

*Alwi et al., 2019*

*Volume 5 Issue 2, pp.1013-1023*

*Date of Publication: 22<sup>nd</sup> October 2019*

*DOI- <https://dx.doi.org/10.20319/pijss.2019.52.10131023>*

*This paper can be cited as: Alwi, A. F., Putra, A. A., Hutami, H. S., Andriany, L. E., & Hanindya, Y. R., (2019). Peer-To-Peer Lending Regulatory Framework Impacts on MSMEs Financing in Indonesia. PEOPLE: International Journal of Social Sciences, 5(2), 1013-1023.*

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## **PEER-TO-PEER LENDING REGULATORY FRAMEWORK IMPACTS ON MSMEs FINANCING IN INDONESIA**

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### **Abstract**

*Micro, Small, and Medium Enterprises (MSMEs) contribute approximately 60% to Indonesian Gross Domestic Product (GDP). However, they struggle to obtain access in financing through traditional means, such as bank loans, due to weak credit ratings. For this reason, Peer-to-Peer (P2P) Lending exist as a viable financing alternative. Correspondingly,*

*the Financial Services Authority (FSA) has taken a rapid measure to accommodate the growth of P2P Lending through FSA Regulation Number 77/POJK.01/2016 concerning Information Technology-Based Lending Services. However, no research analyzed the impact of the P2P Lending regulatory framework on MSMEs financing. This paper examines and analyzes the norms within the Regulation with a combination of empirical and normative approaches. First, this paper found that the purpose of P2P Lending Regulatory Framework is to promote access to financing for MSMEs. Second, P2P Lending Regulatory Framework has a crucial role in activating the digital economy ecosystem for MSMEs. In conclusion, this paper suggests that the law has a role in utilizing the potential of new tech by providing legal certainty.*

### **Keywords**

Business Law, Small Business, Financial Technology, Peer-to-Peer Lending (P2P Lending), Micro, Small, and Medium Enterprises (MSMEs), Indonesia

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## **1. Introduction**

Peer-to-Peer Lending (“P2P Lending”) has become an alternative to bank lending for MSMEs. P2P Lending platform provides easy access to loans by facilitating debt transactions directly between borrowers and lenders via the Internet (Galloway, 2010). Everybody can become borrowers or lenders without the necessity of bank as intermediaries. It is appealing to MSMEs because it omits the requirements of knowledge related to bank, interest, location and attitude (Suryani et al., 2015). P2P Lending may offer MSMEs opportunities to finally get adequate access to loans considering bank reluctance to do the same.

MSMEs consist of 99% of all business entities in Indonesia (Asian Development Bank, 2018), and it contributes around 60% of Indonesia's GDP (Statistics Indonesia, 2017). With that in mind, MSMEs could be the key to uphold the economic resilience in Indonesia from the probability of a global economic recession in 2020 (Hamideh, 2018). However, the problems in getting an adequate source of financing are still hampering MSMEs growth in Indonesia (Rahadi, 2018; GPFI, 2013). Consequently, a numerable amount of MSMEs would then be unable to expand its reach and implement their business. Thus, the Government should note that providing alternative financing for MSMEs can bring a substantial impact on the future of the Indonesian economy.

Responding to the problems above, the Indonesian Government enacted Financial Services Authority Regulation Number 77/POJK.01/2016 (“Regulation”) concerning Peer-to-Peer Lending. Prior to its enactment, Indonesian P2P Lending scoop up 40% of all of the

financial technology (FinTech) firms in the country. Considering the MSMEs issue, Indonesian FinTech firms also place MSMEs as their target (Cambridge Centre for Alternative Finance, 2019, p. 37-38). The status quo shows how the Government already make a pro-innovation step to help the MSMEs financing struggle.

However, even after the Regulation enactment, there were still problems. In FinTech firms' perspective, 33% of them stated that the current FinTech regulatory framework is "excessive and too strict for my platform activities" (Cambridge Centre for Alternative Finance, 2019, p. 37-39). The Government also recognized that not all P2P Lending platforms provide loans for the productive sector. Consequently, they obliged platforms to channel a minimum of 20% from all the loans to MSMEs.

This paper tries to analyze whether the current P2P Lending regulatory framework is upholding or inhibiting the new alternative for MSMEs financing. Further, it explains and examines the problem by breaking it down into four sections. First, the introduction section sets out the context of the research. Second, the next section laid down the theoretical analysis of Roscoe Pound's theory. Third, the core analysis is presented by discussing the connection between MSMEs financing and the Regulation and its role in digital economy activation. Lastly, this paper is concluded by wrapping up all the discussion presented.

