Economic Policy Paper

on

Access to Finance for SMEs: Problems and Remedies

Prepared
under
The DCCI-CIPE, ERRA Project
(CIPE is an affiliate of the U. S. Chamber of Commerce, Washington, DC, USA)

The Dhaka Chamber of Commerce and Industry (DCCI)
65-66, Motijheel Commercial Area, Dhaka-1000

2003

Economic Policy Paper on Access to Finance for SMEs: Problems and Remedies

Prepared by

:

Dr. A.K. Enamul Haque
and Mr. Sakib Mahmud
Subject Matter Specialists

Publishers
The Dhaka Chamber of Commerce and Industry (DCCI) &
The Center for International Private Enterprise (CIPE)
(CIPE is an affiliate of the U. S. Chamber of Commerce, Washington, D.C., USA)

Advisors
M. A. Momen, President, DCCI
Hossain Khaled, Sr. Vice President, DCCI
Md. Hossain A. Sikder, Vice President, DCCI

The Center for International Private Enterprise (CIPE)
Officials
Andrew Wilson
Senior Program Officer for Eastern Europe and Eurasia

The Dhaka Chamber of Commerce an Industry (DCCI)
Officials
Ferdaus Ara Begum
Additional Secretary & Coordinating Officer
DCCI-CIPE/ERRA Project

This Project is supported by a Grant from the Center for International Private Enterprise in Washington, D.C., USA

Contents

Economic Policy Paper on
Access to Finance for SMEs: Problems and Remedies

Chapter-1

1. Introduction

1.1 Small and Medium enterprises of Bangladesh are a heterogeneous group of industrial sub sectors comprising mainly of handlooms and handicrafts, small machine shops, printing press, bicycle and rickshaw assembly, agro processing firms, wood and steel furniture, small metal work and light engineering, electronics, cartwheels, footwear, plastic products, textile dyeing and block printing (manual), computer software and information technology, specialized silk weaving, print shops, small grocery stores, waste paper collection etc. In fact, SMEs provide over 87% of the total industrial employment and responsible for the creation of over 33% of industrial value added goods[1] of Bangladesh (DCCI, 2003). Based on the new definitions of SMEs, which includes industries with investments of Tk. 50 crores, around 95% of the existing industries in the country can be classified as SMEs (Hussainy, 2003)[2]. Hence, the future of Bangladesh industrial development depends largely on the development of SMEs.

1.2 According to a survey conducted by Bangladesh Small & Cottage Industries Corporation (BSCIC), it was found that there were total 197 types of small industries with 38,294 industrial units in the country. Based on 2002-03 data, the sectoral contributions to GDP in Bangladesh were 11.20% for large and medium industries, 4.71% for small industries, the total being 15.91%, as against 18.23% for Agriculture and forestry and 67.05% for others (Ministry of Finance, 2003). The contribution of the entire manufacturing industry to GDP is still very low, particularly for small industries of the country and so it clearly shows that there is room for growth in the SME sector, especially for small manufacturing industries.

1.3 SMEs huge contribution to employment generation and the role they play in sustainable development prompted many countries around the world to come up with special programs and support organizations for the development and growth of this sector[3]. Most of the policies that are developed and extended to SMEs are more or less fiscal and financial incentives in nature. Under financial incentives, favorable policies like tax holidays, capital subsidies, investment allowances, relief from excise duties and duty drawbacks are provided to SMEs. In developed countries like Japan and USA, governments came up with innovative polices like credit guarantee schemes, financial subsidiaries such as small business investment company (SBIC)[4] to develop the culture in venture capital investing, especially for SMEs. There are also regulatory incentives for SMEs such as preferences in government procurement, advance licensing and simplified procedures. Other incentives such as preferential access to land, term loans, working capital, etc. are also extended to SMEs.

1.4 One of the main reasons for SMEs modest contribution to GDP and slow growth and development in Bangladesh – is their insufficient access to institutional and formal source of financing. Most enterprises in the country seek informal funding or are forced to self-

---

1 Dhaka Chambers of Commerce and Industry (DCCI). Annual Report 2002-2003.
2 Al-Husainy, S.M. "Policy Towards Investment and Industrialization". DCCI-CIPE/ ERRA Project, 12 August 2003.
3 Mahajan, V and Dichter, T.W. "A Contingency Approaches to Small Business and Micro enterprise Development." Small Enterprise Development, Vol. 1(1), pp.4-19.
4 Small Business Administration. http://www.sba.gov

fund their activities, which impedes their growth and subsequent development to a certain extent.[5] However, businesses that can actually access formal funding do it in less favorable conditions depending largely on enterprise scale. Unfortunately, it is high level of risk associated with SMEs that impedes the access of competitive funding. Reliance on the financial institutions to get access to fund is not all that popular, as the financial intuitions put SMEs in tight credit constraints due to stringent collateral requirements (Meagher, 1998). As the capital market is not well developed and coordinated in Bangladesh, the entrepreneurs do not feel confident to raise funds through shares and bonds or through venture capital. In order to access these markets businesses are required to show favorable liquidity conditions, profitability, and risks that offer both trust and security to investors. In Bangladesh, SMEs in most cases are unable to meet all the requirements. Therefore, in most cases they have been relying on their personal savings, loans from relatives, friends, moneylenders, retained earnings, profits from other business ventures or funds generated through employee stock ownership. All in all, for SMEs, neither unsecured commercial credit or debentures equity capital in the form of publicly traded shares and private placements, nor NGO micro credit is a viable option.[6]

1.5 Objective of the study is to find out the key constraints in access to finance to SMEs and their possible remedies, especially the ones that are earmarked as thrust sectors[7] under Industrial Policy 1999. The study attempted to cover the role of SMEs in national economy and the impact of the financial and fiscal polices adopted by the government and the financial institutions on SMEs development. A comparative review of the importance and the financial support programs that are available for SMEs in few developed (USA, UK, Japan), newly developed (China and Hong Kong, Malaysia), developing (India, Sri Lanka) countries is also covered. Based on the existing financial infrastructure for SMEs in the selected countries and the experiences associated with different financial and fiscal polices as well as the findings from the questionnaire survey on Small and Medium entrepreneurs, the study provided recommendations to help SMEs to access financing from formal sources in more favorable terms and conditions.

Origin of the Report

1.6 The Dhaka Chambers of Commerce and Industries (DCCI) Research Cell views that poor access to Finance is the most serious difficulties for the development of the SMEs. The experience of the developed, newly developed and rapidly developing countries shows that the SMEs play a significant role and has a major share in the industrial development of these countries. The study is conducted in collaboration with the Instituted of Development, Environment and Strategic Studies of the North South University. In the above context, the study intends to make a comprehensive analysis leading to the preparation of an Economic Policy Paper (EPP) on “Access to Finance for SMEs — Problems and Remedies”. Mr. Sakib Mahmud, Faculty, Department of Economics, North South University (NSU) conducted the study by forming a research team under the supervision of Dr. A.K. Enamul Haque, Director, IDESS[8] and faculty, Economics, North South University. The research was commenced from the mid of September and was completed by first week of December 2003.

---

5 Meagher, Patrick. “Secured Finance for SMEs in Bangladesh”. Institutional Reform and the Informal Sector (IRIS), Job Opportunities and Business Support (JOBS) Program, June1998.

6 Ibid.
7 Industrial sectors that are considered to have the potential to become the major contributors to GDP in the future based on the available resources of the country.
8 Institute of Development, Environment and Strategic Studies (IDESS), North South University

Problem and Purpose of the study

1.7 The objective of this study is

a. Analyze the problems related to access to Finance of nine (9) SME sub-sectors of Bangladesh.

- The sectors are:

Sl. No.	Name of the Sector
1.	Wood & Steel Furniture
2.	Computer software & Information Technology
3. 4.	Spares/ Components of Automobiles Electronics
5.	Specialized Handlooms and Handicrafts
6.	Agro-processing Products
7.	Textile Dyeing and Printing
8.	Plastic Products
9.	Footwear and Leather Products

b. To suggest policies to improve access to Finance for the SMEs.

Statement of the Problems

1.7 From the above discussion the following question arises:-

- Are credit based on high interest rate and stringent collateral requirements- the main obstacles faced by the SMEs in getting loan from financial institutions?
- Are insufficient collateral, lack of knowledge about the methodology in accessing loans from financial institutions, lack of legal enforcements, long standing client relationships – the main reasons behind the difficulty the SMEs face in getting loans with low interest rate from financial institutions?
- Does government participation in setting up special funds or providing guarantee free loan up to a certain limit for SMEs in collaboration with the private sector would alleviate the access to finance problems for SMEs in the country?
- Does collateral back up scheme from the government through public-private partnership employed by countries with well established SMEs support programs, would be a viable option to finance for fixed assets or working capital for SMEs?
- Do corruption, lack of knowledge about conducting sound feasibility study, bureaucracy, paper work, delay or uncertainty – the major impediments in the banking sector that have serious ramifications on SMEs access to finance?
- Does setting up “Venture Capital” system in the capital markets under the supervision of Stock Exchange Commission (“SEC”) be feasible to raise funds for growth potential SMEs?
- Does bank syndication between micro finance institutions and commercial banks be more effective in helping successful micro entrepreneurs to graduate for commercial loans?
- Does restructuring the Credit Information Bureau (“CIB”) with resources a must to help SMEs and financial institutions to get information regarding credit history, bank and firm’s performances etc., for SMEs finance and development?
- Does government or the private institutions can play a better role in providing human resource development and training for entrepreneurs and employees of the financial institutions so that the outcomes from the interactions between players from both sides are maximized?
- Does co-operatives or joint venture between SMEs and large industries can create more value addition and economies of scale?

1.8 The problem statements precisely search for information about the obstacles that the SMEs are facing in accessing loans from the formal as well as informal sources. Based on the survey findings and comparative study conducted on other countries regarding SMEs financing, the authors of the paper tried to come up with mid and long-term policy recommendations to somewhat ameliorate the access to finance problems of SMEs in Bangladesh.

Purpose of the study

1.9 Purpose of the study is to cover the cover the following:

- Role of SMEs in national economy
- Policies and historical role of the SMEs in economic development
- A comparative review of the importance of SMEs have played in few developed economies and in newly developed countries.
- Policies and experiences of the developing countries like Bangladesh (India, Pakistan, Sri Lanka) for SMEs and their experiences.
- Development of the SMEs in Bangladesh
- Promotion of the SMEs in Bangladesh
- General and financial policy of Bangladesh governments for SMEs.
- Subsequent improvement of the policies in financial term
- Impact of these policies on SMEs

Shortcomings of the promotional policies, especially of the financial policies for SMEs in Bangladesh:

- General policy related Shortcomings
- Financial policy related Shortcomings

Based on the experiences of the other countries and the status of SMEs in Bangladesh, the study will provide recommendations on the short, medium and long-term policies for SME sectors in Bangladesh (Short run, mid run and long run)-suggestions will include policies related to financial, fiscal and industrial policies.

Scope of the Study

1.10 To collect information using a survey questionnaire from among entrepreneurs. Number of entrepreneurs chosen for interview sessions and for questionnaire survey is based on the stratified random method where all nine subsectors of SMEs are covered in the survey. To maintain consistency of choosing entrepreneurs from different sub-sectors - a sample size of around 60 entrepreneurs comprising four to eight entrepreneurs from each sub-sector is selected.

Sources and Methods of Collecting Information:

1.12 Following methods will be used in this study.

Content Analysis:

- Of the past and the current Industrial policies of Bangladesh (related to SMEs).
- Analysis of the Budget documents of the government of Bangladesh to find incentive schemes given for SMEs.
- Policies related to development of SMEs in other countries like, India, Sri Lanka, Japan, UK China, Malaysia, and USA.

Group discussion with Industrial Elites

- The study carries out in-depth interviews with eminent industrialists, entrepreneurs in 8 sectors to understand the problems related to SMEs in Bangladesh
- The study also carries out in-depth interviews with government officials involved in SME sectors.
- The study also carries out in-depth interviews with financial institutions involved in SME sectors.

Questionnaire Survey

- The study has collected and analyzed information from the entrepreneurs.

1.13 The research involves a questionnaire survey. The questionnaire asks mostly questions keeping in mind the time factor and the variation in educational background among the respondents. Majority of the questions are pre-coded to facilitate the analysis of data. In some cases, interviews were conducted using the questionnaire as a guide. At the same time, substantial amount of help was taken from the secondary sources like newspapers, magazines, books, and journals based on the relevance to the research.

1.14 Data were analyzed mainly by applying tabular method. In certain cases, charts and simple statistical tools like averages, percentages, etc. were used for the precision of the data analysis.

Chapter-2

2. SMEs in Bangladesh

2.1 Like other developing countries, the role of small and medium enterprises ("SMEs") in the development process of the country is considered to be in the forefront of policy debates. Based on the Interim Poverty Reduction Strategy Paper (I-PRSP)[9] to achieve the desired growth rates, major priorities are to move away from the near stagnant industrial growth path, maximizing wealth creation, exports and employment generation, and simultaneous development of SMEs, cottage industries as well as micro-enterprises (Husainy, 2003). To reduce poverty level, there is an urgent need to create wider employment opportunities for the poor including the hard-core poor so that they would have the required purchasing power to develop and support the rural and cottage industries to provide the foundation for the long term development of SMEs. Currently, over 95% of existing industries of the country can be classified as SMEs according to the new definitions set out in "The proposed Industrial Policy- 2002". Therefore, the development of SMEs can help realize the PRSP and the Millennium Development Goals (MDGs).

2.2 Despite substantial efforts, both at public and private sectors, the growth and development of SMEs in Bangladesh appears to be slow and unsatisfactory with various institutional and infrastructural problems (JOBS/ USAID, 1998; BIBM, 2003). Among all the problems, access to finance to SMEs turned out to be a major impediment hindering growth in this sector where government is focusing to create an employment intensive industrialization based on competitiveness with special emphasis on SMEs with export oriented potentials (Proposed Industrial Policy, 2002).

2.3 Under the various challenges thrown by trade liberalizations including the failures to reach consensus on multifarious trade related issues at WTO ministerial meeting held recently at Cancun and the subsequent rise in popularity of regional cooperation and free trade agreements [FTAs], Bangladesh SMEs can contribute the kind of sustainable development through job creation and technology transfer to its vastly unexplored labor force, both skilled and unskilled.

2.4 Bangladesh government in its current and proposed industrial policy guidelines has been recommending *SMEs focused growth strategies* through labor intensive industrial growth under different import substitution and export promotion policies. Like other successful economies where SMEs played a prominent role, policy makers and the relevant ministries and support organizations are championing the SMEs focused growth strategies for the following reasons:[10]

- Promote and encourage entrepreneurship through the use of micro-entrepreneurial natural and creative talents.
- Needs a relatively lower capital investment, lower capital-output ratio.
- The greater likelihood that SMEs will utilize labor intensive technologies and thus, has an impact on employment generation.

---

9 A Government publication titled, "A National Strategy for Economic Growth, Poverty Reduction and Social Development" on March, 2003, which is also known as Interim Poverty Reduction Strategy Paper ("PRSP"). The paper mainly sets out the medium term macroeconomic framework indicating financing needs and public resource provision to achieve the desired growth rates for long-term poverty reduction and social development objectives.

10 Choudhury, Toufic A. "Financial Sector Reforms: Reflections of Recent Measures", 2003.

- Need shorter time frame to start-up and put into operation to produce quick returns.
- Requires lower infrastructures and consumption of utilities is also minimal.
- SME development can encourage the process of both inter and intra regional decentralization.
- SMEs may well become the countervailing force against the economic power of larger enterprises.
- Innovative SMEs can add more value to the production, which may not be possible by the traditional enterprises or industries.
- SME development stimulates the use of personal savings and promotion of agro-industrial linkages.
- SMEs can help provide the intermediate inputs or raw materials under sub assembly operations of large industries through cooperatives or joint industrial agglomeration through backward and forward linkages.

SME Definition

2.5 Based on the industrial policy needs, the definition of SMEs varies from country to country. For most of the countries, the criteria for defining small enterprises are related to the size and employment. In Japan, SMEs considered enterprises with less than 300 employees with a capital outlay of ¥ 300 million or less for manufacturing, less than 100 employees with a capital outlay of ¥ 100 million or less under wholesale and, less than 50 employees with a capital outlay of ¥ 50 million or less under retail and service sectors (SMEs Information, Japan, 2003). In USA, small and medium enterprises are one, which has less than 500 employees. The EU definition of SMEs is one that employs 250 or less employees and has a capital investment of € 50 million or less. In India, SMEs or Small Scale Industry ("SSI") is the one where investment in plant and machinery where held on ownership terms or on lease or by hire purchase does not exceed Rs. 10 million. In Malaysia, an SME or Small and Medium Industry ("SMI") is defined as a business entity with shareholder's funds below RM 2.5 million and employment size of less than 75 full time workers (APEC Report, 2002).

2.6 At present, Bangladesh is facing the problem of drawing the exact criteria in defining its SMEs. It seems that the government, international financial institutions and the NGOs are in loggerheads while deciding which and what kind of enterprises of the country falls under SMEs. Like Sri Lanka, this has led to confusions in identifying SMEs for various supportive measures.

2.7 Following table shows the criteria set by government and international support organizations in defining SMEs of Bangladesh:

Table 1: SMEs definition: Bangladesh

Policy/Institution	Capital Size	Number of employees
Industrial Policy – 1999	<u>Small industries</u>: Fixed capital investment of less than Taka 100 million. <u>Medium Industries:</u> Fixed Capital investment between Taka 100 million and Taka 300 million. <u>Large Industries:</u> Fixed Capital investment of more than Taka 300 million.	<u>Small industries:</u> 50 or less <u>Cottage Industries:</u> Employing only family members <u>Medium Industries:</u> 50-99 workers <u>Large Industries:</u> 100 or more workers
Proposed Industrial	<u>Small industries:</u>	<u>Small industries:</u>

Policy/Institution	Capital Size	Number of employees
Policy- 2002	Fixed capital investment of less than Taka 250 million. Cottage Industries: Fixed capital investment of less than 1 million employing only family members. Medium Industries: Fixed Capital investment between Taka 250 million and Taka 500 million. Large Industries: Fixed Capital investment of more than Taka 500 million. [US $ 52,500]	50 or less Cottage Industries: Employing only family members Medium Industries: 50-99 workers Large Industries:
World Bank and other International Lending institutions	Fixed Capital: US $ 600,000 or less	
IFC managed Small Enterprise Development Facility (“SEDF”) [for the purpose of the World Bank financed Investment Assistance Scheme]	Fixed capital: Small Scale: Between Taka 300,000 and Taka 10 million [between US $ 5,500 and US $ 185,000] Medium Scale: Between Taka 10 million and Taka 100 million [between US $ 185,000 and US $ 1.85 million]	
Private Commercial Banks (“PCBs”)	Varies based on loan components and risks associated with the business ventures.	

Source: Industrial Policy 1999; DCCI (2003 report); SEDF (2002).

Based on a study done by Bangladesh Unyannan Parishad (“BUP”) - the average size of the SME in terms of investment, employment and production in the country are as follows:

Table 2: Average size of SMEs in the country based on 1998 survey

Activity	Average Investment per Enterprise (in Taka)	Average employment per Enterprise (in Numbers)	Average Annual Production Value per Enterprise (in Taka)
Dairy	422	9	542
Engineering Workshop	1,055,210	16	32,87,275
Handloom and	535,582	25	22,60,040
Dressmaking	1,192,400	10	95,66,590
Rubber, plastic and	2,623,624	19	59,36,545
polythene	976,720	24	1,46,49,333
Herbal & Chemicals	1,455,450	9	8,19,250
Shoe making	726,729	9	57,34,455
Hatchery & Fishery	3,521,490	29	2,57,93,100
Oil Mill	1,772,550	7	4,00,000
Food Products	331,920	6	6,48,000
Ice	674,600	13	80,00,000
Charcoal	1,032,230	16	28,20,600
Tannery	262,100	15	7,47,900
Rice Mill	126,220	6	10,27,200
Bamboo and Cane	244,800	8	10,45,000

Umbrella Making Candle Making Coir RCC pipe Book	12,747 295,500 1,566,680	5 6 8	28,060 3,74,750 32,00,500
Total Average	1,105,409	15	49,47,581

Source: Bangladesh Unnayan Parishad ("BUP"), September 1998.

Following table shows in chronological order what changes that have taken over time in the industrial policies for SMEs over time prior to proposed Industrial Policy prepared in the year 2002:

Table 3: Historical Development in Industrial Policy related with SMEs prior to proposed Industrial Policy 2002

Time Period	Industrial Policy	SME Sector		
		Definition	Major steps	Remarks
Pre 1971	Mainly Karachi centered "Heavy Industrialization"		East Pakistan Small & Cottage Industries Corporation ("EPSCIC") [1957]	SME was neglected seriously, no policy base.
1971-75 [First Industrial Policy]	Nationalization of all major industries-"Inward looking policy"	An enterprise having maximum investment of Tk. 2.5 lacs	Renaming EPSCIC into BSCIC	Nether given any incentive not threatened any more
1975-81 [Second Industrial Policy]	Planned shift from public to private led industrial growth, heading to "free enterprise system"	As above	Department of Industry, ICB, Handloom board and Sericulture Board	Hardly touched anything relating to the development of the SME sector
1981-90 [Third Industrial Policy]	Further emphasis on "free enterprise system" privatization and export oriented industrialization	Extended total investment up to Tk. 15 million	Declaration of New Industrial Policy ["NIP"], providing "Priority Status", giving special incentive and facilities	Most friendly policy for SME but became paper stunt due to no or weak implementation measures in practice
1991-95 [Fourth Industrial Policy]	Preparedness for 'Globalization', privatization and export oriented industrialization	Extended investment ceiling up to Tk. 30 million	Steps were taken to provide special incentives like Small Industry credit	A modest change in policy environment but produced some policy induced constraints hindering SME development
1996-2001 [Fifth Industrial Policy]	Further emphasis on 'Globalization', 'Privatization', and 'Export orientation'	Extended investment ceiling up to Tk. 100 million	No special treatment for SME	Perhaps more policy-induced constraints will hinder the development of SME, if policy is not revised immediately.

