PN-ABC-120

74463

BANK NIAGA

IFI LOAN CASE STUDY

PRE PROJECT NUMBER 940-0002.46

Prepared for:

Office of Development Planning
Bureau for Private Enterprise
Agency for International Development
Washington, D.C. 20523

MAR 1989

MANAGEMENT SYSTEMS INTERNATIONAL

600 Water Street S.W., NBU 7-7
Washington, D.C. 20024

telephone: (202) 484-7170
telex: 4990821MANSY

017-V16

BANK NIAGA EXECUTIVE SUMMARY

The Bureau for Private Enterprise Bank Niaga project established a $2 million loan guarantee facility for Bank Niaga to encourage the bank to lend $4 million to qualifying small and medium scale enterprises (SMSEs). Bank Niaga is the second largest private commercial bank in Indonesia. The project was authorized in August 1985 and began operating in 1986.

The project sought to induce Bank Niaga to lend to SMSEs by guaranteeing 50 percent of the principal of loans to qualifying borrowers. Loans were targeted for Indonesian businesses with monthly sales of $300,000 or less. The loans were also intended to finance start-up or expansion investments by these small companies. In addition, Bank Niaga was obligated to provide over 50 percent of its guaranteed loans to businesses with monthly sales less than $150,000, and 50 percent or more of the loans were to go to businesses outside of Jakarta.

To establish the facility, A.I.D. gave a $2 million, 7 year loan to Rainier National Bank. Under the loan agreement, Rainier established a letter of credit facility to provide L/Cs to Bank Niaga. Once fully utilized, PRE's $2 million facility could guarantee $4 million in rupiah loans by Bank Niaga.

In the event of a loan default in the guaranteed portfolio, Bank Niaga can shed 50 percent of the principal loss to PRE. This 50/50 arrangement gives the bank enough risk so that it takes great care in making loans, while providing an incentive to lend to the target group of SMSE businesses.

Indonesia's Serious Structural Problems

The project was carried out in a difficult financial market environment. Indonesia's financial markets are seriously impaired by government credit subsidies, poor pay back practices among businesses receiving Government of Indonesia-guaranteed loans, frequent foreign exchange devaluations, and continuing political uncertainty. Subsidized SMSE credit programs have made it difficult for private commercial banks to compete in many SMSE market segments. In addition, the extremely short term of deposits held by most private banks has made it difficult and risky for banks to make long-term loans. In this context it was a major challenge for a guarantee project working through a private commercial bank to accomplish significant change in financial market practices.

Project Impacts

The PRE project induced Bank Niaga to extend over 43 medium term loans worth more than $4,734,000 to SMSEs during a period of economic stagnation in Indonesia. When this evaluation study was conducted in October 1988, there were 27 outstanding loans, totalling $1,832,315 in outstanding credit. Average interest rate on outstanding loans was 23 percent and average loan term was 4.5 years. The average loan under the guarantee project was $110,111. <u>There have been no defaults under the project.</u>

Many of the businesses receiving loans used the funds for expansion, and this resulted in significant increases in employment. The study team estimated that the project was associated with a total employment increase of 900 full time jobs in businesses receiving guaranteed loans, 117 of these jobs going to women employees. Guaranteed loan recipients performed very well in terms of earnings and profits during the project because (i) sound businesses were selected as loan recipients, and (ii) these businesses used guaranteed loan funds for productive investments.

Loan recipients were medium sized by local standards, with average total assets of $795,440, and average yearly net income of $76,714. Businesses ranged in asset size from a furniture manufacturer with gross assets of $108,647 to an insurance company with over $9.1 million gross assets in 1987. Seventy-five percent of sub-borrowers were service businesses, while 25 percent were manufacturers.

The PRE guarantee had two primary effects on the lending behavior of the bank: it <u>increased the average term of loans to 4.5 years during a period when the average term of the bank's funds was less than one month, and it decreased the bank's collateral requirements by 22 percent</u>. Because collateral requirements dropped from over 150 percent to 125 percent on guaranteed SMSE loans, Bank Niaga was able to provide <u>larger loans</u> to its SMSE borrowers. One result of these changes was that almost 60 percent of the businesses receiving PRE guaranteed loans were able to use the money to <u>buy fixed assets and machinery</u>.

The project ran into some compliance problems. Size limitations for loan recipients (monthly gross sales) were adhered to generally, but by granting "consumer" loans to individuals, the bank made several loans to businesses that have corporate sales greater than $300,000 per month. Approximately 25 percent of the businesses in our study sample were larger than allowed under the agreement.

<u>Impact on USAID/Indonesia</u>

The Bank Niaga Project has had little impact on the Mission's private enterprise program and has not been replicated by the Mission. This limited impact results from two main reasons: first, the project was not designed to fit into the Mission's private sector development program; and second, lack of clarity about responsibilities for implementing the Niaga project led to coordination difficulties between the Mission and PRE.

Nevertheless, Mission private sector officers stated that the project did provide an opportunity to learn how private commercial credit markets operate in Indonesia and did help the Mission develop contacts with private banks.

BANK NIAGA

TABLE OF CONTENTS

BANK NIAGA - INDONESIA

I. SUMMARY OF INDONESIA'S ECONOMY AND FINANCIAL MARKETS

Until 1983, Indonesia's financial system was tightly controlled. The government in the 1970s began channeling earnings from oil revenues through Bank Indonesia (the Central Bank) into the banking system via low interest rediscounting facilities and liquidity credits. These funds were made available largely to state-owned banks for on-lending to priority economic sectors to accomplish development objectives. Deposit and lending rates of all state-owned banks were set by Bank Indonesia at such low levels that at times they were negative in real terms. Credit ceilings were established both to control the growth of credit and to direct credit towards priority sectors.

Indonesia's oil revenues and agricultural export earnings substantially declined in 1982 and GDP growth slowed dramatically. Faced with a tight balance of payments situation, declining official reserves, and erosion of budgetary surpluses, the government implemented major austerity measures and financial reforms, including a 28% devaluation of the rupiah against the U.S. dollar in March, 1983. Then in June, 1983, the government passed an ambitious package of financial reform measures. Banking institutions were allowed to set their own deposit rates (except for certain savings programs) and lending rates, credit ceilings were abolished for all banks, and the number of programs qualifying for new Bank Indonesia liquidity credits was reduced. The Indonesian financial system, despite the 1983 reforms, remained at a relatively early stage of development.

The Indonesian Government, in its latest effort to continue financial market deregulation, announced a series of measures on October 28, 1988, to increase private sector funds mobilization, improve banking efficiency, and create a better environment for development of capital markets. Bank Indonesia is also implementing a long-term policy of reducing all credit subsidies over time to market rates.

Bankers expect that the big gainers from these reforms will be the stronger domestic private banks, such as Bank Central Asia and Bank Niaga. Private banks will compete deposits that state corporations are now permitted to shift from state to private banks. It is hoped that increased competition will help reduce the high cost of loan funds.

Current Conditions

In general, access to banking facilities in Indonesia outside urban areas remains limited, the banking system lacks medium and long-term finance, and the capital market is in its infancy. Despite the earlier reforms, the steady trend toward shorter deposit maturities reflects the negative psychological impact on savers of three major rupiah devaluations over the past decade. The latest devaluation of 31% against the U.S. dollar occurred in September 1986. Given continuing weak world oil prices, domestic savers are placing their funds in short-term investments to provide greater liquidity for moving funds quickly into stronger currencies in case another rupiah devaluation is expected.

Financial Institutions

Indonesia's financial system consists of Bank Indonesia, 5 large state-owned commercial banks, 10 privately owned foreign exchange commercial banks, 57 private non-foreign exchange commercial banks, 11 foreign commercial banks, 28 development banks, 3 savings banks, 14 joint venture merchant banks, 83 leasing companies, 100 insurance companies, some 5,563 rural credit banks, 480 pawnshops, and 26,179 rural cooperatives.

Commercial banks dominate the financial system, holding 54% of total system assets. Although there are 83 commercial banks, the five large state banks at year-end 1986 accounted for 69% of deposits and 76% of loans. The second largest group, the ten private foreign exchange banks, accounted for 14% of deposits, and 10% of loans. The 57 non-foreign exchange private banks held 12% of deposits and 9% of loans. Lastly, the 11 foreign and joint venture banks accounted for only 5% of deposits and 4% of loans.

Commercial banks are the primary providers of credit. Lending is mainly short-term and includes trade finance and working capital loans. Banks also undertake limited medium and long-term lending, either through BI refinancing schemes or indirectly through rollover of working capital loans or overdraft facilities. Overdrafts and working capital loans often are transformed into longer maturity loans used by companies to finance acquisition of fixed assets.

Banks are reluctant to make term loans due to a variety of factors, including the mismatch of short-term liabilities with term assets, interest rate volatility, inadequate credit and project appraisal capabilities, poor mechanisms for loan recovery (including an inadequately developed legal system and commercial codes), and inability to value and collect against collateral.

Commercial banks are conservative in their lending practices, though less so when lending under government SMSE loan programs. Banks usually lend against collateral, not cash flow, and often require collateral in excess of 150-200% of loan value. State banks have the weakest loan portfolios, owing to poor credit practices used for lending under government programs. Even with the banking reforms, SMSEs will continue to rely on government subsidized programs (currently offering 12% p.a. loans) for funds in the foreseeable future. Both state and private banks provide little additional credit to SMSEs beyond the loan subsidy programs, and they provide little incentive to branch managers to make loans to new SMSE borrowers. The risks to private banks of lending their own funds to SMSEs biases them against financing SMSEs.

Unavailability of credit and excessive collateral required outside urban areas are major bottlenecks constraining economic growth outside of Jakarta. Further, dependence of commercial banks on short-term deposits and their resulting preference for short-term, or working capital lending, exacerbate the difficulties of SMSEs hoping to obtain credit for capital investments.

II. THE LOAN AGREEMENTS BETWEEN BANK NIAGA, RAINIER BANK AND A.I.D.

The Bureau for Private Enterprise loan guarantee facility for Bank Niaga in Indonesia is an innovative project to provide non-subsidized credit to small and medium-scale enterprises. The project, which began in 1986, made a $2 million loan guarantee facility available to encourage Bank Niaga to lend up to $4 million to SMSEs that exceed the size limitations of government-subsidized programs.[1]

The Bank Niaga project was designed and negotiated during early 1985, and authorized on August 29, 1985. The seven year project agreement between Bank Niaga and A.I.D. was signed on October 2, 1985, and the first disbursement of the A.I.D. loan occurred on April 10, 1986. The facility ends on April 10, 1993.

The project was originally intended to provide $4 million in local currency credit primarily to <u>rural non-traditional export businesses</u> that were too large for government programs, but too small to receive private commercial credit.[2]

The final objective of the project, as embodied in the project agreement between A.I.D. and Bank Niaga, was to provide loans to <u>Indonesian businesses with average monthly sales of $300,000 or less</u>. In addition, the credit was to finance <u>start-up or expansion investments</u>. According to the Project Agreement, loans were supposed to be <u>in addition to</u> credit that was already available to a business, and should <u>not be a renewal or extension</u> of a pre-existing loan from Bank Niaga. Bank Niaga

---

[1] Firms with gross sales above $600,000 per year, as stated in the PRE Bank Niaga Investment Proposal, July, 1985. Section 1.01.

[2] AID/PRE Private Sector Revolving Fund Annual Report, 1985. p. 33.

was also obligated to provide 50 percent or more of its loans to businesses with average monthly sales of less than $150,000, and 50 percent or more of the loans to businesses outside of Jakarta.

The program addressed the need to: (1) develop SMSE credit on the basis of the borrower's ability to repay; (2) show how a private commercial bank could profitably deliver SMSE credit without government subsidies; and (3) demonstrate how A.I.D. can collaborate directly with the private sector to achieve development objectives on a self-sustaining basis.

The Bank Niaga loan, like the Far East Bank and Trust (Philippines), and Thai Danu Bank (Thailand) loans obligated by PRE the same year, used the "loan set off" mechanism to guarantee qualifying subloans extended by the local IFI. (See Appendix 4 for a description of the loan set off mechanism.) The loan set off mechanism is a means by which A.I.D. establishes a letter of credit facility with a U.S. bank for the purpose of guaranteeing loans made by a local intermediate financial institution to qualifying businesses.

The Loan Agreement

A.I.D. entered into a $2 million, 7 year loan agreement with Rainier National Bank under which Rainier agreed to set up a L/C standby facility to provide letters of credit to Bank Niaga. The letters of credit issued under the standby facility can guarantee up to 50 percent of the principal of loans provided by Bank Niaga to qualifying sub-borrowers. Once fully utilized, PRE's $2 million loan for the facility stimulates $4 million in rupiah loans by Bank Niaga to qualifying businesses.

In exchange for the $2 million loan, Rainier Bank pays A.I.D. an annual interest rate equal to the three year U.S. Treasury Bill rate, plus 0.1 percent. Rainier Bank repays the principal of the loan in 10 equal semi-annual installments, with the first due 30 months after the first disbursement of the loan.

The Project Agreement

The Project Agreement between A.I.D. and Bank Niaga authorizes Bank Niaga to obtain letters of credit from Rainier Bank to guarantee 50 percent of the principal of loans to qualifying sub-borrowers. This agreement also defines the businesses that may receive loans and the activities that may be financed with guaranteed loan proceeds.

Under this arrangement, the loan provided by PRE to Rainier Bank serves as the collateral for letters of credit issued by Rainier Bank to Bank Niaga. In the event of a loan default in Bank Niaga's guaranteed portfolio, Bank Niaga can shed 50 percent of the principal loss to PRE. This 50/50 arrangement gives the bank enough risk so that it takes great care in making loans, while giving it an incentive to lend to the target group of SMSE businesses.