## **2. Literature Review**

### **2.1 Micro, Small, and Medium Enterprises (MSMEs) in Indonesia**

In the term of assets, referring to Indonesian Law Number 20 of 2008, MSMEs divide into micro enterprises, small enterprises, and middle-level enterprises. MSMEs are the foundation for the Indonesian government to encourage the national economy because it is an economic sector that is able to absorb the largest workforce in Indonesia (Sudaryanto, 2011). Moreover, when the Asian financial crisis hit the country in 1997, MSMEs were found to have been weathering the crisis better than the larger enterprise. MSMEs greater flexibility allowed them to adjust production processes during the crisis, although many had been struck too (Tambunan, 2005). In the other side, MSMEs also face several problems related to the low quality of human resources, limited working capital and lack of mastery of technology (Sudaryanto and Hanim, 2002).

### **2.2 Law as Tool of Social Engineering**

Referring to Roscoe Pound, the law is a tool of social engineering to eliminate obstacle in society and put human interest forward (Pound, 1942, p.487). The law is a tool to regulate things that can and cannot be done through the concept of "rights" and "obligation"

that lean on public interest (McManaman, 2013, p.20). Moreover, the category of social institution security interest and human development act as the basis of public interest injected in law-making. (McManaman, 2013, p.19-20). In the business environment, the function of law is to create stability and predictability (Shihata, 1996, p.1578) so that business actor can operate in a confident manner (McManaman, 2013, p.8). Analogous to the doctrine of *Idee des Recht*, legal certainty (*rechtssicherheit*) should be a part of legal enforcement (Wantu, 2007, p.388).

However, the Pound's theory still has flaws as suggested by scholars. An abstract concept of law (Mackor, 2013, p.448-449) brings up the question of whether the social engineering is a result of the exertion of the system of law as a whole or limited to a particular instrument. In response, this paper limits the concept of law in the context of Pound's theory to legal policy and written law. Setting forth, this paper examines the Regulation as a legal policy and written law that function as a tool of social engineering in MSMEs financing.

### **3. Methodology**

#### **3.1 Type of Research**

The type of legal research is normative-empirical research. The research would not only comprise the theory and legal principles related to the use of Peer-to-Peer Lending as MSMEs financing in Indonesia. However, the research also would like to formulate suitable approaches to determine the impact of the regulatory and legal policy through the growth of MSMEs financing in Indonesia. In library research, secondary data is used to formulate arguments and analysis.

#### **3.2 Data Collection Methods**

The collection of data used for this legal analysis is gained from documentary study and interview with related key persons from multiple backgrounds with the expertise of Business Law and P2P Lending. Thus, in order to conclude, an analytic observation of the existing documents and corroboration from the interviews will be utilized.

#### **3.3 Data Analysis**

The data analysis would be used in this particular research is qualitative research. Consequently, a qualitative means to analyze the data would be necessary. To conclude, the author will make a comparison study from the facts, which are based on the interviews, researches, existing legal instruments and other legal materials, thus becomes a qualitative

data analysis. From these facts, the author will be then able to analyze the data and come to a conclusion and provide an appropriate solution to the legal analysis.

## 4. Result

### 4.1 The Connection between MSMEs Access to Financing and the Regulation

Since its inception, Indonesia laid down its identity as a nation that is based on the Rule of Law (Indonesian Constitution of 1945) founded in constitutional supremacy which laid down in legislation (Siallagan, 2016, p.136). The formulation, as well as the implementation and enforcement, of law, are based on the various rationale (Juwana, 2005, p.24). This rationale needs to be considered for: first, the reason for the formation of statutory regulations; second, determining the objective in the article formulation within a provision (Juwana, 2005, p.24). A legislator should put in mind both things to guard the consistency and correlation between the intention and the achievement after an instrument is enacted (Iyan, 2012, p.174).

#### 4.1.1 The Reason behind the Regulation

This research reviews the objectives behind the enactment of legislation (Juwana, 2005, p.25) which generally can be found in the consideration or general elucidation of a particular regulation (Juwana, 2005, p.27). The Regulation points out in its general elucidation that P2P Lending is a solution for MSMEs to get access to financing. Also, the points that the government is trying to regulate are: (a) consumer protection, (b) organization of P2P Lending activity, and (c) balance of national security with room for innovation to thrive. Moreover, these points are in harmony with the preamble of the Regulation, which highlights of P2P Lending as a financing alternative.

