

POLICY INITIATIVES:

Addressing Financial Obstacles of Micro Small Medium Enterprises (MSMEs) for
Environmental Investment in Indonesia

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ABSTRACT:

This vital role that MSMEs have been playing in the Indonesian economic development was acknowledged by the Government of Indonesia. In the same time, the existence of numerous micro and small enterprises intermixed with housing development poses additional problems in the enforcement and monitoring of the treatment and discharge of wastes. Yet, most of MSMEs face difficulties in managing their resources to acquire efficiency in their production, both through addressing the depletion of resources and inefficiency of equipment. Thus, encouraging those kinds of enterprises to implement cleaner production (reduce, reuse, recycle and recover) is one solution that needs to be promoted. The experience of using environmental soft loan programmes in promoting cleaner production investments in Indonesia has been positive. The analysis demonstrates that such incentive schemes can speed up investment in MSMEs in technologies that reduce the use of resources. At the same time they gradually build capacity in participating banks in assessing environmental risks and developing a new type of a client base. The schemes have successfully evolved into revolving facilities and their sustainability in continuing to support cleaner production financing in Indonesia is ensured. Some banks have realised the financial benefits of cleaner production, but overall in the current cost structure of most MSMEs in Indonesia, some level of support from the government and donors is still necessary to stimulate the market for environmental investments. The paper will describe environmental credit schemes developed by the Indonesian Government as efforts in addressing financial obstacles of MSMEs for Environmental Investment.

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BACKGROUND

The impact of the economic crisis that Indonesia faced in 1997 is one of challenges that Indonesia may still face in the future. It has forced the government to focus on programs pertaining to economic recovery rather than promoting conservation and environmental management. As stipulated in Law No. 25/2000 regarding National Development Programmes, the government has determined poverty alleviation as the highest priority, hence, this makes the mainstreaming policies related to poverty alleviation inevitable. One of the policies in poverty alleviation is to optimize the financial facilities to Micro, Small and Medium Enterprises (MSMEs)¹. One of main reasons for supporting MSMEs financially is the fact that MSMEs were proven to be the toughest among enterprises during the economic crisis. This vital role that MSMEs have been playing in the Indonesian economic development was acknowledged by the Government of Indonesia.

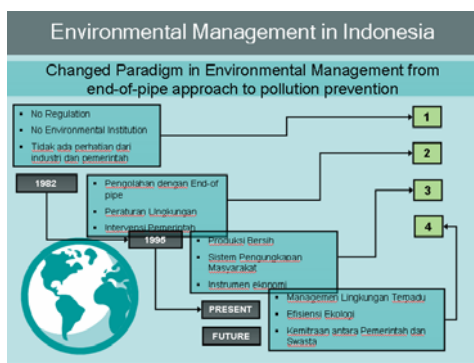
Meanwhile, in order to regain economic growth, the government must not overlook environmental problems in Indonesia which are reaching alarming proportions. The existence of numerous micro and small enterprises intermixed with housing development poses additional problems in the enforcement and monitoring of the treatment and discharge of wastes.

According to statistical data provided by Badan Pusat Statistik (National Statistics Agency), in year 2003, the number of MSMEs in Indonesia is 41 million; Micro enterprises alone reached the figure of 30 million. The mentioned figures also indicate that MSMEs represent 99.4% of employment in Indonesia [2003], and in the same time, contribute 56.7% to Indonesia's GNP (Annual growth of 2.4%) [2003] and 19.35% to Indonesia's export [2000]. In regard to environmental aspect, with the considerable number, MSMEs sector constitute as a very significant sector to be look out. Yet, most of MSMEs face difficulties in managing their resources to acquire efficiency in their production, both through addressing the depletion of resources and inefficiency of equipment. Thus, encouraging those kinds of enterprises to implement cleaner production (reduce, reuse, recycle and recover) is one solution that needs to be promoted.