Source: DCCI Archive.

Sources of Capital for SMEs
Debt Financing

2.8 For almost all the existing and upcoming SMEs of Bangladesh, neither unsecured commercial credit or debentures equity capital in the form of publicly traded shares and private placements, nor NGO micro-credit could be considered as the viable sources to finance. It has been found from previous surveys[11] and observations that Banks, development financial institutions (DFIs) and non-bank financial institutions (NBFIs) such as insurance and leasing companies require real estate and tangible securities, as collateral, for loans in almost every cases. Rather, soft loans are extended to large firms with long standing client relationships with the banks or firms that are benefiting from either through political nexus or having a close relationship with officials who hold high positions representing the lending institutions, both private and public.

2.9 Recently, a World bank funded survey[12] of the small and micro enterprises operating in the Dhaka metropolitan area showed that enterprises which required between USD 4,000 to USD 200,000 financing have no access to any form of financial services as well as overall professional services including marketing, accounting and professional support services.

<u>Loans from friends and family</u>

2.10 In fact, the main source of financing for SMEs in Bangladesh is through informal sources like members of the family, friends and close acquaintances. These loans often take time to mobilize and are therefore not helpful in times of emergency. In many cases, it has been found that SMEs due to significant operating capital constraint during early years of operation become "sick" or face "shut-down" when facing bankruptcy.

<u>Loans from financial institutions</u>

2.11. Formal credit through bank and non-bank financial institutions comes at a high price for SMEs, since the use of security in credit agreements is highly inefficient[13], and non-real estate (movable and intangible) security is largely ineffective. Loans that are obtained from financial institutions are mainly to cover the working capital needs.

<u>Trade credit</u>

2.12 Trade credit is the second most important source for working capital to many small entrepreneurs[14]. Trade credit allows the importer/ buyer of equipments and raw materials to defer cash payments to the suppliers in exchange for the promise to pay them in the future, according to the credit terms. Using trade credit to purchase goods or services from the suppliers creates an account payable.

2.13 In essence, trade credit is actually a short-term loan with interest-free financing. The amount of the loan is equal to the purchase price of the goods or services that the SME importer/ buyer purchased. The loan's due date is the date the importer/ buyer

11 Conducted by JOBS/ USAID in 1998 and BIBM/ BIDS, 2001-2002.
12 Surveys conducted under SEDF of IFC in 2001 and recently, by Bangladesh Enterprise Institute ("BES") under the aegis of the World Bank, 2003.
13 Meagher, Patrick. "Secured Finance for SMEs in Bangladesh". Institutional Reform and the Informal Sector (IRIS), Job Opportunities and Business Support (JOBS) Program, June 1998.
14 South Asia Enterprise Development Facility (SEDF), IFC, 2002. Bangladesh SME Finance: Macro-economic overview of Bangladesh's financial sector. Dhaka, Bangladesh.

required to pay the supplier's bill. As an added benefit, no interest is charged on this short-term loan, as long as the buyer pays the bill off according to the supplier's terms.

Chart 1: Trade Credit flow

Unfortunately, trade credit in the country is provided, especially to SMEs, at a much higher rate of interest than loans from the banks.

Back to back letter of credit [LCs]

2.14 Back-to-back letters of credit are two individual letters of credit that together offer an alternative to a transferable letter of credit. The back-to-back letter of credit allows exporters (sellers or middlemen) who do not qualify for unsecured bank credit to use a letter of credit as security for a second letter of credit in favor of a supplier. In other words, if a foreign buyer will issue a letter of credit to an exporter, certain banks and trade finance companies will issue independent letters of credit to the exporter's suppliers so that the required goods can be purchased. Even if the initial letter of credit is not successfully completed, the second remains valid, and the issuing bank is obligated to pay under its terms.

2.15 Although back-to-back letters of credit provide SMEs virtually unlimited working capital to finance their sales and complete more export transactions, many banks are reluctant to take on this type of arrangement. Because back-to-back letters of credit involve two separate transactions, it is likely that several participating banks will be involved and the risk of confusion and dispute is high. To protect itself, a bank generally will require that the exporter present all relevant documents that are part of the first letter of credit before issuing the second letter of credit. The second document is worded to conform precisely to the original and dated to expire at some date prior to the first, ensuring that the seller has sufficient time to present documents within the time limits of the first. In Bangladesh, back-to-back LCs though used frequently in the garments sector but it is not that popular in other sectors of SMEs.[15]

Leasing

2.16 Leasing companies in the country do not look primarily to the lease assets itself for security, but to separate collateral in lands and buildings. The leased equipments bear less security value in most cases due to their relative illiquidity that arises for using reconditioned equipments on regular basis. Thus, reducing their depreciation value. Due to the use of tangible assets as collateral securities (i.e., lands and buildings) in providing loans, SMEs access to finance from formal sources do not mitigate even though there are good number of medium[16] and small leasing companies operating in the market.

15 Interview with Dr. Zaid Bakht, Research Director, BIDS, October 2003.
16 IDLC and United are the two prominent leasing companies in the country in terms of market share. They operate with some international financial institutions and donor agency equity participation (including the IFC, ADB, Commonwealth Development Corp., and the Korean Government)

Life insurance companies
2.17 Unlike other developed and developing countries, life insurance companies operating the country failed to provide low-interest policy loans to SMEs in large scale to supplement conventional borrowing.

Asset based financing
2.18 Unlike USA and other well-organized financial markets, asset based financing in terms of Accounts receivable and chattel paper is non-existent in the country.

Equity based financing
Equity formation through IPOs and private placements
2.19 Due to lack of investors' confidence in the capital market, which is devoid of an environment that encourages transparency, confidence, competition and innovation, SMEs are reluctant raise funds through the capital market. Though recently Stock Exchange Commission (SEC) has taken some concrete steps to bring back the confidence in the bourses, it would need ample time to implement polices with sound and forward-looking planning prepared by the management team of the relevant entities. Thus, raising capital through initial public offerings [IPOs] and private placements in the capital markets[17] is not considered as viable sources of finance for SMEs.

Employees Stock Ownership
2.20 Employee stock ownership plans that allow employees to own a piece of the business boost production and provide leverage for additional financing for new entrepreneurs or entrepreneurs who are already started their operations, done either formally or informally, has recently become to raise funds for SMEs.

2.21 Overall, difficulty in getting access to finance for SMEs in Bangladesh arises from the following:

Table 4: Supply and demand side problems in getting access to finance for SMEs

A. Supply Side Issues
• Availability of funds to the banks • Lack of access to start-up finance • Lack of appropriate equity finance • Terms and conditions are not suitable for finance • Limited experience of institutions in financing for SMEs
B. Demand Side Issues
• Lack of collateral • Lack of / limited business experience • Lack of information • Lack of management knowledge • Poor presentation of the business request for funding

2.21 The reasons generally provided by the SMEs why purchase of fixed assets and long term investment are not financed by financial institutions or why it is difficult to get loans with low interest rate, are as follows[18]:

- Insufficient collateral possessed by most SMEs.

17 Dhaka Stock Exchange ("DSE") and Chittagong Stock Exchange ("CSE")

18 __, Policy Environment for Financing Small and Medium Enterprises: Demand and Supply Side Issues. Workshop on Financing of Small Enterprises, Bangladesh Institute of Bank Management (BIBM), 2003 and, Meagher, Patrick. "Secured Finance for SMEs in Bangladesh". Institutional Reform and the Informal Sector (IRIS), Job Opportunities and Business Support (JOBS) Program, June 1998.

- Low inventories compared to large enterprises, which can be kept by banks in their warehouses or in separate warehouses controlled by Bank agents.
- Demand for highly secured and liquid government bonds.
- Demand for high corporate securities / deposits.
- Lack of feasibility study and proper business plan.
- Lack of proper documentation; in fact, documentation requirements for all types of loans (but not leases) are onerous, raising fixed costs of borrowing for the SMEs.
- Lack of legal enforcement of credit and securities agreements.
- Low expectations of getting undue favor in the future and kickbacks from SMEs.
- High rate of non-performance / default loans, as there exist a stereotyped conviction in the financial environment that SMEs in most cases will fail or become sick.
- Lack of long standing customer relationship.
- Lack of both public and private sector backed credit guarantee schemes for SME financing.

2.22 The credit market in Bangladesh can be divided based on funding requirement and access to finance. Currently, micro-finance entities are helping activities requiring up to USD 4,000, and the formal commercial banking system is financing credit greater than USD 200,000[19]. Based on an IFC appraisal report, Bangladesh banking market has been divided into four distinct segments as shown below.

Table 5: Segmentation of the Credit Market by Groups in terms of Loan Size

Market Segment	Intermediary/ Vehicle	Key Loan Size and Conditions
1) Micro-finance	BRAC Rural Development Program, Grameen, ASA, Proshika and others	Tk 2,000 – Tk 15,000 (USD 40-300); 15 % pa; 1 year; bi-weekly installments. BRAC's average loan size is Tk 2,600 (US 52). Grameen's average loan size is believed to be Tk 11,000 (USD 220).
2) Very Small enterprises	MELA loans	Tk 20,000 – 200,000 (USD 400-4,000); 15% pa; monthly installments;
3) Small and Medium Sized Enterprises, SMEs	Private Banks	1-3 years; 13-15% p.a.; monthly or quarterly installments. • Tk 200,000 – Tk 1 million (USD 4,000-20,000) • Tk 1m – Tk 3m (USD 20,000 - 60,000) • Tk 3m – Tk 10m. (USD 60,000-200,000)
4) Bigger companies and corporations	NCBs and private banks	Greater than Tk 10 million (USD > 200,000); 4-5 years; 13 % pa; quarterly installments. The private banks and international banks tend to keep credits short, less than 1 year.

Source: IFC Appraisal Report prepared for BRAC

SME finance vs. Micro-Finance

2.23 The main argument for differential treatment of micro and SME finance rests on differences in the socioeconomic characteristics and the nature of demand for finance of

19 IFC, World Bank Data (2002)

the two groups, as well as on differences in the respective lending technologies used and the types of financial institution, which implement them.

Characteristics of the target group
Micro-enterprises

2.24 Micro-enterprises frequently operate on an informal basis, or with the legal status of a sole proprietorship. As a result, there tends to be lack of separation between the finances of the enterprise and those of the micro entrepreneur's private household.

2.25 The vast majority of the Micro-enterprises employ fewer than five persons, even though the official definitions may set the upper limit at 20 or even 30[20].

2.26 Another distinguishing feature of micro enterprises is that they tend to be concentrated largely in the trade sector, and usually operate in the domestic market only. Their demand for credit is therefore primarily demand driven by a need for working capital (Holtmann et al, 2000).

2.27 Based on the activities of the Grameen Bank initiated by Professor Younus, micro lending is often equated with *group lending*. The economic rationale behind this approach is based on assumption that, given the small loan amounts involved, only a group based credit technology would enable the lending institution to keep its administrative costs sufficiently low - for example, by *externalizing the monitoring costs* to the group of borrowers. Group lending is possible at micro level because the Micro-enterprises are often engaged in 'survival' activities and therefore, their credit demand- both in terms of the purpose and the size of the maturity of the loans- is perceived to be quite homogeneous and unlikely to change significantly over time (Holtmann et al, 2000). Accordingly, it can be assumed that credit groups will be relatively stable, and therefore that the saving of transaction costs is permanent.

SMEs

2.28 SMEs usually operate in the formal sectors of the economy, tend to be fully independent legal entities and keep separate business accounts. They are more production and growth oriented, and their activities may extend beyond the borders of the domestic market. Consequently, they need not only the working capital but also investment loans. On average in all over the world, SMEs usually defined as companies with up to 250 employees.

2.29 Group lending is neither necessary nor practicable where SMEs are concerned. It is unnecessary because, by definition, the loan amounts involved are higher, and hence the unit costs are lower. It is impracticable because of the heterogeneity of SME borrowers, which means any attempt to group them together would be extremely difficult and expensive. SMEs lending must therefore be based on a traditional individual lending technology (Holtmann et al, 2000).

Lending institutions
Micro-enterprises

2.30 Based on comparative advantage, lending is believed to be the preserve of NGO for Micro-enterprises. It is based on the observation of the policy makers and economists that micro finance is an aspect of social policy oriented towards poverty alleviation and

---

20 Martin Holtmann et al. "SME Financing: Lessons from Micro finance". SME Issues, Vol. 1, No. 1 November 2000.

should be subsumed under broader social programs of the kind that are usually implemented by NGOs.

2.31 Under group lending scheme of micro finance, each member of the group assumes responsibility (moral, if not financial) for the other members' repayment obligations; the bi-weekly installment plan results in high real interest rates (e.g. 23 – 25 % effective yield for a quoted 15 % annual rate)[21]. Often the rate is considerably higher than this. As of 1998, close to 10 million households were participating in some form of a micro-credit program (SEDF, 2002).

2.32 Cumulative disbursements are estimated at around US $ 2.8 billion, close to 25 % (in 1998) of total banking sector assets[22]. Most of these loans have been better performing than the banking sector assets with average 95 % cash collection ratios (SEDF, 2002).

SMEs

2.33 SME lending is regarded as proper 'banking' business associated with the promotion of economic development and growth, a goal that financial institutions, and banks in particular, can play a decisive role in helping to achieve.

Contribution of SMEs to Industrial Development and GDP:

SMEs contribution to GDP

2.34 As a whole, SMEs provide over 87% of the total industrial employment and responsible for the creation of over 33% of industrial value added goods[23]. According to the proposed new definitions of SMEs with large industries being those requiring investments of Tk. 50 crores and above, one may confer that around 95% of the existing industries in the country can be classified as SMEs. Hence, the future of Bangladesh industrial development depends largely on the development of SMEs, which are at present languishing (Hussainy, 2003).

2.35 Following table shows the contributions of the manufacturing sectors under large & medium and small sub-sectors towards GDP.

Table 6: Manufacturing Industries Contribution to GDP (Current Market Prices)

(Taka Crores)

Class of Manufacturing	1998-99	1999-00	2000-01	2001-02	2002-03
Large and medium size enterprises	23527 (71.76%)	24939 (71.59%)	27340 (71.50%)	29596 (70.80%)	32558 (70.40%)
Small Industries	9256 (28.24%)	9898 (28.41%)	10894 (28.50%)	12209 (29.20%)	13580 (29.60%)
Total	32786 (100%)	34827 (100%)	38234 (100%)	41805 (100%)	46238 (100%)

Source: Bangladesh Aurthonaitik Samiksha, 2003, Ministry of Finance

From the above data, it seems that contribution of large & medium industries has remain centered around 70%, while for small industries it is around 30%. Following table shows the growth rate of the manufacturing industries commencing from 1998-99.

21 South Asia Enterprise Development Facility (SEDF), IFC, 2002. Bangladesh SME Finance: Macro-economic overview of Bangladesh's financial sector. Dhaka, Bangladesh.

22 Ibid

23 DCCI, 2003

Table 7: Growth Rates of Manufacturing Industries at Constant 1995-96 prices

Year	Large & Medium Enterprises	Small Industries	Total Manufacturing Industries
1998-99	4.19	0.75	3.19
1999-00	4.35	5.80	4.76
2000-01	6.55	7.02	6.68
2001-02	4.60	7.69	5.48
2002-03 (Provisional)	6.04	8.01	6.62

Source: Bangladesh Aurthonaitik Samiksha, 2003, Ministry of Finance

Overall sectoral contributions to GDP by the sub-sectors under the manufacturing industry from 1991-92 to 2002-03 are shown below under the following.

Table 8: Sectoral Contributions to GDP (1995/96 constant prices)

(Tk. Crores)

Year	Manufacturing Industry Large & Medium	Manufacturing Industry Large & Small	Manufacturing Industry Large & Total	Agriculture & Forestry	Others	Total GDP
1991-92	12646 (9.05%)	5193 (3.73%)	17839 (12.82%)	32197 (23.13%)	89164 (64.05%)	139200 (100%)
1992-93	137585 (9.47%)	5592 (3.84%)	19377 (13.31%)	32632 (22.42%)	93559 (64.27%)	145568 (100%)
1993-94	14922 (9.85%)	6031 (3.98%)	20955 (13.83%)	32420 (21.40%)	98139 (64.77%)	151514 (100%)
1994-95	16630 (10.46%)	6522 (4.10%)	23152 (14.56%)	31793 (20.00%)	104031 (65.44%)	158976 (100%)
1995-96	17573 (10.57%)	7062 (4.24%)	24635 (14.81%)	32438 (19.50%)	109251 (65.69%)	166324 (100%)
1996-97	18270 (10.42%)	7609 (4.34%)	25879 (14.76%)	34246 (19.54%)	115160 (65.10%)	175285 (100%)
1997-98	19967 (10.83%)	8124 (4.40%)	28091 (15.23%)	34808 (18.87%)	121549 (65.90%)	184448 (100%)
1998-99	20803 (10.76%)	8185 (4.23%)	28988 (14.99%)	35937 (18.58%)	128504 (66.43%)	193429 (100%)
1999-00	21709 (10.59%)	8659 (4.23%)	30368 (14.82%)	38425 (18.75%)	136135 (66.43%)	204928 (100%)
2000-01	23010 (10.67%)	9267 (4.30%)	32277 (14.97%)	40551 (18.82%)	142678 (66.21%)	215506 (100%)
2001-02	23931 (10.59%)	9962 (4.41%)	33893 (15.00%)	41785 (18.50%)	150170 (66.40%)	225848 (100%)
Growth Rate (1991/92– 2001/2002)	6.59%	6.73%	6.62%	2.64%	5.35%	4.96%

Source: Bangladesh Aurthonaitik Samiksha, 2003, Ministry of Finance

2.36 Based on 2002-03 data, the sectoral contributions to GDP in Bangladesh were 11.20% for large and medium industries, 4.71% for small industries, the total being 15.91%, as against 18.23% for Agriculture and forestry and 67.05% for others (Ministry of Finance, 2003). It seems the contributions of the entire manufacturing industry to GDP is low, particularly for small industries of the country. Thus, it clearly shows that there is room for growth in this sector, especially for small manufacturing industries. For that government, key players, policy makers and the civil society need to make coordinated and concerted efforts.

SMEs sectors of Bangladesh

2.37 Mainly specialized textiles, block printing (manual), hand loom and handicrafts, electrical & electronics, agro processed products, leather, ceramic, light engineering, information and communication technology ("ICT"), etc., fall in the category of SMEs.

2.38 The proposed Industrial Policy 2002 recommended the following industries as thrust sectors that can contribute towards economic development and growth:

Table 9: Thrust Sectors based on proposed Industrial Policy 2002

Sl. No.	Name of the Thrust Sector
1.	Agro-based industries
2.	Artificial Flower Making
3.	Computer software and information technology
4.	Electronics
5.	Frozen Foods
6.	Floriculture
7.	Sericulture & silk industry
8.	Infrastructure
9.	Jute & jute mixed goods
10.	Jewelry, diamond cutting & polishing
11.	Leather & leather goods
12.	Oil & gas
13.	Gift items
14.	Stuffed Toys
15.	Textiles
16.	Tourism
17.	Basic chemicals/ industrial raw materials
18.	Dyes and chemicals used in Textile industry
19.	Spectacles frame
20.	CNG
21.	Wood & Steel Furniture

Source: Proposed Industrial Policy, 2002

Out of twenty-nine thrust sectors, almost three-fourth of them fall under SMEs category based on the industrial structure of the country.

2.39 In the year 2002-2003, SMEs contributed US $ 5045 million out of total exports of US $ 5255 million (DCCI Research Cell, 2003). The number seems to be bit controversial, as few industries that are considered as SMEs may be large due to huge investment or the number of manpower engaged concealed by the industries for multifarious reasons. Still, most of the export earnings are more geared towards garments, leather, tea, frozen food etc.

Chapter-3

3. Financial Sector of Bangladesh

3.1 A strong vibrant financial sector can play a significant role in the growth and development of small and medium enterprises by providing credit support to potential entrepreneurs[24]. The study tried to find out the kind of institutional support and fiscal incentives that are provided by the financial institutions of the country for the promotion of SMEs. Starting with the prudent monetary policies adopted by the Bangladesh Bank[25] to help ease the gap between the deposit and the lending rate adopted by the existing financial institutions, it is expected that the access to finance for SMEs from the formal sources would improve by a certain extent (Bangladesh Bank, 2003) The study attempted to find out whether the financial institutions have reduced the rate as expected by the Bangladesh Bank based on its recent findings on the lending and deposit rates provided by the banks[26]. Also, the paper discusses about the recent developments that have taken place in the capital market to attract investors and the possibility of raising capital for growth potential SMEs through venture capital investments by the institutional investors and mutual fund companies.

3.2 In a first step towards an expansionary monetary policy, Bangladesh Bank on November 6, 2003 decided to cut back the requirement of the commercial banks to maintain funds with Central Bank through treasury instruments. Simultaneously, the central bank reduced the bank-lending rate to 5 percent from 6 percent in a bid to reduce interest rates on bank lending[27]. If the national commercial banks ("NCBs") and private commercial banks (PCBs) respond positively towards these by lowering their own rates on savings instruments to a 'rational' level, the capital market would see reversal of its fortune by next year or so[28]. Lack of participation of institutional investors like mutual funds, merchant banks and issue managers are leading to bad investments by the individual investors prompting the companies with mediocre performances to stay in the market (Dhaka Stock Exchange, 2003).

