Strengthening BPRS' Role for SMES in Indonesia

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Abstract

Islamic Rural Bank (BPRS/Bank Pembiayaan Rakyat Syariah) as part of banking ecosystem in Indonesia has niche characteristics and market segmentation in playing their role as financial intermediary. This study aims to explore the existing role of BPRS for Small and Medium Enterprises (SMEs), especially in new normal era. This study conducts three in depth interviews with practitioners in the sector and thematically analysed. Furthermore, Systematic Literature Review (SLR) regarding to community banks across countries, especially in the developed countries are thematically analysed to identify area for improvement for BPRS according to priority as stated in roadmap issued by The Financial Services Authority (OJK/Otoritas Jasa Keuangan). This study elaborates alternate sources of funds, inclusiveness of access, usage of technology, market segmentation and risk management and they are proposed for Indonesian context to scale up the intermediary roles of BPRS for SMEs. This study provides lesson learned from two BPRS in Indonesia. In addition, main takeaways from community/rural bank practices across countries have been provided.

Keywords: BPRS; SMEs; Community/Rural Bank

JEL: G21, L0

1. Introduction

Small and Medium Enterprises (SMEs) are believed to be the driving force of economic growth. SMEs are the main element in the process of economic renewal that promote innovation and rapidly respond to all forms of change (Durrani & Boocock, 2006). SMEs are business activities which can create new jobs and provide economic services to the community. Not only contributing to the process of economic equality through increasing people's income, SMEs also encourage economic growth and contribute to national stability (Hastuti, 2020).

SMEs term has various meanings because it is influenced by several factors such as geographical location, level of progress and business culture, and the country where the SMEs is located. The meaning of SMEs itself is often associated with national programs and regulations so that the understanding of SMEs is determined by various criteria including the number of workers, asset size, annual sales, annual production, and so on (Elasrag, 2016).

In Indonesia, the definition of SMEs can be found in Law (UU/Undang-Undang) Number 20 of 2008 Article 1: 1) micro business is a productive business owned by individuals who meet the criteria for micro business in this Law; 2) small business is an independent economic activity conducted by an individual or business entity which is not a branch or substitute for a company owned, under control or part of a medium-sized business or large business; 3) medium-sized business are independent productive economic activities which are run by individuals or business entities which are not substitutes for or branches of companies that are owned, controlled of part of large companies(UU, 2008).

SMEs have proven their potential and strategic role in strengthening the national economy. These strategic roles include: 1) involving many people from various sectors, especially those directly related to daily economic activities; 2) absorption of many workers, especially in the condition of increasing of investment; and 3) the use of local raw materials and the production of goods and services at affordable prices (Durrani & Boocock, 2006). It means, SMEs contribute in: 1) providing and maintaining economic balance and social progress; 2) reduce the unemployment rate and create new job opportunities; and 3) effectively coming along with changes in market conditions (Elasrag, 2016).

The strategic role and significance of SMEs to the socio-economic are not completely supported by mechanism and networks which can facilitate the growth of these SMEs. Among the challenges faced by SMEs are: 1) limited access to capital; 2) high transaction fees; 3) human resource constraints; 4) legal and regulatory constraints; 5) limited access to technology; and 6) market access constraints (Elasrag, 2016); (Durrani & Boocock, 2006). The global challenges as well as the main challenge faced by SMEs is access to capital. This constraint needs to be observed by various related regulatory agencies and functions through innovative and diverse financing products. One form that might be used is to identify the strengths and potentials of participatory financing in Islamic finance (Elasrag, 2016).

Community/rural bank is an institution which contributes to the growth and development of SMEs. Ghana is one example of such a significant impact. The bank conducts supervision and assistance for its customer's business. In addition, bank also run educational programs for customers to help them understand how loan facilities work and to reduce defaults (Ackah et al., 2014). Rural Community Bank (RCB) is one of the community banks involved in rural infrastructure development in Ghana (Owusu-Frimpong, 2008). RCB works with non-governmental organizations to identify, mobilize, and educate village community groups about the use and benefits of banking services. One of RCB's financial services is the savings of farmer groups used to increase investment in rice productivity through increased labour and the use of fertilizers (Vukey et al., 2022).