Nevertheless, such solution has been facing numerous obstacles, one of which is related to financing environmental investments. Such investments have commonly been perceived as a "cost center", rather than investments that lead to financial sustainability. This perception has

been the rationale for the lack of priority of budget for environmental activities in Indonesia. Thus, the Ministry of Environment Indonesia has been consistently developing policies and initiatives to support MSMEs for environmental investment. Among other the instruments are environmental credit line (a financial incentive type of program for environmental investment), import duty exemption for waste treatment equipment, tax-incentives, etc. The paper will describe the environmental credit schemes as efforts in addressing financial obstacles of MSMEs for Environmental Investment.

POLICY ON ECONOMIC INCENTIVE FOR MSMEs



Of all environmental damage and pollution in Indonesia, some significant percentage is due to pollution caused by the industrial sector. The first measures by the government of Indonesia to reduce pollution problems in the 1980s were through the introduction of regulations and control. These alone mandatory measures did not succeed particularly well in responding to environmental problems. For

this reason, in the mid 1990s, the Ministry of Environment (KLH) started to apply mixed policies and instruments which integrate between the mandatory approach, partnerships and market-based & economic instruments.

To address the above mentioned situation, Government of Indonesia c.q. Ministry of Environment (MoE and Ministry of Finance (MoF) - with close cooperation with Indonesian Central Bank) - developed and has been implementing numbers of economic incentives instruments, including environmental credit schemes which are have been implementing since beginning of 1990s. One of the economic measures implemented since 1992 is a programme of revolving environmental soft loans. The programme, is a joint effort between the government of Indonesia Bank Indonesia (the Central Bank) and channeling banks. This programme so called JBIC PAE started with the offer of a soft loan from the government of Japan to assist industries primarily in managing their pollution loads (end-of-pipe). Following the success of the JBIC-PAE loan scheme, the government of Germany provided a grant to the government of Indonesia through KfW for the first Industrial Efficiency and Pollution Control soft loan programme (IEPC1-KfW). This financial cooperation programme promotes and

speeds up the process of changing environmental management processes towards principles of pollution prevention particularly in SMEs. In year 2005 the government of Indonesia received a soft loan from the government of Germany to continue this approach under IEPC-KfW phase 2. The above soft loan schemes still continue to run although the original donor funds for PAE and IEPC1 have already been fully exhausted. The funds that are now being managed by the banks are those revolving through repayments.

Through the years of experience, MSMEs, which have been aware of environmentally sound investment, have been indicating that getting funds from banks and other financial institutions (FIs) has often been a barrier to realize investment. Loans are often not accessible as credit analyst within the banks or FIs do not see environmental investments as potential investment opportunities. Many companies therefore cannot make use of banks as loan providers but use other sources. However, if these are not available, investments cannot be made. Having learned the situation, Government of Indonesia developed a new environmental soft loan scheme, namely Debt for Nature Swap (DNS) for financing environmental investment for Micro and Small Enterprises (MSEs). The DNS scheme is an innovative effort because it has ideally aims to enhance environmental quality in Indonesia through providing financial assistance to MSMEs which have marginal or outreach financial access to banks in order to be able invest in environmentally friendly technologies, while at the same time supporting the MSMEs to be in better position in terms of product competitiveness.

The above mentioned schemes have shared aims that are to better environmental quality by reducing pollution from the industries and to enhance competitiveness of the enterprises through providing economic incentive of soft loan funds. Nevertheless, the schemes have different structures of implementation. Table 1 shows differences of structure of implementation of the schemes.