3.3 In secured credit transactions in Bangladesh, interest rates vary from 10.50 percent per annum to 19.00 percent per annum (Bangladesh Bank, 2003). Fees, delays, and transaction costs appear to be prohibitive in many cases, especially in transaction of one lakh or less. Documentation requirements for all loans (but not leases) are onerous, raising fixed costs of borrowings to SMEs.

Bangladesh Bank

Bank lending rate to commercial banks

3.4 As mentioned before, Bangladesh Bank lending rate is revised downward to 5 percent from 6 percent in a bid to reduce interest rates on bank lending[29]. The central bank expects at least 1 to 1.5 percent cut by all NCBs and PCBs on their lending rates based on the current lending rate (Bangladesh Bank, 2003).

---

24 Bank Survey Bangladesh. "Consolidated Report on Commercial Banks of Bangladesh: SME Financing". SME Department, World Bank Group; October 2000.
25 Central Bank of Bangladesh.
26 Bangladesh Bank's objective is to reduce the lending rates offered by the financial institutions to single digit rate by middle of 2004.
27 Bangladesh Bank (Information). [Available: http://www.bangladesh-bank.org]
28 Predicted by Salahuddin Ahmed Khan, Chief Executive Officer, Dhaka Stock Exchange (DSE)
29 Bangladesh Bank implemented this policy on November 6, 2003.

3.5 With the current deposit-lending rate spread of about 5-6 percent, the policy makers feels that the ideal situation would be a spread of about 3-4 percent, which would help to provide more loans to potential borrowers, especially the SME entrepreneurs.

3.6 According to a central bank study, the average costs of funds of the nationalized as well as private and foreign banks operating in Bangladesh is 9 percent, while the average interest rate on advances is 13.10 percent (Bangladesh Bank, 2003).

Statutory Liquidity Requirement Ratio ["SLR"]

3.7 The commercial banks' requirement to maintain funds with the Bangladesh Bank [BB] as statutory liquidity requirement (SLR) has been reduced to 12 percent from 16 percent on November 2003. Prior to that the banks had Tk. 19,754 crore stashed with the central bank as SLR and cash reserve ratio ("CRR") on October 16 (Bangladesh Bank, 2003). It is expected that the cut in SLR would increase the liquidity of the banks by Tk. 4000 crore and they would be ready to lend more in the coming months (Bangladesh Bank, 2003).

Cash Reserve Ratio (CRR)

3.8 The cash reserve requirement (CRR) for the scheduled banks with the Bangladesh Bank remained unchanged in FY02 at 4.0 percent of their total demand and time liabilities.[30]

Credit Information Bureau (CIB)

3.9 Credit reporting system in the country is still in its infancy compare to other countries with well-organized financial environment. The Credit Information Bureau (CIB) of Bangladesh Bank requires regulated financial institutions to provide information periodically (quarterly or monthly, depending on the size of the debt) on all debts of 10 lakh and above[31]. But, unlike other countries, only regulated financial institutions and government agencies can obtain information from CIB. Also, information enters the system with a time lag; thus, it takes considerable time to reach the interested parties.[32]

3.10 Due to the absence of market incentives, financial institutions fail or do not feel the urge to provide information on debtors (including, firms) to the CIB periodically until and unless they are forced to do so. Based on Bangladesh Bank rules and regulations, all financial institutions should provide relevant information on debtors to CIB and failure to comply would be subject to fines. As per rule, CIB should have record of each debtor's, individual or a business entity, mortgages and charges against the debtor's assets based on the existing auditing and accounting practices to ensure efficiency and probity.

3.11 If reliable assessment and information on prior liens and credit history of SMEs were kept with Credit information Bureau (CIB), financial institutions and other interested parties with surplus of funds would have been more eager to lend money to growth potential SMEs. Lien registries, credit information agencies and other forms of information and net working are critical to the efficient working of financial markets. It seems that the existing information asymmetries in the country prevents SMEs the opportunities to get access to finance from formal sources, as it increases risk, raise the price of credit, and constrain its allocation of existing customers, established firms and related parties (Meagher, IRIS -JOBS Program report, 1998).

30 Bangladesh Bank Annual Report 2001-2002
31 JOBS/USAID, 1998
32 Based on a study by JOBS/ USAID, it takes around on average 60 days to send information officially from CIB through an informant to the interested parties.

Present lending and deposit rate in the Banking Sector

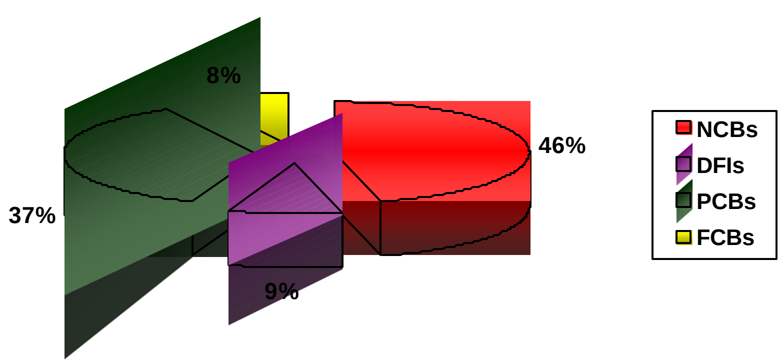
3.12 The banking sector in Bangladesh comprises Bangladesh Bank, the central bank, and four types of scheduled banks. It is dominated by the four nationalized commercial banks (NCBs) that held 46.5 percent of industry assets as of year-end 2001[33]. There are also five government owned specialized banks (DFIs) that held 9.5 percent of industry assets comprised largely of loans to the target sectors. In addition, as of year-end 2001, there were 30 private commercial banks (PCBs) and 12 foreign commercial banks (FCBs)[34]. As of year-end 2001, the PCBs held over 37 percent of industry assets and FCBs held almost 8 percent[35]. Presently the scheduled bank industry comprised 50 banks; one foreign bank sold its business to a local bank in the first half of 2002. The FCBs are mainly involved in international transactions. The DFIs are agricultural and industrial development agencies, with assets comprised largely of loans to the target sectors and government security holdings, and liabilities comprised of deposits and refinance credit from BB.

Table 10- Banking System of Bangladesh

Bank types	Number of Banks	Number of Branches	Net Assets (billion, Taka)	% of industry assets	Deposits (Billions of Taka)	% of industry deposits
NCBs	4	3608	511.52	46.5	486.7	50.93
DFIs	5	1298	104.50	9.5	53.96	5.64
PCBs	30	1331	409.22	37.2	349.81	36.58
FCBs	12	34	85.80	7.8	65.53	6.85
Total	51	6271	1100.66	100.0	956.28	100.0

Source: Bangladesh Bank, Annual Report 2001-2002

Chart 2-Percentage of Industry assets hold by th scheduled banks[source: Bangladesh Bank, 2002]



3.13 In Bangladesh, the banking sector is still dominated by the NCBs, despite some decline in recent years. At the end of 2001 the NCBs accounted for almost 59% of overall banking sector deposits, PCBs 34%, and FCBs 7%. In terms of risk-weighted assets, the dominance of the NCBs is even higher (Bangladesh Bank, 2003).

3.14 Bangladesh Bank is using the US-based CAMEL rating system to evaluate the Bangladesh banking sector. As of year-end 2001, 7 banks were rated as strong, 24 banks rated as satisfactory, 6 as fair, and 14 as marginal[36] (Annual Report 2001-02, Bangladesh Bank). All 4 NCBs were included between the marginal as well as 4 of the 5 DFIs. Thus, indicate that the performance of the PCBs and FCBs are better compared to

33 Bangladesh Bank. Annual Report, 2001-2002.
34 Ibid.
35 Ibid
36 Bangladesh Bank (Information). [Available: http://www.bangladesh-bank.org]

the other two types of scheduled banks. Under the CAMEL rating, the banks are scored every six months on a scale of 1 (best) to 5 (worst) using the following five indicators:

- *Capital Adequacy*
- *Asset quality*
- *Management quality*
- *Earning performance, and*
- *Liquidity.*

A composite score is then produced. Banks, which score 1 or 2, are considered satisfactory, but a score of 5 indicates that examiners feel the bank is likely to fail.

Key Banking Rules and regulations under the aegis of Bangladesh Bank

3.15 New NPL[37] recognition and provisioning requirements were introduced by BB, effective 31 December 1998, and are leading to a strengthening of the banking sector. The recognition and provisioning rates are:

Table 11: Classifications of loans under the Bangladesh Bank

Classification	Definition	Provision Requirement
Performing	Arrears < 90 days	1%
Sub-Standard	Arrears 90 – 180 days	20%
Doubtful	Arrears 180 – 365 days	50%
Loss	Arrears > 365 days	100%

Source: Bangladesh Bank, 2002

3.16 The definition of an NLP does not start until arrears of 90 days are recorded. This is still international standard (IAS) but somewhat below what is now starting to be used in comparable countries, where generally 60 days is now becoming the norm. The other key regulations with which banks are required to comply with, include:

Table 12: Key regulations

Regulation	Definition	Regulation	Definition
Capital minimum	Taka 200m (Taka 400m for new banks).	Liquidity ratio	15 % of deposits.
Capital adequacy ratio	8 %	Cash ratio	CRR 5 % held in CB
Single borrower limit	15 % of bank's capital, but can be increased to 100 % with permission of CB.	Interest non-accrual	90 days
Group borrower limit	100 % of bank's capital	Investments in equities	Total equity holdings cannot exceed 30 % of the bank's capital.
FX net open position	Advised by CB to each bank	Bank ownership	No family is able to hold more than 10% of a bank.

Source: Bangladesh Bank, 2002

37 Non-performing loans.

Bank wise lending rates in the existing scheduled banks

3.17 According to Bangladesh Bank published rates, lending rates in different scheduled banks hovers around 5 percent to 19 percent. For SMEs, the range is between 9 percent to a maximum of 18 percent.

3.18 In the last three years, lending rates decreased at a very slow pace compared to the other South Asian countries. The average lending rate reduced from 13.86 percent on June 30, 2000 to 12.80 percent on June 30, 2003. But, in Pakistan, it decreased from 14.02 percent to 7.58 percent during the same period[38]. Lending rates also shriveled by 6-7 percent in India, Nepal, Sri Lanka and Thailand during the period.

3.19 Under expansionary monetary policy scheme adopted by the Bangladesh Bank in recent times, interests rates on treasury bills decreased by 2-3 percent and call money rate is hovering around 2-3 percent in the last one year (Huda, 2003). Thus, it is expected that the financial institutions would reduce the lending rates after these positive initiatives taken by the Bangladesh Bank including reduction of SLR and the central bank lending rate. It would be beneficial for business enterprises, especially the SMEs, if the interest rates come down to single digit figures like the ones prevailing in most of the developed and developing countries banking system. Following is the bank wise lending rate that is published by the Bangladesh Bank in recent times.

38 Quoted by Bangladesh Bank Deputy Governor Mr. Nazrul Huda in an interview with the Daily Star

Table 13: **Bank wise Lending rate Chart (Percentage Per Annum) November 2003**

Name of the Banks	Agriculture	Large and Medium Scale Lending	Working Capital	Exports	Other Commercial Lending	Small Industry	Others
NCBs							
1. SONALI	5.00-10.00	11.50	13.00	7.00-9.00	14.50-15.00	10.50-11.00	14.50
2. JANATA	9.00-10.00	9.00-11.50	13.00-13.00	7.00-9.00	14.50	10.50	12.00-15.00
3. AGRANI	10.00	10.00-11.50	13.00	7.00-9.00	14.50	10.50-11.00	15.50
4. RUPALI	9.00	11.50	13.00	7.00-9.00	14.50-15.00	10.50-11.00	12.00-14.50
DFIs							
5. BKB	10.00	10.00	10.00	7.00	12.00	10.00	10.00-12.00
6. BSB	-	9.00-11.50	13.00	7.00	14.50	9.00-10.50	12.00-14.50
7. RAKUB	10.00	13.00	14.50	8.75	15.00	12.50	12.00-14.00
8. BSRS	-	10.00-12.00	9.00-13.00	7.00-9.00	14.50	10.00	13.50-14.50
9. BASIC	10.00	10.00-13.00	10.00-14.00	7.00-9.00	15.00	11.50-12.00	15.00
PCBs							
10. PUBALI	10.00-11.00	15.00	13.00-15.00	7.00-10.00	15.00	13.00	12.00-18.00
11. UTTARA	10.00	13.50	14.50	7.00-10.00	14.50	13.00	13.00-15.00
12. AB-Bank	8.00-11.00	13.00-14.50	9.00-14.25	7.00	10.00-15.00	10.00-11.00	9.00-15.00
13. IFIC	12.00	15.00	15.00	7.00-9.00	15.50	14.00	15.50
14. ISLAMI	14.50	14.50	14.50	7.00-9.00	15.00	13.50	15.50
15. NBL	12.00-14.50	14.00-14.50	14.00-14.50	7.00-10.00	14.00-16.00	13.00-14.00	13.00-16.00
16. THE CITY	13.00-15.00	13.00-16.00	13.00-16.00	7.00-9.00	13.00-16.00	15.00	12.00-16.50
17. UCBL	10.00	14.00	14.00	7.00	13.50	12.00	13.00-15.00
18. ORIENTAL	12.00-14.00	14.00-16.00	14.00-16.00	7.00	14.00-16.00	12.00	14.00-16.00
19. EBL	11.00-16.00	12.50-16.50	10.00-15.50	7.00	13.00-16.00	14.00-16.00	16.00-18.00
20. NCCBL	10.00-13.50	13.50-15.50	13.50-15.50	7.00	13.50-15.50	12.00	15.50-16.00
21.PRIME	11.00	13.50-15.50	12.75-16.00	7.00	13.00-16.00	15.00	12.00-16.00
22. SOUTHEAST	9.00-12.00	12.00-14.00	12.00-14.00	7.00-10.00	13.00-14.00	12.00-13.00	13.00-14.00
23. DHAKA	9.00-11.00	12.00-15.00	12.00-15.00	7.00-10.00	12.00-16.00	9.00-12.00	12.00-16.00
24. AL-ARAFAH	14.50	12.00-15.00	13.00-14.50	9.00	15.00	15.00	14.50
25. SIBL	10.00	13.00-14.00	13.50-14.50	7.00-9.00	13.50-15.00	13.00-14.00	8.00-14.00
26.DUTCH BANGLA	10.00	12.50	12.50	7.00	12.50	12.50	12.00-12.50
27.MERCANTILE	14.00	13.00-15.00	13.00-15.00	7.00-10.00	13.00-15.00	14.00-15.00	13.00-15.00

Name of the Banks	Agriculture	Large and Medium Scale Lending	Working Capital	Exports	Other Commercial Lending	Small Industry	Others
28. ONE BANK	8.00-10.00	13.00-15.00	8.00-15.00	7.00-10.00	12.00-15.00	11.00-13.00	12.00-15.00
29. EXIM BANK	9.00-13.00	13.00-15.00	12.00-15.00	7.00	13.50-15.00	12.00-13.00	13.00-15.00
30. PREMIER	12.00-14.00	13.50-15.00	15.00	10.00	15.00	13.50	10.00-15.00
31. FIRST SECURITY	13.00	15.00	15.00	7.00	16.00	14.00	15.00
32. STANDARD	10.00	12.00-14.00	13.00-14.00	7.00	13.00-15.00	14.00	13.00-15.00
33. TRUST BANK	12.00	13.00-15.00	11.00-14.50	7.00-10.00	-	-	10.00-16.00
35. MUTUAL TRUST	10.00	13.50-14.00	13.50-14.00	7.00	13.50-14.00	11.00-12.00	13.50-14.00
36. BANK ASIA	10.00	15.00	15.00	7.00	15.00	13.00-14.00	15.00
36. BCBL	10.00	15.00	14.75	7.00	14.75	14.00	12.00
37. JAMUNA	10.00	15.00	15.00	7.00-10.00	15.00-16.00	14.00	15.00
38. SHAHJALAL	10.00-13.50	12.00-15.50	7.00-15.50	7.00-10.00	10.00-15.50	12.50-15.50	12.50-15.50
39. BRAC	9.00-12.00	13.00-15.00	13.00-15.00	7.00-9.00	13.00-24.00	16.00-18.00	12.00-19.00
FCBs							
40. AMEX	-	10.50-13.75	8.25-12.50	7.00-10.00	8.25-13.00	-	7.00-15.00
41. C.A. INDOSUEZ	8.00-10.00	11.00-13.00	9.50-12.50	7.00-9.00	10.50-12.50	8.50-11.50	11.00-13.00
42. S.T. CHARTERED	9.00-12.00	10.00-13.75	9.00-13.50	7.00-9.00	9.00-14.00	-	11.00-19.00
43. HABIB	10.00	12.50-14.50	12.50-14.50	7.00	13.00-14.50	12.50-14.50	12.50-14.50
44. SBI	10.00-11.00	12.00-13.00	12.50-14.50	7.00-10.00	12.50-14.50	12.00-13.00	13.50
45. NBP	13.00-15.00	13.00-15.00	13.00-15.00	7.00	14.00-16.00	13.00-15.00	14.00-16.00
46. CITI N.A.	10.00-12.00	11.50-13.50	8.50-14.00	7.00-9.50	9.50-14.00	9.00-11.00	8.50-14.00
47. WOORI	7.00-12.00	10.50-14.00	7.00-14.00	7.00-10.00	12.00-14.00	10.00-11.00	11.00-14.00
48. SHAMIL	10.00	14.00	12.00	7.00	13.00	13.00	13.00
49. HSBC	-	11.00-14.00	9.00-14.00	-	-	-	11.00-19.00

Source: Bangladesh Bank, November 2003

Micro- Finance Institutions ["MFIs"]

3.20 First initiated by the Grameen Bank, activities and network of micro-finance institutions has gone up by leaps and bounds in the last fifteen years. These institutions provide or initiate micro lending, which is often equated with *group lending*[39]. The economic rationale behind this approach is based on assumption that, given the small loan amounts involved, only a group based credit technology would enable the lending institution to keep its administrative costs sufficiently low - for example, by *externalizing the monitoring costs* to the group of borrowers. Group lending is possible at micro level because the Microenterprises are often engaged in 'survival' activities and therefore, their credit demand- both in terms of the purpose and the size of the maturity of the loans- is perceived to be quite homogeneous and unlikely to change significantly over time[40]. The Grameen Bank and financial NGOs, mostly modeled on the success of Grameen, mainly operate in rural areas, small towns, and around the suburbs. Clients of MFIs use the loans for service sector trading, vending, and small production activities. The Palli Karma-Sahayak Foundation (PKSF) is a major financial source for the micro-finance NGOs. It is an independent organization funded by a number of sources, included the donor community and the Bangladeshi government (SEDF, 2002). PKSF lends out money to these NGOs without collateral, but still claims to have a payback rate of close to 100%.

Non-bank Financial Institutions [NBFIs]

3.21 The NBFIs sector comprises 28 institutions including 4 licensed by Bangladesh Bank during 2001- 2002.These include 12 institutions engaged primarily in leasing business, 6 in investment financing business, 2 in housing and rest engaged in all these activities[41]. Of the 28 NBFIs, 12 are joint venture with foreign participation and one owned by the government. These institutions have remained marginal accounting for less than 4 percent of financial system assets. Gross assets of NBFIs stood at BDT 23 billion as of June 2002. Gross assets however grew by 50 percent in the year between 2000 and 2002.

3.22 Key indicators of NBFIs showed a mixed bag of performance. NBFIs primarily engaged in leasing had been the better performers. They had maintained a well-balanced and prudent performance in terms of financial indicators. As of end June 2002, total investments of NBFIs stood at BDT 24 billion. Industry's asset quality indicator showed increasing stress in terms of non-performing loans to gross investments. Ratio of NPL to gross investments climbed from 7 percent in year 2000 to almost 12 percent in end-June 2002[42]. It is envisaged that NBFIs would continue to progress and assume a significant role in addressing the development strategies of the country by complementing the banking sector to meet financing requirements of the changing economy.

Capital market/ Stock market

3.23 Banks continue to remain the main providers of long term investment finance in Bangladesh, direct issues of equity and debt in the capital market playing only a minor role. New issues through private placements and public offerings in the capital market in FY02 amounted to Taka 0.55 billion, against long-term bank loan disbursements of Taka

---

39 Grameen Bank. [Information available: http://www.grameenbank.org]
40 Martin Holtmann et al. "SME Financing: Lessons from Micro finance". SME Issues, Vol. 1, No. 1 November 2000.
41 Bangladesh Bank. [Information Available: Annual Report 2001-2002, http://www.bangladesh-bank.org]
42 Ibid.

35.05 billion[43]. The Taka 65.52 billion-market capitalisation of listed stocks in the Dhaka Stock Exchange as of end-June, 2002 likewise looks small, when seen against the Taka 166.80 billion outstanding long-term loans of banks (Bangladesh Bank, 2002). There are 47 listed companies in Dhaka Stock Exchange ("DSE"), which are declaring 10 percent or above dividend regularly (DSE, 2003). It indicates that the investors have to be cautious and analytical before investing in a company.

Table 14: Activities of the Dhaka Stock Exchange (DSE)

	End June		
	FY00	FY01	FY02
No of listed securities	239	244	257
Issued equity & debt (billion Taka)	30.52	32.23	34.97
Market capitalisation (billion Taka)	54.00	72.17	65.52
Turnover (billion Taka)	27.70	49.09	34.94
All-Share price index	561	716	793

Source: Bangladesh Bank, 2003.