Bank Niaga is to make direct, local currency loans to businesses that meet the terms of the project agreement, lending from the bank's general pool of funds. To guarantee qualifying subloans, Bank Niaga assembles a group of qualifying loans and submits a Certificate of Estimated Standby Utilization to PRE. This certificate estimates the guarantee coverage needed over the upcoming six month period and provides a warranty that the bank has met the conditions in the project agreement. Bank Niaga must also submit to Rainier Bank and PRE a Local Lending Bank Standby Certificate. This is a request for Rainier Bank to issue a standby L/C and lists the subloans to be covered by the L/C. Provided all conditions are met, Rainier Bank then issues Standby L/Cs drawn on the standby account. The standby L/C, once issued, guarantees all loans on the Standby Certificate.

The Loan Agreement provides for disbursements of L/Cs of $100,000 or more, with the maximum coverage for any single loan of $150,000. This means that loans to businesses can be no more than a total of $300,000, unless special permission is granted by PRE.

Bank Niaga pays two fees for using the guarantee facility, both in U.S. dollars:

- A .75% annual Guaranty Fee payable to A.I.D. on the average daily amount under guarantee coverage;
- A .15% annual Issuing Fee payable to Rainier Bank on the outstanding amount of Standby L/Cs issued.

Bank Niaga may make a claim for payment under a standby L/C only when principal or interest payments of one or more subloans are at least ninety days past due. When making a claim, Bank Niaga must certify that it has pursued reasonable and diligent collection efforts against the defaulting sub-borrower. Then Bank Niaga must submit certification of default to Rainier Bank for each defaulting subloan.

Once a claim is made, Rainier Bank pays the amount due (50 percent of the outstanding principal) from the guarantee account to Bank Niaga. Bank Niaga has no obligation to repay the collateral account unless it recovers part of the loan from the sub-borrower. Fifty percent of any recoveries are payable to A.I.D. The sub-borrower has no direct obligation to repay A.I.D.

The Training Grant

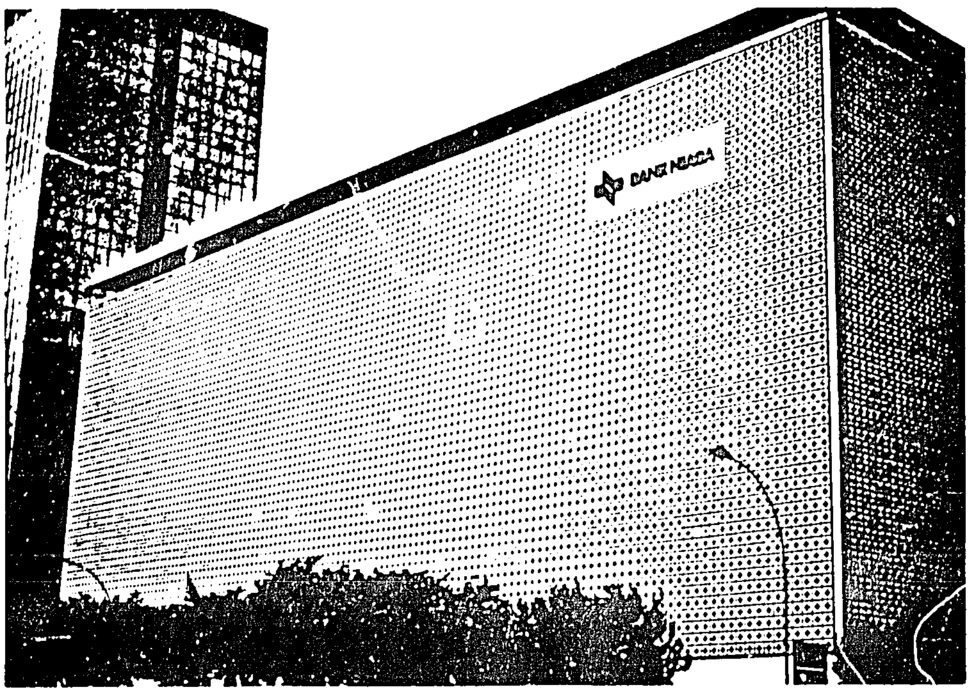
The project also provided a $50,000 grant to Bank Niaga to conduct training of bank staff in SMSE lending.

III. IFI ORGANIZATION AND OPERATIONS

Bank Niaga, the second largest privately owned foreign exchange bank in Indonesia, was selected because it is privately owned and is considered one of the best managed banks in Indonesia.

Operations

Bank Niaga is among the most progressive of the ten private foreign exchange banks in Indonesia. The bank's headquarters and eight branches are in Jakarta, with an additional thirteen branches throughout Indonesia, and one in the United States.



Bank Niaga's Headquarters In Downtown Jakarta

The bank's current strategy is to lend to its traditional clients, large local corporations, while expanding into lending to consumers (automobile, home mortgage and small business loans) and professionals (such as doctors).

Bank Niaga Brochures Advertising
Professional, Home Mortgage and Auto Loans,
Niaga's New Consumer Lending Areas

To pursue this strategy, the bank has aggressively expanded its loan portfolio during the last few years, and has begun to borrow substantial amounts on overnight funds and short-term time deposit markets. A result of this new strategy is drastic increase in marketing during the past two years in an effort to compete with other banks. This effort was successful as shown in the following table; however, the 1987 inflation rate of 9 percent and a 31 percent devaluation in September of 1986 also contributed to the large increases.

BANK NIAGA IN COMPARISON WITH OTHER BANKS IN INDONESIA

(Percentage of Increase from 1986 to 1987)

BANKS	Assets	Loans	Deposits	Profits
Niaga	54%	66%	57%	42%
Private Foreign Exchange	38%	42%	56%	31%
Private Non-Foreign Exchange	45%	40%	50%	21%
State	14%	25%	23%	85%
Foreign	3%	14%	23%	783%
Regional Development	25%	26%	19%	4%

As indicated, Bank Niaga's growth during 1987 exceeded the average for all banks. Profit growth for the bank, although below state and foreign banks, remained higher than that recorded by the private banks. Following is a summary of the Bank's operations for 1986 and 1987:

<u>OPERATING REVENUE</u>
(In millions of rupiah except earnings per share;
as of October, 1988, rp. 1,700 = U.S. $1.00)

For the year:	1987	1986
Income from funds	36,876	28,881
Profit after tax	7,667	5,664
Earnings per share		
- Series A value Rp. 10,000	5,325	3,934
- Series B value Rp. 5,000	2,662	1,967

BALANCE SHEET (At year end)
(Millions of rupiah)

Total assets	781,262	508,370
Total deposits	628,855	384,539
Total loans	607,247	372,055
Shareholders' equity	25,376	21,177

FINANCIAL RATIOS

Return on earning assets	1.26%	1.52%
Return on equity	30.2%	26.7%
Debt equity ratio	28x	22x
NUMBER OF EMPLOYEES	1,549	1,416
BRANCHES AND SUB BRANCHES	23	22

The major operational problem facing Bank Niaga is a shortage of deposits and capital to meet its loan demands. Comparison of June 30, 1987 and June 30, 1988 loan and deposit figures illustrates the bank's inverted liquidity; this causes the bank to be a continual borrower from other banks in overnight and weekly funds markets. The following table illustrates this point:

1988/1987 MID-YEAR COMPARISON OF DEPOSITS AND LOANS
(In millions of rupiah)

	June 30, 1988	June 30, 1987
Deposits:	669,021	431,751
Loans:	771.719	441,803

Bank management believes that additional deposits can be generated through new higher yielding long-term certificates of deposit. The Bank also plans to improve its liquidity by acquiring additional equity capital.

Loans

The Bank has a sound credit system adopted from Citibank in 1974 and put into place with a two-year management contract. The bank's total loan portfolio is diversified into trade (32%), manufacturing (29%), consumer (26%), and service (13%) sectors.

The PRE SMSE loan program is administered in the same way as the bank's other loan programs, and no loan officers work exclusively on the PRE project. The project is managed by the Marketing and Credit Group, with no special organizational arrangements made for administration of the project.

Project loans were originally intended to finance the "start-up or expansion of any commercial productive activity that the Local Lending Bank was not previously financing"[3], but over time, the loan eligibility requirement was interpreted by the bank to include "any worthwhile purpose."

Under the project, 42 loans have been made for a total of $4,734,782. No loan losses have occurred. At the time of this evaluation in October 1988, only one loan was 30 days delinquent. As of September 1988, the outstanding loan portfolio consisted of 37 loans totalling $1,832,315; average interest rate was 23 percent (the prevailing market rate).

The guarantee facility enabled Bank Niaga to extend the equivalent of $4 million in the first year of the program. The facility is reduced semi-annually in equal amounts and will be fully retired in 1992. The annual guarantee ceilings are shown below in millions of U.S. dollars:

---

[3] Bank Niaga Project Agreement, October 2, 1985. Annex A, Objectives Section, Para. 1.

1986	1987	1988	1989	1990	1991	1992	1993
2.0	2.0	1.8	1.4	1.0	.6	.2	0

Loans have been made by six Bank Niaga branches throughout Indonesia and have involved 30 bank personnel from sub-managers through senior bank officials. Project loans are made by branch marketing officers and branch managers. Credit decisions on guaranteed loans are made at the branch level within specified lending limits based on the branch size; branch managers and marketing officers serve as credit committee for these loans.

Bank officials described their administration of the PRE loan project as conservative. Because of strong loan demand and a shortage of loan funds, prospective project borrowers are generally solicited by the bank from its existing clients. The client, however, is not told about the guarantee for fear that such information would be a reason for the client not to repay the loan. This concern about informing borrowers of the A.I.D. guarantee has also been expressed in other countries, for example, the Philippines.

Before a loan is made, the bank collects routine financial statements, as well as employment and sales information to satisfy PRE's reporting requirements. According to bank officials, the regular sub-borrower reports that Niaga must submit to PRE created more paperwork than was required for normal lending, and therefore was a significant burden. It should be noted that as of October 1988 the bank had submitted less than half of the sub-borrower reports that have been required under the project.

Until the end of 1988, the expenses of administering the A.I.D. program were covered by Bank Niaga's headquarters. In late October, the Senior Vice President (Marketing and Credit Group) responsible for the PRE program suggested that administrative costs associated with the program should be shifted to the branches. Because branches operate as profit centers within the bank, several branch managers expressed concern that this change may make guaranteed loans unprofitable for the branches.

Guaranteed loans are secured by collateral, usually real estate. Non-PRE loans traditionally require 150 percent collateral (generally land and buildings), but project loans can be made for as little as 75 percent collateral. Bank branch staff said that the project allowed them to have more flexibility in setting collateral requirements for their smaller borrowers.

Interest rates on project loans are the same as on loans to Niaga's unguaranteed customers. Rates are decided weekly by the Money Management Group which reviews money costs and gives information to the Credit Department to set loan rates. The present cost of money on the overnight interbank fund market is 14.5 percent. The bank estimates its administrative overhead is 2 percent and operating spread is 3 percent. Based on these costs, 19.5 percent is the minimum interest rate. Rates can be either fixed or variable, depending on money market conditions and bank competition. Loan fees of .5 to 1 percent are also often charged on loans with more than one year maturity.

One interesting constraint to lending is the bank's requirement that *no credit can be extended to a borrower older than 55 years of age, and all loans must be paid in full before a borrower reaches 55. Apparently, 55 is the age beyond which mortality is a critical issue and probate is not a realistic loan recovery method.

Training is an important part of the bank's operations. In fiscal 1987, 1,295 of the Bank's 1,549 employees participated in training programs.

IV. LOAN DISBURSEMENT AND IMPACT ON SUB-BORROWERS

Overview

Number of Loans Provided by September 30, 1988:	43
Total Credit Extended by September 30, 1988:	$4,734,782
Average Loan (for 27 current loans)	$110,111
Average Interest Rate (for 27 current loans)	23%
Average Loan Term (for 27 current loans)	4.5 years
Employees Hired By Loan Recipients During Project (est.)	903
Women Employees Hired During Project (est.)	117
Estimated Loan Amount per Job	$5,243

As of September 30, 1988 forty-three (43) loans had been made under the facility, and the total amount lent was $4,734,782. The average loan under the guarantee project was $110,111. The smallest was $15,015 to Toko Sinar; the two largest loans were both for $300,120 to RSB Budi Jaya and to Yayasan LPI. There have been no defaults under the project.

When this evaluation study was conducted in October 1988, there were 27 outstanding loans, with total credit outstanding of $1,832,315. Average interest rate on outstanding loans was 23 percent and average loan term was 4.5 years.

The loan recipients were medium-sized by local standards, with average total assets of $795,440, and average yearly net income of $76,714. Businesses ranged in total asset size from a furniture manufacturing company with gross assets of $108,647 to an insurance company with over $9.1 million gross assets in 1987. Seventy-five percent of sub-borrowers were service businesses, while 25 percent were manufacturers.

Loan Impacts

Loans under the Bank Niaga guarantee facility resulted in significant increases in economic activity and employment in several major urban areas of Indonesia. The PRE guarantee had two primary effects on the lending behavior of the bank: it increased the average term of loans to 4.5 years during a period when average term of the bank's funds was less than one month, and it decreased collateral requirements by 22 percent. Because collateral requirements dropped from over 150 percent to 125 percent on guaranteed SMSE loans, Bank Niaga was able to provide larger loans to its SMSE borrowers. One result of these changes was that almost 60 percent of the businesses receiving PRE guaranteed loans used the money to expand their operations by buying fixed assets and machinery. (One third of the sub-borrowers, however, used the loans to buy buildings, and 7 percent used the loans for working capital.) One quarter of the businesses visited were exporters.

Because Bank Niaga took great care in selecting sound and profitable companies, clients made efficient use of the resources that they purchased with their guaranteed loans. In all businesses visited, loan proceeds were used productively.