Table 1. Differences of structure of implementation of the Environmental Soft Loan Schemes

	JBIC-PAE	IEPC-KfW 1	IEPC-KfW 2	DNS
Target Groups	All scales of enterprises	SMEs	SMEs	MSEs

Implementing Banks	5 National Nasional (State own/private)	4 Regional banks + 1 National Bank	2 APEX Bank, 3 Regional Banks + 1 National Bank	1 Syariat Bank
Type of credit	Investment	Investment	Investment (75%) + working capital (25%)	Investment (60%) + working capital (40%)
Interest Rate (effective)	Equal to Central Bank' Rate	11 – 14% pa	Minimum 2% below market	equal to 10 – 13% pa)
Technical Asistance	- none -	Regional Consultant	Technical Asistance Unit (TAU)	Technical Asistance Unit (TAU)

Note: SMEs = Small and Medium Enterprises MSE = Micro and Small Enterprises

All environmental credit schemes are intended to become self-sustaining revolving facilities with some funds allocated for technical assistance that the banks can make use for advice in environmental issues and liaison with MSME clients. Apart from slightly-below-market interest rates, the main attraction of this scheme to the banks has been the availability of such technical assistance. The facility also helps the banks to identify new reliable and risk-averse clients.

In the following, some lessons learned from the implementation of the above three soft loan programmes will be presented.

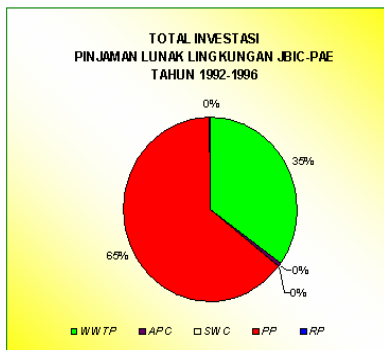
LESSON LEARNED

Lessons Learned 1: Enlarged Capability of SME lending

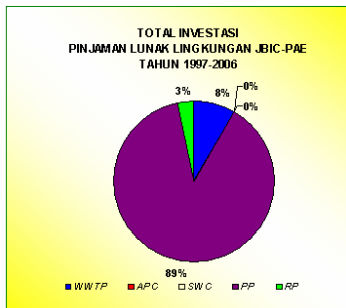
SMEs have limited capacity to absorb and manage technology, funds and human resources and therefore often cannot handle their environmental impact in a sufficiently serious manner. For this reason the government of Indonesia started developing soft revolving loan schemes specifically for SMEs. In 1997 the government of Germany provided a grant in the amount of IDR 53 billion to the government of Indonesia, which was subsequently on-lent to 70 SMEs through banks participating the in scheme called Industrial Efficiency and Pollution Control

(IEPC1-KfW). The success of this scheme, which is still revolving, lead to a follow-up programme called IEPC2-KfW, introduced in 2005 with a total value of EUR 9 million and implemented using a two-step loan structure through Apex and Handling Banks.

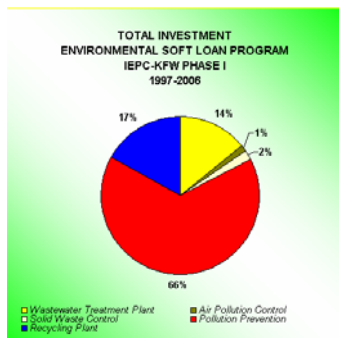
Lessons Learned 2: Changed paradigm in environmental management from end-of-pipe approach to pollution prevention



Total Investment of JBIC-PAE, 1992-1996



Total Investment of JBIC-PAE, 1997-2006



The picture on the left shows that at the beginning of the 1990s environmental management was done through waste management (end-of-pipe). This approach resulted in a perception that environmental management means high costs for both investments and operations & maintenance (cost centre).