Table 15: Industrial term loans by banks (Billion Taka)

	FY99	FY00	FY01	FY02
Disbursement	13.30	16.27	30.57	35.05
Recovery	10.93	16.53	27.95	32.13
Outstanding (end-June)	121.52	136.63	153.79	166.80

Source: Bangladesh Bank, 2003.

Table 16: Activities of Chittagong Stock exchange (CSE)

	End June		
	FY00	FY01	FY02
No of listed securities	163	171	184
Issued equity & debt (billion Taka)	26.66	28.42	30.81
Market capitalisation (billion Taka)	46.50	62.80	56.19
Turnover (billion Taka)	9.55	14.71	15.84
All-Share price index	1174	1502	1316

Source: Bangladesh Bank, 2003

3.24 The present limited role of the capital market in investment financing would expand if the infrastructure of corporate governance, financial disclosure and credit information improves. These measures will instill higher confidence or pull the institutional and prospective investors back to the bourses, especially after the 1996 share scam. Transparent trading rules, and safeguards against price manipulations are also important in sustaining the interest and confidence of savers in the capital market.

A new Chief Executive Officer has been recently appointed in the Stock Exchange Commission ("SEC"), the capital market regulatory authority and there has been already some measures undertaken like arranging a visit for the potential US investors to DSE.

43 *Ibid*

The major steps taken in FY02 by the SEC towards improvement of the issuance and trading environment in the capital market were as under[44]:

- Introduction of Central Depository Bangladesh Ltd (CDBL), a depository for paperless, electronic issuance and trading of securities, was accorded registration under the Depository Rules 2000; the CDBL is expected to be operational by the end of year 2003. It is expected to overcome document cheating.
- 20% initial public offerings ("IPOs") should be reserved for institutional investment.
- Create a suitable environment based on transparency, accountability and adequate rules and regulations to ensure smooth monitoring of activities to bring in more institutional investors like mutual funds, merchant banks and issue managers at DSE and CSE.
- Planning is going on to expedite court cases under the legal system to solve business disputes or to punish the errant companies.
- Abolishment of the weighted average index method and use of circuit breakers separately for shares and debentures for both the DSE and CSE effective from December 2003 (Dhaka Stock Exchange, 2003).

44 Khan, Dr. Salahuddin Ahmed Khan, Chief Executive Officer, Dhaka Stock Exchange (DSE). Interview with the Daily Star, November 6, 2003.

Chapter-4

4. Country Comparative Study

SMEs Development and Financing – Japan:
SME definition:
4.1 From the beginning of the 20th century, SMEs played a key role in elevating the Japanese economy to become one of the strongest in the world by raising productivity and efficiency through specialization in sub-assembly operations under cooperatives or sub-contracting and joint collaboration agreements with large firms. SMEs till today constitute 98% of all enterprises and employs 74% of the workforce of the country though exports as percentage of GDP is only 12% and shares of SMEs in total exports is 13.5%[45]. Following is the SMEs definition set by the Government of Japan:

Table 17: SMEs definition-Japan

Industries	Capital Size (million Yen)	Number of employees
1. Manufacturing and Others	¥300 million or less	300 or less
2, Wholesale	¥ 100 million or less	100 or less
3. Retail	¥ 50 million or less	50 or less
4. Services	¥ 50 million or less	100 or less

Source: JASMEC, 2003

A Historical Overview of SMEs Financial Development:
4.2. Though SMEs journey started in Japan during the early 20th century, many SMEs began operation during the reconstruction period after World War II. As part of the measures for SMEs and in order to prevent economic centralization, the Small and Medium Enterprise Agency was established in 1948 as an extra-ministerial bureau of the Ministry of Commerce and Industry under the guidance of GHQ (the General Headquarters of Allied Powers)[46]. Japan's measures for SMEs started then and have continued ever since. Following is the brief discussion of SMEs historical development and related financial policies for SMEs promotion and growth in Japan commencing from the reconstruction period[47].

Reconstruction Period (1945-1954)

4.3. During the reconstruction period, many SMEs faced problems like lack of materials for production, inflation, and preferences regarding distribution of materials to large-scale industries under the postwar recovery[48]. Also, SMEs were troubled by a low management level, especially in financial accounting; lack of technology, and funding capacity; aimless investment and production, etc.

The Establishment of the small and medium term agency

4.4. To ensure fair trade and to prohibit monopoly power, the Japanese Antimonopoly Act in the form of Law for Elimination of Excessive concentration of Economic Power was enacted in the year 1947.

45 APEC Survey of Small and Medium Enterprises. Member Report of Japan.
46 SME Policies and Historical Development. http://www.sme.ne.jp/policies.
47 After SecondWorld War.
48 SME Policies and Historical Development. http://www.sme.ne.jp/policies.

Preparing the Basic polices for SMEs Development

4.5. During the postwar recovery period, the basic tools for SME developments were prepared for financial resources, cooperatives and management consulting and guidance.

Financial Resource

4.6 Under financial polices for the development of SMEs, the National Life Finance Corporation was established in 1949 to extend loans to SMEs who had been in difficult financial situations in addition to the Shoko Chukin Bank established in 1936[49]. Then the Japan Finance Corporation for Small Business was established in 1953 with government equity to facilitate long-term funding for SMEs.

4.7 To strengthen the financial weakness of SMEs such as a lack of security, the complementary credit support system was started with Small and Medium Enterprise Credit Insurance Law in 1950 and the Credit Guarantee Association Law in 1953[50].

Cooperatives

4.8 The Law on the Cooperative Association of Small and Medium Enterprises was enacted in 1949 with the purpose of correcting the social and economical disadvantages of SMEs and of uplifting their social status[51]. Then cooperatives and groupings of SMEs proceeded.

Taxation

4.9 An important system in this category, the so-called "Blue Returns", started. Since the old official assessment was replaced by the self-assessed taxation system after the War, SMEs were in chaos due to incomplete bookkeeping and the fear of over-taxation. To resolve this situation, the Blue Returns system began in 1949, allowing certain tax merits if a tax return is made with a "certain formula of quick bookkeeping." This system resulted in not only the improvement of financial accounting but also the strengthening the financial system of SMEs.

The High Growth Period, the First Stage (1955-1962)

4.10 Through the Reconstruction Period and by the low 1950s, the Japanese economy recovered almost to the pre-War level and SMEs became very active. Capital investments called for further capital investment. The favorable economic cycle resulted in surging national income, to achieve High Economic Growth.

4.11 In the course of the economic recovery and high growth, large-scale enterprises and SMEs went with two different paces of growth attaining different levels of productivity, wages, technology and financing ability. Thus, the Japanese industry was considered to have a "Dual Industrial Structure" comprising "advanced large-scale enterprises" followed by less advanced "delayed SMEs"[52].

4.12 Through the first and second stages of the High Growth Period, stratification of enterprises developed with a parent enterprise at the top. Japanese SMEs industries became incorporated in division of labor structure, which was predominant in the electrical machinery manufacturing and transportation machinery industries. The

---

49 *Ibid.*
50 *Ibid.*
51 *Ibid*
52 *Ibid*

subsequent improvement of efficiency and progress in technology through economics of specialization with the combination of division of labor typifies the growth and development of Japanese SMEs during this period.

4.13 The Law on Financial Assistance for Promoting Small and Medium Enterprises was enacted in 1956 to support improvement in productivity by applying modern equipment[53]. Municipal governments began to loan under the said Law such funds as were necessary for modernizing equipment. In 1957, the Law Concerning the Organization of Small and Medium Enterprises was enacted. This law was designed to strengthen SME organizations and their business activities[54].

The High Growth Period, the Second Stage (1963-1972)

4.14 In 1960 and thereafter, policies were taken by the government to open the market for trade with foreign investors participation. Under such circumstances, promotion and subsequent development and growth of SMEs was considered a major priority by the government before attaining the objective of a balanced development of the national economy by upgrading the Japanese industrial structure and strengthening of its international competitiveness[55]. To achieve that target, the government promulgated Small and Medium Enterprise Basic Law (the SME Basic Law) in 1963.

4.15 The SME Basic Law was designed to (a) eliminate SMEs disadvantages derived from economical and social restrictions, (b) to support their self-help efforts, (c) to improve their productivity and trading conditions to reduce the dual-structured gap, and (d) to improve the social status of employees associated with the SMEs.

4.16 The Law on Financial and other Assistance for Small Business Modernization was promulgated in 1963 in order to upgrade SME structure and modernize their equipment. This law facilitates the promotion and up gradation of industries where the corporate form of business is basically partnership by forming subcontracting through cooperatives or joint ventures. A loan for upgrading existing technologies and equipments to growth potential SMEs was extended by the *Japan Small Business Promotion Corporation* in 1967 with government investment.

4.17 To safeguard the SMEs during the recession that developed in 1964, laws were established to ensure that a significant number of purchases and orders by the government and municipal governments were kept for SMEs. While international competitiveness became more important due to the deregulation in capital transactions in 1970, the Law on the Promotion of Subcontracting facilities to Small and Medium Enterprises was enacted in order to promote the modernization of subcontracting enterprises.

The Stable Growth Period (1973-1984)

4.18 With the first oil crisis in 1973, the Japanese economy turned from a high-growth period to a stable growth period. With this change, policies for SMEs changed direction from modernization of equipment for upgrading productivity through economies of scale to the establishment of an industrial structure based on “soft” management resources comprising technological innovations, highly skilled and efficient manpower, and free flow of information[56]. The Institute for Small Business Management and Technology was

---

53 Ibid.

54 Small and Medium Enterprise Agency, METI, Japan. http://www.chusha.meti.go.jp.

55 Ibid

56 SME Policies and Historical Development. http://www.sme.ne.jp/policies.

established in 1980 for developing human resources solely for that purpose. To ensure free flow of information on issues mainly concerning entrepreneurship development, product identification, quality assurance, financial facilities through formal sources for start-ups and working capital management etc., information centers at state and regional level were established for the development and growth of SMEs[57].

Transition Period, the First Stage (1985-1999)

4.19 From 1985 onwards, Japan experienced a drastic yen revaluation followed by depression. The yen revaluation dampened the competitiveness of particular types of industry in regions where such industries agglomerated[58]. Rather than shutting down the enterprises completely, government came up with policies to convert the loss making SMEs to help merge with large enterprises through joint agglomeration or cooperatives. If the merger fails to take place, acquisitions by large enterprises were encouraged[59].

4.20 After the collapse of the economic bubble in 1992, the start-ups rate decreased and the closure rate increased for SMEs, and Unemployment also tended to increase with this trend. In order to promote start-ups and starting new business of SMEs in such circumstances, the Temporary Law Concerning Measures for the Promotion of the Creative Business Activities of Small and Medium Enterprises was enacted in 1995. This law was designed to help SMEs and individuals to inaugurate new businesses or invest in research and development, without specifying particular type of industry.

4.21 In the 1980s and 1990s, the environment surrounding SMEs in Japan has undergone many major changes, as a result of intense competition, progress in Information Technology, and globalization[60]. Each SME had to make a change in direction from reduced costs ("cost-down")[61] competition, which has few future prospects, to management issues such as greater product quality and improvement in marketability. In such circumstances, in order to strengthen support for business innovation, the new Law on Supporting Business Innovation of Small and Medium Enterprises (1999) was enacted.

Transition Period, the Second Stage (2000-)

4.22 From the beginning of the 21st century, Japanese economy transformed to growth and maturity stage, where it is feeling the intensity the diversification of consumer needs, the IT Revolution, and the progress of globalization like any other countries around the world. These, along with other factors, have reduced the importance of trying to eliminate the scale gap between SMEs and large enterprises. Rather, there is an urge from the government to increase the number of enterprises engaged in diverse businesses within the same industry, to encourage firms to shift from mass production of standardized products to small-lot production of a variety of products, and to increase business opportunities while intensifying competition[62]. The government fundamentally revised and restructured conventional SME policies including the SME Basic Law in the

---

57 Ibid

58 Ibid

59 The Temporary Law concerning Measures for Changing Business for Specific Small and Medium Enterprises was enacted in 1986, in order to specify type of industry for SMEs and to help convert businesses. Also enacted was the Temporary Law concerning Measures for Small and Medium Enterprises of Specific Regions, in order to promote the conversion of businesses of SMEs in specific regions heavily influenced by the economic depression and yen revaluation.

60 Small and Medium Enterprise Agency, METI, Japan. http://www.chusha.meti.go.jp.

61 Fierce competition among firms to minimize costs effectively for survival and growth in the long term.

62 SME Policies and Historical Development. http://www.sme.ne.jp/policies.

so-called “SMEs Diet” commencing from December 1999[63]. The new SME Basic Law, which is based on a new philosophy of promoting diverse and vigorous growth and the development of independent SMEs, rather than rectifying the gaps, presents three key factors for SME policies. They are:

- Promoting business innovation and new business start-ups (or, promoting self-sustaining enterprises);
- Strengthening the management base of SMEs (or, enriching business resources); and
- Facilitating adaptation to economic and social changes (or, offering a safety net).
- In terms of assistance in fund-raising, new capital markets have started operating in the Japanese financial market, namely, “MOTHERS” from November 1999 and “Nasdaq Japan” from June of 2000. This measure has expanded options for SMEs to raise funds from such capital markets.
- In addition, a credit guarantee system was introduced for the issue of corporate bonds or privately placed bonds by SMEs, in order to promote development of the bond market available to SMEs.
- As a measure to support technological development, the entire government will try to provide subsidies for new business development and spend money on research entrusted to SMEs. The government established a SBIR system, or Small Business Innovation Research system, which offers consistent support up to the commercialization phase.

Main features of Previous and New SME goals and structures

Table 16: Main features of previous and new SME structures and goals

Previous SME Basic Structure	Current SME Basic Structure [added features]
Policy Objective: Reduce the gap between Large enterprises and SMEs in terms of productivity.	Policy Objective: Developing and growing a wide range of independent SMEs for greater economic dynamism, which would ensure, • Creation of new businesses • Promotion of market competition • Increase of attractive job opportunities and, • Revitalization of Economy
Policy Method: 1. Upgrading infrastructure of SMEs to enhance productivity through: • Modernization of facilities • Improvement of existing technologies used in production. • Rationalization in Business Management. • Optimization in Economies of Scale	Policy Method: 1. Providing government support for start-ups for ambitious yet growth potential enterprises by: • Promoting Business innovation (i.e. support for technology, equipments, intangible management resources etc.) • Providing information services, training programs, facilitating fund supply etc. • Providing subsidies, low-interest soft loans and special tax reductions to SMEs that plan to enter new business fields through start-ups, R & D and commercialization. • Raising venture capital funds for new enterprises and Research & Development based industries, especially IT, through stocks, bonds, warrants etc.

63 *Ibid.*

<table>
<tr><td>of production.
• Arrangement of joint operation in businesses through implementation cooperatives and sub-contracting.
• Streamline labor related policies.
• Transparent policies to enter and exit from any kind of business ventures.
• Focus more on commercial and service sectors.</td><td></td></tr>
<tr><td><u>Policy Method:</u>

2. Policies to Finance SME lending and taxation on SMEs
• Facilitating appropriate fund lending mainly through government loans, equity to facilitate long term funding and complementary credit support system.
• Enhancement of business capital
• Optimizing tax burden through establishment of “blue returns” system by allowing certain tax merits if a tax return is made with certain formula of quick bookkeeping.</td><td><u>Policy Method:</u>

2. Common policies to Finance SME lending and taxation on SMEs
• Facilitating appropriate fund lending through loans, credit insurance and credit guarantee system
• Enhancement of equity capital by allowing small and business investment banks and companies to underwrite new shares, corporate bonds and warrants issued by corporation with capital of not more than Yen 300 million and legally securing the limited liability of limited partners that have no involvement in business operations of investment business partnerships.

Optimizing tax burden through tax reduction while procuring raw materials and equipments, extension of deficit carrying over period and carry back of tax deficits, etc. for SMEs whose business plan and feasibility studies of the projects are acknowledged and approved by the government</td></tr>
<tr><td><u>Policy Method:</u>

3. Improving trade conditions through:

• Fair competition</td><td><u>Policy Method:</u>

3.Strengthening management base

• By ensuring managerial resources to SMEs
• <u>Technology / Equipment</u></td></tr>
</table>

[i.e., antimonopoly act in 1947] • Rationalization subcontracting activities between large and small firms • Export Promotion activities • Opportunities for procurement of receiving orders from government etc.	Financial and infrastructural support for creative technology development from government through subsidies and grants under Small Business Innovation Research ("SBIR") program and from Japan Small and Medium Enterprise ("JASMEC") through partnership.] <u>Information</u> Expert opinions on how to prepare a good business plan, evaluation of business feasibility and information on human resources, technology and other various needs are provided to SMEs through regional, local government and business support centers around the country. <u>Patent acquisition</u> State and local government support through free prior-art searches for technologies similar those for which SMEs are going to apply for patent and exemption of annual patent fees for SMEs in R & D or those without sufficient funds. <u>Create database to facilitate manufacturing growth</u> Database on human resources, banking sectors, public and private entities, subcontracting and joint agglomeration with SMEs to facilitate manufacturing activities, both home and abroad. • Stabilizing business management and facilitating change of business. • Facilitating collaboration and joint operation through cooperatives and sub-contracting. • Instill dynamism in Industrial and Commercial agglomeration through partnerships or merger and acquisitions. • Provision of mutual relief system for SMEs while facing natural calamities and legal system of bankruptcy for SMEs.

Source: Small and Medium Enterprise Information, JASMEC, 2002

Financial Support for SMEs

Loans

- Loan for managerial improvement funds of small-scale enterprises ("MARUKEI")

4.23 Government provides low-interest loans that need no collateral or guarantors to those who start up businesses and small-scale enterprises that have undergone management guidance under the new SME basic law.

- Special loans for start-ups

4.24 Government extends loans for facilities and operation to the entrepreneurs who start up business or SMEs that have been operating not more than five years since the start-up.

- Facilities fund system for small-scale enterprises

4.25 For those who start up businesses and small-scale enterprises, lending agencies of local government extend facility funds without interest. The fund is also used to procure raw materials and equipments that the SMEs need to pay by installments or they can use the fund to lease the resources to SMEs for certain agreed period of time.

- Special loans for fostering new developing projects

4.26 Special loans are prepared to support venture businesses that utilize new techniques or offer distinctive and unique goods or services. In the event of insufficient collateral, exception has been made by Japan Finance Corporation for Small Business ("JFS"), which accepts unsecured corporate bonds with subscription warrants on behalf of high growth potential SMEs.

- Replenishment of the low-interest loan system

4.27 Those who implement an acknowledged businesses plan for research and development, etc. or an approved business innovation plan are qualified to apply for various low-interest loan systems prepared by the Japan Finance Corporation for Small Business, National Life Finance Corporation, Shoko Chukin Bank, etc. Following Table 18 provides the salient facts regarding the shares of the government-supported loans for SMEs in Japan:

Table 17: Shares of Government supported loans in SME finance

[As of the end of March 2001] (Unit: Trillion Yen)

Business Category	Name	Total outstanding loans to SMEs	
Private Financial Institution	City Banks	102.7	32.4%
	Main Regional Banks	75.6	23.8%
	Secondary Regional Banks	28.9	9.1%
	Trust Banks and Long-Term Credit Banks	25.0	7.9%
	Shinkin Banks	45.9	14.5%
	Credit Cooperatives[64]	10.7	3.4%
	Sub-total	288.7	91.1%
Governmental Financial Institution	Japan Finance Corporation for Small Business[65]	7.5	2.4%
	National Life Finance Corporation[66]	9.8	3.1%
	Shoko Chukin Bank	10.9	3.4%
	Sub-total	28.2	8.9%
	Grand Total	316.9	100.00%

Source: Small and Medium Enterprise Information, JASMEC, 2002

Credit Guarantee

- Start-up support guarantee by Credit Guarantee Corporations

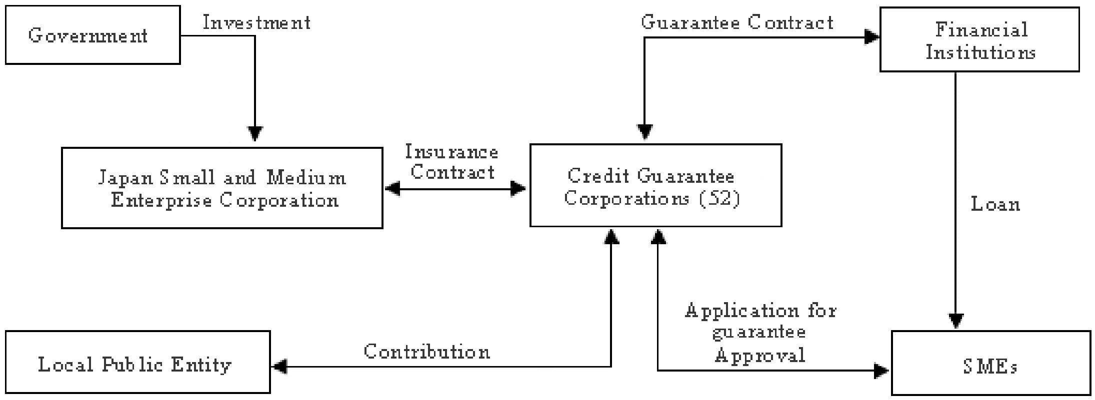
4.28 Existing Credit Guarantee Corporations of Japan provide unsecured debt guarantee to entrepreneurs, who are planning to start up a business or who is operating as an SME for less than five years. To encourage development and growth of SMEs based on backward and forward linkages, this unsecured debt guarantee facility is also extended to companies that are planning to spin off or has already spun off within the fives years counting from the credit guarantee application period. Following chart 3 shows how credit supplementation system works for SMEs in Japan:

64 Outstanding Guarantee Liabilities to SMEs (by Credit Guarantee Corporations, as of the end of March 2001): ¥ 41.2 trillion

65 Only loans to SMEs were considered

66 Only loans to SMEs were considered

Chart 3: Scheme Chart of the Credit Supplementation System for SMEs



Source: JASMEC, 2002

- Venture support guarantee by Credit Guarantee Corporations

4.29 New business exploitation guarantee: Credit Guarantee Corporations facilitate implementation of loans by extending debt guarantees for a business, in which the content of products or services, or the method of providing products or services, is not widely prevalent among SMEs.