Sub-Borrower Visits

In order to gather accurate information about clients and to gain additional insights concerning the operations and impact of the project, visits were made to a sample of sub-borrowers. The sample was stratified in terms of industry, monthly sales, credit history, location and loan performance. The twelve borrowers visited comprise 44 percent of the active Bank Niaga guaranteed accounts, and are generally representative of the range and composition of the guarantee portfolio as a whole.

Interviews with each of these 12 sub-borrowers were guided by a standard data collection guide used by team members to record responses and to ensure consistency in the data obtained. During most visits a tour was taken of the facilities, including buildings, land and equipment purchased with Bank Niaga loan proceeds. These sub-borrower visits are summarized in the Borrower Profiles presented in Chapter VI below.

The increase in economic activity due to PRE guaranteed loans occurred during a period of sluggish economic growth and declining per capita incomes in the country. Nevertheless, the total number of employees working for the 27 outstanding guaranteed clients increased from 594 to 1875 during the project. The average employment increase for sample businesses was 44 percent.[4] Given that the average term of a guaranteed loan is over four years and that many loans funded business expansions, it is probable that many of these jobs will be retained after the end of the PRE project. This indicates that the average investment per job created during the project is about $5,243. Of course, the cost to A.I.D. for each job created is far less than this, because practically all of the guaranteed loans will be paid back to A.I.D. at the end of the project.

<u>A reasonable estimate of the total number of jobs created in all firms receiving guaranteed loans during the period of the project is 903, with 117 of these jobs going to women employees.</u> This estimate is based on the 44 percent average employment gain for the 12 firms in the sample and average employment of 47 workers at the time loans were granted, resulting in an estimated average increase of 21 workers per firm during

---

[4] The average firm in the sample increased the number of women employees by 13 percent during the loan period.

the project.[5] It should be noted that we cannot say that the PRE facility <u>caused</u> these workers to be hired; but rather that the loans were <u>associated with and contributed to this substantial employment growth</u> during a period when per capita income growth has been hovering around 0 percent, and GDP growth was a mere 3.5 percent.

<u>Most borrowers would have received loans without a guarantee project, though the loans would have been smaller and shorter in term.</u> According to bank staff, (including two branch managers and one senior officer) if there had been no guarantee facility, almost all of the companies receiving PRE guaranteed loans would have received comparable but slightly smaller loans from Bank Niaga or another commercial bank. In the words of one Niaga branch manager: "(Under the PRE guarantee facility) we gave longer term loans to small clients, but we would have given these loans anyway." In addition, bank staff said that sub-borrowers under the PRE facility were among Niaga's best small clients.

<u>Conditions in the Loan Agreement</u>

The project agreement stated that qualified sub-borrowers must have four characteristics: (1) be a national of Indonesia; (2) in the case of companies, be one hundred percent privately owned and controlled; (3) have a principal place of business in the Indonesia; (4) have average monthly sales of no more than the rupiah equivalent of $300,000.

A review by the study team suggests that the criteria were adhered to generally, but that by granting "consumer" loans to individuals, the bank made several loans to businesses that have corporate sales greater than $300,000 per month. Approximately 25 percent of the businesses in the

---

5 Average increase in women employed by the firms in the sample was 13 percent during the loan period.

sample of twelve were larger than allowed under the agreement. It appears that no attempt was made to inform Bank Niaga that such consumer loans did not fulfill the objectives of the project.

Bank Niaga reported to PRE that all but one of the companies receiving a guaranteed loan had gross monthly revenues of less than $300,000. (The one company above this limit was reported to have $1,176,471 in monthly sales.) In fact, however, many of the loans were made to individuals rather than companies, and the monthly sales figures reported to PRE were the recipients' personal incomes, and not the incomes of the businesses that actually used the loans.

For example, Bank Niaga made a $115,713 loan to the president of a large insurance company for the company to buy a branch office building in Surabaya. In this instance, Niaga made its loan on the basis of the president's personal income and bank accounts, and reported this personal income as the monthly sales figure to PRE. Loan proceeds then went to the insurance company's branch for purchasing the building. In a second case, Bank Niaga provided a consumer loan to a plastic and enamelware company that reported gross sales of over $6 million per month. The loan, however, was granted in the name of the company owner, and his personal monthly income of $11,059 was reported to PRE as the loan recipient's monthly sales. The proceeds of the loan were used to purchase a new office building for the company.

Some loan recipients were subsidiaries of well-established large companies. For example, a restaurant owner who received a guaranteed loan also operates commodity trading, lumber, scrap steel, hotel and real estate businesses. In this and other instances, the monthly sales figures reported to PRE were the owner's personal income (or in some cases, the subsidiary's sales) and not the conglomerate's sales. When this issue was discussed with local bankers, this difficulty in separating the revenues and earnings of individuals, single businesses and family conglomerates was a common problem in Indonesia.

According to Bank Niaga staff, there were three reasons why loans for corporate use were provided as consumer loans to individuals, with personal rather than corporate income reported to PRE. First, Bank Niaga staff stated that it is too complicated and difficult to obtain accurate financial statements from many family-owned SMSEs. By providing loans to individuals, Niaga avoided the need to compile complete financial statements. Second, Bank Niaga is trying to increase its consumer lending portfolio, particularly loans to high net worth individuals. Many of the guaranteed loan recipients were high net worth individuals, and the guarantee project reduced the bank's risk of pursuing this consumer lending strategy. Finally, some individuals and holding companies have extremely complicated business arrangements, and there is reportedly no accurate way to separate the financial position of one subsidiary from another.

Credit for New Starts or Expansion

"Qualifying Subloans" were also required by the agreement to be for the purpose of financing the start-up or expansion of a business, and the loan was to have been additional to credit already available to the sub-borrower and not a renewal or extension of a pre-existing loan. A survey of sub-borrowers indicates that approximately 40 percent of businesses were not start-ups or expansions.

Covenants in the loan agreement also stipulated that 50 percent or more of sub-borrowers would have average monthly sales of less than $150,000, and not less than 50 percent of sub-borrowers would have their principal business location outside of Jakarta. Ninety-three percent of sub-borrowers had average monthly sales of less than $150,000, and 85 percent were outside of Jakarta.

V. INSTITUTIONAL IMPACT

A. Impact on Bank Niaga

1. Bank Niaga Attitudes Toward the Guarantee Project

Niaga executives cited two main benefits from the project. First, the guarantee allowed the bank to increase the size and improve the terms of loans to high-quality smaller clients. Second, the project helped the bank to gain risk experience with market segments that have been targeted under the bank's consumer lending strategy.

Bank Niaga's attitude toward the guarantee project is summed up in the following points made during interviews with bank officers:

> "The project allowed us to provide longer term loans with less collateral to clients that would have received loans anyway."
>
> "(Public) confidence in Bank Niaga is very important, and so we have had to use very conservative lending practices (under the project)".
>
> "We have learned how to evaluate prospective borrowers without adequate financial information. We found that careful selection of individual clients is extremely important to making sound small business and consumer loans. We have been learning about the character of particular market segments. But the project encouraged us to make safe loans because of our relationship with USAID and because of the publicity. Extra care was taken when we made A.I.D. loans."

As these quotes illustrate, Bank Niaga staff used the guarantee facility to extend larger and longer term loans to clients than they would have without the guarantee. In addition, the guarantee facility helped the bank to implement its consumer lending strategy. But Niaga staff also stated that they only provided loans to safe clients: clients with sufficient collateral, a long history of successful business operations, and a good credit record.

Bank officers stated that they would continue to lend to PRE guarantee facility clients after the end of the project, but that they would select the best clients, and would use the same collateral requirements as before the project, in keeping with their standard procedures for non-guaranteed loans.

Private Banks Minimize Staff Costs

The project demonstrates that it is possible to administer an SMSE loan program within existing bank procedures and without additional personnel or significant changes in credit policies. The bank guarantee facility was implemented within existing banking operations, and the bank used its usual personnel and credit policies and procedures to minimize project costs.

The Bank's Loan to Deposit Ratio is an Important Factor Limiting Niaga's Willingness to Lend to SMSEs.

The project also indicates that a highly leveraged bank can not afford to pursue aggressive SMSE lending, even with a 50 percent guarantee. It is not in a bank's financial interest to make loans that involve risk when the bank has a high loan to deposit ratio. Although a highly leveraged bank can be very profitable, unsound credit can very quickly result in financial disaster for the bank. Bank Niaga is a good example of an extremely highly leveraged bank that is able, with the guarantee program, to make additional sound SMSE loans. Niaga, however, was willing to make additional SMSE loans only to safe customers.

2. Implementation Difficulties

Bank officers had several comments on the implementation of the guarantee project. First, they said that they felt that the guarantee was too expensive, at an annual 0.9 percent of the loan. They claimed that this risk charge is much more than the bank's recent loan loss rate of 0.45 percent, and that no "A.I.D. loan clients" had defaulted.

Second, senior officers mentioned that the reporting system for the project was too difficult for them to comply with, but that several helpful changes have been made during the course of the project. They claim that the latest streamlined version of the sub-borrower reporting forms is acceptable, but that they still cannot provide accurate information on earnings or employment for many clients.

Third, senior bank management stated that communication with A.I.D. concerning the project was not very good, and that it appeared to them that "A.I.D. doesn't care about the project." This concern was also repeated by junior staff who stated that they were frustrated at not getting responses to inquiries about borrower eligibility, payment of guarantee fees to A.I.D., and how to use all of the available coverage in the guarantee account.

3. Provision of Long-term Investment Credit

Expanding businesses with excellent prospects are often unable to find sufficient credit because of the highly conservative banking practices that prevail among private commercial banks in Indonesia. When collateral of up to 200 percent is required for a loan, many businesses find themselves unable to expand because they cannot obtain sufficient credit. One assumption underlying the Bank Niaga project is that reducing the risk of lending to smaller businesses allows credit officers to give more weight to cash flows and project income and less to collateral in credit decisions.

As mentioned above, an investigation of 12 loans demonstrated that loans under the guarantee facility were significantly longer term than Bank Niaga's usual SMSE loans. (As mentioned above, loans were also about 22 percent larger than Niaga's usual SMSE loan.) There was no significant increase in the branches' use of cash flow or project analysis techniques in granting loans.

4. <u>The Investment Development Grant</u>

Bank Niaga received a $50,000 grant to support training of officers for SMSE lending. Bank Niaga used the grant to conduct the following training programs:

A 3 day Basic Marketing Program for junior marketing officers.

A 3 day Marketing Program for intermediate managers.

A 5 day Training of Trainers Program

Under these three programs the following courses were offered:

1. Account Management (22 participants)
2. On the Job Assignment (7 participants)
3. Credit Analysis & Effective Credit Proposal (20 participants)
4. Security Appraisal & Legal (20 participants)
5. Commercial Letter of Credit (23 participants)
6. Macro Economic & Money Market Institutions (20 participants)
7. Bank Marketing Development (23 participants)

According to bank staff, the PRE sponsored training program did not differ in any significant ways from previous training efforts carried out by the bank. The program did not focus particularly on SMSE lending techniques, and did not defray staff development costs directly associated with implementation of the PRE facility.

B. Impact on the Government of Indonesia, GOI

The GOI was not directly involved in the PRE guarantee project. Design and execution of the project were entirely the responsibility of Bank Niaga and PRE. In addition, the only publicity concerning the project that occurred in Indonesia consisted of brief news articles on the signing of the loan agreement in 1985. Because of this limited publicity, very few government officials, and only a small number of private bankers[6] knew anything about the project, and this minimized the institutional impact of the project.

In Indonesia most loans under government subsidized credit programs are guaranteed by the GOI's credit insurance agency. (The level of coverage was recently changed from 80 to 70 percent.) In addition, state banks have been under pressure from the government to give more attention in lending to developmental criteria than to sound credit practices. These factors have resulted in widespread collection and loan write off problems in the commercial banking system. Clients have developed the attitude that if they don't pay their loans, the government will step in and bail the bank out

Because of the widespread assumption that guaranteed credits do not have to be paid back, Bank Niaga chose not to disclose to sub-borrowers their involvement in the PRE loan guarantee program. This position was accepted by PRE, and the result of this lack of public information was that clients, other banks, and government officials, by and large, did not know about the project. None of the government officials or private bankers interviewed in the course of this evaluation study knew about the

---

[6] Officers at Bank Duta, Bank Pan In, and a few other private banks did know that there was some kind of joint Bank Niaga-PRE project being carried out.

PRE project. As a result, the project had significantly less impact as a model for unsubsidized SMSE lending efforts than if the government and bankers had been informed. Revolving Fund projects are expected to provide models for other institutions, so that their successes can be replicated. When virtually no public disclosure is made, a significant institutional impact is lost.

When the study team explained the project to the President of one of the large state banks, Bank Rakyat, and asked his opinion of the approach, he said that it is a good model for unsubsidized programs, and it could be used by state banks to stimulate long-term credit on an unsubsidized basis. He also added that Bank Rakyat would like to imitate Niaga's middle-market lending strategy, because medium-sized companies are a very profitable market.

C. Impact on USAID/Indonesia

The Bank Niaga project has not been replicated by the Mission's private enterprise program. The project has had little impact on the Mission for two main reasons: first, when the project began, it did not fit in with or complement the Mission's private sector development programs; and second, lack of clarity about responsibilities for implementing the project led to poor coordination between the Mission and PRE. Nevertheless, Mission private sector officers stated that observing the project provided an opportunity to learn how the private commercial credit market operates and has helped to develop contacts with private banks. The project has also encouraged the Mission to increase private banks' involvement in policy dialogue and to include private sector banks in their current private enterprise program.

USAID/Indonesia has been heavily involved in financial markets and enterprise development programs, with current activities including the Financial Institutions and Private Sector Development Projects, Agriculture and Rural Sector Support Program, and the upcoming Trade and Enterprise Development, Municipal Finance and Financial Markets Development Projects. The Bank Niaga project did not have major impacts on the private sector program of the Mission. For example, the project has not been used as a model for Mission projects, there has been no policy dialogue with the government based on issues arising from the Niaga project, and the Mission has not worked directly with any Bank Niaga staff on other activities in the Mission's program.

