While not every SME turns into a multinational enterprise, they all face a similar issue in their early days: finding the right type of finance at an affordable cost to start and grow the business. The ability of SMEs to develop, grow, sustain and strengthen themselves is heavily determined by their capacity to access and manage finance. Unfortunately, SMEs in the region consistently cite the lack of access to finance as a serious obstacle to their development. Therefore, this chapter addresses some of the key issues concerning the financing of SMEs.

This chapter begins by describing the current situation of SME financing in the region and the financing needs of SMEs at different stages of growth. Working capital management, obtaining credit and other financial instruments are discussed, as these issues have the most direct impact on SMEs’ cash flow. The myriad ways that SMEs can obtain capital and the relationship between the bank and the borrower are reviewed, together with observations about raising capital. The chapter concludes with policy prescriptions.

The importance of cash flow for small businesses can never be over-emphasized; even profitable firms will fail if they cannot collect the cash that is due to them. Policymakers can have a significant positive impact on SME survival if they articulate and enforce a coherent programme of creditor rights.

A. Raising capital

Raising capital is one of the most critical issues for SMEs’ growth and survival. While the gap in financing SMEs is significant both in developed and developing countries, some differences in characteristics exist.

While an OECD (2006) survey of SME financing indicated large financing gaps in both OECD and non-OECD countries, the overall situation was more severe in non-OECD countries (figure V.1). Further, OECD and non-OECD countries differed significantly on the matter of debt financing: only 30 per cent of the firms in the OECD countries felt a gap existed in debt financing while 70 per cent of non-OECD countries felt the same. This difference strongly the firms in suggests an underdeveloped banking sector, which is the main provider of debt financing, in non-OECD countries. The equity financing gap was more similar among the two groups, at 75 per cent and 60 per cent, respectively, perhaps indicating a large demand for equity financing by advanced SMEs in the OECD countries.

Figure V.1. SME financing gaps in OECD and non-OECD countries

Source: OECD, 2006.
Note: The results are based on a survey in 20 OECD countries and 10 non-OECD countries.

70 It should be noted that the smaller the size of the enterprises, the higher was the portion of non-performing loans.

The disadvantages in SME financing in developing countries also exist in the lending policies of commercial banks, the most important source for SMEs’ external financing (Park, Lim and Koo, 2008). The results of the survey conducted by Beck, Demirgüç-Kunt and Peria (2008) suggested that the financing gap was greater between countries than between firms of different sizes. In developing countries, commercial banks

Figure V.2. Collateral requirement in developing and developed countries

As shown in Table V.1, developed economies rank the highest in terms of strength of legal rights and depth of credit information within the region. They have also developed private credit bureaus that provide credit history for almost the entire adult population. East and North-East Asia ranks second for the first two indicators. The credit information coverage in these countries is relatively comprehensive with the combination of public registries and private bureaus. The strength of legal rights indicator for the other four subregions is not far behind the two leading subregions; however, the lack of public and private credit information is likely to be a major obstacle for getting credit in those countries, especially in the Pacific, and South and South-West Asia.

B. Business life cycle and the need for cash

Throughout the SME life cycle, each stage – start-up, growth, maturity, decline, transition and exit – will have varying cash flow needs. SMEs may obtain equity capital and debt financing from various sources at each of those stages. (Sridhar, 2008). Figure V.4 shows that the particularly crucial periods of cash drain occurs during the start-up, growth and transition stages.73

Figure V.4. SME business growth stages and cash flow

<table>
<thead>
<tr>
<th>GROWTH STAGES</th>
<th>CASH FLOW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Startup</td>
<td>Positive</td>
</tr>
<tr>
<td>Growth</td>
<td>Positive</td>
</tr>
<tr>
<td>Maturity</td>
<td>Break even point</td>
</tr>
<tr>
<td>Decline</td>
<td>Cash drain</td>
</tr>
<tr>
<td>Transition</td>
<td>Cash drain</td>
</tr>
<tr>
<td>Growth decline or discontinuation</td>
<td></td>
</tr>
</tbody>
</table>

Source: Authors’ compilation.

73 This is a simple generalization, though, as real life cycles differ between individual companies, between growth and non-growth sectors, and between new and traditional industries (Johnsen and McMahon, 2005).

The World Bank’s Ease of Doing Business survey measures the level of enterprises’ credit access in a country. Table V.1 shows the four main indicators of facilitation of access to financing and availability of credit information:71

(a) Legal rights – the degree to which collateral72 and bankruptcy laws facilitate lending;
(b) Depth of credit information – rules and practices affecting the scope, access to and quality of credit information;
(c) Public credit registries’ data coverage of borrowing history, thus credit worthiness, of individuals and firms; and
(d) Private credit bureaus’ data coverage of borrowing history, and thus credit worthiness, of individuals and firms.

71 A more detailed explanation of the indicators concerning getting credit can be found in World Bank, 2011a, p. 48.
72 The typology of collateral is given in annex V.1.

Table V.1. Ease of getting credit by subregion

<table>
<thead>
<tr>
<th>Subregion</th>
<th>Legal rights*</th>
<th>Depth of credit information*</th>
<th>Public registry coverage (per cent adults)</th>
<th>Private bureau coverage (per cent adults)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed economies</td>
<td>8.7</td>
<td>5.3</td>
<td>0.0</td>
<td>92.0</td>
</tr>
<tr>
<td>East and North-East Asia</td>
<td>7.3</td>
<td>4.5</td>
<td>20.8</td>
<td>41.3</td>
</tr>
<tr>
<td>North and Central Asia</td>
<td>5.1</td>
<td>4.0</td>
<td>3.6</td>
<td>14.3</td>
</tr>
<tr>
<td>Pacific</td>
<td>6.2</td>
<td>0.7</td>
<td>0.0</td>
<td>4.8</td>
</tr>
<tr>
<td>South and South-West Asia</td>
<td>5.1</td>
<td>2.6</td>
<td>4.7</td>
<td>7.7</td>
</tr>
<tr>
<td>South-East Asia</td>
<td>5.8</td>
<td>2.7</td>
<td>11.4</td>
<td>20.4</td>
</tr>
</tbody>
</table>


* Based on a 0-10 scale with 10 being the most developed.
Notes: (a) Ranking out of 183 economies; (b) developed economies include Australia, Japan and New Zealand; (c) Taiwan Province of China is included in East and North-East Asia; (d) some Asia-Pacific economies (Democratic People’s Republic of Korea; Macao, China; Myanmar; Turkmenistan; American Samoa; Cook Islands; French Polynesia; Guam; Nauru; New Caledonia; Niue; Northern Mariana Islands; and Tuvalu) were excluded from this analysis due to a lack of survey data; and (e) explanatory notes show all countries by subregion.
The first period (start-up) involves a high mortality rate for SMEs if they cannot find enough initial capital, even though the scale of their needs may not be large. In addition to the slow sales that they often face during this stage, it is common for (even profitable) SMEs to fail because, while they may have profits on paper, they do not have the cash in hand from their customers to pay bills or to cover operating costs (figure V.5). This time gap is difficult for start-up businesses to avoid, and survival can depend on a firm’s ability to raise additional working capital. The inability to survive the time gap between cash inflows and outflows is a primary cause of business failure throughout an SME’s entire life. Apart from personal assets and loans from family and friends, during the start-up stage SMEs may get funds from seed capital, venture capital, business angels and/or government or institutional sources.

Figure V.5. Main reason for SME failure: Time gap between receivables and payables

![Diagram showing the time gap between receivables and payables](image)

Source: Authors’ compilation.

In the second period (growth), SMEs pass the break-even point and start making money. 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. While such financing for growth could be supported by short-term loans and working capital generation from their daily business, long-term loans from commercial banks are usually preferred in order to ensure long-term investment and maintain adequate working capital. Venture capital funds may also become an important resource for expansion. The availability of other funds could also increase at this stage with local, national and international financial sources. Entrepreneurs typically experience difficulty raising funds at this critical stage. Commercial banks do not lend easily to those who still have no, or limited, credit record, and venture capital is not readily available for small-scale investment in new businesses, particularly in developing countries.

In the third period (transition), it is necessary for SMEs that are losing money to undertake measures to improve profitability, either by increasing sales or by reducing costs. 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 during cash-drain periods. In financial terms, short term is a period of a year or less while long term represents more than one year.

C. Overview of SME financing

SME financing refers to a range of mechanisms for funding the development of SMEs. There are a number of notable features to SME financing. The ability to increase capital relatively quickly in response to growth is a key feature. Another salient characteristic is complementarity: SME financing augments traditional sources of financing in many contexts. Effective financing mechanisms also contribute to sustainability as the financing of successful and profitable SMEs generates additional capital for future SMEs, thereby creating a virtual cycle. SMEs’ financing needs (as both debt and equity) may vary (Johnsen and McMahon, 2005; and Zavatta, 2008) depending on such factors as:

(a) Home country;
(b) Industrial sectors;
(c) Perceived business risk;
(d) Asset structure (e.g., tangible versus intangible; capital-intensive versus less capital-intensive; and high or low fixed assets);
(e) Debt-to-equity ratio;
(f) Growth rate; and
(g) Profitability.

SMEs can obtain the necessary funds from a number of different financial instruments. These instruments can be broken down into the six general categories listed in table V.2.

Table V.2. Different SME financing sources

<table>
<thead>
<tr>
<th>Category</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Informal financing</td>
<td>Personal savings</td>
</tr>
<tr>
<td></td>
<td>Borrowing from family or friends</td>
</tr>
<tr>
<td></td>
<td>Borrowing from money lenders</td>
</tr>
<tr>
<td></td>
<td>Trade credit</td>
</tr>
<tr>
<td>Internal financing</td>
<td>Retained profit</td>
</tr>
<tr>
<td></td>
<td>Internal savings</td>
</tr>
<tr>
<td></td>
<td>Working capital</td>
</tr>
<tr>
<td></td>
<td>Sales of assets</td>
</tr>
<tr>
<td>Debt financing</td>
<td>Short-/long-term loans</td>
</tr>
<tr>
<td></td>
<td>Line of credit</td>
</tr>
<tr>
<td></td>
<td>Promissory notes</td>
</tr>
<tr>
<td></td>
<td>Credit cards</td>
</tr>
<tr>
<td></td>
<td>Overdraft</td>
</tr>
<tr>
<td></td>
<td>Corporate bonds</td>
</tr>
<tr>
<td>Equity financing</td>
<td>Seed capital</td>
</tr>
<tr>
<td></td>
<td>Angel finance</td>
</tr>
<tr>
<td></td>
<td>Venture capital</td>
</tr>
<tr>
<td></td>
<td>IPOs</td>
</tr>
<tr>
<td>Asset-based financing</td>
<td>Factoring</td>
</tr>
<tr>
<td></td>
<td>Invoice discounting</td>
</tr>
<tr>
<td></td>
<td>Inventory financing</td>
</tr>
<tr>
<td>Leasing</td>
<td>Capital leasing (hire-purchasing)</td>
</tr>
<tr>
<td></td>
<td>Operating leasing</td>
</tr>
<tr>
<td>Government grants and subsidies</td>
<td>Grants</td>
</tr>
<tr>
<td></td>
<td>Interest subsidies</td>
</tr>
<tr>
<td></td>
<td>Credit guarantees scheme</td>
</tr>
<tr>
<td></td>
<td>Loan insurance schemes</td>
</tr>
<tr>
<td></td>
<td>Loan schemes</td>
</tr>
</tbody>
</table>

Source: Authors’ compilation.

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(c) Perceived business risk;
(d) Asset structure (e.g., tangible versus intangible; capital-intensive versus less capital-intensive; and high or low fixed assets);
(e) Debt-to-equity ratio;
(f) Growth rate; and
(g) Profitability.

SMEs can obtain the necessary funds from a number of different financial instruments. These instruments can be broken down into the six general categories listed in table V.2.

Informal finance refers to all transactions, loans and deposits occurring outside the regulation of a central monetary authority (Atieno, 2001). Such funds may come from personal savings, borrowing from relatives or trade credits. Internal
financing is the method of generating funds through a company’s core business, such as through profits and working capital (Wilson, 2011). In developing countries, including those in Asia and the Pacific, informal and internal financing typically dominates SMEs’ financial sources, particularly for start-ups and micro and small enterprises.

Debt financing, which is also a major financial source for SMEs, typically takes the form of credit lines and term loans that must be repaid over time, usually with interest (Helmis, 2006). Most of the debt financing is provided by banks, but it also includes corporate bonds.

Equity financing takes the form of money obtained from investors in exchange for an ownership share in the business (Helmis, 2006). It includes a wide range of financing sources such as business angels, venture capital and initial public offerings (IPOs).

Asset-based financing is defined as obtaining funds by pledging a subset of the firm’s assets as collateral or as the primary source of repayment (Berger and Udell, 2005). The most common types of asset-based financing are factoring, invoice discounting and inventory financing (Business Owners Toolkit, 2012a).

Leasing is a common method of financing equipment. It can be defined as a rental contract specifying the payment schedule for the lessee (the borrower) in exchange of the right to use the fixed asset bought by the lesser (lender) (Berger and Udell, 2005).

The public sector actively promotes the development of SMEs by providing grants and subsidies. This financial support has many flexible forms and is usually delivered to the SME via financial institutions or government line agencies (RAM Consultancy Services, 2005). Some of the major financial instruments for SME development are further reviewed in the following section.