4.30 Guarantee related to management resource utilization: Credit Guarantee Corporations provide debt guarantee to SMEs that exploit new business such as development of new products, technologies, and services in accordance with a new business plan for management resource utilization approved by the Japanese government under "special Measures for Industrial Revitalization".

4.31 Business innovation- related guarantee: Credit Guarantee Corporations provide debt guarantee to SMEs that conduct new business activities such as development of new products and services in accordance with a business innovation plan that is approved under *supporting Business Innovation of Small and Medium Enterprises scheme*.

- Expansion of the debt guarantee system

4.32 For the borrowing of funds for implementing an acknowledged business plan for research and development or an approved business innovation plan, there are measures to raise the insurance limit on the new business exploitation insurance, and separating the insurance limits on the ordinary insurance, unsecured insurance, and special small lot insurance. In addition, exceptional measures, such as special cases that need no collateral or a third party's guarantee, are taken for the new business exploitation insurance concerning an acknowledged business plan for research and development.

Investment

- Support for fund procurement by stock and corporate bonds through venture foundations

4.33 Local government SMEs support foundations and others (venture foundations) patronage creative SMEs in their fund procurement through venture capitals (VC) by utilizing the upgrading loan system of Japan Small and Medium Enterprise Corporation ("JASMEC").

4.34 A corporation or an entity that plans to set up a new business venture is eligible to drum up and accumulate funds through the issuance of new stocks and bonds if it gets the approval or acknowledgement under the "*Law concerning the Promotion of Creative Activities of SMEs*" by the government or by a venture foundation.

Table 19: Details of investment support

Types of support	Brief details of the supporting schemes
1. Indirect Investment	Investment (acceptance of stock, corporate bonds, and warrant bonds) through VC that has received low-interest deposit as investment source from a venture foundation
2. Direct Investment	Acceptance of creative SMEs' stock and corporate bonds (Corporate Bond and warrant bonds) by a venture foundation
3. Debt Guarantee	In order to encourage VCs to accept corporate bonds, venture foundations guarantee part (70%) of corporate bonds accepted by VCs when certain conditions are met (such as approval under the Law concerning the Promotion of Creative Activities of SMEs).
4. Venture Lease Project	A venture foundation provides lease and sales by installment of facilities to venture businesses. Cooperative lease with a private lease company is also possible.

Source: JASMEC, 2002

- Investment project for promoting new business creation through the Limited Partnership for Venture Capital Investment

4.35 A private venture as an executive partner and JASMEC as a limited partner together establish a Limited Partnership for Venture Capital Investment to invest in domestic SMEs at an early stage of growth. JASMEC invests in the Partnership.

- Investment by Small and Medium Business Investment and Consultation companies

4.36 Small and Medium Business Investment and Consultation Companies accept stocks, corporate bonds, and warrant bonds for entrepreneurs that establish a new business and enterprises with advanced or creative technology and know-how.

- Promotion of risk money supply by the angel (personal investor) tax system

4.37 In terms of personal investment in the stock of R&D- type SMEs that have been established within the last ten years, in addition to the angel tax system (capital loss may be carried over three years and added with capital gain on other stock) a new measure has been taken to reduce capital gain by one-fourth that arises from initial public offerings [IPOs] of stocks.

Subsidies

- Project to grant subsidies for new business exploitation (by JASMEC)

4.38 Subsidies are granted to the potential SMEs that capture the actualization of a new idea that contributes to the development of new and innovative products and services.

- Project to grant subsidies for support of new business exploitation (by JASMEC)

4.39 Subsidies are granted to projects conducted by institutions that support SMEs by organizing seminars and training for the entrepreneurs and by providing necessary information and guidance to start up a business or to exploit new avenues. Government and the supporting organizations provide subsidies to cover part of the expense for the projects that serve as a model for other SMEs, such as new business trend survey projects under an approved business innovation plan, new products and technique development projects, sales channel exploitation projects, and human resource fostering projects.

Tax System

- Special depreciation and tax credits concerning investment in equipment

4.40 In terms of machines for business use whose unit or set price is not less than ¥ 2.8 million or not less than ¥ 3.7 million for leased machines - tax credit[67] of 7% of the acquisition cost or special depreciation of 30% is given to the following:

- A corporation (except certain associations) or a sole proprietor that has been doing business for less than 5 years since start-up and is currently engaged in the manufacturing, printing, software, or information processing service industries.
- When the ratio of experiment / research expense to sales is more than 3% than in the previous fiscal or calendar year.
- A corporation or a sole proprietor that intends to implement an approved business plan for research and development, etc.

- Extension of the period allowed for carrying over deficits

4.41 For corporations (except associations) that intend to implement an approved business plan for research and development, etc., the period allowed for carrying over the deficit that generates during the period for implementing the approved business plan (until the business year includes the day after a full 5 years since the start-up) is extended to 7 years from the normal 5 years.

- Carry-back of deficits

4.42 The deficit incurred in SMEs that are corporations established within the last five years may be carried back for the previous year.

SMEs Development and Financing – UK:
SME definition

4.43 In United Kingdom, SMEs is currently defined as the following:

Table 20: SMEs definition- United Kingdom

Type	No. of employees
Small (including Micro businesses)	Up to 49 employees
Medium	50 to 249 employees

Source: SME Information Network, University of Bradford, 2003

4.44 Under European Union ["EU"], SMEs of UK like other member countries has to adopt a common definition so that same policies approved by EU commission can be implemented in multifarious countries. The European Commission has agreed to adopt a new definition of micro, small and medium-sized enterprises (SMEs), aimed at promoting entrepreneurship, investment and growth, facilitating access to venture capital, cutting administrative burdens and increasing legal certainty[68].

4.45 The new definition was shaped by two rounds of extensive public consultation. It maintains the different staff thresholds which define the categories of micro, small and medium-sized enterprises. To allow a smooth transition at EU and national level, the new definition will be used as of 1 January 2005.

67 Tax credit of 7% of the amount corresponding to 60% of the total lease cost for leased machines.
68 SME Knowledge Network, University of Bradford. http://www.bradford.ac.uk/smenetwork

Table 21: New deifinition of SMEs under European Union

Enterprise category	Headcount	Turnover	or	Balance sheet total
Medium-sized	< 250	€ 50 million		€ 43 million
Small	< 50	€ 10 million		€ 10 million
Micro	< 10	€ 2 million		€ 2 million

Source: European Commission, 5 September 2003

SMEs contributions to UK economy

4.46 At the beginning of 2000, it was estimated that there were 3.7 million businesses that were considered a to be active in UK. Of these, small businesses accounted for over 99% and a further 25,000 were of medium size[69]. Thus, SMEs in UK constitute a large percentage of total enterprises like the ones in the developing and developed countries.

4.47 Compared to 20 years ago the level of business stock is approximately 1.3 million higher, and in the past 5 years the area of business showing most moderate growth has been in the 'micro' business sector - organizations employing 10 people or less - this trend looks set to continue[70]. Most of these small firms are new or young businesses - the average of UK enterprise is around 7 years.

4.48 There is also great variance in how numbers employed are spread amongst industry sectors. For example, the share of businesses with fewer than 50 employees can vary from Agriculture (90%) and Construction (76%) to Finance (14%) and Mining (5%)[71]. Based on VAT registration, there is major regional variance in the creation of smaller business. London significantly outperforms the rest of the UK followed by the South East, East and South West displaying higher than average rates. The midlands and the North West show average rates, whilst Scotland, Wales, the North East and Yorkshire & Humber are below average

4.49 Exports: Surveys from the earlier part of the 1990s indicate that only 3.9% of UK businesses sell their products or services overseas. It is estimated that only 100,000 can be regarded as active exporters - 10% of these are small or micro firms.

4.50 Ownership structure: Almost 2.6 million businesses are sole proprietorships and partnerships, which comprise of owner-managers who are self-employed. Approximately 1.1 million enterprises employ people. It is estimated that 7% of all businesses are owned by people who belong to ethnic minorities, and although there are no official statistics available, research undertaken by Barclays Bank would tend to suggest that a third of all businesses are owned by women.

4.51 Facts about UK SMEs:

- 44% of UK SMEs export to Europe
- 38% of SME executives are able to negotiate in two or more languages
- 88% perceive the need for employee training
- 58% of all UK employment is accounted for by SMEs
- 20% have active e-commerce to sell products and services
- 78% of non-e-commerce intend to set up in 2003 / 2004
- 23% of UK manufacturers are SMEs
- 6% of SMEs with websites have a payment facility
- 72% of SMEs are unsure of current interest rates
- 89% would have no clear idea about how to raise outside finance for their business

Source: DTI[72] 2002 Prodata Report

69 Ibid
70 Ibid
71 SMEs in UK. http://www.sme.co.uk
72 Department of Trade and Industry, United Kingdom

SMEs industry breakdown

4.52 General Business activity and construction business seems to constitute majority of SMEs involvement in UK followed by retail & wholesale business and entertainment. Following table shows the SMEs industry breakdown in succinct form:

Table 22: SMEs industry breakdown

Type of Industry	Market Share
1. General Business Activity	22.1 %
2. Construction	18.1 %
3. Wholesale, retail & repair	14.4 %
4. Entertainment / Social	10.0 %
5. Transport / Communications	6.1 %
6. Health / Social Work	5.5 %
7. Manufacturing	9.1 %
8. Agriculture	5.3 %
9. Hotels/ Restaurants	4.2 %
10. Education	3.2 %
11. Financial	1.6 %

Source: DTI 2002 Prodata Report

SMEs financing

Government support for SME financing

4.53 The project has considered both existing loans to business in the UK and areas where further use might be made of government loans. There are few cases of government directly lending or providing investment to businesses. More often intervention is through the use of loan guarantees and occasionally through interest rate subsidies. International comparisons suggest the UK makes relatively little use of loans.

4.54 Compared to other European Union countries, UK makes much greater use of grants to provide credit support to businesses (94% compared with an EU average of 58%) and correspondingly less use of loans and other sorts of support[73]. Looking at grants and tax exemptions together, as both represent direct subsidy, the difference is not so great: 96% compared with a EU average of 81%[74].

4.55 UK primarily uses grants to facilitate SMEs finances whereas other countries provide a range of support through loans and risk capital as well as grants (for example Germany provides loans for regional support and Italy and France provide loans for R&D)[75]. The UK has recently been making more use of equity-based schemes, through the Enterprise Fund, Regional Venture Capital Funds and the Coalfields Enterprise Fund, with the Community Development Venture Fund and the Community Investment Tax Credit soon to follow.

Small Firms Loan Guarantee Scheme

4.56 The Small Firms Loan Guarantee Scheme (SFLGS) aims to assist viable small businesses access loans where conventional finance is unavailable because of a lack of security[76].

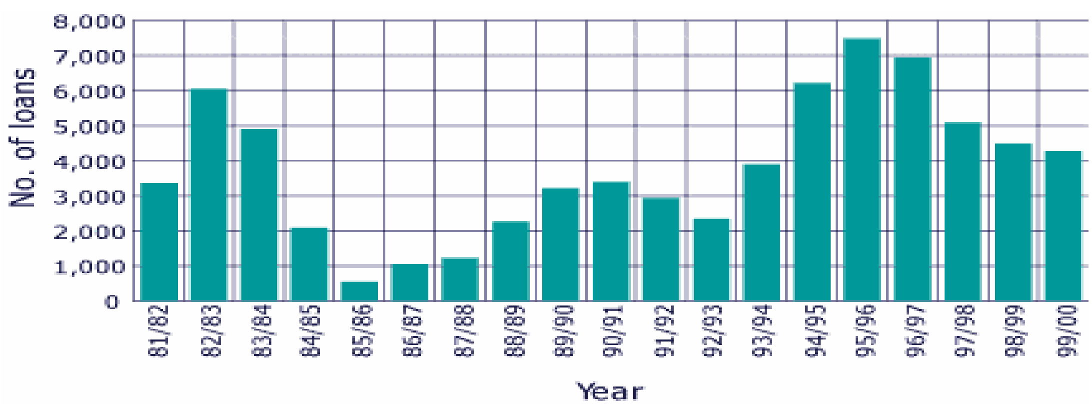
73 Small Business Service. http://www.sbs.gov.uk
74 Ibid
75 Small Business Service. http://www.sbs.gov.uk
76 Ibid

4.57 The Scheme guarantees loans from banks and other financial institutions for small businesses with viable business proposals that have tried and failed to obtain a conventional loan because of a lack of security. Loans are available for periods of between two and ten years on sums from £5,000 to £100,000 (£250,000 in the case of businesses which have been trading for two years or more)[77]. The Department of Trade and Industry (DTI) guarantees 70% of the loan for businesses trading for less than two years, rising to 85% for businesses trading for two years or more. In return for the guarantee, the borrower pays the Small Business Service (SBS) a premium of either 0.5% or 1.5% per year on the outstanding amount of the loan[78]. The commercial aspects of the loan are matters between the borrower and the lender. Typically rates are 2-3% above the base rate.

4.58 To be eligible, a firm must have an annual turnover of no more than £1.5 million (£5 million for a manufacturer). There are a number of exclusions, including retail. Until November 1998 agriculture was not covered by the Scheme, given EU State aid constraints, but a variant of the Scheme is now available in this sector. Loans are available for most business purposes (including provision of working capital), although there are some restrictions. DTI is liable to pay out all legitimate calls on the guarantee for defaulting loans. The full contingent liability is currently around £400 million[79].

4.59 The Government gets revenue from the Scheme from (i) premium payments on guaranteed loans and (ii) where loans default and some of the capital is subsequently recovered by banks (and would be split between SBS and banks 70:30 or 85:15). Chart 3 shows the annual number of loans made under the Scheme. It can be seen that there have been significant variations in the use of the Scheme. Changes in Scheme parameters have a strong impact on take-up, e.g. increase in the premium in 1984 led to a sharp fall in demand. External factors also help determine SFLGS demand, e.g. overall state of the economy, real interest rates and house prices.

Chart 4: Number of guaranteed loans each year



Source: Small Business Service, UK, 2003.

Small Firms Training Loan Program

4.60 The Program aims to encourage more vocational education and training to take place in the small firms sector, to increase productivity and growth. It is administered via

77 *Ibid*

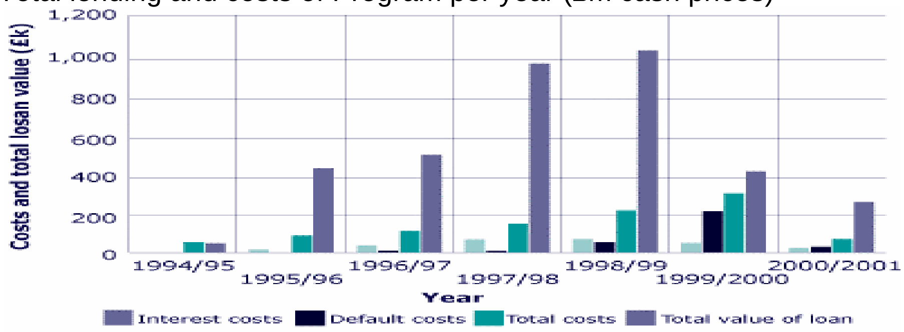
78 *Ibid*

79 *Small Business Service. http://www.sbs.gov.uk*

the Department for Education and Skills (DfES) in partnership with eight well established banks, to help small firms access funds for training[80].

4.61 The Small Firms Training Loan Program (SFTLP) was introduced throughout Great Britain in 1994. The Program provides assistance to small firms in developing and financing their training plans through borrowing, by offering loans, which include a repayment holiday and preferential rates of interest. The intention is that this will overcome the resistance of many small businesses to invest in training. Chart 5 shows the annual costs of the scheme and the total value of loans made in any year. It is notable that the administration costs (particularly the program support costs) are quite high relative to the value of loans, though this is largely a product of low take-up in most years[81].

Chart 5: Total lending and costs of Program per year (£m cash prices)



Source: Small Business Service, UK, 2003.

Credit finance

4.62 As mentioned before, the government and the financial institutions provide different forms of credit finance for start-ups and working capital management of SMEs. Small firms have a high reliance on short term financing through the banking sector. In fact, shareholders finance a low proportion of SMEs assets so debt to equity ratios is relatively high compared to large firms[82].

Guarantee Schemes

4.63 A number of public and private authorities have put in place guarantee schemes to encourage banks to make loans to SMEs, which otherwise probably would not. Borrowers may pay a premium for this service, but it is usually a small amount in relation to the loan itself[83].

4.64 Besides from the public or private entities in UK, SMEs can get hold of the guarantee schemes initiated by the EU and/or the European Investment Fund ["EIF"] namely:

- The EIF Guarantee Operations
- The SME Guarantee Facility
- The Growth and Environment scheme and
- Mutual Guarantee Schemes.

80 Ibid
81 Ibid
82 Ibid
83 SME Knowledge Network, University of Bradford. http://www.bradford.ac.uk/smenetwork

Venture Capital

4.65 Venture capital[84] is another popular and active form of SMEs financing in UK. For many rapidly growing enterprises, particularly in the high tech sectors, venture capital is the preferable alternative. Such enterprises lack tangible assets and cash flow. At the same time, they are attractive to investors because of their potential for high growth and profits. Venture capital also provides a solution for entrepreneurs seeking to start a business and for entrepreneurial managers who want to buy companies they already manage. In addition, venture capital is expected to bring other benefits as well. Financing of growth potential SMEs is not merely a question of supply and demand for funding, but a co-operation between the entrepreneur and the investor. This should be taken into account when planning funding strategies for a growing company. For example, in situations where markets are growing fast, rapid growth might be the only opportunity for a company to survive. In this situation entrepreneurs need back up, good connections and business knowledge in order to take the right decisions. This kind of expertise must be required from a management team of a venture capital fund.

4.66 Compared to US, in terms of volume of transactions, venture capital has not yet developed into a main source of SMEs financing. This "equity gap" is caused by a number of interrelated factors: lack of information among venture capital investors, a weak incentive structure for early stage investments, unwillingness to take risks, unfavorable tax provisions, lack of exit possibilities, etc[85]. As a result, many bright and innovative ideas from potential managers residing in UK end up being developed in the United States or elsewhere, where capital, know-how and the business environment are more conducive to their development and success.

4.67 In UK, lack of venture capital makes many companies over dependent on bank loans and overdrafts for early stage financing. Such financing is usually less flexible, more expensive and less secure. Moreover, since most of the investments made by companies in their early stages of development are intangible, venture capital is the preferable option for many of them.

Leasing

4.68 Leasing has also become a popular form of financing for SMEs in UK in recent times. Due to expensiveness of the bank loans and overdrafts, SMEs are now focusing more on leasing and hire purchase for start-ups and for expansion.

Programs financed by State budgets and EU

4.69 EU initiatives to improve SMEs' access to finance have gained in importance in the last couple of years. This is due to the growing awareness of the problems many European enterprises encounter in obtaining debt finance and risk capital and that the creation of a more favorable financial environment for enterprises. Entrepreneurship constitutes one of the four pillars of the EU Employment Guidelines, which specifically underline the need to improve the conditions of risk capital markets, and to narrow Europe's "equity gap"[86]. The ambition is to create the right conditions for SMEs to start

84 Venture capital is external equity capital invested in companies with growth potential, often hi-tech, and which are not quoted on a stock market. Venture capital generally consists of funds raised on the capital market by specialized venture capital operators (hereafter VC-operators). The equity investment is made for the launch, early development and expansion of a business and the main purpose is to raise the market value of the growing company.

85 European Investment Bank (EIB) assessment on UK, 2003.

86 Ibid

up, flourish and grow and for those with the best growth prospects to be eventually quoted on European Stock Exchanges.