From the reasons above, the Regulation is aimed to increase MSMEs financing. To prove this claim, the Regulation is regarded as public policy that the impacts can be assessed through the overall effect in real-life conditions (Dye, 1981, p.367). In Indonesia, the assessment is done through two obstacles that MSMEs faced: access to financing and reach to geographically remote areas.

**Table 1:** *Distribution of P2P Lending Accumulated Loan to MSMEs*

Accumulated Loan Amount (in bill IDR)	2018	2019					% Δ May 2019 YTD
	Dec	Jan	Feb	Mar	Apr	May	
	22,666	26,004	29,300	33,200	37,013	41,039	81.06
<b>20% Loan</b>	4,533	5,200	5,860	6,640	7,402	8,207	-

<b>Distribution to MSMEs Financing*</b>							
<b>Monthly Growth</b>	-	14%	12%	13%	11%	11%	-

\*P2P Lending platforms are obliged to distribute 20% minimum of accumulated loan for MSMEs based on the discretion of FSA FinTech Director.

In response to the first obstacle, the table above resulted in two findings. First, the loan distribution towards MSMEs financing shows the tendency of increasing. Second, the growth rate of the accumulated loan is stable. This indicates that the market responded positively towards financing access from P2P Lending since its enactment. According to the data, the real-life conditions of MSMEs financing is affected by P2P Lending. In addition, the increase of loan distributed to MSMEs proved that P2P Lending is a viable financing alternative solution. Consequently, the data indicate that the Regulation fit the underlying reason for its formulation.

Moving on, due to the archipelagic nature of Indonesia, the infrastructure is concentrated in Java and Bali (Indonesian Ministry of Public Works, 2017, data of ratio of road length to the area). Although a solution for overcoming geographical barriers have been partially solved by branchless banking, it is still hindered by the general nature of banking business—the need for collateral. In response, more of MSMEs choose P2P Lending as an alternative as it has potential in distributing loans outside Java and Bali.

**Table 2: Distribution of P2P Lending Loans in Indonesia\***

Year	Province	Amount of Loan (in billion IDR)	Distribution Percentage (%)	Increase in Loan Distribution outside Java and Bali (%)
2018	Java and Bali	8,337.4	90.49	3.01
	Non-Java and Bali	876.2	9.51	
2019	Java and Bali	35,902.3	87.48	
	Non-Java and Bali	5,136.6	12.52	

\*Until May of 2019.

In response to the second obstacle, based on the data presented above, the 3.01% increase after the enactment of the Regulation is evidence of P2P Lending contribution towards loan distribution. Compared with the threefold rise of the number of loans in Java and Bali, the amount of loans outside the two islands has increased fivefold in the same

period time. It shows that P2P Lending can reach geographically remote areas that banks or other financial institutions cannot.

All above considered, it is concluded that the Regulation is functioned as a tool to promote access to financing for MSMEs.

#### **4.1.2 Implementation of the Regulation**

Before the enactment of the Regulation, there are no rules or regulation that can limit the conduct done by actors in the P2P Lending business environment. In consequence, everybody can launch their P2P Lending platforms without any intervention from the government. This leaves the standard of treatment towards user inadequate to prevent fraud from happening. Evidently, based on Fraudulent Investment Taskforce data, there are around 168 reported fraudulent P2P Lending platform (Satgas Waspada Investasi, 2019).

It should be noted that the function of law in a business environment is to create stability and predictability (Shihata, 1996, p.1578). In this context, the lack of regulation to accommodate P2P Lending business activities has caused problems in the society. The analysis in this point is to prove that the enactment of the Regulation has established a stable and predictable environment for P2P Lending.

The Regulation set out a regulatory framework for consumer protection and P2P Lending to operate. There are requirements of minimum paid-up capital of IDR 1 billion to register and IDR2,5 billion to get a license to operate. Moreover, there are requirements to meet a minimum system standard under Article 25 to 28, i.e. data centre and data recovery centre, data recovery, audit track record, and cyber security system. Additionally, Article 19 and 20 set out the rights and obligation of both lenders and borrowers, which were vague before the existence of the Regulation.

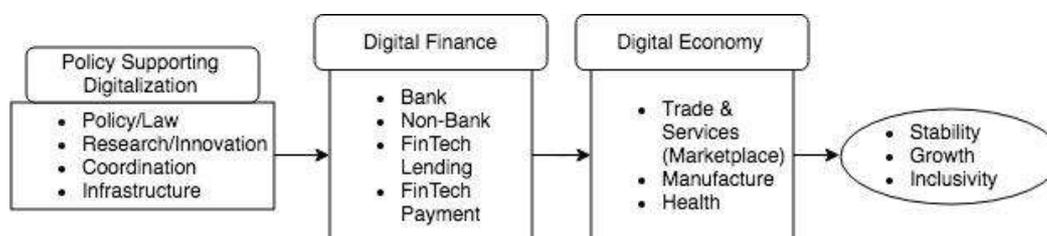
Following the Regulation, the P2P lending platform, lenders and borrowers can all operate confidently due to established legal certainty (Shihata, 1996, p.1584). The more confident the business actors in P2P Lending, the more financing transaction can be distributed between those actors, including MSMEs. Thus, the implementation of the Regulation indirectly promotes MSMEs access to financing.

#### **4.2 P2P Lending Regulatory Framework Role in Activating MSMEs Digital Economy**

The existence of P2P lending Regulations is interpreted as one of the government's agendas to provide benefits to the community. If analyzed further, the basis for the Regulation emphasizes on the greater good of society. The Regulation emphasizes the principle of utility to the extent that the law can provide benefit to the community (Bentham.

1996, p.7). Here, the discussion of P2P Lending will interpret the community as Indonesian society. Hence, to analyze the extent of benefits given, it can only be done in a broader perspective.

The P2P Lending regulation is one part of the activation of the digital economy, a technological innovation that affects the economic and social activities of the community. In Indonesia, before the birth of the Regulation, the government had a vision for Indonesian digital financial ecosystem. The potential contribution of the digital economy to Indonesia is USD 155 billion in Indonesian GDP and 3.7% of workforce growth in 2025 (McKinsey, 2016). The Indonesian approach in utilizing digital economy in Indonesia with the following references:



**Figure 1:** Indonesian Approach in Utilizing Digital Economy

The Indonesian government takes cautious steps in addressing the digital economy. This is so as the first step in the digital economy activation is through policy, which supports the digitalization process. Referring to Table 3, if the government skipped over the early stage, the excess of digital finance and following stages could not be contained.

Furthermore, the digital economy creates opportunities for MSMEs to develop and integrate between online and offline ecosystems. Focusing on the problems of MSMEs financing, P2P Lending is the right solution as elaborated in the preceding sections. To back up this claim, as per AFPI data, 60% of funds channeled through P2P Lending are allocated to the productive sector.

The banking sector is the most impacted in this direction of policy. As the interest of the community is inclined towards P2P Lending, the benefit of the banking sector declines. Correspondingly, products offered by P2P Lending is levelling up the playing field of the traditional banking business. However, this competition from P2P Lending platforms may also prompt banks to recapture market share by extending more loans to MSMEs and improve the service offered to them (Naoko Nemoto, et al., 2019, p.1).

In the end, loans provided by P2P lending act as substitutes for retail loans bank provided for infra-marginal borrowers, as well as complimentary for banks in providing

smaller loans. Based on the preceding analysis, even though P2P Lending has the potential to erode banking market share, the Indonesian government has realized that the quantitative benefits of P2P Lending are higher for the community interest. Thus, the agenda of activating P2P Lending was born in Indonesia, along with the Regulations outlined in 2016 (Huan Tang, 2019, p. 1932).

## **5. Conclusion**

In essence, the Regulation is intended to promote access to financing for MSMEs. Together with P2P Lending, access to capital and funding are better provided. Not only that, under the Regulation, P2P Lending is also credited to the increasing number of distributed loans and reach for MSMEs in geographically remote areas. Lastly, since the enactment of the Regulation ensures legal certainty, the stakeholder can utilize P2P Lending activities more confidently.

Moreover, in a broader perspective, the Regulation plays a vital role in activating the digital economy ecosystem for MSMEs. The Regulation has commenced the process of utilizing the digital economy by putting forward a policy that supports the process of digitalization. All in all, P2P Lending activation becomes the priority of the government to alleviate the playing field of banks while accommodating the interest of the community.

Regarding this research, there should be any future research regarding other digital lending impacts on MSMEs financing or the P2P Lending's sector impacts through MSMEs financing toward countries. In sum, the law has a role by providing legal certainty in the utilization of new technology. Contradicting the adage of "*het recht hinkt achter de feiten aan*" (the law always be the one that lags), the law in this matter is not something that is falling behind but leads.

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