

Chapter 1

Overview: Small and Medium Enterprises' (SMEs') Access to Finance in Selected East Asian Economies

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CHAPTER 1

Overview:

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1. Background and Research Objective

As the Association of Southeast Asian Nations (ASEAN) vows to accelerate the establishment of an ASEAN Economic Community (AEC) by 2015, the 18th ASEAN Summit, under the chairmanship of Indonesia, has reaffirmed the pivotal role of SME development as a critical element towards narrowing the development gaps amongst and within the ASEAN member states. Recently, the Economic Research Institute for ASEAN and East Asia (ERIA) together with Republic of Indonesia's Ministry of Trade (MoT), and Ministry of Cooperatives and SMEs (MoCSME) hosted a major symposium entitled "Towards a People-Centered ASEAN Community: Strengthening SMEs in ASEAN" on May 2nd, 2011. There were more than 200 participants from the business community, government officials, diplomats, academics, civil society, and media. What emerged from the symposium is that SMEs can play a pivotal role in bringing the benefits of ASEAN economic community building to the people. Concrete recommendations that have been put forward give much needed impetus to examining and shaping the regional integration architecture embodied in the AEC Blueprint measures from the lens of the development of SMEs in the region (i.e., their growth, adjustment, and participation in deepening trade and economic linkages within ASEAN and East Asia). One of the main recommendations is to develop a range of programs or approaches to provide financing for SMEs with little collateral, such as credit insurance or guarantee schemes, credit rating or borrower risk rating, a "one finance advisor-one village" approach, and training local financial institutions on risk management and borrower-risk rating.

Findings from ERIA's SME research project in FY 2009 confirmed that access to finance is amongst the most critical factors determining the competitive readiness of regional SMEs and their ability to fully exploit and participate in the global economy and business opportunities from regional economic integration and, in particular, participation in regional production networks (Thanh, Narjoko, and Oum, 2009).

In this context, the ERIA's SME research in fiscal year 2010 attempted to shed some light on the issues of SME financing in selected East Asian economies. It intended to elaborate upon the following questions: (i) what are the major SME sources of

external finance, (ii) to what extent, if any, is the SME sector identified by size, country, and in aggregate for a sample of countries in East Asia, systematically disadvantaged or rationed with respect to access to external financing, (iii) what are the key factors contributing to the extent of this rationing (stringent requirements) focusing on firm characteristics, owner characteristics, and firm performance (iv) how important is credit rationing for the performance of SMEs in a sample of East Asian economies.

2. Methodology

The research methodology adopted a structured questionnaire survey of SMEs conducted in eight East Asian countries (Cambodia, China, Indonesia, Laos, Malaysia, Philippines, Thailand, and Vietnam)¹. A total of 150 usable samples were targeted for each country. The questionnaire was aimed at collecting information on SME characteristics, and sources and usage of finance. Information on the following SME characteristics was collected: basic characteristics (i.e., size, age), ownership, cost and input structure, performance (i.e., participation in production networks, sales, sales growth, profit rate, etc.), sources of finance and usage, capability to innovate, and managerial background. The sample contained observations of firms with a maximum of 200 employees. The survey was conducted over the last two or three months of 2010, and adopted a one-to-one approach to minimize reporting errors (i.e. the researchers pay one or two visits to the respondents in order to collect all the information sought by the questionnaire). As a result the study managed to gather slightly more than 1178 respondents over a rather limited time-period.

¹ The format of the questionnaire is largely adapted from a “Survey on Financing of Small and Medium Enterprises 2007” conducted by the Small Business and Special Survey Division, Statistics Canada.

3. Structure of the Report and Key Findings

In Chapter 2, Charles Harvie develops and presents a framework within which the concept of a “financial gap” or “credit rationing” can occur in the context of SMEs, and alternative measures are developed and proposed. Its measurement is critical for the conduct of an empirical study concerned with identifying statistically significant factors influencing the magnitude of this funding or credit gap in relation to the SME sector. Focus of the framework is placed on identifying the significance of firm attributes or characteristics, owner attributes, and firm performance upon the existence of financial gaps or credit rationing, in aggregate and by source of finance, for SMEs (micro-, small- and medium-sized). The statistical significance of financial gaps or credit rationing for the performance of SMEs in aggregate for the eight countries, by individual country and by size of SME, are also investigated.

