Financing Small and Medium Sized Enterprises for Sustainable Development: A View from the Asia-Pacific Region
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The author gratefully acknowledges the contributions made by Masato Abe, Sailendra Narain, Michael Troilo and J. S. Juneja.

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1. SMEs’ VARYING FINANCIAL NEEDS: THE POLICY-MAKER’S PERSPECTIVE

1.1. SME access to finance: a subregional comparison

“Small and medium-size enterprises account for the largest share of employment in the developing world. They are also more likely than large firms to be credit constrained. These businesses need working capital to operate, to grow and to compete in the marketplace. So access to finance is crucial to their success.”

World Bank, Doing Business 2015.

As the above quotation intimates, limited access of SMEs to even the most basic financing tends to be a relatively generic issue, whether they are located in less developed, developing and developed countries. It is a generic problem across the globe, and no less valid in the Asia-Pacific region. The differences between countries and regions tend to lie in the degree of intensity of this constraint, which can vary significantly. For example, SMEs in less developed countries typically have a much more difficult time accessing finance than their counterparts in developed countries. This is due to a number of factors, including their own risk profiles and suitability for external funding (ie. demand side weaknesses), as well as the relative strength and capacities of the banking and finance sector (ie. supply side inadequacies). In addition, the capacities and resources of government agencies in developed countries tend to be greater, which then allows for larger and more effective policy interventions to try and overcome market failures or address regulatory constraints. There can also often be greater market and regulatory failures at work in less developed and developing economies, compared with more developed countries.

Indeed, developed countries tend to have a more developed financial and regulatory support structure that serves to reduce the risk and costs of lending to SMEs, and thus allows the market to be a more efficient provider of such finance. These can include stronger ownership rights, their adjudication and enforcement, which makes it easier for banks to foreclose on assets pledged as security for loans that have defaulted, for example. They will also more likely to host private credit bureaus that provide credit history for almost all firms that have ever taken a loan, again reducing the risk entailed for the finance provider. A good personal borrowing history by an individual that needs a loan to start a business venture may encourage a bank to provide the finance, based more on his/her credit history than whether or not collateral is available. Ratings agencies and secured transaction registries can also be useful in this regard. And with recent advances in ICT, the use of ‘big data’ allows financiers to forecast with greater confidence on the likelihood of an applicant’s credit standing. But in countries where such ‘big data’ do not exist, or are fragmented or go unshared (for whatever reason), these kinds of support structures, so useful in mitigating SME risk, cannot be implemented so easily, or require substantial efforts and cost to be developed.

Just as not all countries are the same in their ability to provide SME finance, it is similarly the case that not all SMEs are the same. And thus, not all SMEs’ financing needs are the same. As a consequence, SME financing should ideally span a range of activities, products, services and mechanisms for funding the development of SMEs.
SME financing is not wholly divorced from other kinds of banking and finance, but it
does tend to have its own special characteristics intended to serve the particular needs of
SMEs. One is the ability to mobilize capital relatively quickly, in response to start-up or
growth opportunities, and market windows, that can rapidly arise (and equally rapidly
close). Another salient characteristic is one of complementarity, with SME financing
augmenting more traditional sources of financing in many contexts. But the precise
financing needs and expectations of SMEs (whether in the form of debt and/or equity)
tends to vary, depending on (but certainly not limited to) such factors as:

(a) Home country profile;
(b) Industrial, agricultural or services sector in which the SME is operating;
(c) Perceived business risk of the SME and its business venture;
(d) Asset structure of the SME (e.g. tangible versus intangible, capital-intensive
    versus less capital-intensive, high or low labour content);
(e) Debt-to-equity ratio of the SME (i.e. how ‘leveraged’ the business is);
(f) Anticipated future growth rate of the SME;
(g) Profitability of the business;
(h) A range of social and cultural factors;
(i) The wider macro-economic health of the country (and even the global
    economy) at a particular time, influencing the SMEs’ business prospects; and
(j) Current size, stability and complexity of the financial sector, influencing the
    propensity to lend to SMEs and other high risk sectors.

The principal SME finance instruments can be broken down into the six broad
categories, namely: informal, internal, debt-based products and services, equity-based
funding avenues, non-collateralized debt products, and government grants or subsidies.
Each of these instruments will be briefly discussed:

- Informal finance refers to all financial transactions, between two parties, that
  occur outside the regulatory framework and enforcement of a central banking
  and finance authority. Such funds may come from personal savings, borrowing
  from relatives or ‘loan sharks’. The primary concern with this kind of
  financing is that it is beyond the regulatory body’s ability to regulate and
  enforce the process, such as protecting users and prosecuting abusers (such as
  usuries), as well as inhibiting its ability to enact its fiduciary, monetary and
  systemic banking sector responsibilities.

- Internal financing is the method of generating funds through a company’s core
  business, such as through withheld profits and using working capital. In
  developing countries, including those in Asia and the Pacific, informal and
  internal financing typically dominates SMEs’ financial sources, particularly
  for start-up ventures and micro and small enterprises.

- Debt-based financing, which is also a major (and formalized) source of
  funding for SMEs, typically takes the form of credit lines, term loans, rolling
  overdrafts and other debt products that must be fully repaid over time, with
  interest. Most debt financing is provided by commercial banks. This is
  typically the most common (and therefore most important) form of financing
  that SMEs -- and others -- think of when they consider access to finance. The
  most common form usually entails the borrower providing some kind of
  collateral as security against the loan, should he/she be unable to service the
loan, as stipulated in the loan contract. There may also be various supporting services, such as credit guarantee schemes, used to encourage (by mitigating some of the risks of) lending to SMEs and other eligible businesses.

- Equity-based financing spans a range of activities whereby investors provide funds (and sometimes also non-financial assistance also) in exchange for an ownership share or other interest in the business. It includes a wide range of financing sources such as business angel networks, venture capital, private equity, and even share issuance through initial public offerings (IPOs). There are also debt-equity hybrid instruments, such as convertible loans, whereby a loan is converted into shares at a later date, if contractually agreed by both parties.

- Non-collateralized debt products are typically a way of issuing financing while circumventing the need for collateral, which can often pose a problem for SMEs. The most common types of asset-based financing are factoring, invoice discounting and inventory financing. Financial leasing is another common method of financing the acquisition of equipment by SMEs.

- In some countries, the public sector sometimes actively promotes the development of SMEs by providing grants, subsidies, or guarantees. These are often provided through devoted state agencies or through commercial financial institutions, with clear criteria that establish which SMEs are eligible to apply. The efficacy of using such instruments to overcome or mitigate market failure tend to be controversial, given the use of public funds and the risk of losses to the state budget, but are popular with policymakers that wish to support SME sector development.

Figure 1 seeks to depict much of this in graphic form, focusing on the relative risk and return expectations attached to each SME financing form (see the left-hand column, from high to low), the degree of sophistication (and therefore likely transaction costs) depicted in the right-hand column, also from high to low. The central area depicts the differing SME finance products and services in a matrix that combines both the risk/reward/sophistication/transaction cost expectations mentioned before, combined with the typical needs and financing options of (a) micro and start-up, (b) small and (c) medium sized enterprises. Thus, for a start-up venture, probably angel financing comes with the highest degree of risk and need of investor sophistication, relative to the ease of using some personal savings of the entrepreneur concerned (if he or she should have some) to get the business going. For larger SMEs, investment by a private equity/venture capital investor, followed by an initial public offering (IPO) is probably as sophisticated a form of financing that one might consider, relative to getting a short-term loan for use as working capital.
Further details and discussion on all of these SME finance instruments are explored later in the paper, with an emphasis on providing an Asia-Pacific perspective. At this stage it is already evident that the potential range of SME financing options available in some countries is quite substantial, with an aim of meeting the specific needs of SMEs at different stages in their development, and seeking to do different things with the funding on offer. Needless to say, in some less developed and developing countries, not all these options are available - for a wide range of reasons - whether they be regulatory, market-influenced, historical, and/or capacity related.

Turning to Asia and the Pacific, a recent joint study by the ADB and OECD (2014) on ‘Enhancing Financial Accessibility for SMEs’ notes the following broad profile in Asia’s access to finance for SMEs, as compared with other regions of the globe (table 1):

(a) Enterprises in Asia have less access to credit and overdraft facilities than their counterparts in other regions.

(b) SMEs in Asia have lower access to credit than large firms in Asia.

(c) SMEs in Asia were only slightly more likely to report financial constraint than larger Asian firms, though much less than in other regions.

(d) SMEs in Asia were least likely to have made recent investment, and most were reliant on retained earnings for both investment and working capital.
(e) SMEs in Asia were least likely to apply for a loan.

(f) SMEs in Asia were more likely to be required to provide collateral for loans and were more likely to be financed by state-owned banks.¹

Table 1. Enterprise characteristics and access to financial services (%), Asia and non-Asia compared.

<table>
<thead>
<tr>
<th>Item</th>
<th>Non-Asia</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
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<td></td>
<td>Small</td>
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<tr>
<td>Exporter</td>
<td>9.7</td>
<td>22.4</td>
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<tr>
<td>Investment - fixed assets</td>
<td>34.9</td>
<td>34.9</td>
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<td>Female owners</td>
<td>41.2</td>
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<td>Financially constrained</td>
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Banking access

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<th>Sources of credit for most recent loan</th>
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<td>Checking</td>
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<tr>
<td>Overdraft</td>
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<td>Credit</td>
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</table>

Private commercial banks                   79.3 | 77.9 | 84.6 | 28.3 | 27.0 | 27.9 |
State-owned banks                          14.8 | 18.5 | 13.5 | 59.1 | 65.5 | 70.2 |
Nonbank financial institutions¹             5.2  | 2.8  | 1.3  | 8.6  | 6.9  | 1.6  |
Other                                     0.7  | 0.7  | 0.6  | 3.9  | 0.5  | 0.4  |

* Nonbank financial institutions include microfinance institutions, credit cooperatives, credit unions, or finance companies.


The World Bank’s latest ‘Doing Business’ survey also provides some revealing data pertaining to the Asia-Pacific region (World Bank, 2015). One of the ten metrics used to measure the relative ease of doing business in the 189 territories covered is access to credit (the most basic form of finance). Tables 2 and 3 show the rankings of East Asian & Pacific countries and South Asian countries by this particular metric based on the 2015 survey.² Surprisingly perhaps, Cambodia ranks first in the former subregion, ahead of (less surprisingly) Singapore and Hong Kong, China; and Malaysia. At the other end of the spectrum, Myanmar, Papua New Guinea and Timor-Leste rank lowest on access to credit. In the South Asian subregion, India ranks top-most for access to credit, followed by Bhutan, while Bangladesh ranks bottom, followed by Pakistan.

¹ See ADB-OECD (2014), pp. 30-32. The same report notes (pp. 37-38): “Given the prominent role of state-owned banks in SME lending in Asia, increasing the supply of SME financing would also require the expansion of the private sector in financing, which needs to be supported by improvements in firms’ financial reporting and the availability of credit bureaus, which works to reduce informational asymmetry in the market. The supply of adequate, affordable, and responsible credit would help Asian firms to grow and enhance their productivity. In the long run, this would translate into higher wages for workers and contribute to inclusive growth in the region.” See p. 138.

² The reader should note that UNESCAP’s regional classification does differ from the World Bank’s regional groupings for the Asia-Pacific region.
Table 2. Doing Business 2015 rankings for East Asia and the Pacific, by ‘getting credit’

<table>
<thead>
<tr>
<th>Economy</th>
<th>Ease of Doing Business Rank</th>
<th>Filtered Rank</th>
<th>Starting a Business</th>
<th>Dealing with Construction Permits</th>
<th>Getting Electricity</th>
<th>Registering Property</th>
<th>Getting Credit &amp;</th>
<th>Protecting Minority Investors</th>
<th>Paying Taxes</th>
<th>Trading Across Borders</th>
<th>Enforcing Contracts</th>
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Table 3. Doing Business 2015 rankings for South Asia, by ‘getting credit’

<table>
<thead>
<tr>
<th>Economy</th>
<th>Ease of Doing Business Rank</th>
<th>Filtered Rank</th>
<th>Starting a Business</th>
<th>Dealing with Construction Permits</th>
<th>Getting Electricity</th>
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<th>Paying Taxes</th>
<th>Trading Across Borders</th>
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If one looks at the specificitie s of the rankings for ‘getting credit’, some interesting evidence comes to light. For example, Cambodia, which came top for getting credit in the East Asian and Pacific subregion, ranked a more humble 135th overall in the Doing Business 2015 survey of 189 economies (and 12th in the world on the access to credit metric). So why did Cambodia rank so well on the access to finance metric? The answer probably lies in the following facts:

(a) The strength of legal rights for the country is high, scoring ‘yes’ for 11 out of 12 measures used (compared with average of 6 for the region as a whole and the OECD countries’ average).

(b) The depth of credit information available is quite high, scoring ‘yes’ for 5 out of 8 measures used (compared with an average of 4 for the region as a whole).

(c) And while Cambodia does not have a credit registry, the credit bureau coverage for the country is 29.3% of the adult population, compared with an average of 20.4% for the region as a whole.

Thus, while Cambodia does not have a highly liquid and robust formal banking sector, it does perform well in providing the right kind of conducive support – legal rights, credit information and bureaus – that can make the provision of credit easier.

In contrast, Myanmar ranked bottom in the East Asian and Pacific subregion for getting credit, somewhat in conformity with its 177th ranking for Doing Business overall, and 171st global for access to credit. Much of that is due to the paucity of credit available (ie. liquidity) in a weak banking sector where loans are relatively scarce, and the considerable challenges that SMEs in particular cite in accessing funding. But another constraint – and in contrast with Cambodia – is that:

(a) The strength of legal rights for the country is low, scoring ‘yes’ for just 2 out of 12 measures used (compared with average of 6 for the region as a whole and the OECD countries’ average).

(b) The depth of credit information available is also low, scoring ‘yes’ for none out of 8 measures used (compared with an average of 4 for the region as a whole).