D. Forms of finance

Figure V.6 shows major instruments of SME financing (Berger and Udell, 2005; IFC, 2009; Szabó, 2005; Women’s World Banking, 2004; and Zavatta, 2008). The figure was developed to present a comprehensive set of SME financial instruments, whose features are relevant to the size and credit history of individual firms. These financial instruments can also be categorized based on creditors’ perceptions on risk and return as well as the level of financial sector sophistication in an economy. These financial instruments are not exclusive and policymakers often use various instruments in concert to support SMEs. A discussion of these instruments, beginning with the financial instruments with the lowest financial sector sophistication and progressing to the highest level, follows.

**Box V.1. Development of an SME financing support system in China**

“Development of an SME financing support system” is an ADB project for developing the comprehensive institutional and regulatory framework of SME financing in China. The main objectives of this project are to: (a) increase the total amount of equity and debt financing available to SMEs; (b) attract private sources of SME financing; and (c) encourage investment by increasing the profitability and reducing the risk of loss to the lending institutions. After analyzing the existing strengths and weaknesses of SME financing in China, ADB proposed the following four main policy recommendations to make the Chinese SME financing system more effective:

1. **Equity financing for SMEs in traditional sectors**

SMEs in traditional sectors such as food processing, retailing and consumer services are important due to their job-creation function. They generally face difficulties in attracting investors who believe that the potential return on investment is not high enough to justify the risk of loss involved. Government intervention has to focus on either increasing the potential profit of businesses or reducing the risk of loss while providing direct equity financing. To ensure the success of the public equity funds, specific measures are recommended including: (a) introducing private co-investors and profit-driven fund managers; (b) increasing the share of return for private investors; and (c) limiting the investment coverage strictly to SMEs.

2. **Legal and regulatory framework**

The absence of supportive laws and regulations in China severely limits the availability of financing for SMEs, especially from private and foreign sources. ADB identified many principal barriers of investment in SMEs in the existing legal and regulatory framework of China. Taking private investment funds as an example, company laws in China had strict limitations in investment percentage, organizational structure and fund operations, which severely inhibited the development of the private venture capital industry. ADB proposed drafting new laws or making legislative changes in laws relating to the following aspects:

(a) Organizations and operations of private investment funds and public credit guarantee agencies;

(b) Company laws; and

(c) Bankruptcy and security legislation.

3. **Equity financing for technology-based enterprises**

More than 200 public funds for technology-based enterprises had been established by regional and local governments but most of them lacked efficiency and had a low level of return on investment. To solve this problem, ADB recommended several measures for funding operations, including hiring skilled and profit-motivated fund managers, and focusing on investing in start-ups and SMEs. In addition, ADB recommended competition among fund receivers as well as transparency in the whole selection and operation processes.

4. **Credit guarantee for bank loans to SMEs**

Debt is an important source of SME financing. The establishment of a credit guarantee programme can facilitate SMEs’ debt financing by sharing the risk with lenders. ADB presented a comprehensive framework for a loan guarantee programme covering legislation, regulation, operating procedures and service and liquidation operations. It has also provided some risk management procedures for such a programme.

1. Personal net worth or saving

The first step in accessing capital is to fund the venture with the entrepreneur's own assets, e.g., savings. After investing his/her own money the entrepreneur then typically turns to family and friends (or banks) for personal loans (Shane, 2008). It is important to highlight for policymakers the fact that entrepreneurs and small business owners will generally go to formal financial institutions only if personal sources have been exhausted. They will finance their businesses from personal savings first; thus, policies that protect individual wealth, such as tax reforms\(^\text{75}\) and property rights, indirectly assist the financing of SMEs.

2. Working capital

Working capital represents the excess of current assets over current liabilities such as debt, where “current” is a time span of a year or less. A high level of working capital indicates significant liquidity, and it is frequently used to measure a firm's ability to meet current obligations (Scott, 1997). Positive working capital requires the maintenance of steady operating cash flows.

Working capital is a necessity for enabling all businesses to continue functioning, particularly new businesses. This is commonly overlooked in business planning. For example, growth intentions are often not supported by sufficient working capital. Rapid growth needs high inputs of capital, which can be difficult for SMEs to secure and sustain. It is essential that each firm has proper working capital management (ESCAP, 1997).

Prior to borrowing from the financial sector, SMEs can manage their working capital to generate cash for operations. This is particularly important for SMEs because they often do not have easy access to financing from external sources. SMEs' skilful management of working capital can increase cash flows and minimize the short-term need for external debt financing (see figure V.7). For example, SMEs could delay paying vendors while also collecting their receivables more actively in order to increase available working capital (this is called trade credit; see the next subsection for more details). They could also attempt to minimize their inventory and/or reduce operating costs, or sell unnecessary or unproductive assets to gain needed cash. Financial institutions, in addition to providing funds to SMEs, can offer SMEs consulting services in working capital management, including techniques of cash flow forecasting, and rescheduling or refinancing of existing loans.

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\(^{75}\) Refer to annex III.2 for further discussion on this aspect.

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**Figure V.6. Forms of finance for SMEs**

<table>
<thead>
<tr>
<th>Creditor/investor’s perception on risk and return</th>
<th>Forms of Finance</th>
<th>Financial sector sophistication</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Angel finance, Venture/capital, IPO/Stock market</td>
<td>High</td>
</tr>
<tr>
<td>Medium</td>
<td>Seed capital, Corporate bond</td>
<td>Medium</td>
</tr>
<tr>
<td>Low</td>
<td>Microfinance, Long-term loan, Credit guarantee</td>
<td>Low</td>
</tr>
<tr>
<td></td>
<td>Short-term loan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Factoring</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Leasing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Trade credit</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Working capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Personal saving</td>
<td></td>
</tr>
</tbody>
</table>

**Figure V.7. Examples of working capital management**

- **Increased working capital**
  - Profitable business
  - Sales of unproductive assets
  - Inventory reduction
  - Cash flow forecast
  - Refinancing/rescheduling of loans
  - Late payment to suppliers
  - Quick customer payment

Source: Authors' compilation.
3. Trade credit

Trade credit, or buyer’s credit, is an important source of capital and is the second largest funding source for SMEs after banks and private lenders (Campbell, 2009). Trade credit is an arrangement between businesses to purchase goods or services on account without making immediate payments. The agreement is provided by suppliers to buyers to bill the buyer for payment at a later stage. A specific fixed period (e.g., due between 30 days and 90 days after the invoice date) is agreed upon within which the customer is required to make full or partial payment. Trade credit conditions are usually industry-specific; however, it is underpinned by collaboration between businesses to make the use of capital more efficient and effective.

Trade credit serves as a valuable source of finance especially in the developing world. The “buy-now-and-pay-later” mechanism, in particular, holds many advantages for SMEs. One of the most important advantages is that it helps to increase working capital by postponing the amount of monetary expenditure in order to create positive cash flows (figure V.8) while reducing capital investment requirements (Tradecredit, 2008). A further advantage is that it allows businesses to focus on growth and other productive activities with the assurance of sufficient investment and without restrictions on their development and expansion (Tradecredit, 2008).

Figure V.8. Trade credit

![Diagram of Trade credit]

Source: Authors’ compilation.

4. Leasing

In order to help small borrowers, some banks, non-banking finance companies and other financial institutions offer leasing. Leasing is a convenient option to assist SMEs in obtaining business equipment for a smaller cash outlay than an outright purchase. The SME can finance up to 100 per cent of the equipment value without collateral. Repayment schedules can be adjusted according to cash flow. Documentation requirements and approval time are relatively simple and short.

There are two basic types of lease: 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. Both types of leases can be useful for increasing the cash flow of the lessee, but only the capital lease confers ownership of the asset on the lessee at the end of the lease period.

A leasing arrangement typically involves the following (CIMC, 2011):

(a) The lessee (borrower) selects an asset (e.g., equipment, vehicle or software) that the lessor (the finance company) owns or will buy for renting to the lessee;
(b) The finance company is the legal owner of the asset during duration of the lease;
(c) The lessee has the control of that asset to use during the lease period;
(d) The lessee pays monthly rental or installments for the use of that asset;
(e) The lessor recovers a large part or all of the cost of the asset plus earns interest from the rentals paid by the lessee; and
(f) At the end of lease period, the lessee has the option to acquire ownership of the asset (i.e., transfer of title after paying the last rental or bargain option purchase price).

5. Factoring

Factoring is a relatively new form of asset-based financing for increasing working capital in Asia and the Pacific, and refers to the sale of accounts receivables by a company to a third party (called a factor) for immediate money and finance (Sridhar, 2008). A bank or a specialized financial institution may purchase accounts receivable from an SME with adequate trustworthiness for cash at a discount from the face value, thus assuming the risk on the ability of the buyer to pay and handling collections on the receivables. This practice, called factoring, may increase SMEs’ short-term cash flows, while reducing administrative costs of accounts receivables (Sridhar, 2008).

There are three main differences between factoring and bank loans. First, the emphasis is on the value of the receivables instead of the firm’s creditworthiness. Second, factoring is a purchase of financial assets rather than a loan. Finally, factoring involves three parties (i.e., a firm, a buyer/customer and a factor) while a bank loan only involves two (i.e., a firm and a bank) (EURO-Phoenix, 2011).

SMEs, especially start-ups and those with poor credit histories, may find factoring attractive because it places less reliance on collateral. The key value of factoring is that underwriting is based on the risk of the receivables (e.g., the buyer) rather than the risk of the seller (Klapper, 2006). Factoring may be particularly suited for those SMEs holding account receivables from large or foreign firms whose credit risk is far lower than the sellers themselves (Sridhar, 2008).

Factoring is an expensive form of financing in comparison to bank loans and therefore may not be the ideal choice when other sources of financing are viable. 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 often requires the endorsement of, or notification to the buyers in advance; this may signal financial weakness.76

76 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 (Asset Based Finance Association, 2011).
6. Short- and long-term loans

Short- and long-term loans, especially from commercial banks, are a very common form of financing for SMEs. The length of the loan generally depends on the collateral, guarantee or credit history of the borrower.

Short-term loans are the most common form of bank loans for start-ups and small businesses, as commercial lenders are generally less willing to take large risks with new companies. They have a maturity of one year or less, although many are repaid within a shorter timeframe (Peaveler, 2012). They are usually taken out for a specific expenditure, for example, to purchase a piece of equipment or to pay a particular debt. In this context, a fixed amount of money is borrowed for a set time with a fixed interest rate (Business Owner's Toolkit, 2012b). In general, the sources of short-term financing for SMEs include a line of credit, promissory notes, other short-term banking instruments (credit cards and overdrafts) and loans from other financial companies.

Short-term financing is easier to arrange, has lower costs and is more flexible than long-term financing. However, short-term financing is more vulnerable to interest rate swings, requires more frequent refinancing and requires earlier payment. Compared to long-term financing, short-term financing allows a business to operate with more flexibility and sufficient freedom, and it is usually less expensive. Therefore, SMEs can rely on short-term loans to operate on thin cash reserves, to meet sudden financial needs or to gain additional working capital, especially in such situations as a temporary cash crisis or delay in an expected payment from a debtor (ShortTermLoans, 2011). In addition, one source may be more suitable than the others because of differences in their interest rate and collateral requirements; thus, SMEs may consider using one or more short-term sources in a given circumstance.

A related form of short-term borrowing, which is typical in developed countries, is a line of credit that sets a maximum amount of funds available from the bank to be used when needed for working capital or other cash needs. This allows the business to borrow funds quickly up to a certain limit with floating interest, which they pay only on the outstanding balance (Business Owners' Toolkit, 2012c). If the business does access this credit, it must make monthly payments of interest and principal towards the debt. A line of credit gives SMEs flexibility and typically lasts for three years, subject to renewal.

Beyond lines of credit, another typical short-term borrowing instrument that is common in some Asia-Pacific countries (e.g., India, Japan and the Republic of Korea) is a promissory note, a negotiable instrument payable to the bearer on demand. It details the terms of a promise by one party (the borrower, sometimes also called the maker, obligor, payer or promisor) to pay a sum of money to the other (the lender, or sometimes payee, obligee or promisee) (Self-Counsel Press, 2009). An SME with adequate creditworthiness can issue the note and will repay the principal in a fixed future time, e.g., three months later, according to the demand of the lender together with interest, or may make interest payments according to a pre-determined schedule, such as monthly or quarterly. The clauses of a promissory note are simpler than those of a loan agreement; therefore, a promissory note is more flexible and negotiable than loan agreements.

Credit through credit cards, which are often used by SME owners, are also a form of short-term loans. Credit cards are a convenient means of making payments and tracking expenses but have higher interest rates than other forms of short-term borrowing. Sometimes it works as a substitute for other types of loans by SMEs, because small firms and start-ups usually have little credit history to ask for commercial loans. In addition to a personal credit card, there are business cards with more specific functions for business operations but which can more expensive and more difficult to qualify for (Dratch, 2011). Based on a survey in the United States, a personal credit card was widely used among the smallest firms, while the use of business credit cards generally increased with firm size (Mach and Wolken, 2006).

Overdraft financing is provided when businesses make payments from their business current accounts that exceed the available cash balance (Touch Financial, 2000). The overdraft limit needs to be negotiated with banks, and the amount borrowed is repayable on demand by the bank. Depending on the size of the overdraft, a bank may require the SME to provide some collateral.

Long-term commercial loans usually refer to those repaid beyond one year and up to three years (Business Owners’ Toolkit, 2012d). This type of loan enables businesses to invest and expand their business with less risk of financial uncertainty, and increases working capital while reducing the amount of installments. Longer-term commercial loans are used for a variety of purposes, such as purchases of major equipment and plant facilities, business expansion or acquisition costs. Lenders require significant collateral because the risk increases with the term length.

It is more difficult for SMEs to obtain long-term loans due to the lack of adequate assets to use as collateral and the insufficient supply of such long-term loans, particularly in developing countries (IFC, 2009). The obvious consequence of a long-term loan shortage is that SMEs are unable to plan long-term investment decisions (Obamuyi, 2007). One solution involves government intervention through mechanisms such as credit guarantees (see next subsection) or direct long-term loans.

Some government agencies and international institutions are also devoted to helping to solve this problem. An apt example is two-step loans. These are often designed to support development in specific sectors in developing countries. It takes its name from the process whereby funds are first provided by the public sector to a local financial institution and are then disbursed to multiple end-beneficiaries (Association for Promotion of International Cooperation, 2011). In general, the maturity of this type of loan is quite long and the interest rate is lower than the market rate (Okuda, 1993).
7. Credit guarantee

Loan credit guarantee schemes (CGS) have been recognized as one of the most effective ways of providing assistance to SMEs’ debt financing. Various governments, often in cooperation with international financial institutions, employ CGS to serve as long-term mechanisms for SME support by cushioning banks from the risks associated with lending to small businesses. These schemes help entrepreneurs to secure both short-term and long-term credits with less collateral or even without collateral. Another policy objective of the schemes is to provide an opportunity for banks to learn more about SMEs – their problems and operations – and to help improve handling of their SME loan portfolios. Through their direct association with SMEs, financial institutions can gradually learn how to lend independently to SMEs.

Levitsky (1997) analyzed various types of CGS and found that most schemes had guarantees for between 60 per cent and 80 per cent of the loan amount; the key factor underpinning their success was a strong cooperative relationship between guarantors and lenders. Apart from the benefits already mentioned, one of the major arguments in favour of these guarantee schemes is that these funds can reach important levels of leverage (five times or more in developed countries) (Levitsky, 1997). In practice, the credit guarantee is often a soft loan.

While many countries in the Asia-Pacific region have been operating CGS, 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 confidence among banking institutions. Issues surrounding the system of guarantee include: (a) moral hazard; (b) high administrative costs due to complicated procedures and fragmented clients; (c) staff reluctance to deal with SME loan portfolios; (d) delays in paying claims; (e) low demand by SME borrowers; and (f) limited outreach by banks. As such, experience shows that banks have not always chosen to utilize these schemes and sometimes have had to be forced by the government into cooperating. Some of the problems identified above could be resolved if staff were better trained and motivated to deal with SMEs. The administrative costs of credit appraisals and monitoring SMEs could also be reduced by outsourcing these activities to providers, such as chambers of commerce and federations of industries. Last, the risk of moral hazard/non-repayment might be reduced via relationship development and/or lower loan guarantees.

Box V.2. Japan’s SME credit guarantee schemes

The Credit Guarantee Corporation (CGC) of Japan, which was established in 1937, aims to help SMEs raise funds from financial institutions by providing credit guarantees on commercial loans. The National Federation of Credit Guarantee Corporations comprises of 52 local CGCs, with at least one in each of the 47 prefectures of Japan, which engage in activities that support local businesses, promote standardized guarantee systems and respond to specific local needs.

Japan’s credit guarantee scheme is characterized by two key functions: (a) a credit guarantee function; and (b) a credit insurance function. The credit guarantee function is illustrated in figure V.9 with nine steps. Following the submission of the SME loan application (1) and its corresponding creditworthiness check (2), a guarantee certificate is issued to the financial institution (3), and the SME is then required to pay a guarantee fee to the CGC before the loan is extended (4). Successively, the

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77 Other major public support schemes for facilitating SME debt financing include interest subsidies, credit insurance schemes and promotion of promissory notes, which are delivered to the SME sector either via commercial banks or non-banking financial institutions (RAM Consultancy Services, 2005).

78 Soft loans are provided by the public sector at lower-than-market interest rates.

79 However, lower loan guarantees may discourage financial institutions to participate in the guarantee schemes.
8. Microfinance

Microfinance, as described by the Consultative Group to Assist the Poor (2011), comprises a wide range of financial services geared towards the poor and low-income 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 facilitating financial inclusion for these businesses. The Microfinance Information Exchange (2010) reported that as of 2010 there were 15.8 million active borrowers and 5.8 million depositors in select developing countries in East Asia, South-East Asia and the Pacific, with an average loan balance of $306.5 per borrower. In contrast, the average loan balance in South Asia is only $144 per borrower, but there are 53.7 million borrowers and 26 million borrowers.

SME is required to make repayments according to the agreed terms and conditions of loan with the financial institutions. 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 the payment from CGC under the guarantee. Afterwards, CGC will obtain the right of indemnity against the SME and recover the loan repayment, often through assisting the SME to rebound. To facilitate the process, CGCs place certain deposits with the participating financial institutions.

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 to promote their operations and enhance the management base. As figure V.10 shows, the national and local governments and JFC provide credit insurance funds, various subsidies, deposits and compensation for losses. With the active engagement of CGCs and the support from government organizations, more than a million cases were approved by CGCs in the fiscal year, to the amount of Y 14.17 trillion (approximately $13 billion).
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Among the notable large-scale microfinance projects in the region the Microfinance Initiative for Asia stands out (IFC, 2010). Another feature of microfinance in Asia and the Pacific is that microfinance institutions specifically set women as a target client group. In 2010, the percentages of female clients in East Asia (and the Pacific) and South Asia were 56.76 and 91.54 per cent, respectively (Microfinance Information Exchange, 2010).

Box V.3. Examples of credit guarantee schemes: India, Pakistan and Turkey

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 to bank finance is often very low due to the perceived high risk of default. To protect themselves from defaults, banks insist on collateral; SMEs 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 SMEs 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.

In 2009-10, 151,387 credit guarantee proposals were approved with a total credit amount of Rs 68,751.1 million (approximately $ 1,317 million). The cumulative number of proposals since the establishment of the scheme in 2000 is 303,982, which accounts for Rs 118,354.1 million (approximately $ 2,270 million) guaranteed for SME loans.


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 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.

Apart from CGF, the Credit Guarantee Scheme, offered by the State Bank of Pakistan, is implemented to endorse accessibility of financing for low-end fresh and collateral deficient borrowers.

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

C. Credit guarantee fund, Turkey

In 1993, Turkey established its credit guarantee fund under the auspices of the Small and Medium Industry Development Organization – one of the major organizations responsible for the SME policy of Turkey and a major stakeholder in the fund. The other main shareholders include the Union of Chambers and Commodity Exchanges of Turkey and 20 major banks in Turkey.

The main objective of the fund is to support SMEs by providing a guarantee for their financing and by increasing their credit usage in general. The guarantees are targeted at supporting youth and woman entrepreneurs, promoting innovative investments and high-tech SMEs, encouraging exports, increasing the rate of employment and contributing to local development. Since its foundation, the fund has helped nearly 10,000 SMEs with guarantees of more than $ 1 billion.

Apart from the credit guarantee fund, the Small and Medium Industry Development Organization also provides direct loans under its loan programmes. The key features of the programmes are zero interest rates, easy payment periods, clear non-payment terms and pre-defined maximum limits. These loan programmes are mainly conducted in the areas of export promotion, new employment, digital infrastructure, relocation of the leather sector in industrial zones and machinery and equipment credit for the food sector.

Source: Republic of Turkey Small and Medium Enterprises Development Organization (undated).
2012a). Under the Microfinance Initiative for Asia, the KfW Development Bank of Germany and the International Finance Corporation (IFC) agreed in 2007 to invest $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: (a) the creation and enhancement of the institutional capacity for sustainable microfinance delivery; and (b) the strengthening of linkages between domestic and international capital markets.

Many types of organizations provide microfinance. Among MFIs, not-for-profit organizations, self-help groups, state-owned banks and commercial institutions can be found. While these organizations differ considerably in their operating models, they often share one important common characteristic: high repayment rates. By applying innovative solutions, such as a shared liability model and collateral-free lending, MFIs are able to keep the average default rates as low as 2.4 per cent worldwide (Microfinance Information Exchange, 2010). An apt example is the Group Model applied by the Grameen Bank. In this model, the borrowers are divided into five member groups and each group jointly assumes debts. Consequently, peer pressure and collective responsibility can help to control the default risk (Grameen Bank, 1998). Many MFIs have successfully proved that the poor are “bankable” and that the base of the pyramid, e.g., the poor and micro enterprises, is a financially viable market.

The nominal interest rates charged by most MFIs in the Asia-Pacific region range from 30 per cent to 70 per cent per year, which are very high compared with the rates of commercial banks and subsidized lending organizations (Fernando, 2006). The high nominal interest rate is mainly due to the high cost of funding, inflation and high cost of administration and operation associated with MFIs (Microfinance Information Exchange, 2010). 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, the debate about whether it is ethically justifiable to profit from the poor (Grameen Foundation, 2010) and the serious problem of market saturation and over-indebtedness have led to more stringent scrutiny of microfinance (Kappel, Krauss and Lontzek, 2010). Nonetheless, microfinancing remains a powerful tool for financial inclusion, particularly for SMEs.

9. Corporate bonds

A corporate bond is a debt instrument issued by a corporation, the holder of which receives interest from the corporation periodically for a fixed period and repayment of the principal together with the interest due at the end of the maturity period (Securities and Exchange Board of India, 2010). Corporate bonds are a good source of longer-term debts, with medium and long-term maturities. Compared with bank loans, corporate bonds are more flexible because a company can determine the terms and the date to maturity. Another advantage is that the issuance of corporate bonds can raise funds without affecting shareholders.

It can be difficult for SMEs, particularly in developing countries in Asia and the Pacific, to issue bonds. Investors are not interested in bonds when disclosure of financial information is lacking and the national bond market is not developed. Furthermore, the bond market is not always accessible to SMEs, or simply does not exist.

Corporate bonds have substantial issuance costs, including a large fixed-cost component (Altunbas, Kara and Marques-Ibanez, 2010) (table V.3 for detailed cost items). The scale of debts for a single SME may not be large enough for achieving cost efficiency and the issuance costs therefore become a major obstacle for accessing such a financing instrument.

### Table V.3. Issuance costs of corporate bonds

<table>
<thead>
<tr>
<th>Recipient</th>
<th>Typical cost item</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulator or government</td>
<td>Stamp duty, issue licence fee (may take the form of a prospectus reviewing fee, securities registration fee and so on)</td>
</tr>
<tr>
<td>Stock exchange</td>
<td>Listing fee</td>
</tr>
<tr>
<td>Intermediaries</td>
<td>Underwriting, management and placement fees (“gross spread”), trustee fee, payment agent fee, listing agent fee and intermediaries’ out-of-pocket expenses</td>
</tr>
<tr>
<td>Professionals</td>
<td>Legal fee, accountant’s fee and rating fee</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Prospectus printing expenses, road show expenses and staffing costs</td>
</tr>
</tbody>
</table>

Source: Endo, 2008.

A plausible solution to the inherently higher credit risk and the scale problem may involve pooling a group of SMEs for corporate bond issuance (Park, Lim and Koo, 2008). The combination of SMEs with various degrees of risk exposure to the economic cycle may lower the risk to an acceptable level for investors. The high issuance cost could also be lowered with a sufficiently sized deal.

10. Seed capital

For entrepreneurs, seed capital – the financing of direct equity capital for start-ups – is needed to establish their business. It can come from various forms of equity and debt such as convertible equity loans and soft loans. The main underlying characteristic of this form of financing is that the capital provider may not seek high rates of return and may be satisfied with modest returns on investment. This is usually the case with public agencies that have the mandate to provide seed capital for business start-ups (UNCTAD, 2001b).

The providers of seed capital have evolved into partnerships between governmental agencies and banks, with the former acting as a mediator and the latter as a source of lending capital. Banks usually allocate a certain amount of seed capital through funds designated for SME development; however, these funds usually do not provide enough variety of financing packages, nor the full capital, needed by the SMEs (UNCTAD, 2001b). Therefore, public sector assistance is often needed to fill this gap.

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82 However, seed capital typically comes from entrepreneurs’ savings and/or informal loans from their associates.

83 There are dangers of moral hazard if policymakers extend soft loans as well as exposed risks taken by public agencies.
For example, ING Bank of the Netherlands has established a seed capital fund that exposes the bank to only 50 per cent participation in the financing of any SME. Another example is of the partnership between Enterprise Ireland and the Bank of Ireland, with the Enterprise 2000 Seed Capital Fund, that offers a combination of equity loan financing (in a 1:3 ratio) to start-ups. The loan amount ranges from € 32,000 to € 125,000. The fund, a partnership between the State and private funds, does not require personal guarantees, but does require a post investment follow-up (European Commission, 2000). In India, the State Bank of India (SBI) provides interest-free seed capital of up to Rs 1 million to entrepreneurs under a scheme aimed at encouraging SME development in India. The scheme offers the matching seed capital for entrepreneurs to secure traditional banking loans for their business, and has a five-year moratorium on repayment of that initial seed capital (Sikarwar, 2010).

Direct government support for equity financing typically experiences difficulties in making equity investments effective. The issues include unclear SME beneficiaries, lack of business expertise, inappropriate organizational structure and cultural mismatch between government and business.

11. Angel finance

At the very early stage of the business life cycle, SMEs without a proven track record can find it especially difficult to access finance. In such cases, angel finance can be a potential source of funding worthy of exploration. Angel investors are described as high net-worth individuals with extensive entrepreneurial experience, who provide seed capital for early-stage ventures in return for convertible debt or an equity stake (Freear, Sohl and Wetzel, 1994; and Avantage Ventures, 2011).

Unfortunately, as Scheela and Isidro (2009) pointed out in their study on business angels in emerging Asia-Pacific economies, there is a dearth of well-documented reports on this particular topic. Due to the absence of reliable quantitative data on business angels in the Asia-Pacific region, an accurate assessment of indicators such as availability of funds and number of deals is lacking. However, considerable descriptive and anecdotal data exists that provides valuable insights into this field. Among other things, the field of angel finance is frequently characterized as being financially risky, with only 10 per cent to 20 per cent of the investments bringing a return. In the assessment of the prospective investee, the angel investor demands a solid business plan, entrepreneurial leadership and growth potential (SPRING Singapore, 2011b). In addition to the financial incentive, SMEs should not overlook the great potential (SPRING Singapore, 2011b). In addition to the business plan, entrepreneurial leadership and growth prospects, the angel investor demands a solid financial incentive, SMEs should not overlook the great potential (SPRING Singapore, 2011b). In addition to the business plan, entrepreneurial leadership and growth prospects, the angel investor demands a solid financial incentive.

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 during the past decade. The Business Angel Network South-East Asia (BANSEA) is among the more established and prominent networks of angel investors in the region. Based in Singapore, BANSEA was founded in 2001 and has about 50 members. With a vision of “fostering a vibrant start-up ecosystem in which angel investors fund entrepreneurs who eventually become angels themselves,” the members have invested about S$ 18 million in almost 80 start-up enterprises (BANSEA, 2012). The early stage companies that manage to pitch successfully to investors receive funds in the range of S$ 100,000 to S$ 1 million (BANSEA, 2012). While not every SME will meet the investment criteria of business angel networks or individual angel investors, angel finance represents an increasingly important source of funding for a selected number of SMEs in Asia-Pacific.

12. Venture capital

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 rather than from dividend income. Venture capitalists are actively involved in the operations and management of such SMEs to ensure the success of their investments. They generally possess experience with investing in previous start-ups and general business expertise – as such venture capital is typically characterized as requiring a long-term risk finance operation (Ross, Westerfield and Jordan, 2008; and UNCTAD, 2001b). 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 banks (UNCTAD, 2001b). It is not uncommon that in a portfolio of 20 companies only one will return anything to the venture capitalist; in this case the hope is that the one company will provide a big payoff.

A distinction is usually made between seed capital and venture capital, with seed capital referring to the financing of direct equity capital for start-ups in the initial stages to supplement the shortfall in capital needed by the firms. On the other hand, venture capital refers to the next one or two phases of finance needed to achieve company stability and ensure strong growth potential (UNCTAD, 2001b). Venture capitalists do not necessarily invest their own money (Thunderbird Angel Network, 2010).

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 four years, after which the venture capitalist will typically sell the shares of the company on a stock exchange (e.g., 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.

To lower their risk exposure, venture capitalists typically provide financing in stages, with each installment sufficient enough to reach the next development stage (Ross, Westerfield and Jordan, 2008; and Zavatta, 2008):

(a) Start-up – additional funding for marketing and product development expenses for an early-stage firm;

44 In the authors’ interviews with venture capitalists, the typical outcomes they described for a 20-firm portfolio was that 5 would lose money, 14 would either break even or produce modest profits, and only one firm would be “successful, i.e., yield the type of return they seek.
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 willing to take on greater risks. Some of the advantages for venture capitalists for SMEs are (UNCTAD, 2001b):

(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) Operating costs are lower due to the absence of high interest rate payments;
(d) Venture capital is a long-term or at least medium-term capital commitment in contrast to short-term loans from banks; and
(e) The managerial know-how provided by venture capitalists can, in some cases, be more valuable to the start-ups than the actual financing.

However, there are also some disadvantages:

(a) Because of the high-risk nature of venture capital and the timeframe for returns as well as a lack of adequate skills and corporate information, finding initial investors may be difficult, particularly in Asia-Pacific developing countries; and
(b) The need for highly-liquid capital markets is not as pressing, compared to open-ended funds or mutual funds, since venture capital funds have a long-term involvement in their target companies. Nevertheless, an exit mechanism is necessary for venture capitalists to benefit from capital gains. This is difficult in almost all developing countries in Asia and the Pacific, except those with fairly developed stock markets. Other mechanisms such as guaranteed buy-backs are not realistic for SMEs.

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 (UNCTAD, 2001b). Venture capital is a familiar source of funding for SMEs in Europe and Israel, and the amount of venture capital utilized in China has risen tremendously during the past five years (Zero2IPO, 2010). Some countries, such as India, have set up sector-specific venture funds for the ICT industry and biotechnology sector (Small Industries Development Bank of India, 2011).

13. Stock market and initial public offerings

The stock market is a financial source for SMEs at a later stage of development, and an IPO is the main way to go public. Access to the stock market is a key stage in the growth of SMEs, especially for the high-tech, high-growth firms. In an IPO, a company raises capital by issuing shares to investors for the first time and subsequently becomes listed on a stock exchange (Government of Canada, 2003). 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 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 by far the most preferred exit mechanism for early stage investors such as business angels and venture capitalists (Zavatta, 2008). An efficient IPO mechanism can encourage risk-taking investments and more capital flows into innovative, high-growth-potential firms (Riding, 1998).

Box V.4. Pros and cons of equity financing for SMEs

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>Equity finance is raising funds for enterprise activities by selling shares to individuals or institutional investors who receive ownership interests in the enterprise. It is notable that there is a trade-off between the benefits and potential shortcomings of equity finance. A significant advantage of equity finance is that it does not need to be repaid and there is no interest rate on the money. Investors can also bring with them valuable skills, networks and experience, and assist with developing business strategies and decision-making. Moreover, as the business grows, it can be supported with follow-up funding by investors already involved and knowledgeable about the firm (Business Link, undated). In addition, equity finance can help SMEs to reach the minimum equity requirement set by banks, thus increasing the opportunities to obtain bank loans (Sridhar, 2008).</td>
<td></td>
</tr>
<tr>
<td>However, raising equity finance can be costly and time-consuming, particularly for small businesses, and may take management focus away from the key business activities. Also, management time has to be invested to provide regular feedback to investors as part of the monitoring process. Moreover, a certain amount of control over the management and decision-making has to be shared with investors (Business Link, undated). In general, equity investment is associated with high risks; therefore, equity investors would expect a rate higher than public trade investors, even though the expected return of equity injection declines for each round as the risk becomes lower (Sridhar, 2008). This characteristic may reduce the possibilities for SMEs in conservative lines of business to access the equity sources in the early stages.</td>
<td></td>
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</table>

Note: Specific forms of equity financing can be found in Zavatt, 2008.
Going public also brings new challenges to SMEs. They must report to the public because of the new management structure, and maintain high growth potential to avoid undervaluation of their stock and poor medium-term returns. 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 (Riding, 1998).

To take full advantage of this approach, the prerequisite is to have adequately developed capital and stock markets in terms of depth and liquidity (Park, Lim and Koo, 2008). An expanded venture capital market and financing would, in turn, encourage more IPOs because venture capital supports the growth of firms to a later stage and provides adequate financing resources for IPOs (Government of Canada, 2003). Governments and SME agencies may also facilitate this approach by establishing information sharing systems to improve investment information transparency and by providing consultation services to reduce issuance costs.

### E. Sources of funds

While commercial banking plays a key role in formal SME financing, informal financing such as own funds as well as loans from relatives and associates, and internal financing such as retained earnings and trade credit, dominate the financial sources of SMEs. For example, in ASEAN countries 75 per cent to 90 per cent of SMEs rely on informal financing and internal financing (RAM Consultancy Services, 2005). In China, entrepreneurs’ personal savings provide between 50 per cent and 80 per cent of start-up capital, while approximately 20 per cent and 15 per cent of capital comes from bank loans and borrowing from friends, relatives and other individuals, respectively (Hussain, Millman and Matlay, 2006).

This section provides some quantitative evidence of major financial sources for SME development. For this purpose, two countries from Asia and the Pacific (i.e., Japan and Malaysia) and one country and one regional grouping from outside the region (i.e., the United States and the European Union) are taken as examples.

The sources of start-up financing in Japan, including the amounts involved, are presented in figure V.11. Informal financing (e.g., own funds; loans from relatives and friends) is the major source of finance for supporting the capital needs of entrepreneurs, although the amounts are relatively small. Public support also provides substantial amounts of funds to start-up businesses in Japan, reflecting its well-developed public assistance to entrepreneurs. While commercial loans from the banking sector play a smaller role, they provide relatively large amounts of funds to start-ups. It is noteworthy that venture capital provides by far the largest amounts of funds among financial sources although coverage is still limited.

Table V.4 illustrates the financing sources for Malaysia SMEs in different life cycle stages. Almost 68 per cent of SMEs in the sample make use of self-financing during their start-up period but this falls quickly with the growth of the firms. Venture capital shares a similar trend as self-financing,

<table>
<thead>
<tr>
<th>Phase of life cycle/financing sources</th>
<th>Start-up</th>
<th>Established</th>
<th>Mature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-financing</td>
<td>68.0</td>
<td>21.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Government schemes</td>
<td>7.8</td>
<td>13.0</td>
<td>9.0</td>
</tr>
<tr>
<td>Venture capital</td>
<td>10.8</td>
<td>8.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Short-term loans from banks</td>
<td>20.8</td>
<td>28.6</td>
<td>23.1</td>
</tr>
<tr>
<td>Medium-term loans from banks</td>
<td>10.4</td>
<td>32.6</td>
<td>21.8</td>
</tr>
<tr>
<td>Long-term loans from banks</td>
<td>7.4</td>
<td>23.7</td>
<td>37.2</td>
</tr>
<tr>
<td>Non-bank financial institutions</td>
<td>8.7</td>
<td>7.1</td>
<td>10.9</td>
</tr>
</tbody>
</table>

**Source:** Rozali and others, 2006.

**Notes:** Short term loan is granted for less than one year; medium term loan is for one to three years; and long term loan is for more than three years. As multiple choices can be selected, total exceeds 100 per cent.
even though the percentage is much lower. In comparison, long-term loans become more and more accessible to established and mature SMEs, and bank loans are the most important source for them. Other financial sources such as government schemes and non-bank institutional financing are equally distributed among SMEs in each stage of development at around 10 per cent.

Table V.5 compares financial sources used by small businesses in the United States in 1998 and 2003. In the United States, the banking industry is highly developed; thus, small businesses can access a wide range of credit services (e.g., line of credit, term loans and credit cards). Trade credit is also a main source for small business finance, and more than 60 per cent of SMEs employ it to finance their businesses. Around 30 per cent of business owners use their own assets as a key financing source. Only 8.7 per cent of small business received capital lease services in 2003.

Table V.5. Financial sources of SMEs in the United States, 1998 and 2003  
(Unit: Per cent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Line of credit</th>
<th>Loan</th>
<th>Credit card</th>
<th>Leasing</th>
<th>Loan from owner</th>
<th>Trade credit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Mortgage</td>
<td>Vehicle</td>
<td>Equipment</td>
<td>Personal</td>
<td>Business</td>
</tr>
<tr>
<td>2003</td>
<td>34.3</td>
<td>13.3</td>
<td>25.5</td>
<td>10.3</td>
<td>46.7</td>
<td>48.1</td>
</tr>
<tr>
<td>1998</td>
<td>27.7</td>
<td>13.2</td>
<td>20.5</td>
<td>9.9</td>
<td>46.0</td>
<td>34.1</td>
</tr>
</tbody>
</table>


Another study supports this trend in the European Union. Figure V.13 shows the employment of financial sources by SMEs in the European Union. Debt financing through commercial banks (via overdrafts, lines of credit and bank loans) is the most important source of SMEs’ external financing. Trade credit, an informal financing instrument, is also adopted by more than 25 per cent of SMEs. Moreover, the usage of other financial instruments such as leasing, hire-purchase and factoring increased from 2009 to 2011 is now used as frequently as bank loans.

Figure V.12 shows the major institutions used by Europe Union-based SMEs to obtain capital. Banks are by far the most popular financial institution when SMEs need financing. Close to 8 out of 10 companies surveyed went to a bank in order to obtain capital (79 per cent). Around a quarter of SMEs approached leasing or renting companies (24 per cent), and 1 in 10 go to public institutions supporting investment (11 per cent) (EOS Gallup Europe, 2005).

Figure V.12. Institutions used by European Union-based SMEs to obtain capital, 2005  
(Unit: Per cent)

Notes: Percentage of respondents; conducted in 15 European countries, namely Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxemburg, Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom.

Figure V.13. External financing sources of European Union-based SMEs, 2009-2011  
(Unit: Per cent)

Source: European Central Bank, 2011.  
Notes: Data for the preceding six months and percentage of respondents. The data are a survey conducted in Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain.
F. Financial institutions for SMEs and their challenges

In the Asia-Pacific region, depending on the economic status of the country, the financial sector contains various financial institutions. Some of the main institutional providers of SME financing consist of the following (Flibby, 2009; World Bank, 2005):

(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; and
(g) Public and private credit guarantee institutions.

Some Asia-Pacific countries 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.

International financial institutions, such as the World Bank and ADB, also devote resources to specialized financial institutions for lending to SMEs. International financial institutions have become particularly active in the region. For example, the International Finance Corporation (IFC) in 2010 committed $86.3 million to micro, small and medium-sized enterprises in South Asia. By the end of 2009, IFC’s SME financial institution clients had taken out 374,000 loans in the region, totalling $10.7 billion (IFC, 2010b). In East Asia and the Pacific, IFC has committed $416.6 million in 2010, and SME financial institution clients had taken out 86,000 loans, totalling $17.2 billion by the end of 2009 (IFC, 2010c).

While financial institutions supporting the development of SMEs in the Asia-Pacific region have become increasingly active in the past few years, the banking sector remains the most important source of external financing for SMEs (Park, Lim and Koo, 2008). Banks offer diversified loans with different terms and various supplementary financing instruments such as export credit and discounting. Commercial banks in some countries also provide special loans targeted at priority sectors and key segments of the population as identified by the government, including SMEs.

However, SME development funds through commercial banks and financial institutions are not typically successful. Small bank loans and loans to SMEs as a percentage of total lending declined the past decade (Hall, 2009). Table V.6 contains data based on a global survey of 91 banks in 45 countries, conducted in 2008. It indicates that SMEs are strongly discriminated against by banks during loan issuance (also Table V.3). The survey result supports a commonly shared idea that the smaller the size the higher the risk. It partially rationalizes banks’ discriminatory behaviour towards SMEs.

From the banks’ perspective, the scarcity of funds for loans, especially in developing countries, means there is less incentive to seek out the profitable SMEs when larger and more qualified clients are available. Formal financial institutions often face higher transaction costs when dealing with the rather fragmented SME sector because the credit monitoring process requires an extensive branch network with more staff. The poor accounting system of many SMEs and insufficient collateral due to limited fixed investment also create obstacles to meeting the terms and conditions for borrowing from banks (ESCAP, 1997). Lack of risk management skills related to SME lending has contributed to significant non-performing loan problems in the past, demonstrating an inconsistency between commercial banks and SMEs, and discouraged banks from further lending to SMEs.

In addition to the general case shown in the last two right-hand columns of table V.6, the Asia-Pacific region has also seen a rising percentage of non-performing SME loans in the past few years. In China, the China Banking Regulatory

### Table V.6. Different bank loan features of different-sized enterprise, 2008

<table>
<thead>
<tr>
<th></th>
<th>Share of total loans (per cent)</th>
<th>Loan fees (per cent of size of loan)</th>
<th>Share of non-performing loans (per cent of total loans)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean for developed countries</td>
<td>Mean for developing countries</td>
<td>Mean for developed countries</td>
</tr>
<tr>
<td>Small enterprise</td>
<td>12.0</td>
<td>2.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Medium enterprise</td>
<td>10.1</td>
<td>13.7</td>
<td>0.4</td>
</tr>
<tr>
<td>Large enterprise</td>
<td>27.9</td>
<td>32.8</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Source: Developed from Beck, Demirgüç-Kunt and Pería, 2008.
Commission reported that non-performing loans (NPLs) to SMEs hit 22.1 per cent by the end of July in 2008, about two times the average 14.7 per cent of China (Xinhua Economic News, 2008). The State Bank of India, the country’s largest lender, also reported that NPLs were rising, particularly in the SME sector (Choudhury and Rodrigues, 2010). The State Bank of Pakistan reported that NPLs in the SME sector increased by PRs 5.1 billion to PRs 96 billion by the end of 2010 (Daily Times, 2011).

The need for financial institutions to provide more suitable products and services for SMEs, develop comprehensive risk management skills and improve information transparency has been recognized. A number of financial institutions have also moved to offer non-financial assistance to SMEs for their capacity-building to 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 (SME Bank Pakistan, undated). The SME Bank in Malaysia (also known as the Bank Perusahaan Kecil & Sederhana Malaysia Berhad) specifically targets SMEs and provides comprehensive advisory services to complement products offered by commercial banks. Some examples of these services are in-depth entrepreneurship training programmes for graduates, vendors, mentors and women (Bank Perusahaan Kecil & Sederhana Malaysia Berhad, 2012). Indonesia Eximbank, an export financing institution in Indonesia, has also developed technical assistance that includes quality improvement of products, product processing, packaging and marketing. Korean Eximbank assists stakeholders with capacity-building in the form of training and guidance in connection with export and trade financing activities (Korea Eximbank, 2011). The Korean Development Bank (KDB), a state-owned DFI in the Republic of Korea, facilitates the management and normalization of troubled corporations through corporate restructuring and consulting services that covers public, development and overseas projects (KDB, 2010).

$Box V.5. SME finance in Sri Lanka$

The present financing structure of SMEs in Sri Lanka is shown in figure V.14. Debt institutions, e.g., DFIs and commercial banks, are the major providers of financial services to SMEs but the emphasis of each type is different. DFIs such as DFCC Bank and the National Development Bank offer longer-term, project-based credits for SMEs with relatively low interest rates. Medium-term financing providers consist of NGOs, cooperatives and government institutions. A large number of local and international NGOs are engaged in microfinance activities, and some have now transformed their microfinance operations into separate entities. Thrift and Credit Co-operative Societies and other cooperatives advance loans largely from mobilized savings. Government institutions, such as the Central Bank of Sri Lanka and Industrial Development Board, do not provide credit directly to SMEs but facilitate the lending process with credit guarantee schemes and technical expertise for SME lending. Commercial banks mainly offer short-term loans to SMEs because of the short-term nature of their deposits. Several commercial banks function as participating credit institutions in implementing SME credit schemes and provide their own schemes to assist SMEs. In addition, equity market, debenture market and venture capital companies act as supplements in SME financing by providing equity and debt financing to SMEs and start-ups; however their influence is limited.

$Figure V.14. Present institutional financing structure of SMEs in Sri Lanka$

Sources: JICA, 2009 and GTZ, 2009.
Box V.6. Challenges of development finance institutions

For decades, DFIs, which are specialized financial institutions established by governments with specific development mandates, have played a significant role in the development of emerging and advanced economies. DFIs can provide SMEs with a range of specialized financial products and services in the form of medium and long-term loans, equity capital and guarantees for loans (Bank Negara Malaysia, 2012). They help small businesses to graduate to become medium-sized enterprises where feasible, and then large enterprises.

Some countries in Asia and the Pacific, such as Malaysia and Singapore, have facilitated loans to SMEs via credit ratings. A standardized process of rating SME credit results in greater consistency and reliability in lending. The credit rating process consists of:

(a) A comprehensive assessment of the overall condition of an SME;
(b) A review of the financial condition and several qualitative factors that have bearing on the creditworthiness of an SME (e.g., management skills; and reputation and goodwill);
(c) A composite appraisal/condition indicator and size indicator;
(d) Categorization of an SME, based on industry and size, for evaluation against its peers;
(e) Quality and characteristics of leadership; and
(f) Tools that enhance the market standing of an SME among trading partners and prospective customers (e.g., technologies, production facilities, knowledge and distribution channels).

In response to these challenges, some DFIs have transformed themselves into commercial banks in order to be able to mobilize more funds, both for short- and long-term lending. In India for example, the Industrial Credit and Investment Corporation of India Bank (undated), a former development financial institution, moved towards universal banking in the 1990s to offer more diversified financial services. Similarly, the Industrial Development Bank of India (undated), after serving as a DFI for 40 years, decided to function as a commercial bank in addition to its original role of a DFI in 2004. Furthermore, the Industrial Finance Corporation of India (2008), the first development financial institution in India, transformed in 1993 from a statutory corporation to a company to fulfill its need for funds and direct access to capital market.

The risk and uncertainty of commercial banks’ common policy “borrowing short and lending long”, and DFIs’ unique contribution of more comprehensive, long-term contributions to SMEs, including non-financial measures, suggests that DFIs converting themselves into commercial banks may not be ideal for SME financing; similarly, neither is commercial banks playing a dual role (AAMO, 2007). Policymakers should strive to promote a vibrant commercial banking sector as well as sound DFIs.

Table V.7 provides a comparison of the key differences between DFIs and commercial banks. Compared to commercial banks, one significant difference of DFIs is that they do not restrict themselves to providing only credit but also offer technical consulting and advisory services for the development of SMEs (Bank Negara Malaysia, 2012). Instead of basing the lending criteria solely on the financial viability of a proposal, DFIs pay considerable attention to the socioeconomic impact of their financing operations. Furthermore, DFI consideration is given largely to government economic strategies, rather than simply the maximization of profits (Malik, 2008).

While DFIs have many valuable strengths compared to commercial banks, there are also some difficulties and shortcomings. First, DFIs have come under rigorous challenge from commercial banks, which increasingly aim to become universal banks, and have gradually entered into the realm of long-term lending that was traditionally the domain of DFIs (Benston, 1994). Furthermore, DFIs lack a diversified range of institutional products and services. In addition, due to their shortage of adequate and independent resource bases, their lending resources are much more limited than those from commercial banks (Wattanapruttipaisan, 2003). DFIs also have experienced difficulties in raising resources at competitive rates compared with those offered by commercial banks (AAMO, 2007).

Table V.7. Comparison of commercial banks and development banks

<table>
<thead>
<tr>
<th></th>
<th>Commercial banks</th>
<th>Development financial banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Driving force</td>
<td>Market</td>
<td>Government</td>
</tr>
<tr>
<td>Primary goal</td>
<td>Maximization of profit</td>
<td>Overall socioeconomic development</td>
</tr>
<tr>
<td>Product and service</td>
<td>Diverse</td>
<td>Limited</td>
</tr>
<tr>
<td>Loans</td>
<td>Short term</td>
<td>Medium and long term</td>
</tr>
<tr>
<td>Interest rate</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Resource base</td>
<td>Extensive and independent</td>
<td>Dependent and inadequate</td>
</tr>
<tr>
<td>Lending criteria</td>
<td>Financial viability of proposal</td>
<td>Socioeconomic impact</td>
</tr>
</tbody>
</table>


G. Credit rating scheme

Some countries in Asia and the Pacific, such as Malaysia and Singapore, have facilitated loans to SMEs via credit ratings. A standardized process of rating SME credit results in greater consistency and reliability in lending. The credit rating process consists of:

(a) A comprehensive assessment of the overall condition of an SME;
(b) A review of the financial condition and several qualitative factors that have bearing on the creditworthiness of an SME (e.g., management skills; and reputation and goodwill);

Box V.6. Challenges of development finance institutions
In the Asia-Pacific region, India has recently been proactive in formalizing a credit rating scheme for SMEs. Businesses with both the highest operating performance and financial stability are entitled to a reduction of 100 basis points (1 per cent) 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 per cent (Petkar, 2010). The Government is subsidizing up to 75 per cent of the cost of the credit rating scheme in order to encourage SMEs to improve performance and credit rating. The SME Rating Agency of India Ltd. was jointly set up by National Small Industries Corporation Ltd., financial institutions, commercial banks and other stakeholders as the country’s first rating agency that focuses primarily on the SME sector (SME Rating Agency of India, undated).

H. Financial support during economic downturns

SMEs are generally more vulnerable during economic downturns (e.g., the Asia financial crisis in 1997-1998 and the global economic crisis in 2008-2009). In addition to the direct shock of decreased demand, SMEs suffer from liquidity and credit problems due to tight money supply. Delinquent accounts receivable hit SMEs more severely than large enterprises as SMEs typically have higher debt-equity ratio and less cash on hand. Export-oriented SMEs are also vulnerable to variations in exchange rates. All these factors tighten cash flows and trap them in financial difficulties, which make financing SMEs one of the most important issues during an economic crisis.

This problem cannot be solved by market mechanisms alone due to the shortage of capital in most SMEs and the frailties of the banking sector. On one hand, the lack of transparency of financial conditions and managerial/marketing skills marks SMEs as high-risk clients. On the other hand, banks in crisis suffer their own financial problems and tend to be more risk-averse in issuing credit to the high risk and low profit segments of their clientele such as SMEs. These two factors combine to produce an environment where there is a disincentive for banks to lend to SMEs. This situation thus requires government intervention to ensure SMEs’ survival.

Almost all governments are aware of SMEs’ financial difficulties, and financial support measures have been adopted to boost their capital. The single most vulnerable area affected due to adverse economic conditions relates to quick access to finance in adequate quantities. Within this context, some governments have taken post-crisis measures such as increases in credit guarantee coverage, extension of credit guarantee terms, rehabilitation credits and more liberal trade/export credits. One effective policy measure may also be to introduce incentives for lending to the SME sector, especially export credit to recapture global markets. These measures must be accompanied by rigorous monitoring mechanisms to prevent the misuse of such incentives.

As a response to the 1997 Asian financial crisis, for example, a number of the Asia-Pacific governments issued laws and decrees, and shored up governmental agencies to improve the financial conditions of SMEs. Typical cases involve the new SME basic laws in the Republic of Korea and in Japan, the credit guarantee scheme for small businesses in Thailand and specialized SME banks in a number of countries in the region (Ying, 2009).

Direct financial support, including additional credit lines and loan guarantee schemes, are widely used to facilitate the financing of SMEs, and greater budgets are generally allocated to these schemes during a financial crisis. For example, the Government of Kazakhstan allocated 25 per cent of its emergency spending, amounting to approximately $956 million, to SMEs in response to the global financial crisis of 2008 (Pasadilla, 2010).

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. Tax-related policies mainly include tax credits, cuts, deferrals and refunds. During a financial crisis, temporary tax measures are taken and tax

Box V.7. Japan’s comprehensive policy framework to support SMEs during the global economic crisis, 2008 and 2009

The Lehman crisis of September 2008 seriously affected Japanese SMEs by sharply limiting their financing channels and severely reducing the demand for their exports. 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 October 2008, the SME Agency, in collaboration with the Japan Finance Corporation and Shoko Chukin Bank, 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, the impact of a disaster, failure of the main bank etc.). Additional credit guarantees were made available with a total budget of ¥ 36 trillion used to guarantee loans to SMEs in all industries – raising the coverage from 80 per cent to 100 per cent of loan losses (CCG, 2011). It also issued safety-net loans to SMEs temporarily facing cash-flow problems due to a radical change in the business environment with a budget of ¥ 21 trillion. The regular corporate income tax rate was also lowered for SMEs from 22 per cent to 18 per cent for two years during the global financial crisis (Deloitte, 2010).

The SME Agency also provides emergency employment subsidies, designed to prevent SME employees from losing their jobs and to stabilize employment, amid the deterioration of employment conditions with the rapid economic downturn. The subsidies include a temporary layoff allowance or wage equivalent per person per day, training expenses and a temporary transfer allowance, all of which can be claimed for up to 300 days within three years.

Another SME Agency measure is 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. Specifically, it provided information and advice related to the new Companies Act, including programmes such as the accounting adviser system, that significantly benefitted SMEs’ financial management.

Sources: JSBRI, 2010, and SME Agency of Japan, undated.
rebates are often used to promote exports. For example, China increased its tax rebate seven times within 10 months from August 2008. The experience of OECD countries indicates that governments should consider cutting “profit-insensitive” taxes that are paid regardless of whether SMEs are recording a profit or loss (e.g., payroll taxes, licensing fees and capital taxes). Thus, the ability of SMEs to finance working capital internally will increase (OECD, 2009b). Related to this, an interest rate decrease would also reduce the cost of SME financing. With this in mind, the Central Bank of Indonesia gradually decreased its benchmark interest rate from 9.5 per cent in November 2008 to 7 per cent in June 2009 (Bank Indonesia, 2011).

Governments may also consider measures to reduce risks and transaction costs for banks, and provide them with centralized SME credit information and technical assistance needed for lending SMEs. Other measures include: (a) simplifying the application and grant procedures; (b) developing more efficient procedures to evaluate SME credit risks; (c) providing more assistance to government agencies and other service institutions for SMEs; and (d) exploring new channels for SME financing, such as equity financing and asset-based financing, as discussed above.

SME financing policies should also pay more attention to helping SMEs achieve long-term survival and competitiveness. Even though short-term measures, e.g., soft loan schemes mixed with expanded credit guarantee coverage, help alleviate the immediate financing problems of SMEs and increase their immediate cash flows, such emergency fund provisions are unsustainable and may be detrimental to the long-term interest of SMEs. For example, data from the SME Bank of Thailand (2003) indicates that 40 per cent of the non-performing loans to SMEs came from loans provided during the Asian financial crisis years (1997-2001) in support of the government policy to resolve liquidity problems in the financial system. In this sense, long-term measures are

**Box V.8. Urgent policy interventions by Japan and Thailand for SME rehabilitation in disaster-hit areas, 2011**

**A. Japan**

In addition to enormous human and physical damage, the Great East Japan Earthquake in 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 radiation leakage rumours related to the nuclear power plant accidents and this led to a subsequent decline in consumer confidence.

Specific measures, which mainly focused on financial 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 businesses.

Credit guarantee corporations also established a special guarantee programme, with a 100 per cent credit guarantee to support emergent working capital needs of SMEs that had received a disaster victim certificate. These were issued by the local municipalities, certifying 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 disaster in central Thailand in 2010 was one of the worst in Thai history, with one-fifth of the country becoming inundated, including several major industrial estates. The unprecedented level of flooding not only threatened the supply chain and food security, but also seriously affected a large number of SMEs. To restore the country’s stability and prosperity, the Government prepared a three-phase strategy (i.e., immediate phase, short-term phase and long-term phase) with a budget of more than $10 billion to promote the economic recovery.

The objective of the 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 short-term phase lasts for one year. The focus of this phase is to provide financial support to people and businesses affected by the floods and investment incentives and other measures to facilitate affected business operations. The specific measures include:

(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; and
(g) A plan of action for the removal of water and quick reconstruction of the affected industrial estates.

The long-term phase provides a comprehensive framework of water management and flood prevention. Through the development of a water management system, flood warning system and a better infrastructure design, the Government is determined to ensure industrial confidence and economic development in the long term.

needed to ensure the survival of SMEs, including: (a) identifying new markets; (b) investing more in research, development and innovation; (c) the provision of consultancy and information, especially on operations and financial management; (d) supporting education and training (e.g., TVET); and (e) building up comprehensive legal, tax and regulatory frameworks for an enabling business environment (Eurofund, 2011).

I. SMEs’ view of major constraints

Despite various financial schemes and informative mechanisms, access to “timely and adequate” credit and establishing a good relationship with bankers are two persistent major problems for SMEs. According to a 2009 Asian Development Bank survey of SMEs in 13 countries, obtaining capital is the top constraint for firm formation and growth (ADB, 2009). There are several reasons why this is so.

Recent market developments and trends show that in the name of single window assistance many banks, including DFIs, have entered the arena of term lending, including short-term loans to SMEs. Despite this progress, there is a wide time lag between the approval of SME loans and the disbursement of funds. Since a portion of these loans pays for operating expenses, SMEs barely manage to survive while they wait. This scenario again underscores the importance of cash flow.

Although most of the governments in the Asia-Pacific region have formulated well-structured policies and placed well-developed institutional financing agencies on the ground to meet the needs of SMEs, there is a gap in the actual implementation of these policies. Bank management may not appreciate the dire need that SMEs have for cash. Banks may be willing to help but their SME clients get lost in the shuffle as bank management caters to larger, wealthier customers. Unfortunately, the SME-banker relationship may then become adversarial, further defeating the best intentions of policymakers. Part of the intransigence often lies with the owner of the SME, who may not be able to communicate effectively with the banker or present their needs in a way that would give incentives for the bank to cooperate.

Entrepreneurs also face various constraints to source financing, including specific problems related to short- and long-term loans.

(a) Specific problems related to short-term loans:
   (i) Delays in sanction and inadequate limit sanction;
   (ii) Inordinate gap between commissioning of the project and availability of working capital;
   (iii) Complex and lengthy documentation;
   (iv) Improper mix of fund-based and non-fund based facilities;
   (v) High cost of credit; and
   (vi) Insistence on high margins and collateral.

(b) Specific problems related to long-term loans:
   (i) Delay in appraisal of projects;
   (ii) Rigid and complex procedures;
   (iii) High cost of credit;
   (iv) Delays in disbursements;
   (v) Unwillingness to exercise delegation of powers by functionaries;
   (vi) Insistence on higher margin money;
   (vii) Insistence on more than 100 per cent collateral; and
   (viii) Non-availability of working capital sanction letter from commercial banks.

As shown in figure V.15, the growth ability of small firms tend to be more vulnerable to financing constraints than those of large firms. When facing the same financing problems, the reduction of growth is more severe if the size of an enterprise is small. In general, financing obstacles result in an average decline of ten per cent in growth for small firms compared with six per cent for their larger counterparts. The figure also indicates that for bank requirements and conditions for financing, together with access to different financing modes, small firms still report a larger decrease in growth than larger firms in each situation.

Figure V.15. Effect of financing constraints on growth

Note: This figure shows the effect of different financing obstacles on firm growth for small and large firms, measured at the average constraint for the two group sizes.
J. Potential market distortion by public interventions in SME financing

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 or state-owned banks and non-financial institutions including cooperatives and governmental agencies. This assistance can be in the form of soft loans, interest subsidies and ceilings, credit guarantees and credit insurance, seed capital, venture capital, loan quotas, loan waivers and through the promotion of promissory notes (RAM Consultancy Services, 2005).

Additionally, there are measures for facilitating SME financing that do not provide direct credits but concentrate on strengthening the financial regulatory framework, building financial infrastructure and enhancing SME capacity-building and creditworthiness (IFC, 2011b).

The rationale for government intervention is to address deficiencies and market failures in the SME finance space. Well-designed government interventions can improve financial regulatory frameworks and financial infrastructure. It is also necessary when there is a lack of financial resources for particular groups (e.g., start-ups with little collateral and credit history, and women entrepreneurs) that cannot be easily solved by the markets. As discussed above, interventions are also warranted during periods of instability and crisis, where there is an actual or potential collapse of financial intermediation by private agents (IFC, 2010a).

Public interventions in SME financing may cause negative market distortions and long-term losses to the financial sector. 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 in Asia and the Pacific. Thus, the fiscal costs of the support could be high – often much higher than predicted before implementation (World Bank, 2008b).

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 (Hallberg, 1999). As a result, a “non-repayment culture” may be created among beneficiary enterprises. “Moral hazard” may also be created and inhibit financial institutions from implementing and improving risk management techniques.

Third, such measures may distort competition in the financial market and result in a “crowding out” effect, as they discourage firms from using non-subsidized financial institutions (i.e., private financial providers if the subsidies are exclusively for DFIs) and non-subsidized forms of financing (e.g., personal savings) (Hallberg, 1999). This “crowding out” effect may lead to significant long-term losses that give few incentives both to SMEs to operate transparently, and to financial institutions to lend to SMEs.

The role of government intervention is important in expanding SME finance spaces. This is especially relevant in developing countries as they usually have less efficient financial markets compared to their more developed counterparts. However, it is equally important to minimize the potential distortions brought along by improper actions. Governments should keep in mind the fact that the goal of government intervention is to achieve an efficient market (Ganbold, 2008). Identifying the market failure and setting intervention boundaries is the key prerequisite to designing an 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 evaluated carefully to measure achievements in terms of outreach and leverage (IFC, 2011b).

State-owned financial institutions, including state-owned banks and development financial institutions, are widely used to serve SMEs as they have more incentives and willingness to serve certain segments of the market. Compared to their private counterparts, some state-owned financial institutions have less-developed SME lending technologies, lower levels of profitability and higher costs (Rocha, 2011). The failure of many state banks can be also explained by political interference, excessive risk exposure due to irrational development goals and internal operational inefficiencies (IFC, 2011b). To take advantage of state-owned financial institutions for SME financing, independent corporate governance, efficient operation and proper SME lending and risk management technologies are essential. A less distorted solution to the SME financing problem may be a well-designed credit guarantee scheme with an adequate capital base (IFC, 2012b).

Direct lending as well as programmes collaborating with other financial institutions in the form of soft loans, lines of credit, co-financing and equity funds will likely continue to be a popular interventions for SME financing in developing countries, due to their simple structure and fast rate of implementation (IFC, 2012b). Such programmes should also be carefully designed to minimize the subsidy component, political interference and 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 very high quality (Levy, 2002). The operation of the programme needs to be market-oriented and a commercial interest rate should be applied. The mission and products of the programme should be flexible and adapted according to market maturity (Levy, 2002).

Most of the related literature emphasizes that the key role of government in improving access to finance is to offer a policy environment that allows competitive and diverse financial service providers to flourish (Ganbold, 2008). For SME financing, the least distortional method may be that government performs a market facilitation role to narrow the gap between SMEs and the financial sources. The primary objective for the government is to create an overall enabling environment that offers incentives for financial providers to fill the SME finance space. This requires a proper regulatory and supervisory framework that balances the risk and benefits of providing innovative SME financial products while narrowing the existing financial gaps.

Governments also have the responsibility to build reliable and comprehensive financial infrastructure, such as
accounting and auditing standards, and credit information systems, in order to reduce the information asymmetries and legal uncertainties in SME financing (World Bank, 2009a). In addition, governments and SME agencies may facilitate SME capacity and creditworthiness by providing localized training and consultation services in collaboration with local financial service providers to meet the specific needs of both the supply and demand sides (IFC, 2011b). 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 (IFC, 2011b).

K. Major issues for policy interventions

While a number of schemes exist that address SME financing gaps, they are contingent upon: (a) an attitudinal environment that welcomes innovation and entrepreneurship; (b) formal legal institutions that protect property rights; and (c) institutional financing procedures that are consumer-friendly. Policymakers therefore need to ensure that the existing overall business climate is conducive for people to engage in entrepreneurial activities with adequate and timely financial assistance. To achieve this, the following topics are suggested for consideration in the light of global best practices.

1. Maximizing working capital

In a number of developing countries in Asia and the Pacific, the sophistication of their financial sector still remains low, and capital and equity markets have yet to be developed adequately; thus, formal, institutional financing is difficult for SMEs to access. For those economies (e.g., least developed countries), one of the most effective policy options in the short term would be to maximize working capital of SMEs through the effective utilization of both informal and internal financing.

Informal financial instruments, including entrepreneurs’ own savings and assets as well as borrowing from parents, relatives and friends are particularly important for new and small businesses during their seed and start-up phases. Trade credit or buyer’s credit, another informal financial instrument, has been a major financial source for SMEs in developed countries and could be used by SMEs in the Asia-Pacific developing countries to increase their cash flows.

Internal financing refers to the generation of funds through an enterprise’s retained earnings, which requires a profitable business model. Such internal fund-raising could be achieved by various measures, such as increasing sales, reducing operational costs, minimizing inventory and physical assets, forecasting cash flows properly and reducing external debt financing.

Neither informal financing nor internal financing requires external creditors and investors’ involvements to raise funds for SMEs, so the existence of well-developed capital and equity markets is not necessary. Such financial instruments could provide large flexibility to SMEs’ working capital management mainly by reducing the needs of external financing (e.g., bank loans). Policymakers can encourage SMEs to use those financial instruments in order to maximize their working capital by: (a) cultivating entrepreneurship culture; (b) developing a pro-business regulatory framework and tax system; (c) protecting property rights; and (d) improving managerial skills of entrepreneurs and SME owners. Within this context, policymakers may wish to collaborate in providing services and training through an existing web of business associations such as local chambers of commerce and industry.

2. Narrowing the gap in SME financing

Some agencies have pointed out that in developing countries the financial gap has been growing between commercial debt financing and microfinance (IFC, 2010a; and JFC, 2011). They argue that micro and small enterprises, including start-ups, have been in a disadvantaged position to access institutional debt financing. While the traditional term loans have focused on financing large firms or SMEs with relatively healthy performance and sufficient financial records, microfinance targets the poor, low-income groups and the informal sector with small-sized loans as well as high interest rates. Between those target groups of commercial banks and microfinance institutions, small (and micro) enterprises are growing. They have difficulty in raising funds from commercial banks because they have inadequate collateral and financial record, yet they are not satisfied with microfinance loans due to small loan size and high interest rate. Figure V.16 illustrates the financial gap in SME financing.

![Figure V.16. Financial gap in SME financing](image)

Source: Modified from JFC, 2011.

To narrow the gap, policymakers may consider some options. First, microfinance, as it has been growing rapidly in the region and may expand its operations to target small businesses, providing large-size loans with discounted interest rate. Second, commercial banks may wish to extend their financial services to those small players perhaps in cooperation with public credit guarantee agencies, where public support is required. Third, governments could launch and further develop various forms of financial assistance to them.

3. Develop and balance both debt and equity markets

Although the roles of debt and equity markets are theoretically clear, in practice these two financial systems differ widely across countries in Asia and the Pacific. In general, countries with bank-centred debt financing systems tend to be less conducive than stock market-centred systems to entrepreneurial activity. However, a bank-centred system may be a preferable option for countries with poor information infrastructures. On the other hand, stock markets take more time to develop but tend to encourage more entrepreneurial, high-growth ventures (based on the experience of developed countries). The majority of the
innovations by SMEs have been successfully commercialized through stock markets, especially in the United Kingdom and the United States. In contrast, other developed countries rely more heavily on their banks – with Germany and Japan as prime examples (Benston, 1994). Within Asia-Pacific, some of the major stock markets (i.e., China; Hong Kong, China; Indonesia; India; Republic of Korea; Singapore; Sri Lanka; Taiwan Province of China) are well established, while other developing economies are working hard to strengthen their stock markets. Policymakers in most Asia-Pacific countries should focus on SME access to debt primarily through their banking sector, but with an eye towards establishing the regulations essential to a functional stock market (e.g., financial reporting requirements and statutes protecting minority shareholders).

SMEs list on stock exchanges for a variety of reasons, including gaining access to funds outside traditional sources (e.g., commercial banks), to spread the risk of high growth strategies and to increase corporate profiles (Pacific Economic Cooperation Council, 2003). As such, the following example from New Zealand illustrates a successful initiative undertaken by policymakers to incorporate SMEs into the equity markets.

Small New Zealand companies, with high-growth potential, face difficulties in listing on the main local stock exchange, the NZX Limited. To ease their burden, policymakers in 2005 initiated a new stock market, the New Capital Market, to address the equity needs of SMEs by providing a structured, cost-effective and fast initial public offering mechanism (NZVIF, 2011; PECC, 2003). The Seed Co-Investment Fund in New Zealand was also established to support SMEs with strong potential for high growth (Ministry of Economic Development, 2009). Overseen by the New Zealand Venture Investment Fund Ltd., 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 (NZVIF, 2011):

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

As of November 2011, the Seed Co-Investment Fund had a capital allotment of $48 million and 13 accredited Seed Co-Investment Partners. The fund and its investment partners have invested, on a one-to-one basis, in 64 New Zealand companies that have successfully established their business operations. These 64 SMEs are part of a diverse group of industries, ranging from biotechnology, information technology, marine safety, bottling and semiconductors to commercial cleaning services (NZVIF, 2011).

4. Reduce information asymmetry

Inadequate or insufficient information is one of the main obstacles hampering financing for SMEs. With information asymmetry, banks cannot be sure of the creditworthiness of SMEs, and potential equity investors may forego the equity offerings of SMEs unless policymakers implement expensive safeguards. It is costly and inefficient for individual lenders or investors to collect the information. SMEs, however, usually lack financial administrative skills to provide this information, or may even lack the basic knowledge about what type of information should be prepared.

Policy intervention can be essential in addressing this issue. The possibility for SMEs to obtain financial support from institutional lenders and equity investors should be increased to provide enough incentives for SMEs to produce credible accounts and operate transparently (OECD, 2006). Policymakers not only need to educate SMEs about related regulations, standards and practices, they must also strive to streamline them. There is a careful balancing act that policymakers must consider between the needs of creditors and investors to feel secure and informed, and the ability of SMEs to meet these needs.

Governmental organizations and SME agencies also need to initiate or pursue a dialogue with financial industries at the national level about methods for achieving better understanding, e.g., possible codes of conduct or specific information tools. Policies are needed to promote transparent lending terms and conditions of financial institutions. Training and information programmes, based on different information requirements of various financial institutions and investors, can also be implemented to assist SMEs in dealing with financing issues.

The credit history of SMEs is also an important piece of financial information. The credit rating scheme discussed above can provide effective indicators for the credit history of SMEs. An information-sharing mechanism among institutional lenders and investors, such as databases containing SME credit information and borrowing history, could be adopted by policymakers to increase information sharing and transparency. Such measures may automatically reduce the default risk of SMEs, because they need to maintain good credit records to further access financial resources.

5. Facilitate equity funding

Many governments have programmes for the direct injection of equity (or start-up capital) into SME ventures; however, the operational results of such programmes are not encouraging. Direct government programmes generally lack both the appropriate incentive structures and the expertise to administer the programme in a professional manner (OECD, 2009b). A better alternative is for policymakers to work alongside private sources of equity, such as the Business Angel Network South-East Asia (BANSEA), in order to meet SME needs, while building the institutional capacity of equity markets with pro-business securities regulation. Transparency and shareholder protection allow higher-end types of financing, such as venture capital, to flourish while being comprehensible enough to invite SME participation, albeit often with professional legal counsel.

Within this context, the public sector is expected to serve as a conduit for building trust between SMEs and private capital.

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89 For the details of BANSEA see the earlier section in this chapter on angel finance.
For example, the Business Development Bank of Canada (BDC), a state-owned specialized development bank, focuses on leveraging private sector funding by running various equity and non-equity programmes (BDC, 2011). The most notable feature of BDC is its cooperation with the venture capital industry in Canada in addition to providing direct equity investment to SMEs. Good examples involve capital injection into private equity funds that target certain objectives (e.g., high-tech, life science and start-ups), supporting angel groups to professionalize their industry and helping venture capital to develop global networks and connect with potential stakeholders (BDC, 2011).

A more comprehensive programme, such as the European Risk Capital Action Plan, to improve entrepreneurs’ access to risk capital finance could be an effective way of dealing with fragmented equity markets (European Union, 2006). Compared to the BDC, the Plan does not provide funds directly, but encourages investment from stakeholders by creating a favourable equity investment environment. The Plan concentrates on introducing a modern and flexible set of legal and administrative rules, designing appropriate tax regimes, facilitating the establishment of public risk capital and investment funds at all levels, and developing innovative sources of investment such as angel investors and employee financial participation (European Commission, 2003).

6. Combine financial services and business development services

Banks tend to charge SMEs higher interest rates and demand collateral relative to the asset base as a risk management technique (Beck, Demirgüç-Kunt and Peria, 2008). As mentioned above, this is a response to the lack of transparency regarding the creditworthiness of SMEs. Beyond credit rating schemes, policymakers should encourage SMEs to seek BDS providers, including various business associations such as chambers of commerce and federations of industries, and to work with banks to resolve financial and operational issues. A suitable combination of financial and non-financial services for SMEs is the most needed support. In this regard, financial institutions should consider: (a) developing capacities to provide information on markets and training facilities; (b) evaluate joint venture proposals; (c) assist in the development of business expansion plans; (d) guide financial and taxation matters; and (e) advocate the cause of SMEs at appropriate forums. Such an approach would obviate many difficulties in the SME sector.

Over time, BDS providers can also add value to bank lending and SME development due to their proximity to their clients as well as their direct knowledge of the enterprises’ financial status and past performance. BDS providers are often better

Box V.9. SME financing through public-private partnership in Japan

A number of city-level chambers of commerce and industry in Japan have provided non-collateral loans to their small business members in collaboration with state financial institutions. For example, the Kyoto Chamber of Commerce and Industry facilitates the engagement of its small-sized business members (with no more than 20 employees) with JFC for long-term loans of up to $ 200,000 or equivalent. Such SME loans can be provided without any collateral and personal guarantee, and with a discounted interest rate for both working capital and asset investment. In addition to their good financial record, one of the major requirements for small businesses is that they have to receive training and counselling by the chamber before receiving loans. The advantages of this system are that the chamber can understand the conditions of small business members better than financial institutions, thus securing their repayment without collateral, while improving the capacity of the members. The institutional framework of the partnership is illustrated in figure V.17.

Figure V.17. Institutional framework of public-private partnership in Japan

Sources: Kyoto Chamber of Commerce and Industry, undated; and JFC, 2011.
placed than financial institutions for identifying potential clients, ascertaining their creditworthiness, imparting professional financial and accounting techniques and other services germane to lending and repayment of debt. 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. Business development services are the central focus of the next chapter, which addresses many of these key issues in greater detail.

A number of BDS programmes, such as EMPRETEC – the Spanish acronym for emprendedores (entrepreneurs) and tecnología (technology) – address the business development requirements of SMEs. EMPRETEC is a capacity-building programme established by UNCTAD to promote the creation of sustainable support structures that help promising entrepreneurs build innovative and internationally competitive SMEs (EMPRETEC, 2008). The central product of this programme is entrepreneurship training workshops that provide participants with an opportunity to learn from successful entrepreneurs and apply these lessons to their own business behaviour. The core goal of this entrepreneurship training is for SMEs to improve their creditworthiness and attractiveness to potential investors from venture capital funds and financial institutions (UNCTAD, 2001b).

Enterprise Africa, a UNDP programme modelled on EMPRETEC, also encourages the private sector, such as large corporations, banks and consulting firms, to support SMEs through activities such as providing financial contributions, enhancing access to credit and contributing to training and post-training programmes and services (United Nations, 2011). A key feature of this programme is the joint credit delivery scheme whereby Enterprise Africa provides support and capacity-building services, and assumes responsibility for loan referral and monitoring – thus reducing lending costs for partner financial institutions and improving SMEs chances of securing access to finance (UNCTAD, 2001b).

7. Strengthening the bank-SME relationship

Despite the efforts of policymakers to enable SMEs to access bank loans, there is still much room for improvement. As mentioned above, banks may not appreciate the SMEs’ dire need for quick capital, while SME owners may not understand bank policies for mitigating risk. While policymakers may craft effective strategies, their efforts may be frustrated when applied in practice. Intermediaries may lack either the incentives or the competence to build and sustain bank-SME relations.

Communication and education are important, both for SMEs and for banks. What is crucial is the consistency of these efforts. There needs to be an ongoing programme of communication and education that policymakers implement. Such a programme must be both convenient and relevant to both SMEs and banks in order to be credible. For example, a research programme has been conducted in Sweden since 1999 to foster better relationships between the credit sector and SMEs through interactions and information exchange between the two groups: (a) banking representatives, SMEs, auditors and tax authorities; and (b) academic representatives (European Commission, 2007). Another example involves the SME Centre for Asia in the Philippines, which provides a training framework for financial institutions dealing with the SME sector, comprising seminars, exhibits and a venue for banks to build linkages with SME entrepreneurs (SME Centre for Asia, 2011).

The following recommendations are made for designing a capacity-building training programme:

(a) Research, identify and review existing training materials;
(b) Adapt materials and prepare draft training packages;
(c) Field-test draft packages by running a few pilot programmes;
(d) Evaluate and refine programme contents based upon the field test;
(e) Run training-for-trainers programmes;
(f) Collaborate with selected trainers from developing countries in their first programme; and
(g) Disseminate training packages and obtain feedback on their utility for further refinements.

The key issues and suggestions for strengthening bank-SME relationships are summarized in table V.8.

8. Introduce a four-tier national financial system

Today’s global economy exhibits unparalleled dynamism and experiences rapid changes. These changes affect SMEs more than larger firms due to the fact that they have fewer resources to cope with the volatility. In addition to the traditional forms of term loans and working capital, they require new forms and instruments to remain competitive. In this environment, national economies must hasten to keep pace and realign their own financial system accordingly; otherwise countries will start to lag behind.

Within this context, a four-tier national financial system is proposed as follows (figure V.18; see also figures II.5 and V.6):

(a) First tier – an apex bank (or agency) for SMEs that oversees policy prescriptions, 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 should augment financial resources for all the concerned players and provide them with institutional support from time to time;
(b) Second tier – national financial institutions, commercial banks, specialized DFIs such as exim banks, credit guarantee agencies, credit information providers (e.g., credit registries), venture capital associations/networks and support institutions, such as national BDS provider associations/networks and national chambers of commerce and industry, should play the role of credit providers or facilitators to the organized sector of SMEs. In addition, corporate
Table V.8. Issues and suggestions for strengthening bank-SME relationships

<table>
<thead>
<tr>
<th>Issue</th>
<th>Bank</th>
<th>SME</th>
</tr>
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<tr>
<td>Insufficiency of credit</td>
<td>• Fear of non-payment should be addressed via proper assessment of risk and moral support from relevant government agencies.</td>
<td>• Careful planning for credit needs based on a specific, workable business plan.</td>
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<td></td>
<td>• Update credit databases to include SMEs.</td>
<td>• Supporting documents for verification should be kept ready.</td>
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<td></td>
<td>• Joint appraisal with commercial banks/DFIs and BDS providers.</td>
<td>• Be open to banks in discussing all financial problems.</td>
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<td>Delays in credit sanctions</td>
<td>• All data requirements for credit appraisal should be communicated to SMEs in one installment.</td>
<td>• Prepare thoroughly for presentation, interview etc.</td>
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<td>• The appraisal process should be explained in the initial interview.</td>
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<td></td>
<td>• The appraisal should continue even if a credit officer goes on leave but one person should ultimately be accountable for each SME application.</td>
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<td></td>
<td>• A single-window approach should be followed for appraisal.</td>
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<td></td>
<td>• The appraisal process should be focused on continuous improvement, including the models used for risk measurement.</td>
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<td>Collateral requirement is too high</td>
<td>• Get a second opinion on need for collateral, perhaps from a BDS provider. Consider future cash flow as the primary security for SMEs.</td>
<td>• Work with the bank and BDS providers to reduce risks.</td>
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<tr>
<td>Information requirements are too</td>
<td>• Checklist of information on requirements to be prepared for SMEs with due care.</td>
<td>• Offer some collateral if feasible.</td>
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<tr>
<td>high or not available</td>
<td>• Use of computers for data storage and analysis.</td>
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<tr>
<td></td>
<td>• Standardize the data requirements for loan applications across different institutions.</td>
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<tr>
<td>Compliance with loan agreement,</td>
<td>• Arrange audits to minimize inconvenience to borrowers.</td>
<td>• Cooperate with the bank since post-sanction formalities are also for their benefit.</td>
</tr>
<tr>
<td>including audits</td>
<td>• Explain timing and procedures for loan compliance.</td>
<td>• Regular submissions of statements and returns.</td>
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Box V.10. Methods and criteria for bank loan appraisal

There are two major appraisal methods for loan applications – transaction lending and relationship lending. The main difference between the two methods is that the former is primarily based on quantitative data (e.g., financial statements, bank accounts, credit scores, size of equity, assets and cash flow prediction) while the latter is based on qualitative data (e.g., management skills, leadership, owners’ characters, banking relationship, reputation and quality of human resources) (RAM Consultancy Services, 2005).

In practice, particularly in developing countries in Asia and the Pacific, these two methods are often used by commercial banks in a mixed way to fit in with their unique operating environment. The World Bank’s global survey on the banking sector reveals that banks consider specific factors in evaluating commercial loan applications (Beck, Demirgüç-Kunt and Peria, 2008). In general the following criteria are used:

(a) Financial assessment of the business;
(b) Firm’s credit history with the bank;
(c) Characteristics of the firm’s owner (age, sex, leadership, managerial skills etc.);
(d) Purpose of the loan;
(e) Collateral;
(f) Firm’s credit history from a credit registry; and
(g) Size of the loan.

(bond markets (and stock markets in an extreme case) also fall within this category for open market borrowing (and share offering);
(c) Third tier – subnational development financial institutions, regional banks, BDS providers, and local chambers of commerce and industry have
(a) Fourth tier – at the base of the pyramid, MFIs cover the unorganized microenterprises and self-help groups through the provision of microcredit. MFIs have been placed at the base of
the system because they have to cover the biggest segment as well as largest number of enterprises and individual entrepreneurs in the field. The MFI system is experienced and best-suited to keeping close contact with clients and to ensuring full recovery of loans. It is also equipped to give non-financial support to entrepreneurs.

9. Other policy responses: What works and what does not?

The policy reviews in this chapter provide guidance on how policymakers can approach issues of access to finance by SMEs. Some of the key observations are set out below:

(a) The public sector and financial institutions must understand the corporate life cycle and associated cash requirements of SMEs. They need to place emphasis on the policies that assist in financing SMEs during their cash drains and to take measures to ease funding constraints due to the time gap between receivables and payables by employing various financing instruments;

(b) Governments should provide a knowledge-sharing and communications platform for different stakeholders (e.g., government, SME agency, financial institutions and SMEs) in order to increase mutual understanding and to share experiences;

(c) Governments need not operate financial assistance programmes for the SME sector directly, but they should work as a facilitator. In particular, policymakers should avoid introducing direct lending and credits at subsidized rates. Such programmes can go through the process of financial intermediation;

(d) Commercial banks have been found to incur large losses on account of publicly subsidized interest rates and non-payment by borrowers;

(e) Loan waivers by governments eventually distort the credit culture;

(f) Market failures should not be tackled with government finance. Governments should intervene and work with/through commercial forces to correct the distortions;

(g) Policymakers must give adequate attention to the protection of creditors’ rights by introducing a suitable set of laws that protect lenders from non-payment. Without creditors’ rights, the market for credit can be expected to remain underdeveloped;

(h) Governments should promote a collateral and third-party guarantee-free or reduced lending system, suitably backed by credit guarantee schemes or cash flow-based financing to encourage lenders to assist SMEs;

(i) Governments should concentrate policies on promoting the availability of risk capital to innovative, high-growth SMEs, mainly during the early stages of financing;

(j) Public sector funds could still be used to leverage private sector financing in order to reduce the financing gap;

(k) Policymakers should recognize 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:

(l) Governments should take emergency measures and facilitate extra credits to help SMEs through economic downturns. In addition, they should take measures to help SMEs build up long-term survival capacity and enhance long-term competitiveness;

(m) Governments must carefully design all the intervention policies to avoid market distortion;

(n) Policymakers should provide information and consultation services for SMEs to obtain funds (focusing on available sources of financing, understanding and meeting different criteria for different sources and dealing with legal and contract issues);

(o) Governments should provide training on accounting and financial management skills while raising SMEs’ awareness of the importance of cash flow management; enhance their ability to obtain funds; help them use different financing sources efficiently;

(p) Governments should facilitate the designing of financial services that are suitable for SMEs;

(q) Governments should facilitate FDI to the SME sector; and

(r) Governments should, in association with private sector associations, chambers of commerce and BDS providers, encourage small businesses to maintain and report reliable information. This will help to reassure financial institutions to lend to SMEs.

A brief summary of general policy measures for SME financing is provided in table V.9.

L. Summary

Financial capital is a critical input for businesses in general, and SMEs in particular. Without adequate and timely finance there can be no start-up, much less expansion or long-term sustainability. This chapter began by emphasizing the need for cash. An SME can show legitimate profits on its books but will ultimately fold if it is not collecting the cash from customers. While this may seem obvious, collecting cash is a tedious process that new business owners often fail to consider in their planning. They assume that as long as they offer a product that consumers want, the cash will simply appear; however, the reality is that extensive follow-up may be required to get the cash from the sale. The rule of thumb for policymakers is to favour policies that provide quick cash to SMEs as opposed to policies that offer deferred benefits.

This need for cash was then linked to the life cycle stages of the firm. Entrepreneurs may obtain the funds necessary for start-up from their own savings or loans from family and friends, but the crucial period occurs soon after operations begin. There is a gap between when suppliers must be paid and receivables are collected; this gap is the foundation of working capital management (figure V.4). Policymakers at the local level need to educate new business owners about the necessity of working capital management; this should be included in business and entrepreneurship curricula.

<table>
<thead>
<tr>
<th>Policy measure</th>
<th>Type</th>
<th>Intervention</th>
</tr>
</thead>
<tbody>
<tr>
<td>SME Act</td>
<td>Legal</td>
<td>Introduce a national Act for development of SME sector.</td>
</tr>
<tr>
<td>Property rights</td>
<td>Legal</td>
<td>Proper property registration facilitates loans with collaterals.</td>
</tr>
<tr>
<td>SME development regulations</td>
<td>Regulatory</td>
<td>Suitable regulations create enabling environment for SMEs.</td>
</tr>
<tr>
<td>Financial sector reforms</td>
<td>Regulatory</td>
<td>Financial sector reforms facilitate timely and adequate finance to SMEs.</td>
</tr>
<tr>
<td>Central banking directives</td>
<td>Regulatory</td>
<td>Central Bank directs banks and financial institutions to support SME sector as priority sector.</td>
</tr>
<tr>
<td>SME development policies</td>
<td>Regulatory</td>
<td>A set of comprehensive development policies and programmes including financial support and exit policies for SMEs.</td>
</tr>
<tr>
<td>Fiscal incentives</td>
<td>Indirect government support</td>
<td>Fiscal and taxation policies increasing working capital and encouraging SME investments.</td>
</tr>
<tr>
<td>International cooperation for fund support and FDI</td>
<td>Indirect government support</td>
<td>Encourage international funds and TNCs for lines of credit and FDI.</td>
</tr>
<tr>
<td>Capital market and stock exchange development</td>
<td>Regulatory</td>
<td>Encourage SMEs for market borrowing and equity support.</td>
</tr>
<tr>
<td>Information and credit scoring</td>
<td>Financial intermediation</td>
<td>National network for credit and credit scoring of SMEs.</td>
</tr>
<tr>
<td>Financial intermediation development</td>
<td>Financial intermediation</td>
<td>Specialized financial institutions for assisting SMEs, such as SME banks, EXIM banks, venture funds, MFIs etc.</td>
</tr>
<tr>
<td>Financial services package</td>
<td>Financial intermediation</td>
<td>Enabling government policies encourages the financial system to offer a full range of financial services including debt, equity and innovative finance to SMEs and to offer BDS.</td>
</tr>
</tbody>
</table>

Source: Authors’ compilation.
The various financing options available to SMEs were then discussed. In addition to informal and internal financing, such as personal savings, working capital and trade credit, the traditional way involves using the banking system for debt financing. When new business owners cannot find the capital to expand within their own networks, they turn to banks. The usually tense relationship between banks and SMEs is noted, as both parties are often insensitive to the needs of each other. There is ample room in such a situation for the involvement of policymakers, primarily as facilitators. Banks need credit guarantees and other forms of risk mitigation. The most effective policies make credit information available for markets to use. Direct intervention (e.g., government loans and blanket guarantees) generally suffers from moral hazard and high administrative costs and is therefore less effective. However, on occasions, such direct intervention can be necessary; this is highlighted by the given examples of successful credit guarantees provided by the Governments of India, Japan, Pakistan and Turkey.

Additional financial measures include leasing, factoring, corporate bonds and seed capital as well as equity financing such as angel finance, venture capital and IPOs. These methods are common in advanced economies and are gaining traction in the Asia-Pacific region. Naturally they require the highest level of investor protection policies and rule of law as well as sophisticated capital and equity markets. As a matter of systemic improvement, policymakers should strive to balance the use of debt and the use of equity for supplying capital to their nation’s businesses. Over-reliance on the banking sector is a hallmark of the Asia-Pacific region; future development should see more of a mix.

Beyond the balance of debt and equity, the chapter proposes other major areas of policy intervention. SMEs can increase working capital by improving their managerial capacity and utilizing financial techniques such as trade credit, thus reducing their need to borrow money from external sources. Reducing information asymmetry is a key; often SMEs do not know what financing options are available or how to access them. Financial institutions have difficulty gauging the creditworthiness of SMEs. Policymakers need to bridge these knowledge gaps. It is not sufficient to provide financing, as lack of managerial know-how can lead to wasting loans. Policymakers should package financial capital with business development services, an issue that is addressed in greater detail in chapter VI.

The relationship between banks and SMEs was explored in table V.8. It is noted that there is a role for both commercial banks and DFIs in supporting SMEs; policymakers should not favour one at the expense of the other. Robust competition in the financial sector will help SMEs and the overall economy. The authors suggest that the national financial system should follow the AAMO (2007) four-tier model depicted in figure V.18, with an apex SME bank supported by various levels of DFIs and banks and a foundation of microfinance.

The chapter concluded with a review of policy responses: what works and what does not? Table V.9 sets out a matrix of policy measures facilitating access to finance by SMEs. It is re-emphasized that government officials should adapt these general recommendations to the unique circumstances of their respective countries.
Annex V.1
Typology of collateral

Collateral is usually requested by lenders to serve as credit enhancement to reduce the risk of a borrower’s default. The main types of collateral that the borrowers can use are:

(a) Property – a borrower may pledge property as security for a loan. If the loan is not repaid at maturity, these securities may be sold to reimburse the lender. Acceptable property and financial assets include any or a combination of real estate, equipment, inventory and precious metals (Holdsworth, 2009);

(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 loans. Common financial assets used for this purpose include savings accounts, certificates of deposit, stocks and bonds (SBA, 2009);

(c) Accounts receivable – sometimes banks lend money against accounts receivable. The borrower can select some of the larger and better accounts receivable and assign them to the bank or the financial institution. The purchaser may pay through the borrower or directly to the bank depending on the contract arrangements (SBA, 2009);

(d) Life insurance – the cash value of a life insurance policy serves as collateral. The borrower can get credit from the insurance company directly or assign the policy to a bank (SBA, 2009); and

(e) Third-party loan guarantee – under a third-party guarantee agreement, the guarantor has an obligation to pay the lender the amount owed if the borrower defaults on the loan (Rocks, 2010). In some cases, several guarantors are required by the bank to co-guarantee one loan to ensure the safety of the credit; and

(f) Public credit guarantee – government agencies provide public credit guarantees to target groups (e.g., SMEs). Generally, the borrowers need to satisfy several criteria to obtain the guarantees, so that participating banks can issue corresponding credits to the successful borrowers.

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90 For more detailed information, see the discussion on factoring in this chapter on page 92.