In Chapter 3, Sothea Oum, Charles Harvie, and Dionisius Narjoko present an empirical analyses based on the analytical framework developed in Chapter 2. They find that, although a significant number of SMEs still rely on their internal resources for both start-up and business expansion, external finance is very important for aspiring smaller domestically owned companies in less developed economies which make lower profits and which have insufficient access to funds. Moreover, the size of the SME and stage of the country's development (reflecting financial market conditions and development) also affect the diversity of financial institutions and financial products that SMEs can access. They also find that there is potential for credit rationing, or risk premiums exercised by financial institutions on SMEs. The key findings from their analysis suggest that size and stage of country development (financial market development) do affect the conditions of external finance offered to SMEs, i.e., larger SMEs in more developed economies tend to get bigger loans, with longer terms and at a lower interest rate than otherwise. Finally, they also find that the owners' net worth, collateral, business plan, financial statement, and cash flow are critical for financial institutions in devising the financial conditions they extend to SMEs. In other words, financial intuitions seem to put higher risk premiums on opaque SMEs by offering less favourable financial conditions to less well-established and transparent SMEs. Financial access has a

significant impact on an SME's innovation capability and participation in export markets, and the study suggests that bigger SMEs with access to larger loans, of a longer duration, and with a lower interest rate are more capable of innovation and exporting activity, since external finance with favourable conditions provides SMEs with enough time and resources to innovate and enter foreign markets. They also propose some policy recommendations to tackle these problems that are summarized in the latter part of their chapter.

In Chapter 4, Luyna Ung and Sovuthea Hay address the financial constraints faced by SMEs in Cambodia. The paper argues that an under-developed financial market underpins biased provision of credit to micro-sized firms and SMEs that would limit their business expansion. They find that firms which have high sales volume and high profit margin are highly likely to obtain finance, and that collateral is predominantly required. These findings infer that credit is rationed by the market (financial institutions) and intervention is needed to widen access to finance. They propose a number of policy recommendations to address "the missing middle phenomenon". First, the government should provide incentives for export firms to find local partners; provide information on market access, management and technical supports; and enhance awareness among local SMEs of opportunities to supply the existing export-oriented large enterprises through tour organizing, workshops, or seminars. Second, in response to banks demanding collateral and other forms of guarantees for extending credit, the government could help SMEs by expediting land titling, offering a credit guarantee scheme, and creating a credit information bureau that would facilitate the process of lending. Third, improving fair competition among banks is necessary as this could lead to improvements in the terms and conditions of loans through competition between larger banks or with other financial institutions. Finally, the government should address issues surrounding the formalization and registration process for SMEs by giving incentives such as tax benefits, consultancy services, technological know-how transfer, management training, provision of information, access to government procurement contracts, study tours, trade fairs, exhibition priority, and other benefits that they could immediately obtain.

Phouphet Kyophilavong, in Chapter 5, examines financial barriers confronting Lao SMEs. Lao SMEs are at an early stage of development and face various problems. One of the most important issues is access to finance. The main objective of the paper is to

gain a better understanding of the characteristics of Lao SMEs' access to finance. His empirical results confirm that SMEs with financial constraints perform poorly compared with SMEs that do not have such constraints. Only a few SMEs could gain access to finance, about 20% of the 198 SMEs in the survey. There are various constraints facing Lao SMEs related to access to finance, such as: collateral, the complex application process, and lack of information from financial institutions. About 80% of SMEs which requested finance were not satisfied with the lending terms of the financial institutions. Domestic firms which are large in terms of capital and can manage to improve their business innovation seem to have greater access to finance. The author proposes some policy measures to assist SMEs gain access to finance, such as: (i) improving the financial system and liberalizing the financial sector in order to increase competition and to have greater diversification in the financial sector; (ii) improving the business climate in order to minimize the cost of doing business and improving innovation and productivity; and (iii) providing training on access to finance and establishing credit guarantee schemes for SMEs. In addition, the establishment of specialized banks or financial institutions targeting the needs of SMEs should be considered.

