorized as Micro KUR and 51.41% as Retail KUR. The borrowers of KUR loan are micro and small debtors. The realization of KUR loans per 31 January 2017 is distributed for the majority of micro debtors (87.27%) and 12.73% for small debtors.

Table 3.4 Realization of *Kredit Usaha Rakyat* (KUR) Loans (per 31 January 2017)

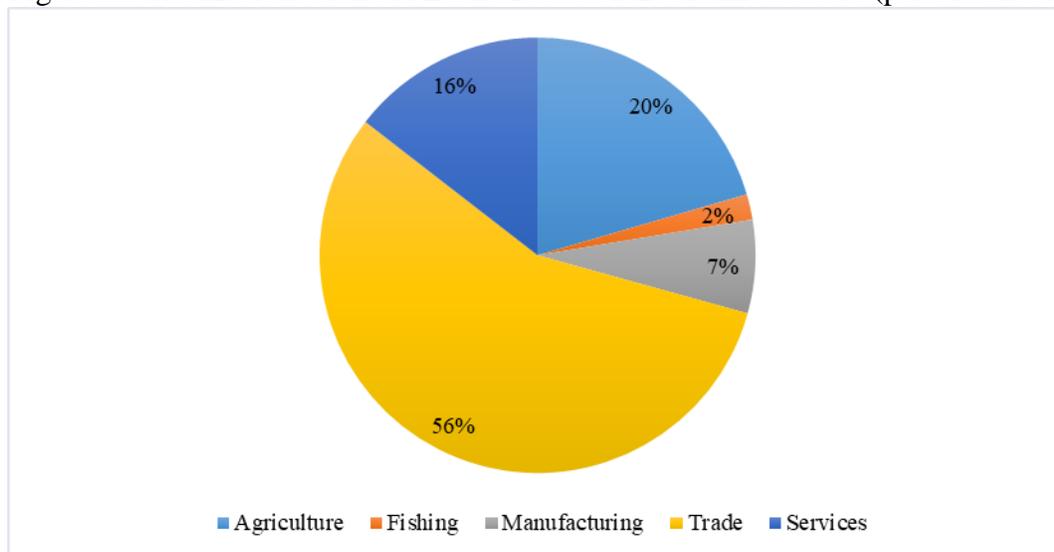
Type of Executing Banks	Micro KUR			Retail KUR		
	Outstanding Loans (Million IDR)	Debtors (people)	Average of Loans (Million IDR)	Outstanding Loans (Million IDR)	Debtors (people)	Average of Loans (Million IDR)
BRI	1,056,041.75	64,129	16.47	52,212.68	272	191.96
Bank Mandiri	90,009.78	4,623	19.47	501,134.18	5,882	85.20
BNI	2,976.54	162	18.37	307,481.96	1,212	253.70
BCA	1,045.50	45	23.23	23,207.65	286	81.15
Bukopin	0	0	0	25,013.24	79	316.62
Bank Sinarmas	50.00	2	25.00	5,582.00	26	214.69
Bank Permata	0	0	0	2,400.00	11	218.18
Bank Tabungan Pensiunan Negara	2,819.80	189	14.92	370.00	3	123.33
Bank OCBC NISP	0	0	0	3,750.00	9	416.67
BPD	8,928.50	472	18.92	308,065.00	2377	129.60
Total	1,161,871.87	69,622	136.38	1,229,216.71	10,157	2,031.10

Sources: Data Processed (KUR Ekon, 2017)

Based on the industrial sector (Figure 3.5), the distribution of KUR loans by executing banks is dominated by the trade sector. In this sector, KUR loans reach 1,344 billion IDR or 56% from the total realization of KUR loans per 31 January 2017. The agriculture sector has received

the second highest amount of KUR loans (20%). In this sector, the amount of KUR loans that have been distributed is 490 billion IDR. The services sector is distributed 347 billion IDR and 166 billion IDR for the manufacturing sector. The smallest amount of KUR loans is distributed for the fishing sector at 45 billion IDR.

Figure 3.5 Realizations of KUR Loans Based on Economic Sectors (per 31 January 2017)



Source: Data Processed (KUR Ekon, 2017)

The state-owned guarantee company, Perum Jamkrindo, has played a significant role in KUR loans by increasing capital and expanding services. The government has placed a sum of public funds through the KUR program as additional state capital to strengthen the function of Perum Jamkrindo. The state government induces supplementary subsidies, which are placed as equity, to the state-owned guarantee corporation (Perum Jamkrindo) totaling 1.75 trillion IDR to implement KUR programs. Additionally, the government offers an endorsement for guarantee fee that should be paid by MSEs. According to Table 3.5, in 2010, Perum Jamkrindo had provided 22.8 trillion IDR of KUR loans or 87.01% from total loans delivered for MSEs. The volume of KUR loans in 2010 was only 18.88% from total guaranteed loans. This percentage increased in

2011 and 2012, respectively became 37.32% and 42.58%.

Table 3.5 Credit Guarantee Volume of Perum Jamkrindo (Billion IDR)

Year	KUR	Micro and Small Credit	Others Credit	Total
2010	6,459	964	26,783	34,206
2011	20,233	1,742	32,241	54,216
2012	22,798	3,331	27,414	53,543
Total	49,490	6,037	86,438	141,965

Source: Data Processed (Perum Jamkrindo, 2012; p. 113-120)

The KUR distribution mechanism is set as follows: 1) direct distribution from executing bank to MSEs and cooperatives; 2) indirectly distributed through linkage institutions with the executing pattern; and 3) indirectly distributed through linkage institutions with the channeling pattern. The period of KUR loan for the investment capital shall not exceed five years, while for working capital it shall not exceed three years. When an extension, addition, or restructure is needed, the loan period can be extended to a maximum of six years for credit or working capital financing, and ten years for credit or investment financing that is effective from the date of the initial agreement.

CHAPTER 4

Performance Evaluation of a Credit Guarantee Scheme to Support Financial Development of Micro and Small Enterprises in Indonesia

4.1. Introduction

The objective of this study is to describe the performance of CGS from the three perspective parties of the CGS. In this chapter, this study examines the effective operation of Perum Jamkrindo by evaluating its ability to create profits, maintain claim rates and recover the claims of loan defaults. Then, Financial Additionalty (FA) and Economic Additionalty (EA) are examined to investigate the benefits of guaranteed loans by Perum Jamkrindo to support financial development in Micro and Small Enterprises (MSEs).

FA and EA were investigated to evaluate the benefits of guarantee schemes for MSEs through surveying the beneficiaries of Perum Jamkrindo. The impact of identified factors on the incidence of FA was examined using logistic regression analysis. These factors are capacity, real assets, working capital, the genders of the owner, the age of the owner, entrepreneurial experience, industry, and length of the banking relationship.

The investigation in this chapter is employed to respond to the research questions: ‘Is the operation of Perum Jamkrindo effective based on its ability to create profits, maintain claim rates and recover the claims of loan defaults?’ ‘To what extent, do the guaranteed loans (KUR loans) of Perum Jamkrindo affect their beneficiaries (micro and small firms) based on FA and EA?’

Perum Jamkrindo operates effectively since the premium fees of Perum Jamkrindo can cover the claims and total operational costs. The rate of default loans and the payment of claims of Perum Jamkrindo were deemed to be at an acceptable level. Moreover, responses obtained from the survey showed a significant appraisal of additionalty. FA was at a considerable degree,

where some parameters positively impacted FA. These parameters include the gender of the owner, the craft industry, and the length of banking relationship. Considering the EA, guaranteed loans were succeeded in increasing sales and profits of MSE, and also able to create jobs.

4.2. Measuring Performance of Credit Guarantee Schemes

Previous studies concluded that guaranteed loans could encourage financial development for Small and Medium Enterprises (SMEs). For example, Boocock and Shariff (2005) used a sample frame of 800 New Principal Guarantee Scheme (NPGS) borrowers in West Malaysia to explore the connection between the FA and some variables, such as loan size, collateral, firm size, legal status, industry, and ethnic background. The result of this study indicated that there was not a single variable that significantly influenced FA on its own. However, a group of variables (size of the loan, size of the firm, and ethnic background) were connected considerably.

Monitoring the three parties of the CGS is crucial to obtain a meaningful performance evaluation of the CGS. The best method to monitor the performance of a guarantor is by evaluating the cost-effectiveness of a guarantee operation. One of the primary indicators of CGC performance is financial sustainability, which could be measured by the equity ratio. Sustainability, in terms of finance, indicates the CGC's capacity for managing losses and continuity for providing enough equity based on the expected liabilities. Jonsson (2009) argued that financial sustainability might rely on the ability of the guarantor to deal with all operational costs and the cost of default through a premium fee paid by the clients. This sustainability is also influenced by the income from investing the guarantee fund itself and the subsidized loans from donor institutions. A good guarantee scheme should continue to have an equity ratio below a specific level that may hinge on the default risk of the portfolio. Equity ratios of guarantee

schemes vary from 5 to 10, describing some aspects of the scheme, such as management of risk, the implications of government policies, and also the maturity of the scheme.

As the initial cost to the credit guarantee schemes, the default rate serves as one of the essential indicators for measuring the performance of credit guarantee schemes. A modest price of default loans could represent contrary evidence about a CGS that implies limited activities and the aversion of high risk (Green, 2003). On the other hand, HM Treasury concluded that the scheme could be inefficient at increasing access for small lending propositions, when the default rate is high (reported in Cowling, 2010). Furthermore, the probability of defaults on guaranteed loans is influenced by the number of guarantees offered by the guarantee corporations (Riding and Haines, 2001). This fact means that if the level of guarantees rises, the rate of loan default will probably increase. In the first two years of the program, the increase of default rates might soar and achieve their highest level. However, the benefits would probably follow in the third year (Riding and Haines, 2001; Cowling, 2010).

Additionality is a primary indicator for measuring the performance of a guarantee scheme. It refers to the ability of clients to obtain funds with the existence of a guaranteed loan. FA and EA are the indicators of additionality. FA represents the ability of the recipient of the guarantee scheme to obtain the loan that might not have been provided in the absence of the scheme (Jonsson, 2009; p.59). FA was calculated by using the formula of National Economic Research Associates/NERA (reported in Boocock and Shariff, 2005; p. 448).

$$\textit{Additionality (percent)} = \frac{A+C-B}{A} \times 100 \quad (4.1)$$

Where: A is Perum Jamkrindo's finance raised. B is alternative finance that could have been raised. C is finance raised at the same time as Perum Jamkrindo's finance. Additionality will be 100 percent if $C = B$, or $C=0$ and $B=0$, $(C + A) = B$.

As such, the EA concepts are comprised of economic and social benefits. EA describes the outcome derived from the financial assistance obtained by a consumer. EA is categorized into direct additionality and indirect additionality (Boocock and Shariff, 2005). Direct EA is measured through the performance indicators of the firms, such as employee development, return and turnover a year after receiving the guaranteed loan. The entrepreneurial activity in the economy as an impact of the guarantee scheme is related to indirect EA (Gibb, 1999). The indirect EA is evaluated based on the ability to export and innovate, which is indicated by developing a new product or service and introducing new technology into the production or delivery process.

4.3. Research Method of this Study

4.3.1. Data Analysis

Quantitative and descriptive qualitative methods were used to investigate the performance Perum Jamkrindo. Whether the process of Perum Jamkrindo was effective is described by its ability to create profits, maintain the claim rates and recover the claims of loan defaults. Furthermore, assessments of FA and EA were performed to investigate the benefits of the guaranteed loans from Perum Jamkrindo to their beneficiaries. This study focused on Micro and Small Enterprises (MSEs), since most of businesses in Indonesia are MSEs (99% from total businesses).

This study aims to examine the factors that influence the effectiveness of the CGS to support financial access for MSEs, which is indicated by the FA. Levitsky (1997) determined the

minimum requirement of FA for justifying credit guarantee schemes as 60%, while Boocock and Shariff (2005) suggested a minimum requirement of 30-35%. Therefore, based on these requirements, this study formulates when FA is 30% or higher, it means that the borrowers can access credit because of the existence of CGS. Conversely, when the FA is below to 30%, it means that the CGS is not able to support MSEs in accessing credit from banks.

Consequently, to accomplish this purpose, the study conducts a logistic regression analysis. Binary logistic regression analysis is used to explain the relationship between the dependent variable in the form of binary data with independent variables in the form of continuous and categorical data. The dependent variable is known as the incidence of FA and characterized as a dichotomous dependent variable. The FA is divided into two categories. First, FA of less than 30% is given a value of “0”. Second, FA of 30% or more is assigned a value of “1”.

Furthermore, the independent variables are identified as the determinants of commercial lender decisions for granting a loan (Boocock and Shariff, 2005; Riding et al., 2007). The general model of logistic regression is formulated as follows (model 1):

$$Y_i = \alpha + \beta X_i + \epsilon_i \quad (4.2)$$

Where: “Y” = FA; “X” refers to business characteristics (annual sales, employment, capacity, real asset, working capital, legal status of business, industry, and business plan) and owner characteristics (gender of the owner, age of the owner, and length of banking relationships); and “i” represents firms.

The model estimates the coefficients (β) of the group of independent variables. Independent variables are the determinant factors that may influence the credit decision of a

lender, based on the '5Cs' of commercial lending. The '5Cs' of commercial lending consist of capital, collateral, capacity, condition, and character.

Character is linked to credit history, which indicates a borrower's reputation for repaying debt. The credit report of borrowers informs their character. It contains the loan information of the borrowers, such as how many loans have been made by the applicant in the past and if they have repaid the loan on time. These reports also include information on collection accounts, judgments, and bankruptcies. Capacity measures a borrower's ability to repay a loan by comparing income against recurring debts and assessing the borrower's debt-to-income ratio. Investigating the borrower's income is conducted by the lenders by looking at the period a borrower has been running their business, which is then combined with information about the sustainability of their business. The lenders also evaluate the amount of capital used for potential investment by a borrower. A significant contribution by the borrower decreases the chance of default. The lenders can repossess the collateral, when the borrower default on payments. It means that the collateral can help to secure a loan. The conditions of the loan are described by the interest rate, the amount of the loan, and the purpose of the loan. All of which affect the willingness of the lender to provide a loan.

Based on the '5Cs' of commercial lending, this study considered twelve independent variables. These variables consist of annual sales, capacity, number of employees, real assets, working capital, gender of the owner, age of the owner, entrepreneurial experience, legal status, industry, business plan, and length of the banking relationship (Table 4.1).

Table 4.1 Selection and Definition of Research Variables

Variable	Definition and rationale
Annual sales (X_1)	The annual sale revenue is a proxy of the firm's size and capital. The annual sale is a sales average per year of the respondents and is measured by calculating the logarithm of its value.
Capacity (X_2)	The capacity variable is calculated as the ratio between revenues from the annual sales to the amount of requested loan.
Number of employees (X_3)	The number of employees implies the size of the company. It is a representative measurement of the company's amount of capital since it is common that large enterprises employ a higher level of capital. Then, to be able to meet with the assumption of normality, the number of employees is assessed by measuring the logarithm of its value.
The loan's purpose: <ul style="list-style-type: none"> • Real assets (X_4) • Working capital (X_5) 	A loan utilized to cover real assets and working capital may particularly relate to the capacity of the actual asset to be used as the collateral for the loan. The variable of the loan's purpose is evaluated as two dichotomous variables. The first is assigned equally as one when the firm is funding real assets, and zero in other cases. The second variable is assigned equally as one if the company is funding working capital, and zero in other cases.
Gender of the owner (X_6)	This variable is assigned as one when the owner is male and zero when the owner is female.
Age of the owner (X_7)	The age of owner may influence the capacity to access a loan, where very young owners might encounter more constraints in accessing credit than older ones. In this study, owner's age is expressed by the dichotomous variable. This variable is set to 0 if the primary owner is less than 35 years old, and is set to 1 if the owner is 35 or older.
Entrepreneurial experience (X_8)	The owner(s)' entrepreneurial experience is frequently quoted as one of the character dimensions of commercial lending. Based on this rationale, the greater the owner's experience, the greater the likelihood of them receiving credit. This variable is measured in the number of years of experience reported by the owner of a firm. This variable is transformed by calculating the square root of its value to better adjust to the assumption of normality.
Industry (X_9)	The industry is based on four categories set to 1, 2, 3, and 4. Restaurants are coded as 1, hotels are coded as 2, travel businesses are coded as 3, and craft industry are coded as 4.
Length of banking relationship (X_{10})	The duration of the borrower firm's relationship with the lender indicates the degree of information asymmetry that might exist between the lender and the borrower. This variable is evaluated as an indicator of character and shows the capacity of the lender to assess the small business borrower. The length of the relationship is measured based on the number of years of the relationship.

Source: Author

Furthermore, investigating whether the borrowers of Perum Jamkrindo generate significant EA, a target group of companies was compared. These groups are those that had received benefits from guaranteed credits and those that had not been successful in getting a loan from a formal financial institution, especially banks (Riding and Haines, 2001). However, Boocock and Shariff (2005) proved that this was unsuccessful because of two rationales. First, “the diverse motivations, constraints, and uncertainties create problems in locating appropriate pairs of micro and small firms” so it could lead to systematic biases. A reliable national database of MSEs is unavailable, and the province of Nusa Tenggara Barat (NTB) does not have such a database. Secondly, the lenders provided guaranteed loans to MSEs for very different reasons, causing some difficulties in identifying a proper control group with the same characteristics as the guaranteed enterprises. Therefore, as an alternative method, the overall employment rates for the micro and small sectors, which are collected from secondary sources, were employed for standardizing purposes.

4.3.2. Data Collections

The author collected secondary data to examine the effective operation of Perum Jamkrindo. The source of secondary data is the annual report of Perum Jamkrindo.¹¹ Also, case studies were employed to carry out the evaluation of the benefits of the CGS for MSEs. By conducting a small survey, the author obtained the data concerning the assessment of the CGS benefits. The small survey was undertaken from September to December 2014. It was conducted in a particular industry and region to get a homogeneous response. The tourism sector in Lombok was selected since it is one of the biggest industries in Lombok.

¹¹ The annual reports of Perum Jamkrindo are provided at <http://www.jamkrindo.co.id/laporan-tahunan>

The respondents of the survey are the MSEs in the tourism industry, which received a KUR loan guaranteed by Perum Jamkrindo, in the city of Mataram and the regency of West Lombok. Three hundred clients were chosen as the sample to represent the selected population, but only 109 respondents provided usable responses. Furthermore, a closed/open-ended questionnaire was used in the interviews with the micro and small firm respondents. The instrument in the survey is formulated by adopting the research instruments of Boocock and Shariff (2005). In-depth interviews were administered with some key informants, such as a director of the CGC and the loan provider (bank), to reinforce the findings. For the data collection, seven enumerators who had experience in collecting data were hired and trained to carry out the data collection.

The data collection was conducted based on two groups. The first group was held in the regency of West Lombok in the villages of Banyumulek, Gunung Sari, and Sayang-sayang. These villages were chosen because these areas are centers of the craft industry, including bamboo craft, and woodcraft. About 74 samples of MSEs that obtained guaranteed loans were collected. The second group consisted of some main urban areas of Mataram and Sekarbela. These locations are the centers of the gold and pearl jewelry and culinary industries. The number of samples that were collected in these areas was 35 samples.