(c) And Myanmar has neither a credit registry nor a credit bureau system to cover the adult population of the country, compared with an average of 20.4% for the region as a whole.

Little wonder, then, that SME-related banking and finance in Myanmar is so constrained, as the relevant support structures are not in place. With regard to the related issues of investor protection, enforcing contracts and resolving insolvency, again Myanmar ranks poorly, at 178th, 185th and 160th, respectively. These high risk levels also make it difficult to provide financing with confidence (and Cambodia ranks better in these metrics also).

Turning to the South Asian subregion briefly, a similar picture is apparent. In India, the strength of legal rights (6 out of 12) are higher than the regional average of 5, the depth of credit information (7 out of 8) is higher than the regional average of just 3, and 22.4%
of the adult population is included within credit bureau coverage, compared with a regional average of 11.3%. Meanwhile, Bangladesh has no credit bureau coverage (although it does have credit registry), and scores nil out of 8 for the depth of credit information. It is no coincidence that the Doing Business 2015 survey stresses the importance of credit registries when it comes to the issue of access to finance, and their development should be considered as part of regional action plans to foster improved access to finance for the SME sector in the Asia-Pacific region.

However, it is also important to keep in mind that the results of surveys which focus on the views, preconceptions and opinions of SMEs will also vary across countries depending on, not only the ‘reality’ of the financial provision situation, but also the expectations of the sample being assessed; in this case SMEs. Firms that expect financing to be made available are likely to be more critical of funding constraints than firms in countries where formal financing is much less abundant, and do not so readily view access to (formal) finance as a key component of the enabling environment. Is access to finance for start-up companies in a less developed or developing country harder to find than for their peers in a developed country? Experience would suggest almost certainly so. And yet in some business surveys, the results are often much less pronounced, or even counter-intuitive, precisely because of this ‘anchoring bias’, as perceptions and expectations of those surveyed are influenced by the immediate environment in which they operate.

### 1.2. The SME business life-cycle

Throughout an SME’s life cycle, each individual stage – whether it is start-up, growth, maturity and graduation to a large enterprise, decline or transition or acquisition, and ultimately a likely (solvent or insolvent) exit – will entail different financing needs. SMEs may obtain equity capital and debt financing products and services from various sources at each of those stages, although some become of greater utility than others at different times. Figure 2 provides a stylized representation of SMEs’ financial needs during the start-up, growth and transition stages.

**Figure 2. Stylized representation of the various growth stages of an SME**

![Stylized representation of the various growth stages of an SME](source: Abe and others (2012).)
For a number of reasons, the first period (SME start-up) typically has a high mortality rate for SMEs, such as a poorly conceived or flawed business plan, a change in market conditions or some other exogenous factor, the departure of a key human or other asset, etc. But it may also be for want of sufficient initial start-up capital, even though the scale of the funding needs is relatively humble. The issue here is typically one of ‘chicken and egg’ – having insufficient funds to fully commence operations and thereby being unable to provide a product or service to customers from which revenues flow-in to fund those initial operations. If customers or clients are slow to pay, or exercise their right to delay payment by an agreed period (e.g. 30 days from the date of invoice), the resulting dislocation of funding outflows and inflows can send an SME into speedy insolvency; unable to meet its salary, rental, utilities or other financial obligations. This time-money gap is difficult for start-up businesses to avoid, and survival can depend on a firm’s ability to raise additional working capital. Apart from personal assets and loans from family and friends (or usuries), during the start-up stage SMEs may be able to get funds from seed capital, venture capital, business angels and/or government or institutional sources, if and where they exist. Alas, numerous developing countries are unable to provide such support.

In the second period (SME growth and maturity), SMEs pass through the critical ‘break-even’ point and start generating earnings. At this point, they normally require additional financing, such as a large amount of working capital as well as investment in production facilities and human resources, to reach the next level of more sustainable business. While such financing for growth could be supported by short-term loans and retained earnings from their daily business, longer-term loans are usually preferable, in order to preserve adequate working capital, as well as to better match the term of the loan financing with the depreciation of the assets being acquired. Venture capital and private equity funds may also become an important resource for expansion. Entrepreneurs still typically experience difficulty raising funds at this stage, even if their pilot business model has passed the first stages, as the perceived risk remains high.

In the third potential period (decline and transition, assuming the SME proves unable to graduate to a higher level), it is necessary for SMEs that are losing money to undertake measures to improve their profitability, either by increasing sales or by reducing costs, or other ways of recalibrating the business in some form. While long-term financing or working capital generation is necessary for continuous enterprise growth and development, immediate short-term financing, perhaps through commercial debt financing, is often critical for SMEs to stay afloat during such cash-drain periods. A sale of the business to an outside investor is also a consideration, and where debts remain, the new owner will need to factor this liability into the price of the assets being offered for sale.

### 1.3. Working capital: funding day-to-day operations

Across all three periods of the life-cycle, one well-established (and valid) truism in SME development pertains; it is that even a fundamentally profitable business can be rendered insolvent by poor cash flow management. Indeed, the importance of cash flow for small businesses is hard to over-emphasize. Lumpy payments for goods sold, or a mis-match between revenues and costs can force a company into involuntary insolvency. Hence the paper’s first recommendation: basic working capital is essential for the functioning of all
businesses, including SMEs, if they are to maintain operations. This is typically – but not always – in the form of debt (or loan) financing of some kind, with a conventional provider of ‘plain vanilla’ funding, such as a bank. The financing itself may be in the form of a loan, or a revolving overdraft facility, secured by the SME’s assets or that of its owner(s) personal assets. As the SME expands its business, it may be possible for it to fund more of its working capital needs from internal resources, such as its own balance sheet or retained earnings. But it is rare that (and potentially risky if) a firm seeks to operate on internal revenues alone, without the need for some kind of external financing resource to call on at times of cash flow shortage, particularly these days with increasing e-commerce and B2B transactions conducted on-line or through other electronic means or fund transfers.

1.4. Fixed capital: funding investment

The second recommendation made by this paper is that, in order for SMEs to thrive and flourish there is also a need for more long-term funding sources, both debt and equity, to support sensible capital investment for corporate growth. Cash (flow) may be ‘king’, as the popular saying goes, but long-term capital is ‘queen’. Short-term loans, principally intended for working capital needs, are not well designed to fund more long-term working capital investment needs. Reconciling the mismatch of differing length of maturities between assets and liabilities is a challenging exercise that even banks – the financial professionals, as it were – often find difficult to achieve successfully, and hence the fear of bank-runs or other systemic crises. To expect SMEs - most of which would not regard financial management as a core competence - to be able to take on this task is therefore unrealistic, and tempting a rise in the number of insolvencies. If an SME just needs a short-term bridging loan or overdraft to cover a 30-day payment period, then clearly short-term working capital will suffice. But if the same SME plans to invest in some new machinery and needs to borrow a substantial sum of money for this purpose, then it will need a longer period of time to pay back the loan, potentially as long as the accepted accounting period for the full depreciation of that machinery. Clearly, here the need is for fixed capital finance.

It is in this context that both long term debt products and services, as well as equity financing, can play an important role in providing the kind of financing most appropriate for SMEs that need long-term funds for capital investment. For reasons that are self-evident, this is sometimes referred to as ‘patient capital’, in that the finance provider must wait quite some time to see its funding fully returned, with a return, thus extending their exposure to SME risk. Financial leasing, for example, neatly combines the term of the ‘loan’ with the use of the equipment that is leased. Only after the equipment is fully depreciated, in accounting terms, does the ‘loan’ cease, and formal ownership of the assets is transferred from the lessor to the lessee. Leasing is discussed further below.

Equity finance also tends to have a relatively long-term horizon line, with fund managers and their investors typically expecting not to exit from an SME investee for a period of between three and five years, and sometimes even longer. For example, a venture capital investor will usually seek to stay invested in an SME while it transitions to a markedly bigger business – whether through organic growth or acquisitions – and therefore allows for the investor to exit with a substantially greater return on the shares previously acquired. That, in turn, is determined by the company’s valuation, which can be calculated in various ways – such as share price-to-book value, share price-to-earnings
multiples, earnings-per-share and EBITDA (net earnings before interest, taxes, depreciation and amortization) – but in all cases is usually driven, at least in part, by the actual size of the business. And such growth takes time, even if accelerated through the means of acquiring other SMEs. Similarly, a private equity investor will typically wish to exit an SME investment through a large trade sale or an initial public offering, which necessitates the business scaling up to a level where it is of interest to a large strategic investor who wishes to acquire that firm’s market share and revenues, or where the sale of shares to the wider community of portfolio investors (including retail investors, as well as institutional investors) is sufficiently large in scale to make economic sense. In the case of the latter, the transaction costs of conducting an IPO, and the subsequent operating costs of remaining compliant with the more onerous regulatory and reporting requirements expected of listed firms, effectively necessitates that only medium or large companies pursue this option.

Thus, from the policy-maker’s perspective, an ‘enabling’ environment for SMEs that puts too much emphasis on short-term finance is likely to be sub-optimal. It may help SMEs get started, in some cases, and help other SMEs remain operational, but it will be unlikely to fund the development of the sector in a more meaningful way. If one excludes those SMEs and entrepreneurs that simply wish to survive but not expand and develop, then access to fixed capital is becoming an increasingly important determinant of success as business itself becomes more technologically advanced, more complex and discerning in how it works, more inter-connected (with manufacturing occurring across borders, as the production chain is more finely ‘sliced and diced’); higher levels of standards and rules-based requirements are imposed, and the expectations of end-consumers rises to new highs. It is in this context that, as production and services activities become increasingly international and networked in nature, those SMEs with aspirations for growth need to remain competitive with their peers in other countries. And even for those SMEs with much more modest goals, failure to keep up with industry standards for quality and other metrics by which performance is judged could see SMEs lose the traditional markets on which they depend. Thus, SME finance becomes an important component of an economy’s industrial strategy, and its future economic prospects. From the point of view of policymakers, who are concerned about job creation and improving incomes, much depends on supporting the community of SMEs to graduate to larger levels of size and sophistication and improved levels of price competitiveness.

1.5. Beyond collateral: supporting the good and recycling the bad

Reference has already been made to the issue of collateral: the physical assets pledged as security by a borrower to a lender in case the former is unable to service the loan. For banks and other lenders, collateral serves as a credit enhancement to reduce the risk of a borrower’s default, as they would lose ownership of the assets pledged as security if they did so, and thus serves as a strong inducement to abide by the terms of the loan contract. And should the borrower still default, the financial provider has the legal right to take ownership and sell off the assets provided as collateral, as a means to recoup some or all of the loan amount given, including interest foregone.

In some Asia-Pacific countries, such as Myanmar, central bank rules make it mandatory that commercial banks take collateral for all loans provided. In some other countries, while the banking regulations may not explicitly prohibit the taking of collateral as
security on loans, most banks are reluctant to do otherwise, and therefore the collateral requirement is also virtually universal. In more developed countries, unsecured lending is more common, with banks focusing less on the assets which are preferred by an applicant, and more on the cash flows and profitability of the business as an indicator of whether or not to lend.

Some of the main types of collateral that the borrowers can use include:

(a) Property – a borrower may pledge physical property as security for a loan. If the loan is not repaid, the property may be sold in order to reimburse the lender. Acceptable property and financial assets may include real estate, equipment, inventory, etc. This is perhaps the most common form of collateral, and typically the most difficult for SMEs and informal enterprises to provide, whether because they do not possess such assets, or their legal proof of ownership – and the ability to transfer ownership – is not sufficiently clear.

(b) Financial assets – it is possible to get a loan by assigning financial assets to the bank. In this situation, the bank keeps the assets until the borrower has repaid the loan. Common financial assets used for this purpose include savings accounts, certificates of deposit, stocks and bonds.

(c) Life insurance – the cash value of a life insurance policy can serve as collateral, whereby the borrower can get credit from the insurance company directly, or assign the policy to a bank.

(d) Third-party loan guarantee – under a third-party guarantee agreement, one or more guarantors sign an obligation to pay the lender the amount owed if the borrower defaults on the loan.

(e) Credit guarantee – some government agencies provide credit guarantees to target firms, which effectively serve as pledges that should the borrower default, the lender will be reimbursed by the guarantee scheme.

It will come as little surprise that SMEs typically find the ‘collateral constraint’ an onerous demand that they often struggle to comply with. Many lack the collateral required, or are (understandably) reluctant to pledge personal assets, such as their house, in support of a loan for a start-up business venture. In the view of most SMEs, the collateral issue is a major obstacle to accessing financing, and can be exacerbated further when banks and other loan providers expect to take collateral that is valued at markedly more than the loan size. The reason often cited for this is that there are costs and risks associated in taking ownership of and then selling assets pledged as security on a loan that subsequently went delinquent and for which the lender must have some degree of additional compensation or protection. This is often the case in jurisdictions where the ability of the courts to rule and enforce decisions made on the transfer of physical assets is weak, slow, unreliable, or vulnerable to coercion. In such cases, the cost of financing is inevitably going to be more demanding for SMEs, as the finance provider is operating in a much more uncertain environment, and thus must absorb a higher degree of uncertainty and risk. Furthermore, the price of the assets provided as security may decline in value over time, while the loan is still performing, and so a safety cushion needs to exist. This can be the case, for example, when property is provided as security
on a loan, the market value of which may change (up or down) over time.\textsuperscript{3}

However, the orderly ‘work through’ of assets in insolvent companies and loans that have become non-performing are an important element of SME financing, if not the most obvious one that policymakers typically consider. If lenders could not recoup their losses on debt provided to SMEs, they would either stop lending altogether (particularly in economies where the regulator does not allow banks to ‘price for risk’ in their lending activities), or charge markedly higher rates of interest (in economies where the regulator allows the market to determine the rate), or go out of business themselves. This extends to other assets of insolvent SMEs too. For these productive assets to remain idle, when they could be put to good use by other SMEs, is a drain on an economy. Thus, while the collateral constraint is a legitimate frustration for many SMEs looking for debt financing, it is a ‘necessary evil’ in many cases, even when the value of the collateral is a (reasonable) multiple of the size of the loan to which it serves as security. Going one step further, this is also why the relative ease with which failed SMEs can go through orderly insolvency (i.e. ‘wind up’ their operations) is almost as important as the relative ease with which firms can be incorporated and formalized. Productive assets need to be put to work by firms that can use them to generate economic growth, jobs and income for an economy, and should not be allowed to lie idle in firms that have gone out of business.