Meanwhile in Indonesia, one source of funding or capital for SMEs is Islamic Rural Bank (BPRS). According to Law (UU) Number 21, year 2008 concerning Islamic Banking, BPRS is an Islamic bank which does not provide payment activity services in its operations (HAM, 2008). Having the status of rural bank, BPRS operates in rural areas which are the basis of SMEs in Indonesia (Syauqi Beik et al., 2009). The main customers of BPRS in Indonesia are SMEs. Thus, the role of BPRS is important considering that SMEs contributed to 61.97% of the Gross Domestic Product (GDP) in 2018, or around 64.2 million institutions (Rifa'i, 2017).

Apart from being a support for capital, BPRS has a role for SMEs in terms of integrated development and cooperation. The development provided is in the form of supervision and financing in the context of providing production facilities. Meanwhile, integrated cooperation is stated in a memorandum of understanding between BPRS and SMEs. The purpose of the memorandum of understanding is to enhance business continuity; enhancing networking and mutually beneficial cooperation between small and large business; and assist BPRS in increasing the financing for small business in a safer and more efficient way (Ilham & Yati, 2015).

In encouraging the contribution of banking sector to the development of SMEs in Indonesia, Central Bank of Indonesia (*BI/Bank Indonesia*) has issued Bank Indonesia Regulation Number 23/13/PBI/2021 concerning the Macroprudential Inclusive Financing Ratio (*RPIM/Rasio Pembiayaan Inklusif Makroprudensial*) for Conventional Commercial Banks (*Bank Umum Konvensional*), Islamic Commercial Banks (*BUS/ Bank Umum Syariah*), and Islamic Business Units (*UUS/ Unit Usaha Syariah*). This regulation requires bank to allocate a minimum of 20% of financing for the SMEs sector since 2022. According to the regulation access to inclusive financing can be done through Rural Bank (*BPR/Bank Perkreditan Rakyat*) and Islamic Rural Bank (*BPRS*).

In practice, BPRS characteristically performs the intermediary function towards Islamic Banks, either in the form of Islamic Commercial Bank (*BUS/Bank Umum Syariah*) or Islamic Business Units (*UUS/Unit Usaha Syariah*). This can be seen, from the provisions stipulated by the financial authorities. From the business process, when established, BPRS are required to place authorized capital in the form of deposits at BUS or UUS (3/POJK.03/2016). BPRS also have special characteristics that ideally can improve financial inclusion given the niche market segmentation and intensive communication approach to customers and prospective customers.

Based on several studies, the intermediary role of BPR and BPRS is not efficient. To increase the efficiency of the intermediary role, BPR and BPRS must increase their capital. Apart from the capital factor, the efficiency of BPR and BPRS is also influenced by: 1) the location of the whereas the BPR and BPRS located in urban areas are more efficient than those in rural areas because of the supporting infrastructure. In term of efficiency, BPRS are more efficient than BPR (Wasiaturrahma et al., 2020a); 2) economic freedom; 3) government spending; and 4) freedom of investment. Based on these factors, to increase the efficiency of BPRS, government policies which support financial sector freedom and reform are needed (Masrizal et al., 2022).

BPRS face problems related to competition that needs to be faced with existing ecosystem (Anwar et al., 2021) and limited capital (Nurhasanah et al., 2020; Sukmana et al., 2018). Research is needed to identify potential innovations to be conducted to strengthen the role of BPRS in developing SMEs in Indonesia. BPRS have similar characteristics to rural or community bank in terms of location and activities coverage. Therefore, a Systematic Literature Review (SLR) was conducted to identify the good experiences and lessons that can be drawn from the practices of community/regional/rural banks across countries. This process complements in-depth interviews conducted with BPRS practitioners and technology service providers, in relation to the digitalization discourse that is being promoted by the regulator. Since previous studies discussed more about the performance and efficiency of BPRS in Indonesia, this research aims to fill in the research gap by **analyzing and identifying relevant innovations to strengthen the role of BPRS in the development of SMEs** in Indonesia.

Proposed research questions:

Q.1. How are the existing role of BPRS for Small Medium Enterprises (SMEs), especially in new normal era?
*Q.2.*What kind of innovations that are needed to strengthen the role of BPRS in the development of SMEs in Indonesia?

2. Method

This study uses a qualitative approach, through in-depth interviews and Systematic Literature Review (SLR). Interviews provide an opportunity to researchers to obtain information which is not contained in publications or written documents (Eriksson & Kovalainen, 2008). This study uses semi-structured interviews to obtain information relevant to the research scope (Gill et al., 2008).

Interviews were conducted in August 2022 with three informants. Two informants are directors of BPRS and one informant is a director of technology service provider for financial institutions. The two BPRS were chosen considering their innovations. BPRS A is an Islamic rural bank which is the initiator of program that has a collaboration with several institutions, including the local governments and offers interest-free financing program. Meanwhile, BPRS B is an Islamic rural bank which has obtained a permit as Islamic financial institution to collect cash waqf *(LKS PWU/Lembaga Keuangan Syariah Penerima Wakaf Uang)*.

SLR is conducted using keywords to get relevant articles (Jesson et al., 2011; Pesendorfer & Lehner, 2016; Xiao & Watson, 2019). This study used the keywords "rural bank" and "community bank" in the last 12 years (2011-2022) to obtain articles published in Scopus indexed journals as of September 9, 2022. These criteria were chosen to ensure the quality of the references used. Based on language and accessibility criteria, 45 articles were used and further analysed to obtain information related to their experiences and innovations.

Table of Articles Based on Aspects and Year of Publishing

Year	Sources of Funding	Inclusiveness	Risk Mitigation	Market Segmentation	Technology
2022	2	1	4	1	1
2021	5	2	0	0	0
2020	1	3	4	2	2
2019	2	0	1	0	0
2018	0	1	2	0	0
2017	1	0	0	1	1
2016	1	0	0	0	0
2015	0	0	1	0	0
2014	0	0	1	0	0
2013	1	1	0	1	0
2012	0	0	0	0	0
2011	0	1	1	0	0

Total	13	9	14	5	4

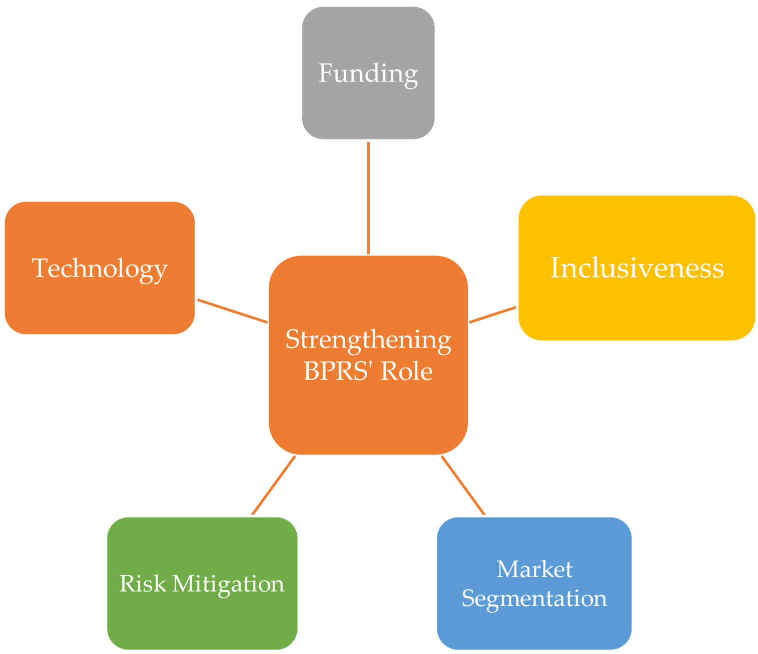
(Source: Author's analysis)

3. Results

BPRS in Indonesia have a significant role in the development of SMEs. However, it cannot be denied that BPRS are still experiencing a number of problems ranging from capital issues, default risk mitigation, market segmentation that still overlaps with BUS/ *Bank Umum Syariah* and UUS/ *Unit Usaha Syariah*, to the use of technology. During the new normal era, there are BPRS which made a number of innovations to solve the problems mentioned. Among the innovations are utilizing funds from local government and community waqf funds as capital; running a financing program without collateral and margin; using a saving facility to minimize the risk of default; having the risk management team which has negative relationship to financial risk.

Forty-five relevant articles are categorized based on the major themes discussed, including funding, inclusiveness, market segmentation, risk mitigation, and technology as illustrated below:

Areas for Strengthening BPRS' Role



3.1.Sources of Funding

SMEs loan growth is positively and significantly related to core deposit growth of community bank (Brewer et al., 2023).Almost all community banks in several countries have similar funding sources, namely owner's capital and deposits from third parties dominated by deposits (Fayman et al., 2022a). These sources of funding greatly influence the structure of the credit extended, capacity to handle risks, as well as bank profitability (Feng & Wang, 2021).

More capital will help community banks to be more resilient to shocks (Balla et al., 2019). The growth in the number of rural bank deposits will affect the growth of loans or credit which can be channelled to SMEs (Yang et al., 2021). Sources of fund in the form of interbank loans affect bank efficiency in terms of liquidity risk. In addition, the funding structure which is dominated by third party funds has an impact on bank profitability due to high costs charge from this type of funding (Zafrizal et al., 2021).

According to the SLR, it was found that community banks were the main sources of funding for certain communities, such as farmers, especially women, etc. The common funding structure is joint responsibility, so that everyone in the group is fully responsible for repaying loans and has the opportunity to receive loans to increase their agricultural productivity (Vukey et al., 2022b). This kind of funding structure is proven to be able to provide higher loans compared to funding structures which are dominated by deposits (Berger et al., 2014; Brewer et al., 2021). SBLF/ Small Business Lending Funding program is another funding structure adopted by community banks to increase small business lending (Amel & Mach, 2017).

In the case of Indonesia, sources of funding are the main problem BPRS regarding SMEs financing. Therefore, many BPRS prefer customers who have fixed income over low-income and non-permanent customers (Nurhasanah et al., 2020b), meanwhile some of BPR and BPRS relying its funding on non-traditional deposits (Moechdi et al., 2016). Based on Islamic Banking Statistics for December 2021, 68% of the financing disbursed by BPRS uses Murabaha contracts. This is an option for BPRS considering the risk aspect which is assumed to be lower (BPRS A and BPRS B). Liquidity mismatch is a condition faced by BPRS because basically the characteristics of Third Parties Fund (*DPK/Dana Pihak Ketiga*) are short term and more dynamic, whereas in profit sharing schemes, it requires a longer time.

Previous research identified that some BPRS used funds originating from BUS or UUS. This condition causes higher cost of funds and less competitive. Thus, other funding sources and/ or schemes are needed for BPRS. Among alternative sources of fund that can be considered by BPRS in Indonesia, namely:

a. Optimization of Regional Government (*Pemda/ Pemerintah Daerah*) and Community funds. This is made possible based on the Islamic Banking Law (UU/ Undang-Undang Perbankan Syariah) Number 21 of 2008 Article 9 which states that BPRS can be owned by Indonesian citizens and/ or Indonesian legal entities whose owners are all Indonesian citizens and/ or local governments. More than 90% of BPRS A shares are owned by the Regional Government, while 67% of BPRS B shares are owned by Community Organization (*Ormas/Organisasi Masyarakat*). In addition, to obtain new sources of funding, with the involvement of the Regional Government and Ormas, BPRS will benefit from the network owned by the Regional Government and Ormas to increase the DPK.
b. Waqf, especially cash waqf. BPRS B obtains an alternative source of funding by becoming an Islamic Financial Institution Recipient of Cash Waqf (LKS PWU). By becoming LKS PWU, BPRS can receive waqf funds to be managed by nazhir. Funds received and deposited increase the composition of DPK of BPRS.

3.2.Inclusiveness/Access to Finance

Access to capital for farmers provided by the Rural Community Banks has positive impact on the technical efficiency of small-scale farmers in Ghana (Missiame et al., 2021), though access of farmer to institutional credit is sometimes constrained by many conditions (Attipoe et al., 2020). However, overall, access to capital in Ghana, which should be able to reach 61% based on the level of public literacy regarding rural bank credit products, is only realized as much as 41% (Missiame et al., 2021). Meanwhile in the United States, after the recession, community banks were still able to provide 30% credit to SMEs compared to non-community banks (Nguyen & Barth, 2020). In India, rural bank expansion decreased poverty (Buliskeria & Baxa, 2022).