4.4. Profile of Research Sites

This section presents a broad view of the profiles of the research sites to give an overview of the location where this study took place. Most data presented in this section is covering the city of Mataram and the regency of West Lombok as the surveyed locations. Research sites in Mataram City are located in three regions, which are Mataram, Sekarbela and Sayang-sayang

4.4.1. Geographical Position and Administrative Regions of NTB

Administratively, the province of Nusa Tenggara Barat (NTB) consists of two large islands, which are Lombok and Sumbawa. This province also consists of around 135 smaller, mostly uninhabited islands. The total area of the region reached 20,153.15 square kilometers. This province is located between 115° 46' - 119° 5' east longitude and 8° 10' - 9 ° 5' south latitude. Sumbawa has an area of 15,414.5 square kilometers (76.5%) or 2/3 of the field of NTB, and Lombok only makes up 1/3 of NTB. NTB encompasses eight regencies, two cities, 116 districts, and 1,141 villages (see Table 4.2).

Table 4.2 Number of Districts and Villages by Regencies/Cities (January 2015)

No	Regency/City		Districts	Villages
1	Lombok	Lombok Barat	10	122
2		Lombok Tengah	12	139
3		Lombok Timur	20	254
4		Mataram	6	50
5		Lombok Utara	5	33
6	Sumbawa	Sumbawa	24	166
7		Dompu	8	81
8		Bima	18	193
9		Sumbawa Barat	8	65
10		Bima City	5	38
Total			116	1141

Source: Data Processed (BPS NTB, 2016a; p. 35)

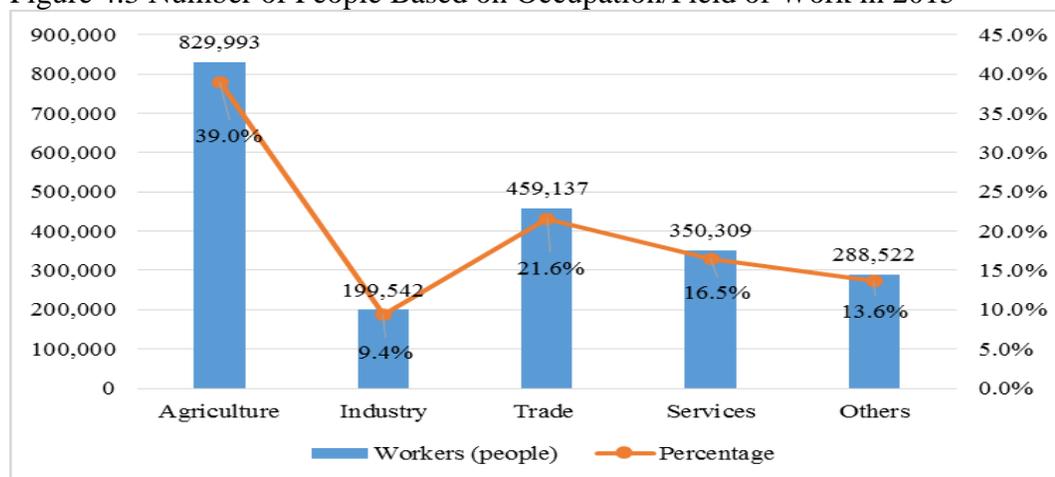
4.4.2. Population and Labor Force of NTB

NTB has a population of 4.8 million, 70% of them live in Lombok, made up of 2,315,234 males and 2,458,561 females (BPS NTB, 2016a; p. 95). Sumbawa, the larger island, has a population density of only 92 people per square kilometer, compared to 708 people per square kilometer in Lombok (BPS NTB, 2016a; p. 95). Therefore, the economy of NTB might well represent the economy of Lombok or vice versa. The number of households in the province is

1,327,948, with an average of 3.568 people per household (BPS NTB, 2016a; p. 98). Organized into age brackets spanning five years, the composition of the population of NTB forms a pyramid. The age bracket with the highest number of people is the 0-4 year age bracket, and the age bracket with the fewest people is that of 60-64 years (BPS NTB, 2016a; p. 96).

Increasing employment opportunities is one of the development strategies implemented by the government. It is expected that an increased number of jobs will boost economic growth, reduce poverty and ultimately improve public welfare. In 2013, the number of jobs for NTB was indicated by 1,982 thousand people or 61.92% of the working-age population had jobs (BPS NTB, 2013). However, the proportion of the population in work decreased slightly from 2012, when 1,979 thousand people or 62.41% of the working-age population was working (BPS NTB, 2012). The existence of the informal sector is expected to open up employment opportunities for the people, so this area is of particular concern to the government. According to occupation/field of work, as presented in Figure 4.3, the most significant number of people work in agriculture, followed by trade, then services, and the fewest in the finance sector.

Figure 4.3 Number of People Based on Occupation/Field of Work in 2015



Source: Data Processed (BPS NTB, 2015)

4.4.3. Gross Regional Domestic Product of NTB

The typical indicator that is used to measure the economic performance of a region is Gross Regional Domestic Product (GRDP). The contribution of each economic sector toward the GRDPs of NTB from 2012 – 2014 is indicated in Table 4.3. The economic structure of NTB, according to business fields in 2014, is dominated by three main sectors, namely: Agriculture, Forestry, and Fishing (23.54%); Wholesale and Retail Trade, Cars and Motorcycle Repair (13.86%); and Mining and Quarrying (11.78%). This data is not much different compared to 2012 and 2013. From the expenditure point of view, about 76.65% of the NTB GRDP is used for household consumption and 38.72% is used for Gross Domestic Fixed Capital. The growth rate of GRDP in NTB in 2014 was 6.15%.

Table 4.3 Percentage of the Contribution to the GRDP Based on Sectors in NTB

No.	Business Field	Percentage of contribution		
		2012	2013	2014
1	Agriculture, Forestry, and Fishing	24.24	23.82	23.54
2	Mining and Quarrying	14.75	13.38	11.78
3	Manufacturing Industry	5.00	4.91	4.72
4	Electricity and Gas	0.06	0.05	0.06
5	Water and Garbage Management	0.09	0.10	0.10
6	Construction	9.29	9.20	9.34
7	Wholesale and Retail; Motorcycle and Car Repair	13.28	13.59	13.86
8	Transportation and Warehouse	7.28	7.89	8.44
9	Accommodation, Food and Beverage	1.88	2.16	2.40
10	Information and Communication	2.11	2.12	2.11
11	Finance and Insurance	3.14	3.36	3.44
12	Real Estate	3.14	3.36	3.50
13	Business Services	0.17	0.18	0.19
14	Administration, Defense and Compulsory Social Security	6.62	6.69	7.43
15	Education	4.89	5.04	4.94
16	Health services and Social Activities	1.95	1.99	2.00
17	Others	2.11	2.16	2.15
	GRDP	100	100	100

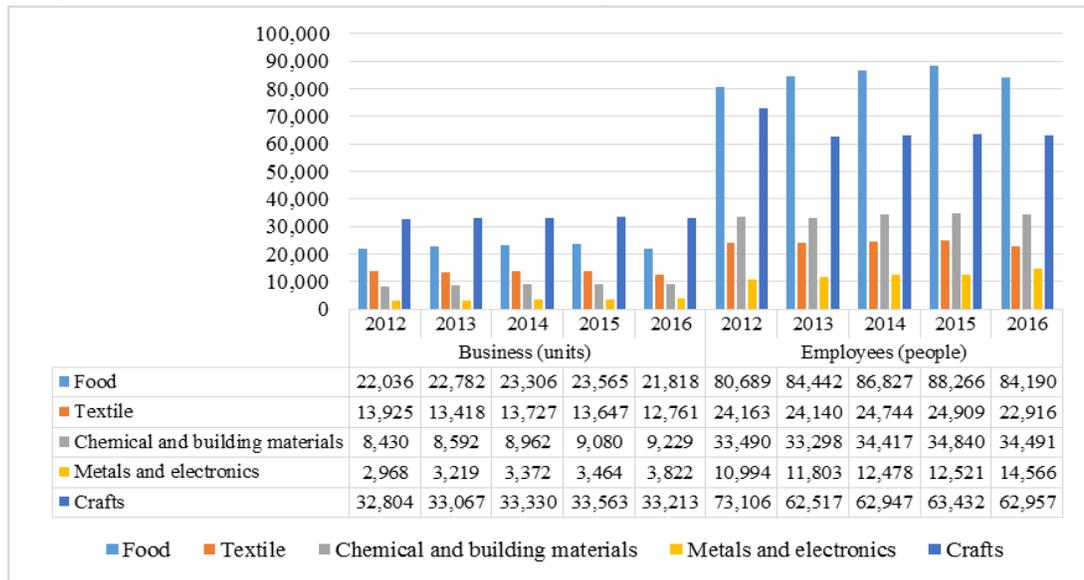
Source: Data Processed (BPS NTB, 2016b)

4.4.4. Profile and Distribution of Micro and Small Businesses in NTB

Small businesses in Indonesia are identical with small industry and the home industry, as stated by the Indonesian Central Bureau of Statistics. The number of employees is used to classify the size of the industry; a business with 1-4 employees is a micro and small industry, an enterprise with 20-99 employees is medium industry. Lastly, a prominent industry business has 100 or more employees. Even so, there are several definitions of micro and small businesses, and it seems that micro and small business retains a consistent characteristic. First, the separation of duties between administration and operation is not clear. Most of this industry is run by an individual who also serves concurrently as the company's owner and manager, and then their family and close relatives are employed as the workers. Second, the micro and small industry has a limited ability to access loans from formal financial institutions. They tend to depend on other sources such as family, relatives, traders, or even local money lenders. Third, most micro and small businesses are characterized by the absence of legal status.

The industrial sector in NTB has not contributed significantly to the local economy because its share is only about 5%. Concerning industry sectors in NTB, more than half of all micro and small businesses are active in the crafts and food industries, followed by the textile industry and chemical, metal and electronic industry with around 17.37% and 14.22% respectively (Figure 4.4). According to Figure 4.4, the largest number of employees based on sector is in the food and crafts industry, about 69.15% of total employees working in MSEs in NTB. Other industries, chemical and building materials, textile, and metals and electronics contributed to around 15.06%, 10.86%, and 4.94% of total employees respectively.

Figure 4.4 Number of Micro and Small Enterprises Based on Sector NTB 2012-2016



Source: Data Processed (Disperin Provinsi NTB, 2016; 2015; 2014; 2013; 2012)

4.4.5. Exports of NTB

According to Table 4.4, after excluding the mining products, the export value of NTB Province in 2014 was 1.9 million USD. This value increased by approximately 132% compared to the export value in 2013. Craft produced by MSEs in NTB is one of the essential local commodities. This industry makes a significant contribution to the export value compared to the agricultural sector, but its contribution is smaller than the fishing sector. The contribution of crafts industry to the export value in 2014 was 18.51%. It decreased from 2013, which was 41.59%.

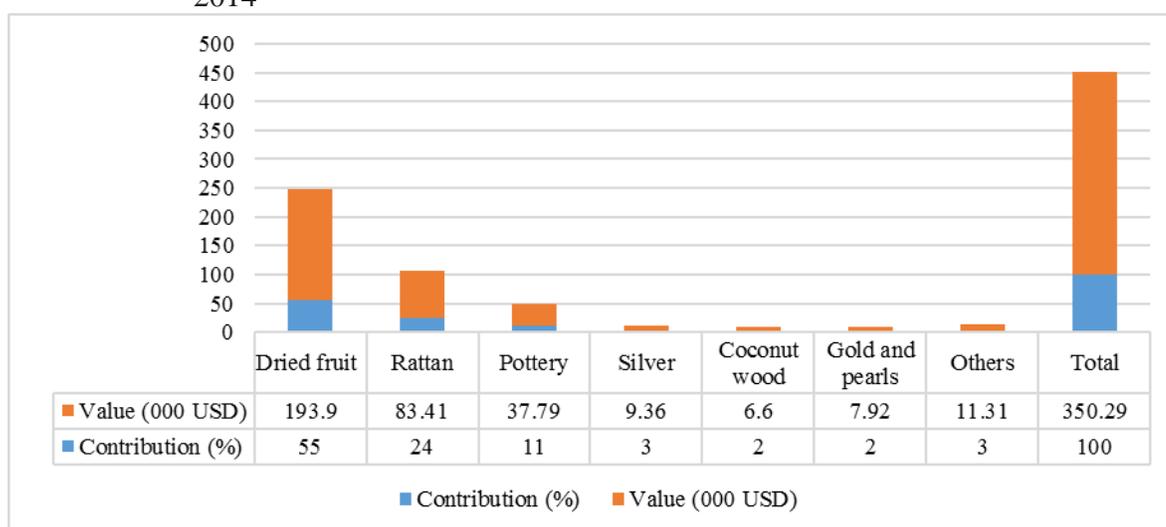
Table 4.4 Volume and Value of Foreign Exchange by Production Sectors

Production Sector	Value (US Dollar)		Contribution (%)	
	2013	2014	2013	2014
Crafts industry	345,962.29	350,279.01	41.59	18.51
Agricultural products	900.00	272,986.42	0.11	14.43
Fishery products	484,942.56	1,269,064.63	58.30	67.06
Total Export	831,804.85	1,892,330.27	100.00	100.00

Source: Data Processed (BPS NTB, 2016a; p. 289)

Based on commodities exports in 2014, there were 20 kinds of commodities, whereas in 2013 there were only 14 types of products. From 20 varieties of commodities, 14 commodities (70%) came from the crafts industry, contributing to 13% of total exports of NTB. The products from the craft industry were pottery, rattan, coconut wood, silver, pencils, wood, ceramics, reeds, shells, gold jewelry, and pearls. Further explanation is presented in Figure 4.5.

Figure 4.5 Contributions of Craft Commodities to the Export Value of Crafts Industry in 2014



Source: Data Processed (BPS NTB, 2014a)

4.5. Empirical Results

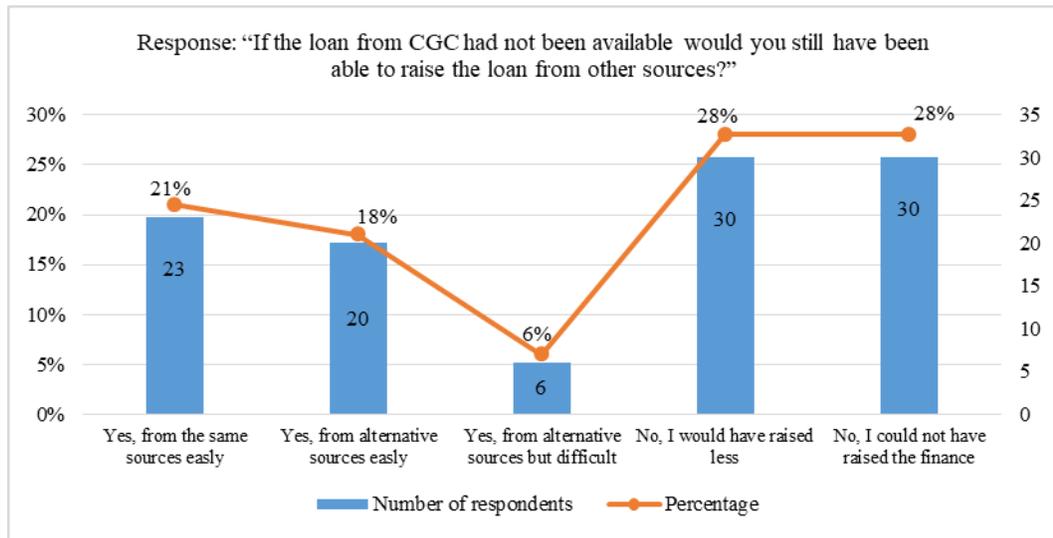
4.5.1. Descriptive Statistics of the Survey Results

4.5.1.1. Ability to Apply the Guaranteed Loans

Different kinds of financing resources are externally available for micro and small-scale businesses. However, due to the absence of collateral, these business organizations were unable to access those resources. Through interviews with the respondents from the MSEs, the study sought to understand the ability of the respondents to gain loans from external sources (see Figure 4.6). Responses from most respondents (56%) indicated that they were unable to obtain a

loan without the existence of the guaranteed loans. About 39% of respondents said they could access non-guaranteed loans quickly from the same sources. Then, the rest of those interviewed (6%) claimed that they had obtained a loan from other sources, such as family members, non-government money-lending organizations, and local moneylenders. They were confronted with some challenges.

Figure 4.6 Respondents' Ability to Raise a Loan from Other Financial Sources



Source: Survey Results in West Lombok and the City of Mataram

A high FA of the CGS is indicated by the high ability to raise a guaranteed loan. The survey results regarding respondents' ability to get funding from external financing sources are quite varied. The relatively new businesses have a lower probability of accessing guaranteed loans, mainly from formal financial institutions. Only 20 enterprises (18% of total respondents/109) could get a loan from other external sources, such as private financial institutions, friends, and local money lenders. Of these enterprises, 17 are categorized as a mature enterprise with the age of firms being more than three years, whereas three enterprises are identified as young companies with the age of enterprises being three years or less. This

condition indicates that micro and small-scale businesses and also young businesses are most likely to be restricted in accessing loans in the credit markets. Therefore, Perum Jamkrindo has served as a considerably efficient tool to gain financial assistance, especially for these groups of businesses. The summary of the interview results with the respondents about their capacity is presented in Box 4.1. The respondents who were interviewed for this study are MSEs which are located in West Lombok and Mataram City.

Box 4.1

- The interview question is *“If the guaranteed loan had not existed, would you still have been able to access a loan of the same amount?”*
- My financial source to raise capital for running my business is only from a bank, if I can get a guaranteed loan from a bank.
 - A loan from a bank is my primary financial source, without a loan from a bank I can only raise limited capital from sales.
 - A loan from a bank is my primary financial source. I only got a limited loan from my relatives, which is not enough for encouraging my business.
 - I am able to look for a loan since there are many informal financial sources but the interest rate is higher. With a really feasible business, I believe that I can pay back the loan including its cost (interest rate 13% per month). I still use it, since it is really easy to get and I can use the loan right at the time when my business really needs it.
 - Since I had enough collateral, I did not encounter any difficulties when looking for a loan from other financial sources
 - I couldn't get a loan from other financial institutions, but I can get a limited loan from a cooperative which requires little collateral.
 - I will look for another financial source, such as private FI and cooperatives, which are easier to apply for and they can provide a larger loan.

On behalf of the Indonesian government, the Central Bank of Indonesia (Bank Indonesia) has set up a strategy to encourage financial access for MSMEs through supporting banking commitments to provide services to these businesses. Banks are required to allocate a certain percentage (20%) of their credits to these firms. The credit allocation for MSMEs by commercial

banks in Indonesia is presented in Table 4.5. In 2015, the state-owned and private national banks were recorded as the most significant creditors for MSMEs with the proportions of 46% and 40% of total loans respectively.