The other policy-related point emanating from this is that the determinants of SMEs’ access to finance at acceptable costs (e.g. not being forced to use ‘loan sharks’ and usury rates of interest on loans), is not always a function of the financial sector alone. The above discussion clearly shows how the quality of the legal system, for example, and its enforcement can have a considerable impact on finance provision. And even within the financial sector, any bank lending, whether SME-oriented or not, assumes that banks too have access to adequate funds (or ‘liquidity’) to make loans. However, if their deposit base is small, or the inter-bank market is weak (or non-existent), or the costs of funding are high, then such an assumption can be called into question. Thus, robust SME financing activity is dependent in large part on having a robust banking and finance sector.

Having explored the wider context in which SME finance is enacted, and considered some of the important determinants of its provision, sections 3 and 4 can ‘map out’ in more detail the various financial products and services that can best be utilized by SMEs, and thus be delivered in support of SME sector development. These are broadly divided into, first, debt products (in section 3), and then equity products (in section 4).

\textsuperscript{3} Mongolia provides a good example of this. As the IFC report on SMEs in Mongolia (2014c) notes: “The strengthening of SMEs is crucial to achieve broad-based and sustainable growth in Mongolia. Nevertheless, SMEs are constrained by a number of problems, among which access to finance is identified as one of the most difficult barriers to growth and development. As far as the banking sector is concerned, loans provided by commercial banks tend to be short-term, expensive and require very high collateral. Collateral requirements are particularly constraining for SMEs since commercial banks usually ask for immovable property due to the non-existence of a central registry of movable assets. Weaknesses in the legal framework for enforcement mechanisms also force banks to avoid accepting the pledge of movable property. Securing repayment in a case of competing claims can be very difficult, especially when real-time information on priority pledges is not available. As a result, the market for providing bank finance against movable collateral is almost non-existent in Mongolia.” See p. 2.
2. MAPPING OUT SME FINANCE: DEBT PRODUCTS AND SERVICES

2.1. SME debt-financing options

Having touched on informal and internal sources of SME finance, and conventional bank lending, additional forms of SME-oriented financing can be considered, as shown in figure 1. With regard to debt instruments, they include a range of traditional and more innovative services, spanning:

(a) **Trade credit**, or buyer’s credit, which is often an important source of capital for SMEs, after banks and private lenders. Trade credit is an arrangement between businesses to purchase goods or services, on account, without making immediate cash payments. Instead, it is mutually agreed that the buyer is billed for payment at a later stage (usually between 30 and 90 days after the invoice date). Trade credit conditions can be quite industry or product-specific, but the generic principle is for participating businesses to make use of their capital more efficient and effective. Trade credit serves as a valuable source of finance for SMEs in less developed and developing countries in particular. The ‘buy-now-and-pay-later’ concept holds many advantages for SMEs, one of which is helping to increase working capital and create positive cash flows.

(b) **Financial leasing** is particularly seen as being ‘SME-friendly’, as it overcomes the collateral constraint issue (i.e. the requirement to pledge assets as security on a loan), as well as smoothing out payments for a large fixed capital investment. Leasing can be offered by banks, non-bank financial institutions of various kinds, and by specialized leasing companies. Under a financial lease, an SME can finance up to 100 per cent of the equipment value without collateral, as the actual ownership of the leased assets remains with the finance provider, until all the payments have been successfully made; only then does the SME take legal ownership. Payment schedules can be also adjusted according to cash flows, or other determinants, rather than a rigorously uniform schedule that is difficult for an SME to meet. Documentation requirements and approval time can also be relatively simple and short.

There are two basic types of financial leasing: capital and operating. A capital lease, or hire-purchase, treats the leased equipment as an asset owned by the lessee (an SME), whereas an operating lease does not. A leasing arrangement typically involves the following procedure (or some variant of):

(i) The lessee (borrower) selects an asset (e.g. equipment, vehicle or software) that the lessor (the leasing or finance company) will acquire for renting to the lessee, and a lease agreement contract is signed between the two parties.

(ii) The finance company is the legal owner of the asset during duration of the lease, and keeps the documentary evidence of this ownership right.

(iii) The lessee has control of that asset to use during the agreed lease period, and pays regular installments for the use of that asset, according to the terms set out in the contract.
(iv) The lessor ultimately recovers the cost of the asset, plus interest, from the rental payments made by the lessee.

(v) At the end of lease period, the lessee has the option to take ownership of the asset.

Because leasing is so useful for SMEs as an alternative source of debt finance, policymakers are often keen to encourage the development of a leasing industry, whether through existing financial institutions and banks, or through the establishment of specialist leasing companies. The interest rates charged by leasing companies tend to be slightly higher than that for a conventional bank loan, partly because their cost of funds is slightly higher while they must also factor in the higher entailed transaction costs and make provision for a default contract, which then requires them to take back physical ownership of the leased asset and its subsequent sale. In cases where SMEs have insufficient collateral to provide as security on a loan, a lease agreement can be a welcome alternative, even if the cost is slightly higher. One method that some governments have used to help kick-start the leasing industry is to allow accelerated depreciation on leased assets, so that the cost can be financially ‘written off’ by the lessee more quickly than if the asset concerned had simply been bought outright, which serves as a further attraction.

Another important structure that supports financial leasing is the creation of collateral registries – also sometimes referred to as secured transaction centres – that allow for the registration of movable assets (such as machinery, transportation or inventory) pledged as collateral on loans. These registries allow for a lessor (or indeed any lender) to take movable assets as security, without actually having to take legal or physical custody of them, knowing that they have not already been pledged as security (or ‘existing liens’) to another finance provider. Online systems now permit such registration to be done quite easily, speedily and cheaply, and the same is true for those wishing to refer to the register. In the case of leasing, the leased assets can be recorded as such on the registry database, thereby allowing the leasing company a high degree of confidence that they will not be sold on by the lessee, nor pledged as collateral to get a different loan. However, for this to work well, there is a need for a single, national collateral registry and database, as the efficiency gains are diluted if there is a need for a lessor (or any finance provider for that matter) to look through multiple databases housed in multiple secured transaction centres.

(c) Factoring is a relatively new form of asset-based financing for increasing working capital, and refers to the ‘sale’ of accounts receivables (i.e. funds that the SME expects to receive in the future for work done) to a third party (called a factor), in exchange for immediate cash. A bank or a specialized financial institution may purchase accounts receivables from an SME with adequate trustworthiness, for cash, typically at a discount to the total ‘face’ value of those receivables. That discount is to compensate the factor for assuming the risk on the ability of the buyer to honour the payment when due, and for handling all the costs entailed in the collection of the receivables. This practice increases SMEs’ short-term cash flows, as they get their payments faster than would otherwise be the case, while reducing the administrative costs and other burdens of chasing up all accounts receivables. In Asia, factoring activity
has been on the rise (table 4).4

There are three main differences between factoring and bank loans. First, the emphasis is on the value of the receivables, instead of on the firm’s overall creditworthiness or its ability to pledge sufficient collateral. Second, factoring is essentially a purchase of financial assets, rather than the provision of a loan. Thirdly, in the case of SME finance, the risk of non-payment lies not with the firm itself, but with its customers (should they not pay up). If the customers are large TNCs or other firms of large size and reputation, then the risk is much less than that of the SME, and thereby serves as a better risk prospect for the financial institution conducting the factoring. And that is perhaps its main attraction in the context of SME financing, as it sees the SMEs ‘leverage’ the lower risk profiles of their larger customers to their own (but legally and morally legitimate) advantage. But factoring can be an expensive form of financing, in comparison to bank loans, and therefore may not be the ideal choice when other sources of financing are available to SMEs. The rate of return should be considered in advance, and factoring may be adopted only when the expected return of capital is higher than the cost. Factoring also often requires the endorsement or notification of the relevant buyers (i.e. the large firm that is expected to pay the accounts receivables, when due) in advance, and this runs some risks of being misinterpreted.5

4 See ADB-OECD (2014), pp. 132-139. With respect to factoring activity in Asia, the author notes: “Factoring is a growing business globally. Asia is participating in this trend, though factoring is still small in scale in the region. Ideally, factoring takes on a catalytic role in connecting SMEs to the growth-and-graduation cycle of enterprises. To this end, the factoring industry may target growing SMEs to develop a niche market. In this regard, the factoring industry in Asia has dual potential. At the national level, domestic factoring as part of diversified financing mechanisms will support growth-oriented SMEs in expanding, given additional funding flexibility. At the global level, international factoring as a complement to trade finance will support SME exporters and promote intraregional trade that serves global rebalancing.”

5 Invoice discounting is a similar asset-based instrument as factoring, in that the invoice discounter advances an agreed percentage of the invoice value (receivables). The main difference is that invoice discounting allows SMEs to continue administering their sales ledger, rather than transferring this responsibility to the factor, and the service is usually undisclosed to customers.
Table 4. The rise of factoring in Asia, 2006-2012:

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<th>Source</th>
<th>(million)</th>
<th>2006</th>
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<th>2008</th>
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<th>2012</th>
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<td>7,020</td>
<td>3,578</td>
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<td>3,780</td>
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<td>0.2</td>
<td>70.2</td>
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<td>104,923</td>
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<td>3,956</td>
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<td>115</td>
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<td>88</td>
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<td>82</td>
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<tr>
<td>Asia Total</td>
<td>200,240</td>
<td>233,453</td>
<td>313,000</td>
<td>278,192</td>
<td>474,183</td>
<td>680,234</td>
<td>765,200</td>
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<tr>
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<td>1,788,287</td>
<td>1,732,856</td>
<td>2,225,325</td>
<td>2,720,300</td>
<td>2,878,511</td>
<td>161.0</td>
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</tr>
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</table>

Note: Dollar data converted from euro data using the exchange rate of $1 = €1.35; GFC = Global financial crisis.

Microfinance covers a wide range of financial services geared towards the poor and low-income household group, as well as micro, small and start-up enterprises. Microloans, savings and micro-insurance are examples of such financial services, which are aimed at providing access to formal finance and financial inclusion for these businesses; borrowers that are often excluded from the official credit market, and therefore must resort to more informal, unstable and expensive alternative sources of capital. Overall, the microfinance sector in Asia and the Pacific has showed impressive growth rates over the past few years. Among the notable large-scale microfinance projects in the region, the Microfinance Initiative for Asia stands out. KfW Development Bank of Germany and the International Finance Corporation (IFC) agreed to invest US$1 billion during the course of three to five years. Using debt and equity investments, structured finance and consulting services for Asian micro-financing institutions (MFIs), the Microfinance Initiative for Asia targets two main objectives: (i) the creation and enhancement of the institutional capacity for sustainable microfinance delivery; and (ii) the strengthening of linkages between domestic and international capital markets.

Many types of organizations provide microfinance: MFIs, not-for-profit organizations and NGOs, self-help groups, inclusive businesses and social enterprises, state-owned and private commercial banks, government ‘policy banks’ and others can all operate microfinancing schemes. While these organizations differ considerably in their operating models, they often share one important common characteristic: high repayment (and interest) rates. By applying innovative solutions, such as a shared liability model and collateral-free lending, default rates can be surprisingly low for such an apparently poor sector of the market. An apt example is the Group Model applied by the Grameen Bank of Bangladesh. In this model, the borrowers are divided into five member groups, and each group jointly assumes debts. Consequently, peer pressure and collective responsibility can also help to control the default risk. Many MFIs have successfully
proved that the poor are ‘bank-able’, and that the so-called ‘base of the pyramid’ is a financially viable – and even lucrative – market.

The nominal interest rates charged by most MFIs in the Asia-Pacific region range from 30 to 70 per cent per year, which are very high compared with the rates of commercial banks and subsidized lending organizations. The high nominal interest rate is mainly due to the high cost of funding, inflation, and high cost of administration and operations associated with MFIs. Nonetheless, microfinance remains attractive to SMEs because it specifically caters to this sector, is more accessible, and most loans are still cheaper than informal or black market financing sources. More recently, a debate concerning the serious problem of market saturation and over-indebtedness has led to more stringent scrutiny of microfinance activity. Nonetheless, microfinancing remains a powerful tool for financial inclusion, particularly for smaller SMEs and those located outside the main banking areas.

Having ‘scoped’ the various main forms of debt financing potentially available to SMEs, the pros and cons of these funding vehicles can be evaluated.

2.2. The attractions and risks of SME debt finance (and credit guarantee schemes)

The perceived risks and additional transaction costs associated with SME financing are well known. Smaller and younger companies are widely, and rightly, seen as being greater risk prospects than their larger and more mature peers. SMEs may have greater growth potential, but this is of little interest to commercial banks, that, unlike equity investors, are primarily focused on making loans and having them reach maturity safely. Not only are the risks greater, but so too are the costs of making and monitoring many small loans to SMEs, compared with a handful of loans to far larger firms. Although the same amount of money might ultimately be lent out in both scenarios, the transaction costs for the lender are markedly greater in the former. And the due diligence that the lender must conduct on a small SME and its finances will inevitably take longer than that of a publicly-owned and externally audited large firm.

This leads to another SME financing constraint: the ‘information asymmetry’ that typically exists between an SME borrower and a lender. While the lender may have access to a range of information sources and tools that will help in making some appraisal of the borrower, it will almost never be in possession of as much information as the SME itself. This puts the lender at a disadvantage, and therefore a greater degree of risk. The owner of the SME could abscond with a loan, or use it for purposes not agreed to in the contract. The SME or its owner may have other debt obligations – including informal ones that go unrecorded in any credit bureau – that the lender is unaware of. The list of scenarios goes on. Little wonder then that some banks are reluctant to lend to SMEs, when it appears much less risky, and operationally cheaper, to lend to a large business that would find it much harder to mis-represent itself or misinform the lender, and which may have a markedly better corporate governance structure that lessens the risk further.