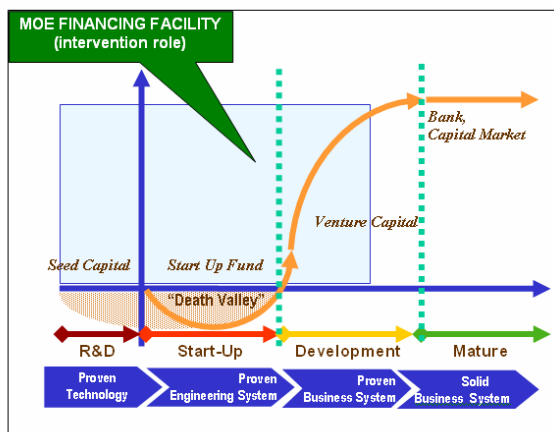
As a result, banks found it very difficult to fund environmental investments and did not support companies (particularly SMEs) in environmental management. This paradigm changed at the end of 1990s when several industries became aware of the savings that could be achieved through cleaner production measures, both in terms of reduced waste management costs and in terms of decreased need for raw materials and other inputs.

As is demonstrated by this picture, banks gradually started to see that environmental investments can be interesting and financially rewarding. Cleaner production equipment accounted for 89% of investments under PAE-JBIC and 86% under IEPC1-KfW. This shows that cleaner production equipment has become an interesting object for financing by banks and for companies to get funding for.

Lessons Learned 3. Contribute to efforts on poverty alleviation

One of the policies in poverty alleviation is to optimize the financial facilities to Micro and Small Enterprises (MSEs)². One of main reasons for supporting MSEs financially is the fact that MSEs were proven to be the toughest among enterprises during the economic crisis. This vital role that MSEs have been playing in the Indonesian economic development was acknowledged by the Government of Indonesia by determining the year 2005 as the Year of International Micro Credit.

Lessons Learned 4. Serve a bridge for non-bankable MSMEs to become bankable



In 2003, only about 15% of micro and small enterprises in Indonesia could be financed through the formal banking sector, while the rest were served by non-banking financial assistance such as NGO and cooperatives. The environmental soft loans schemes, allow numbers of MSEs which are considered as non bankables to be able get access to financial resources. The softloans has encouraged those

kinds of enterprises to become better in their both economical and environmental performance. By the time MSEs reached better economical performance, they could be then considered as potential and eligible for the banks.

Lessons Learned 5. Encouraged Participation of banks in implementing industrial efficiency, cleaner production and pollution reduction.

During 14 years implementation of the environmental soft loan programme, one important lesson is that this programme has been encouraging participation of banks in environmental management fields. The participation even strengthens by reason of facts experienced by banks. In the following, experience gained by some implementing or handling banks of the soft loan schemes will be summarized as follows:

² Based on circular letter No 3/9/BKt/2001 Central Bank of Republic of Indonesia regarding guidelines of loan Implementation to Small Enterprises. Among other criteria are assets excluded Land and building is maximum IDR 1 Billion, Annual sales turnover is maximum IDR 200 million, Maximum Loan Amount is IDR 500 million.

Change of approach from End-of-pipe to preventing loss-making waste resulting in benefits to both the environment and company performance. Financing environmental investments, particularly End-of-pipe, requires high amounts and the availability of regular funding for operation and maintenance. As such funds add to the cost load of the enterprise (cost centre), they will burden company performance but cannot be prevented because they form a part of the company's environmental management obligations. The cleaner production approach, through the change or addition of technology which increases efficiency and reduces the use of raw materials and chemicals, represents the most advantageous solution in attempting to improve company efficiency.

Environmental management in SMEs is not a risk for banks. Considering these limitations at SMEs, such soft loan schemes provide a measure to assist such companies in overcoming financial difficulties while improving the production process into a cleaner and more efficient one. Environmental investment in the form of cleaner production equipment improves both the environmental and economic performance of the SME allowing it to have sufficient funds to repay the loan. The facts and figures from enterprises which received soft loans from the handling banks show that there are both financial and environmental benefits to the end user. A soft environmental loan in line with commercial banking conditions of BNI (including for SMEs) does not constitute a risk for the bank.