Table 4.5 Growth of Micro, Small and Medium Loans Grouped into Bank Types
(Billion IDR)

Types of Banks	2012	2013	2014	2015	Growth (2014-15)	Share (2015)
State-owned Banks	242,861	304,751	344,937	386,717	12.11%	46.41%
Regional Dev. Banks	45,081	46,896	53,377	56,995	6.78%	6.84%
Private National Banks	228,991	245,101	315,809	333,994	5.76%	40.08%
Joint Venture Banks	8,750	11,379	13,467	13,638	1.27%	1.64%
Foreign-owned Banks	713	697	4,247	1,683	-60.37%	0.20%
Rural/Islamic Rural Banks	25,830	30,648	35,741	40,189	12.45%	4.82%
Total MSME's Loans	552,226	639,471	767,578	833,217	8.55%	

Source: Data Processed (Bank Indonesia, 2016; p. 1)

The *Kredit Usaha Rakyat* (KUR) loan is one of the credit programs created by the Indonesian government to overcome the difficulties of MSMEs in accessing loans from a formal financial institution, such as banks. To encourage banks and other financial institutions to provide the KUR loan from their assets, the Indonesian government initiated a guarantee for the KUR loan through Perum Jamkrindo. In only three months after its launch in 2007, 1.7 trillion IDR¹² had been disbursed. According to Table 4.6, in 2010, Perum Jamkrindo had provided 6.5 trillion IDR of KUR loans or 19% of total loans provided to MSMEs. This percentage increased significantly in 2011 and 2012 and became 37.32% and 42.58% respectively of total loans provided to MSMEs.

¹² 1 USD equivalent to 14,000 IDR

Table 4.6 Credit Guarantee Volume of Perum Jamkrindo for MSMEs (Billion IDR)

Year	KUR	Small and Micro Credit	Other Credit Scheme	Total
2010	6,459	964	26,783	34,206
2011	20,233	1,742	32,241	54,216
2012	22,798	3,331	27,414	53,543
Total	49,490	6,037	86,438	141,965

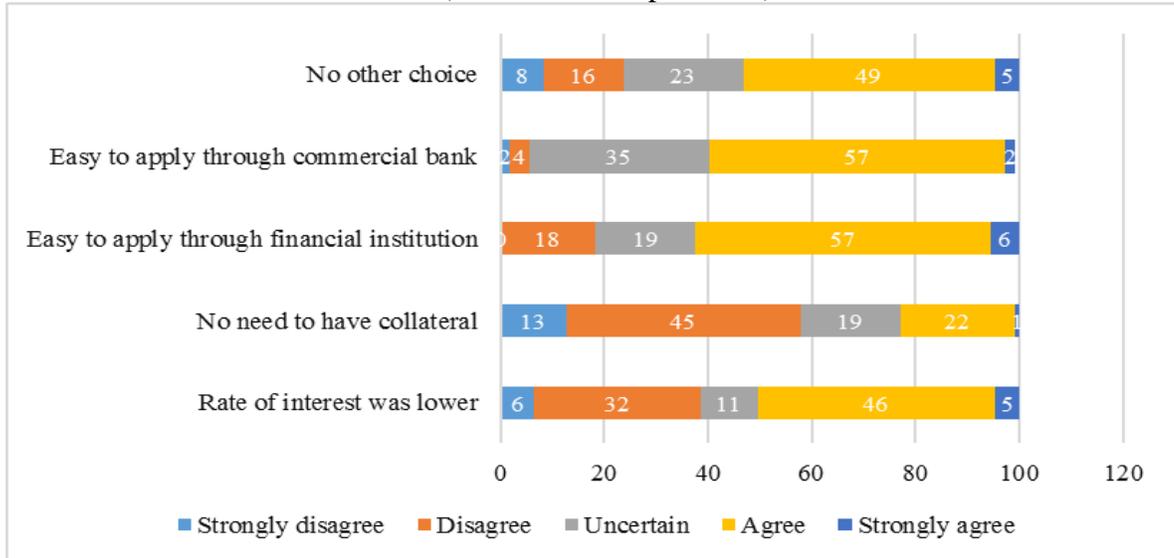
Sources: Data Processed (Perum Jamkrindo, 2012; p. 113)

4.5.1.2. Reasons for Applying for the Guaranteed Loans

Many Micro and Small Enterprises (MSEs) in Indonesia do not use banks as their financial sources for some reasons. First, many of them have less information about the procedure of applying for a loan from a bank. Second, the application process/mechanism for loans is difficult for them. Third, many MSEs often do not have collateral. Fourth, they believe that loans from commercial banks have high interest rates. Fifth, their loan application was turned down by a particular bank. Last, some of them are unwilling to get a loan from banks because of personal reasons.

This study set some questions to describe the respondents' motives for choosing a loan guaranteed by Perum Jamkrindo. According to Figure 4.7, 62% of respondents argued that the interest rate charged by the commercial banks (partner banks of Perum Jamkrindo) is lower than other formal and informal financial sources. Then, followed by 38% of respondents are disagreed or strongly disagreed. This result indicated that the interest rate charged by the commercial banks for the loans which are guaranteed by Perum Jamkrindo is acceptable for these respondents. The KUR scheme provides the loan with an extremely low interest, e.g. 9% per annum. On the other hand, other financial sources, such as cooperatives, private banks, private financial institutions and local moneylenders charge a higher interest rate.

Figure 4.7 Respondents' Responses to the Reasons for Choosing a Guaranteed Loan by Perum Jamkrindo (% from 109 respondents)



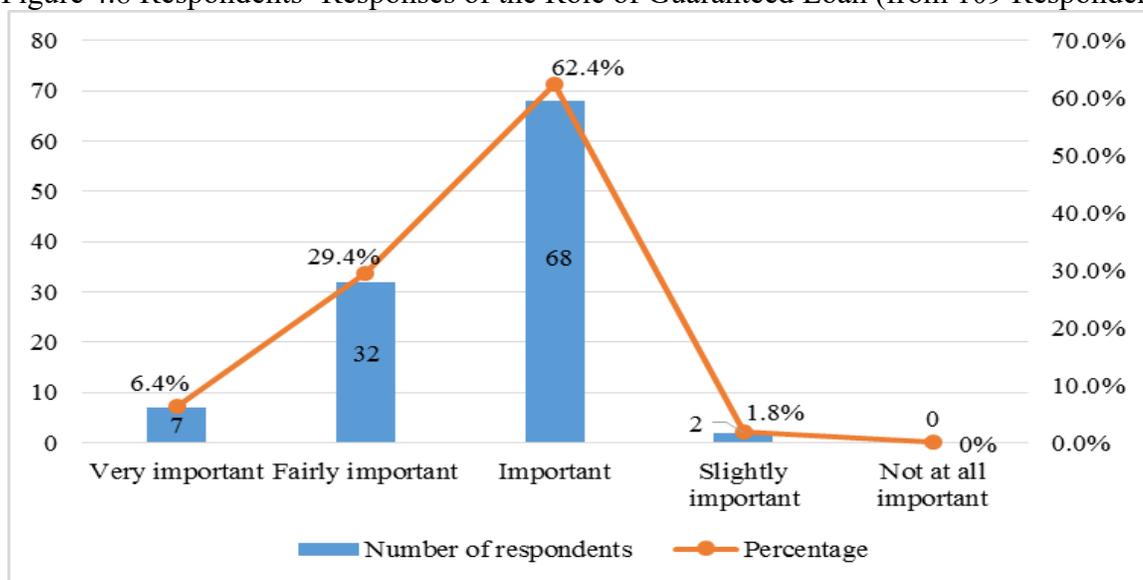
Source: Survey Results in West Lombok and the City of Mataram

Providing enough collateral is almost compulsory for the borrower to obtain a loan from a commercial bank under guarantee schemes. The survey results showed that 58% of total respondents had to provide enough collateral and 19% of total respondents were uncertain about this factor. Meanwhile, 23% of the total respondents had different experiences. Boocock and Shariff (2005) argued that as the CGS involves risks in businesses, to secure conventional loans, the borrowers are forced to pledge all available assets and avoid the guarantees. Nonetheless, it has to be mentioned that the collateral that has to be provided by the borrower to get a guaranteed loan (KUR loan) tends to be less. For instance, a borrower, who applies for a KUR loan of about 30 million IDR, gives his/her motorcycle ownership document (BPKB) as the collateral. The economic value of his/her motorcycle is lower than the guaranteed loan that he/she applied for.

Moreover, the respondents apply for guaranteed loans because of the simple application procedure. Most respondents, 59% of total respondents, found that it is easy to secure guaranteed loans from commercial banks. Furthermore, 35% of total respondents perceive uncertainty about

this reason, but based on the in-depth interview with these respondents, it was concluded that most of these respondents still indicated a positive experience regarding the application process of the guaranteed loan. On the other hand, only 6% of the total respondents experienced some difficulties in applying for a guaranteed loan from the commercial banks. Furthermore, most respondents, about 77%, argued that they chose a guaranteed loan since there was no other choice.

Figure 4.8 Respondents' Responses of the Role of Guaranteed Loan (from 109 Respondents)



Source: Survey Results in West Lombok and the City of Mataram

The vast majority of respondents (about 98%) argued that guaranteed loans play a significant role in their business development (Figure 4.8). The owner of a pearl business in Mataram city stated (Personal communication, September 2014):

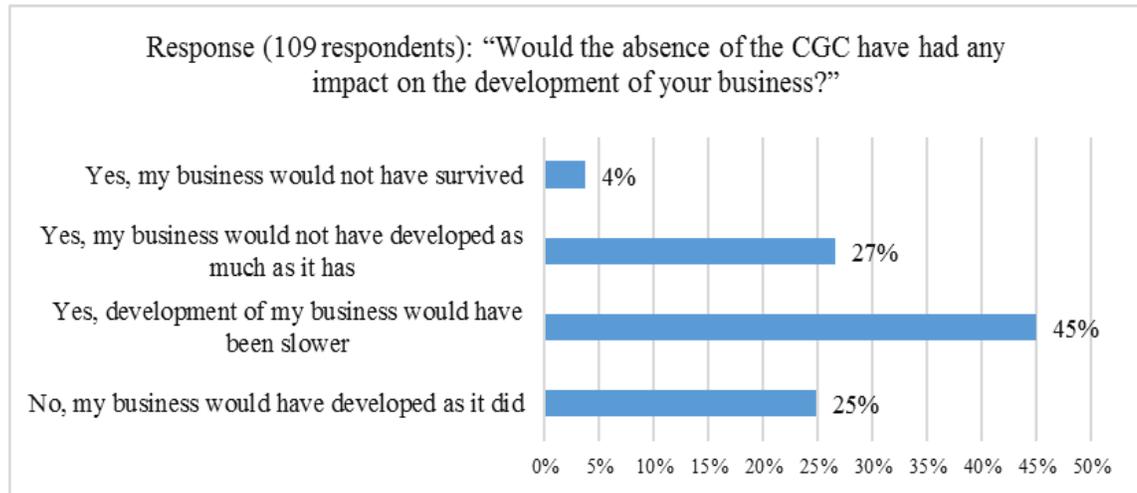
“I run my business with limited capital, so I urgently need a loan from a commercial bank to grow my business. However, I was unsuccessful in obtaining a loan because I had a lack of collateral and administration requirements, such as financial records”.

However, Perum Jamkrindo, as a guarantee corporation in Indonesia, was still unable to reach its primary target to provide credit access to qualified MSMEs that do not have sufficient collateral. Perum Jamkrindo has not run its businesses based on the standard policy of the guarantee scheme, yet it has participated in supplementary credit services of commercial banks through implementing the common banking mechanism in the administration of small-scale lending. Subsequently, the task of the CGC to facilitate the challenges in obtaining loans for micro and small-scale businesses remains an open area for inquiry.

4.5.1.3. Impact of Guaranteed Loans on Business Development

The effect of the guaranteed loans on business growth was analyzed to find out whether the loan affects the actual additionality of the guarantee scheme (Figure 4.9). The development of participating businesses would have been affected by the absence of the guaranteed loans, which was indicated by most respondents (76% of the total respondents). About 4% of total respondents likely could not have survived, while 27% indicated that their businesses would not have grown as much as it did. Furthermore, 45% of the total respondents suggest that their business would have grown more slowly. Despite their ability to operate their businesses, these respondents would not have been able to maximize their capacity to grow their business significantly, namely by increasing their productivity, sales, and profit. On the other hand, only 24% of the total respondents were able to manage their firm's business without the guaranteed loan because they could seek other financial sources. Most of these respondents received loans from family members and private funding corporations.

Figure 4.9 Impact of a Guaranteed Loan on Business Development



Source: Survey Results in West Lombok and the City of Mataram

The survey results indicate that guaranteed loans have a significant impact on the business development of the respondent firms. An interview in September 2014 with a craft businessman gave valuable insight into the impact of guaranteed loans on business development. In this case, he asserted:

“The development of sales and production in the craft industry is determined by both domestic and foreign tourists. My regular customers are domestic tourists who buy my products in small amounts. With these customers, I can survive in this business. Therefore, if I want to enlarge my business by selling craft products abroad, I should produce high-quality craft products. For that, I need a sufficiently significant amount of capital. The primary source of capital that I might access is a commercial bank. I have been provided with a loan by BPD as one of the partner banks of Perum Jamkrindo. As a reseller, I bought the craft products by using this loan and sold these products to overseas customers, thereby increasing sales and garnering significant profit” (Personal communication, October 2014).

This story revealed that the loan provided by commercial banking and guaranteed by Perum Jamkrindo has a critical effect on business development, although the borrowers are still required to hand over collateral. The summary of the interview results with respondents is described in Box 4.2.

Box 4.2. Summary of Interview Results

The interview question is, “*Had guaranteed loans not been on offer, would your business have been able to develop as it has?*”

- I would not have been able to develop my business, especially when I got a big order from a customer. If I did not have enough capital to deal with that order, it made my customers look for another art shop.
- A loan from a bank is my primary financial source. Without a loan from a bank, I can only raise limited capital from sales.
- A loan from a bank is my primary financial source, I only got a limited loan from my relatives, but it would not have been enough to grow my business.
- I am able to look for capital since there are many informal financial sources, but the interest rate is higher than formal financial sources. With a very feasible business, I believe that I can pay back the loan, including its cost. I still use loans from *rentenirs*, since they are effortless to get and I can use the credit right at the time when my business needs it.
- I could not get a loan from other financial institutions, but I can get a limited loan from a cooperative which requires little collateral.
- I would look for another financial source, such as a private FI or cooperatives, which are easier to apply for and they can provide more substantial loans.

4.5.2. Performance of Credit Guarantee Schemes

The performance of the CGS is evaluated based on the three parties, which are a borrower, lender, and guarantor. In this chapter, the performance of the CGS is described in terms of two parties, which are guarantor and borrower. Meanwhile, the performance of the lender side is described in Chapter 5.

Evaluating the performance of the guarantor can be conducted based on some of the relevant performance indicators, which are transaction cost of guarantee issued, recovery rate, average time (days) needed to issue a guarantee, average time (days) needed to pay out a claim, and the number and value of guarantees issued (Deelen and Molenaar, 2004). This study focuses on the indicators of operating costs of guarantee schemes, the claims rate, and the capacity of the

CGS to recover the claims. The capacity of the guarantor to cover its costs (mainly from operational costs and defaults) influences the financial sustainability of the guarantor. This capacity is built through charging fees to its clients, direct subsidies from donor agencies or revenue from investing the guarantee loan itself. The default rate implies the risk of a guarantee scheme. A low default rate may indicate limited activity and high-risk aversion. However, the importance of this indicator may be illustrated by the fact that the initial cost of most CGSs is that of honoring defaults.

The concepts of FA and EA are useful for evaluating the impact of the CGS on borrowers. The evaluation of the FA is often limited to the number of additional loans. However, in this study, the FA also covers loan conditions, compared to what is otherwise available on the conventional loan market. The loan conditions are indicated by the reduction in collateral requirements, rapid loan processing, more significant and more extended term loans, and interest rates.

The most tangible parameter of the performance of participating lenders is the claims rate. Therefore, this study evaluates how the lenders reduce the possibility of a loan default by exploring their behavior and attitude towards micro and small borrowers. This behavior and attitude are illustrated in the way they are making relationships with micro and small borrowers. This chapter describes the performance evaluation of the guarantor and the borrowers. Meanwhile, the performance of the participating lenders is described in the next chapter.

4.5.2.1. Guarantor

The evaluations of CGC could be conducted based on costs and benefits. Guaranteed loans that support the development of MSEs may convey significant benefits to the borrowing

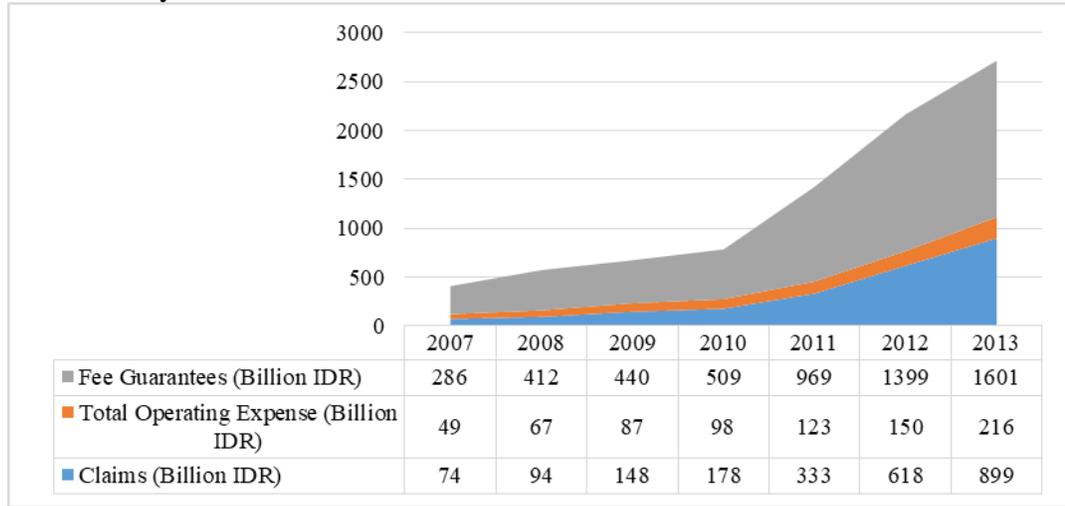
entrepreneurs and, through job creation to the rest of society. However, some borrowers are unable to meet the repayment obligations of their debt. Thus, the guarantors also face material real costs of honoring the borrowers guarantee to the lenders. To the extent that the primary cost of the guarantor is that of honoring defaults. Vogel and Adams (1996) identify three categories of costs for guarantors, which are cost of the infrastructure, incremental costs of compliance, and subsidization of defaults.