These kinds of issues explain why SME finance often needs to be encouraged by policymakers, so as to avoid credit rationing issues in the sector. One such policy approach to this issue is that of liberalizing interest rates. While the central bank, as
regulator, has a fiduciary duty to protect consumers, including borrowers, from excessively high rates of interest, there needs to be some degree of flexibility in the setting of individual interest rates, so that lenders may 'price for risk'. If an SME is seen as a more risky borrower proposition, then in order for the lender to agree to a loan, it may be necessary to set a higher rate of interest to compensate the latter for absorbing that additional risk. And while an SME may not like the notion of paying a higher rate of interest, this is better than being completely shut out of the loan market in cases where policymakers insist on setting a standard rate of interest – in an understandable but misguided desire to be equitable to all borrowers – that does not allow lenders to ‘price for risk’.

The risks of debt financing do not lie just on the supply side of the SME finance equation. SMEs themselves can face risks if they become unduly reliant on a particular source of financing, should that source suddenly contract or stop altogether. A regulatory change that deliberately or inadvertently prompts lenders to halt their activities due to uncertainty or some kind of prohibition would be one example. Another risk that has become increasingly apparent in this age of globalization is that of an economic or financial crisis which can impact both on the intrinsic business of the SME as well as its funding sources, as banking and finance sectors seek to withdraw from whole areas of business, or have their own sources of funding reduced considerably. At this point, ‘credit rationing’ comes into play, and often SME-oriented loans are the first to be scaled back.

One of the more controversial (but popular) ‘weapons’ in the SME finance ‘arsenal’ for policymakers is the use of credit guarantee schemes (CGS), intended to lessen the risks faced by finance providers in serving the SME sector, and thereby increase their appetite for doing business in this sector. These CGS have been used quite extensively in parts of Asia and the Pacific, as a means of supporting greater debt financing of the SME sector, and other areas of the corporate community deemed to be a priority by policymakers, even though empirical research suggests that they are difficult to make sustainable in the long run, and can generate substantial costs to the underwriters (usually the government) if pursued incorrectly. Both Malaysia and Thailand, for example, have had somewhat mixed experience in implementing CGS in a sustainable fashion. In the case of Malaysia, commercial banks’ concerns that not sufficient funds had been allocated to underwrite the CGS (and thus might not be able to honour all of its commitments) meant that they were cautious in using its services. In the mid-1990s, a private CGS was established in Singapore, designed to be the first Asia region-wide provider of credit guarantees, but the impact of the ‘Asian financial crisis’ of 1997-1998 left it with the need for recapitalization. However, when shareholders disagreed on this issue, the company was obliged to run down its assets and was fully liquidated in 2005. Two CGS in South Korea encountered a similar fate as a result of the same crisis. In countries such as India, Japan, Malaysia, Republic of Korea and Thailand CGS are government

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6 Similar public support schemes for facilitating SME debt financing include interest rate subsidies, credit insurance schemes and the promotion of promissory notes, which are usually delivered to the SME sector either via commercial banks or non-banking financial institutions. For a good depiction of the use of CGS in the agricultural sector, see Zander and others (2013).
institutions, whereas in China private credit guarantee firms tend to dominate.\(^{7}\)

The main goal of a CGS is to cushion banks and other financial institutions from the risks associated with lending to small businesses, and thus can help SMEs access both short-term and long-term credits, with less collateral or sometimes even without any collateral if regulations allow. One international study, Levitsky (1997), analyzed various types of CGS and found that most schemes had guarantees for between 60 and 80 per cent of the loan amount, and that the key factor underpinning success was a strong cooperative relationship between guarantors and lenders. One of the most successful examples is that of Japan (box 1). Box 2 examines the experiences with CGS in India and Pakistan.

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**Box 1. Japan’s SME credit guarantee schemes**

The Credit Guarantee Corporation (CGC) of Japan was established in 1937 with the aim of helping SMEs raise funds from financial institutions by providing credit guarantees on commercial loans. The National Federation of Credit Guarantee Corporations comprises 52 local CGCs, with at least one in each of the 47 prefectures of Japan.

Japan’s credit guarantee scheme is characterized by two key components: (a) a credit guarantee function; and (b) a credit insurance function. The credit guarantee function consists of nine individual steps (see figure 3 below). Following the submission of the SME loan application (i) and its corresponding creditworthiness check (ii), a guarantee certificate is issued to the financial institution (iii), and the SME is then required to pay a guarantee fee to the CGC before the loan is extended (iv). As with a normal loan, the SME is required to make repayments, according to the agreed terms and conditions made with the financial institutions (v). However, in the event that the SME is unable to make all or part of the repayments within the agreed term, the financial institution can request payment from CGC under the guarantee scheme (vi and vii). Afterwards, CGC will obtain the right of indemnity against the SME (viii) and recover the loan repayment, often by providing assistance to the SME to recover its financial footing (ix).

To further spread the risk of default, all loans are automatically insured by the Japan Finance Corporation (JFC) every time CGC approves a credit guarantee. This essentially serves as the credit insurance function of the credit guarantee scheme and is maintained by public funds. CGC pays a credit insurance premium to JFC and will get a subrogated amount from JFC if it makes payments on behalf of an SME under

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\(^{7}\) For more on Asian CGS, see Shim (2006). In concluding, the author notes: “The cross-country evidence [in Asia] suggests that credit guarantee institutions that are highly leveraged, provide close to complete guarantees for loans, or offer a large amount of credit guarantees relative to GDP, tend to exhibit poor underwriting performance and profitability. The historical performance of credit guarantee systems highlights the importance of guarantors having sufficient capitalisation and prudent risk management practices.” Also see ADB-OECD (2014), pp. 85-89, profiling the CGS in Indonesia, the Philippines, Sri Lanka and Thailand.
the guarantee scheme. While the operations of CGCs are financed primarily by the guarantee fee, and capital gains on CGCs’ assets, the national and local governments also provide financial support to the National Federation of Credit Guarantee Corporations and CGCs, so as to promote their operations and enhance the management base. As figure 3 below shows, the national and local governments and JFC provide credit insurance funds, various subsidies, deposits and compensation for losses. This is not a small or simple process to introduce or implement, and the associated sunk costs need to be borne in mind by smaller and less developed countries in particular. Only if the anticipated rise in lending activity exceeds markedly the costs of pursuing such an intervention does it make economic sense to proceed along these lines.

**Figure 3. Institutional framework of Japan’s credit guarantee scheme**

While numerous countries in the Asia-Pacific region have been operating CGS of one kind or another - some for many years - the operational experiences of these schemes have been mixed. Despite the best intentions of policymakers, CGS have often failed to inspire sufficient confidence among banking institutions to increase their SME-oriented financing activity, or resulted in large losses for the public purse.

Particular issues surrounding the system of guarantees include: (a) moral hazard, where the presence of an implicit guarantee allows the financial provider to not
conduct sufficient due diligence on applicants, and thus be too quick to grant loans that will default, knowing that any losses will be taken up by the CGS; (b) high administrative costs, due to the complicated procedures and fragmented client base of such a scheme; (c) delays in paying claims made by financial providers for loans under the CGS that have defaulted; (d) sometimes low demand by SME borrowers, therefore undermining the point of trying to use CGS to stimulate greater supply of SME finance; (e) limited outreach by banks; and (f) a concern by some finance providers that the government will be unable to honour all guarantees made, and thus they are reluctant to participate. As such, experience shows that banks have not always chosen to utilize these schemes, and sometimes have had to be forced by the relevant government agency into participating. The administrative costs of credit appraisals and monitoring SMEs could possibly be reduced by outsourcing some of these activities to other service providers, such as chambers of commerce and federations of industries. As for the risk of moral hazard/non-repayment, this could be partly mitigated by providing only partial loan guarantees, although too much dilution of this would then run the risk of rendering the scheme disinteresting to potential participants.

Box 2. Examples of credit guarantee schemes in India and Pakistan

A. Credit guarantee fund for micro and small enterprises, India

The micro and small enterprise (MSE) sector in India includes an estimated 26 million enterprises, providing employment to approximately 60 million people. Despite the size and importance of this sector, access of MSEs to bank finance is often very low due to the perceived high risk of default. To protect themselves from defaults, banks insist on collateral; MSEs struggle to provide it. In order to facilitate collateral-free credit and make it available to the MSE sector, the Government of India launched the credit guarantee fund for MSEs in 2000. As of March 2010, there were 112 participating lending institutions registered with the fund, comprising banks, institutions and corporations.

This fund offers both term loans and working capital facilities up to Rs 10 million (approximately $190,000) per borrowing unit, which can be extended without any collateral security or third-party guarantee to a new or existing unit in the MSE sector by a single lending institution. Any credit facility covered under the scheme is not eligible for additional coverage. The extent of credit guarantee ranges from 62.5 per cent to 85 per cent, depending on the borrower category and the credit facility. The guarantee under the scheme runs through the agreed term loan/composite credit, and has a tenure of five years or as five-year blocks, depending on whether the working capital facility is standalone or not.

Source: Ministry of Micro, Small and Medium Enterprises, 2011.8

B. SME Credit Guarantee Fund, Pakistan

The SME Credit Guarantee Fund (CGF) of Pakistan was incorporated in 1984 as a public-private partnership company. As a subsidiary of the Small and Medium Enterprises Development Authority of Pakistan, CGF aims to facilitate SME access to finance.

The endowment fund of CGF was created by pooling equity investment of PRs 10 billion by the

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8 Also see Zander and others (2013), pp. 35-39.
government and partner banks on 1:1 basis. Funds are invested in deposits and securities. Returns are used to meet the operational expenses and offset subrogation losses of CGF. The upper limit of guarantee exposure may be up to 10 times that of the endowment fund (e.g., PRs 100 billion).

CGF provides credit guarantees for both working capital financing and capital investment. Guarantees are primarily given to the following: (a) individual SMEs on a retail basis; (b) overall portfolios for SMEs; portfolios earmarked for a priority sector; and (c) programme lending schemes for specific clusters. In general, guarantees issued by CGF are only partial in nature. Proportions of risk to be borne by the respective parties are 50 per cent for CGF, 30 per cent for banks and 20 per cent for SMEs through collateral. CGF may also issue full guarantees, in line with the specific needs of disadvantaged regions and sectors.

CGF works closely with its partner banks in ensuring that processes have minimal potential risks. First, banks carry out credit checks and risk assessments of all applications. Following this due diligence by banks, applications are forwarded to CGF for their own processing. If the application passes both processes, a guarantee will be issued by CGF and forwarded to its partner bank.

Source: Presentation by the Small and Medium Enterprise Development Authority, 29 June 2011, Bangkok.

2.3. Secured transactions, credit reporting and the use of ‘big data’

As intimated earlier, an important support structure for access to finance, particularly for SMEs, is the access to data that allows banks and other financial institutions to provide credit with some degree of ‘visibility’. There is a high degree of correlation between stronger secured transaction and credit reporting systems and the ease with which private sector firms can gain access to debt finance. As the World Bank ‘Doing Business’ 2015 report – Getting Credit (case study report) – notes: “Where the legal framework provides stronger protection of secured creditors’ rights and credit reporting systems provide more relevant, reliable, timely and sufficient data, the private sector tends to have better access to credit. [And] … results show that both transparency in the secured transactions system and access to credit information—elements that create predictability for secured creditors and provide lenders with tools to assess the creditworthiness of borrowers—are associated with a higher level of private sector credit, and this leads to more business creation or expansion in the long term.”

As the same report points out, a secured transactions system “promotes the availability of credit by reducing the risk to lenders of accepting movable assets as collateral. This can be achieved by taking a functional approach to secured transactions and implementing modern collateral registries—such as those in … New Zealand”. The utility of such a system is primarily to assist lenders to SMEs to have some protection against the possibility that the borrower has “hidden liens” (i.e. the assets being offered as collateral for the loan have already been pledged elsewhere to another lender). And yet, in South Asia, just two out of eight countries have a functional approach to secured transaction centres, and in East Asia and the Pacific the number of countries is 10 out of 25. However, to be effective, “an integrated legal framework for secured transactions needs to be accompanied by a modern collateral registry for movable assets. Such registries allow a lender to take security rights in an asset without having to take physical custody of it.” Indeed, some studies suggest that a new collateral registry can improve access to bank finance quite markedly. So, more loans, at cheaper prices, and longer lending terms, even in quite small economies.
Tellingly, ‘Doing Business 2015’ found that in five small economies that had recently created registries and reformed secured transactions laws (ie. the Marshall Islands (2010), the Federated States of Micronesia (2007), the Solomon Islands (2009), Tonga (2011) and Vanuatu (2009)), the number of filings had reached a total of more than 20,000 by end-January 2014, and the number of searches had exceeded 60,000, despite the small scale of their respective business and banking sectors.

A credit reporting system, on the other hand, “provides lenders with the most relevant, reliable, timely and sufficient credit data”. Here too, the empirical evidence strongly suggests that such systems can have a significant and highly positive impact on the amount of lending done to business, and particularly to SMEs. “By collecting information on individuals and small firms, credit bureaus and registries provide banks with the information they need to assess creditworthiness. … [Indeed, a] 2007 study found that in developing economies access to credit grew twice as fast for small firms as for large ones after new credit reporting systems were introduced.” But here again, as with CGS, the sunk costs of introducing and implementing such a system can be potentially large, and there needs to be a high degree of confidence that if introduced the scale of increased lending activity that is induced as a direct result of such a system is a multiple of the investment made. Best practice would also suggest that, where possible, such credit information systems should be independent, and charge for their services so as to be sustainable and not become a drain on the public purse.