4.70 Like other European union member countries, SMEs in UK can obtain funds from different venture capital and credit guarantee facilities. Following table shows the kind of facilities that are available for SMEs to obtain funds:

Table 23: Venture Capital and SME Guarantees through European Union

	EIF[87] / ETF[88]	ETF Start up	I-TEC[89]	Eurotech[90]	CREA[91]
Funding	Investment in funds, Max. 25%, 12.5 M Euro	Investment in funds, Max. 25%, 10 M Euro	Grant max. 50 the operational of the fund Management. Max. 300,000 E	Grant to fund Management	Repayable loan, 50% of the opera costs of the management Max. 500,000 Eu
Budget an Duration	Approx. 200 M Euro	170 – 190 M E	11 M Euro		8 M Euro
Beneficiari	Funds >15 M E Investing In innovative, High-tech Companies in Stages	Small funds (min. 5 - 10 M or newly establ or regional, sec technology Specialized, or R&D-oriented	Funds speciali New companie Regional focus R&D-oriented	Funds focused on Transnational High Technology Projects (THTPs)	Funds establishe 1.10.1997 or yet to be estal Focused on busi Creation And transition of Ownership
SME Defir	EIB	Community	Community	EIB	Community (sma enterpr.)
Employees	< 500	< 250, focus <	< 250	< 500	< 50
Turnover	Max. 75 M Eur	Max. 40 M Eur	Max. 40 M Eur	Max. 75 M Eur	Max. 7 M Euro
Ownership Investmen Stage	≤ 1/3 by non-S All stages, bias Early stage	≤ 1/4 by non-S Seed, start up, Early stage	≤ 1/4 by non-S Early stage	≤ 1/3 by non-S All stages	Max. ¼ by a larg Company Seed finance an Transfer Period
Contact po	All stages, bias Early stage	Seed, start up, Early stage	Early stage	All stages	Seed finance an Transfer Period
Source of Finance	EIF Equity Tea	EIF Equity Tea	DG Enterprise LIFT Helpdesk	DG Economic Financial Affair Financial Operations Ser	DG Enterprise /B
Funding	EIF, EIB	Community bu	Community bu	Community bu	Community budg

Source: EU Funds, 2002

4.71 Funding can also be generated for SMEs through joint ventures or mergers. SMEs can get into joint venture programs not only with large and similar SMEs within EU but also enterprises around the world that suits their export and promotional objectives. Following table discusses the joint venture programs available under EU:

87 European Investment Fund
88 European Technology Facility
89 Innovation and Technology Equity Capital
90 Eurotech Capital
91 Capital Risque pour les Enterprises d'Amorçage

Table 24: Funding for Joint Ventures under European Union Programs for SMEs

	JEV[92]	ECIP[93] (all facilities closed)	JOP[94]
Budget and Duration	80-100 million Euros 1998-2000	250 million Euros 1995-1999	
Beneficiaries	Joint Ventures: every type of Consortium, partnership or Common enterprise between at least two SMEs from two EEA-states	Facility 1: Chambers of Commerce, Professional Organizations. Facility 2: EU-companies Wishing to undertake a JV-project with Companies from countries in Asia, Latin America, The Mediterranean and South Africa. Facility 3 and 4: JVs established in one of those countries with locals by EU partners	Facility 1 (closed): JOP-Financial Institutions, Chambers of Commerce, etc. Facility 2 (closed): EU-Companies wishing to undertake a JV-project with companies in CEEC[95], NIS[96] or Mongolia. Facilities 3 and 4 (closed): JVs established in one of those countries with locals by EU-partner
SME Definition Employees	Community < 250	< 500	Community < 250
Turnover	Max. 40 million Euros	< 75 million Euros	Max. 40 Meuro
Ownership	≤ ¼ by non-SME	≤ 1/2 larger company	≤ 1/4 by non-SME
Type of projects funded	1. Preparations for setting up a joint venture 2. Investments in the joint venture	1. Identification of JV-Partners and projects. 2. Feasibility studies 3. JV capital requirements 4. Training, technical or Management assistance	1. Identification of JV-Partners and projects. 2. Pre-feasibility and Feasibility studies 3. JV capital requirements 4. Training, technical or Management assistance
Type of funding	Preparation phase: Reimbursable advance that can be transformed into a grant. Investment phase: Grant. Max amount: 100,000 Euros	1. Grant 50%, max 100,000 Euros 2. Interest free advances 3. Equity hold or loans 4. Interest free loan or grant Max support/project for 2,3,4 Together is 1 million Euros	Grant 50%, max 100,000 Euros Grant, 50% of pre-feasibility Study. Interest free financing, 50% of feasibility study Grant, 10% for JVs in CEECs Equity and loans, 20% for JVs in NIS and Mongolia 4. Grant 50% of eligible costs

92 Joint Economic Venture (JEV)
93 European Community Investment Partners (ECIP)
94 Joint-Venture Programme
95 Central and Eastern European Countries (CEEC): Albania, Bosnia-Herzegovina, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Slovakia, Slovenia
96 New Independent States (NIS) and Mongolia: Armenia, Azerbaijan, Georgia, Moldova, Mongolia, Russian Federation, Ukraine, Uzbekistan

SMEs Development and Financing – USA:

SME definition

4.72 From the beginning of the 19th century, SMEs played a significant role in providing jobs to the immigrants and the unemployed, which ultimately played a key part in transforming USA into a major economic superpower. SMEs, in fact, constitute 98% of all business enterprises in USA employing 53% of the labor force (APEC Report, 2001)[97].

SMEs financing

4.73 The most common forms of SMEs financing in USA are as follows:

- Personal Savings
- Debt financing
- Equity Financing
- Government Programs

Personal Savings

4.74 To launch their business ventures and to survive and grow initially, small and medium entrepreneurs rely mainly on their *personal savings*. They also depend on their *mortgage financing* and *credit cards* to start their business[98].

Debt financing

Loans from friends and family

4.75 Just like any other countries, most small and medium entrepreneurs depend on friends and family as critical sources of funds for their start-up firms.

Loans from financial institutions

4.76 Financial institutions provide different kinds of loans to suit the needs of the potential entrepreneurs. To provide loans to SMEs, credit guarantee schemes under private and public entities are there to help the banks to extend loans to entrepreneurs to start or to expand their businesses, which they wouldn't have done if there were no guarantees from third party sources.

Assets based financing

4.77 Under asset based financing, accounts receivable and inventory can be used as collateral to provide loans to potential SMEs (US Chambers of Commerce and Industry, 2003).

Leasing

4.78 Recently, leasing has become a major source of financing for SMEs. Rather than taking loans from formal and informal sources, entrepreneurs lease equipments, premises and technologies to launch their products and services.

Trade Credit

4.79 In USA, Suppliers often provide an easily available way to supplement conventional borrowing to SMEs, where without this facility it would be almost impossible to provide the necessary goods and services.

Life Insurance companies

4.80 Life insurance companies have low-interest policy loans to SMEs to supplement conventional borrowing, where the sources of funds are clients from different levels of income.

---

97 Small and Medium Enterprise Ministerial Meeting, Thailand. "The Continuum of Capital Formation in the United States". Member Report: USA, APEC, August 2003.

98 US Chambers of Commerce and Industry. . http://www.uschambers.com

Equity based financing

Equity formation through cooperatives

4.81 Equity formation through Cooperative agreements with other businesses of any size for sharing costs is common among SMEs or any new entrepreneurs with good growth prospects of their business ventures.

Angel investors club

4.82 Wealthy individuals and entrepreneurs that have cashed in on their successful enterprises, popularly known as angel investors in USA, provide an important source of necessary funds to SMEs. Angel investors traditionally focus on entrepreneurial ventures at the early stages of development, before the rollout of products or expansion phases[99]. Angels assume great risk in the expectation of high returns. They contribute more than just money to their portfolio companies- they sit on the board of directors, offer advice on product development, prepare marketing strategies, and help secure follow-on financial deals.

Venture Capital

4.83 Besides Angel investors, there exist venture capital firms in USA that contribute more than capital to the invested companies – they bring industry knowledge, technological know-how as well as financial expertise[100]. In USA, major providers of venture capital are: private and public pension funds, endowments, foundations, corporations, foreign investors and wealthy individuals.

Initial Public Offerings and Private Placements

4.84 SMEs can raise capital through initial public offerings and private placements at the vibrant and well-organized US capital market, which supports an environment that encourages transparency, confidence, competition and innovation. For the initial public offerings, SMEs need to follow stringent Stock Exchange Commission [“SEC”] regulations, whereas, private placements allow the firms to raise funds by selling an issue of debt or equity securities to buyers that qualify as accredited investors[101]. Since accredited investors are presumed to be experienced and well knowledgeable investors, sales to them are exempt from the registration requirements of the SEC.

Employees Stock Ownership

4.85 Employee stock ownership plans that allow employees to own a piece of the business boost production and provide leverage for additional financing for new entrepreneurs or entrepreneurs who are already started their operations.

Government Programs

Small Business Investment Company (“SBIC”)

4.86 To promote equity investment in small firms during the early stage of market development of young companies, mainly SMEs, US Small Business Administration (“SBA”) launched Small Business Investment Company (“SBIC”) in the 1960s[102]. It helped develop the culture and the emergence of financial professionals in venture investing that led to the creation of a competitive market in the 1980s and especially, during the 1990s.

Regional cooperation through the creation of FTAs

4.87 Government encourages formation of cooperatives or industrial cooperation among SMEs under the Free Trade Agreements [“FTA”] of the selected countries. Under FTA agreements, SME conglomerations are formed with other North and South American countries, members of APEC like Singapore, Australia, etc.

---

99 Small and Medium Enterprise Ministerial Meeting, Thailand. “The Continuum of Capital Formation in the United States”. Member Report: USA, APEC, August 2003.

100 Ibid

101 Ibid

102 Small Business Administration. http://www.sba.gov

SMEs Development and Financing – China & Hong Kong:

SME definition

4.88 In terms of job creation and expanding entrepreneurship, SMEs plays a key role both in Mainland China and it's annexure, Hong Kong. SMEs constitute around 98% of all enterprises and SMEs share in employment is 63% in Hong Kong alone. As at December 2000, there are approximately 290,000 registered SMEs in Hong Kong.

4.89 In both Hong Kong and China, SMEs are defined as following,

Table 25: SMEs definition-China and Hong Kong

Industries	Capital Size (million Yen)	Number of employees
1. Manufacturing	US $ 8 million or less	100 or less
2, Non-manufacturing	US $ 5 million or less	50 or less

Source: APEC Member Report, Hong Kong, 2001

4.90 As the economic development of Hong Kong and the mainland are intertwined, the SME policies and support schemes are almost similar in most cases. The report focuses on SMEs development and financing mainly on Hong Kong rather than China due to availability of information from reliable sources[103].

Distribution pattern of SMEs- Hong Kong

4.91 SMEs comprise around 98% of all the enterprises in Hong Kong[104]. Distribution pattern of SMEs are explained below:

Table 26: Distribution Pattern of SMEs

Sl. No.	Type of Industry	Percentage Share of SMEs in each sector	Distribution of SMEs among the sectors	Percentage share in terms of sales volume[105]
1.	Agriculture & Fisheries	100 %	Not available	100 %
2.	Mining and Quarrying	66.67 %	0.001 %	35.6 %
3.	Manufacturing	98.18 %	13.86 %	53.0 %
4.	Electricity, gas & Water	83.87 %	0.01 %	1.5 %
5.	Construction	Not available	Not available	46.3 %
6.	Commerce	98.87%	60.51 %	74.4%
7.	Transportation, storage & communications	96.16%	2.74 %	37. 3 %
8.	Finance, insurance, real estate & business services	97.88 %	14.55 %	44.9 %
9.	Community, social and personal services	96.41 %	8.32 %	Not available

Source: SMEs in Hong Kong, 1993

103 APEC survey of SMEs on Hong Kong, 2001

104 Hall, Chris. "APEC and SME Policy: Suggestions for an Action Agenda". University of Technology, Sydney [20 01].

105 SMEs percentage share in terms of sales volume is calculated in Gross output for mining & quarrying, manufacturing, utilities; gross value of construction performed for construction industry; sales & other receipts for commerce; business receipts & other income for transportation and communications and, the financial & retail sector.

Main Problems encountered by SMEs:

4.92 Like many other ASEAN and APEC countries, SMEs in Hong Kong and mainland China faces the following constraints:

- Lack of adequate collateral for obtaining additional bank financing for business expansion.
- Increasing costs of production and operation, particularly labor and property costs.
- More susceptible to fluctuation due to small volume of business.
- Limited ability to diversify investments due to limited funds available.
- Weaker bargaining power in obtaining favorable terms.
- Tight labor market and difficulty in recruiting and retaining staff.
- Keen competition in overseas markets.
- Tariff and non-tariff barriers in overseas markets.
- Increasing regulations for environmental protection.

4.93 Hong Kong government came up with the following means to overcome most of the constraints faced by SMEs; they are, as follows,

- Increasing automation and streamlining procedures to improve efficiency.
- Industrial upgrading.
- Removal of restrictive measures in overseas markets.

4.94 The relocation of labor-intensive processes offshore such as to Southern China has allowed Hong Kong manufacturing enterprises, including SMEs, to continue to compete on low-cost basis in the lower-end market segment while those remaining in Hong Kong, again including SMEs, can switch to the production of technology-intensive and products in the upper-end of the market[106]. Hong Kong manufacturers are continuously improving their productivity and moving up the value-added ladder so that they remain competitive in the world market.

4.95 The need to support Hong Kong's production base in Southern China has resulted in a demand for the services industries e.g. trading, transport, communications and finance, hence providing more opportunities for SMEs as well as large enterprises in the services sector.

4.96 After extensive consultation with the public, in particular SME associations, the *Small Medium Enterprise Committee* of Hong Kong, known as *"Committee"* for short, reckons that in the face of three major economic developments, namely globalization of world economy, China's accession to the World Trade Organization (WTO) and the emergence of a knowledge-based economy, SMEs need greater support in six areas, namely, business environment, financing, corporate governance and culture, human resources, technology application, and market expansion if they are to rise to new challenges and capitalize on new business opportunities[107].

Financial Schemes for SMEs

Establishment of four funding schemes

4.97 Hong Kong government in collaboration with Small medium development committee or Committee" set up four funding schemes to help SMEs enhance their overall competitiveness. The details of the recommendations are set out below.

- SME Business Installations and Equipment Loan Guarantee Scheme

4.98 Around $500m million is allocated for SME Business Installations and Equipment Loan Guarantee Scheme to help SMEs secure loans from banks and financial institutions to acquire the necessary business installations and equipment for enhancing productivity and competitiveness. The maximum amount of guarantee that an SME can receive is 50% of the loan or $500,000 (whichever is the less). The maximum guarantee

106 APEC survey of Small Business Enterprises. Member Report of Hong Kong. APEC, 2001.
107 Ibid

period is three years. To encourage SMEs improve their financial management and to increase the transparency of their accounts, SMEs wishing to make use of the scheme are required to submit audited accounts to the relevant lending institutions.

4.99 The Committee estimates that under normal circumstances, the overall default rate of the Scheme should not exceed 15%. In order to benefit as many SMEs as possible, the Committee suggests that the Government work on the basis of a 15% default rate. With a capital amount of $500 million the Government will be able to commit a total of $3.3 billion as the maximum amount of guarantees for the scheme[108]. Under this scenario, it is estimated that the scheme will help SMEs raise at least $6.6 billion in the market, benefiting about 6 600 SMEs. If we assume the average the size of a loan case to be, say $0.7 million, which means that on average the Government has to provide $0.35 million as guarantee per loan case, then about 10 000 SMEs will benefit from the Scheme[109].

- SME Development Fund

4.100 Government set up a $200 million SME Development Fund to subsidize projects to be carried out by eligible support organizations, trade and industrial organizations, professional bodies and research institutes to enhance the competitiveness of SMEs in general or SMEs in specific sectors[110]. The maximum amount of grant for each project is $2 million. Applicants are required to contribute part of the expenses of their projects, but this requirement may be waived under special circumstances.

- SME Training Fund

4.101 An SME Training Fund with the $300 million set aside by the Financial Secretary in the Budget in March 2001 to subsidize, on a dollar-to-dollar matching basis, training provided by SMEs to their salaried employees, which are relevant to their business operation (APEC Survey, 2002). In addition, a $100 million subsidy on a dollar-to-dollar matching basis is allocated for SME employers to attend training courses relevant to their businesses. Together they will constitute the SME Training Fund, with a total amount of $400 million (APEC Survey, 2002). Eligible training courses include training courses provided by local training organizations; overseas training courses; and training courses commissioned by SMEs to suit their particular needs and conducted by training organizations/higher education institutions or individual instructors. The subsidies cover direct course expenses only. For employees' training, the maximum amount of subsidy that each SME can obtain, on a cumulative basis, is $10,000. For employers' training, the maximum amount of subsidy that each SME can obtain, on a cumulative basis, is $5,000 (APEC Survey, 2002). The subsidy would be reimbursed to the concerned SMEs after the relevant employers/employees have completed the approved training courses.

4.102 The Committee estimates that, through the Scheme, about $800 million will be spent on SMEs' training initiatives, and that employees of at least 30 000 SMEs and employers of at least 20 000 SMEs will benefit[111].

- SME Export Marketing Fund

4.103 Based on the recommendation of the committee, Government came up with a $200 million SME Export Marketing Fund to subsidize SMEs' participation in export promotion activities held locally or outside Hong Kong (including trade fairs and study missions) (APEC Survey, 2002). For each successful application, the subsidy will cover 50% of the fundable items of the approved export promotion activities, or $10,000 (whichever is the less). Subsidy would be reimbursed to the concerned SMEs after they have completed the approved export promotion activities. Each SME can only receive subsidy once under the Scheme. The Committee estimates that, through this Scheme,

---

108 APEC survey of Small Business Enterprises. Member Report of Hong Kong. APEC, 2001.
109 Ibid
110 Ibid
111 Ibid

about $400 million will be spent on export promotion activities, benefiting at least 20 000 SMEs[112].

Table 27: Summary of the four funding schemes and their implications on SMEs

	SME Business Installations and Equipment Loan Guarantee Scheme	SME Development Fund	SME Training Fund	SME Export Marketing Fund	Total
Capital Amount	$ 500 million	$ 200 million	Employees' training: $300 million Employers' training: $100 million	$ 200 million	$ 1.3 billion
Maximum Amount for SME	$500,000 or 50% of the approved loan amount	$ 2 million per project	Employees' training: $10,000 Employers' training $5,000	$ 10,000	-
Minimum no. of SMEs likely to benefit	6,600 SMEs	20,000 SMEs	Employees' training: 30 000 SMEs Employers' training: 20 000 SMEs	20,000 SMEs	96,600 SMES

Source: Small and Medium Enterprise Development Committee

Financing

Narrowing the existing gap in the loan market

4.104 Most financial institutions have not yet put in place a mechanism for the effective assessment of the credit risk of SMEs. Furthermore, because of inadequate transparency of their financial status and management, SMEs often are unable to provide financial institutions with sufficient information to assess their business performance and prospects (APEC Member Report, 2002). As a result, many financial institutions are still cautious about approving loans for SMEs. To narrow the existing gap in the existing loan market, government has taken or intended to take the following steps[113]:

4.104.1 Roundtable discussions are established among SMEs, financial institutions, the Hong Kong Monetary Authority (HKMA) and Government departments responsible for commerce and industry to enhance communication to look into priority areas for SMEs development;

4.104.2 A checklist of information is made mandatory to be hand over to SMEs seeking loans by financial institutions when assessing loan applications should be drawn up by the roundtable for the reference of SMEs

4.104.3 A comprehensive Commercial Credit Reference Agency has been set up by the Hong Kong Monetary Authority ["HKMA"] to help financial institutions as well as SMEs to conduct their own feasibility study or due diligence while approving or accessing different loan schemes, and

4.104.4 Government is providing the required support to the financial sector to develop and put in place a credit scoring system[114] with which financial institutions can make objective and prompt assessments of credit risks on the basis of various indicators, thereby facilitating the processing of loan applications from SMEs.

---

112 Ibid

113 APEC survey of Small Business Enterprises. Member Report of Hong Kong. APEC, 2001.

114 Asch, Latimer. "Credit Scoring: A Tool for More Efficient SME Lending". SME Issues, Vol.1, No.2, November, 2000.

Developing diversified financing tools and channels

4.105 Apart from seeking credit facilities from financial institutions, other financial tools and channels are developed for SMEs financing[115].

4.105.1 Services of the Hong Kong Export Credit Insurance Corporation have been strengthened. This includes modifying the Corporation's insurance risk assessment process by providing different percentages of indemnity according to the levels of risk involved, and providing additional diversified credit insurance products;

4.105.2 Feasibility of credit guarantee in the form of insurance is now studied by the trade, with a view to strengthening SMEs' financing capability; and

4.105.3 Policies are in place to enhance SMEs' knowledge of various types of equity financing, including venture capital funds.

Facilitating SMEs to grasp information on the financing market

4.106 To facilitate SMEs to widen their knowledge on various financing means and the financial management requirements of financial institutions, the government has set up[116]:

4.106.1 SME financial resources database to help SMEs identify suitable financial institutions and financing packages according to their own needs; and

4.106.2 In collaboration with other SME support organizations, the government organizes educational activities to motivate SMEs to enhance their financial transparency and to acquire better knowledge of and skills in financial management.

SMEs Development and Financing – Malaysia:

4.107 Malaysia has transformed from a commodity-based producing nation to being a manufacturer of industrial products, geared towards exports. With a good track record of economic growth exceeding 8% per annum, the country is well poised to fulfill its vision of becoming fully industrialized nation by the year 2020[117].

4.108 Following a period of rapid expansion in the last eight years, the Malaysian economy is estimated to expand at a more sustainable pace as the year progresses, where the main impetus to growth continues to come from the manufacturing sector which is envisioned to record a double-digit growth.

4.109 In the external trade scene, export of manufactured goods continue to remain the largest contributor to Malaysia's total exports; where product enhancement, competitive pricing and improved marketing strategies have enabled Malaysian manufactured goods to penetrate non-traditional markets like Africa and Oceania. In terms of composition, electrical and electronic products continued to compose the largest share of the export structure, where it grew from 37.7% in 1991 to 52.95% in 1996[118].

SMEs definition - Malaysia

4.110 SMEs in Malaysia comprise 96% of all enterprises and employs 40% of the entire labor force[119]. In Malaysia, an SME unit is defined as,

- SME/ SMI unit: " A business entity is considered as SME or Small Medium Industry ("SMI") unit with shareholder's funds of below RM 2.5 million and employment size of less than 75 full time workers[120]."