Issuing a guarantee is costly. In many cases, this cost, which is paid by claims, is higher than the premium income (guarantee fee). The ability to manage and cover costs is a critical indicator of the performance of a CGC. Perum Jamkrindo has been able to deal with losses because the premium fee of the guarantee has continually surpassed the claim rate (See Figure 4.10). This condition possibly shows the higher accomplishment of the schemes and reflects the capacity of the schemes to be sustainable. In 2013, Perum Jamkrindo was required to pay out 0.9 trillion IDR¹³ for claims with premium fees totaling 1.6 trillion IDR (the ratio between claim payment and the premium fee was 0.56). When the amount of the guaranteed loan is enlarged, then the claim payments of default loans tend to increase.

On the other hand, when the value of the guaranteed loan is expanded, it can give the result in a rise in the premium fee of guarantee. As the essential revenue, the premium fee could deal with aggregate working expenses and taxes. To sum up, Perum Jamkrindo demonstrated its ability to achieve a considerable profit.

¹³ 1 USD equivalent to 14,000 IDR

Figure 4.10 Premium Fees of the Guarantee, Aggregate Working Expenses and Claims Paid by Perum Jamkrindo



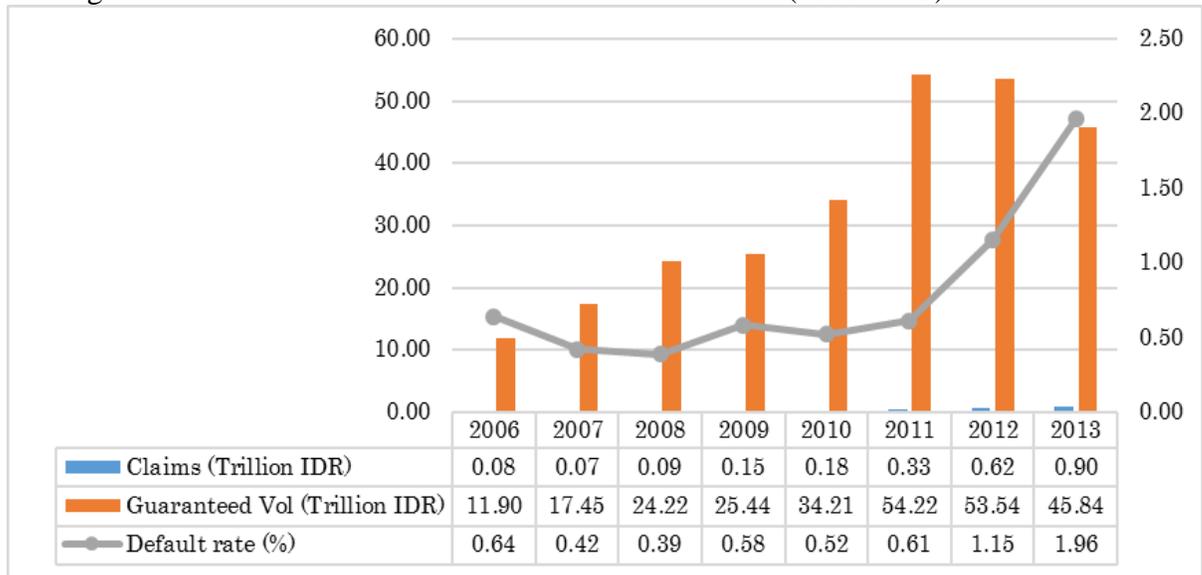
Sources: Data Processed (Perum Jamkrindo, 2010; 2011b; 2012; 2013)

The operating costs of guarantee schemes tend to be higher if the guarantee schemes operate in many branch offices. However, having fewer branch offices can reduce the possibility of claims. Therefore, by having 20 branch offices, Perum Jamkrindo was able to decrease the number of claims, and the amount of total operating costs was lower than the claims (Figure 4.10). It indicated that the operation of the guarantee scheme was effective. The most important thing with many branch offices is that Perum Jamkrindo can reach many financially-constrained MSEs in many regions.

The claims rate is one of the critical factors for evaluating the effectiveness of a guarantee program. Levitsky (1997) concluded that best-practice guarantee schemes have a default rate of 2% – 3%. As shown by Figure 4.11, the rate of loan default under the terms of Perum Jamkrindo was below 2%, which demonstrated an outstanding operational accomplishment of the guarantee scheme. The rates of loan default have increased from 0.39% to 1.96%. As Levitsky (1997) argued, the default rate of the guaranteed loans in the first year of operation is usually low, since

the debtors will pay back the credit regularly. However, the default rate grows in the following years with the rise of the guaranteed volume.

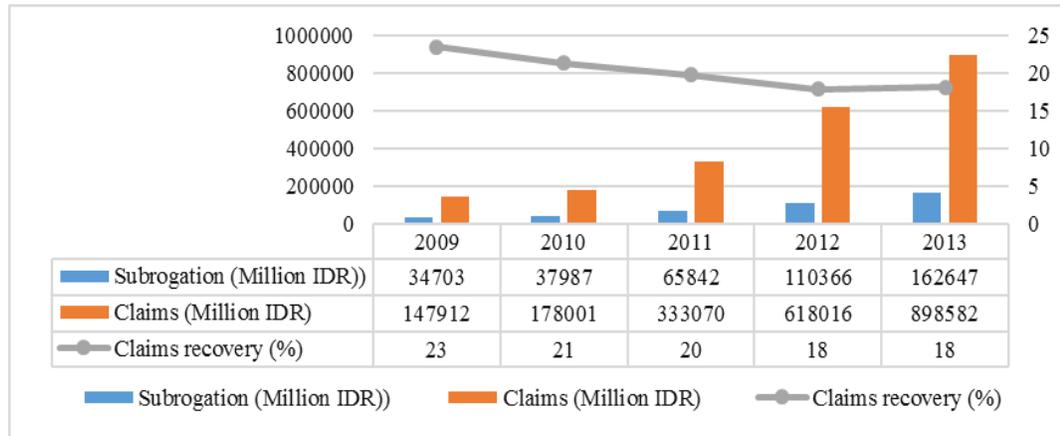
Figure 4.11 Rates of Default Loans of Perum Jamkrindo (2006-2013)



Sources: Data Processed (Perum Jamkrindo, 2010; 2011b; 2012; 2013)

Furthermore, Figure 4.12 shows that the capacity of Perum Jamkrindo to regain claims was generally low. This capacity declined from time to time. As can be seen, in 2009, Perum Jamkrindo managed to regain 23% of claims, and it fell considerably to 18% in 2013. This result suggests that initiating an effective strategy for claim recuperation and utilizing experienced staff must be taken into account as the most critical task to deal with functional claims recuperation. As Hiemann and Noorjaya (2001) reported, claims can be reduced through prudent lending, continuous monitoring, and strict collection procedures. The useful recovery loans will boost the revenue of subrogation, and in the end, the capacity to be sustainable will also rise.

Figure 4.12 Subrogations Income, Claims Payment and Claims Recovery of Perum Jamkrindo



Sources: Data Processed (Perum Jamkrindo, 2010; 2011b; 2012; 2013)

4.5.2.2. Borrowers

4.5.2.2.1. Financial Additionality

The Financial Additionality (FA) refers to the ability of sample respondents to get an additional loan that might not have been available without the existence of the KUR loan guaranteed by Perum Jamkrindo. The survey of borrowing experiences of MSEs was analyzed to evaluate these additionalities. Table 4.7 shows that the baseline FA was derived from the sample of firm respondents.

Table 4.7 Financial Additionalities – the Sample Firms of the Survey (Million IDR)

Firm	Loan provided by other sources ¹⁴	Guaranteed Loan	Aggregate Loan	Max loan provided by other sources	FA	
					Amount	Baseline FA (%)
A	0	100	100	75	25	25
B	0	50	50	50	0	0
C	95	100	195	100	95	95
D	0	150	150	50	100	67
E	25	60	85	50	35	58
All	120	460	580	325	255	55

Source: Survey Results from Questionnaire Responses

¹⁴ The other sources are private financial institutions, cooperatives, local moneylenders, or even family and friends.

Three examples are provided to describe the calculation of FA. Firstly, the owner of firm 'A' was established in 2012, and the owner was looking for 100 million IDR to expand his business. Based on the collateral he had, the maximum loan that he could get from a financial institution was around 75 million IDR. However, by using a guaranteed loan from Perum Jamkrindo, he was able to raise a loan of 100 million IDR. The owner of firm 'A' preferred to use the guaranteed loan for running the business. Otherwise, he would have had to pay higher borrowing costs. It means that with the absence of a guaranteed loan, Firm 'A' may not have been able to raise its loan to the utilized amount (100 million IDR) in which the guarantee scheme gives a benefit of 25 million IDR (about 25%) of the total guaranteed loan; thus, the FA is 25%.

Secondly, Firm 'B' produced craft products and applied for a loan of about 50 million IDR from a financial institution. However, the owner was able to obtain a guaranteed loan of 50 million IDR with a cheaper borrowing cost, thereby making FA zero. The zero FA indicates that even though the credit guarantee from Perum Jamkrindo was not available, Firm B was still able to get the loan provided by another financial institution.

Finally, firm 'C', an art shop, needed 195 million IDR. In this case, firm 'C' was able to obtain a loan from another financial institution with a maximum of about 100 million IDR. Meanwhile, firm 'C' was able to obtain 100 million IDR guaranteed loan. So, it only needed 95 million IDR from another financial institution. Thus, without the existence of a guaranteed loan, firm 'C' might not have been able to add to its loan. In this way, the guarantee scheme creates a benefit of about 95% of the total guaranteed loan resulting in an FA of 95%.

To sum up, based on Table 4.8, if the guaranteed loans had not existed, firm 'A', firm 'C', firm 'D', and firm 'E' would not have been able to attain their required investment or working

capital. Only firm ‘B’ could have raised loans without the assistance of the guaranteed loan. However, firm ‘B’ would use a guaranteed loan instead of an unguaranteed loan since it is cheaper than the unguaranteed loan. The FA of Perum Jamkrindo, which was derived from the survey, is shown in Table 4.8.

Table 4.8 Financial Additionalities from the Survey Results (Million IDR)

Industry	Loan Provided by Other Sources	Guaranteed Loans	Aggregate Loans	Max Loans Provided by Other Sources	FA	
					Amount	Baseline FA (%)
Restaurant (12)	415	3,850	4,265	1,260	3,005	78
Hotel (7)	535	12,245	12,780	3,155	9,625	79
Travel (14)	370	1,750	2,120	1,450	670	38
Craft (76)	590	6,445	7,035	2,700	4,335	67
Total (109)	1,910	24,290	26,200	8,565	17,635	73

Source: Survey Results from Questionnaire Responses

According to Table 4.9, the total amount of external loans that were planned by 109 respondents was 26,200 million IDR. Interviews with the respondents revealed that without the existence of guaranteed loans, lenders would have been willing to provide maximum loans of around 8,565 million IDR or 33% of total external loans. Perum Jamkrindo’s NTB branch office supplied guaranteed loans of 24,290 million IDR for 109 micro and small respondents or 93% of total external loans. Meanwhile, the remaining external loans provided by other financial institutions was around 1,910 million IDR or 7% of total external loans. Hence, the benefit that micro and small respondents could have been advanced through guaranteed loans is 17,635 million IDR, or 73% of total guaranteed loans. As stated by Levitsky (1997), 60% FA is the minimum requirement for justifying CGS. While Bannock and Partners (reported in Boocock and Shariff, 2005) suggested an FA of at least 30-35% is required. This result implies that the

guaranteed loans of Perum Jamkrindo give significant benefits for micro and small borrowers.

The survey results confirmed that the guaranteed loans from Perum Jamkrindo in the NTB branch office substitute for funding from other sources. The respondents tend to use a guaranteed loan to meet their planned capital needs since this loan is less costly than finance from other sources. This result showed that the CGC was able to assist the respondents to increase their loans or had given financial assistance to a more significant number of respondents.

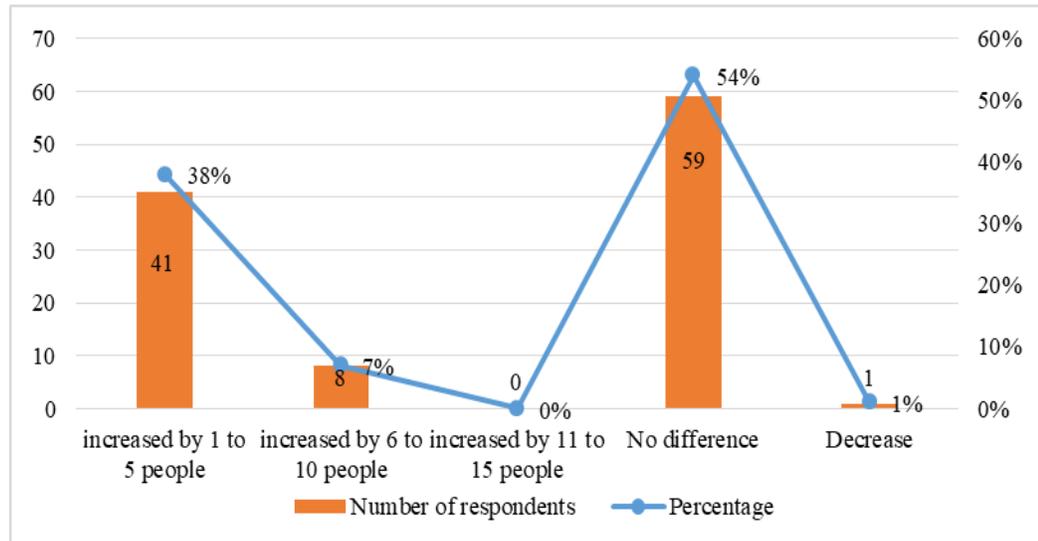
4.5.2.2.2. Economic Additionality

The role of a guarantee scheme to support financial access for MSEs can also be described from the economic side referred to in this study as EA, which can be divided into direct EA and indirect EA. The regional government of Nusa Tenggara Barat (NTB) consents to continue encouraging financial support for the development of MSMEs. In 2015, the distribution of loans for MSMEs delivered by commercial banks in NTB showed an increased level at 9.05% compared to the previous year (Bank Indonesia, 2015; p. 2).

The performance of firms could describe the direct EA after being provided with guaranteed loans. The survey results show that after being provided with a guaranteed loan, only 45% of the total firms could increase their employment rates (Figure 4.13). About 38% of respondents could increase jobs growth to 1-5 people, while 7% of respondents could increase the employment growth to 6-10 people. The net rise of total employees for the overall company respondents one year after accepting the guaranteed funds was 67 employees, a rise of 25% after exempting those respondents with zero FA and employees lost. For all the industries in NTB, employment rose by 4.5% in 2013 (BPS NTB, 2014b), while the contribution of the industry sector to GRDP was 4.4% (BPS NTB, 2016c). In conclusion, the respondent firms typically

attained employment growth more than the industry sector as a whole. It means the existence of guaranteed loans could encourage the creation of jobs.

Figure 4.13 Employment Growths of the Respondents



Source: Survey Results from Questionnaire Responses

Based on the analysis of EA, employee growth might be influenced directly by the credit guarantee program. Cowling and Mitchell (2003) confirm this result in their study, stating that using the guaranteed loans to overcome the lack of working capital does not have a sufficient impact on sustainability in increasing output and employment. However, in practice, the number of a company’s employees is affected by many factors, external and internal to the firm (Meyer and Nagarajan, 1997), such as the type of industry that the business operates in, the utilization of funds, and other factors. To an extent, employment growth is affected by the availability of guaranteed loans and other factors as well.

Therefore, job growth can be increased through various programs. Policies to increase employment growth must not only be carried out by supporting micro and small businesses to access capital, but must also be supported by providing assistance to strengthen other aspects,

such as in terms of improving the quality of the production process and increasing market share.

Figure 4.14 Sale and Profit Growth of the Respondents (%)



Source: Survey Results from Questionnaire Responses

Furthermore, most respondents were able to increase annual sales revenues after being provided with Perum Jamkrindo’s guaranteed loan (Figure 4.14). About 67% of respondents were able to increase annual sales by more than 11%, then 27% of respondents were able to raise annual sales by 1% to 10%. Meanwhile, about 5% of respondents did not manage to make any difference in sales revenue after obtaining the guaranteed loan. On the other hand, 1% of respondents failed to raise sales. Also, according to Figure 4.14, about 70% of respondents were able to increase their profit by more than 11% and 24% of respondents raised profits by 1% to 10%. This result is consistent with the ability of respondents to increase sales after being provided with guaranteed loans. Using guaranteed loans, they can grow their businesses and make more profits. On the other hand, 6% of respondents were unable to make a difference in profits after receiving the guaranteed loan.

The impact of indirect EA on the competitiveness of a nation could not be captured only

from supply-side improvements. Therefore, indirect EA should be described through innovation, exports, and entrepreneurial activity, which can then create ‘value-adding’ to the economy as a whole. Based on the survey results, most respondents (66% of total respondents) had not participated in any practical workshop about the utilization of new technology products. The rest of them (34% of total respondents) had attended such training. The Ministry of Micro, Small, and Medium-sized Business, Ministry of Industry and Trade, Vocational Training Centre, and other NGOs in NTB have offered these training courses.

A lack of technical training limits the ability of MSEs to introduce new technology. Thus, they have less ability to create new products and add innovation to their products. It may imply a low ability of MSEs to apply high technology to make products that qualify for export. Based on the survey, only 7% of respondents had been able to sell their products overseas. In 2014, the percentage of export of the craft industry in NTB decreased by about 9.04% (BPS NTB, 2016a; p. 289). It may have been exacerbated by the indication that only a limited number of respondents (approximately 35% of total respondents) had participated in any training activities related to entrepreneurship in business management.

A home-based industry characterizes the industry of handicraft in Lombok. Its primary products are mostly produced manually or hand-made. The craftsmen have a specific craft skill that is combined with local values and local wisdom. In the production process, the craftsmen use their hands with feeling and artistic merit. Sometimes they also use a simple tool. As stated by a craftsman in Banyuwulek (Personal communication, September 2014):

“I use a very simple tool to make my craft products ... the government of Mataram City has often invited us for training to use modern tools for creating our products ... the government also gives us the tools to be used in a group, but it is not effective, I need a tool that belongs to me and not to a group, and then I should be given guidance on how to use and maintain the tools....”

Most of the craftsmen learned their expertise from the surrounding community; they learn from one another. Subsequently, these craftsmen handed down their expertise and skills to their family members. As such, they, habitually support the craftsmen in creating crafts-products. These members of the family received low wages, and they were even unpaid occasionally, since they were assisting craftsmen who were the breadwinners in their families. Moreover, these craftsmen were not able to get into markets due to some reasons, such as a lack of resources, limited business network, insufficient capital, short of strategic lines of product distribution, shortage of outstanding linkages, and little knowledge of entrepreneurship. Thus, most of their work is dependent on the requests of orders from wholesalers and dealers, who resell their products at the domestic price. At this point, the distributors gain a noteworthy profit when they resell the craft products to local or overseas consumers.

A similar scenario also occurs in the pearl industry in Sekarbela. The customers of this industry are national and international buyers, where a significant volume of sales comes from international clients. However, the design of pearl jewelry from the Sekarbela Village is not suited to the customers from specific countries such as USA, Japan, China, and Europe. Thus, these international buyers only bought the pearls and made the pearl jewelry with their designs. This condition makes the ability to create a profit decrease since it would be more profitable if they could sell pearl jewelry.