Long-term conditions reduce the level of loan defaults. It can be shown that in any production process in an enterprise each input (raw material, energy, water, etc.) will leave the facility either as a product or a non-product. Products can be sold and therefore represent a positive contribution to the company's cash flow. However, non-product output usually does not represent a positive contribution to the company cash flow and can be considered as a cost to the enterprise. It is in the interest of the enterprise to make efforts to minimize such costs. Based on this conclusion, before an SME submits an application for waste treatment equipment, it should also analyze carefully if there are opportunities to reduce the cost of waste or make more efficient use of resources. Regular cleaner production assessments help the enterprise to become forward-looking and an example of a client that can be relied upon and that can become a good debtor for a bank with a low risk of default.

Environmental Investment climate emerge new opportunities for banks in financing environmental investments. The various types of environmental investment are new for the banking sector. Environmental investments are not restricted to the industrial sector only, but

can be applied also to the service sector such as hotels and hospitals. Basically efficiency in the use of energy, raw materials and water needs to be applied by all sectors. The recycling sector has traditionally seldom received funding from banks, but in fact it has excellent potential for bank loans as a solid market has developed for recycled products. The growing number of consumers who prefer organic products also pushes the fish processing sector to apply methods that use inputs that avoid endangering the environment or the consumer. This soft loan schemes have increased the knowledge at banks that environmental investments do not only relate to liquid, air or solid waste management, but also to procuring production equipment to improve efficiency or various machines to support the recycling industry.

Improving the understanding and awareness of integrating environmental aspects in the bank's business. A bank will face various risks in providing funds to any enterprise, such as risks that may emerge when the bank underestimates environmental factors around it. Such risks include legal exposure, reputation and credit risk. Through implementation of the soft loans schemes, banks has gained understanding of environmental risks for banks. Because of these risks that have a potential impact of the client's loan performance can be minimized or even eliminated. In the future banks will be sensitive to the efforts by its debtors towards reducing the environmental impact of their activities. This environmental soft loan programme is not only a sustainable funding scheme, but also consitutes a source of learning and increased awareness and knowledge to build the bank's capacity in this field. Relevant bank staff will continue receiving training in environmental awareness and tools through the capacity building activities included in the programme.

Building the better corporate image of Banks. Considering current global developments in the field of environment, the involvement of banks in promoting more efficient industries, cleaner production and air pollution reduction through funding environmental investments through its debtors adds supplementary value to the image that banks already have. The banks should use every opportunity to find positive ways to enter the global market. Through this environmental investment programme banks wish to become a bank which not only has an image in financing but also in caring about the environment.

Closing Remarks

The environment soft loan schemes give a multiplier effect to the banks, MSMEs and government. Banks have a benefit through new clients and improved capacity in

understanding environment. SMEs get a benefit through improved access to credit and relationship with bank. Communities get a benefit through more efficient use of inputs and lower pollution load. MoE, Banks and Central Banks has a closed relation and coordination to manage environment.

Solving environmental problems through investment in pollution prevention or cleaner production equipment and machinery that improve industrial efficiency is a triple win for all parties: "win" for the enterprise, "win" for the bank, and certainly "win" for the environment. Enterprises which improve their efficiency or invest in equipment which reduces the use of raw materials, chemicals, water or other resources gain considerable benefits. In addition, compliance with environmental regulations improves through the reduction of quantities of waste that need to be treated. The reduction of the quantities of resources which were earlier wasted in the production process will have a positive impact in our efforts to improve the quality of the environment in Indonesia.

The role of banks in financing environmental investments greatly encourages more environmentally friendly enterprises. Financing through soft loan schemes has provided an excellent learning opportunity for banks, particularly BNI and Bank Jateng, in seeing that environmentally friendly measures do not only constitute a cost center, but that they can also increase earnings so that the risk of default in the SME sector can be prevented.

To sum up, the government's policy initiative in developing and implementing economic instruments as incentive schemes has significantly addressed financial obstacles for environmental investment faced by enterprises, especially MSMEs. Yet, for better achievement, the initiative on economic instruments needs to be enhanced and complemented with other instruments.

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