Figure 4, taken from ‘Doing Business 2015’ shows the flow of credit information. On the far left are SMEs (and individuals) seeking loans or other forms of finance, whether through banks and other financial institutions or other providers of some kind of credit. In the case of banks and other credit institutions, the data collected in processing the applications is passed on to a credit registry that collects it in order to create a comprehensive ‘data bank’. The reports that the credit registry then issues can then be used by the financial regulator and commercial financial institutions alike, to better inform their activities. Advances made in recent decades in information and telecommunications, data storage and analysis, as well as the Internet (and websites with a high degree of ‘functionality’) has made this whole process much speedier, more efficient and less costly.

In addition, banks may also send on the same information gathered during loan applications and approvals to one or more credit bureaus, the reports of which can then be fed back to commercial banks as well as other organisations that have need of information on the credit-worthiness of small firms and individuals. The rise of credit bureaus has allowed for the development of ‘credit scoring’ models which use the analysis of large amounts of quantitative data to try and forecast the probability that a borrower, including SMEs, will default on their loan commitments. This in turn can significantly reduce the perceived risk of providing credit to small borrowers, and even help facilitate the provision of credit to areas of the economy where mainstream lending was not previously available. Here again, advances in ICT and sophisticated analysis of ‘big data’, the scope of which was simply not feasible before, has had an important role to play in the development of credit scoring. However, for credit scoring to really have an impact, the quality of the data and its analysis have to be trusted to a high degree by banks and other financial institutions given the predictive nature of the service.
Figure 4. Flow diagram for a credit information system comprising both credit registry and credit bureau

Note: Some economies have only a credit registry, some have only one or more credit bureaus, and some have both a credit registry and one or more credit bureaus. Credit bureau networks tend to be more complex than credit registry networks because they generally include a larger variety of data providers and data users.

What in effect is happening is that information is being pooled and shared, so as to better inform various relevant service providers about the quality of the pool of borrowers or consumers. As the note under the figure states, some economies have just one credit registry, while others also have one or more credit bureaus in addition. Some economies may have one or more credit bureaus, but no credit registry. Some economies may have neither credit registry nor bureaus, while some may have both. In East Asia and the Pacific, just four countries appear to have a credit bureau or registry that covers at least 5% of the loan universe and offers credit scoring. This compares with 12 countries that have a credit bureau or registry with at least 5% coverage, but no credit scoring is provided. A further two countries have a credit bureau or registry, but with less than 5% coverage. And seven countries in the region have no a credit bureau or registry at all in operation.

Figure 5 shows that as the strength of legal rights and depth of credit information indices increases (denoted on the Y-axis as ‘distance to frontier score’), so too does the amount of domestic credit provided to the domestic sector (denoted on the X-axis, shown as a percentage of GDP).
Figure 5. Economies with stronger systems for secured transactions and credit reporting have higher levels of domestic credit provided to the private sector

Source: Doing Business database. World Bank, World Development Indicators database.

Note: Domestic credit to private sector refers to financial resources provided to the private sector by financial corporations, such as through loans, purchases of nonequity securities, and trade credits and other accounts receivable, that establish a claim for repayment. The correlation between the distance to frontier score for getting credit and domestic credit to private sector as a percentage of GDP is 0.34. The relationship is significant at the 1% level after controlling for income per capita.

Some countries in Asia and the Pacific, such as Malaysia and Singapore, have facilitated loans to SMEs using standardized credit ratings as yet another way of addressing the all-important information asymmetry issue. The credit rating process typically consists of:

A comprehensive assessment of the overall financial and operational condition of the SME; A detailed review of the financial condition of the firm, and several qualitative factors that have bearing on the creditworthiness of an SME (e.g. leadership acumen and management skills, capacity, industry reputation and goodwill); Categorization of the SME, usually based on industry and size, for evaluation against its relevant peers; And the use of a statistical model that allows for an unsubjective credit score to be applied.

In the Asia-Pacific region, India has been proactive in formalizing a credit rating scheme for SMEs, and those SMEs with both the highest level of operating performance and level of financial stability are entitled to a reduction of 1% from the annual interest rate on their borrowing, if they participate in the credit rating scheme, while those with strong performance and stability are rewarded with a reduction of 0.5% (50 basis points). However, the government subsidizes up to 75% of the cost of the credit rating scheme through the SME Rating Agency of India Ltd., jointly established by National Small Industries Corporation Ltd., as well as through some other financial institutions, commercial banks and other stakeholders. The SME Rating Agency is the country's first rating agency that focuses primarily on the SME sector.
However, as the high degree of government subsidy implies, such exercises can be quite costly relative to their beneficial impact. Not only must the initial rating exercise be carried out diligently, but updates must also be conducted on a fairly regular basis, and that entails costs that someone must bear. In the case of larger firms, credit ratings are typically used as a precursor to, and subsequent support for, corporate bond issuances (rather like countries’ ratings and their sovereign bond issues). Here, the cost of the credit rating is typically incurred by the firm concerned as part of the transaction costs of conducting the bond issue. But in the case of SMEs looking for simple bank loans, the justification for the costs of credit rating is less apparent and credit rating is therefore often simply inviable, unless a government agency is willing to heavily subsidize the process, which is often not the case in developing countries. One of the more constant criticisms of credit ratings is that the company concerned pays for the exercise by a reputed ratings agency, rather than the prospective investors in the bond issue. Thus the credit ratings agency may face a conflict of interest in being remunerated by a client that wishes to receive the best possible rating, as that rating will determine the ‘cost’ (i.e. the interest rate or coupon rate) of the debt funding it is seeking to acquire.

3. Mapping out SME finance: equity products and services

3.1. Advantages and disadvantages of equity financing of SMEs

“Let’s face it: the bulk of small and medium-sized enterprises (SMEs) are still financed mainly by bank credit. However, as bank finance is harder to come by in the current post-crisis environment, fostering non-bank financing alternatives may help closing an SME financing gap.”

< http://oecdinsights.org/2014/12/03/stimulating-sme-equity-financing-change-the-culture/ >

As explained above, debt-related financing is by far the largest source of finance for SMEs in the Asia-Pacific region, and globally. Banks and other providers of debt products and services are the primary source of financing for smaller firms that have yet to establish the scale of investor appetite that would allow for more elaborate and usually expensive forms of financing, such as equity funding. The legal and regulatory framework – and institutional capacity for its enforcement – of equity financing is also more demanding to establish. But an SME sector unduly reliant on debt financing poses a number of risks, particularly if the banking sector is adversely impacted in some manner, or if the cost of borrowing rises markedly. It is in this regard that equity finance can make a valuable contribution to the ‘access to finance’ mix for the SME sector. Some of the smallest vehicles are ‘angel investor’ networks, where high net worth individuals provide technical assistance and funds to help young firms that are considered to have strong growth potential.9 Slightly larger are venture capital investors

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9 For more on angel investors, see chapter 2 of OECD (2011), pp. 27-66. The authors note: “While venture capital tends to attract the bulk of the attention from policymakers, the primary source of external seed and early-stage equity financing in many countries is angel financing not venture capital. In addition, angel investors tend to be less sensitive to market cycles than venture capitalists, although a “wealth effect” could impact how much they are willing to invest when markets fluctuate.” See p. 10.
that will typically seek to acquire a stake in a small, but proven company, and help them make the next development leap. Then there are private equity investors that usually focus on larger SMEs, with an eye to scaling them up to a level where they can graduate out of SME classification, and possibly even conduct an initial public offering of shares. Each of these forms of equity financing is further explained below.

The primary attractions of such equity financing are multiple. First, the finance provider is essentially taking all the financial risk; there is no interest or capital payment to be incurred by the SME, particularly if the business fails to meet the revenue goals set in its business plan. Secondly, the funding provided typically comes along with other non-financial inputs and technical assistance that can be very helpful in strengthening the managerial, accounting, governance and other capacity of the enterprise. Thirdly, the past – and sometimes considerable – experience of equity investors can be of significant help for a young firm that has yet to experience the full demands of what can sometimes be a hostile business environment. In equity financing, the interests of the SME and the investor are aligned in making a success of the business for all shareholders and other relevant stakeholders concerned. In contrast, in debt financing the alignment is less clear; while the bank clearly desires the firm to be viable enough to service its financing commitments, the bank does not have an explicit need for the company to grow. If an SME should run into difficulty of some form, the equity investor is probably more likely to try and assist in recovering the situation than a lender, at least until it becomes apparent that the situation cannot be recovered. A bank may be willing to restructure its loan to an SME that is in operational trouble so as to increase the chances of getting its money back, but rarely will it be willing to get involved in providing technical assistance to address the underlying problem.

However, there are also multiple disadvantages of equity financing of SMEs. First, with debt financing the owner(s) of the SME is only contractually bound to meet the loan terms, and retains full ownership of the company. There is no dilution or surrendering of ownership entailed. But equity investors will typically expect to have a stake in the business, in return for the funding provided, which then dilutes the ownership stake of the SME owner(s). Secondly, depending on the style of equity investor, the degree of intervention in the day-to-day business can range significantly, from virtually hands-off to very much hands-on. That could lead to tensions, particularly if compromises must be struck on key issues. Some technical assistance and guidance is not always welcome. And thirdly, the transaction costs and complexities of structuring most equity finance deals – including legal and financial due diligence – tend to be greater than with a debt financing product. And those higher costs mean that adequate returns can be hard to make on relatively small deals, making larger SMEs the more likely recipients of such offers of equity finance (unless they are in particularly high growth sectors).

3.2. Forms, attractions and risks of SME equity finance

The following forms of equity financing of SMEs can be distinguished:

(a) Angel finance is typically used at an early stage in the business life cycle of an SME, when it probably has little or no proven track record and therefore can find it particularly difficult to access finance. In such cases, angel investors can be a potential source of funding worthy of exploration. They are typically high net-worth individuals with extensive entrepreneurial or industry experience, who provide seed
capital for early-stage ventures in return for convertible debt or an equity stake in the business. However, the presence of angel investors is, as yet, more well-established in the United Kingdom and United States and some other countries, relative to large parts of the Asia-Pacific with a few possible exceptions. Angel investing is inevitably a risky source of financing, particularly for the investor. And the prospective investor typically demands evidence of a solid business plan, entrepreneurial leadership and growth potential before considering ‘taking on’ and personally mentoring the SME concerned.

In striving for a more organized and professional approach to angel finance, a number of local and regional business angel networks have been set up in Asia and the Pacific over the past decade. Singapore-based ‘Business Angel Network South-East Asia’ (http://www.bansea.org) is among the more established and prominent networks of angel investors in the region, with a vision of “fostering a vibrant start-up ecosystem in which angel investors fund entrepreneurs who eventually become angels themselves”. The typical investment size is between S$100,000 to S$1 million – well below the usual scale of investment for venture capital or private equity investors.

(b) **Venture capital** is a form of investment finance designed to provide equity or quasi-equity funding to private SMEs, where the primary return to investors is from capital gains (i.e. share price increase) rather than from dividend income. Venture capitalists are often actively involved in the strategic operations and management of such SMEs to help ensure the success of their investments, and provide useful support where they can add value. Investors are attracted to venture capital investments due to the potentially large gains from future sales of shares of the company, and are therefore willing to accept the higher risks involved, compared to traditional loans. Indeed, a typical private equity investors’ portfolio will typically consist of a range of investee firms, some of which will prove unsuccessful, some will make an adequate return, and just a few will prove to be high successful.

The style and activity of venture capital tends to vary greatly, depending on the top-down strategy of the investor, the industry or industries on which it is most focused, as well as the more fundamental characteristics that the investor is looking for in its investee firms. A venture capital fund would typically invest in an SME within a high-growth sector that seeks to expand its operations. Alternatively, they can also partake in buyouts of more established companies. The duration of involvement of a venture capitalist is usually between two and five years, after which the venture capitalist will typically sell the shares of the company on a stock exchange (e.g. through an IPO), as a trade sale to other companies, through a management buyout to transfer managerial control, or by selling the whole stake in the company to a more established competitor or other venture capitalists. If the exit from the investment is successful, the investment can be considered to have been a good one.

To lower their risk exposure, some venture capitalists provide financing in stages, with each installment sufficient for the investee firm to reach the next development stage. Those stages will vary, according to industry, but often consist of the following:

- (a) Start-up – additional funding for marketing and product development expenses for an early-stage firm;
- (b) First round – financing for prototype production and manufacturing plans;
(c) Second round – major investments needed in order to begin manufacturing, marketing and distribution of product;
(d) Third round, also called the mezzanine level – the expansion funds required for a newly-profitable company;
(e) Fourth round, also called bridge level – intended to finance the “going public” IPO process.

Venture capital has the potential to offer valuable sources of finance that complement the more traditional credit finance provided by commercial banks. Some of the factors hindering SMEs’ access to capital from traditional credit institutions are less important to those venture capitalists with an appetite for greater risks. Some of the advantages of venture capitalists for SMEs include:

(a) Venture capitalists are willing to accept higher risks than traditional banks, in exchange for potentially large gains from the future sale of shares of the company;
(b) Venture capitalists do not require collateral from borrowers;
(c) Post-investment operating costs can be lower due to the absence of high interest rate payments;
(d) Venture capital is a long-term commitment in contrast to short-term loans from banks;
(e) The managerial know-how provided by venture capitalists can, in some cases, be more valuable to the start-ups than the actual financing;
(f) The presence of a reputable venture capitalist may give added comfort to banks and other financial institutions, thereby making access to credit easier, and potentially cheaper.

However, there are also some disadvantages of venture capital investment, from the perspective of SMEs considering this option:

(a) Due to the high-risk nature of venture capital, the extended timeframe for returns, and a lack of adequate skills and corporate information, it may be difficult to find and attract venture capital investors, particularly in some developing Asia and Pacific countries.
(b) An exit mechanism is necessary for venture capitalists to benefit from capital gains. This can be difficult in some developing countries in Asia and the Pacific, except in those with fairly developed stock markets. Other mechanisms such as guaranteed buy-backs are not realistic for SMEs.
(c) Venture capital is costly at the beginning as the investor needs to conduct a rigorous time-consuming financial, legal and operational due diligence on the SME. While the company rarely pays for this, the investor will likely need to make a fairly considerable investment (US$1m or more, and usually over US$5m) in the company to have any chance that the return – if successful – will support such up-front transaction costs.
(d) While the SME owners do not have to service and repay a bank loan, they will have to dilute their equity ownership in the company. Should the company prove hugely successful, then the ‘cost’ of this dilution (in terms
of the value of the shares now owned by the venture capital investors) may exceed the costs associated with bank loans many times over.