4.5.3. The Impact of Economic and Social Characteristics of MSEs on the Incidence of FA

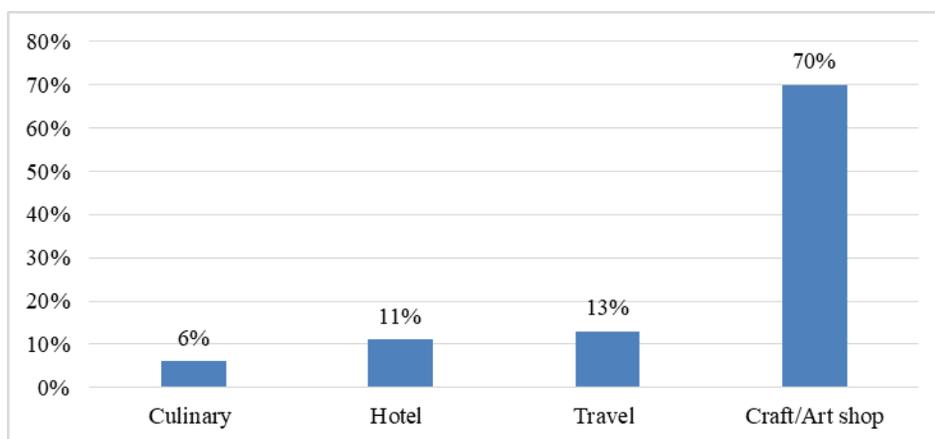
A statistical model was developed to present an outlook of the impact of economic and social characteristics of MSEs on the incidence of FA. This part describes the descriptive analysis, correlation results, and regression results. Logistic regression was employed to analyze

the impacts of economic and social characteristics of micro and small borrowers on the incidence of FA. The logistic regression results show that most of the independent factors are not significantly linked to FA.

4.5.3.1. Descriptive Data of Respondents

109 valid responses were obtained from 300 total samples of MSEs, of which 94% are family businesses. All of the sample respondents received a guaranteed loan, and among the total sample, 19 enterprises also received informal loans (family and local money lenders). The sample respondents are involved in the tourism sector of which 70% work in the craft industry, 13% in the travel industry, 11% work in the small hotel industry and 6% in the culinary industry (Figure 4.15).

Figure 4.15 Industry Types of Respondent Firms (n=109)



Source: Survey Results from Questionnaire Responses

Based on survey results, the maximum size of a guaranteed loan is 500 million IDR used for investment capital while the average size of guaranteed loans is 110 million IDR. Guaranteed loans for investment capital are mainly used to cover fixed assets. Most respondents (about 52 enterprises) used guaranteed loans for both real assets and working capital, 32 enterprises used

loans only for working capital, and 25 enterprises for real assets. After receiving a guaranteed loan, 49 enterprises were able to increase their employee numbers with an average growth of three employees. Other analyzed features of respondents, which could affect the ability of companies to get a commercial loan under guarantee schemes, are described in Table 4.9.

Table 4.9 Characteristics of the Respondents (n = 109)

Respondent Characteristics		Data
Owner experience (years)		5*
Number of employees (persons)		9*
Age of the owners (years)		42*
Legal status:	Family business (%)	93
	Have legal status (%)	7
Types of Industry:	Culinary (%)	6
	Hotel (%)	11
	Travel (%)	13
	Craft/Art shop (%)	70
Gender of the owners:	Male (%)	65
	Female (%)	35
Education of the owners:	Undergraduate (%)	25
	Diploma (%)	6.50
	Senior high school (%)	50
	Junior high school (%)	6.50
	Elementary (%)	12
Purpose of loans:	Working capital (%)	75
	Real assets (%)	72

Source: Survey Results from Questionnaire Responses

Note: * Mean Value

Descriptive statistics of research variables are presented in Table 4.10 below. It is shown that the variable, length of the relationship, has the highest variant of 2.10 with an average of 3.36, with a minimum value of 1 year, and a maximum of 8 years. This data indicates that the length of the relationship between lenders and borrowers fluctuates significantly.

On the other hand, the variables of annual sales and the number of employees have low variance values that are respectively 0.08 and 0.05, with an average value of 8.57 and 0.60 respectively. The variable of annual sales has a minimum value of 8.03 or 107.15 million IDR

and a maximum value of 9.30 or 1,995.26 million IDR. Furthermore, the variable number of employees has a minimum value of 0.00 or 1 person and a maximum value of 1.08 or 12 people.

Table 4.10 Descriptive Statistics (n = 109)

Variable	N	Minimum	Maximum	Mean	Mode	Std. Deviation
Annual Sales	109	8.03	9.30	8.57	8.10	0.28
Capacity	109	0.14	7.94	1.94	1.50	1.28
Employees	109	0.00	1.08	0.60	0.48	0.21
Real Assets	109	0.00	1.00	0.72	1.00	0.45
Working Assets	109	0.00	1.00	0.75	1.00	0.43
Gender of the Owner	109	0.00	1.00	0.65	1.00	0.48
Age of the Owner	109	0.00	1.00	0.80	1.00	0.40
Entrepreneurial Experience	109	0.00	7.00	2.74	2.00	1.86
Industry	109	1.00	4.00	3.46	4.00	0.93
Length of Relationship	109	1.00	8.00	3.36	3.00	1.45
FA	109	0.00	1.00	0.61	1.00	0.49

Source: Primary Data (Processed)

4.5.3.2. Pearson Correlation Results

Pearson correlation analysis was conducted to examine the correlation between all variables. The dependent variable is the incidence of FA. The independent variables are the proxy of the entrepreneur and business characteristics, which are capacity, real assets, working capital, the gender of the owner, the age of the owner, entrepreneurial experience, industry, and length of the banking relationship. The Pearson correlation results are presented in Table 4.11 below.

Table 4.11 Pearson Correlation Results (n=109)

Variables	Capacity	Real Assets	Working Capital	Gender of the Owner	Age of the Owner	Entrepreneurial Experience	Industry	Length of Relation	FA
Capacity	1.00								
Real Assets	0.20**	1.00							
Working Capital	-0.02	0.36**	1.00						
Gender of the Owner	-0.17*	0.05	-0.02	1.00					
Age of the Owner	-0.14	0.09	0.03	-0.08	1.00				
Entrepreneurial Experience	0.27**	0.24**	0.00	-0.07	0.07	1.00			
Industry	-0.20**	-0.04	0.01	0.07	-0.07	0.11	1.00		
Length of Relationship	-0.02	0.06	0.19**	0.02	0.11	0.18*	-0.24**	1.00	
FA	1.00	0.07	0.19**	0.20**	-0.03	0.10	0.11	0.47**	1.00

Source: Primary Data (Processed)

Note: ***Significant at 1%

**Significant at 5%

*Significant at 10%

The positive coefficients mean that when the value of one variable increases, the value of the other variable also tends to increase. On the other hand, negative coefficients indicate that when the value of one independent variable rises, the coefficient value of the other variable tends to decrease. In Table 4.11, it is shown that several independent research variables have a positive and negative correlation with other research variables. The value of the correlation coefficient indicates that most the relationship formed is weak and not a perfect relationship because the coefficient value is in the range of $-1 < r < 1$.

4.5.3.3. Logistic Regression Results

Logistic regression analysis was employed using the data from the survey on the beneficiaries of Perum Jamkrindo in the guaranteed loans from the NTB branch office. This analysis estimates the effect of eight enterprise characteristics on FA as a proxy for the benefits of the CGS. These characteristics are capacity, real assets, working capital, the gender of the owner, the age of the owner, entrepreneurial experience, industry, and length of the banking relationship. The dependent variable is the incidence of FA that is categorized as a dichotomous variable. The logistic regression results are presented in Table 4.12.

Table 4.12 Logistic Regression Results (n=109)

Variables	B	Odds Ratio	Marginal effect	Standard Error
Capacity	-0.03	0.97	-0.00	0.04
Real Assets	0.79	2.20	0.11	0.09
Working Capital	1.13	3.11	0.17	0.12
Gender of the Owner	1.28	3.60	0.19**	0.08
Age of the Owner	-0.79	0.46	-0.11	0.09
Entrepreneurial Experience	-0.08	0.92	-0.01	0.02
Industry (Reference = Restaurant)				
Industry 2 (Hotel)	0.62	1.86	0.09	0.19
3 (Travel)	-0.36	0.70	-0.05	0.20
4 (Craft)	2.30	10.01	0.33*	0.70
Length of Relationship	1.21	3.34	0.17***	0.02

Source: Primary Data (Processed)

Note: ***Significant at 1%

**Significant at 5%

*Significant at 10%

According to Table 4.12, there are three independent variables (the borrower and business characteristics) contributing significantly to the incidence of FA. These variables are the gender of the owner, the craft industry, and the length of the banking relationship. The marginal effect

reflects the change in probability at $FA = 1$ for every unit change in the independent variables. The gender of the borrowers also made a positive and significant contribution to the incidence of FA at 5% significance level. The marginal effect for the gender of owner of 0.19 implies that, for two hypothetical individuals, the predicted probability of success is 0.19 higher for male respondents, than for female respondents.

The gender of owner has the odds ratio at 3.60, which means the male respondents were provided with a higher guaranteed loan, as much as 3.60 times more frequently compared to the female respondents. The lenders tended to offer higher guaranteed loans to male borrowers since the lenders perceived that a male borrower has a higher ability to run a business and categorized them as more creditworthy customers.

The craft industry also made a positive and significant contribution to the incidence of FA at 10% significance level. The marginal effect for craft industry of 0.33 implies that, for two hypothetical individuals, the predicted probability of success is 0.33 times greater for the one in the craft industry than for a respondent in another industry. The variable of craft industry has an odds ratio at 10.01, which means the respondents, who run a craft/art shop, were provided with a higher guaranteed loan, as much as 10.01 times more frequently compared to other respondents, who run other businesses. The largest number of enterprises based on sector is in crafts industry, about 45.12% of total informal industries in NTB (Disperin Provinsi NTB, 2016; p. 4). The craft industry also creates jobs significantly, about 29% of of total employees working in MSEs in NTB (Disperin Provinsi NTB, 2016; p. 4). It implies that, this industry is an important industry in economic activities of NTB.

The length of relationships also made a positive and significant contribution to the incidence of FA at 5% significance level. The marginal effect for length of relationships of 0.17

implies that one-unit increase in the length of relationships will produce a 0.17 increase in the probability of success for an otherwise average individual. The length of the banking relationship has the odds ratio at 3.34, which means the respondents with longer banking relationships would have accessed more significant guaranteed loans, as much as 3.34 times greater compared to the respondents with a shorter banking relationship.

According to this rationale, the longer the relationship between borrower and client, then the more creditworthy they are, since they have already made several transactions. The lenders tend to provide a guaranteed loan to a more creditworthy customer. This result indicates that the length of the banking relationship seems to be necessary to contribute to the existence of loans for MSEs.

On the other hand, some variables do not contribute significantly to the incidence of FA. These variables are the capacity of the business, the purpose of loan for funding real asset and working capital, the age of the owner, the entrepreneurial experience of micro and small borrowers, and three types of the industry (culinary, hotel, and travel). This result implies that the provision of guaranteed loans is not much influenced by the business characteristics of micro and small borrowers.

The CGS in Indonesia is a government policy aimed at encouraging the development of MSMEs, especially those for MSEs. The main obstacle these entrepreneurs faced is related to the ability to access capital for running their business. Therefore, the Indonesian government initiated this scheme to support financial access for all feasible MSEs and also young entrepreneurs, which do not have legal status, are unable to provide a business plan or even financial report, still have a little business experience and are still categorized as micro and small-scale businesses.

4.5.4. The Connection between Financial Additionality and Economic Additionality

The FA and EA are two indicators to measure the benefit of the CGS to the borrowers. As mentioned earlier, the FA refers to the ability of borrowers to access a loan when the guarantee scheme is available. On the other hand, EA refers to the economic and social benefits of the CGS. The hypotheses of this study related to the connection between the FA and EA is “when the FA increases it will be followed by the increasing of EA”. EA is divided into direct and indirect EA. The direct EA is described by the performance of firms, such as employee development, profit and turnover one year after receiving the guaranteed loan. The indirect EA is evaluated based on ability to export and innovate, which is indicated by developing a new product or service and, or by introducing a new technology into the production or delivery process.

The survey results and data analysis show that most respondents benefit from the guaranteed loans, they can access loans to run their business because the guarantee scheme exists. About 61% of respondents were able to access/raise the loan because of the existence of the guarantee scheme. This condition is indicated by the value of FA of 30% or more. Meanwhile, 39% of respondents did not experience this, which is indicated by the value of FA of less than 30%. From this result, it can be concluded that the existence of the guarantee scheme gives benefits for MSEs by enabling them to access loans.

Moreover, the investigation of the EA was implied by the performance of firms. The respondents who were being provided with KUR loans to run their business properly could increase their employment rates by 25%. Meanwhile, for all the industries in NTB, employment rose by 4.5% in 2013 (BPS NTB, 2014b). This result suggests that the respondent firms typically attained employment growth more than the industry sector as a whole. Furthermore, most respondents can increase their annual sales revenues after being provided with KUR loans, most

respondents (93.6% of respondents) were able to increase annual sales. Also, about 53% of respondents were able to increase their profit.

Based on this result, the hypotheses of “when the FA increases it will be followed by the increasing of EA” is accepted. This result suggests that when the guarantee scheme can support the respondents in accessing a proper loan to run and enlarge their businesses, then the respondent may be able to make more profit. However, if we evaluate from the indirect EA, the guaranteed loan could not make a positive impact in increasing the ability of respondents to export their products, as only 7% of respondents had been able to export their product.

The indirect EA is related to the competitiveness of a nation through innovation, exports and entrepreneurial activity. Most respondents (66% of total respondents) had not attended any technical training related to adding new technology products, then it makes MSEs have limited ability to introduce new technology, and then they have less ability to create new products and add innovation to their products. It may imply a low ability of MSEs to apply high technology to make qualified products for export. It may be exacerbated by the indication that only limited respondents (about 35% of total respondents) had engaged in any entrepreneurial development or business management training.

Moreover, a simple regression analysis was also conducted to strengthen the descriptive analysis of the connection between FA and EA. The dependent variables refer to the indicator of EA, which are annual sales, employee, and capacity. The independent variable is FA. The general model is formulated as follows (model 2):

$$Y = \alpha_1 X + \epsilon \quad (4.3)$$

The simple regression results are summarized in Table 4.13 below.

Table 4.13 Simple Regression Results (n=109)

	Employment	Annual Sales	Capacity
FA (Mean)	0.17**	0.26**	-0.04
Adjusted R-squared	0.67	0.62	0.41

Source: Primary Data (Processed)

Note: ***Significant at 1%

**Significant at 5%

*Significant at 10%

According to Table 4.13 shows that FA gave a significant and positive contribution to the employment and annual sale of the respondents. The marginal effect of the connection between FA and employment is 0.17. It means that a one-unit increase in FA will produce a 0.17 increase in the employment. Then, the marginal effect of the connection between FA and annual sale is 0.26. It means that a one-unit increase in FA will produce a 0.26 increase in the annual sales. This result indicates that the purpose of Indonesian government to increase the employment rate through implementing a CGS has been reached. To sum up, the significant connection between employment and FA implies that the CGS could create jobs and gives the significant contribution to the Indonesian economic activity.

4.5.5. Existence of Local Money Lenders

This study also discovered that the loan sharks, known as '*rentenirs*', typically become a common feature of informal financial sources for the MSEs in Lombok. This is because the loans are agreed to quickly and for a short period. However, these local money lenders imposed an extremely high rate of interest, e.g. almost 14% monthly for micro and small-scale loans. The long-term relationship between the '*rentenirs*' and the clients and their family members as well is

a characteristic of the financial transaction between them. This relationship can serve as social capital to gain loan approval from the *'rentenirs'*.

The provision of loans from the local money lender can be an effective method to address the inadequacy of information in the segmented financial market (Grootaert and Bastelaer, 2002). Local money lenders have sufficient information to assess the creditworthiness of borrowers because of the long-term relationship between both parties. Consequently, the high-risk and low-risk borrowers can be differentiated by the lenders, and afterward, they can personally arrange the rate of interest for the borrowers.

In developing countries, such local moneylenders are frequently a function of the primary accessible loan providers to the MSEs, and they demand a high-interest rate. Nonetheless, a considerable number of micro and small companies utilize this financial source to obtain a loan due to its ease of access, and the installment payment method can be arranged according to their needs. The respondents who received the loan from a *'rentenir'* did not face any problems in paying the high interest as long as they can borrow money to maintain their businesses.

The story of the crafts businessman in Banyumulek is an excellent example to describe the phenomena of *'rentenirs'* as the most common financial source for MSEs in Lombok. He stated that he preferred to borrow money from a *'rentenir'* since the method of installment payment suited the features of his business. He sometimes got an order from a client to produce mostly a vast number of craft products. In this situation, he required a simple and substantial provision of capital to fulfill the order.

Furthermore, he said that when the craft businessmen utilized a bank credit to increase their capital, they may be on the brink of bankruptcy. They could pay the installment of the loan in the first few years, and after that, they would not be able to do so for the rest of the time.

Contrariwise, the other craftsmen said that when they used a loan from a '*rentenir*,' they might be able to maintain their business. They could pay the installment of the entire loan soon after they got paid by their client. It appears that the income flows of the borrowers were congruent with the ability to pay the installment of the loan. Consequently, Perum Jamkrindo ought to consider structuring a suitable mechanism and method of installment payment for providing a guarantee to micro and small-scale credit. An industry-based system would likely be an outstanding choice to guarantee a loan for micro and small businesses since this system would be built based on industry features.

MSEs only think about how to obtain loans for running their businesses, where they perceive that the loan could increase their income. However, that loan negatively impacts on their welfare, since the income they gained is used to pay the interest rate. Furthermore, sometimes, they have to sacrifice their consumption to repay the loan and its high interest rate. This condition is a kind of paradox: that the 'credit programs' with lower interest rates could not reduce the existence of loans with higher interest rates (from a '*rentenir*').

This situation happens because of several reasons. Firstly, the '*rentenirs*' are more active in looking for clients than a formal financial institution (bank). They are also more flexible in their operation and develop more personal interaction with the clients. The flexibility is necessary for maintaining the '*rentenirs*'-borrower relationship. For instance, the '*rentenirs*' discerns the economic condition of the borrowers and allows them to reschedule the repayment of the loan. Secondly, the transaction between a '*rentenir*' and a borrower is based on trust, which is a characteristic of money transactions with MSEs and rural communities.