Mission officers report that they feel the project should have been designed to contribute to the Mission's ongoing enterprise development activities. They also indicated a willingness to participate in the design of local Revolving Fund projects, to take administrative responsibilities for projects developed with PRE/I, and to use Revolving Fund and other PRE resources in ways that complement Mission private enterprise activities.

An objective of Revolving Fund projects is to provide examples of credit project models that the Mission can use in own program. In the Bank Niaga case, few Mission officers outside of the private sector office knew about the Bank Niaga project, and because of this the project did not get widespread attention as an example of the constructive role guarantee projects can play in supporting development objectives.

Lack of Clear Responsibility for "Account Management"

The Mission played only a small role in implementing the project. A personal services contractor (PSC), with 25 percent of his salary paid by PRE and 75 percent by the Mission, was made responsible for backstopping the project in the Mission. The PSC felt that he was not given the authority necessary to interpret the loan agreement or to help the bank by answering questions about project implementation, and therefore referred almost all Bank Niaga matters to PRE in Washington.

At the same time, the PRE Investment Office assumed that their part-time officer in the Mission should backstop the project by insuring that reporting requirements were met, by enforcing compliance with terms of the loan agreement, and by assisting Niaga in implementing the project. This situation resulted in confusion over responsibility for implementing the project.

VI. BORROWER PROFILES

The following pages provide brief descriptions of the twelve sub-borrowers visited. The descriptions are intended to capture something of the flavor of the businesses involved. Statistical and financial information on these enterprises is presented in tabular form in Appendixes 2 and 3.

Mr. Loekito Koesoemo
Cleaning and Trading Birdsnests
Surabaya, Java
Loan: **$236,471**

Twenty years ago Mr. Loekito and his wife operated a coconut export trading business on Java. On their trips to Hong Kong, friends in the crown colony used to ask them to bring edible birds' nests from Java. Seeing this as an opportunity to supplement their income from coconut trading, the Loekitos began selling nests in Hong Kong on a commercial basis. After 12 years of operating the birds' nest business as a sideline, the Loekitos gave up their coconut business and started processing and trading birds nests full time.

The nests Loekito buys, cleans and sells are made entirely of bird saliva by birds in central Java. It takes a bird an average of two or three months to make one nest weighing 10 grams. Nests are collected by villagers and sold, uncleaned, to the Loekitos for about $300 a kilo. When Loekito buys the nests they are dirty, varying in color from yellow to black.

The nests are then soaked in water and hand cleaned by the Loekitos' employees. Cleaning by hand takes about 15 minutes per nest. Loekito cleans the nests this way even though a nest cleaning machine is available locally, because the Loekitos believe that hand cleaned nests are better in quality, provide more jobs and higher profits. Most of the 165 young women who clean nests are paid less than $3.00 per day.

Cleaned, Dried Nests Put Back Into
Their Original Shape Before Packing for Export

The nests are then dried in rooms filled with table fans. The dried nests are reshaped into their original cup-shaped form, and then taken to Hong Kong where they are sold at a price of about $1000 per kilo. All of the nests are sold abroad, with buyers including major restaurants in Hong Kong as well as distributors selling to restaurants and traders in Singapore and Japan. Currently, the Loekitos are the largest birds' nest processor and exporter in Indonesia. Most other exporters sell uncleaned nests to distributors in Hong Kong and Singapore; the Loekitos clean all of the nests that they export because they can sell higher quality, cleaned nests at a greater margin than uncleaned ones.

A Nest Cleaner Working With A Tweezers

Before receiving a $54,811 loan under the PRE/Niaga program, the Loekitos had never had a commercial loan for their nest business. Their first loan was for three years at an interest rate of 22 percent, and was used to buy the house in which they currently run their cleaning and drying operation. This house is in a wealthy residential area about one kilometer from their own residence. Loekito felt that such a valuable commodity required the better security available in a good residential area rather than an industrial area.

The biggest constraint facing the couple now is the large working capital requirements of a commodity like birds nests. The business currently has, by conservative estimates, over $500,000 in inventory at any given time, and they feel that they now require almost $1,000,000 in working capital to begin to sell directly to distributors in Hong Kong, Singapore and Japan. In order to help the business meet this working capital requirement, Bank Niaga granted a revolving credit facility to the couple in April 1987; the terms were one year at 22 percent, with 100 percent collateral. For the first year this credit was guaranteed by the PRE facility, but it has now been renewed on an unguaranteed basis.

Between the time when the first Bank Niaga loan was granted and September 1988, the couple has hired 115 new workers (all of these were women). They currently have no trouble selling every nest they clean, and intend to add more rooms to the cleaning house and buy more uncleaned nests. Once their inventory increases, they hope to begin to sell directly to buyers in Japan, Korea and Germany.

Sadijono Hardjokusomo
Insurance Company
Surabaya
Loan: $115,713

Mr. Sadijono Hardjokusomo is the President of P.T. Asuransi Ramayana. P.T. Asuransi Ramayana, established in 1956, is the 5th largest of 65 insurance companies in Indonesia. The company provides fire, marine cargo, hull, motor and miscellaneous property insurance. In 1987, the company had total assets of $9.1 million and net income of approximately $233,000. In 1986, the latest period for which the figure was available, the company had gross premium income of $11,815,566.

P.T. Asuransi currently has 16 branches in the country, with the largest in Jakarta, and second largest in Surabaya. The Surabaya branch has grown quickly, spurred by the rapid increase in shipping trade through Surabaya's port. In 1986 the company decided that its old office in downtown Surabaya was too small and so new office space was needed.

P.T. Asuransi has had a deposit relationship with Bank Niaga for ten years, and recently received a loan from Niaga to purchase an office building for its Malang Branch. The Surabaya P.T. Asuransi branch manager approached the Bank Niaga Darmo Branch in Surabaya for a loan to buy a building. The branch, which usually makes "consumer loans", agreed to make a loan in the name of the president of P.T. Asuransi. (Consumer loans are loans to individuals, collateralized by personal assets and guarantees.)

By making a consumer loan to the president of the insurance company, the Darmo Branch was able to cut the usual loan approval time down to one week, and to put the loan under the PRE guarantee facility. If the loan had been made to the company, the branch would have had to complete a thorough credit analysis of P.T. Asuransi. On the other hand, to make a personal consumer loan to the company president, they only had to verify the president's personal income and bank accounts. In addition, P.T. Asuransi Ramayana has monthly premium income of over $900,000, while the president's personal income is significantly below the PRE maximum of $300,000.

Soetjipto Yoe Angga
Korean Garden and Canton Barbecue & Noodle Restaurants
Surabaya
Loan: $181,269

Mr. Soetjipto's family migrated from China several generations ago, and since then has been in the commodity trading and banking business. Mr. Soetjipto has operated many lines of business since his father sold the family bank over a decade ago. He started his first business, an inter-island shipping company, almost 10 years ago after he determined that there was a serious shortage of small ships to carry goods between Indonesia's major islands. His current businesses include commodity trading companies that deal in timber, corn, onions, soybeans and tamarind, a scrap metal business, a real estate company, and two restaurants, a Korean and a Chinese Barbecue restaurant.

Several years ago Mr. Soetjipto and his wife started the Korean restaurant in a major downtown Surabaya shopping center to provide Mrs. Soetjipto with a business. At that time the couple approached Bank Niaga for a loan to finance working capital, staff training, and to set up a food preparation factory to barbecue the meats and prepare vegetables and sauces. The bank decided to grant a consumer loan to Mr. Soetjipto because to make this type of loan the branch only had to examine Mr. Soetjipto's personal bank balances and collateral. If it had been submitted as a corporate loan, the branch would have had to obtain and check financial statements for Mr. Soetjipto's many and complicated businesses.

In December 1987 Bank Niaga granted Mr. Soetjipto a 300,000,000 rupiah loan ($181,269) for ten years at 22.25 percent. The collateral for the loan was the building and land for the food processing factory worth

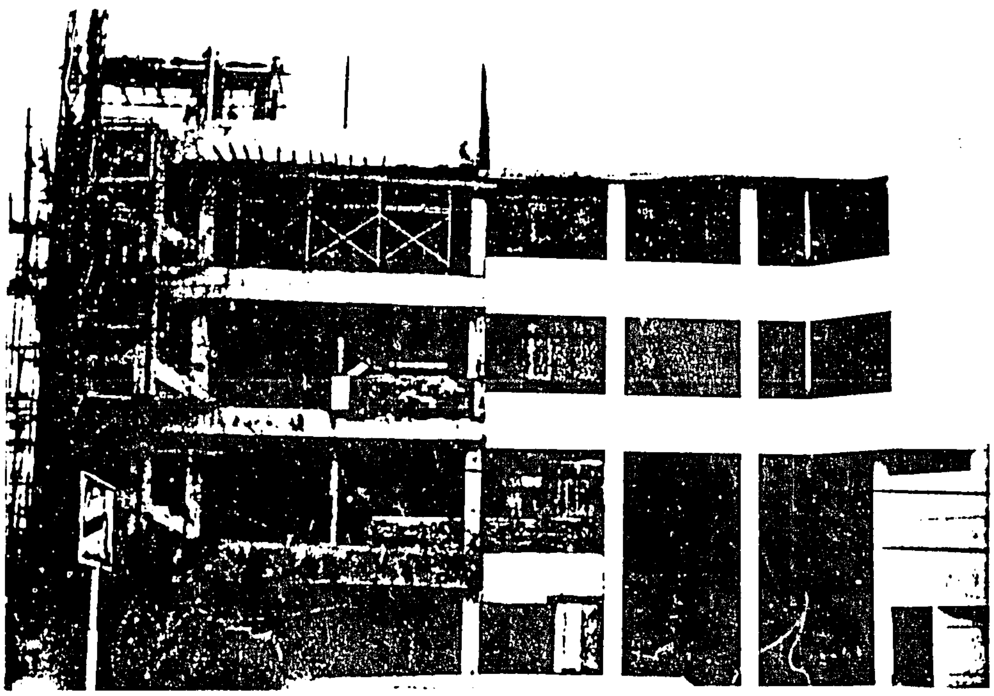
Rp. 300,000,000. After the business began to show a profit, the couple opened a Chinese Barbecue restaurant in the same shopping center. Proceeds of the loan were used to complete the building, to buy food processing equipment, for the salaries of two chefs from Hong Kong and two from Korea to run the restaurants and train staff for two years.

The Entrance To The Korea Garden Restaurant
Located In A Busy Shopping Center

As of September 1988, the restaurants have combined monthly gross sales of almost $30,000 per month. Mr. Soetjipto says that because he imports 100 percent of the beef and 70 percent of the sauces served in the Korea Garden Restaurant, his profit margins are small, but he hopes to make some of the sauces locally soon. Mr. Soetjipto also is planning to franchise his Canton Barbecue Restaurant to open another branch in another major Surabaya shopping center.

RSB. Budi Jaya
OBGYN Clinic
Surabaya
Loan: $300,120

Dr. Ichramsjah Rachman received his certification as a doctor of obstetrics and gynecology in 1970. He set up an eight bed clinic in a lower middle class area of Surabaya, while also performing mandatory full-time service in a local government hospital. By the mid-1970s his clinic, specializing in delivery of babies, had 12 beds, but still only one doctor and one midwife. As his practice grew, Dr. Rachman added an operating theatre. With rapidly increasing demand for his services, and a pressing need to involve specialists in his clinic, he began to consider building a small hospital, and purchased several plots of land around his clinic.



Budi Jaya Clinic With Half of the Building Completed

In the early 1980s the Indonesian Health Ministry began a program to encourage the building of private hospitals and Dr. Rachman unsuccessfully applied for a permit to construct one. In 1986, along with small group of doctors, Dr. Rachman applied once again and was granted a certificate to establish the Budi Jaya Clinic. By this time the group had grown to 22 doctors, most of whom had become partners in the new hospital company. The company applied to Bank Niaga for financing to construct a hospital building, and was granted a 4 year, 22 percent loan for $300,120. Collateral for the loan is land and building worth 83 percent of the loan. According to Niaga branch staff, if there had been no PRE guarantee facility available, the bank would have given only $181,000, and would have charged an additional 1.2 percent interest. Gross revenues for the hospital at the time the loan was made were estimated at $7,550 per month, with most doctors working only part-time until the clinic is completed.

As of September 1988, four floors of the building are complete with 50 patient beds and two operating theatres in service. The entire building is expected to be completed in December 1988. Current staff consists of the following:

15 obstetricians
3 anesthesiologists
2 pediatricians
1 pathologist
1 general practitioner
18 nurses
5 midwives
15 support and administrative staff

The Revolving Fund loan file for Budi Jaya Clinic states that the clinic will purchase equipment from the United States. Hospital staff interviewed said that they intended to purchase some machinery and equipment from the U.S., but that in fact they have made their purchases from Taiwan, Japan and Germany. Staff doctors mentioned that in their experience, U.S. equipment is often significantly more expensive than similar equipment from other sources, and they have difficulties in obtaining adequate maintenance services for U.S. goods.

Dr. Rachman expects that the clinic will be in full operation by spring of 1989. In 1987 the doctor received a certificate in in-vitro fertilization (IVF) and menopause under a WHO program in London. He now plans to begin an IVF program in the clinic; this will be the first such program in East Java. In addition, the group has been promised a license to establish a general hospital, and says that they would be interested in considering a joint venture project with a foreign health company to undertake this project.

Yayasan Lembaga Pendidikan Indonesia
Business College
Jakarta
Loan: $300,120

Yayasan Lembaga Pendidikan Indonesia, LPI, is a non-profit foundation established over two decades ago by a wealthy Indonesian shipping company owner. LPI now operates two non-profit academies, the Akademi Keuangan Dan Perbankan (AKP), a banking and finance college, and the Akademi Bahasa Asing Indonesia (ABA Indonesia), an Indonesian and English language institute. Both AKP and ABA Indonesia are run on a non-profit basis, and in order to serve lower middle class and poor students, receive continuing support from the LPI Foundation.

The banking academy, AKP, was founded in 1966 as a three-year college offering Bachelors Degree programs in finance and bank management. The academy currently has 2000 students, and operates with a staff of 75 instructors and 28 support staff. In 1987 the college had gross revenues of approximately $45,000 per month, and net fixed assets of $190,000.

The biggest problems facing the college are improving its level of government accreditation, and charging fees that are high enough to cover costs. Students pay $280 per year for tuition and examination fees; the director of AKP estimates that other three year programs in banking and finance charge on the average $415. Given the current accreditation level of the college, it has been difficult to raise the fees more than 3 percent per year recently. Because Indonesia's inflation rate has been over 10 percent for the last several years, the college's revenues have not kept up with costs.

In order to raise tuition fees, they must raise the accreditation of the college. If the college can accomplish this, then the finance officer says he can raise fees by $60 per year. To raise the accreditation level, they must have 70 percent or more of their students pass standardized examinations. To get this pass rate, the college must improve the quality of their programs.

Since June 1988, over 70 percent passed. When the MSI evaluation team visited the college in September 1988, it was told that one more exam period with over 70 percent passing means that their accreditation increases.

To finance their program to improve the accreditation of the college, AKP's management decided to seek a loan to purchase their building and for working capital. In late 1987 they approached Bank Niaga's local branch and requested a loan. In February 1988, Bank Niaga granted a $300,120, 20 month PRE-guaranteed loan at 23 percent interest to purchase a building on the college's main campus, and added an additional unguaranteed working capital loan for $29,000. These loans were provided in the name of the LPI foundation rather than the college, and were collateralized by the foundation's guarantee.

As of September 1988 the college had rescheduled part of its outstanding debt because of insufficient cash flows. They hope that passing over 70 percent of their students will allow them to raise fees, and this will make paying off the outstanding loan feasible. If they can not raise their fees, they may have to ask the foundation's help in paying off their loan.

P.T. Mangku Jaya Abadi
Women's Magazine
Jakarta
Loan: $150,602

P.T. Mangku Jaya Abadi Company publishes Sarinah, a women's magazine. The magazine, issued every two weeks, is described by its chief financial officer as similar to Family Circle in the U.S. The glossy covered magazine covers fashion, home furnishings, cooking and women's issues. In addition to Sarinah, the company also publishes some novels.

Covers Of Recent Issues Of Sarinah

Sarinah was started in 1982 by four partners, 3 men and one woman, with an investment of $175,000, and an initial circulation of 35,000. Current circulation is 140,000 throughout Indonesia, current monthly sales are $291,000, gross assets are $2.3 million and net worth is $147,000. The company has a total of 120 full time employees, including 70 women.

P.T. Jaya Abadi has had a banking relationship with Niaga ever since the company started. Bank Niaga provides evergreen working capital credits that are used to pay regular production and marketing expenses. In February 1988 Bank Niaga gave Jaya Abadi a credit of $150,602 under the guarantee facility, and increased the total line of credit for the company to $382,000. The PRE-guaranteed loan was granted for 15 months at 23 percent, and is 116 percent collateralized by land, cars and paper inventory owned by the company.

There are currently 8 other women's magazines in Indonesia, with two, Femina and Kartini, competing directly with Sarinah for the urban middle class women's market. In addition, with Indonesia's low per capita income ($520 in 1985) declining by of 1% per year from 1982 to 1986, the market is highly competitive. To make things more difficult, the government has limited advertising space in magazines to 35 percent of all pages in order to spread advertising revenues among companies. This particular rule has resulted in low growth in advertising earnings for Sarinah, and advertising rates in Indonesia that are among the highest in the world.

Under these conditions, Sarinah's circulation has stagnated and the company's financial manager has been seeking means of improving the company's performance. In 1987 she began a project to create a mass market edition of the magazine, using simpler language, fewer pages, bigger print, and extensive rural distribution operations. This down-market version would be targeted toward women outside of Jakarta, with an expected starting circulation of 50,000.

The finance manager says that they have developed good financial projections for this project, but that Bank Niaga refuses to allow further increases in the publisher's line of credit. The finance manager remarked: "As usual, they only give us half of what we need!" Such creative tensions are commonly found in banker-client relationships.

Budi Cahyono Prawiro
Buana Printing
Jakarta
Loan: $60,640

Budi Cahyono Prawiro operates a small but growing offset printing shop in Jakarta's Chinatown. Since establishing the business in 1980, it has grown from 8 to 40 employees, including 2 women on the administrative staff. Budi used his own capital initially to get started in the printing business. His first bank loan came in 1982 from Bank Central Asia, Indonesia's largest private foreign exchange commercial bank. This working capital loan was used to buy the company's printing plant, and was subsequently converted to a fixed asset term loan. Besides the printing company, Budi's family invested in a retail computer shop one year ago. This business is operated separately from Buana Printing and is managed by Budi's brother.

Mr. Budi's business at first was dependent on one major account, a large joint venture pharmaceutical company for which he printed boxes for medicines, toothpaste and other products. Buana Printing also prints advertising posters and pamphlets and product labels for its clients. By 1987, with business beginning to slow, Budi determined to raise additional capital for the purchase of new equipment to expand his plant capacity and his client base.

Mr. Budi approached Bank Niaga for a fixed asset term loan to purchase a new German-made offset printing press. Budi, whose firm's total assets were about $395,000 before the loan, received a Rupiah 100,000,000 ($60,640) two year loan at 24 percent p.a. under the A.I.D facility in March 1987. The loan is secured by real estate, including the land, plant and machinery owned by the company. The new printing press allowed Budi not only to increase output, but to increase quality as well. Budi can now easily accept multicolor orders that were difficult to produce on his old machines.

Mr. Budi's business has grown to the point where he now has 10 major customers who account for over 70 percent of his total profit. These clients include such prominent names as Phillips Electronics, Bata Shoes, and Djarum, a major tobacco company. Total annual sales have reached $544,000, while Buana has total assets of over $470,000. A major problem now for the busy company is production scheduling. Buana Printing runs 3 shifts, 24 hours a day, as clients demand quick turnaround time. Competition is fierce, with three competitors alone situated on the same street as Budi's shop. One advantage Buana Printing has is its graphic design service, something that is usually offered by only big companies.

Mr. Budi reports that he needs additional credit, particularly working capital prior to year-end when his company receives many orders for printing calendars. Budi has to buy large amounts of paper and process it over several months during which he receives no advance payments from clients. As it takes 1-2 months from invoice date to collect on receivables, the entire calendar making process can take up to

4-5 months before payment is received. This puts serious strains Budi's cash flow position.

Haryono
Truck Transport Company
Surabaya
Loan: $58,825

Mr. Haryono founded his transport company in 1969 to carry goods between major urban centers on the island of Java. The company now employs 50 men and transports tires, coffee, pharmaceutical drugs, and other products between Surabaya, Jakarta and Bandung. Each of Haryono's trucks makes an average of four fully loaded round trips per month from Surabaya. Haryono's fleet now consists of 18 trucks, all of French, German, and Japanese origin. Spare parts are cheapest for German trucks and Mr. Haryono reports that German vehicles also last the longest, with an average of 10 years before they need to be replaced.

Two Trucks Standing in Mr. Haryono's Loading Area

Haryono's last major loan before coming to Bank Niaga was a 1982 unsubsidized five year term loan from Tamara Commercial Bank, a medium sized private non-foreign exchange commercial bank. Since then Haryono has developed a relationship with Bank Niaga and has drawn down two loans from the bank because it offered him larger loans at lower rates of interest than Tamara Commercial Bank. His first loan in February 1986 was for a home mortgage which currently has $55,900 outstanding under it. Bank Niaga's loan to Haryono under the A.I.D. guarantee facility is a five year fixed asset loan for Rupiah 100,000,000 ($60,640) at 26 percent p.a. granted in August 1987. The loan was used to purchase new trucks and for financing ongoing operations. Haryono's fleet now includes two modern container trucks that he operates jointly with another transport company.

Haryono's annual sales have reached $300,000, double the $150,000 figure achieved five years ago. While business volumes and sales figures have steadily grown, however, tough competition in the truck transport business has kept profit margins low. In addition, the purchase prices of imported trucks have risen rapidly, as have fuel prices and imported spare parts costs (largely due to the rupiah's two major devaluations since 1983). Haryono has sought to offset the higher costs of doing business by improving the administration of his business and increasing the average payload carried by his trucks from 10 to 20 tons.

Haryono appears disappointed with the low margins and stiff competition in the transport business. His immediate goal is to sell his truck transport company in order to finance a new shrimp farm and cold storage company that he is planning to start with three partners. The group has already approached Bapindo, the state development bank, for both subsidized investment and short-term working capital loans that the commercial banks are unable to offer. Having had previous working experience in a prawn fishing and processing business from 1977-81, Mr. Haryono is confident he can make a greater profit in shrimp farming and cold storage than in the transport business.

Yong Wie Leng
Furniture Shop
Surabaya
Loan: $88,235

Yong Wie Leng is a third generation Chinese manufacturer of furniture. He currently owns two furniture workshops, employing a total of 50 male laborers, and is planning to build one more workshop financed by the cash flow from his business. He also owns a small construction business that builds residential homes and employs 20 laborers.

Mr. Yong's furniture business has total assets of about $109,000 and equity of $35,000. The business has grown dramatically since Yong received a rupiah 150,000,000 ($88,235) five year fixed asset loan at 24 percent p.a. from Bank Niaga in December 1987 under the A.I.D. facility. The proceeds of this loan were used to purchase a three story building to serve as a furniture showroom. The building is collateral for the loan. Mr. Yong has hired two women to work with him in the showroom.

Prior to this purchase, Yong's friends sold the furniture directly to other acquaintances and private companies. He also only employed 15 workers in his workshops and monthly sales averaged about $11,750. After opening the showroom, sales almost immediately doubled, the number of workers employed more than tripled, and business continues to grow. In fact, Mr. Yong now proudly points out that monthly sales have just reached $35,000, of which 15-20 percent is profit.

Mr. Yong's New Showroom Building

Yong's success in his furniture business is encouraging him to diversify his business interests. He plans to join with three partners to set up a lac plantation on Lombok, east of Bali. Their intent is to export lacquer. They have approached Bank Rakyat Indonesia, which offers subsidized credits for agricultural development projects, for a term investment loan.

Agung Widjojo Njoto
Architect/Contractor
Surabaya
Loan: $82,350

Mr. Agung has been in the construction business for 20 years. Prior to becoming a contractor, he helped his father in his wood furniture business. At that time Agung observed that office building and residential construction would be a profitable business, and this led him to establish his own company. Mr. Agung sometimes joins with other developers in construction projects, but normally is the sole contractor for his projects.

Workers Carrying Cement Bags
At One Of Mr. Agung's Construction Sites

Agung currently is very busy, with five separate construction projects going on now. He employs 175 laborers on these projects, 10 percent of whom are women. He also has an office staff consisting of 10 employees, 2 of whom are women. Mr. Agung mainly constructs office buildings, but occasionally builds residences, shops and factories. Buyers of his buildings include both companies and well-to-do individuals. Monthly sales average about $13,500, of which just over $5,000 represents profit, according to Mr. Agung. He confides that he faces no major problems in his business as it is always easy to obtain laborers, who work for $2.35 or less per day, and city permits for building construction.

Mr. Agung's main banking relationship is with a tiny (total assets in 1986 of $6.1 million) private non-foreign exchange commercial bank, Bank Karman. Over the past two years, he obtained working capital loans from Bank Karman priced at 24 percent p.a. On the advice of a friend who banks with Bank Niaga, Mr. Agung approached Bank Niaga for a loan to purchase an office building to serve as company headquarters. Bank Niaga, under the A.I.D. guarantee facility, granted him a rupiah 140,000,000 ($82,350) seven year fixed asset loan at 22 percent p.a. in March 1987. The building serves as collateral for the loan.

In an effort to diversify his business interest, Mr. Agung is planning to join two partners in setting up a lac plantation on Lombok. He had recently constructed a shopping center on Lombok and, while there, found both weather and competitive conditions suitable for the lac plantation business. He and his partners initially intend to rely on their own modest resources to undertake the project, but plan to obtain bank borrowings as the project gets off the ground.

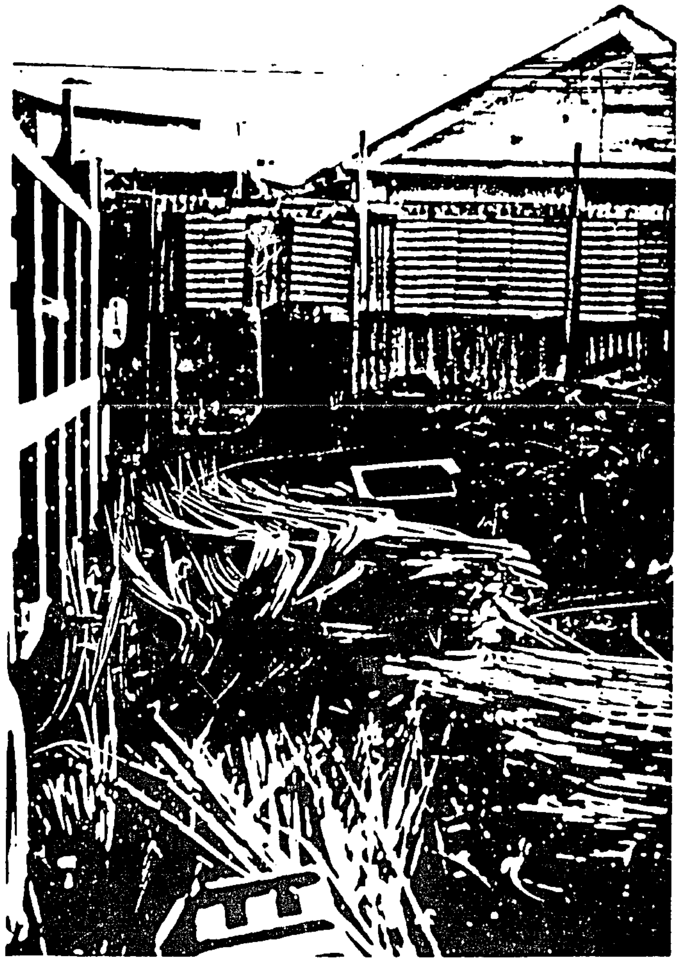
Soemarsono Salim
Construction Steel Trader
Surabaya
Loan: $123,500

Mr. Salim launched his current business of trading in construction steel rods and wire and scrap steel in 1985 after successfully managing an electrical shop in Surabaya for 15 years. His wife now runs the electrical shop selling lamps, wire, and similar goods. Mr. Salim sells structural steel for reinforced concrete construction to retail shops in the Surabaya area. He purchases the steel from various sources, including two companies in Surabaya, two in Jakarta, and one in Medan. Mr. Salim is the sole agent for the latter company, P. T. Gunung Gahapi, his largest supplier. Because he buys from P.T. Gunung using cash, the company gives him a substantial discount. Discount purchasing enables Salim to compete with local steel makers that are unable to match his lower selling prices to local retail steel buyers.

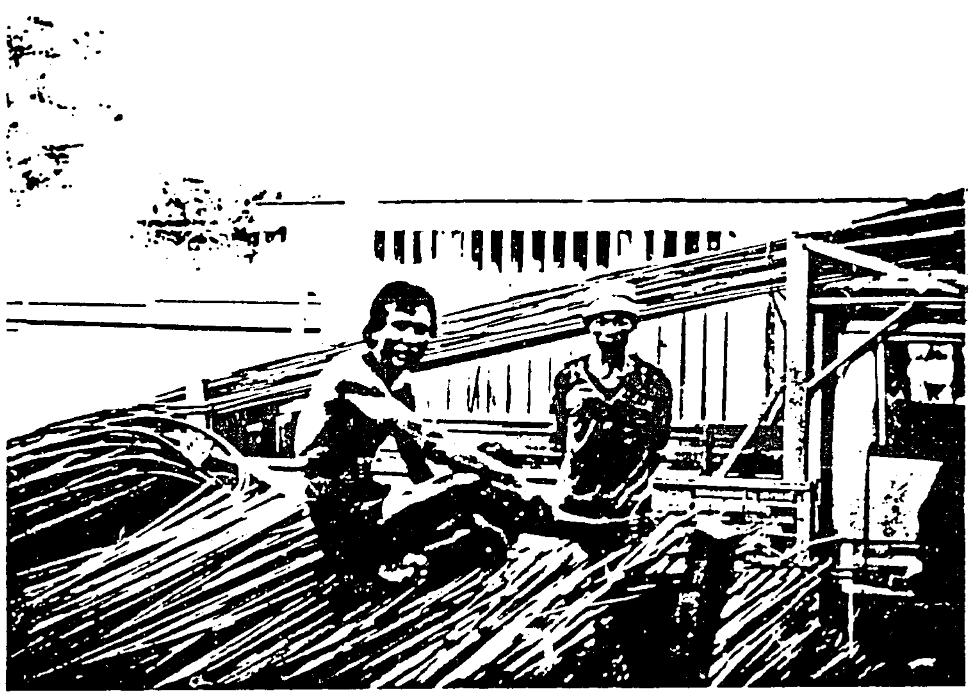
Mr. Salim is also in the scrap steel business. He purchases scrap stainless steel from factories and junkyards and he sell it in Japan, Singapore, Taiwan, and Hong Kong.

Salim's business is prospering, with annual sales, according to Bank Niaga files, approaching $14 million. Expenses are low, as Salim has only 6 staff people and 9 laborers working in his main wholesale warehouse. He has another 3 staff, including 2 women, and 6 workers employed at his retail steel sales shop.

Profits, according to Mr. Salim, are hard to predict given the wide price fluctuations for steel and steel products. In 1987, for example, Mr. Salim suffered a 30 percent loss on the resale of steel when prices rose first by 70 percent at the wholesale level and then fell quickly after his wholesale purchases. Salim estimates that his average monthly profit ranges from $1,200-$4,700. This may be a very low estimate, however, given Bank Niaga's estimate that his profit margin is 5 percent of sales. This rate would mean that Salim's business actually earned a $700,000 profit on $14 million in annual sales reported in 1987.



Steel Rods For Use In Reinforced Concrete Construction
Stockpiled In Salim's Warehouse



Two Of Salim's Staff Resting After Unloading An Incoming Truck

Mr. Soemarsono Salim initiated his banking relationship with Bank Niaga after Niaga offered to make money transfers for him at no cost. He still maintains a current account at Bank Central Asia, Indonesia's largest private non-foreign exchange commercial bank.

In February 1988 Bank Niaga gave Salim five year guaranteed loan for rupiah 210,000,000 ($123,500) at 24 percent p.a. for the purchase of fixed assets. He purchased a shop, which serves as collateral for this loan, to sell construction steel to major buyers. While hard to quantify up to this point, the new shop has helped expand total sales.

Mr. Salim also is the owner of a fast food restaurant in Surabaya, and he is currently planning to open a supermarket in Surabaya in the near future which will be managed by a nephew and will feature food, clothing, and cosmetics.

H.M.Y. Bambang Sujanto
P.T. Kedawung Setia Industrial Ltd.
Surabaya
Loan: $164,700

Mr. Bambang Sujanto, along with his three brothers and four sisters, runs a large and prospering family business, P. T. Kedawung Setia Industrial Ltd., established by their father in 1974. The company, which began as a wood products factory, now manufactures four product lines: (1) Enamelware; (2) Corrugated carton boxes; (3) Polyprophylene plastic mats; and (4) Egg tray cartons. Mr. Bambang is company chairman.

The sprawling factory complex, located in a suburban area outside of Surabaya, is modern and well maintained. There is sufficient undeveloped property in the complex on which to expand facilities, something which Mr. Bambang intends to do in the near future. The factory currently employs

2,000 workers; 40 percent of the employees are women who are mainly engaged in handicraft work on enamel pots, pans, and kettles. Total corporate assets are valued at $7.4 million.

The most profitable business line, by far, is the enamelware division. Monthly sales of enamelware products have now reached $900,000. A growing proportion of this figure represents exports to such countries as Saudi Arabia, the Philippines, and the U.S.A. Mr. Bambang claims to have recently completed $500,000 in exports over a two month period, and, in addition, has a $7.5 million contract for the export of enamelware products to the U.S. in 1989. Since it will be necessary to expand production in the enamelware factory in order to be able to fill all the orders, Bambang is importing new machinery from Holland, China, Taiwan, and Japan and supplies of raw material from West Germany. The new addition to the factory will require the hiring of 300 more laborers.

The corrugated carton box division produces monthly revenues of $8,000, while the plastic mat division brings in $300 monthly and the egg tray carton line only $100. Profits for the company as a whole for the year through August 1988 were up 15 percent over the same period in 1987. Profit reported by corporate accountants through August 1988 totals $205,000, and projections for year-end are profits of $308,000.

The company primarily banks with Bank Rakyat Indonesia, the large state-owned bank, from which it has had term investment loans to support plant and equipment purchases. Mr. Bambang approached Bank Niaga for a loan and one was granted in March 1987 under the A.I.D. guarantee facility. The loan is for Rupiah 280,000,000 ($164,700) for seven years at a rate of 22 percent p.a. to purchase fixed assets. Bambang used the loan proceeds to purchase a building, which collateralize the loan, to serve as an office for corporate sales and representation in Surabaya. By making a consumer loan to the chairman of Kedawung Setia Industrial the Darmo Branch of Bank Niaga was able to adhere to the A.I.D. requirement that loans under it facility be made to borrowers having monthly revenues under $300,000. While Mr. Bambang's company has monthly sales revenues for larger than this figure, Bambang's personal income is well below this level.

In addition to his role as chairman of Kedawung Setia Industrial, Mr. Bambang also is a major partner in the new three star Malang Regent International Hotel, has a 10 percent investment interest in a small finance company in Jakarta, owns a 300 acre fruit orchard in Malang, and is just starting a shrimp farming and cold storage business.

P.T. MULTI PANEN RAYA ([7])
Cattle Feedlot and Slaughter Company
Ujung Pandang
Loan: $103,650
Loan has been repaid.

South Sulawesi ranks third in Indonesia, behind East Java and Bali, as a producer of cattle for meat. East Java and Bali, however, are currently slaughtering more cattle than their annual increase in herd size and their output is decreasing. As a result, South Sulawesi is considered to be the primary cattle raising area in Indonesia for the future.

P.T. Sama Samsega is a large, Jakarta-based buyer of cattle. Much of its supply is purchased from South Sulawesi. In order to diversify its business and to achieve vertical integration, P.T. Sama Samsega's corporate parent established P.T. Multi Panen Raya (MPR) in 1985 in Ujung

[7] Excerpted from Philip K. Brewer, USAID/Jakarta Letter No. I/33, July 2, 1987. Our thanks to Mr. Brewer for the use of this sub-borrower description.

Pandang, the capital of South Sulawesi. MPR does not presently raise cattle itself but purchases two year old cattle from farmers in South Sulawesi for subsequent sale to P.T. Sama Samsega. MPR is of average size for cattle feedlots, and enjoys an excellent reputation among farmers for paying bills on time or, if needed, in advance.

MPR ships the cattle live by boat to Jakarta, a trip of four to five days. Unfortunately, cargo boats are used because neither of the two shipping companies has boats designed for cattle. The cattle must be lifted aboard, instead of walking on as they would a cattle boat, and are so frightened by the experience that they often do not eat well for several days. This problem is compounded by the fact that the boats do not have pens for the proper holding and feeding of cattle. After arriving in Jakarta the cattle are kept in holding pens, where they may continue to eat poorly, often for several days before being slaughtered. Thus, many cattle die before being slaughtered and those that do not often lose valuable weight.

Of MPR's seven competitors, five ship live cattle as described above and two slaughter the cattle in Sulawesi and ship the frozen meat. These two firms, however, have excess capacity at their slaughter house and cold storage facilities. In order to avoid the problems and costs of shipping live cattle by boat, MPR rented one of these slaughter house and cold storage facilities part-time but found it inefficient and unable to provide a satisfactory level of quality. MPR resumed shipping live cattle by boat and decided to construct its own facilities.

MPR obtained a $104,000 loan from Bank Niaga under the PRE guarantee program and used the proceeds, along with an additional equity contribution, to purchase 13 hectares of farm land approximately four kilometers from Ujung Pandang airport. The land will be used for growing cattle feed and fattening, slaughtering and freezing cattle. None of their competitors grows feed and fattens cattle before slaughtering.

Eighteen month old cows purchased from local farmers will be fattened for three to six months. During that time the weight of the average cow will increase from 200 to 300 kilos. The cows will eat locally produced feed pellets and elephant grass. Because elephant grass is not grown on South Sulawesi, MPR expects to grow part of its elephant grass needs itself and to introduce the crop to local farmers and purchase their output. The cattle farm will have 30 sheds each capable of fattening 200 cows. Each month MPR will slaughter, freeze and ship by air 2,000 head of cattle to Jakarta, more than double its current output.

Currently there is little pressure to sell to new markets. MPR and its competition are unable to satisfy the demand for meat in Jakarta. Nonetheless, once they become fully operational, MPR expects to begin selling to Kalimantan and Irian Jaya and hopes to export to Brunei.

Since it will have a modern, efficient cold storage facility, MPR is considering diversifying into other food products within a few years. The most likely such products are shrimp and fish which South Sulawesi has in abundance.

Approximately thirty people will be hired to run the new facility in five months when it is finished. The decrease in employment at MPR over the past year was due to a decline in part-time employees when MPR stopped renting the local slaughterhouse and cold storage facilities. The decrease will be more than compensated for by the new hires.

MPR expects to beat its competition by having modern facilities and by fattening cattle before slaughtering. The two firms currently operating slaughterhouse and cold storage facilities suffer from high overhead due to their excess capacity. These facilities are too large relative to current cattle production in South Sulawesi. MPR's smaller facilities will be appropriate for the current market size and will be able to grow as needed. Furthermore, fattening the cattle is a cost effective means for MPR to produce more and higher quality meat at a lower cost than the competition.

MPR will also work with the veterinary school at the local university. The university will provide technical assistance while MPR will provide animals for research and a fully equipped laboratory. MPR expects a symbiotic relationship will develop where the university will benefit from the access to modern laboratory facilities and MPR will benefit from the research of the students and professors.

Appendix 1. Study Team Members

Robert Gandre, Financial Markets Specialist

John Gardner, Banking and Finance Specialist

Allen Eisendrath, Business Specialist/Institutional Analyst

APPENDIX 2

BANK NIAGA SUB-BORROWER PORTFOLIO

SUBBORROWER	ORIGINAL LOAN	INTEREST RATE	MONTHLY SALES	NET INCOME	TOTAL ASSETS	EMPLOYEES
Budi Cahyono	$60,640	24.00	$45,382	$57,706	$512,353	40
Loekito Koesoemo	211,993	22.00	87,255	283,529	596,471	165
Eddy Santoso	84,797	22.00	13,627	0	352,824	18
Agung Widjojonyoto	84,797	22.00	13,324	61,176	599,882	80
H. Soeratman	169,594	22.00	14,020	0	2,161,765	25
Bambang Soejanto	169,594	22.00	11,059	0	5,294,118	60
Habib Widjaja	60,569	25.20	8,652	89,412	665,706	180
CV Waringin	75,712	25.20	6,745	67,176	470,529	40
Hendro S. Putra	121,729	22.80	12,451	22,941	472,556	50
drh. Yenny S.	39,370	22.00	105,882	61,262	452,397	50
Sadijono H.	115,713	22.00	24,510	0	0	27
Charles Pacardy	47,544	variable	49,020	147,059	735,294	40
Yanto Congkono	44,997	variable	8,824	88,235	1,000,000	75
Freddy W.	48,817	variable	9,804	58,824	294,118	15
Erlanggwang W.	31,837	variable	8,088	12,941	500,000	15
Tan Han Kiong	31,837	variable	9,804	58,824	705,882	30
Sunandar W.	32,899	variable	4,118	41,176	382,353	15
Rusmin Limoa	27,289	variable	6,127	58,824	588,235	15
Haryono	60,938	26.00	23,590	25,294	372,941	50
Jati Mesem	24,184	26.00	7,255	38,000	669,647	325
Mirota Nayan	60,459	23.00	194,590	67,659	1,028,222	160
Sutjipto J.A.	181,269	22.25	30,461	56,471	0	78
Yong Wie Leng	90,634	24.00	11,471	74,118	108,647	52
RSB. Budi Jaya	300,120	22.00	7,549	18,529	152,237	45
Yayasan LPI	300,120	23.00	33,618	188,941	590,118	90
PT Mangku J. Abadi	150,060	23.00	29,157	246,118	2,332,353	120
Soemarsono S.	126,888	24.00	1,176,471	247,059	438,235	15
CURRENT LOANS TOTA	2,754,402					1,875

63

APPENDIX 3: Data On Sub-borrowers Visited

SUBBORROWER	ORIGINAL LOAN	MONTHLY SALES (PRE Records)	MONTHLY SALE (Corp.Record	YEARLY NET INCOME	TOTAL ASSETS	INITIAL EMPLOYMENT	FINAL EMPLOYMENT	EMPLOYMENT GAIN	TOTAL WOMEN EMPLOYEES	NEW/OLD CLIENT	COMMENTS
Budi Cahyono P.	$60,640	$36,089	$45,382	$57,706	$512,353	30	40	10	2	Old	
Loekito Koesoemo	211,993	87,255	236,471	283,529	596,471	50	165	115	165	New	Graduated/1st loan
Agung Widjojonyoto	84,797	13,324	13,529	61,176	2,161,765	20	80	60	9	New	
Bembang Soejanto	169,594	11,059	6,666,667		5,294,118	60	60	0	60	New	Graduated
Sadijono Hardjokusumo	115,713	24,510	984,631		7,521,238	22	27	5	6	Old	
Haryono	60,938	23,590	24,510	25,294	372,941	48	50	2	0	New	
Soetjipto Yoe Angga	181,269	30,459	29,512	56,471		78	78	0	15	New	
Yong Wie Leng	90,634	11,471	35,294	74,118	108,647	15	52	37	2	New	
Budhi Jaya	300,120	7,593	7,593	18,529	152,237	27	45	18	25	New	
Yayasan Lembanga Pend. In	300,120	15,745	15,745	188,941	590,118	84	90	6	13	New	
PT Mangku Jaya Abadi	150,060	291,225	291,265	246,118	2,332,353	115	120	5	66	New	
Soemarsono Salim	126,888	1,176,471	411,765	247,059	438,235	15	15	0	3	Old	Transfer
SAMPLE TOTALS	$1,852,766	$1,728,791	$8,762,364			564	822	258	366	New	
SAMPLE AVERAGE	$154,397	$730,189	$144,066								

APPENDIX 4: DESCRIPTION OF THE LOAN SET-OFF MECHANISM

Excerpted from the Bureau for Private Enterprise, Private Sector Revolving Fund Annual Report, December 1985.

Loan Set Off Structure

Background. The Loan Set Off structure, developed by the Bureau for Private Enterprise in FY 85, represents a variation of the earlier mechanism and one by which AID can establish a letter of credit facility with a U.S. bank for the benefit of a financial institution in an AID-recipient country. Under this structure, AID enters into a loan agreement with the U.S. bank under which the U.S. bank agrees to issue or confirm letters of credit in an aggregate amount up to the outstanding principal balance of the AID loan.

AID, in this instance, is the customer or account party under the letters of credit, and the loan agreement constitutes the letter of credit application. Typically, the letter of credit application will include an undertaking by the account party to reimburse the issuer for any amounts paid out under the letters of credit. The loan agreement under the Loan Set Off structure limits the U.S. bank's right to reimbursement to the right to set off amounts paid under the letter of credit against the U.S. bank's principal repayment obligation under the AID loan.

Structure. The letter of credit facility thus established operates in the same manner as the facilities established by the Collateral Account structure developed by PRE during FY 84. Standbv letters of credit issued by the U.S. bank can guaranty a portion of local currency loans by a host country bank ("Local Lending Bank") to an identified class of subborrowers such as small agribusinesses or nontraditional exporters. Such letters of credit can also guaranty some or all of loans to the local lending bank by local investors (as through a public bond offering) for on-lending to the qualifying subborrower group.

69

Under the Loan Set Off arrangement, AID shares in the credit risk of the subloans with the local lending institution but has no recourse to the local lending bank for the AID portion of the credit risk in the event subloan defaults lead to letter of credit claims. The documents which the local lending bank must present to obtain payment under the letter of credit include an "Assignment and Certificate" under which the local lending bank (1) certifies the occurrence of the default and the collection efforts it has made for recovery, and (2) assigns to AID a percentage of its rights against the defaulting subborrower equal to the percentage of the subloan that was guarantied by the letter of credit. The assignment and certificate will generally also include the local lending bank's promise to continue reasonable collection efforts on the defaulted subloan and to remit to AID a portion of the recoveries that corresponds to the portion of the subloan assigned to AID. If further collection efforts yield no further recoveries, the local lending bank has no obligation to pay AID, and the defaulted subloan will result in a principal loss under the loan.

Under the latter arrangement in which the standby letters of credit guaranty borrowings by the local lending bank, AID does have full recourse to the local bank in the event of a claim against the letter of credit. Defaults under subloans will not result in claims on letters of credit until such defaults actually cause the insolvency of the local lending bank.

A third use of the letter of credit facility is to induce a U.S. bank, usually the same bank that is the borrower

66

under the AID loan, to confirm commercial or trade letters of credit issued by the local lending bank at the request of customers belonging to the designated class of eligible subborrowers. The beneficiaries of such trade credits will typically be U.S. exporters of products needed by the eligible subborrowers, e.g., farm equipment or production inputs for small agribusinesses. Amounts paid to the beneficiary-exporter by the U.S. bank can be set off against the AID loan principal, as with the standby letters of credit, if the local lending bank has not reimbursed the U.S. confirming bank within an agreed time period.

Comparative Advantages of the Collateral Account vs. the Loan Set Off Structure. The differences between the Collateral Account and Loan Set Off structure lie not in the nature of the letter of credit facility but in the mechanism for setting it up. The Loan Set Off structure has several important advantages over the Collateral Account structure. Most importantly, there are countries in which banks have offshore borrowing limits such as Indonesia. The Collateral Account structure requires the local lending bank to enter a loan agreement under which it is the direct borrower of U.S. dollars. PRE's experience, at least in Indonesia, was that many banks were not willing to use a substantial portion of their offshore borrowing limits in a loan facility that does not permit the banks freely to utilize the U.S. dollars borrowed. Under the Loan Set Off structure, when used to guaranty subloans directly, the local lending bank is beneficiary of a standby letter of credit facility and has no obligation to repay U.S. dollars except to the extent of remitting to AID a portion of the recoveries on defaulted subloans.

The Loan Set Off structure is also somewhat simpler from a legal point of view. There is no account owned by a host country bank which creditors of the bank might seek to attach. AID need not concern itself with taking a security interest in a somewhat unorthodox bank account with the attendant perfection and choice of law questions.

Finally, the Loan Set Off structure permits the establishment of a letter of credit facility with perfect liquidity. The U.S. bank under the Collateral Account structure is concerned with having to pay claims at a time when the U.S. government securities have not reached maturity and must be sold at a discount if the bank wants immediate reimbursement.

The Collateral Account structure does, however, have certain advantages of its own. If properly established, there is a good chance that AID need not take the risk of a possible U.S. bank insolvency. AID's recourse is to a segregated identifiable account which might not be treated as an asset of the U.S. bank in an insolvency proceeding. This same assurance could be obtained with the Loan Set Off structure if AID insisted that the U.S. bank secure its loan obligations by a pledge of U.S. government securities in a segregated account. Such a pledge, however, is likely to reduce the interest rate the U.S. bank is willing to pay.

It is not possible at this time to reach a firm conclusion on which structure produces the highest yield for AID. To date, the Collateral Account investments have been limited almost exclusively to U.S. Treasury Bills or Notes, and the U.S. bank has generally deducted a small management fee from the earnings. The interest rates proposed by the U.S. banks in PRE's FY 1985 projects for the Loan Set Off structure were generally higher than the 180-day Treasury Bill rate and did not include any management fee. PRE now has sample documentation for both versions and will utilize both for at least another year to see how each operates in practice. U.S. banks have shown considerable interest in each structure.

PRE has long sought to cofinance projects with private U.S. banks. Both loan structures afford PRE a potential to induce cofinancing through the U.S. bank's fractional sharing of credit risk. U.S. banks are very unlikely to share subloan credit risk, however, and the manner in which local lending bank credit is shared requires careful thought at the project design stage.

Appendix 5. Review of Indonesia's Economy and Financial Markets

Indonesia's oil revenues and agricultural export earnings substantially declined in 1982 and GDP growth slowed dramatically. Faced with a tight balance of payments situation, declining official reserves, and erosion of budgetary surpluses, the government implemented major austerity measures and financial reforms, including a 28% devaluation of the rupiah against the U.S. dollar in March 1983. Then, in June 1983 the government passed an ambitious package of financial reform measures.

The 1983 financial sector reforms focused on these objectives: (1) reduce dependence of the banking system on Bank Indonesia liquidity credits; (2) stimulate private financial savings and encourage offshore capital inflows; and (3) improve state-owned bank performance through increased competition with the smaller private sector banks. Banking institutions were allowed to set their own deposit rates (except for certain savings programs) and lending rates, credit ceilings were abolished for all banks, and the number of programs qualifying for new Bank Indonesia liquidity credits was reduced.

Following the 1983 reforms, gross assets of the organized financial sector tripled over the five-year period 1982-87, averaging 23% growth per annum in nominal terms. Financial savings grew vigorously in response to high real interest rates offered by all banks. In particular, growth in rupiah time deposits over that period averaged 40% annually, substantially expanding the lending capacity of financial institutions. Intense bank competition for funds, however, has sparked high nominal interest rates, with time deposit rates rising from 15.5 to 20% for short-term deposits. Private banks, given their smaller capital size and lack of access to the

, 10

huge deposits of state-owned corporations, pay from 1-2.5% more for their deposits than state banks.

High real interest rates are needed to attract private savings and to provide support for the rupiah under Indonesia's free foreign exchange regime. High real rates discourage capital flight and encourage foreign currency inflows. In addition, intermediation charges at Indonesian banks are among the highest in Asia and contribute significantly to a high real interest rate lending structure.

The 3-month time deposit rate now averages about 18%, while inflation is pegged at 9%. The real interest rate is, therefore, about 9%. High real interest rates and large bank spreads, averaging 6-8% on loans, have produced nominal lending rates ranging from 21-26%. These rates are a serious financial burden for Indonesian companies. They also promote investments that offer quick financial paybacks.

B. Institutional Framework

Indonesia's financial system consists of Bank Indonesia, 5 large state-owned commercial banks, 10 privately owned foreign exchange commercial banks, 57 private non-foreign exchange commercial banks, 11 foreign commercial banks, 28 development banks, 3 savings banks, 14 joint venture merchant banks, 83 leasing companies, 100 insurance companies, some 5,563 rural credit banks, 480 pawnshops, and 26,179 rural cooperatives. There is also a small capital market consisting of a stock market with 24 listed companies and a bond market in which 6 companies have issued corporate bonds.

The Indonesian financial system, despite reforms since 1983, still remains at a relatively early stage of development. A prominent feature of the financial structure is extensive government ownership of financial institutions. In addition to Bank Indonesia, five state-owned commercial banks dominate Indonesia's financial sector, in part because they receive deposits from state enterprises and have easy access to Bank Indonesia's refinancing facilities. The dominance of government financial institutions over private institutions is clearly revealed in their asset holdings. Government institutional assets at year-end 1986 comprised more than 82% of financial sector assets, down marginally from 87% of assets in 1982.

In general, access to banking facilities in Indonesia outside urban areas is limited, the banking system lacks medium and long-term finance, and the capital market is in its infancy. The Indonesian Government, in its latest effort to continue financial markets deregulation, announced a series of measures on October 28, 1988, to increase private sector funds mobilization, improve banking efficiency, and create a better environment for development of capital markets.

Bank Indonesia

BI plays a particularly important role in Indonesia's financial system. It is responsible for currency issue, government banking, liquidity management and monetary policy implementation, and is the chief regulatory agency and lender of last resort. To promote economic development, it has provided loans directly for major investments by state-owned enterprises (SOEs) and indirectly to priority sectors through liquidity credits for on-lending by commercial banks. Bank Indonesia has been the principal source of medium and long-term funding for SMSE credit programs. Though the 1983 financial reforms reduced the number of BI liquidity credit programs, and growth of new liquidity credits has slowed since then, at year-end 1987 these credits were still 30% of total

78

outstanding credits to private and public enterprises. This is a decline of only .2% since March 1983. Direct BI credits accounted for another 4% of system outstandings in 1987. Out of total organized financial sector assets of Rp 88 trillion ($51.5 billion), BI accounted for 33.3% of assets, or Rp 29.3 trillion ($17.1 billion).