115 APEC survey of Small Business Enterprises. Member Report of Hong Kong. APEC, 2001.
116 Ibid
117 Small and Medium Enterprise Ministerial Meeting, Thailand. "Business Creation, Capital Formation, and Financial Access for SMEs and Micro Enterprises". Member Report: Malaysia, APEC, August 2003.
118 Ibid
119 Ibid

4.111 Therefore, like any other ASEAN country, SMEs account for the majority of local business establishments in Malaysia. But, unfortunately, like other ASEAN countries, especially in East and South Asia, majority of the SMEs in Malaysia are in the form of traditional SMEs with no strong linkages or relationship with large, modern industrial factories. In this aspect, SMEs in Japan made significant strides from the beginning by forming joint cooperatives or agglomeration with large firms through sub-contract agreements.

4.112 The Malaysian government has considered that a speedy and efficient way to strengthen Small Medium Industries ["SMIs"], which would act as supporting industry under sub-assembly of the production process of the final goods and services, is to invite foreign SMEs with high technologies to invest in Malaysia (Karikomi, 1998). The government's main objective was by doing that the foreign SMEs would transfer their technologies to local SMEs. Thus, the Malaysian government aggressively attracted foreign SMEs by offering variety of incentives[121] to them. Allured by the attractive packages, SMIs in Malaysia have been built up and strengthened directly by foreign SMEs (Karikomi, 1998).

Profile of Small and Medium Industries in Malaysia

4.113 At present, the small and medium industries (SMIs) account for more than 80% of the total manufacturing establishments in Malaysia; where 88% are Small scale Industries and 12% belongs to the Medium scale Industries.

4.114 The SMIs have experienced substantial gains in productivity, even though they only contribute 13.8% to total output and 40% to employment[122]. Added value per employee grew at an annual rate of 6.4% for the period of 1991 to 1996. It has seen a steady rate of growth for the period and rose from 29.6% in 1995 to 30.5% in 1996[123]. The majority of SMIs are still concentrated in the traditional sectors of:

Table 28: Sectoral distribution of SMI's in Malaysia

Sl. No.	Sector	Percentage Share to GDP
1.	Food and beverages	20 %
2.	Fabricated metal products	18 %
3.	Wood and wood products	17%
4.	Basic metal	4%

Source: ASEAN Small and Medium Enterprises, 2003

4.115 However, only 20% of the SMIs actually export their products (Karikomi, 1998). The major contributions to Added Value per Employee growth came from the sub-sectors of automotive, electrical and electronic products where subcontracting activities were most prevalent with the Government taking a proactive role in these activities.

---

120 Karikomi, Shunji. "The Development Strategy for SMEs in Malaysia". Institute of Developing Economies, APEC Study Center. Working Paper Series 97-98:No.4, March 1998.

121 Foreign SMEs, especially the Japanese electrical /electronic firms, established new affiliated firms rather than new business departments in their existing firms because they were able to receive various benefits, such as an exemption of corporate tax for five years and easy visa procedures for Japanese staffs who were essential for setting a new operation. Thus, a lot of Japanese affiliated firms in Malaysia manufacture a small number of products on a massive scale.

122 Total SME contribution to employment in Malaysia is 40% and SMEs constitute 96% of all enterprises.

123 Bhumiputra Commerce. "Malaysia: The Economic Package. Special Economic Services". Vol.4, May 24, 2003.

4.116 The improvement in Added Value per Employee was due to an increase in Total Output per Employee at an average growth rate of 4.3%. The positive growth is also reflected in Added Value per Total Output with a growth of 2.0% for the 5-year period up to 1996 (APEC Survey: Malaysia, 2003). The high growth in Total Output was consistent with the increase in local and export demand for electrical and electronic products and machinery and equipment creating demands from the larger industries for supply and intermediate products produced by the SMIs as they respond to the market demand. This positive growth was also to the extent due to the proactive role undertaken by the SMIs; coupled with the incentive schemes and supports extended by the Government through various policy measures and generous tax incentives (Karikomi, 1998). The policy measures include fiscal, monetary and administrative assistance to encourage investment, R&D, export and Human Resource Development.

Role of SMIs in Malaysia

4.117 The small and medium industries (SMIs) assume a critical role in the country's industrialization program through the strengthening of backward industrial linkages. During the late eighties and early nineties, it was found that the SMIs in Malaysia do not have the production basis or the kind of specialization of a supporting industry for assembly or processing industry. In order to rectify this situation, Malaysia introduced the Vendor Development Program ["VDP"] to recreate the Japanese production system of relationships among assembly firms and subcontractors. The plan was to establish "anchor" companies nominated by the government that would nurture "vendor" companies or SMEs that needed some special support to develop.

4.118 The Second Industrial Master Plan[124] (IMP2) recently announced by the Government provides the basis for the achievement of a broad based, resilient and internationally competitive industrial sector (Karikomi, 1998). Under IMP2, the Small and Medium Industries Developing Cooperation ["SMIDEC"] in collaboration with the government introduced industrial linkage program ["ILP"] in 1997. The primary objective of the program is to set in place policies and programs to further develop and integrate domestic SMIs as the critical and strategic link to develop and strengthen the cluster formation and to increase domestic value-added (Karikomi, 1998). The SMIs will assume these roles by complementing the activities of the large-scale industries through integration into the mainstream of the industrial development through the provision of critical parts and components as well as expanding their market internationally. As the SMIs grow, their progress will strengthen and widen the industrial base as well as enhancing export-led growth. Following is the industrial development program introduced by the government:

Table 29: Industrial Development Program

Objective: • Development of local SMEs as manufacturers or suppliers of critical components / services to large-scale companies including MNCs[125]. • To develop efficient and competitive SMEs, capable of producing high value-added and quality products, components, and services for the open market, both domestically and internationally.
Participants: (a). The Linkage: SMEs as primary and secondary suppliers. (b). The Lead: principal companies, which can be MNCs or local large-scale companies.

124 Second IMP; 1996-2005
125 MNCs stand for Multinational Companies

(c). The Financier: participant Banks, non-bank financial institutions or venture capitalists. (d). The Technology Supplier: Lead companies or any independent technical/ research institute or companies. (e). SMIDEC: project manager/ Coordinator.
Priority Areas: (a). *Electrical/ Electronics industry* [i.e., consumer electronics, computers, peripherals and telecommunications, semiconductors and electronic components / appliances etc.] (b). *Transportation and equipment industry* [i.e., automotive and motorcycle, marine and aerospace]. (c). *Machinery and Engineering Industry* [i.e., machine equipments/ tools, molds and dies, utilities etc.] (d). *Others* [i.e., chemical and petrochemical, resource and agro-based etc.]

Source: SMIDEC, 2002

Financial Schemes

4.119 Based on the objective to develop and promote SMEs and to ensure their sustainable development in the future, following financial schemes are provided by the government, banks, non-bank financial institutions and SMIDEC:

Loans

4.120 Around 38% of the total lending portfolios are provided to SMEs and SMIs[126]. Interest rate charged on loans vary according to the type of projects and the riskiness associated with them.

New Micro-credit Scheme

4.121 Besides creation of micro-credit bank, RM 500 million (S$227 million) has been set aside for a *new micro-credit scheme* for small businesses in agriculture - a sector that the government nowadays sees as an important new growth area[127]. An additional fund of RM 300 million will be injected for non-agricultural businesses, under a separate micro-credit scheme through the national savings bank (Kassim, 2003).

4.122 Easier accessibility to funding resources, lower cost of borrowing and more expeditious loan approval as well as flexible repayment schedules under the micro credit scheme should pave the way for the emergence of budding entrepreneurs.

New Entrepreneurs fund ["NEF"]

4.123 To develop SMEs and SMIs in the country, Bank Negara created RM 1 billion *new entrepreneurs fund* ["NEF"] (Kassim, 2003). It is expected that NEF would provide entrepreneurs a bigger pool of funds and opportunity to invest in small businesses.

Terms and conditions for SME loans

4.124 Under terms and conditions of SME loans,

- SMEs need to show that the business has adequate capital, is viable and able to generate sufficient cash flow to repay the loans.
- Otherwise, SMEs need to provide collateral as proof of commitment.

126 Karikomi, Shunji. "The Development Strategy for SMEs in Malaysia". Institute of Developing Economies, APEC Study Center. Working Paper Series 97-98:No.4, March 1998.

127 Kassim, Yang Razali. "Entrepreneurship drives shift to high gear". Business Times, May 29, 2003.

Guarantee schemes: Graduation from micro to SME entrepreneur

4.125 Government, financial and non-financial institutions provide credit guarantees to potential SMEs[128]. Under micro credit schemes, successful entrepreneurs are provided credit guarantees by the micro-credit banks so that they would be eligible for commercial loans from banks and other non-bank financial institutions. In fact, the program helps the micro entrepreneurs to graduate to become SME entrepreneur through access to other sources of finance for expansion or start-up purpose.

Grants

4.126 Partial grants are provided to SMEs for the purpose of:

- Research and Development
- Process Improvement
- Technology acquisition
- Quality certification
- Market Development

4.127 Special consideration is given to women entrepreneurs so that they can also play a key role in developing potential sectors.

Venture Capital

4.128 Venture capital is another common source of funding. Major sources of fund for venture capital are from the Government and Business Corporation. The major areas focused by venture capitalists are electronics, Information and communication technology ["ICT"] and the manufacturing sectors.

SMEs Development and Financing – India:

4.129 With a contribution of 40% to the country's industrial output and 45% to direct exports, the Small-Scale Industry (SSI) sector has achieved significant milestones for the industrial development of India. Special emphasis has been put on this sector with the multiple objectives of employment generation, regional dispersal of industries and promoting entrepreneurship since independence[129]. In terms of employment generated, the SSI sector is next only to agriculture employing approximately 19 million people[130].

4.130 In India, an SSI Unit is defined as-

- SSI Unit: " one where investment in plant and machinery where held on ownership terms or on lease or by hire purchase does not exceed Rs. 10 million (1USD=Rs.49) ". There also exists a definition for micro-enterprises, which are popularly known as "Tiny Units".
- Tiny Unit: "A tiny unit is one where investment in plant & machinery does not exceed Rs. 2.5 million".

4.131 From about 80,000 units in the late 1940s to over 3.3 million units today, the SSI sector has been proving its mettle from the 20th century by maintaining a steady growth[131]. The SSI sector in India can alone contributes 7% to India's GDP[132]. The

128 Small and Medium Enterprise Ministerial Meeting, Thailand. "Business Creation, Capital Formation, and Financial Access for SMEs and Micro Enterprises". Member Report: Malaysia, APEC, August 2003.

129 Mahtma Ghandhi, chief architect of India's independence used the ideology of economic self-reliance at village level to not only reduce India's independence of the British Rule but also to generate mass employment.

130 "Financing SME technology", Dr. Sailendra Narain, Center for SME Growth and Development Finance, India; 1997

131 Small Scale Industries (SSI). [http://www.laghu-udyog.com/ssiindia] performance of the Indian Small Scale Sector in terms of critical economic parameters such as number of units, production, employment etc., is praiseworthy. Following table 25 shows sectoral contribution of SSI's to the export basket of India:

Table 30: Percentage of SSI in total exports of India

Sl. No.	Sector	% Of SSI in total exports
1.	Sports goods	100
2.	Readymade garments	90
3.	Woolen garments, knitwear	35
4.	Processed foods	65
5.	Marine products	29
6.	Leather products	80
7.	Plastic products	45
8.	Cosmetic, basic chemicals & pharmaceutical products	55
9.	Engineering goods	30

Source: SME India report, 2003

4.132 Within the SSI sector, an important role is played by the numerous clusters that have been in existence for decades and sometimes even for centuries. According to a UNIDO survey of Indian SSI clusters undertaken in 1996, there are 350 SSI clusters and approximately 2000 rural and artisan based clusters in India. It is estimated that these clusters contribute 60% of the manufactured exports from India. Among the larger clusters, it is worth mentioning those of:

- Panipat accounting for 75% of the total blankets produced in the country;
- Tirupur, which is responsible for 80% of the country's cotton hosiery exports;
- Agra with 800 registered and 6,000 unregistered small scale units making approximately 150,000 pairs of shoes per day with a daily production value of 1.3 million dollars and exports worth US $ 60 million per year;
- Ludhiana, a city that is well known as the Manchester of India, which alone contributes 95% of the country's woolen knitwear, 85% of the country's sewing machines and 60% of the nation's bicycle and bicycle parts.
- Finally, the world famous cluster of Bangalore, operating in the software sector, deserves an explicit reference.

4.133 Despite such achievements, the majority of the Indian SSI clusters share significant constraints like technological obsolescence, relatively poor product quality, information deficiencies, poor market linkages and inadequate management systems. Moreover, with the Indian economy on the path of liberalization, all SSI clusters (even the best performing ones) are increasingly feeling the competitive pressures coming from the international markets.

<u>Existing SME financing arrangements in India</u>

4.134 Just like any country, no small-scale industries ("SSIs") unit can take off without monetary support. This need for finance can be classified into the following types:

- Long and medium term loans
- Short term or working capital requirements
- Risk Capital - Seed Capital/Marginal Money
- Bridge loans

4.135 The financial assistance in India for SSI unit is available from a variety of institutions. The important ones are:

- <u>SIDBI</u>: Small Industries Development Bank of India (refinance and direct lending)

---

132 *Ibid*

- SFCs[133]: State level Financial Corporation e.g. Andhra Pradesh State Financial Corporation.
- NSIC: National Small Industry Corporation.
- Small Industry Development Corporations of various states.
- Commercial/Co-operative Banks.
- DIC: District Industry Center.

4.136 State Financial Corporations, SIDBI and State Industrial Development Corporations[134] provide long and medium term loans. Banks also finance term loans. This type of financing is needed to fund purchase of land, construction of factory building/shed and for purchase of machinery and equipment. The term loans are secured against mortgage of assets such as land, building, machines, equipment and other stocks. The short-term loans are required for working capital requirements, which fund the purchase of raw material and consumable, payment of wages and other immediate manufacturing and administrative expenses. Such loans are generally available from commercial banks.

4.137 There is, however, a Single Window Scheme, for SSI units. Under the scheme, one agency, either the bank or the financial institution, funds both the term loan and working capital requirements. This scheme applies to all SSI projects with project cost up to Rs 50 Lakhs. The working capital loan is generally secured against

- Pledging of stocks, raw materials and finished goods,
- Advances against work-in-progress (WIP),
- Advance against bills.

4.138 For loans from financial institutions and commercial banks a formal application needs to be made. The details of documentation that need to be provided with the loan application are shown here.

- Documentation for Loan Application
- Balance Sheet and Profit Loss Statement for last three consecutive years of firms held by promoters
- Income Tax Assessment Certificates of Partners/Directors
- Proof of Possession of Land/Building
- Architects estimate for construction cost
- Partnership deed/Memorandum and Articles of Associations of Company.
- Project Report
- Budgetary Quotations of Plant and Machinery

4.139 A sanction or rejection letter is issued by bank after its assessment of the application. After receiving a sanction letter applicants need to indicate in writing their acceptance of terms and conditions laid down by FI/ Banks. Subsequent loan is disbursed according to the phased implementation of the project.

4.140 In today's environment there are other choices apart from commercial banks and Government owned financial institutions. These options include venture capital funds and non-government finance companies.

Schemes for financial assistances to SSI's:

4.141 Following Table 31 shows the financial schemes that are available for entrepreneurs to start new ventures and also expand existing business. Also, the list of

133 Information, available [online]. [http://www.smeindia.com/fincorp1.asp]
134 Small Industries Development Organization (SIDO). [http://www.laghu-udyog.com/sido.sido.htm]

key institutions which are in the forefront of providing financial assistance are given below for availing the assistance from them.

Table 31: Major Schemes for Financial Assistance to SSI's

Scheme	Eligibility	Purpose	Limit
1. General Loan	All Proprietary, Partnership, Private/Public Limited Companies, Industrial Co-operative Societies for establishing tiny, small scale and medium scale industrial units and service oriented industries	For acquiring assets for setting up new units and for expansion, diversification and modernization in case of existing units.	Project cost should not exceed Rs 12.00 crores.
2. Equipment Refinance Scheme	Existing well performing small and medium scale units: -Assisted by the Corporation, or by any other State/Central financial institution. Bank /self-Financed. -Units should be in operation for at least 4 years from the date of commercial production, earned profits/declared dividends, during immediate preceding 2 years, not defaulted in repayments to institutions / bank.	For acquiring identifiable items of plant and machinery/other equipments including energy saving systems, for modernization/ expansion balancing/ replacement or any other purpose except new projects	Project cost including proposed equipment should not exceed Rs. 12.00 crores.
3. Modernization Schemes	Existing tiny, village, small and medium scale units, which are in operation at least for 5 years. In case of replacement/renovation, the machinery should have been in use in the unit for a period at least 5 years. Mere replacement of machinery or solely for expansion of capacity is not covered.	Assistance for modernization. • Up-gradation of process/Technology & product • Export oriented • Import-substitution • Energy Saving • Anti-pollution measures • Conservation/ Substitution of scarce raw materials. • Improvement in capacity utilization through increase in productivity and de-bottle necking.	Total Project cost should not exceed Rs.12 crores.

		• Improvement in material handling etc.,	
4. Schemes for Hotels / Motels/ Restaurants	Entrepreneurs setting up Hostels/Motels/ Restaurants projects	For construction of Janata/single star/Two star/Three Star hotels, setting up of restaurants with motel projects with wayside restaurants and lodging facilities of about 10 rooms/dormitory. Assistance is considered to acquire land, building, plant & machinery, kitchen equipment, furniture & fixtures, crockery & cutlery, etc.	Approvals from Dept of Tourism, Govt. of AP and Govt. of India. -Municipal approval for building plans. -Minimum standards fixed by State/Central governments. -For motels on par with Janata Category -Minimum land area required for: Janata Hotel :500 sq.yds 1&2 Star Hotels: 750 sq yds. 3 star Hotels: 1000 sq. yds
5. Scheme for Tourism related facilities	Entrepreneurs setting up Tourism Related activities	For setting up of -Development of Amusement Parks -Cultural Centers/ Conventional Centers, Restaurants. -Travel, Transport and -Tourist Service Agencies	<u>Cost of project:</u> Need-based -Approvals from Tourism Dev. Agencies.
6. Assistance to Hospitals/ Nursing Homes	Entrepreneurs setting up Allopathic Nursing Homes/Hospitals having qualified PG Doctors (MD/MS) on full-time basis having a minimum bed strength of 10. Ayurvedic/Homeopathic/ Unani/Naturopathy Nursing Homes are not eligible.	For setting up Nursing Homes/ Hospitals. For expansion/ modernization of existing nursing homes. Assistance for land, building, medical equipment including diagnostic and therapeutic eqpt., air-conditioners, ambulance etc.	<u>Cost of project:</u> Need based Not exceeding Rs.12.00 crores per project
7. Assistance to acquire Electro-medical equipments	Qualified medical practitioners use/Entrepreneurs employing qualified Doctors.	For acquiring Electro-medical/other related equipment	-<u>Cost of project:</u> Need based
8. Civil Contractors Scheme	Proprietary/Partnership Firms, Private/Public Limited companies of Class I & II Civil	For working capital to meet short term working capital (maintenance expenses)	Proprietary & Partnership Firms: up to Rs.120 Lakhs Private & Public Ltd Companies: up to Rs.240

	Contractors.	requirements.	Lakhs.
9. Assistance for setting up Industrial states	Any entrepreneur interested for development of contiguous land into industrial estate/area. Minimum land required 10 acres. Proposals should include construction of industrial sheds.	For purchase of land, cost of land development, cost of stamp duty etc, for development of infrastructural facility such as approach roads, drainage, water supply system, power distribution lines, central effluent treatment plant, construction of industrial shed/multi-storied industrial buildings, etc.,	Cost of project: not exceeding Rs.12.00crores.
10. Scheme for qualified professionals	Qualified professionals in the fields of Management, Accountancy, Medicine, Engineering etc. for setting up own professional practice/consultancy ventures and for acquiring additional equipment for existing/established professional firms.	Assistance for acquiring land, building, furniture & fixtures and related equipment. Cost of land& building should not exceed 50% of total project cost.	Cost of project: below Rs.20.00 lakhs.
11. Scheme for Technology development and modernization	Sole proprietary, partnership firms, Co-operative Societies, Private & Public Limited Companies of small scale industrial units including ancillary units which are going in for modernization/ technology up gradation which should be in operation for 3 years and not defaulted to institutions and banks.	For purchase of capital equipment, need-based civil works, acquisition of land, acquisition of technical know-how, designs, drawing, up gradation of process technology and products, improvement in packaging, cost of TQM and acquisition of ISO 9000 series Certificate and additional/ incremental margin money for working capital.	Project outlay not to exceed Rs.100 lakhs. Outlay on land and building should not exceed 25% of the project cost. Minimum promoters contribution 25% of the project cost.
12. Poultry firm scheme	New and experienced promoters are eligible to set up poultry farms of layers/Broilers/Parental broilers with minimum of 15,000 birds capacity.	Assistance for acquiring land, construction of civil works, machinery and initial stock of chicks, feed, medicines and vaccines.	Project cost: Need based.
13. National Equity Fund	New projects in tiny and SSI sectors irrespective	For acquiring assets to	Project cost: Not exceeding Rs.10.00 lakhs

Scheme	of location. Existing tiny & SSI and service enterprises except transport operators undertaking expansion/modernization, technology up gradation and diversification irrespective of location. Sick units in tiny & SSI sector including service enterprises. Units in Metropolitan area, projects that avail of any margin money or seed/special capital assistance under Schemes of Central/State Governments, SFCs and other State level institutions or banks (except State investment subsidy) are not eligible for assistance.	establish tiny and small-scale units.	for new units and for existing projects including outlay on modernization /expansion etc. <u>Promoter's contribution</u> Minimum of 10% of project cost. <u>Soft loan:</u> 25% of project cost with 1% service charge.
14. Composite Loan Scheme	For setting up units in cottage, village and tiny sector and in places where the population is less than five lacs. However, the population restriction does not apply to artisans.	For equipment and/or working capital as also for work sheds.	Project cost not exceeding Rs.50, 000/- Promoters contribution-Nil
15. Working term loan through Merchant Banks	Existing units assisted by the Corporation/units availed term loan not less than Rs.5.00 lakhs earlier and have closed the loan account/units financed by the Corporation and in operation for more than three completed years and have earned net profits for the last 3 years, regular in repayment to the financial institutions, should not have availed re-schedulement facility	Assistance below Rs 150 lakhs to meet short term working capital requirements of existing units and other purposes, except for speculative purposes, except for speculative purpose. Loans above Rs.50.00 lakhs are considered for short-term working capital requirements only. Total assistance to all the associated units of a group of companies shall not exceed	Loan shall be a minimum of Rs.150 lakhs Loan shall be secured by collateral security of 150% Loan repayment period: For loans up to Rs.10.00 lakhs – 12 months From Rs.10.00 lakhs to Rs.25.00 lakhs 18 months From Rs.25.00 lakhs to Rs. 50.00 lakhs-24months From Rs.50.00 lakhs to Rs.150.00 lakhs-36 months above Rs.150.00 lakhs to Rs.240 lakhs repayment shall be fixed on case to

	more than once from the corporation.	Rs.300.00 lakhs.	case basis.