4.6. Conclusion

This study found that Perum Jamkrindo operates the guarantee scheme efficiently because of its capacity to deal with all claims and aggregate working expenses by the income obtained from the premium fee of the guarantee. It demonstrates that Perum Jamkrindo could make a profit. The rate of default for Perum Jamkrindo's loan guarantees was positioned at an acceptable level (i.e., lower than the universal standard, i.e., at 2 - 3%). Nonetheless, the rate of default rate and the claim payments demonstrated a rising trend. It may indicate that lenders relaxed the evaluation process of credit decision-making for micro and small clients. The purpose of KUR loans is to support the availability of financial access for MSEs. Moreover, the recovery of claims was relatively low, because a proper action to manage claim recovery did not seem to be taken by Perum Jamkrindo. Perum Jamkrindo still faces a lack of appropriate recovery procedures and experienced staff.

FA and EA were measured to represent the benefit of guaranteed loans to MSEs. The responses from the survey indicated a meaningful assessment of additionality. Based on the calculation of FA from the survey results, it indicates that the FA is at a significant level. It means that most respondents were able to get additional loans due to the availability of KUR loans guaranteed by Perum Jamkrindo. Furthermore, the regression results show that of three independent variables (the gender of the owner, the craft industry, and the length of banking relationship) have positive and significant impacts on the incidence of FA. It implies that these variables have a significant role in making credit decisions by lenders since these variables may indicate the creditworthiness of borrowers.

The guaranteed loans deliver some positive outcomes related to direct and indirect EA. From employment growth, the respondent firms typically showed higher growth than the tourism

sector as a whole. Furthermore, most respondents were able to increase their annual sales revenues and increase profit after being provided with Perum Jamkrindo's guaranteed credit. However, the limited ability of micro and small respondents to introduce new technology and to innovate reduces the capacity to run their business and the chance to sell their products overseas.

From the perception of respondents, the survey results show that most respondents were not able to extend the loan when the guaranteed loans did not exist. It implies a sufficiently high level of FA. It also indicates that limited proportions of alternative financial sources are available to the respondents. The interview results show that most respondents indicate that the existence of the guaranteed loans will have a positive effect on their businesses. The respondents stated that they could not enlarge their business significantly or even run them if they could not access the loans.

CHAPTER 5

Role of Lender-Borrower Relationships in the Distribution of Indonesian Guaranteed Loans (*Kredit Usaha Rakyat Loans*) for Micro and Small Enterprises.

5.1. Introduction

Chapter 4 of this thesis presents an analysis that highlights the critical role of credit guarantee schemes to increase financial access for Micro and Small, and Medium Enterprises (MSMEs), especially for those who are micro and small-scale business, and also young businesses. Previous studies also suggest that these schemes can improve credit availability for such firms. For instance, an international survey by KPMG (2011) reported that the global implementation of guarantee schemes could significantly boost the amount of credit issued, especially for Small and Medium Enterprises (SMEs). The guarantee parties investigated in this survey indicated that only 10% to 20% of their borrowers would have been able to obtain a loan without a guarantee. Other empirical research concluded that guaranteed loans positively affected the availability of loans to small businesses (Riding et al., 2007; Zecchini and Ventura, 2009; Cowling, 2010; Uesugi et al., 2010).

Credit guarantee schemes are able to support small-scale enterprises experiencing difficulties, and are widely implemented in various countries. The existence of asymmetric information is frequently connected to the effectiveness of these schemes (Ono et al., 2011). Guaranteed loans might generate a moral hazard indicated by the lack of motivation of the borrower to repay the loan. This problem could be harmful to the sustainability of the guarantee corporation since it increases the possibility of loan default. In addition, the defaulted loans do not only decrease the performance of the guarantee corporation but also the performance of the participating bank.

This moral hazard problem can be overcome through collecting information about the borrower, such as characteristics of the borrower and the borrower's business condition. This information could encourage the lender to employ a proper credit evaluation to assess the creditworthiness of the borrowers. The ability of a lender to collect information about a borrower is influenced by how the lender creates relations and interactions with the borrowers. The relationship between lender and borrower may lessen the informational friction and increase the availability of loans for small companies (Cole, 1998; Petersen and Rajan, 1994).

This study found a positive and significant contribution of the length of the relationship between lender and borrower to the incidence of FA. It implies that the respondents with longer banking relationships would have accessed more significant guaranteed loans than to the respondents with a shorter banking relationship. The longer the relationship between borrower and client, the more creditworthy they are, since they have already made several transactions. The lenders tend to provide a guaranteed loan to a more creditworthy customer. This result indicates that the length of the banking relationship seems to be necessary to contribute to the existence of loans for Micro and Small Enterprises (MSEs).

This research also found an interesting phenomenon related to the distribution of the *Kredit Usaha Rakyat* (KUR) loan as a guaranteed loan by Perum Jamkrindo. The Indonesian government frequently states that KUR loans are one of the credit programs created by the government in order to expand credit access for MSEs. However, this information has a negative impact that triggers a moral hazard problem with micro and small borrowers. These borrowers seem to be less willing to pay back the loan since they perceive that the KUR loans are provided for them by the government. As described earlier, to overcome this moral hazard problem, the

lenders through their Account Officers (AOs) can explore the lender-borrower relationship in the process of the KUR loan distributions for micro and small borrowers.

Therefore, the influence of lender-borrower relationships on the effectiveness of public credit guarantee programs is an interesting topic to be investigated. This chapter aims to explore the aspect of the lender-borrower relationship in the distribution of guaranteed loans (KUR loans) concerning the reduction of the moral hazard problem in small lending cases. Moreover, based on the description in Chapter 4, most Indonesian micro and small companies have worked closely and developed a strong relationship with local money lenders who provide financial credit for their business activities. This kind of relationship enables the local money lenders to endure in the credit market. Since the KUR loan may have the same characteristics as that of the local moneylenders, it is essential for KUR to operate a similar system to maintain the sustainability of its loan.

These relationships are made through communication between the bargaining parties, i.e., AO and the owner of an enterprise. Thus, in the distribution process of KUR loans, the role of an AO is very crucial in the gathering of soft information concerning those micro and small borrowers. Moreover, the long-term relationship between the lender and the borrower is built based on trust, which is a characteristic of money transactions made by MSEs. Thus, this study focused on examining the existence of lender-borrower relationships in micro and small-scale lending guaranteed by Perum Jamkrindo. This chapter aims to describe the role of the lender through the AO to maintain the sustainability of the guaranteed loans. Two main questions are posed for the purpose.

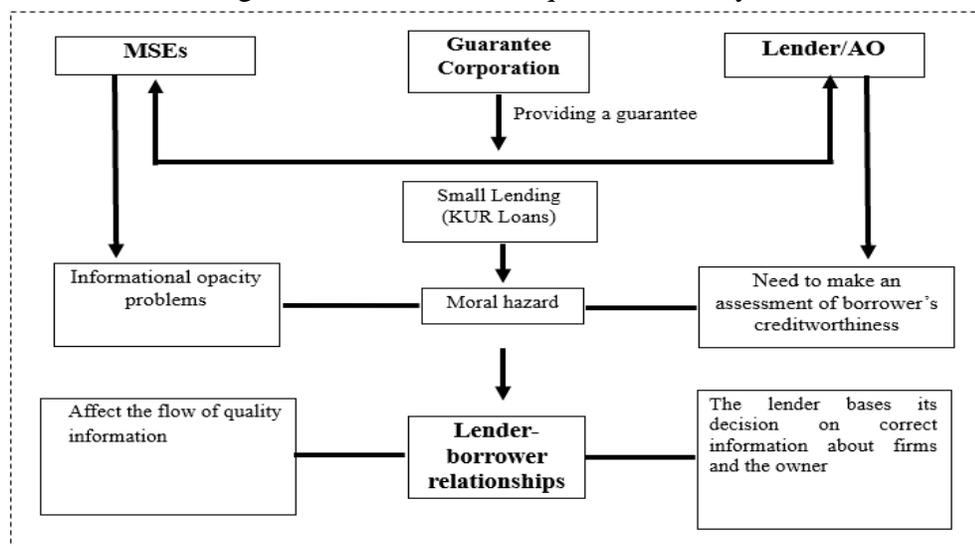
In this chapter, a descriptive qualitative approach was utilized to present a more detailed analysis. Section 5.1 gives an introduction to this chapter. Section 5.2 describes the qualitative

approach used in this study. Section 5.3 describes an overview of lender-borrower relationships. Section 5.4 describes how relationships between lenders and borrowers created to increase the provision of guaranteed loans provided to micro and small enterprises. Section 5.5 investigates length of lender-borrower relationships. Section 5.6 evaluates the effect of lender-borrower relationships on the sustainability of the guaranteed loans. Evidence from case studies is presented in Section 5.7. Finally, Section 5.8 concludes this chapter.

5.2. Qualitative Approach

The existence of a relationship between lender and borrower was investigated by applying a qualitative approach. This approach was also employed to evaluate the role of the lender-borrower relationship in increasing both the accessibility of guaranteed loans as well as repayment performance. Qualitative studies are appropriate when describing process, content, and the dynamics of networks, rather than purely structural matters (Jack, 2005). Through this approach, a more detailed and richer analysis is presented (See figure 5.1).

Figure 5.1 Framework of qualitative analysis



Source: Author

The relationships between lenders and borrowers were investigated through observing the interactions and communication between borrowers and the AOs of banks, as the crucial person representing the lender. The results from this analysis are used to formulate a framework for their relationships in distributing KUR loans. The AO is the critical bank worker who has the most crucial ability to collect soft information regarding the conditions of the business, proprietor, and members of a community. Measuring and communicating this soft information is challenging to conduct through the formal structure of an organization.

The AOs were interviewed in depth to investigate the comprehensive information of how their relationship with the borrowers was built. Since the KUR loans are provided and distributed by the partner banks of Perum Jamkrindo, the AOs from these banks were chosen as participants of the study who were expected to provide information regarding their methods of communication and interaction with the clients. The banks involved in this study are BRI, Bank Mandiri, BTN, and regional development banks. The first interviews were conducted from June to September 2015 and the second from January to February 2016. The descriptive data from the survey of micro and small borrowers is also presented in this chapter to strengthen the qualitative results.

The most crucial strategy of a commercial bank in enlarging its micro-credit business is to make a vast number of micro outlets. These outlets are formed as sub-branch offices and terrace offices that can reach many micro and small businesses around the nation. These offices have the closest access to micro and small businesses. The bank employs more AOs and staffs to encourage the operation of these offices. As the frontline of a bank, the AOs are expected to be able to promote the functions of terrace offices to support the role of the bank as the financial intermediary for the micro and small sectors. Therefore, the respondents of this study are the AOs

of BRI, Bank Mandiri, BTN, and regional development banks.

5.3. Overview of Lender-Borrower Relationships

The soft information is collected through continuous interaction between lenders, borrowers and also the borrower's local community in diverse ways. Mostly, the soft information deals with the issue of the creditworthiness of the borrowers. This information is not easy to observe, verify or even communicate to others. This soft information is used by the lenders to execute a credit agreement for micro and small borrowers. The lender's ability to gather the information depends on some factors, such as their ability to communicate and interact with the borrowers, to build trust between both parties through interaction over time, and to maintain a long-term relationship.

The KUR loan is the most crucial credit program guaranteed by Perum Jamkrindo, to support financial access for micro and small businesses in Indonesia. By 2014, the commercial banks in Indonesia had delivered about 175,168 trillion IDR¹⁵ of KUR loans for 50.5 million debtors. The lenders (commercial banks) avoid providing loans for micro and small businesses because the credit risk of these clients is high. Thus, the guarantee from Perum Jamkrindo aims to transfer credit risks from the lenders to the CGC so as to encourage the lenders to offer loans. However, this guarantee also has a negative effect for sustainability of the KUR loan because the borrowers perceive that this loan is a public fund which then makes the borrowers reluctant to repay the loan. Therefore, as the principal state-owned CGC in Indonesia, Perum Jamkrindo must have an effective mechanism for guaranteeing the KUR loan.

A defaulted loan is always directly connected to the borrower and the lender, so that the

¹⁵ 1 USD equivalent to 14,000 IDR

lender is the main party who can reduce defaulted loans that may arise because of the moral hazard problem. The lenders also aim to reduce loan default since it could influence their performance. It means that the lenders also have a significant role in the effectiveness of guaranteed loans. Thus, the banks' decision to partner with Perum Jamkrindo for developing credit for micro-scale businesses leads them to adjust to new concepts under small-scale dimensions, utilizing other patterns of thinking, and methods that have been executed for other commercial loans.

The guarantee loans for micro and small-communities would not be useful if they were designed using commercial banking standards because these micro enterprises have various disadvantages associated with all aspects of their businesses. Hence, the design of these products and services ought to be made easier. In any case, the simplification of arrangements is anticipated to result in various potential risks, which can potentially influence the continuity of micro credit. The lender should conduct a different process of submission for micro and small-scale loans, in which the intangible characters of the would-be-borrowers happens to be vital as they are not identified by notes, archives or other things that can be controlled. At this point, intuition and feeling will play a significant role. These sorts of methods could function as building blocks for both bank and borrower to develop a sound relationship. As such, future problems from the prospective borrowers concerning the possibility of loan default could be minimized.

5.4. How are Relationships between Lenders and Borrowers Created to Increase the Provision of Guaranteed Loans Provided to Micro and Small Enterprises?

Lender-borrower relationships are employed to reduce the problem in the implementation of credit guarantee schemes, which is a moral hazard problem. This problem occurs due to the borrower's reluctance to pay back the credit after receiving information about the credit program being a government initiative. In such a case, the lender (as Perum Jamkrindo's partner bank) has an essential role in addressing this problem by optimizing the AO's role. The AO has a unique relationship with the customer, where such relationships generate a positive aspect that develops steadily. In this case, the AO's main role is to determine those who qualify to receive a loan, especially micro and small borrowers. After all, this is a challenging role.

The difficulty arises because the business undertakings as well as personal lives of corporate managers are not separated, where the company's capital is often closely linked to an owner's equity, thus contributing to the ambiguity of business performance achieved by MSEs. Accordingly, the AO needs to assess how the company's economic performance is primarily influenced by a client's personal life. Through intense communication, both the borrower and the AO discuss issues of a personal nature, which eventually increase the integration of business relations.

On the other hand, for conventional loans, the borrowers have to provide financial statements, legal status, and other formal documents. Nonetheless, the opposite characteristics and conditions of micro and small and borrowers may persuade the AOs to employ a different strategy in assessing a customer's eligibility. This study only investigated how the AOs make a judgment to approve a micro loan. The interview results with the AOs related to how they communicate and interact with their prospective micro and small borrowers are presented in Box

5.1.

Box 5.1. Interview result with the AOs

BRI KR2 said,

“Before I contact and interview the borrowers, firstly, I attempt to collect information about them from their neighborhood and visit their business site. A relationship can be created by having many interactions with a client. From this relationship, I am able to identify a client very well. In other words, when I ask some questions of a client, they will not mind since I know them well. They would not be too defensive”. (Personal communication, June 2015)

Then, BPD1 also mentioned that:

“As the AOs, we must understand the lives of our customers. In this way, we can tap into the information from them; eventually, this information leads us to build up a valuable and extraordinary discussion and communication.....As such, we can obtain information to appraise the borrowers’ financial soundness. Through this ongoing communication, a “relationship” comes into being”. (Personal communication, June 2015)

BRI KR1 said that:

“I attempt to gather information about borrowers from their neighborhood. I conduct regular visits and observe the client’s business. At the beginning, I try to trace the borrower’s behaviors and character through exploring my intuition and interpreting their body language.” (Personal communication, July 2015)

According to Box 5.1, most AOs develop excellent communication with potential clients. Nearly all AOs share similar ideas, i.e. they are forced to gather information about the borrowers’ businesses as well as their private life through visits to clients’ business sites and the client’s neighborhood. A number of the borrower’s private issues may impact on their capacity to repay the credit regularly. For example, a customer who has a family issue, such as a household conflict, is inclined to experience problems in repaying the loan routinely since such problems frequently weaken his/her capacity for operating a sound business.

Collecting the ‘soft information’ from micro clients takes time; it cannot be worked out in a short time. To be provided with this information, the AOs should regularly interact with clients. This interaction assists the AOs to understand the dynamic situations faced by the customers, and from this standpoint, these AOs are required to translate the information provided by the

customers. In other words, this implies the interaction creates a relationship. Based on interaction theory, the relationship that actively involves both individuals should be considered (Ford, 1997).

Lender-borrower relationships create meaningful private information about prospective micro borrowers. Consequently, to cope with credit rationing issues because of the asymmetric information problem, the banks collect data and create an appropriate credit contract for micro and small clients. The study of Lehmann and Neuberger (2001) supports this finding. The AOs of the banks could generate valuable loyalty from the debtor, thereby enabling inexpensive renegotiations of credit agreements through the private information that they gradually collected. Berger and Udell (2001) additionally remarked that over time, the accumulated information delivers substantial merit beyond the company's financial reports, collateral, and credit score. They also concluded that the information helps the lender deal with informational opacity problems.

The high transaction costs inherent in micro and small credit leads most lenders not to deal with micro and small lending, and thus they are more inclined to provide conventional loans with various requirements that can reduce credit risk. However, many potential consumers are micro and small entrepreneurs, since the number of MSEs is more than 90% of the total number of enterprises in Indonesia. Therefore, creating a lender-borrower relationship is an effective way to include the micro and small-scale loans while managing the inherent risks of these loans.

The relationship between lender and borrower enables both parties to develop understanding among participants of the network. Lender-borrower relationships could help to recognize the needs and resources of borrowers. This is demonstrated in the interview results with some AOs (presented in Box 5.2).

Box 5.2

BRI KR3 stated:

“Serving a client who I know well is a priority for me.... particularly a client who comes from my family....evaluating his/her credibility to accept a loan is easier for me and does not take much time....and someday, even if an issue repaying the loan occurs, credit restructuring will be much easier” (Personal communication, January 2016).

BTN1 said that:

“All customers are served the same way... if they are my family members or not....certainly, when a client is from my family, I will know him/her better. However, the most crucial thing is the creditworthiness of the client, whoever the client is. I absolutely do not want to deal with any trouble because of family issues.” (Personal communication, February 2016)

MB1 said that:

“I would try to offer more consideration and some advice when a client deals with issues in repaying the loan, rather than forcing them to repay the loan on time. Then, I hope he can solve the repayment issues. In fact, in the case of loan default, I will not mind giving concessions to provide a rescheduling of the loan payment. Hence, the clients tend to respect what I have done to support them, and I am very confident the client will do their best to repay the loan as soon as possible” (Personal communication, July 2015).

According to the interview results in Box 5.2, the creditworthiness of familiar customers is easier to trace also in case of loan default, it is easier to apply a restructuring of credit. It means that the familiar customers pose a lower risk to the lender. However, if the AOs restrict themselves only to serve well-known clients, the AOs will have a limited number of clients and may not be able to meet their target for the number of clients. Therefore, every time the AOs make a new client (micro or small borrower), they try to make a close relationship by creating much interaction before and after loan approval. Finally, the AOs commonly have a close connection with their clients. Based on the survey results of the borrowers, 55% of the total respondents know the AO as family, relatives, friends, or even acquaintances, while 45% did not know the AO before.

Furthermore, the borrowers also feel in the same way that they are more certain to get the

KUR loans because of their relationship with the bank's officer. The experience of applying for a KUR loan was described by a pearl business person in Mataram. He acknowledged that he was provided with a loan since he had a relationship with a bank's AO. He said that the AO assisted in providing all the requirements to secure the loan.