Access to funds or community banks inclusiveness is influenced by the bank's communication with customers and using information about customers to choose a loan structure which suits the needs and abilities of customers (Yan, 2011). Customer satisfaction towards inclusive lending practice can be predicted by demand aggregation advantage (Dadzie et al., 2013). In Indonesia, BPR and BPRS are still not efficient in conducting their intermediary role (Wasiaturrahma et al., 2020b). This can be seen from the limited access to loans for SMEs in the form of certain terms and conditions for borrowing customers. These terms and conditions are required to ensure that the customers able to return the loan in accordance with the agreement (Sigit Parawansa, 2018).

Meanwhile, based on the conducted interviews, it is known that BPRS A and BPRS B facilitate offline financing application. To increase public access, especially SMEs to BPRS in the new normal era, there is a BPRS program to facilitate financing up to certain nominal. BPRS A even runs a financing program without collateral and without margin using subsidized funds from the Regional Government (*Pemda*). BPRS requires alternative capital or sources of fund in order to be able to provide unconditional financing to customers, especially SMEs.

3.3.Market Segmentation

In China, rural banks aim to address three problems namely agriculture, farmers, and rural areas. In addition, the existence of rural banks is also intended to help SMEs in the region (Kang, 2013). In the United States, the profitability of small rural banks has declined in areas that have become large rural bank markets (Spurlin, 2022).

Meanwhile in Indonesia, BPRS develop their own market by utilizing religious emotional networks and approaches to public figures and leaders of Islamic Organization (Said et al., 2020). About 156 BPRS in Indonesia, grouped into three, namely group 1 as many as 128 BPRS consisting of banks with positive growth. Group 2 of 18 bank consists of banks with negative growth, especially in the last two years. Group 3 of 10 banks consisted of banks with negative growth in the initial observation period and turned to grow in the following periods (Sartono et al., 2017). Higher market concentration can help BPRS increase profitability (Widarjono, Mifrahi, et al., 2020).

The area which BPRS can reach is limited to certain province. However, in general, BPRS A and BPRS B feel competition from other types of banks which ideally have different market segments. In practice, the main target of BPRS is also the target market for BUS and UUS. It is illustrated that a number of sharia commercial banks also provide financing for SMEs with a plafond between IDR 1,000,000 – 100,000,000. The main segment of Islamic commercial banks financing is SMEs and the underprivileged who live and work in the area of the Islamic commercial bank network (Juwaini, 2020).

A new policy approach is needed to provide clarity in market segmentation for the financial services industry in Indonesia. For example, government assistance and programs for disbursing financing to SMEs should be collaborated with BPRS which characteristically have more intensive access and communication with customers. Currently, government support and programs are still distributed in collaboration with commercial banks. Based on the report of Regional Development Bank Association (*asbanda/ Asosiasi Bank Pembangunan Daerah*) from 2019, the 19 best performing banks in SMEs financing are commercial banks such as BRI, BNI, Bank Mega, Bank Mandiri Taspen, Bank Jateng, Bank Bukopin, Bank BCA Syariah and others. This success also was encouraging by the government through Bank Indonesia Regulation Number 17/12/PBI/2015 concerning Provision of Credit or Financing by Commercial Banks and Technical Assistance in the context of SMEs development.

3.4.Risk Mitigation

In some countries, community banks handle risks more quickly (Fayman et al., 2022b; Hassan et al., 2022). Several risk mitigation measures taken by rural banks include: first, in the United States, the 2017 tax cut regulations increased rural banks resilience to risk (Fang & Yeager, 2020). Second, rural banks respond to liquidity shocks by adjusting their balance sheets, by increasing loans once deposits are withdrawn (Allen et al., 2022; Kashian & Tao, 2014). Third, some rural banks make certain policies related to assets to protect banks from risks associated with choosing bad assets (Say et al., 2020). Fourth, increasing supervision and macro-prudential testing to mitigate systematic risks in the rural banking sector (Kress & Turk, 2019). Fifth, derivatives to reduce sensitivity of profitability to credit risk (Shen & Hartarska, 2018). Sixth, maintaining market power, total capital, financing and efficiency (Widarjono et al., 2022). Seventh, income diversification in order to reduce poor financing (Widarjono, Anto, et al., 2020). Eighth, financial incentives to increase lending for SMEs (Hughes et al., 2019). Ninth, use a loan quality rating system or credit score (Berger et al., 2011; Li & McMahan, 2015).