Tran Tien Cuong, Bui Van Dung, Nguyen Thanh Tam, and Trinh Duc Chieu take up the case of Vietnam in Chapter 6. They investigate access to finance and the financial gaps and factors constraining such access, of Vietnamese SMEs operating in the Textiles and Garment, Automotive Components Manufacturing, and Electrical and Electronics Industries. Their chapter shows that capital shortage presents a serious barrier to SME development in Vietnam. Many enterprises in their survey sample did not access to finance because they had sufficient internal funds or they encountered obstacles from credit providers, or there were some drawbacks inherent to the SMEs themselves. The survey results indicated the constraints facing SMEs in accessing finance, namely: lack of collateral, young age of the enterprises, major owners having insufficient experience in running or owning businesses, they are of micro size, and they had no participation in production networks. The chapter also shows that the success of SMEs, gauged by larger profit margins as well as earning profits in two consecutive years, is influenced by external factors, such as using two sources of finance, i.e. commercial or personal loans and credit lines from financial institutions including credit cards, and credit from state-owned credit institutions or government

grants, as well as relying on SME policy support from the government. In recent years, many SMEs have received both legal and direct support, most common forms of which are improving the legal framework and business environment, simplifying administrative procedures, and financial assistance in the form of solving tax and financial problems. Furthermore, the authors propose the following measures. From the supply side, banks and other financial institutions should change their traditional mindsets and adopt an appropriate approach to SMEs as a group of borrowers, considering their weaknesses compared to larger enterprises. Encouraging financial institutions to give supporting loans to SMEs, especially credit guarantee funds, is an equally important measure on which the government needs to focus their efforts. Since credit guarantee funds are still operating with low efficiency and little experience in Vietnam, sharing of experience between the country and its East Asian counterparts should be encouraged. From the demand side, it is necessary to overcome the barriers faced by SMEs in accessing finance, such as: overcoming the lack of collateral or property for mortgage by promoting credit guarantee funds; strengthening SMEs' capacity to prepare loan-financed project documentation in order to meet credit providers' requirements; improving accounting, ensuring transparency in business operations, particularly financial management; ensuring that financial institutions have appropriate confidence in SMEs when approving their loan requests; and improving the quality of human resources.

In Chapter 7, Chaiyuth Punyasavatsut examines barriers facing Thai SMEs. The chapter examines financial gaps and factors for better financial access for Thai manufacturing SMEs. The results indicate that SMEs obtain only 30 percent of their financing from external sources. Most of them use their own funds, and borrow from friends and relatives to start and run their businesses. They tend to use an overdraft in order to fulfil working capital requirements. As far as external finance is concerned, small businesses still mostly depend on banks. Despite various measures of support from the government, only 40 percent of Thai firms, mostly small, gain access to credit. The perception of SMEs is that important obstacles which block access to finance are: a lack of information and advice from financial institutions, the complexity and cumbersome loan application process, and inadequate collateral. From the financial institutions' perspective the main obstacles to SME lending are as follows: inadequate

collateral, lack of business experience, lack of a sound business plan, non-performing loan (NPL) history, and high transaction costs per loan application. Thai banks traditionally have collateral-based lending practices, and lack know-how on how to assess and differentiate SME risk. These exacerbate financial gaps and access for SMEs. SME characteristics that are associated with better access to finance are those that reflect good performance and value of firms. Firm characteristics contributing positively to credit access are high sales to assets ratio, low leverage ratio (debt to equity), business experience (older firm or more experienced business owner), and collateral pledge on loans. With respect to financial gaps the author proposes three recommendations. First, improve the Credit Guarantee Mechanism as a means of helping SMEs with inadequate collateral to gain access to finance. Successful credit guarantee schemes then require appropriate risk sharing and prudential measures to reduce over-borrowing and moral hazard behaviour. Second, improve financial information disclosure by SMEs to provide essential information such as good record keeping and proper financial accounting for loan documentation. Information transparency and disclosure can be viewed as evidence of adequate management and the financial literacy of SMEs. Finally, strengthen institutional capabilities in SMEs' credit risk evaluation and management so that financial institutions can provide more information-based lending rather than the collateral-based lending seen at present.