The KUR loan is guaranteed by Perum Jamkrindo and collateral for this loan is officially not compulsory. Hence, the AOs create a specific strategy to develop a more in-depth relationship with these clients to maintain the performance of the loan. The AO-borrower relationships impact the success of business exchanges between them. To this extent, when the evaluation of borrower's creditworthiness is difficult to attain, then AOs will measure it through personal linkages. Nevertheless, the AOs employ the standard procedure of the bank in processing loan proposals from the MSEs. Thus, it can be inferred that both lenders and borrowers rely not only on impersonal sources of information but also on familiar informants.

The story and interview results indicate that lender-borrower relationships tend to affect the approval decision and restructuring of funds in the case of default. To sum up, the performance and sustainability of a lending program might be influenced by these relationships.

5.5. Length of Lender-Borrower Relationships

The ability of AOs to collect and read the soft information of borrowers is affected by the length of the lender-borrower relationship. Credit application for new clients requires a thorough and costly evaluation; thus, lenders are inclined to agree with credit extension for existing borrowers. The longer lender-borrower relationships are, the higher the possibility of loan approval is, as described by an AO, *"The existing clients and customers who have a good track record from their previous debt in other financial institutions are my priority...I ensure approval*

of credit for these clients” (Personal communication, June 2015). The other AO described another aspect:

“I could find a potential client from the existing customers. The business information of the potential client, for instance, his/her supplier and potential customers, can be collected through frequent interactions. Thus, I may be able to evaluate his/her business feasibility, and then I agree to approve his/her credit application” (Personal communication, January 2015).

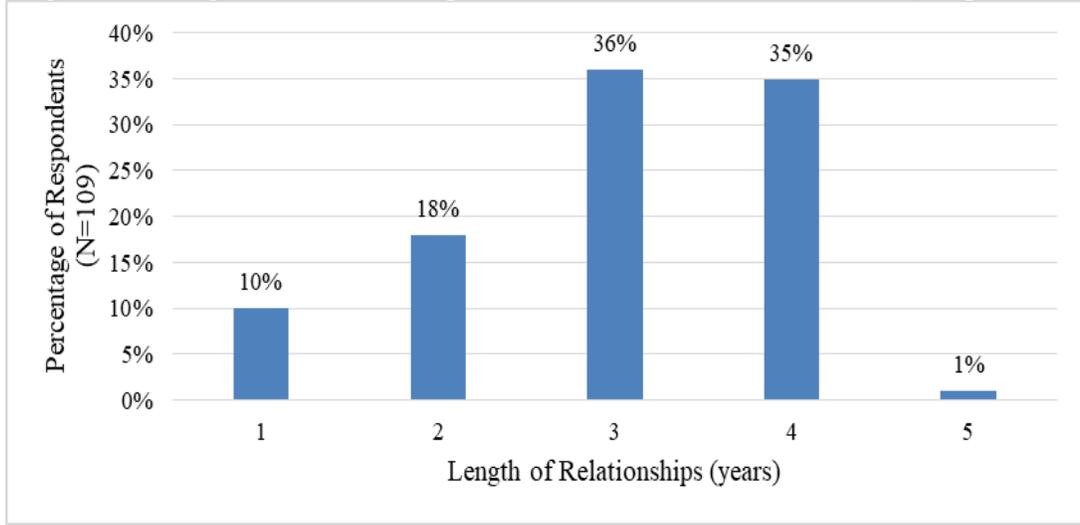
In the same vein, a borrower who works as a wood craftsman in the village of Rungkang Jangkuk said, *“Since I have had a relationship with a bank in Mataram for five years and I know an AO at this bank, I can always extend my credit easily”* (Personal communication, October 2014).

From such a continuing relationship, the AOs give priority to the recognized borrowers since these borrowers show a greater certainty of their characteristics. To an extent, the lenders avoid the cost of complex contracting by employing frequent personal interactions. This action is consistent with the standard of economic arguments that states the actors employ deeper relationships for economic purposes.

The AOs tend to be motivated to act on behalf of a borrower and risk their reputation when the AOs have a long-term relationship with the borrower. However, the features of the loan are not affected by this relationship. Instead, the AOs risk their reputation to influence the judgment of a credit supervisor related to the creditworthiness of a borrower. The survey results of this study show that most respondents, who received KUR loans, have extended relationships with AOs.

Figure 5.2 shows that the majority of the respondents (72% of the total) have developed a relationship with a particular bank for three years or more, while the remainder (28% of the total) have experienced two years or less than that.

Figure 5.2 Lengths of Relationships between the AOs and Borrowers (Respondents)



Sources: Survey Results in West Lombok and Mataram

The survey results, which show that the duration of the lender-borrower relationship is closely related to the accessibility of a guaranteed loan, are consistent with previous studies. The enterprises that have a long relationship and more sources of funding services tend to receive loan extension, and their requests for loans are less likely to be rejected (Ono et al., 2011; Riding et al., 2006). This section concludes that the long-term relationships between lender and borrowers could create many advantages that boost loan accessibility for micro and small clients.

5.6. The Effect of Lender-Borrower Relationships on the Sustainability of the Guaranteed Loans

Sustainability is one of the critical indicators of the effectiveness of credit guarantee schemes, and all three parties of these schemes play a crucial role in maintaining this sustainability. Every party is aware of the vital purpose of the credit guarantee schemes and plays a part in ensuring its success. The guarantor sets up an effective mechanism to guarantee the bank's loan provided for micro and small borrowers. The commercial banks also try to create a

credit scheme for MSEs with the appropriate mechanism to reduce the incidence of loan default. Generally, micro and small borrowers are constrained by commercial banks because they cannot provide collateral. Through the guarantee system, the commercial banks are willing to provide credit for this group.

In principle, micro and small borrowers do not need collateral to access KUR loans. However, in practice, borrowers still provide collateral, although it is only a small amount. Most of the AOs gave the same explanation that *“providing collateral is still one of our requirements, especially for new clients.”* However, the collateral which they asked for has only a small value. The aim of asking for collateral is *“to bond a customer to us”* (Interview results with the AOs, February 2016). This evidence indicates that the value of the collateral is lower than the outstanding loan. For instance, for a KUR loan of 25 million IDR, a borrower provided a certificate of motorcycle ownership as the collateral. The economic value of the motorcycle was about 8 million IDR. Based on this example and the interview results, the aim of providing low-value collateral is mainly to develop a close connection and relationship with the borrowers.

A high level of trust in a relationship would enable micro clients and lenders (AOs) to discuss contingent credit agreements. The risk inherent in the contingent agreement was often predicted to the degree of the trust and reciprocity in the relationship rather than from other information, such as financial statements. It could also be an extension of providing a loan for an existing borrower with a good track record. Some evidence about this aspect is described by an AO (BRI KR1):

“My friend already runs a business and needs a loan to develop his business...I have known him for a long period...and I said, “Okay, I will help you to get a loan without any collateral. Just provide the documents”. I can do this only for a KUR loan ... I usually do it for my friends that I know well... moreover, I think it will help me to find reliable clients...” (Personal communication, January 2015)

The AOs tend to give priority to an existing client to receive a loan. However, the AOs cannot offer any different terms of credit, such as a lower interest rate, since the interest rate is already set by the head office. On the other hand, the relationships between lenders and borrowers may also have negative outcomes. The results of the field study indicated that AOs tend to prioritize borrowers they already know personally. The negative aspect of this is that delivering an unprofitable loan to a known customer resulted in a profitable unknown customer being unable to access a loan.

5.7. Case Study of Credit Approval Process

The use of case studies is employed to strengthen the evidence of the role of lender-borrower relationships in providing loans for micro and small businesses. The success stories of small borrowers in accessing KUR loans are described in this study. The borrowers may be able to obtain a recommendation from the AOs and successfully gain access to loans when they have a good relationship with an AO. The AOs know the borrower's business very well and believe that they can pay the loan back. The sustainability of the relationship between the AO and the borrower increases the performance of repayment rates.

5.7.1. The Case of "Annan Pottery"

Annan Pottery is an art shop in Banyumulek. The owner of Annan Pottery has been running this craft business for 15 years. He started the business on a small-scale, and later it became more successful, and it has developed significantly. In the beginning, the company was focused on producing craft products which were then sold to customers. Most of the customers are domestic tourists, and a few are international visitors. At that time, he only needed a small amount of capital to run the business.

After running the business for about five years, he could develop his sales by accepting substantial orders from customers from outside the region, even nationwide. He provides craft products not only by producing his own but also by collecting from other craftsmen, who produce craft on a small scale. Since then, he has required significant additional capital to deal with many kinds of orders. He tried to look for an additional loan from a number of financial sources, such as cooperatives, commercial banks, and microfinance. He avoided a loan from a '*rentenir*' because he believes it is prohibited by his religion. As the loans from cooperatives and microfinance were not large enough, the only possible source of funding was obtained from the commercial banks.

He then applied for some credit from commercial banks that could provide a sufficiently adequate loan for him. Eventually, he managed to get a loan from the NTB regional bank. However, in his first attempt, he failed because he did not have enough collateral (120% of the total loan) and the collateral he provided was not congruent with the bank's requirements. Hence, the bank recommended he apply for a KUR loan since the collateral for this loan is not compulsory. He had a good experience in applying for this loan since he already had a connection with the bank through some business events that he had attended. So, the bank gave him helpful advice to comply with the loan approval process.

To be provided with that loan, he had to comply with general requirements for applying for a loan, such as a residence card, family registration card, tax ID number, business license, bank account, and his certificate of motorcycle ownership as collateral. The agreed period of the loan was three years, and the interest rate per month was 0.5%. The loan approval process took only three days, and then the owner of Annan Pottery received the KUR loan of 50 million

IDR¹⁶. Since then, he has been able to access other additional loans from the NTB regional bank easily.

5.7.2. The Case of “Sinar Mutiara Lombok”

Sinar Mutiara Lombok is a pearl art shop located in Mataram. It started in 2012. The art shop sells many kinds of pearl jewelry, most of which are handmade products. The owner buys pearls from the wholesaler and produces the jewelry by having craftsmen make the jewelry based on her designs. She started the business with 500 million IDR support from her family. That loan was not enough for running and developing her business, so she searched for some additional loans from other sources. After one year of running the business, she finally got a loan from a commercial bank in Mataram.

The owner of Sinar Mutiara Lombok told her story of applying for the loan from Bukopin Bank. She was successful in obtaining a loan since the bank’s AO is her friend. The AO offered her a credit program known as KUR guaranteed by Perum Jamkrindo. She got the ‘KUR Retail’ of 500 million IDR. Furthermore, she indicated that she was offered a KUR loan by the bank without any complicated requirements. She just had to provide the main requirements, such as residence card, family registration card, tax ID number, business license, and bank account. Then, for the collateral, she used her certificate of property ownership.

5.8. Conclusion

Previous studies conclude that a lender utilizing a guarantee scheme can expand credit access, particularly for micro and small firms, and also for newly developed firms. Then, the

¹⁶ 1 USD equivalent to 14,000 IDR

ability to access credit also increases a firm's ex-post performance. The KUR loan is a type of guaranteed loan, and in 2014, more than 12 million MSEs around the nation were provided with KUR loans. It indicates that the KUR loan is crucial to increase financial access for these MSEs that face a problem of a lack of adequate collateral. Nonetheless, the KUR loans trigger other problems that come from the borrower, such as moral hazard. This problem is caused by the low desire of the micro and small borrowers to pay back the loans since they perceive that the KUR loan is a public loan and a credit program created by the Indonesian government.

A substantial number of small branch offices and terrace offices have been created to enable a considerable number of micro and small-borrowers to access KUR loans. The AOs serve many micro and small borrowers in these offices. The AOs also work at the location of these borrowers and transact on the spot. Thus, the borrower does not have to go to the office. Intensive interaction is conducted by the AOs to evaluate the creditworthiness of borrowers to be provided with a KUR loan. The AOs build good relationships with the micro and small borrowers to be able to evaluate the feasibility and creditworthiness of these customers appropriately. The lenders can maintain the performance of the KUR loans by building relationships with the borrowers. For instance, the Non-Performing Loan (NPL) of the KUR loan is relatively low and this scheme has reached a significant number of micro and small borrowers.

The lenders also employ a different strategy in approving a KUR loan since most KUR borrowers are MSEs. It is believed that the sustainability of this credit scheme can be maintained adequately by creating a robust lender-borrower relationship. The strong lender-borrower relationship is developed by the AOs, as the frontline officers, by having much communication with the prospective borrowers. Through this relationship, the AOs may be able to identify the '5Cs' of customers comprehensively in order to approve credit. From the '5Cs', the most

challenging task for the AOs is to measure the character of borrowers. The AOs apply many methods to be able to measure the aspect of the character, such as regularly visiting and observing the clients, and even using their intuition. By taking this step, the credit rationing problems faced by MSEs might be solved by designing a proper loan agreement that is made based on the borrower information.

The prospective borrowers, who have strong relationships with the AOs, will have a higher chance of obtaining a loan. Additionally, the AO would tend to approve the extended credit because accommodating a new customer requires a thorough and costly evaluation. Hence, they tend to give priority to clients already known to them, whose creditworthiness is easier to measure, and whose credit restructuring is easier to arrange. Well-known clients can be easily managed in the case of loan default. When such customers faced loan default, the AOs tended to provide concessions in payment of the loan by rescheduling the payment.

Moreover, this relationship will eventually lead to the sharing of their personal information. The work of AOs to evaluate the creditworthiness of borrowers will depend on the private information disclosed by the borrowers. From this information, the AO may be able to make a proper credit decision and provide their products to the borrowers. The AOs will be motivated to risk their reputation on behalf of the borrowers due to their long-term relationship. This recommendation tends to influence the expectations of the credit decision-makers about the borrower's creditworthiness rather than the credit's features. The AOs are more informed about the borrower's characteristics. Then, the performance of repayment rates is the desired goal of the lender (AO) and the borrower that they attempt to achieve. Therefore, the banks should give more lending authority to the AOs for making a judgment of creditworthiness. It means that the AOs have a crucial role in recommending loans for approval.

Chapter 6

Conclusion

6.1. Role and Performance of Credit Guarantee Schemes to Support Financial Development for Micro and Small Enterprises

The performance of the CGS is evaluated based on the three parties, which are a borrower, lender, and guarantor. Evaluating the performance of the guarantor can be conducted based on some of the relevant performance indicators. This study focuses on the indicators of operating costs of guarantee schemes, the claims rate, and the capacity of the CGS to recover the claims. The capacity of the guarantor to cover its costs (mainly from operational costs and defaults) influences the financial sustainability of the guarantor.

Based on the investigation of Perum Jamkrindo as the state-owned credit guarantee corporation in Indonesia, this study concludes that the operations of Perum Jamkrindo are efficient based on its capacity to cover all operational expenses of the guarantee scheme (total operational costs and costs of defaults) through premium income (guarantee fee). This ability may indicate a capacity for making a profit. Moreover, the default rates, which are described by the claim payments, are relatively low. It demonstrates an outstanding operational accomplishment of the guarantee scheme. The default rates should be followed by the ability to recover the claims, which can influence the capacity of the guarantee scheme to be sustained. The ability of Perum Jamkrindo to recover claims is relatively low. Thus, initiating an effective strategy for claim recuperation and utilizing experienced staff must be taken into account as the most critical tasks to deal with functional claims recuperation.

The benefit of a guarantee scheme to MSEs is described through FA and EA. The

investigation of these indicators shows that the FA of Perum Jamkrindo is at a modest level, where some indicators influence the FA significantly, for instance the gender of the owner, the type of industry (craft industry), and length of the banking relationship of micro and small borrower. Concerning the EA, the credit guarantees provided by Perum Jamkrindo reveal some positive outcomes. For example, by using the loans guaranteed by Perum Jamkrindo, micro and small borrowers have been able to generate sales and profits. This means that the respondents are able to increase sales after being provided with guaranteed loans. Using guaranteed loans, they can grow their businesses, make more profits, and also can create jobs even though in a relatively small amount.

However, most respondents MSEs still have low productivity and could not improve marketing access, so they are unable to increase employment significantly. Moreover, these enterprises indicate a weak capacity to organize their businesses and export their products due to a limited ability to introduce new technology to their production and distribution, and also limited entrepreneurial skills. Therefore, the government could provide high-tech production equipment and training in skills to operate the equipment, and assist in the protection of product designs produced by MSEs by facilitating patents, as well as optimizing information technology to improve marketing access.

The micro and small clients may prefer to apply for a loan that is guaranteed by a guarantee scheme since it has a low-interest rate and easy application process. Usually, the main objective of CGS's is to ease the financial constraints of micro and small borrowers in accessing a loan from a commercial bank because of collateral problems. In the case of Perum Jamkrindo, this objective did not seem to be achieved because the partner banks of Perum Jamkrindo obliged the availability of sufficient collateral to secure a loan. This fact is also supported by previous

research showing that the CGCs in Indonesia do not seem to be operated well as a real guarantor for micro and small lending, but involved in bank credit supplementary services. Thus, they have to consider a proper mechanism for approving guaranteed loans for MSEs, in which they may be able to achieve their purpose of supporting the financial development of micro and small businesses. The guarantee mechanism should be created specifically based on the industry characteristics of micro and small sectors.

6.2. Employing Lender-Borrower Relationships to Enhance Performance of Guaranteed Loans

The KUR loan was initiated to increase financial access for the MSEs that have insufficient collateral and need simple terms of credit. Nonetheless, the fact that the KUR loan is a public loan and a credit program created by the Indonesian government causes the emergence of other problems that come from the borrower, such as moral hazard. This problem arises if the borrower is informed that the loan is guaranteed by Perum Jamkrindo on behalf of the government. Thus, the borrowers have a low desire to pay back the loans.

The national banks, such as BRI the largest intermediary bank for KUR loans, overcome this problem by opening a substantial number of small branch offices and terrace offices, thereby enabling a considerable number of micro and small-borrowers to access KUR loans. In these offices, the AOs serve many micro and small borrowers. The AOs also work at the location of these borrowers and transact on the spot, so the borrower is not required to go to the office. The approval processes for KUR loans is conducted by having ongoing interaction between borrower and lender (AO). Through these interactions, the AOs are able to evaluate and precisely assess the creditworthiness and feasibility of borrowers to be provided with a KUR loan. Therefore,

lenders can maintain the performance of KUR loans.

The sustainability of the CGS can be maintained adequately by creating an ongoing lender-borrower relationship. The relationship is conducted by the AOs, as the frontline officers, by having much communication with the prospective borrowers. Through this relationship, the AOs collect information about the business and also borrower's private life. Therefore, the AOs may be able to identify the '5Cs' of customers comprehensively in order to grant credit approval. The most challenging task for the AOs is to measure the character of borrowers. The AOs apply many methods to be able to measure the aspect of the character, such as employing regular visits and observation of the clients, and even by using their intuition. By taking this step, the lenders obtain information that is used to design a proper loan agreement in order to deal with the credit rationing problems faced by the MSEs.