The United States pioneered the use of venture capital and is still the world leader in terms of money invested and number of deals, but other countries are now developing their own venture capital funds. In the Asia Pacific region, countries such as India have set up sector-specific venture funds for the ICT industry and biotechnology sector.

(c) **Stock market and initial public offerings** tend to be only a viable financial source for SMEs at a much later stage of development, given the scale of the funding required. In an IPO, a company raises capital by issuing shares to investors for the first time and subsequently becomes listed on a stock exchange. In these transactions, shares are sold to investors to provide equity capital for the company in return for company ownership. Going public through an IPO gives SMEs access to a pool of capital that is much larger than capital provided by a relatively small group of original owners and investors. It provides an alternative way to raise long-term capital instead of debt financing. IPOs give extra credibility to suppliers and customers, help boost employees’ morale, and may attract other financing sources. More importantly, an IPO is one of the most preferred exit mechanisms for early stage investors such as business angels and venture capitalists. Thus, an efficient IPO mechanism can encourage risk-taking investments and more capital flows into innovative, high-growth-potential firms, which explains in part why most governments are so enamoured with stock markets. However, going public also brings new challenges to SMEs. They must regularly report to their public shareholders and are under much closer scrutiny, including having to conform to tougher regulations pertaining to accounting and auditing. Considerable costs are also associated with IPOs, including significant time and money invested in both the initial process of issuing shares and the ongoing requirements for disclosure and shareholder relations.10

3.3. **Business development services, and balancing debt with equity**

One main recommendation of this paper is that the provision of improved access to finance for SMEs should ideally be conducted in the context of a wider suite of business development and enabling environment interventions in support of this sector. This kind of holistic approach not only allows for welcome efficiency gains, but also raises the potential for synergies and other benefits emanating from an SME-friendly harmonization strategy. For example, the provision of incubator services for start-ups

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10 For more on the role of capital markets for SME development in Asia, see Shinozaki (2014). The author states proposes “…five core elements to develop an SME capital market [in Asia]: (i) demand creation focusing on target segments such as social enterprises and women-led SMEs, with designing a low cost structure for SME access to capital markets; (ii) establishment of investor base that provides initial risk capital for potential growth-oriented SMEs, with fostering the venture capital industry; (iii) strengthening market literacy for potential SME issuers and investors; (iv) investor protection mechanisms backed by proper laws and regulations; and (v) facilitation measures for access to an SME market backed by a comprehensive policy support framework with well-organized policy coordination among regulators and line Ministries responsible for SME sector development and access to finance.” See pp. 35-36.
can be linked to bank financing and other financial service providers, such as angel investors and venture capital fund managers. Or, as SMEs meet particular accounting and reporting standards, they can be eligible for consideration under loan programmes that offer a reduced rate of interest, commensurate with the reduced risk that they now present.

Policymakers should also encourage SMEs to seek business development service (BDS) providers that can also assist them to become better risk propositions, for example through accounting and auditing. This might be impractical on a single SME basis, but business associations, chambers of commerce and federations of industries could work with the banking community to address some of these issues. Indeed, a combination of financial and non-financial services for SMEs would be most ideal in terms of technical support. In this regard, financial institutions should consider: (a) developing capacities to provide information on markets and training facilities; (b) evaluating joint venture proposals; (c) assisting in the development of business expansion plans; (d) guiding financial and taxation matters; and (e) advocating the cause of SMEs at appropriate fora.

Over time, BDS providers can also add value to bank lending and SME development, as they are often better placed than financial institutions for identifying potential clients, ascertaining their creditworthiness, imparting professional financial and accounting techniques, and other services germane to lending and the repayment of debt (without breaking any client confidentiality agreements that may exist). This complementary nature between BDS providers and financial services helps to minimize both the risk and transaction costs to creditors and investors and makes access to credit and equity less costly and cumbersome for SMEs.

Banks and conventional lending products remain the mainstay of funding for SMEs in the Asia-Pacific region. However, SMEs may seek to list on stock exchanges for a variety of reasons, including gaining access to funds outside traditional sources (e.g. commercial banks), in order to spread the risk of high growth strategies and increase their corporate profiles. Depending on the regulatory framework in the country, and in cases where foreign institutional investors can also buy a country’s stocks, the attraction of tapping large pools of money held in the international centres of capital markets and fund management also have their appeal. Clearly, the funding needs (and the associated non-financial value added aspects of service provision) vary greatly for different SMEs in different sectors and economies, and at different stages in their business cycles. In this regard, it is important that a balanced mix of both equity and debt products and services are available, wherever possible, as no one size fits all. Box 3 provides an example in New Zealand of a successful initiative undertaken by policymakers to better incorporate SMEs into the equity markets.
Box 3  Incorporating SMEs in equity markets—an example from New Zealand

Smaller New Zealand companies, but with high-growth potential, can face considerable difficulties and costs in listing on the main local stock exchange, the NZX. To ease their burden, policymakers initiated a new stock market, the NXT (www.nxt.co.nz), to better address the equity-financing needs of SMEs by providing a structured, cost-effective, and fast initial public offering mechanism. In addition, the Seed Co-Investment Fund (http://www.nzvif.com/seed-co-investment-overview.html) was also established to support SMEs with strong potential for high growth. Overseen by the New Zealand Venture Investment, the Seed Co-Investment Fund aims to accelerate the seed capital market for start-up companies to the point of self-sustainability, and to foster investment inflows into innovative start-up firms. Some of the key provisions include:

(a) Co-investment with accredited investment partners, in a 50:50 matching scheme;
(b) Investment into the seed- and start-up stages of businesses;
(c) Investments must be made into New Zealand businesses.

Like New Zealand, other Asia Pacific countries have also established similar kinds of secondary equity markets for smaller firms (and funds) that would not normally be able to (or would struggle to) meet the listing requirements of the relevant ‘mainboard’. For instance, the SME Board in China (established in 2004), KOSDAQ in South Korea (est. 1987), the SME Platform in India (est. 2012), the SME Board in the Philippines (est. 2001), the Market for Alternative Investments in Thailand (est. 1998) and the UPCoM (unlisted public company) market in Viet Nam (est. 2009).

4.  SPECIALIST SME-FOCUSED BANKING: HELP OR HINDRANCE?

4.1.  An overview of specialist SME-focused banking in the region

Within the Asia-Pacific region, and depending on the economic status of the country, the banking and financial sector contains various institutions that provide financing for SMEs. Some of the main institutional providers of SME financing comprise (but are not necessarily limited to) the following key actors:

(a) Development financial institutions (DFIs) for long-term loans;
(b) Commercial banks extending both long-term loans and short-term finance for daily operations;
(c) Specialized financial institutions (usually licensed for limited operations, activities, or services to differentiate them from full-service commercial banks), such as export and import banks that provide trade finance and export credit, as well as rural banks, microfinance banks and non-bank finance companies;
(d) Government programmes or agencies for rural finance, microfinance or SME finance;
(e) Membership-based cooperative financial institutions (CFIs);
(f) Postal savings banks (PSBs) or institutions;
(g) Public and private credit guarantee institutions.
Some Asia-Pacific countries such as Malaysia, Pakistan and Thailand have opted to set up apex banks for SMEs, generally known as SME banks, exclusively to cater to the needs of the SME sector. Non-banking/non-profit financial institutions and microfinance institutions have also cropped up to serve select sectors and categories of small borrowers. Some DFIs have also become more active in providing short-term loans and micro-lending in recent years. Some can even be specific to one or more business sectors, notwithstanding the lack of diversification this entails for their portfolios. Multilateral financial institutions, such as the World Bank and Asian Development Bank, also devote resources to support specialized financial institutions for lending to SMEs, such as on-lending through domestic banks and finance companies, trade finance schemes, SME-oriented credit lines, and other two-step systems. These lending schemes are typically linked to technical assistance initiatives intended to help ensure that the financial assistance is used to best effect. As such, they are an important component of the SME funding and support environment in the Asia Pacific region. In addition, a wide range of bilateral donors and international NGOs are also active development partners in this field.

A number of financial institutions have moved to offer non-financial technical assistance to SMEs in the form of for capacity-building, and thereby enhance their profitability. For example, the SME Bank of Pakistan offers a range of business development services in the areas of marketing, accounting, product design and business planning, while the SME Bank in Malaysia (Bank Perusahaan Kecil & Sederhana Malaysia Berhad) provides comprehensive advisory services to complement products offered by commercial banks. Some specific examples of these services are in-depth entrepreneurship training programmes for graduates, vendors, mentors and women. Indonesia Eximbank, an export financing institution, has developed technical assistance that includes quality improvement of products, product processing, packaging and marketing. They assist stakeholders with capacity-building in the form of training and guidance in connection with export and trade financing activities.

Many governments use direct and indirect public interventions to promote SME financing. Direct interventions made by governments are typically in the form of grants, subsidies and tax breaks, and are often delivered through dedicated governmental agencies. Some governments also provide financing assistance via commercial/state-owned banks or non-financial institutions including cooperatives and governmental agencies. This assistance can be in the form of soft loans, interest subsidies/ceilings, credit guarantees and/or credit insurance, seed capital, venture capital, loan quotas, loan waivers and promotion of promissory notes. The rationale for government intervention is clear. Well-designed government interventions can improve financial regulatory frameworks and financial infrastructure. They are also necessary when there is a lack of


12 The ADB also recently created a supply chain finance programme for cash-strapped SMEs in Asia, in partnership with Standard Chartered Bank, to share risk in financing more than US$800 million in supply chain transactions over three years, most of which will be directed through SMEs that are supplying large companies with materials for intermediate and final production, as well as retail sales. For the ADB’s overall ‘take’ on SME financing, see: http://www.adb.org/features/enhancing-small-enterprises-access-finance-adbs-take.
financial resources for particular groups (e.g., start-ups with little collateral and credit history, and women entrepreneurs) due to market failures of one kind or another. Time-bound special interventions may also be warranted during periods of instability and crisis, where there is an actual or potential breakdown in financial intermediation activities.

But public interventions in SME financing typically also cause unwelcome market distortions, side-effects and long-term losses to the financial sector or public purse. First, it is often difficult to ensure that financial support reaches the target group. This is especially problematic when the target group cannot be well defined, which is often the case with the SME sector in the developing countries of Asia and the Pacific. Second, public interventions may lead to weaker financial discipline in the SME debt market, because with grants and subsidies both lenders and borrowers suffer less direct losses when defaulting. As a result, a ‘non-repayment culture’ may be created among beneficiary enterprises. ‘Moral hazard’ issues may also be created which inhibit financial institutions from implementing and improving risk management techniques. Third, such measures may reduce market competition in the financial market and result in a ‘crowding out’ effect, as they discourage firms from using non-subsidized financial institutions and non-subsidized forms of financing. This ‘crowding out’ effect can lead to the opposite of what is desired, in the long-term, of a robust and commercially viable banking and finance sector that is willing and able to serve the SME sector. Thus, while the role of government intervention can be important in expanding SME finance spaces, and especially in less developed and developing countries, it is equally important to guard against undesirable market distortions brought by improper actions. Identifying the market (or regulatory) failure and setting intervention boundaries is the key prerequisite to designing any appropriate strategy. In all cases, government intervention should be carefully designed to avoid any disincentive for private sector providers of financial services to serve the SME segment. They also need to be monitored and evaluated carefully, so as to measure impact, and ensure that the desired effects are occurring.

State-owned financial institutions, including state-owned commercial banks and development financial institutions, are often employed when it comes to direct financial support for SMEs, sometimes performing this function in their role as so-called ‘policy banks’. And yet, compared to some of their private counterparts, state-owned financial institutions may have less-developed SME lending technologies, lower levels of profitability and higher costs, rendering them much less capable to perform this function. The failure of many state-owned banks can be also explained by political interference, excessive risk exposure due to irrational development goals, and internal operational inefficiencies. Therefore, to use state-owned financial institutions for SME financing, the presence of good corporate governance practices, efficient operations, and proper SME lending and risk management technologies are essential. Some would argue that a less distorted solution to the SME financing problem is a well-designed credit guarantee scheme, with an adequate capital base. Others still would advocate that it is better to work through the commercial banking sector itself, using credit lines for on-lending along with various kinds of regulatory support and technical assistance.

Indeed, collaborating with other financial institutions in the form of soft loans, lines of credit, co-financing and equity funds will likely continue to be popular interventions for SME financing in developing countries due to their simple structure and fast rate of implementation, as well as their reduced potential for unwanted distortionary impacts.
However, such programmes need to be carefully designed to minimize the subsidy component, political interference and adverse crowding-out effects on the private sector. A good financing programme requires precisely defined performance targets, an independent governance structure, clear selection criteria for both beneficiaries and collaborating institutions, and a management team of high quality. The operation of the programme also needs to be market-oriented and a commercial interest rate should be applied, where possible.

Most of the relevant SME development literature emphasizes that the best role of government in improving access to finance is to offer a policy environment that allows competitive and diverse private sector financial service providers to flourish, rather than seeking to get directly involved, i.e. to be a catalyst and enabler, not a market participant. For SME financing, the least distortionary role for the government tends to be a market facilitator that helps to narrow the gap between SMEs and the financial sources, and to undertake regulatory and other efforts to address market obstacles and failures. The key here is to create an overall enabling environment that offers incentives for established and professional financial providers to move further into the SME finance space, where demand exists. This also requires a robust regulatory and supervisory framework that helps balance the relative risk and benefits of providing innovative SME financial products. Increasing government procurement from SMEs, instead of direct financing support, is another effective measure to enhance SME credit-worthiness and viability, by avoiding delays in receivable payments and by increasing cash flow. And in developing countries where the government dominates procurement activity, assisting SMEs to access this field of business can do much to bolster their overall financial standing. A good example is the ‘Building Markets’ programme in Myanmar (http://buildingmarkets.org/our-impact/myanmar) which includes a component that seeks to assist SMEs to take better advantage of procurement opportunities through a series of initiatives, technical assistance and interventions.

4.2. Introducing a four-tier national SME finance system

Today’s globalized and fast-evolving economy arguably impacts SMEs more than many much larger firms, if only because they have fewer resources to cope with the volatility and the impacts of industry developments on them are less visible. Thus, in addition to the traditional forms of term loans and working capital, they may require new forms and financial instruments to help remain competitive, more notably in some industries. In this kind of highly globalized business environment (as evidenced by the rise of international production networks), national economies must try and keep pace, and recalibrate their own financial system accordingly.

Within this context, and that of SME financing, a four-tier national financial system to support SME’s access to funding is proposed to supplement more mainstream banking and financial activity as follows:

(a) First tier – an apex bank (or financial agency) for SMEs that oversees policy prescriptions, any potential credit guarantee schemes, new financing schemes and programmes, business development services and training, and the flow of credit (and equity) to the sector. Above all, the apex bank can augment financial resources to SME sector stakeholders and provide them with institutional support from time to time. But it should ensure that its activities do provide genuine ‘additionality’, only
where market failures are apparent, and that it does not serve to undermine the commercial banking sector, nor serve to mitigate the adverse impact of regulations that need to change. An apex bank for SMEs may also have an advocacy role to play, in identifying where regulatory failure is apparent, and lobbying for the requisite changes to be made, as these are likely to span the mandates of multiple government agencies. Most importantly, it should be selective in its approach, and only pursue interventions that will genuinely serve to overcome structural and cyclical market failures, and have a net positive affect in this regard. Conversely, it should not serve to increase the degree of ‘moral hazard’ in the economy.

(b) **Second tier** – consisting of national financial institutions, state-owned and private commercial banks, specialized DFIs, credit information providers, and venture capital associations/networks and support institutions. BDS networks and associations, and national business institutes, chambers of commerce and industry can also play a role, either as credit providers or facilitators of finance to the SME sector. The role of credit registries, credit bureaus and collateral registries are also part of this tier.

(c) **Third tier** – consisting of subnational development financial institutions, regional banks, local BDS providers, and local chambers of commerce and industry, and business associations which should have a mandate – and the resources – to support access to finance in a specific geographical area (province or municipality). Specific BDS providers, such as clusters and incubators, could also serve proximate SMEs, perhaps with an emphasis on particular business sectors receiving their support. The same could be true of sector-specific business associations, working to assist their members.

(d) **Fourth tier** – at the ‘base of the pyramid’, micro-finance institutions (MFIs) covering informal SMEs and micro-enterprises, social enterprises and other small-scale inclusive business initiatives, through the provision of micro credit. Although depicted as being at the base of the system, these actors have to cover the largest number of enterprises and individual entrepreneurs. The MFI system can also be equipped to provide non-financial forms of support to entrepreneurs. To fulfill the mandate of MFIs, they need to be given national recognition and legal status in the country’s financial system, so as to enable them to serve a potentially immense number of micro-enterprises, as well as be able to attract funds for on-lending. Ideally, they should be permitted to also take deposits, where deemed appropriate, if the right regulatory safeguards are in place.

As discussed earlier, among the factors that hinder SMEs from accessing formal financial institutions are: (a) lack of transparency in SME management; (b) information asymmetry; (c) low managerial capacity; (d) low available collateral; (e) small capital base; (f) small economies of scale; and (g) high transaction costs. A lack of mutual trust looms large in the minds of both banks and SMEs. The scarcity of term loans from banks and higher loan default rates by SME customers serves as evidence of this attitude. However, policymakers and other stakeholders can facilitate in building up this trust. Merely exhorting the financial sector to innovate, change and lend liberally will not make the SME sector thrive. Rather, success lies in having a ‘two-way’ flow of discourse, promoting mutual trust and cooperation on both sides, aligning commercial interests.
In this regard, giving support to BDS providers, both at the national and regional levels, is a good start. These institutions can help project an image of SME member/clients as: (a) profitable; (b) dependable; (c) creditworthy, with economic viability; and, above all, (d) timely repaying entities. This will then help to build adequate confidence among lending institutions in giving financial support, while enhancing their relationship-building with the SME sector. Robust competition in the financial sector will also help SMEs (and the overall economy), as financial institutions look for market niches and ways to differentiate themselves, their products and services, and become more innovative and consumer-oriented in their bid to capture greater market share and business volumes.

4.3. Financial support during economic downturns

SMEs are generally more vulnerable during economic downturns than their larger peers. In addition to the direct shock of decreased demand, SMEs suffer from liquidity and credit rationing problems due to tight money supply and an increasingly risk-averse banking sector. Delinquent accounts receivable hit SMEs more severely than large enterprises as SMEs typically have a higher debt-equity ratio and less cash on hand. Export-oriented SMEs are also vulnerable to any erratic variations in exchange rates. All these factors tighten cash flows and can trap SMEs in financial difficulties, which makes the issue of sustained financing of SMEs one of the most important issues during an economic crisis. This kind of exogenous shock problem rarely can be solved by market mechanisms alone due to the shortage of capital in most SMEs and the frailties of the banking sector. Banks and financial institutions in crisis may also suffer their own financial problem and lending dries up. These factors combine to produce an environment where there is a disincentive for banks to lend to SMEs. This situation thus requires government intervention to help ensure SME sector survival.

Within this context, some governments have been forced to adopt short-term, post-crisis measures, such as increases in credit guarantee coverage, extension of credit guarantee terms, rehabilitation credits and more liberal trade/export credits. One policy measure may also be to introduce incentives to financial institutions for lending to the SME sector, especially extending export credit which is needed to allow SMEs to continue trading with overseas markets. These measures must be accompanied by rigorous monitoring mechanisms, however, to prevent the misuse of such incentives, and ensure that they do genuinely bring about ‘additionality’. As a response to the 1997-1998 Asian financial crisis, for example, a number of Asia-Pacific governments issued laws and decrees and strengthened relevant government agencies to improve the financial conditions of SMEs. Typical examples are the new SME laws in Japan and the Republic of Korea, the credit guarantee scheme for small businesses in Thailand, and the establishment of specialized SME banks in a number of countries in the region. The Government of Kazakhstan allocated 25% of its emergency spending, amounting to almost US$ 1billion, to SMEs in response to the global financial crisis of 2008.

Indirect financial support, such as tax incentives and lower interest rates, are also common steps taken by governments to increase the cash flows of SMEs. In this case, the financial support is not provided through direct funding interventions aimed at improving the levels of liquidity available for SME financing, but rather in reducing the financial burdens that SMEs face. In so doing, this should then free up funding for SMEs.
to use to meet working capital needs; hence the notion of ‘indirect’ financial support. Tax-related policies mainly include tax credits, cuts, deferrals and refunds. During a financial or economic crisis, temporary tax measures can be taken and tax rebates are often used to promote exports. For instance, during the economic slowdown in Viet Nam during the period 2013-2014, the Government enacted a number of schemes of this kind which were intended to help a struggling SME sector. The experience of OECD countries indicates that governments should consider cutting “profit-insensitive” taxes (i.e. taxes that are paid regardless of whether SMEs are recording a profit or loss, such as payroll taxes, licensing fees and capital taxes). This would increase the ability of SMEs to finance working capital internally. Related to this, an interest rate decrease can also reduce the cost of SME financing, although such a move is predicated on the assumption that SMEs have appetite for financing at such times of economic downturn; some recent evidence from Asia Pacific countries in economic difficulties suggests that SMEs actually seek to cut down their debt obligations, and have virtually no appetite for financing to support capital investment. Rather, they adopt a wait-and-see approach to their business, including their funding needs, especially when policymakers react to local currency depreciation by increasing interest rates. Boxes 4 and 5 describe country experiences with supporting SMEs in times of crisis (box 4) or disaster (box 5).

**Box 4. Japan’s policy to support SMEs during the global economic crisis of 2008-2009**

The global financial crisis that started with the Lehman Bank implosion of September 2008 seriously affected Japanese SMEs, by sharply limiting their financing channels and severely reducing the demand for their exports. Thus, the Small and Medium Enterprise Agency (SME Agency) of Japan played an important role in the recovery of SMEs by easing their financial burden. In collaboration with the Japan Finance Corporation and Shoko Chukin Bank, the SME Agency launched emergency guarantee and safety-net (soft) loan programmes to support SMEs whose business stability was threatened by external factors (e.g. reduced orders from major customers, delayed payments and/or bankruptcy, failure of the main bank, etc.). Additional credit guarantees were made available to guarantee loans to SMEs in all industries – raising the coverage from 80 per cent to 100 per cent of loan losses. It also issued safety-net loans to SMEs temporarily facing cash-flow problems. The regular corporate income tax rate was also lowered for SMEs, from 22% to 18%, for two years.

The SME Agency also provided emergency employment subsidies, designed to prevent SME employees from losing their jobs. The subsidies included a temporary layoff allowance or wage equivalent per person per day, training expenses and a temporary transfer allowance, all of which could be claimed for up to 300 days, within three years. Another SME Agency measure was the provision of information and consultation services for SMEs. During the financial crisis, the SME Agency offered information and advice on various tax and accounting measures to help SMEs take advantage of new tax incentives.

Box 5. Policy interventions for SME sector rehabilitation in disaster-hit areas

(a) Japan

In addition to the enormous human and physical damage, the Great East Japan Earthquake of March 2011 inflicted damage to approximately 740,000 SMEs within the affected prefectures. In addition, the earthquake had an impact on SME operations nationwide due to supply chain disruptions and electricity shortages, leading to decreased production and exports. At the same time, the demand side of the economy was weakened by rumours, partly related to radiation leakage by the nuclear power plant accidents and a subsequent decline in consumer confidence.

Specific measures, which mainly focused on financial support and employment support, were quickly undertaken to maintain SMEs’ liquidity and to revitalize the private sector. As for financial support, the Japan Finance Corporation and Shoko Chukin Bank jointly established a special recovery loan programme with a separate credit line, extended grace and repayment periods and reduced interest rates, particularly for small business.

Credit guarantee corporations also established a special guarantee programme, with a 100% credit guarantee to support emergent working capital needs of SMEs that had received a disaster victim certificate. These were issued by the local municipalities who certified that an SME was partially, extensively or completely damaged by the earthquake or the tsunami. Employment support included special unemployment benefits for disaster-affected employees, subsidies to maintain SMEs’ employment and job fairs for new graduates in the regions that were affected by the disaster.

(b) Thailand

The flooding of central Thailand in 2010 was one of the worst in the country’s history, with one-fifth of the country being inundated, including several major industrial estates. The unprecedented level of flooding not only imperiled the food security of many Thais, but also threatened the supply chain of many businesses and seriously affected a large number of SMEs. To restore the country’s stability and prosperity, the Government prepared a three-phase strategy, with a budget of more than US$10 billion to promote the economic recovery.

The objective of the first, immediate phase was to help people and businesses adjust to the flood situation within two months. In addition to rehabilitation activities, several economic measures were introduced, consisting of developing the skills of labour, restoring infrastructure, regulating prices and water management.

The second, short-term phase lasted for one year. The focus of this phase was to provide financial support to people and businesses affected by the floods, investment incentives and other measures facilitating business operations. The specific measures included:

(a) Individual and enterprise loans for reparation of residences and reconstruction;
(b) Loans for the development of flood-protection systems for industrial estates and manufacturers;
(c) SME loans and credit guarantees from the Small Business Credit Guarantee Corporation;
(d) Two-step loans and safety-net loans with guarantees provided by the Japan Bank for International Cooperation for the recovery of businesses, especially SMEs;
(e) Consideration by the Board of Investment of Thailand on the extension of the incentive period and the investment benefits for affected investors;
(f) Facilitation of visa applications and employment licensing procedures;
(g) A plan of action for the removal of water and quick reconstruction of the affected industrial estates.
The final, long-term phase aims to provide a comprehensive framework of water management and flood prevention. Through the development of a water management system, flood warning system and better infrastructure design, the Government aims to regain industrial confidence and economic development in the long term.


The one caveat to this kind of direct support, during periods of economic deterioration, uncertainty and possible credit rationing, is that the interventions must be appropriate, well-focused and time-bound. By their very nature, such support is distortionary, and this may be a valid way to proceed during particularly difficult times, but it should not seek to ‘paper over cracks’ that exist in the provision of finance to SMEs (and the corporate community as a whole) due to long-standing market or regulatory failures. The interventions should provide temporary and specific relief, and be impactful in this regard, but not be extended, and not frequently, to create a false sense of security by the recipients. For developing economies in particular the costs of such interventions for the public purse can be considerable, and during times of economic downturn there are likely to be multiple calls on additional public funds for assistance in various areas of the economy. As with any kind of subsidy, such direct interventions – largely under-written by tax-payers – cannot afford to become seen as automatic or permanent in nature. This is particularly true in an increasingly globalized world where the contagion effects of one large economy’s downturn can send out ripple effects across the globe, thereby making the sense of vulnerability to such exogenous shocks to the domestic economy a far more frequent (if not virtually constant) affair.

4.4. A brief note on the impact of society, culture and tradition

For a number of reasons, this paper has avoided the temptation to explore the argument that SMEs’ direct access to finance requirements differs from economy to economy, and even within national economies. To some extent, of course, that is a valid issue to explore but beyond the direct mandate of this paper. Even so, all banking and financing activity is conducted within a wider social, economic, political, historical, religious and cultural context. This is certainly true for the Asia-Pacific region also. At the most basic level, financial and marketing schemes enacted by a bank in one country which resonate well with its customer base, could prove to be totally unsuccessful in another country. The working and other practices of a financial institution may appeal in one economy, but utterly flounder in another where a different approach is adopted.

Host country laws and regulations also help determine the form in which SME finance may be enacted in a particular economy, of course. Some central bank regulators permit non-collateralized lending, for example, while others explicitly prohibit it. Some central banks set interest rates (and fix or manage exchange rates), while others allow the market to decide, and others yet look to ‘finesse’ the activities of the market in various direct and indirect ways. But even where current laws and regulations permit (or at least do not prohibit) certain types of financing, historical practices and proclivities can influence both what the banking and financial sector feels able to supply and what SMEs and other businesses seek. For example, there tends to be a greater emphasis on equity finance and other non-lending instruments in the so-called ‘Anglo-Saxon’ tradition of funding business endeavour, relative to some other socio-cultural contexts. Within the Asia and
Pacific region this is apparent in the greater emphasis placed on stock markets, for example, in former British colonial economies, relative to those of France or the Netherlands. The transitional economies of what was previously ‘French Indo-China’ (i.e. Cambodia, Lao PDR and Viet Nam), for example, have only embarked on their first secondary markets for equities in the last 15 years or less, and had no prior experience of stockmarkets, in contrast with countries such as India and Malaysia, former British colonies, where equity finance was well-established in the early part of the last century.13

One kind of banking which is particularly noticeable in parts of Asia and the Pacific is so-called ‘Islamic banking’, where the actual modalities of providing access to funds by financial institutions must be compliant with Islamic laws. The charging of interest rates, for example, on loans is neither deemed permissible in some Muslim countries nor desirable by some customers, and so alternative services and products have been developed, such as ‘sukuk’ bonds.14 The financing of companies involved in the production of alcohol or gambling is also not permitted in some countries. This also extends to equity financing; quite a number of investment funds have been established over recent decades, and both Dow Jones and FTSE have their own Islamic market indices to serve as benchmarks for these funds. This has led to the development of a not insubstantial Islamic banking and finance industry in parts of Asia and the Pacific.

Cultural factors can also play a role in the extent to which women entrepreneurs and their businesses can gain equal access to finance, relative to their male peers. Gender equity in the provision of SME finance is not always evident, and the factors behind it can be both multiple and complex. Some examples suggest, however, that women often make better credit risk than men, notably in areas like micro-finance, with a better track record of servicing their financial debts in a timely fashion. This in turn would suggest that it makes good commercial sense for SME finance providers to mainstream ‘gender equity’ into their lending practices, both in terms of their own internal operations and their client base. The particular case of Mongolia is instructive in this regard, where

13 Perhaps one striking exception to this broad rule of thumb is Myanmar. Although part of the British Empire until the late 1940s, what was then Burma did not have any stock market, despite having a relatively large economy at that time. One of the principal reasons for this was that, from the end of the last Anglo-Burmese war in 1886 until the late 1930s, Burma was an outlying province of greater India, and thus the stock exchange in Calcutta served that purpose. Further, initial public offerings and secondary market listings only really make financial sense for relatively large firms, due to the transaction costs entailed and the need to have a large universe of potential minority investors. In the context of colonial Burma, there were few wholly domestic companies that would meet these criteria, with the largest firms typically British in origin.

14 Sukuk is the Arabic name for financial certificates, but commonly refers to the Islamic equivalent of bonds. As interest-bearing bonds are not permissible in Islam, Sukuk securities are structured to comply with Islamic law and its investment principles, which prohibit the charging of and/or paying interest. This is typically done by involving a tangible asset in the investment. For example, giving partial ownership of a property built by the investment company to the bond owner, and so the bond owner may then collect his/her profit as a rent, which is allowed under Islamic law.
women-owned SMEs are typically regarded as more risky lending propositions (than their male-owned counterparts), and yet have a better track record when it comes to not defaulting on loans.15

5. CONCLUSIONS AND POLICY RECOMMENDATIONS

Based on the discussions, the following six main policy recommendations can be made regarding SME financing, particularly from the Asia Pacific perspective:

(a) The provision of basic working capital is essential for the functioning of all businesses, including SMEs, if they are to maintain their operations. This is the ‘bread and butter’ element that is a virtually prerequisite if an economy wishes to create a robust and sustainable SME sector. If individual SMEs – along with informal businesses and micro-enterprises – are denied this, then SMEs may have to perilously rely on informal finance and usury. Even if informal financial facilities were considered adequate from an SME point of view, without an effective regulatory framework to govern this activity, the risks of a systemic collapse are greatly increased.

(b) Further, for SMEs to further thrive and prosper there is a need for more long-term funding sources, both debt and equity, to support sensible capital investment. The right kind of funding is required to help SMEs expand their markets and client base, improve quality, make advances up the value chain, increase their revenues and capture more value, and plug into increasingly important cross-border production networks. It cannot be done using the same kinds of basic, short-term financial products that are used for working capital needs.

(c) In this context, a proper balance between debt and equity funding sources is required, with availability of venture capital and private equity particularly important for supporting and scaling-up entrepreneurial and innovative businesses. Equity investors help share some of the (not inconsiderable) risks associated with young firms, sometimes venturing into fields that credit officers would not feel comfortable with. They can also contribute additional technical assistance and industrial experience. For a start-up venture that has yet to attain a strong income stream, an unduly large reliance on debt financing – which needs to be serviced – is a risky proposition.

(d) Further, for developing countries with large rural sectors, the availability of micro-finance and other funding for small-scale agribusiness is

15 See IFC (2014c). The report notes: “Lending to women is generally perceived by the banks as more risky than lending to men, as women more often lack assets that can be provided as collateral. At the same time, both commercial banks and [non-bank financial institutions] say that loan repayment rates by women are higher than those of men. Financial institutions are either not aware of or not convinced that women-owned SMEs are a distinct business segment or at least a significant market opportunity. One of the reasons for this lack of awareness can be the reluctance of financial institutions to collect gender-disaggregated data on SMEs. This makes it difficult to estimate the share and analyze the profitability of women-owned SMEs in the total SME portfolio. Collecting and analyzing gender-disaggregated data, however, could be the first step to recognizing women-owned SMEs as an underserved yet profitable client segment.” See p. 3.
particularly important. Typically, rural and agricultural areas are usually ‘under-banked’, and so access to finance is even more challenging. But there also need to be financial products and services that meet the particular needs of (and constraints faced by) the agricultural sector, such as planting seasons, harvests and other critical moments in the unique rhythm of rural life. Proffering the same kinds of loan products and services that are used in urban areas are unlikely to receive as much customer interest, come with higher transaction costs (and therefore less income) and risks for the service provider and most importantly, run the risk of creating a heavily indebted agribusiness sector. Therefore, more finely calibrated and designed financial products and services need to be devised that are congruent with the needs of SMEs in agribusiness. The recent burgeoning of ‘phone banking’ and other financial services derived from advances in ICT and technology have the potential to greatly assist economies in this regard, by reducing transaction costs, lowering risk levels, and offering a financial service that – along with other applications – is of benefit to the customer base.

(e) There are also non-collateral debt products and services like financial leasing and factoring (also sometimes referred to as ‘pledging accounts receivables’) which are particularly well suited to SMEs, and thus should be considered for introduction, if not already in operation, and where resources allow. A lack of adequate physical collateral to proffer as security for loans is one of the single largest constraints faced by SMEs when seeking access to finance, and so financial products that mitigate this obstacle will always be helpful, even if their cost is often slightly greater. Again, advances in technology and the use of ‘big data’ are allowing financial institutions to better analyze and predict portfolio risk, which then permits them to place less onus on collateral if laws and regulations permit. Moving to a place where more SME finance is done with emphasis on cash flows and income streams as the determinant of default risk, rather than whether or not the finance provider can take possession of a firm’s office or the owner’s house, has got to be a welcome advancement.

(f) Finally, the provision of improved access to finance for SMEs needs to be seen in the context of a wider range of business development and enabling environment interventions in support of this sector. While access to finance is an important determinant of SME sector development, it is not the only one, and there is also the potential to mix commercial funding sources with other activities, such as incubators, matching grant funds and other initiatives intended to create a ‘package that can help foster the next generation of firms in an economy. A business environment without sufficient access to finance is not an enabling one for SMEs, but access to finance alone is insufficient to constitute an enabling environment.

To take the last point just one step further, one can validly argue that the policy interventions required to improve SMEs’ access to finance extend well beyond the financial sector, and even the SME sector. The issue of access to finance for SMEs, like most other areas of SME development and private sector development, is a cross-cutting
one and thus spans the mandates of multiple government agencies. It is of course most important that banks and other finance providers have access to adequate funds, are willing and able to extend the right kinds of products and services to SMEs, that the cost burdens of such transactions are not unduly high, that SMEs are able to manage and harness those funds to best effect, and that such financing is used wisely. But that in itself is not enough. The right legal framework, court system, implementing capacity and numerous other support structures need to be in place also. And for optimal effect, the provision of finance to SMEs – whether working capital or investment capital, debt funding or equity finance – needs to be integrated with other forms of BDS provision, such as incubation, accounting and auditing, technical and quality standards, networks of various kinds, and all the other elements that make up an enabling business environment for SMEs to bloom and prosper.

It is hoped that this paper gives sufficient insight and evidence in support of these six policy-oriented recommendations and the logic that lies behind them. They are by no means the only components of SMEs’ access to finance that host countries need to proffer, as part of delivering an enabling business environment. But they are some of the most critical and sometimes overlooked components, which is somewhat surprising when one recalls that the SME sector typically constitutes the largest part of the corporate community in any economy, whether developed or developing, at least as measured by the number of company registrations (as opposed to contribution to total salaried employment or GDP output). The SME sector certainly should not be regarded as an obscure or peripheral part of the financial sector’s overall market. Nor are the policy recommendations listed above particularly specific to the Asia-Pacific region in any way, but they address generic issues that are equally pertinent in this large part of the world as they are in other parts of the globe. Perhaps a good place to start conceptualizing what an individual country might do in this respect is to refer to the four-tier SME finance concept proposed earlier. It is unlikely that an economy could pursue the full suite of proposed interventions in one go, and some economies may have already implemented elements of this ‘pyramid’. But there may be components that have yet to be pursued, and the conceptual structure allows one to begin to view the issue in a holistic manner.

In addition, and to conclude, a dozen useful lessons have been learnt in different parts of the Asia-Pacific region concerning SME finance; both in terms of what seems to work and what does not. Some of the key observations include:

(a) Relevant government agencies and the commercial financial sector need to understand the typical life circle and associated cash requirements of SMEs, which will morph over time. In this regard, they also need to consider policies that assist in financing viable SMEs facing cash drain periods and identify ways of helping SMEs overcome the time gap between receivables and payables through various ‘bridging’ instruments.

(b) Relevant government agencies should consider the development of knowledge-sharing and communications platforms for relevant stakeholders involved in SME finance, in order to increase mutual understanding and to share experiences. With the development of the Internet, the creation of such interactive portals, with quite high degrees
of functionality, need not be expensive to develop and can even become sustainable in themselves.

(c) In general, policymakers should not seek to develop and operate financial assistance programmes for the SME sector directly, but rather act to catalyze and support activities that address market failures by the relevant financial industry actors. In particular, policymakers should avoid introducing direct lending and credits at subsidized rates, as they come with moral hazards attached, can be a burden on the state budget if not self-sustaining, while government agencies rarely make good financiers.

(d) Loan waivers and other kinds of (well intentioned but flawed) subsidies aimed at increasing SMEs’ access to finance, issued by government agencies, are rarely sustainable, carry moral hazard, and can even distort the same credit culture and discipline that policymakers are trying to promote.

(e) Market failures in SME finance should not be addressed with government finance. Governments should intervene and work with/through commercial forces to identify and address those failures, whether through regulatory interventions or more applied methods.

(f) Policymakers must give adequate attention to the protection of creditors’ rights and property rights, by introducing a robust set of rules that protect lenders from non-payment, and enforcing those rules in a robust and transparent manner. Without creditors’ rights, the market for SME finance can be expected to remain under-developed, as the risks and uncertainties will be too high, and the cost of borrowing too expensive.

(g) Governments should consider promoting the development of new, ‘SME-friendly’ financial products and services that will better meet the needs of the SME sector and increase the aggregate volume of SME finance made available.

(h) In countries where it is appropriate, governments should consider introducing policies that will promote the availability of risk capital for innovative SMEs and business ventures in high growth sectors, particularly during the early stages of financing when other forms of financing are likely to be scarce. In this regard, it may be feasible for public sector funds to be used in partnership with private sector financiers to support particular industry sectors in which SMEs are active and are delivering innovative products or services.

(i) Policymakers should appreciate the need for proximity between lenders and borrowers, particularly in the case of small-scale loans. Regional and local equity initiatives (e.g. subnational funds) are appropriate for such types of lending. The same is true of micro-financing activity for MSMEs in rural areas and agribusiness. For inclusive economic growth, it is essential that the provision of SME finance is not restricted to a small number of urban locations.

(j) Governments may occasionally need to consider taking emergency (and temporary) measures and facilitate extra credits to support SMEs in times of severe economic downturns or natural disasters. In addition, they should take measures to help SMEs build up their long-term survival
capacity and competitiveness to make them resilient. Care must be taken in this regard in order not to undermine the commercial finance sector, and interventions of this nature need to be measured and brief.

(k) There is a role for business associations, chambers of commerce and other business development service providers to help SMEs get improved access to information on financing, and also provide technical assistance that will make them more attractive (i.e. lower risk propositions) to potential sources of funds. These might include training on accounting and financial management skills, while raising SMEs’ awareness of the importance of cash flow management and helping them to discern different kinds of financing sources for different needs.

(l) Finally, there is also considerable merit in examining ways in which foreign direct investment activity can be used to dovetail with SME finance promotion activities, to good effect. For example, the presence of large foreign firms can support factoring services, and can be a source of ‘balance sheet’ funding (and business demand) themselves.16

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16 For perhaps the most in-depth depiction of SME financing in Asia, including 14 specific country profiles, see ADB (2014).
REFERENCES


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