Prior to the 1983 reforms, BI set the deposit and lending rates of state banks. After permitting all banks to determine their own rates for most loans and deposits, BI introduced money market instruments (SBI, or Bank Indonesia certificates, in 1984; and SBPU, or bank money market securities, in 1985) and rediscount windows to assist it in managing the banking system's liquidity. These instruments carried a maximum maturity of 90 days. By regulating the volume and discount rates of SBI and SBPU securities, and by placing a ceiling on inter-bank borrowings, BI has been able to influence interest rate levels on interbank call money. The critical need to stem capital outflows also prompted BI to raise SBI yields to a maximum 15.5% from 13% in February and March 1988. This was followed by increases in commercial bank time deposit rates.

The October 1988 reforms supported growth of the money market, extended maximum SBI and SBPU maturities to six months, abolished the restrictive ceiling on interbank loans, and established more frequent auctions for these securities. These actions should increase the volume of securities in the market. Bank Indonesia, however, still does not issue medium or long-term securities, and this deprives the market of an effective floor for establishing term interest rate levels.

13

Commercial Banks

Commercial banks dominate the financial system, holding total assets of Rp 47.2 trillion ($27.6 billion), or 54% of total system assets. Although there are 83 commercial banks, the five large state banks at year-end 1986 accounted for 69% of deposits, 76% of loans, and 78% of total bank assets. The second largest group, the ten private foreign exchange banks, accounted for 14% of deposits, 10% of loans, and 10% of total assets. The 57 non-foreign exchange private banks held 12% of deposits, 9% of loans, and 6% of total assets. Lastly, the 11 foreign and joint venture banks accounted for only 5% of deposits, 4% of loans, and 6% of total assets.

The five state banks are full service banks which provide foreign currency accounts. They are expected to lend primarily to assigned economic sectors, but in practice lend to a wide range of sectors. Given their extensive branch networks, they are the major channels for official development credit. Bank Rakyat Indonesia (BRI), the largest state bank, has been the main source of SMSE term finance.

The ten private foreign exchange banks also are full service banks and are much larger than non-foreign exchange banks. Their average net worth was Rp 35.7 billion ($27.9 million) and average asset size Rp 525 billion ($307 million) in 1986. In contrast, the non-foreign exchange banks, unable to engage in foreign currency activities, had net worth averaging less than Rp 6.4 billion ($3.75 million) and average assets of only Rp 59 billion ($34.4 million). Many of these 57 banks exist to finance the non-bank operations of their family owners, and contribute little to competition for credit in the financial system. Before the latest banking reforms, foreign banks were restricted to operating in

Jakarta, though banks often serviced clients located outside Jakarta through their overseas offices.

Bank Deposits

Commercial banks obtain funding by accepting demand, savings and time deposits and through borrowing. Aggregate BI statistics on system deposits reflect deposits held not only by commercial banks, but also deposits of savings and development banks. As of March 1987, total deposits were Rp 24.06 trillion ($14.07 billion), with 31% demand, 7% savings, and 62% time deposits. Since the 1983 reforms, demand deposits have dropped from a high of 60% of total deposits. Demand deposits cannot compete with time deposits because the latter provide the highest rates of interest. Savings deposits on most accounts have interest rates set under various government schemes, and have languished at between 4.7-6.6% of deposits since 1982.

May 1988 figures on rupiah time deposits held at state commercial banks, which hold about 65% of total system time deposits, reveal that Indonesian savers place on average 90% of time deposits for terms of one year or less. The trend over the prior two years was toward a shorter time deposit maturity structure, with one year deposits declining from 57% to 41% of the total, and six month deposits declining from 14% to 9% of total time deposits. One and three month deposits have risen from 20% in 1986 to 36% of total rupiah time deposits in May 1988. Foreign currency time deposits held in Indonesian banks, which account for about 25% of all time deposits, are even more skewed towards the short-term, with 75% of deposits held in one and three month maturities.

/15

The steady trend toward shorter deposit maturities reflects the negative psychological impact on savers of three major rupiah devaluations over the past decade. The latest devaluation of 31% against the U.S. dollar occurred in September 1986. Given continuing weak world oil prices, domestic savers are placing their funds in short-term investments to provide greater liquidity for moving funds quickly into stronger currencies in case another rupiah devaluation is expected. Informed estimates are that Indonesians already hold as much as $10 billion in financial assets outside Indonesia.

Bank Credit

Commercial banks are the primary providers of credit. Lending is mainly short-term and includes trade finance and working capital loans. Banks also undertake limited medium and long-term lending, either through BI refinancing schemes or indirectly through rollover of working capital loans or overdraft facilities. In April 1987, BI expanded bank overdraft facilities for clients to 15% of a client's loans or deposits, and extend overdraft duration from 7 to 15 days. Overdrafts and working capital loans often are transformed into longer maturity loans used by companies to finance acquisition of fixed assets.

Statistics on the maturity structure of banking credits are unsatisfactory as they misclassify short-term credits carried for more than 12 months as long-term credits. Rollover of short-term credits meets part of the demand for investment funds. Even by the flawed statistics, however, loans of maturity beyond 12 months have declined from over 41% of total rupiah credits in 1983 to less than 40% in 1987. Banks are reluctant to make term loans due to a variety of factors, including the mismatch of short-term liabilities with term assets, interest rate

16

volatility, inadequate credit and project appraisal capabilities, poor mechanisms for loan recovery (including an inadequately developed legal system and commercial codes), and inability to value and collect against collateral.

Indonesia's banking system has low liquidity, as is evident from year-end 1986 results showing state banks having an average 160% loan to deposit ratio, private foreign exchange banks at a 107% ratio, and private non-foreign exchange banks with an average 113% ratio. The state banks have been funding asset growth largely by borrowing from Bank Indonesia and from overseas banks. Private banks borrow less extensively than state banks, but when they do, they borrow from the money market or, in the case of foreign exchange banks, from overseas lenders. The recent reform package, which reduced reserve requirements from 15% to 2% of deposits, is intended to inject more liquidity into the banking system.

Commercial banks are conservative in their lending practices, though less so when on-lending BI liquidity credits. Banks usually lend against collateral, not cash flow, and often require collateral in excess of 150-200% of loan value. The state banks have the weakest loan portfolios, owing to poor credit practices used for lending under liquidity credits. Most liquidity credits are 70% guaranteed by Askrindo, the Indonesian Credit Guarantee Corporation. BRI, for example, which provides loans to SMSEs under BI's KMKP and KIK liquidity credit facilities, has loan arrears under these programs of around 35%. Surveys have shown that 40% of delinquent borrowers view these credits as grants and have no intention of repaying them.

11

Development Financial Institutions

Indonesia has 28 development banks, including 1 state bank (Bapindo), 26 regional government banks, and 1 private bank. It also has 3 savings banks, consisting of 1 state bank (Bank Tabungan Negara or BTN) and 2 private banks. State banks dominate this sector. While development banks have the most expertise in medium to long-term advances, their role as long-term lenders has been limited.

Bapindo holds some 60% of development bank assets, yet is constrained by lack of funds and a 10% loan arrears rate. The regional banks are small in terms of capital and assets. They provide commercial services and treasury-type functions to regional governments, and are poorly trained for term lending beyond KIK/KMKP and other government-sponsored credit programs. Development banks hold Rp 3.1 trillion ($1.8 billion) in assets; this is 3.6% of financial sector assets. Savings banks have Rp 1.6 trillion ($935 million) in assets, accounting for only 1.8% of system assets.

Non-Bank Financial Institutions

First established in 1972, Indonesia's 14 joint venture merchant banks have been formed between foreign banks and Indonesian local partners. These merchant banks issue and underwrite securities, buy equity in companies, and make short and medium-term loans largely to multinational and joint venture companies. They hold Rp 2 trillion ($1.2 billion) in assets, but account for only 2.3% of system assets. Designed to support the development of money and capital markets, the continued weakness of these markets limits merchant bank growth.

Indonesia has some 100 life, social, and indemnity insurance and reinsurance companies. Funds mobilized by insurance companies are conservatively invested, mainly in time deposits and short-term securities. At year-end 1986, insurance company gross assets totaled Rp 3 trillion ($1.75 billion), accounting for about 3.4% of system assets. A few large state-owned companies hold more than half of sector assets.

Indonesia's 83 leasing companies are almost all in the private sector and mainly act as finance companies by providing capital goods on a rental basis. Lease financing has shown rapid growth from a low base, reaching roughly Rp 1.4 trillion ($820 million) in gross assets in 1986, and accounting for 1.6% of system assets.

Rural Banks

BRI supervises and finances the 5,563 rural banks that hold only a small fraction of financial system assets. Non-bank finance is provided by 480 state-owned pawnshops and some 26,179 village cooperative societies. In aggregate, these institutions account for Rp 400 billion ($250 million) in assets, only 0.5% of total system assets. They provide only short-term liquidity, not capital, and require very high collateral. Most rural people depend heavily on sources of informal credit, such as traditional Chinese moneylenders. Interest rates are much higher than for subsidized loan programs, but borrowing is more convenient.

Capital Markets

The capital markets include the portion of the financial system that provides medium and long-term funds for creating fixed productive assets. Indonesia, once largely reliant on oil revenues for investment funds, has since the 1983 banking reforms raised part of its investment capital from domestic savings through the banking system. Most investment capital,

14

however, still comes from subsidized loans to priority economic sectors. Consequently, most large companies depend excessively on debt financing.

In 1977, Indonesia began a capital market development program including: a) opening the Stock Exchange that was closed in 1958 after nationalization of Dutch companies; b) establishing the Capital Market Executive Agency, Bapepam, to regulate the market and operate the Exchange; and c) establishing the state investment company and unit trust, Danareksa, which acts as an underwriter and can purchase up to 50% of any public offering. Tax incentives were provided for companies to sell shares to the public and for individuals to purchase shares.

Results of this program were limited and the securities market remains in an infancy stage. Only 24 companies have issued shares to the public, 18 of which were foreign joint venture companies required to sell shares to Indonesians. These firms have not viewed the market as a source of funds or as a means of enhancing company value. Further, Danareksa's control over 40% of the market's shares for use in its unit trusts also inhibits attempts to develop secondary market trading. Secondary market trading peaked at 20,000 shares per day in 1982 and currently ranges from 7,000 to 15,000 shares daily. The total capitalization of the 24 listed companies as of October 1988 was only Rp 183.3 billion ($108 million).

Only a half dozen, mainly government, institutions have issued bonds on the exchange with a total nominal value of Rp 750 billion ($440 million). Recent public bond issues offering coupon interest of around 18% p.a. sold poorly, with underwriters forced to hold many bonds. Investor preference for the shorter maturities and similar or higher rates offered by time deposits hurt bond sales. Nonetheless, bonds have played a more significant role than shares given their higher yields averaging

16-18%. The stock market offered dividends in 1987 of 13-14%, but no capital gains due to poor market performance. In fact, the stock market is dividend-driven and has little opportunity for capital gains because of Danareksa's mandate to enforce market price stability and prevent "speculation."

Both stock and bond yields have under-performed bank time deposits since 1983. This is largely owing to the 15% tax on dividends, capital gains and bond interest while a similar tax on bank deposits was indefinitely postponed. The recent banking reform package removed this tax discrimination against the securities markets by implementing the 15% tax on bank deposits effective November 14, 1988. While this new tax creates a more level playing field for the securities markets, there is concern that investors may move now to lower-yielding time deposit funds overseas. It remains to be seen whether banks will raise their deposit rates to prevent possible new capital flight.

Bank Deregulation and SMSE Lending

The October 28, 1988, banking deregulation measures are aimed at increasing private savings mobilization, attracting offshore funds, increasing competition within the banking industry, and providing new incentives for capital markets development. Bank Indonesia is also implementing a long-term policy of reducing all credit subsidies over time to market rates. Bankers expect that the big gainers from these reforms will be the stronger domestic private banks, such as Bank Central Asia and Bank Niaga, whose asset growth before the reforms already outstripped that of the state banks. Private banks will compete to pick up part of the 50% of total deposits, or roughly Rp 5 trillion ($2.9 billion), that state corporations are now permitted to shift from state to private banks.

81

To encourage competition, the government has eased restrictions on foreign bank operations, reopened the industry to new banks, given more freedom to banks to open branches in small towns and villages, and liberalized procedures for creating new rural banks. It is hoped that increased competition will help reduce the high cost of loan funds. Implementation of the tax on bank time deposits, as well as government easing of the stock exchange's corporate listing requirements, removal of some restrictions on foreign ownership of shares, and permission for opening a privately run over-the-counter market for SMSEs are all measures designed to promote the stock exchange and reinvigorate the capital markets.

Even with the banking reforms, SMSEs will continue to rely on government subsidized loan programs (currently offering 12% p.a. loans) for funds in the foreseeable future. Both state and private banks provide little additional credit to SMSEs beyond the loan subsidy programs, and they provide little incentive to branch managers to make loans to new SMSE borrowers. The risks to private banks of lending their own funds to SMSEs biases them against financing SMSEs. These risks are related to difficulties in obtaining secure collateral and high default rates among these borrowers. Further deterring bank lending are high administrative costs associated with small loans, particularly for new businesses in rural areas.

<u>Unavailability of credit and excessive collateral required outside urban areas are major bottlenecks constraining economic growth outside of Jakarta.</u> Further, dependence of commercial banks on short-term deposits and their resulting preference for short-term, or working capital lending, exacerbate the difficulties of SMSEs hoping to obtain credit for capital

investments. <u>The SMSE sector will continue to be underfinanced until either increased competitive pressure or government regulation compels Indonesian financial institutions to compete more actively for small enterprise borrowers.</u>