In Chapter 8, Rajah Rasiah examines the ease of access to finance among SMEs in Malaysia. His results show that there is an obvious bias in the financial environment facing smaller firms, which is reflected in the strong inverse relationship between access to finance and firm-size. Access to finance was inversely correlated with labour productivity, which shows that the more productive firms have less access to finance or simply that the cost and other terms of external capital are too high for the better performers. The relationship between firm-size and incidence of participation in R&D activities was also inversely related, demonstrating that in Malaysia smaller SMEs are more dynamic than larger ones. Given that several firms reported having declined the pursuance of external funds on the basis of the terms and conditions, rather than whether they can access it at all, the inverse relationship may actually show that the better performers who have the option of internal sources of funding show higher labour productivity than those who have received external funds. The Malaysian evidence

shows that governments should review their financial instruments to ensure that preferential credit is matched to the needs of the more entrepreneurial firms, and should take small firms seriously as they have proven to be more dynamic than larger SMEs in Malaysia. Small size should not be seen as a deterrent to participation in R&D activities.

In Chapter 9, T.M Zakir Machmud, Ainul Huda and Rhita Simorangkir identify and examine key characteristics and financial constraints faced by Indonesian SMEs. They reveal that about 56 percent of SME respondents have access to finance, which is defined as an ability to acquire finance from external financial institutions. Although having the ability to acquire funding from external sources, reliance on internal financial sources, particularly personal savings and retained earnings, still prevails and plays a crucial role. To a large extent such conditions may reflect the fact that the majority of Indonesian SMEs are still considered to be traditional or conventional in doing business. They find that there is no significant difference in owner characteristics between SMEs that have access to finance and those without access. Both SMEs with access and without access perceive rising business costs as the main obstacle to expansion of their business. The survey also interviewed 11 financial institutions, mainly those from the banking sector. From the lender's perspective the three most important reasons to turn down a loan application are: (i) poor credit history; (ii) poor business plan; and (iii) insufficient sales, revenue, and cash-flows. Reflecting on the survey's findings, some broad policy recommendations are proposed to improve access to finance. First, there must be some capacity-building assistance for SMEs, such as preparing simple business plans, developing simple accounting standard operating procedures and cash flow management systems. This could be conducted by the financial institution itself or require third parties such as private sector firms, for instance through business development services (BDS). Second, the government should provide some incentives for banking institutions to channel credit to productive sectors, rather than consumer credit. Third, they should promote and socialize the use by SMEs of alternative institutions to obtain finance, particularly in remote areas. One example of these alternative institutions is a cooperative that provides deposit and credit services (koperasi simpan pinjam) to members. Promoting the establishment of forums or associations for these cooperatives would lead to the development of a secondary market for these cooperatives.

In Chapter 10, Rafaelita Aldaba presents analysis of a survey of 97 firms in the garments, textiles, automotive, electrical and electronics, and food manufacturing industries in the Philippines. The chapter highlights the difficulties faced by SMEs in accessing finance. For both firms with access to finance as well as those that did not make any requests for finance, financing obstacles are seen as one of the four most serious problems restricting the growth of their businesses. The survey indicates the continued dependence of SMEs on internal sources of financing, not only during the start-up phase but also to finance the current operations of the business. Close to 41% of the respondents intend to expand the size and scope of their business in the next two years. 67% said that financing the expansion through internal funds alone is insufficient, with the same proportion of firms indicating that they would finance their expansion by making a loan request. Previous surveys also showed that a substantial proportion of firms planned to borrow in the future. However, the continuing dependence of firms on internal sources of financing seems to suggest a gap between the plans of firms to borrow and the actual amount of funding made available by banks. SMEs, particularly the smaller ones, have been unable to access funds due to their limited credit track record, limited acceptable collateral, and inadequate financial statements and business plans. The bank survey showed that the top reasons for turning down financial requests were the firms' poor credit history, insufficient collateral, insufficient sales, income or cash flow, unstable business type, and poor business plan. To improve SMEs' access to finance, the chapter suggests the establishment of the Central Credit Information Corporation in order to address informational asymmetries. Changing the mindsets of banks and introducing non-traditional approaches to SME lending would also be important, along with training and capacity-building programs for SMEs in order to improve their financial literacy and management capacity.

Sun Xuegong and Liu Xueyan in their study of SME access to finance in China in Chapter 11 concluded that SMEs in the survey have been suffering from financing difficulties, even while China has experienced a lending spree. The future tightening of monetary policy will worsen the financing situation for SMEs. A proper policy response to the financing predicament facing SMEs is imperative and should be based on a good understanding of the reasons for their financing difficulties to which this survey study is designed to contribute. The survey reveals that financial institutions are quite selective

in responding to financing requests from SMEs. Basically, financial institutions give preference to older, larger, and faster-growing SMEs in specific types of business. The backgrounds of the SMEs' owners are also important. An experienced, wealthier, and older SME owner is more trusted by financial institutions. Other factors matter too. For instance, if the SMEs have collateral or participate in international production networks, their chances of getting financing are improved. The financial institutions also favour an SME with strong innovation potential, business capability, and good performance. In China, a number of policy areas are of particular importance. First, China's big-bank-dominated financial system exacerbates the problem of asymmetry of information. Small financial institutions should be developed to be in proximity to SMEs. Financial sector liberalization therefore needs to be expedited. Barriers to the private sector's participation should be eliminated. Second, the excessive risk aversion of financial institutions toward SMEs' financing needs to be corrected. The Asian financial crisis alarmed the Chinese government and as a consequence it began to tackle Non-Performing Loan (NPL) problems very rigorously. As a result the banking sector has taken a very conservative stance in risk control when dealing with the private sector and SMEs, even though the economic situation has now changed. To alleviate the SMEs' financing situation a little more risk-taking by banks should be encouraged. Third, China should take bolder steps to develop direct financing for SMEs. Among other things private equity (PE) is now a booming business in China, as more and more wealthy people seek high returns from their assets. The SME sector has the opportunity to benefit from the private equity investor. A favourable regulatory environment and fair competition should be established for the development of direct financing. Fourth, the credibility gap of SMEs needs to be addressed. The government should facilitate the collection and dissemination of the credit records of SMEs. A government-sponsored guarantee program can also play an important role in enhancing the credibility of SMEs.

4. Policy Implications

There are a number of important policy implications arising from the study. *First*, business start-ups remain heavily dependent upon loans from friends and relatives of the business owner and upon retained earnings. This severely constrains the growth of new businesses which are critical to the future growth and development of the region. *Second*, loans from financial institutions are important as a source of finance for SMEs, but financial institutions still remain limited in their ability to provide the necessary products and services required for SMEs and for new start-ups in particular. Expanding the breadth and depth of such products and services by financial institutions (other than commercial banks) and the development of alternative sources of finance to meet the needs of SMEs remains an important task of policy. *Third*, finance for ongoing business operations also remains heavily dependent upon the resources of the business owner, loans from individuals, and government financial assistance. This indicates the pressing need to develop business development services, primarily provided through the private sector. *Fourth*, credit rationing (amount of finance and cost of finance) appears to be imposed by financial institutions and is most apparent by size of SMEs and by stage of country development. *Finally*, developing and emerging economies experience potential credit rationing and financial gap problems more intensely by their SMEs due to: having smaller sized SMEs, many of which are informal; low profit margins; lack of firm transparency; lack of business plans; lack of cash flow; less wealthy entrepreneurs; less collateral, weaker corporate governance and entrepreneurial skills, less breadth and depth in financial markets, greater macroeconomic imbalances, and having a more distortionary legal, institutional and regulatory environment.

In order to address these shortcomings in terms of SMEs' access to finance, particularly in emerging markets and developing economies, a number of policy measures need to be addressed. The following policy measures could be taken into considerations.

First, regional governments, particularly in emerging markets and developing economies, will be required to address macro policy measures that contribute to sizeable budgetary imbalances with resulting national saving and investment imbalances,

compounding difficulties for the private sector in general in gaining access to finance. Government policies that place emphasis on rapid industrialization through discriminatory measures that favour large firms will also add to the problems facing SMEs wishing to gain access to finance.

Second, on the supply side, measures will be required to deepen and broaden financial markets in regional economies with the aim of encouraging greater competition in terms of providers, reducing the cost of borrowing, and stimulate greater provision of finance (non-bank financial institutions, equity markets, venture capital markets, etc.) that will enhance the provision of diversified products and services more in line with meeting the needs of the SMEs.

Third, the empirical results suggest that smaller SMEs in emerging markets and developing economies have the most difficulty in obtaining finance, and they face higher interest rates. This is not surprising and is consistent with the literature in the context of economies where a lack of transparency in firm operations and poor corporate governance contributes to asymmetric information and greater lending risk, as perceived by financial institutions and greater informality in firm operations. In this context it is essential to implement policy measures aimed at improving the legal, institutional, and regulatory framework. The legal framework should ensure property rights and contain provisions that protect lenders against bankruptcy and delinquent loans, and encourage lending institutions to lend to SMEs. In addition, they should also contain provisions that ensure access to land and land use rights, which is particularly important for SMEs as a source of collateral. The institutional and regulatory framework should be structured to encourage the formal registration of SMEs and should not contain bureaucratic and regulatory processes as well as taxes that make the costs of formalization (compliance costs) greater than the benefits to be obtained from formalization. The regulations should be as transparent and simple as possible, aimed at improving corporate governance and transparency arising from the adoption of good book-keeping and accounting standards.

Fourth, microeconomic policies aimed at opening up markets and creating a level playing field for all enterprises will encourage more efficient resource allocation and improve productivity. The establishment and nurturing of a vibrant SME sector will encourage greater competition. This should also be encouraged in the financial sector,

with the objective of increasing access to finance in general, as well as reducing the cost of finance.

Fifth, encourage the establishment of industry organizations for SMEs that will represent the interests of members and provide market information and assist in capacity building.

Finally, introduce credit guarantee schemes subject to rigorous and viable business plans, credit ratings, and information systems. Establish specialised and better development financial institutions such as SME banks, and the provision of business development services that can assist SMEs in embedding business training (e.g. management, business plan, book keeping and accounting, financial literacy) and network promotion.

However, quotas imposed on commercial banks for loans to private sector SMEs, interest rate subsidies for SMEs, and tax concessions should be avoided since they are ineffective due to an absence of sound legal and institutional capacities (weak governance).

In summary, specific policy measures should comprise the following:

- Encourage formalize by making it easier and less costly/ bureaucratic to become a formally registered enterprise.
- Reduce bureaucratic regulations and taxes that encourage informal business behaviour with the aim of encouraging larger firm size.
- Improve SME governance and entrepreneurial skills.
- Target wealthy entrepreneurs/owners to establish new firms or expand their existing businesses. Also target these for upgrading skills, innovation capability, etc.
- Encourage foreign owned enterprises to establish in the country, or establish majority foreign owned joint ventures with local SMEs.
- Improve book-keeping requirements of SMEs to improve transparency.
- Provide advice/ assistance in the preparation of business plans.
- Clarify collateral ownership by SMEs, particularly important in emerging economies in the context of land ownership or leasing.

- Reduce taxes/ charges on SMEs particularly where they disproportionately affect SME profits and cash flow.
- Tackle legal, institutional and regulatory distortions that discourage commercial bank-SME loans, such as intellectual property rights (IPR) laws, bankruptcy laws, lending on a non commercial basis, etc. These are particularly problematic in emerging market economies.
- In addition to these, government needs to tackle: macroeconomic imbalances (national savings and investment), limited depth and breadth of financial markets, and implementing microeconomic reform measures that encourage competition (in financial markets).
- In the more developed economies governments need to play a targeted role in establishing venture capital markets, in collaboration with the private sector, for high tech SMEs, as well as access to equity markets.
- Establish a credit rating agency for businesses, where possible, to make the task of banks lending to SMEs much easier.
- Encourage bank-client relationships to overcome some of the problems relating to asymmetric information and moral hazard.

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