BPRS A uses a saving facility to minimize the risk of default. Technically, parties who receive financing are advised to open a saving account and spare their income from their business to be kept in the form of saving at the BPRS. This mechanism requires a special team that visits customers every day to ensure that customers keep their saving account increasing. Meanwhile, BPRS B have the risk management team since 2020. Ownership by BPRS management has a negative relationship to financial risk (Fithria et al., 2021). The community as a shareholder in making BPRS operational decisions and financing to community members is expected to be one of the risks mitigation efforts, as have been practices by community banks across countries.

3.5.Technology

Increased internet access has negative effect on the performance of small rural banks in the United States. This indicates that online banking services can threaten the existence of small rural banks (Spurlin, 2022). The existence of Peer-to-Peer lending has become a substitute for rural bank loans in 2018. The impact of the existence of Peer-to-Peer lending is greater for regions with a large number of rural banks and low economic growth (Kohardinata et al., 2020). Meanwhile in Ghana, technology is used to overcome certain risks so as to increase bank efficiency (Say et al., 2020). Likewise in Italy, rural banks use technology to reduce the occurrence of defaults and increase loan transactions (Milani, 2017).

BPRS in Indonesia generally use simple technology to provide a core banking system and to provide information to the public through the provision of a website. Based on information from BPRS A and BPRS B, characteristically BPRS customers are a category of people who are not using technology to access financial services. Communication between BPRS and customers and prospective customers is conducted offline, so that the use of technology has not become a priority for BPRS. In addition to consideration of effectiveness, cost is one of the considerations that BPRS have not optimized the use of technology. On the other hand, there are alternatives for providing technology by third parties with a profit-sharing system, for example VisiCloud.

4. Conclusion

Islamic Rural Banks, or BPRS in Indonesia still need to be strengthened in order to fulfil their role as a driving force for SMEs development. Based on the systematic literature review and interviews related to the five aspects of strengthening the role of BPRS, it is concluded that:

a. The majority of Community/ Rural Bank funding sources are third party funds in the form of deposits. Some Community Banks in other countries have innovated using certain communities as sources of funding, such as farmers, rural women's groups, and so on. In Indonesia, BPRS A's funding sources is the Regional Government (*Pemda*), while BPRS B's funding sources is certain communities/ organizations.
b. Easy access to financing could increase the productivity of SMEs. However, Islamic Community Banks or BPRS stipulate terms and conditions for access to financing in the framework of risk mitigation. One of the innovations made by BPRS in Indonesia is to improve public access. BPRS B facilitates financing up to a certain nominal value, while BPRS A provides financing products without collateral and margin by utilizing subsidized funds from the Regional Government (*Pemda*).
c. Community Banks aim to help SMEs in the regions. However, sometimes community banks have to compete with larger banks. In Indonesia, the target

market of BPRS is also the market target for Islamic Commercial Banks and Islamic Business Units.

d. Various methods are used by community banks in risk mitigation, such as tax deduction rules to increase bank resilience; set the balance; asset policy; improve supervision; derivatives; maintaining market power, total capital, financing and efficiency; and income diversification. The BPRS in Indonesia use different risk mitigation methods. BPRS A uses a savings facility to minimize the risk defaults.
e. Community banks utilize technology to mitigate a number of risks. In Indonesia, BPRS A and BPRS B have not made the use of technology a priority because of the characteristics of customers who are categories of people who are not used to using technology to access financial services. In addition, cost is one of the considerations that BPRS have not optimized the use of technology. While on the other hand, there is an alternative to provide technology by third parties with a profit-sharing system.

5. Policy Recommendation

Based on the conclusion, this research proposes the following policy recommendations:

a. Encouraging innovation in financing sources for BPRS. Among them through the Regional Government (*Pemda*), Community Organizations or certain community, and endowments.
b. Risk management uses a joint responsibility scheme. This scheme can be done by opening a savings account where deposits are made every day and then debited every time a customer's financing return is due.
c. Regulate market segmentation of the banking sector in Indonesia so that BPRS do not compete with Islamic Commercial Banks or Islamic Business Units.
d. Cooperate with technology providers to accelerate services, expand market through digitalization, and mitigate some risks.

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