The borrower's creditworthiness is challenging to evaluate. It can be measured through personal networks, and both sides can share the information about their needs and resources that can be used as a basis to improve mutual understanding. The prospective borrowers, who have a strong relationship with the AOs, will have a higher chance of obtaining a loan. These borrowers include family, relatives, friends, and even acquaintances. Also, AOs tend to approve the extended credit because accommodating a new customer requires a thorough and costly evaluation.

Moreover, the well-known clients can be managed easily in the case of loan default. When customers faced loan default, the AOs tend to provide concessions in repayment of the loan by rescheduling the payment. In order to respect this concession, the customer may make the best effort to repay the loan as soon as possible. Therefore, the micro and small borrowers that have had a long relationship with the lender/AO may have a greater chance of being provided

with a loan.

However, since the AO must get a specific target of the amount of outstanding loan, it forces AOs to serve all kinds of borrowers and serve them in the same way. Moreover, the relationships between lenders and borrowers may create agency problems because of a different incentive set between the AOs and the bank due to the providing authority for the AOs. Then, these relationships have negative outcome, which is delivering an unprofitable loan to a known customer resulted in a profitable unknown customer being unable to access a loan. Therefore, the bank is still concerned about controlling and evaluating the performance of AOs individually by applying a loan review function. The achievement of AOs is evaluated based on performance of loans executed by the AOs for borrowers. As a result, the AOs would not provide loans to unprofitable borrowers because it will affect their performance and provide a negative track record for their careers.

Trust between lender and borrower creates a strong lender-borrower relationship. This relationship will eventually lead to the sharing of their personal information. The task of AOs to evaluate the creditworthiness of borrowers will depend on the private information disclosed by the borrowers. Based on this information, the AO may able to make a proper credit decision and provide their products to the borrowers. Sharing information between AOs and borrowers is a kind of a 'quid pro quo', which means that both parties can obtain useful information. The AOs will be motivated to risk their reputation at the bank on behalf of the borrowers due to their long-term relationship with the borrower. This recommendation does not necessarily affect the credit's features but instead influences the expectations of the credit decision-makers about the borrower's creditworthiness. The lender (AO) and the borrower have their own desired goal and attempt to achieve it through applying proper actions in maintaining the performance of repayment rates

since it influences the sustainability of the CGS.

6.3. Recommendations

All businesses in Indonesia is dominated by micro and small businesses (99% of the total businesses), while the number of medium businesses comprise only 0.1% of the total businesses. This means the number of large businesses only makes up a very small portion of the total number of businesses. However, these Micro and Small Enterprises (MSEs) in Indonesia are confronted with more critical monetary limitations. These MSEs receive a smaller amount of loans compared to the bigger ventures. Insufficient collateral is one of the reasons why commercial banks are less willing to provide loans to these firms. This financial constraint for such enterprises is due to asymmetric information issues that exist between lenders and debtors.

Therefore, the main objective of Perum Jamkrindo as the stated-owned credit guarantee corporation in Indonesia is to ease the financial constraints of MSEs in accessing a loan from a commercial bank. However, this objective does not appear to have been met because the partner banks demanded the availability of collateral to secure loans guaranteed by Perum Jamkrindo. Moreover, Perum Jamkrindo does not seem to have operated correctly as a true guarantor of the credits given to these enterprises, but has instead become involved in bank credit supplementary services. Thus, they need to utilize a proper procedure to authorize a guaranteed credit for MSEs, in which they may able to achieve their purpose: to support the financial development of these MSEs. The guarantee mechanism should be created specifically based on the industry characteristics of micro and small sectors.

The benefit of a guarantee scheme to MSEs is described through FA and EA. The guaranteed loan has encouraged job creation, and using guaranteed loans, the MSEs have been able to grow their businesses and make more profits. However, the micro and small borrowers

indicate a weak capacity to organize their businesses and export their products due to a limited ability to introduce new technology to their production and distribution, and also limited entrepreneurial skills. MSEs in Indonesia are also characterized as the traditional and family businesses. They run their business without professional management.

Therefore, the Indonesian government has to initiate other programs to strengthen the ability of MSEs to introduce new technology and to develop entrepreneurial skills, such as providing high-tech production equipment and training in skills to operate the equipment. The government could also provide management and entrepreneurial training to MSE owners. The government has also assist in the protection of product designs produced by MSEs by facilitating patents, as well as optimizing information technology to improve marketing access.

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Appendix 1: Primary Data

No	Annual sales	Capacity	Employee	Real asset	Working capital	Gender of owner	Age of owner	Entrep. Exp.	Industry	Length of relations	FA (30%)
	X1	X2	X3	X4	X5	X6	X7	X8	X10	X12	Y
1	8.73	0.79	0.78	0	1	0	0	0	4	3	1
2	8.49	1.15	0.48	0	1	1	1	5	4	3	0
3	9.3	0.99	1	1	1	1	1	2	4	5	1
4	8.56	2.06	0.48	0	1	0	1	0	4	3	1
5	8.48	3.16	0.3	1	1	1	0	2	4	3	1
6	8.73	3.15	0.48	1	1	1	1	6	4	3	1
7	8.1	3.13	0.3	1	0	0	1	3	4	2	0
8	8.64	2.49	0.6	1	1	1	1	4	4	3	1
9	8.26	2.12	0.48	1	1	1	1	4	4	3	0
10	8.8	1.58	0.6	0	1	1	1	2	3	3	1
11	8.18	2.73	0.48	1	0	0	0	2	4	2	1
12	8.43	1.17	0.48	0	1	0	1	1	4	3	1
13	8.03	1.57	0.48	0	1	0	1	7	4	3	0
14	8.1	2.5	0.48	0	1	0	1	2	4	3	0
15	8.26	3.6	0.48	0	1	1	1	4	4	3	1
16	8.49	1.51	0.7	0	1	1	1	6	4	3	1
17	8.1	2.78	0.3	1	0	0	1	3	4	1	0
18	8.4	1.47	0.3	0	1	1	1	0	4	2	0
19	8.03	3.67	0.3	0	1	0	1	0	4	2	0
20	8.1	5	0.3	0	1	0	1	0	4	1	0
21	8.64	2.9	0.6	0	1	1	1	2	4	3	1
22	8.53	1.36	0.7	1	1	0	0	6	4	5	1
23	8.56	2.77	0.7	0	1	1	0	3	3	5	0
24	8.56	1.03	0.6	1	1	1	1	6	4	5	1
25	8.65	1.5	0.78	1	1	1	1	4	4	5	1
26	8.72	1.62	0.6	0	1	0	0	2	3	5	0
27	8.43	1.5	0.48	1	1	0	1	7	4	3	0
28	8.43	2.25	0.48	1	1	1	0	2	4	2	1
29	8.86	1.39	0.78	1	1	0	1	4	2	5	1
30	8.56	1.2	0.78	1	1	1	1	3	4	3	1
31	8.64	3.35	0.7	0	1	1	0	0	3	3	0
32	8.81	2.17	0.7	1	1	1	1	5	4	5	1
33	8.1	1.25	0	0	1	1	0	2	1	1	0
34	8.62	2.31	0.3	1	1	1	1	0	4	3	1
35	8.86	1.37	0.85	1	1	1	1	5	4	8	1
36	8.67	2.35	0.6	1	1	0	1	6	4	3	1

37	8.46	0.44	0.48	1	1	0	1	6	1	5	1
38	8.7	1.43	0.6	1	1	1	1	6	4	5	1
39	8.64	2.93	0.48	1	1	0	1	5	4	3	0
40	8.65	1.8	0.6	1	1	0	1	4	4	5	1
41	8.65	1.5	0.6	1	1	0	1	3	1	5	0
42	8.26	3.27	0.3	1	1	1	1	0	4	2	1
43	8.46	3.63	0.3	0	1	1	0	0	4	2	0
44	8.51	2.13	0.48	1	1	0	1	0	3	2	0
45	8.43	2.16	0.48	1	1	0	1	0	3	2	1
46	8.67	3.13	0.7	1	1	1	0	3	3	2	1
47	8.73	0.67	0.7	0	1	1	1	3	2	3	1
48	8.7	0.71	0.9	1	0	1	1	2	2	5	0
49	8.76	0.48	0.85	1	0	1	1	3	2	3	0
50	8.18	6	0.3	1	1	1	0	2	4	2	1
51	8.16	2.07	0.48	1	1	1	1	0	4	2	0
52	8.43	2.08	0.48	1	1	0	1	3	4	2	0
53	8.6	2.67	0.6	1	1	1	0	3	3	3	0
54	8.8	1.8	0.85	0	1	0	1	2	2	5	0
55	8.42	3.25	0.48	1	1	0	1	7	4	2	0
56	8.86	0.97	0.9	1	1	0	1	2	1	5	1
57	8.69	0.65	0.85	1	0	1	1	2	2	5	0
58	8.37	2.35	0.48	1	1	1	1	2	3	3	0
59	8.42	1.73	0.6	1	1	0	1	2	1	3	0
60	8.33	1.43	0.48	1	1	1	1	3	4	2	0
61	8.67	1.57	0.85	0	1	1	1	3	3	5	1
62	8.65	1.22	0.78	0	1	1	1	2	2	3	1
63	8.37	2.94	0.48	0	1	1	1	2	4	3	1
64	8.46	2.76	0.48	0	1	1	0	1	4	3	1
65	8.46	1.93	0.6	1	1	1	1	2	4	3	1
66	8.65	0.41	0.78	1	1	1	1	2	2	5	1
67	9.26	0.9	0.95	1	1	1	1	3	4	5	1
68	9.18	1	1.08	1	1	1	0	3	4	5	1
69	9.21	2.7	0.95	1	0	0	1	3	4	5	1
70	8.84	0.58	0.85	0	1	1	1	2	4	5	1
71	9.03	1.78	0.85	0	1	0	1	3	4	5	1
72	8.86	0.73	0.9	0	1	1	1	3	4	5	1
73	8.8	1.05	0.9	0	1	0	1	0	4	5	1
74	8.73	0.36	0.78	1	1	0	1	2	4	5	1
75	8.91	0.74	0.9	1	1	1	1	2	4	5	1
76	9.1	1.94	0.95	1	0	1	1	3	4	5	1
77	8.65	1.29	0.85	1	1	1	1	1	1	5	1

78	8.64	6.24	0.85	0	1	1	0	2	4	3	1
79	8.26	1.5	0.3	1	0	0	1	3	4	1	0
80	8.43	2.25	0.3	1	0	1	1	2	4	1	0
81	8.26	2	0.3	1	0	1	1	2	4	1	0
82	8.1	1.79	0.48	1	0	1	1	5	4	1	0
83	8.1	0.53	0.3	1	0	1	1	4	4	1	1
84	8.56	1.03	0.48	1	0	0	0	4	4	2	0
85	8.69	1.23	0.48	1	0	1	0	2	3	3	0
86	8.6	0.82	0.6	1	0	1	1	1	3	3	0
87	8.7	2.33	0.6	1	1	1	1	6	4	3	1
88	8.26	0.51	0.3	1	1	1	1	3	4	1	0
89	8.65	1.41	0.6	1	0	0	0	4	4	5	1
90	8.64	0.73	0.6	1	0	1	1	3	4	2	0
91	8.8	0.14	0.6	1	0	0	1	6	2	5	1
92	9.08	0.34	0.9	1	1	1	1	3	2	5	1
93	9.13	7.94	0.78	1	1	0	1	3	4	5	1
94	8.39	0.18	0.48	0	1	0	1	4	4	1	0
95	8.73	2.45	0.7	1	1	1	1	2	2	5	1
96	8.46	2.15	0.48	1	0	1	1	2	4	1	0
97	8.69	0.98	0.7	1	0	1	0	5	4	3	1
98	8.8	2.25	0.85	1	1	1	1	0	3	5	1
99	8.64	4.4	0.85	0	1	1	1	0	3	3	0
100	8.1	1.67	0.3	1	1	0	1	0	4	2	0
101	8.1	0.83	0.3	1	0	0	1	2	1	2	0
102	8.37	1.74	0.6	1	1	1	1	2	4	3	1
103	8.4	0.83	0.6	1	0	1	1	1	4	3	1
104	8.77	3.93	0.9	1	1	1	1	5	4	5	1
105	8.37	1.96	0.3	1	1	1	0	6	4	2	1
106	8.46	3.63	0.48	1	0	1	1	1	4	3	1
107	8.4	0.83	0.3	1	0	1	0	1	4	3	1
108	8.82	1.1	0.6	1	0	1	1	3	4	5	1
109	8.67	1.34	0.6	1	0	1	1	2	2	5	1

Appendix 2: Questionnaire

I. Questioner for Borrower (Small and Medium Enterprises)

Please circle numbers or tick boxes as instructed

1. **What is the legal status of your firm?** _____

Sole proprietorship	1
Partnership	2
Private Limited Company	3
Other (<i>please specify</i>)	4

2. **In which year was the firm established?** _____ **Year**

3. **What is your business activity**

Restaurant	1
Hotel	2
Travel	3
Art Shop/handy craft	4

4. **How many people are presently working in your firm? (*including owners and full-time employees*)**

1 - 10	1
11 - 15	2
16 - 25	3
25 & above	4

5. **Gender of the owner/manager**

Male	1
Female	2

6. **Could you please indicate your age group**

Under 20	1
20 - 29	2
30 - 39	3
40 - 49	4
50 - 59	5
60 and above	6

7. Could you please tell us your highest academic qualification

Primary school	1
Junior High School	2
Senior High School	3
Diploma	4
Degree or Equivalent - Science/Technical	5
Degree or Equivalent - Business/Management	6
Other (<i>please specify</i>)	7



8. Was your business established before you applied for the guaranteed loans or was it formed at that time?

Established	1
New	0

9. Did you have any experience in running a small business before you applied for the Jamkrida?

Yes	1
No	0

IF NO, PLEASE PROCEED TO QUESTION 12

10. If yes, how many years of business experience?

Under 1 year	1
1 to 3 years	2
4 to 6 years	3
7 to 9 years	4
10 to 12 years	5
13 to 15 years	6
16 years or more	7

11. What external source(s) of financial advice have you used?

(You may tick more than one, if applicable)

<input type="checkbox"/>	None
<input type="checkbox"/>	Relatives/Friends
<input type="checkbox"/>	Bank Manager
<input type="checkbox"/>	Accountant/Auditor
<input type="checkbox"/>	Chamber of Commerce
<input type="checkbox"/>	Other (<i>please specify</i>).....

12. Have you attended any entrepreneurial development/business management training courses organized by the government or private sector?

Yes 1
No 2

IF NO, PLEASE PROCEED TO QUESTION 15

13. If yes, who provided the entrepreneurial development/business management training courses? (you may tick more than one, if applicable)

<input type="checkbox"/>	Department of Cooperatives and Small and Medium Businesses
<input type="checkbox"/>	Department of Industry and Trade
<input type="checkbox"/>	PT. PNM (Persero Permodalan Nasional Madani)
<input type="checkbox"/>	PINBUK (Pusat Inkubasi Bisnis Usaha Kecil/Small Business Incubation Center)
<input type="checkbox"/>	Other (please specify).....

14. Have you attended any technical training courses organised by the government or private sector?

Yes 1
No 2

IF NO, PLEASE PROCEED TO QUESTION 17

15. If yes, who provided the technical training courses? (you may tick more than one, if applicable).

<input type="checkbox"/>	Department of Cooperatives and Small and Medium Businesses
<input type="checkbox"/>	Department of Industry and Trade
<input type="checkbox"/>	TPKU (Tempat Pelatihan Ketrampilan Usaha/Center of Business Skill Training)
<input type="checkbox"/>	BLK UKM (Balai Latihan Kerja Usaha Kecil Menengah/ Training Center of Small and Medium Enterprises)
<input type="checkbox"/>	Other (please specify).....

16. Did the firm have a written business plan before seeking to raise the loan? (A definition of a business plan is a document which contains an analysis of the firm's current position, where it would like to be in the future, and how it plans to get there)

Yes 1
No 2

17. Did the guaranteed loan form part of a finance package?

Yes 1
No 2

22. Why did you prefer to accept the guaranteed loan?

(Please circle the appropriate number for each reason on a scale of 1 to 5)

1 = Strongly Disagree 2 = Disagree 3 = Uncertain 4 = Agree 5 = Strongly Agree

	Strongly Disagree				Strongly Agree
Rate of interest was lower	1	2	3	4	5
No need to have collateral or security	1	2	3	4	5
Easy to apply through finance companies	1	2	3	4	5
Easy to apply through commercial banks	1	2	3	4	5
No other choice	1	2	3	4	5
Low repayment	1	2	3	4	5
Other (please specify) _____	1	2	3	4	5

23. What sort of security/guarantees did you have to provide to obtain the guaranteed loan?

None	1
Personal guarantee/other guarantors	2
Mortgage on properties	3
Stock exchange securities	4
Fixed Deposit	5
Other (<i>please specify</i>) _____	6

24. When preparing your application for the guaranteed loan you were asked to forecast the anticipated levels of turnover, profit and employment. In general, how has your business performed against those forecasts?

Exceeded	1
Achieved	2
Under-Achieved	3

**25. Can you estimate your current annual turnover?
(to the nearest thousand)**

Rp.,.....,.....

**IF YOUR FIRM HAS NO TURNOVER, PLEASE PROCEED TO
QUESTION 28**

26. With the money raised through the guaranteed loans, by how much has your annual turnover increased?

Increased by 1 to 5 percent	1
Increased by 6 to 10 percent	2

Increased by 11 to 15 percent	3
Increased by 16 to 20 percent	4
Increased more than 20 percent	5
No Difference	6
Decreased (<i>please specify</i>) _____	7

27. **With respect to profit can you estimate your current annual net profit margin (*pre-tax*)?**%

28. **With the money raised through the guaranteed loans, what increased level of profit margin have you achieved?**

Increased by 1 to 5 percent	1
Increased by 6 to 10 percent	2
Increased by 11 to 15 percent	3
Increased by 16 to 20 percent	4
Increased more than 20 percent	5
No Difference	6
Decreased (<i>please specify</i>) _____	7

29. **What was the level of employment in your company, employees at the time you applied for the loan provided under the guaranteed loans?**

30. **With the money raised through the guaranteed loans what level of employment do you think you have achieved?**

Increased by 1 to 5 employees	1
Increased by 6 to 10 employees	2
Increased by 11 to 15 employees	3
Increased by 16 to 20 employees	4
Increased more than 20 employees	5
No difference	6
Decreased (<i>please specify</i>) _____	7

31. **Since receipt of the guaranteed loans what proportion of your new business has come from:**

Within your state%
Elsewhere in Indonesia%
Export business%

33. **What proportion of your increased sales do you think you have won from:**

Competitors located in your state%
Other firms in Indonesia%
Overseas firms%

34. How important do you consider the guaranteed loans has been to your firm?

- | | |
|----------------|---|
| Vital | 1 |
| Very Important | 2 |
| Important | 3 |
| Unimportant | 4 |

35. If there any other aspects of the guaranteed loans you would like to comment on please do so below:
