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SMEs Financing in Developing Asia

Opportunities and Constraints

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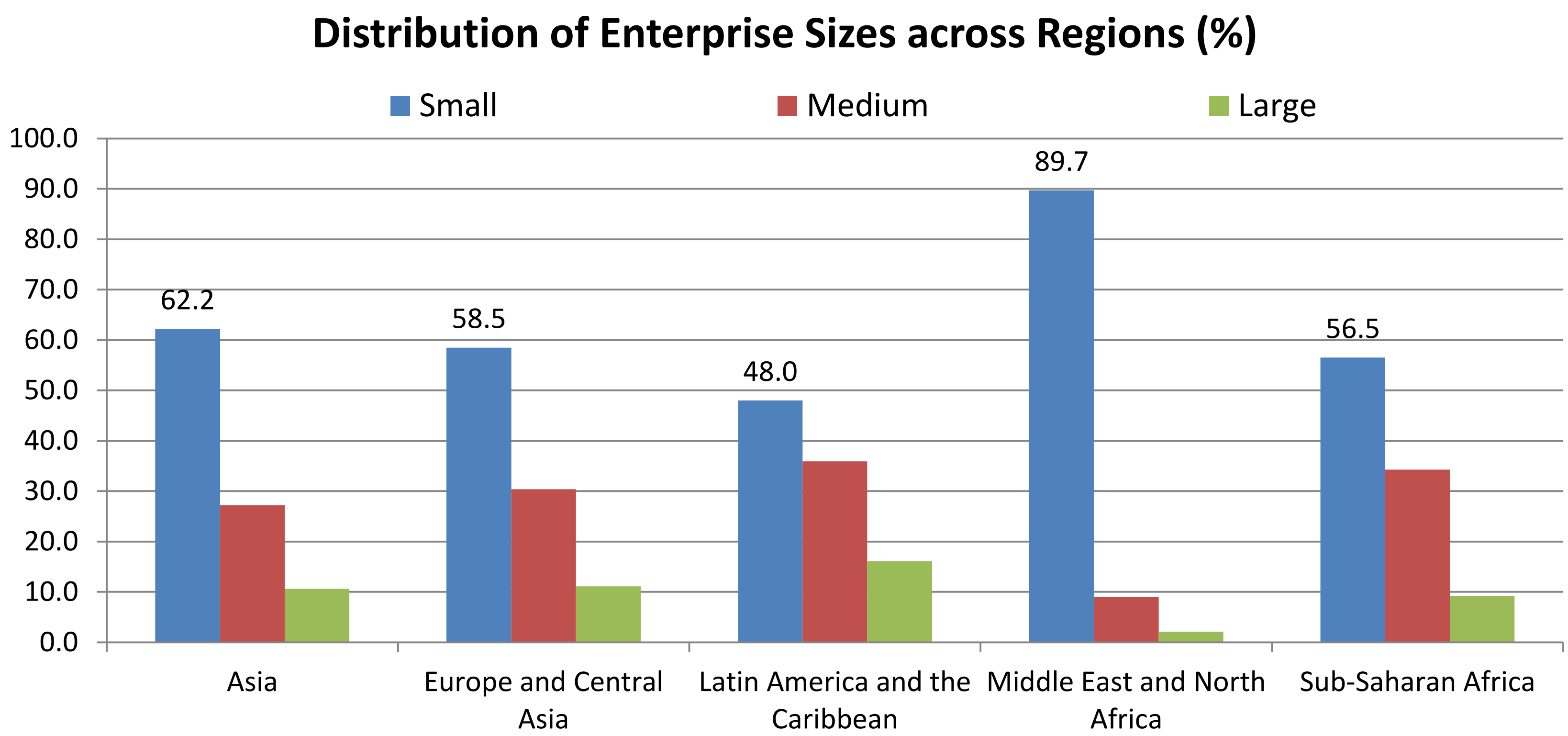
0. Introduction and Contents

- **Motivation**: A vibrant SME sector can reduce income inequality, create jobs and promote growth in developing Asia.
- **Contents**:
  1. Role of SMEs in developing Asia
  2. Size of SME credit gap in developing Asia and barriers to accessing finance
  3. Characteristics of SMEs Bank borrowers in the People’s Republic of China and ASEAN economies
  4. Opportunities and challenges facing foreign banks in developing Asia
- **Developing Asia**: Korea, Peoples Republic of China (PRC), ASEAN, India, Other South Asia

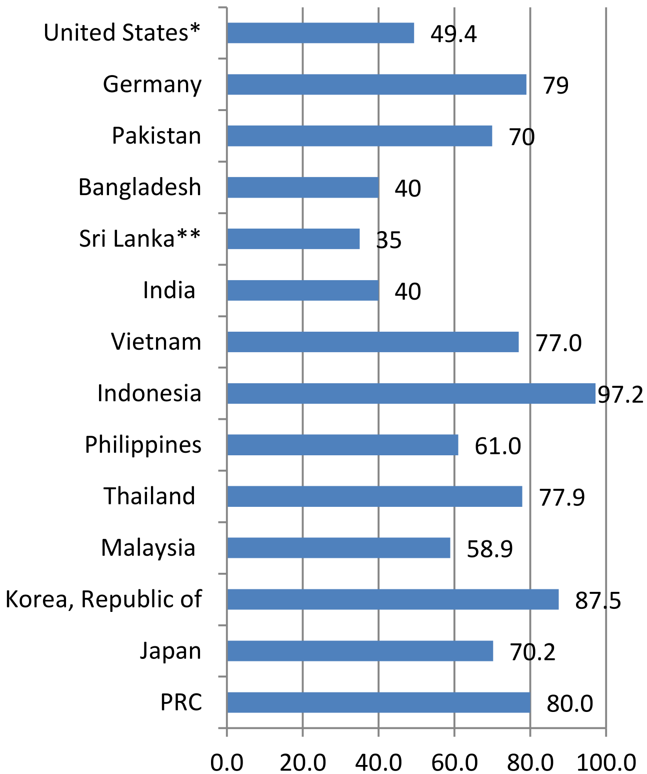
1. SMEs Make up the Majority of Firms in Developing Asia



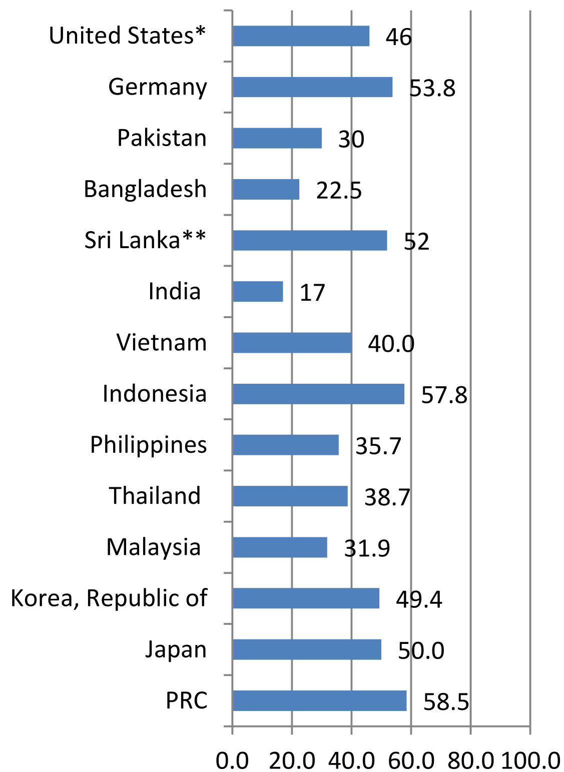
Note:
SME is defined as firms with less than 100 employees.
Uses the most recently available data from the World Enterprise Surveys
Asia refers to Afghanistan, Bangladesh, Bhutan, PRC, Indonesia, Kazakhstan, Kyrgyz Republic, the Lao PDR, Nepal, Pakistan, the Philippines, Sri Lanka, Tajikistan, Timor-Leste, Uzbekistan, and Viet Nam.
Source: ADB–OECD study on enhancing financial accessibility for SMEs: Lessons from recent crises. Mandaluyong City, Philippines: Asian Development Bank, 2013

SMEs Contribute Much to Economic Activity but Less to Trade in Developing Asia

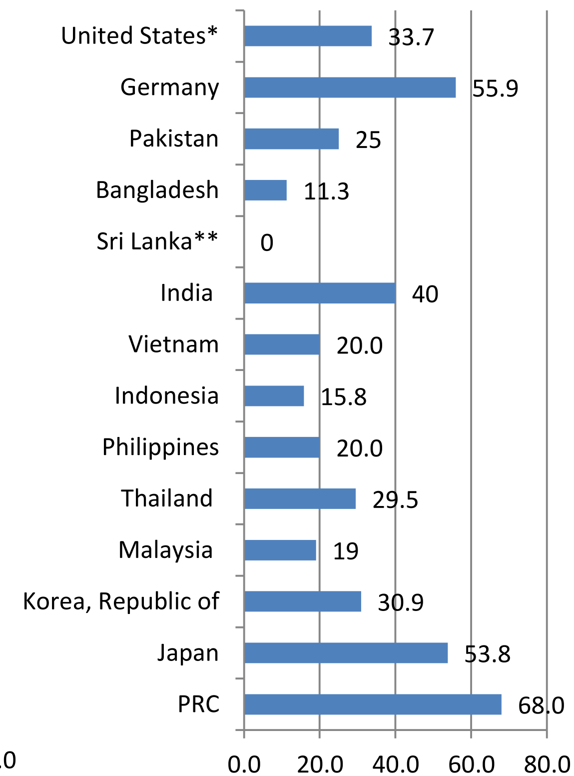
SME share of total employment (%)



SME Contribution to GDP (%)



SMEs share of total exports (%)



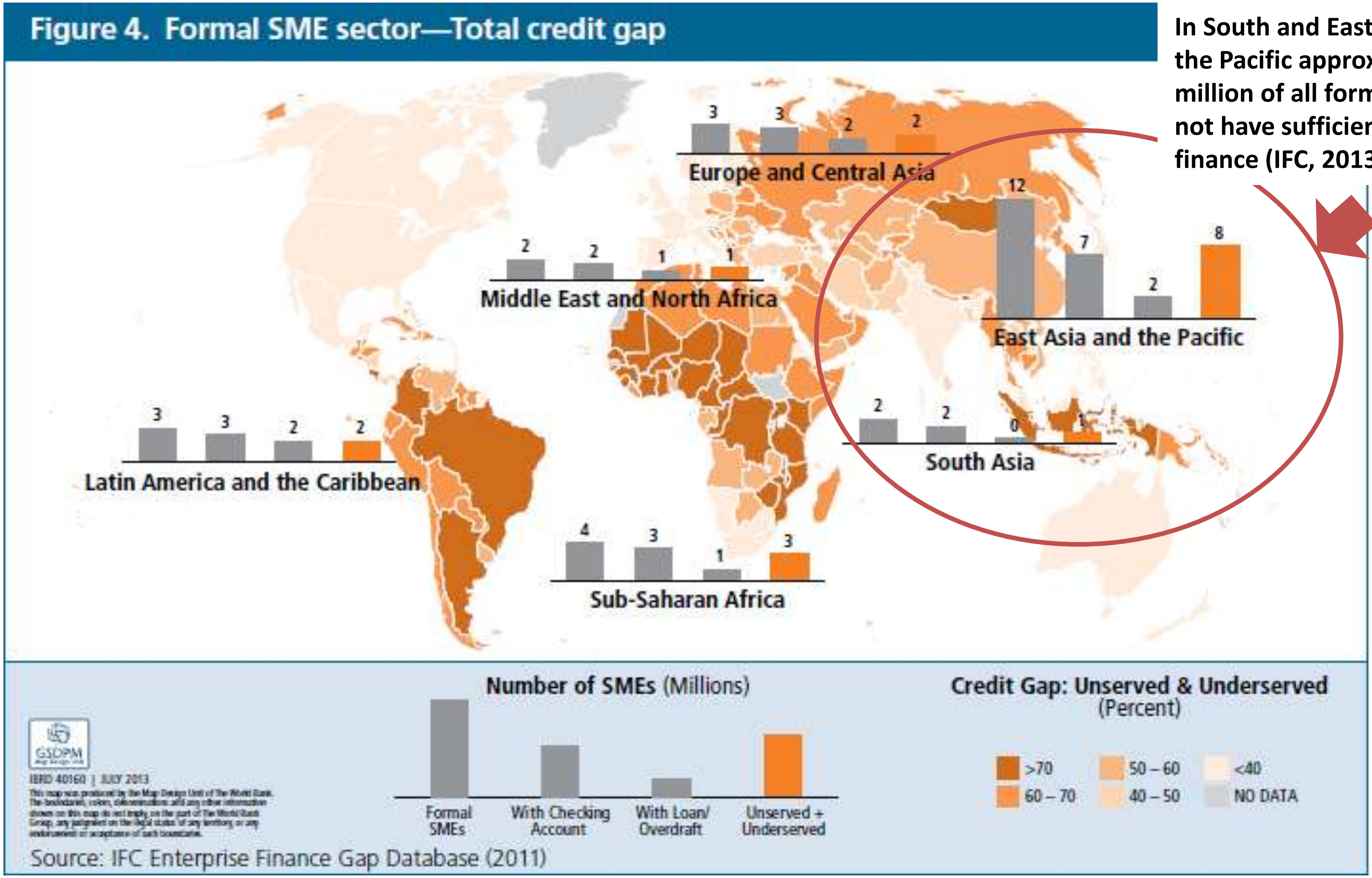
Note:
SME definition varies by country.
Use most recently available data
* percent of the private nonfarm GDP in 2008
** Data not available for SME shares of exports in Sri Lanka.
Source: Various statistical agencies (ASEAN SME data, Business in Asia, DTI Philippines, PRC Ministry of Industry and Information Technology, European Commission fact sheet, Small Business and Entrepreneurship Council)

SMEs Face Many Barriers, Including Access to Finance

	All countries	Malaysia	Thailand	Philippines	Indonesia	Viet Nam
Incentives						
Tax rates	31.9	31.1	54.8	42.9	14.3	16.5
Tax administration	26.7	24.0	49.6	34.2	13.3	12.4
Customs and trade regulations	20.0	20.1	41.0	18.0	12.5	8.7
Business licensing and permits	16.7	16.4	25.4	22.1	16.5	2.8
Political instability/ economic uncertainty	34.7	28.8	84.0	28.9	29.5	2.3
Supply side						
Transport	23.8	11.3	33.6	26.5	23.2	24.2
Electricity	29.6	17.9	42.4	30.6	30.2	26.7
Telecommunication	10.4	9.3	24.5	7.6	6.6	3.8
Access to finance/credit	34.6	22.1	44.3	28.5	38.6	39.4
Inadequately-educated labor force	28.0	24.1	60.2	16.8	15.4	23.7
Labor regulations	17.4	17.2	35.2	15.5	11.3	8.0
Access to land	16.0	11.1	11.7	9.6	19.2	28.3
Other						
Crime, theft and disorder	24.5	25.3	53.7	16.5	21.4	5.8
Corruption	30.1	20.6	59.7	37.4	23.4	9.5
Practices of competitors in informal sector	38.6	20.7	55.9	44.5	36.6	35.3

Source: Wignaraja, G., (2013), “Can SMEs participate in global production networks”, in Elms, D., and Low, P., (ed), *Global Value Chains in a Changing World*, World Trade Organization: Geneva

2. SME Credit Gap is Severe in Developing Asia



In South and East Asia and the Pacific approximate 9 million of all formal SMEs do not have sufficient access to finance (IFC, 2013).

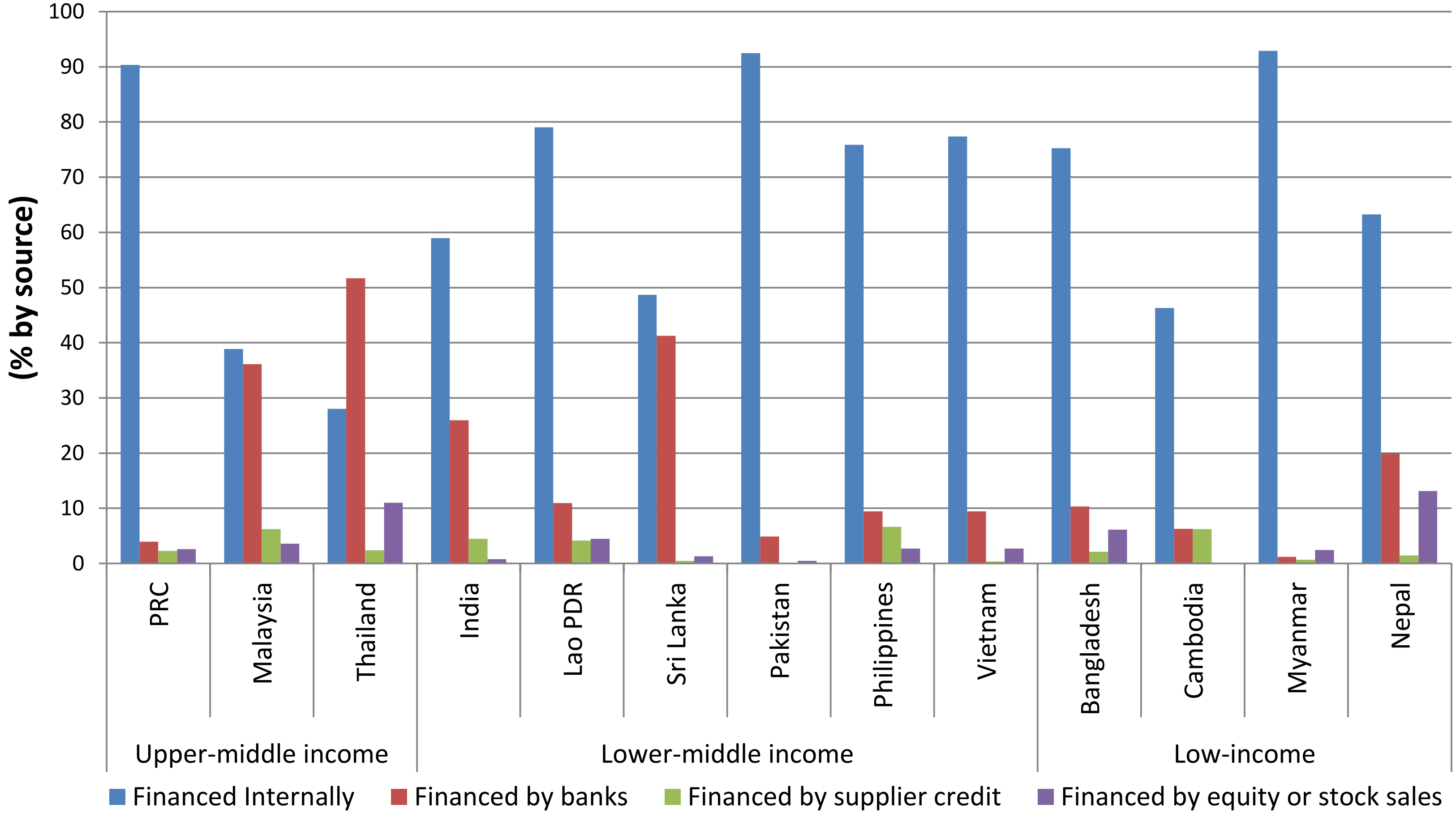
Note: Credit gap" is the difference between formal credit provided to SMEs and total estimated potential need for formal credit based on McKinsey & Co. estimates.
Uses the IFC Enterprise Finance Gap Database (2011)
Source: From the IFC report "Closing the Credit Gap for Formal and Informal MSMEs" (2013)

SME Credit Gap Varies Across Developing Asia

	Total Credit Gap (US $ Billions)	Average Credit value Gap per Enterprise (US$)
Singapore	7.1	856,000
Brunei Darussalam	7.2	736,000
Hong Kong	10.2	733,000
Republic of Korea	28.5	503,000
Malaysia	8.0	126,000
PRC	62.7	44,000
Thailand	11.8	126,000
Indonesia	11.8	29,000
Sri Lanka	0.1	54,000
Philippines	2.0	59,000
Vietnam	4.3	42,000
Lao PDR	0.2	13,000
India	3.4	54,000
Pakistan	2.9	51,000
Bangladesh	1.8	17,000
Cambodia	0.4	50,000

Note: "Credit gap" is the difference between formal credit provided to SMEs and total estimated potential need for formal credit based on McKinsey & Co. estimates.
Source; IFC Enterprise Finance Gap Database (2011).

Sources of Finance for Investment Projects of SMEs in Developing Asia



Note:

SME is defined as firms with less than 100 employees

Use the most recently available data

Source: Author's calculations using World Bank Enterprise Survey Data

3. Explaining Bank Borrowing for SMEs in PRC and ASEAN

- Wignaraja and Jinjarak (forthcoming) examine the relationship between firm characteristics and finance in SMEs in PRC and ASEAN economies
- Recent micro data on over 8000 firms from PRC and ASEAN (Indonesia, Malaysia, Philippines, Thailand, and Viet Nam)
- Preliminary findings from the study for PRC and ASEAN include:
  1. SMEs typically resort more to internal sources rather than external to finance their activity
  2. With external finance, SMEs typically use non-bank sources more than banks
  3. SMEs which borrow from banks undergo financial audits and tend to be older and also be exporting
  4. Personal assets of SME owners tend to matter more as collateral for SME borrowing from banks

Influence of Firm Characteristics on Bank Borrowing

Y = Bank Borrowing (% working capital)	Firm Size (number of employees)			
	≤ 25	> 25 & ≤ 100	> 100 & 250 ≤	> 250
Firm age	**.52**	**.37**	**.49**	**.30**
	(.21)**	**(.14)*****	**(.16)*****	**(.13)****
Export participation	**.30**	**.15**	**.12**	**.10**
	(.09)***	**(.05)*****	**(.05)****	**(.05)****
Foreign ownership	-21.77	-29.83	-15.42	-21.93
	(8.51)**	(4.23)***	(4.60)***	(3.94)***
Managerial experience	-.52	-.45	.10	.28
	(.22)**	(.15)***	(.19)	(.16)*
Financial audit	**9.37**	**1.27**	**3.97**	**8.89**
	(4.30)**	**(3.16)**	**(4.58)**	**(4.46)****
ISO certification	-18.23	-11.54	-6.88	-1.26
	(6.60)***	(3.18)***	(3.99)*	(4.03)
Labor Intensive	5.44	9.13	20.11	17.07
Industries	(5.53)	(4.67)*	(6.76)***	(6.50)***
Capital Intensive	16.12	12.62	20.14	2.52
Industries	(5.01)***	(4.13)***	(6.16)***	(6.05)
constant	-73.61	-26.43	-38.62	-22.15
	(6.26)***	(5.31)***	(8.00)***	(8.08)***
Pseudo R-sq.	.01	.01	.01	.01
observations	2,859	2,729	1,336	1,156

Note: This table reports regression results of lender type (dummy dependent variable) on firm characteristics (control variables) for firms at different sizes. The estimation method is Probit. The analysis pools firm observations across PRC, Malaysia, Thailand, Indonesia, Philippines, and Viet Nam. Standard errors are in parentheses; *** (**, *) denotes statistical significance at 1 (5, 10) percent level.

Source: Wignaraja and Jinjarak (forthcoming).

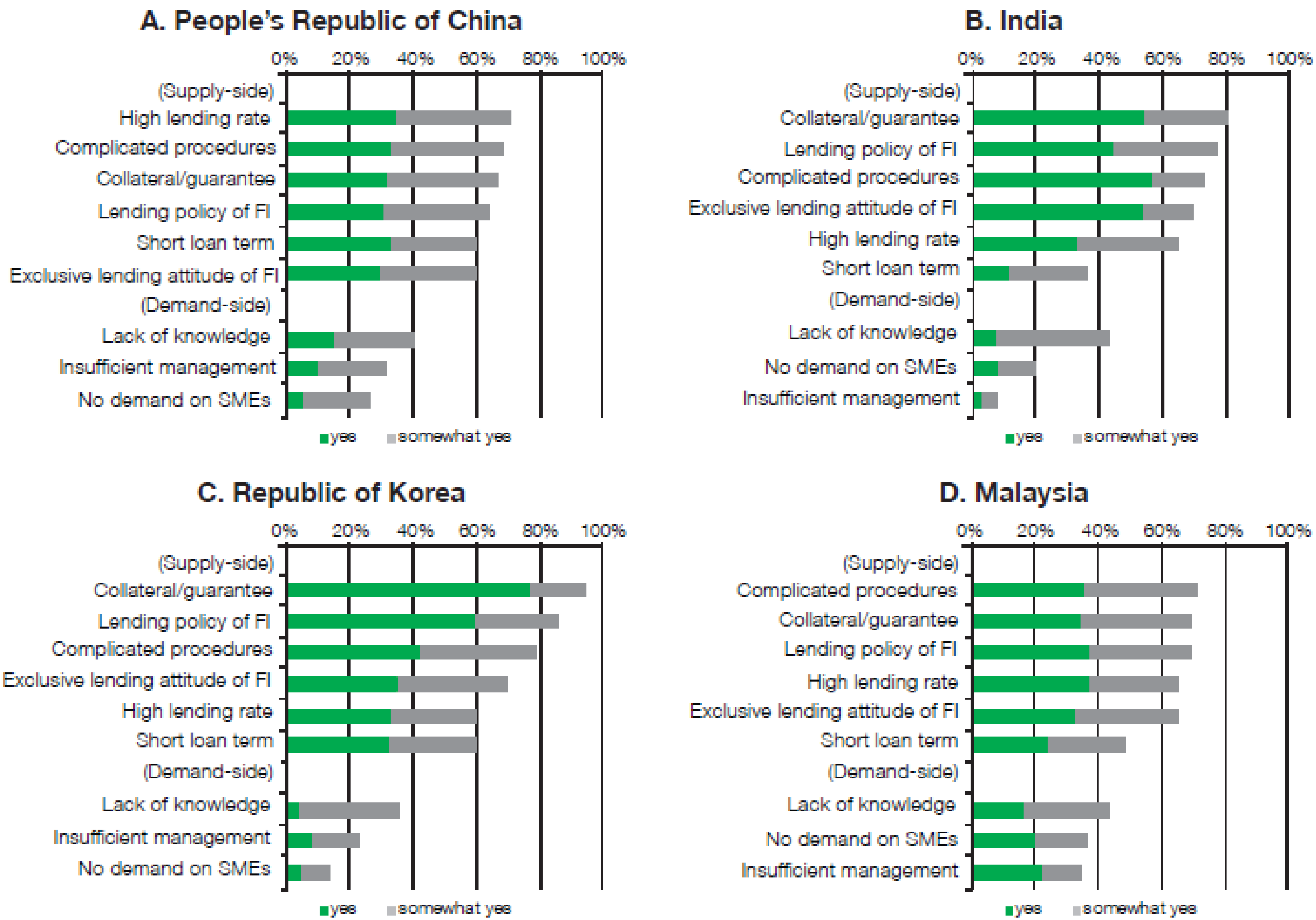
Personal Assets Matter as Collateral for SME Borrowing from Banks

Y = Collateral in Use	Probit Estimation: Probability of Collateral Type		
	Personal Assets	Account Receivables	Properties & Equipment
SME dummy variable	.22	-.42	-.44
	(.12)*	(.13)***	(.10)***
Firm age	-.02	-.01	-.01
	(.00)***	(.01)**	(.00)
Export participation	.00	.00	-.00
	(.00)	(.00)	(.00)*
Foreign ownership	-.76	-.09	-.26
	(.18)***	(.16)	(.12)**
Managerial experience	.01	.01	.01
	(.01)*	(.01)	(.00)**
Financial audit	-.24	.01	-.44
	(.10)**	(.13)	(.10)***
ISO certification	-.24	.41	-.17
	(.12)**	(.13)***	(.10)*
Labor Intenstive	.30	.13	.51
Industries	(.14)**	(.19)	(.13)***
Capital Intensive	.12	.25	.24
Industries	(.13)	(.17)	(.11)**
constant	-.70	-1.37	.80
	(.18)***	(.23)***	(.16)***
observations	981	981	981

Note: This table reports regression results of collateral type (dummy dependent variable) and collateral/loan value (continuous dependent variable) on firm characteristics (control variables) for firms at different sizes. The estimation method is Probit. The analysis pools firm observations across PRC, Malaysia, Thailand, Indonesia, Philippines, and Viet Nam. Standard errors are in parentheses; * (**, *) denotes statistical significance at 1 (5, 10) percent level.**

Source: Wignaraja and Jinjarak (forthcoming).

Barriers for SMEs in Accessing Financial Institutions



Source: ADB–OECD study on enhancing financial accessibility for SMEs: Lessons from recent crises. Mandaluyong City, Philippines: Asian Development Bank, 2013

4. Foreign Banks in Developing Asia – Opportunities and Challenges

- Foreign banks can play an important role in reducing the large credit gap for SMEs in developing Asia
- Firms report lower financing obstacles in countries with a higher share of foreign banks, a finding that holds across different size groups of firms (Clarke, Cull, and Martinez Peria, 2006).
- This positive effect can be a direct or an indirect one
  - Direct effect - Foreign banks can bring the necessary know-how and scale to introduce new transaction lending techniques
  - Indirect - By competing with domestic banks for large corporate clients, they can also force domestic banks to go down market to cater to SMEs (de Haas and Naaborg, 2005)
- Evidence shows that country risk, regulations and business environment can impact foreign bank entry in developing Asia

Standard and Poor's Assessment of Sovereign Risk

S&P Rating	Asian Economies
AAA	Singapore
AA-	PRC, Japan
A+	Republic of Korea
A-	Malaysia
BBB+	Thailand
BBB	Philippines
BBB-	India
BB+	Indonesia
BB	
BB-	Vietnam, Bangladesh
B+	Sri Lanka
B	Cambodia
B-	Pakistan
CCC-	

Notes:
AAA = Prime; AA+ ,AA, AA- = High grade; A+, A, A = Upper medium grade; BBB+, BBB,BBB- = Lower medium grade; BB+,BB, BB- = Non-investment grade speculative; B+, B, B- = Highly speculative; CCC+ = Substantial risks; CCC = Extremely speculative CCC- ,CC, C = Default imminent with little prospect for recovery; D = In default.
Use the Foreign Currency Rating
Source: Standard and Poor's Sovereign Ratings

Business Environment for the Private Sector

Barriers to Business in Emerging Asia					
	East of doing business Rank (out of 189 economies)	Protecting Investors Rank (out of 189 economies)	Strength of investor protection index (0-10)	Starting a business - Time (in days)	Starting a business - Cost (% of income per capita)
Singapore	1	2	9.3	2.5	0.6
Japan	27	16	7	22	7.5
Korea, Rep.	7	52	6	5.5	14.6
Malaysia	6	4	8.7	6	7.6
PRC	96	98	5	33	2
Thailand	18	12	7.7	27.5	6.7
Indonesia	120	52	6	48	20.5
Sri Lanka	85	52	6	8	20.5
Philippines	108	128	4.3	35	18.7
Vietnam	99	157	3.3	34	7.7
Lao PDR	159	187	1.7	92	6.7
India	134	34	6.3	27	47.3
Pakistan	110	34	6.3	21	10.4
Myanmar	182	182	2.3	72	176.7
Bangladesh	130	22	6.7	10.5	19.9
Cambodia	137	80	5.3	104	150.6
Nepal	105	80	5.3	17	34.6

Notes: Protecting Investors Indicator assesses the strength of minority shareholder's protection against directors' misuse of corporate assets for personal gains. A score of 10 means highest standards of protection are given to investors.
Starting a Business Indicator covers preregistration, registration and post registration.
Source: The World Bank Doing Business Report (2013)

Foreign Bank Entry

Country	Regulation covering Foreign Bank Entry	Foreign Equity Ownership		Branch vs. Subsidiary - Key Differences in Rules	Comments
		Pre-crisis (1996/1997)	Post-crisis (2007/2008)		
PRC	Regulations for the Administration of Foreign Funded Banks (November, 2006)	Not available	20 percent - single foreign investor	Minimum asset requirement higher for a branch than a subsidiary/joint venture bank	Foreign banks are encouraged to have local incorporations. Those banks that don't have this will not be allowed to accept deposits of less than RMB 1 Million
			25 percent - overall investment limit	Branches not allowed to do retail business while subsidiaries are eligible to do so	
India	Roadmap the Presence of Foreign Banks in India (2005)	49 percent	74 percent	Foreign banks can establish presence either through branches or as a 100 percent wholly owned subsidiary (WOS)	The banks must lend 32 percent of their net credit to priority sectors. Can do so by granting export credit
Indonesia	New Banking Law (November 1998)	49 percent	100 percent	Foreign banks subsidiaries are not governed by different regulations	A new draft of Indonesia's banking bill has revealed that lawmakers will proceed with a plan to restrict the operation of foreign banks, setting a deadline for them to become legal entities in the form of Perseroan Terbatas (PT) and capping the level of foreign ownership

Foreign Bank Entry *(cont)*

Country	Regulation covering Foreign Bank Entry	Foreign Equity Ownership		Branch vs. Subsidiary - Key Differences in Rules	Comments
		Pre-crisis (1996/1997)	Post-crisis (2007/2008)		
Thailand		25 percent	100 percent	A foreign bank subsidiary is allowed to open one branch within Bangkok and three branches elsewhere A full branch of a foreign bank is not allowed to open any branches	100 percent foreign equity ownership only for 10 years after which the foreign investor will be allowed to purchase additional shares only if their stakes fall below 49 percent
Korea, Republic of	Modified Banking Law (1998)	49 percent	100 percent	The capital structure, entry and exit regulations are different for branches	Financial Supervisory Commission needs to approve when foreign ownership stakes exceed 10 percent
Malaysia	Master Plan (2001)	30 percent	30 percent	There are no foreign bank branches . New branches or ATMs not allowed All foreign banks are required to be locally incorporated viz. they have to be subsidiaries	Already existing subsidiaries were allowed to open 4 additional branches in 2006
Philippines	General Banking Law (2000)	60 percent	60 percent	No specific differences in regulations governing branch and subsidiaries	Since 2000, foreign bank subsidiaries can enter into the country only by purchasing an existing domestic bank

Source: Gopalan, S. and Rajan, R., (2010), "Financial Sector Deregulation in Emerging Asia: Focus on Foreign Bank Entry," The Journal of World Investment Trade and Trade, 11 (1), pp.91-108.

5. Conclusions

- SMEs make up the majority of firms and make a notable contribution to economic activity in developing Asia but are not much in trade
- Access to finance is a barrier for SMEs and the credit gap is particularly severe in developing Asia affecting an estimated 9 million SMEs
- SME characteristics influence bank borrowing
  - ✓ Older, financially audited, exporting SMEs tend to borrow from banks
  - ✓ Personal assets of SMEs matter as collateral
- Foreign banks can play a role increasing SME access to finance in developing Asia, but may face some challenges

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