Source: SME India Report, 2003[135]

4.142 List of key Financial Institutions involved In Financing the above Schemes:

- INDUSTRIAL FINANCE CORPORATION OF INDIA (IFCI)
- INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI)
- INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)
- EXPORT-IMPORT BANK OF INDIA (EXIM BANK)
- INDUSTRIAL RECONSTRUCTION BANK OF INDIA (IRBI)
- SHIPPING CREDIT AND INVESTMENT CORPORATION OF INDIA (SCICI)
- INFRASTRUCTURE LEASING AND FINANCIAL SERVICES LTD. (IL&FS)
- TECHNOLOGY DEVELOPMENT AND INFORMATION CORPORATION OF INDIA LTD. (TDICI)
- RISK CAPITAL AND TECHNOLOGY FINANCE CORPORATION LTD. (RCTFC)
- TOURISM FINANCE CORPORATION OF INDIA (TFCI)
- NATIONAL BANK FOR AGRICULTURAL AND RURAL DEVELOPMENT (NABARD)
- NATIONAL SMALL INDUSTRIES CORPRATION (NSIC)
- STATE FINANCIAL CORPORATIONS (SFCs)
- STATE INDUSTRIAL DEVELOPMENT CORPORATIONS
- STATE INDUSTRIAL INVESTMENT CORPORATIONS (SIICs)
- STATE SMALL INDUSTRIES DEVELOPMENT CORPORATIONS (SSIDCs)
- SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)
- NATIONAL CO-OPERATIVE DEVELOPMENT CORPORATION (NCDC)

SMEs Development and Financing – Sri Lanka:

SME definition

4.142 In Sri Lanka, there are no clear definitions of SMEs. Different government agencies use different criteria to define SMEs. This has led to confusions in identifying SMEs for various supportive measures. On the other hand, countries like Japan [i.e., SME definition based on Small and Medium Enterprise Basic Law, 1999], India [i.e., Small Scale Industry or SSI in terms of limits on investment on plants and machinery, excluding investments in land, buildings, equipments and anti-pollution measures], EU countries [i.e., based on number of employees, amount of turnover and total balance sheet] etc., have clear definitions on SMEs that help interested parties to come up with the exact policies and recommendations for their growth and development. Table 31 shows the definitions on SMEs that are developed by multifarious entities to fulfill their own objectives.

Table 31: SMEs definition: Sri Lanka

	Capital Size	Number of employees
Industrial Development Board ["IDB"]	Rs. 4 million [US $ 42,000]	50 or less
Department of Small Industries ["DSI"]	Rs. 5 million or less [US $ 52,500]	50 or less
Financial Institutions (for the purpose of the World Bank	Rs. 16 million or less [US $ 168,000]	

135 Small Medium Enterprises of India. [http://www.smeindia.com].

financed Investment Assistance Scheme)		
Sri Lanka Export Development Board ("SEDB")	Fixed capital: Rs. 8 million or less [US $ 84,000] Annual export Turnover: Rs. 50 million [US $ 525,000]	
The World Bank		Small: Fewer than 49 Medium: 50-99 Large: More than 100

Source: SME development in Sri Lanka; Review, 2002

Significance of SME sector on Sri Lankan economy

4.143 SMEs accounts for a very high percentage of the total number of industrial and business establishments as in other developing countries. SMEs promote economic growth by import substitution as well as through direct exports, and they mostly supply goods and services to large directly exporting ventures and thereby contribute towards alleviating balance of payments difficulties (Hewaliyanage, 2001).

4.144 According to the industrial census conducted by the Department of Census and Statistics in 1983, there were a total of 102, 721 registered and informal industrial units in the country producing various types of products and employing 639, 256 persons. The survey findings indicated that industrial establishments below 5 employees accounted for 84% of the total establishments and 28% of the total employment, but accounted for only 7.5% of the total output and 7.0% of the value added in the industrial sector. Enterprises having over 5 employees represented less than 15.7% of all establishments, but accounted for 92.5% of the output and 71.6% of total employment (Central Bank of Sri Lanka, 1998).

4.145 Another survey conducted by United Nations Development Program in the year 2000, estimated that SMEs with fixed assets of Rs. 16 million or less accounted for 90% of all enterprises, 70% of total employment, and 55% of gross value added in the private sector (Ponnamperuma, 2000).

4.146 Recently, Annual Industrial Survey ("AIS") conducted by Department of Census and Statistics of the Ministry of Finance and Planning based on three major industrial sectors[136] found that SMEs constitute around 90% of all enterprises, but their contribution to the overall output in each sector is very low (about 6%)[137]. On the other hand, there are only 2% of large-scale establishment in the category of Manufacturing, but it accounts for more than 50% of output. Similar analogy was found for other sectors that are considered under the AIS survey (Gamage, 2002).

4.147 Thus, it can be observed that like many developing countries and some developed countries around the region [i.e., ASEAN, APEC and SAARC countries] around the region, SMEs have contributed significantly in terms of employment share and share in

136 Mining and quarrying, Manufacturing and, Generation and distribution of electricity, gas and water under International Standard Industrial Classification ["ISIC"] of the United Nations.

137 Aivazian, Varouj, Majumder, Dipak, Santor, Eric. "Financial Constraints and Investment: Assessing the Impact of a World Bank Credit Program on Small and Medium Enterprises in Sri Lanka". University of Toronto, August 2001.

GDP although their contribution to the national economy in terms of output and productivity share in employment has been very low.

<u>SME policy in Sri Lanka</u>

4.148 After gaining independence from the British Rule in 1948, successive Sri Lankan governments imparted industrial policy decisions mainly geared more on direct investments by the government itself to set up industrial ventures, rather than on private sector initiatives through the provisions of incentives and subsidies. In keeping with these policies, large state owned enterprises were set up in Sri Lanka to manufacture cement, paper, chlorine and caustic soda, cotton yarn and fabric, canned food products, construction steel, bricks and tiles, ceramic ware, boots and shoes, agricultural implements, petroleum products, fertilizer and host of other products. Few incentives were given to induce private sector investment which had to face severe competition from imports in the context of relatively low rates of tariff protection inherited from British rule which were not reversed upwards (Wickramasinghe, 1993).

4.149 Though from 1960 to 1978 there was reversal of policies to put drastic control on imports and exchange controls, private entrepreneurs failed to respond due to lack of capital in acquiring latest machineries and technologies, raw materials and know-how, which could only be imported through the licenses issued by the government[138].

4.150 Therefore, the failure to develop SME industry in post independent Sri Lanka can be attributed mainly to the economic and industrial policies of the governments, which were more favorable to the development of large state-owned enterprises[139]. In a market economy, small and medium industries develop alongside large industries in competition with or complementary to the later. Small-scale production can be competitive with large-scale production because of lower investment per worker and the use of less sophisticated technology adapted to the skills of available supplies of educated but untrained and inexperienced labor[140].

4.151 The change in the economic polices of Government after 1977, especially the heavy investment by the governments and the private sector in the industrial sector development through the creation of SMEs and the adjustment of the exchange rate through continued depreciation led to the demand for building materials for the construction industry, wood product and furniture, prepared foods and handicrafts (Gamage, 2003). Adjustment of the exchange rate created new markets for more traditional exports like jewelry, pre-packed spices, leather products as well as traditional exports of tea packaged in wide range of containers made of paper, wood, reeds and ceramic made in small factories and workshops. The policies, in fact, encouraged *import substitution led development* in Sri Lanka from the late 70s (Gamage, 1970).

4.152 At present, the main features of the strategies for SME development under the industrialization policy are[141]:

- Developing a base for economic and industrial growth for SMEs under the broad policies and programs of the governments.

138 Gamage, Aruna. S. "Small and Medium Enterprise Development in Sri Lanka: A Review". 2003.
139 Ibid
140 In Japan, Korea and Taiwan, this sort of complementary production exists between small and large industries through cooperatives, joint ventures or through industrial agglomeration. This may evolve the manufacture of components and / or the sub assembly of components to be incorporated in the final products manufactured by the large-scale industries.
141 Gamage, Aruna S. "Small and Medium Enterprise Development in Sri Lanka: A review"

- Creating and strengthening the financial, technical and managerial infrastructure to fill existing gaps and/or to provide additional support necessary for efficient and productive growth of small enterprises.
- Increasing market efficiency by encouraging information exchange and improving provision of information on new methods and opportunities.
- Promoting the regional development of industry through Free Trade Agreements ["FTAs"].
- Lending support to governmental, non-governmental and independence initiatives for creating income-generating opportunities, self-employment, and entrepreneurial ventures in rural and urban areas.

Financial schemes to develop and promote SMEs

4.153 A major problem in the SME sector is the shortage of capital due to number of reasons such as lack of access to bank facilities, lack of knowledge of bank procedures, long delays and inability to provide guarantees [Wickramasinghe, 2002]. Although there are some loan schemes available, the high rate of interest makes the venture unattractive. According to an evaluation study conducted by a panel of experts under Entrepreneurship Development Programs ["EDP"][142], over 85% of the respondents identified procurement of capital as the area in which they needed most support to succeed in business (Aivizian, 2001). Following are the financial schemes adopted by the governments of Sri Lanka[143]:

Providing institutional credit to SMEs

4.154 Creation of People's Bank in 1961 and at the same time the nationalization of Bank of Ceylon were landmarks in providing institutional credit and credit facilities under special programs for SMEs. Some domestic private banks have also introduced special facilities to these industries with the expansion of their branch network.

<u>Credit Guarantees through Small Scale Industries Credit Scheme ("SSI")</u>

4.155 With the main objectives of encouraging, promoting and developing SMEs in Sri Lanka, the Industrial Development Board ("IDB") was established in 1969. Over the years, the IDB concentrated mainly on the development and dissemination of appropriate technologies, marketing facilities and in some cases, financial facilities and conducting entrepreneurship training and Small Business training for the small-scale industrial sector.

4.156 The Small Scale Industries Credit scheme ("SSI") was introduced in 1974 in order to enlarge the small industry sector credit base.

4.157 In collaboration with the Central Bank of Ceylon through bank syndication in 1979, IDA started providing credit guarantees on SMI loans with financial assistance assured by the IDA.

<u>Loans under Project financing scheme for SMEs</u>

4.158 Sri Lanka government established the National Development Bank ("NDB) in 1979 with the primary objective of providing project finance for large industry, agriculture and commerce. NDB is also required an important secondary objective to ensure that small

---

142 Entrepreneurship Development programs ["EDP"] was launched in 1987 by the Chambers of Commerce Industry with the financial support from the Asia Foundation (Ranasinghe, 1996)

143 Aivazian, Varouj, Majumder, Dipak, Santor, Eric. "Financial Constraints and Investment: Assessing the Impact of a World Bank Credit Program on Small and Medium Enterprises in Sri Lanka". University of Toronto, August 2001.

industrialist are given access to project finance on the same term and conditions as afforded to large borrowers (Gamage, 2003).

Table 32: Board of Investment ["BOI"] incentives for SMEs in Sri Lanka

Description of Activity	Qualifying criteria			Incentives				
	Minimum Investment in Rs. Mn.	Minimum direct/indirect export requirements (% of output)	Minimum new employment required	Full Tax holiday	Concessionary Tax at 15%	Import Duty Exemption: On Capital Goods	Import Duty Exemption: On Raw Materials	Exemption from Exchange Control
1. Textile & ancillary industries (existing) including yarn, thread etc								
(a) Domestic market oriented	5	49	None	None	On Export	Yes	Yes	No
(b) Export oriented	5	50% or more within 5 yrs.	None	5	On Export	Yes	Yes	Yes, its 90% is exported.
2. Software Development								
(a) Domestic market oriented	None	0-69%	25 technically qualified persons	5 yrs.	As per IR Law after tax holiday	Yes	n.a.	No
(b) Export Oriented (new & existing companies)	None	More than 70%	-do-	8 years	12 years after tax holiday	Yes	n.a.	Yes
3. Manufacture are trading of Gems, Diamonds & Jewellery								
(a) New manufacturing enterprises	10	70%	None	20 years	As per IR Law after tax holiday	Yes	Yes	Yes
(b) Existing Enterprise	5	70%	20 years	20 Years	-do-	Yes	Yes	Yes
(c) Trading Enterprises	None	90%	None	20 years	-do-	During establishment period1 (2 yrs.)	Yes	Yes
4. Agriculture, Dairy & Livestock Development								

(*a*) *Small Scale New (Domestic market) Agriculture, Dairy, Livestock Development & Storage*	2.5	None	None	None	5 Years	n.a.	Only during project establishment period	No
New (export market)	2.5	None	None	50%	5 Years	15 Years	Yes	Yes, for the exported qty only.

Source: Board of Investment [“BOI”], 2003

Board of Investment [“BOI”] schemes for SMEs

4.159 Table 32 above shows the special incentives including financial and tax provisions[144] provided by BOI of Sri Lanka for the development and promotion of SMEs.

Creation of Regional Rural Development Banks

4.160 The establishment of Regional Rural Development Bank “RRDB”) in 1985 made available an additional credit outlet to small business sector. These banks implemented several micro credit schemes.

National Policy on SMEs

4.161 Recently, Government of Sri Lanka adopted a comprehensive national policy on SMEs, where there are suggestions to put emphasis[145] on the following issues:

- To have a clear legislative definition on SMEs
- To conduct a comprehensive Industrial Strategy
- To expand institutional support [i.e., creation of Export Promotion Bank (“EPB”) to provide seed capital to SMEs at low interest rate under soft loans initiative and easy access is one of the steps taken by the government in this regard]
- To give incentives, assistances and tax concessions like the ones adopted by the developing and developed countries where SMEs development were proved successful.
- To strengthen inter-industrial linkages
- To create entrepreneurial path within the system of General and Vocational education

144 Board of Investment [BOI], Sri Lanka, 2003 [Available: online].
145 Gamage, Aruna. S. “Small and Medium Enterprise Development in Sri Lanka: A Review”, 2003.

Chapter-5

5. Data Analysis: Findings of the Study

5.1 The questionnaire survey covered 57 small and medium enterprises from the wood and steel furniture sector, computer software and information technology sector, spares of automobiles sector, electronics, handlooms and handicraft sectors, agro-based products, textile dyeing and printing sector, plastic products, and footwear and leather sectors. This is shown in Table 5.1.

Table 5.1: Characteristics of the Sample by SME subsectors.

SME Subsectors	No	Percent	Cumulative
Wood and Steel Furniture	7	12.3	12.3
Computer software and Information Technology	9	15.8	28.1
Spares / components of Automobiles	4	7.0	35.1
Electronics	3	5.3	40.4
Specialized Handlooms and Handicrafts	9	15.8	56.1
Agro-processing Products	7	12.3	68.4
Textile dyeing and Block Printing	4	7.0	75.4
Plastic Products	8	14.0	89.5
Footwear and Leather Products	6	10.5	100.0
Total	57	100.0	

5.2 While there is no national data on the type of SMEs by their pattern of ownership, our sample survey collected data from four types of SMEs. Nearly 46% of them are registered under private limited company act, 38 percent are owned under sole proprietorship, 9 percent are partnership and the rest are public limited companies. Majority of the small entrepreneurs are either registered as the sole proprietorship or under private limited company. Considering this, our sample does represent the SMEs of Bangladesh in terms of their ownership pattern.

Table 5.2: Characteristics of sample SMEs by ownership pattern

	Number	Percent	Cumulative
Sole proprietorship	21	38.2	38.2
Partnership	5	9.1	47.3
Private Limited Company	25	45.5	92.7
Public Limited Company	4	7.3	100.0
Total	55	100.0	

5.3 Forty percent of the SMEs surveyed had initial investment of Taka 300,000 or below. Other 38.2 percent were with initial investment between Taka 300,000 and 1,00,00,000. Table 5.3 shows the distribution of sample SMEs with their initial fixed investments.

Table 5.3 : Initial Fixed Investment in the SMEs

Investment	Number	Percent
Below Taka 300,000	22	40.0
Between Taka 300,000 to Taka 1 crore	21	38.2
Between Taka 1 crore to Taka 10 crore	9	16.4
Between Taka 10 crore to Taka 25 crore	2	3.6

Between Taka 25 crore to Taka 50 crore	1	1.8
Total	55	100.0
Missing Total	3.5 100.0	

5.4 On average SMEs are found to be selling their products in more than two markets. Table 5.4 shows that nearly 66.7 percent sells in the retail market, 55.6 percent sells to niche markets, 33.3 percent sells to industries, and 48.1 percent sells to foreign markets. Clearly, the linkage between the large industries and the SMEs is the weakest of all according to our findings. Moreover, nearly 69 percent said that they will be interested to find new markets abroad to sell their products.

Table 5.4 : Markets in which SMEs sell their product.

SMEs selling to	% of responses	% of Cases
Retail market	32.7	66.7
Niche market	27.3	55.6
Industrial Market	16.4	33.3
International Market	23.6	48.1
Total Responses	100.00	203.7

5.5 According to our sample number of employees in the SMEs of Bangladesh varies widely. Table 5.5 shows that nearly 38.2 percent of them employs less than 25 full time employees per firm (nearly 70 percent of the employment are full time employment in the SMEs), while the next largest group consists of 30.9 percent of the SMEs and they employ between 75 and 99 persons.

Table 5.5: Full time employees in the SMEs

Number of Full time employees	Percent
Less than 25	38.2
25 to 49	12.7
50 to 74	14.5
75 to 99	3.6
100 or above	30.9
Total	100.0

5.6 Survey results show that there are at least six reasons for which SMEs seek loans from financial institutions. The first reason is to initiate the business. Nearly 78.8 percent of the SMEs took credit to start their business. To buy raw materials for production from local markets is the second most important reason for taking credits (62.5 percent). The third reason is to facilitate works in progress and the fourth one is for renting or leasing premises. Considering the responses, it is clear that most of the SMEs need finance at the initial stage of their operations.

Table 5.6 Reasons for Taking Credits by SMEs

Reason for seeking credits	% of responses	% of cases (rank)
To start the business	12.6	78.6 (1)
To rent/lease premises	8.3	51.8 (4)
To procure equipment from local market	7.7	48.2 (6)
To procure equipment from international market	8.0	50.0 (5)
To procure raw material from local market	10.0	62.5 (2)
To procure raw material from international	7.4	46.4 (7)

market		
To facilitate export	7.1	44.6
To facilitate works in process To pay against accounts receivable	9.7 3.1	60.7 (3) 19.6
To finance prepaid expenses	2.9	17.9
To build up inventory	4.9	30.4
To hire skilled labor/experts	6.6	41.1
To patent and trademark products	2.6	16.1
To ensure quality control/ ISO certificates	4.0	25.0
To finance equity share	3.7	23.2
Others	1.5	9.0
Total	100.0	625.0

5.7 For how many years these SMEs needed the loan? Survey results show that most of them needed the finance for a period of 1 to 4.8 years period of time (the average). Table 5.7 shows the details.

Table 5.7: Time requirement for loans

Item	Mean(years)	SD
To start the business as capital investment	4.8654	3.7564
To rent or lease premises	2.8000	1.4832
To procure equipment from domestic market	2.0417	2.4921
T procure equipment from international market	4.1200	3.5397
To procure raw materials from domestic market	2.7083	2.3686
To procure raw materials from international market	1.0200	.7842
To facilitate work in process	1.6667	1.1547

5.8 Survey results show that most of the SMEs got the loan at an interest rate above 14% (table 5.8)

Table 5.8 Interest Charges on Loan to SMEs

Reasons for taking the loan	Mean Interest Charges	Standard Deviation
To start business as capital investment	.1444	.0280
To rent or lease premises	.1520	.0311
To procure equipment from domestic market	.1594	.0167
To procure equipment from international market	.1400	.0249
To procure raw materials from domestic market	.1594	.0167
To procure raw materials from international market	.1450	.0171
To facilitate work in process	.1500	.0255

5.9 In terms of the time lapse between initial application for the loan and its ultimate delivery, table 5.9 shows that on average it took 7.8 months for an SME to get their loan money for starting the business. If they were to get a loan for rental/leasing of premises, the waiting period increased to 9.8 months. However, we found cases where it took nearly 42 months for an SME to get their loan.

Table 5.9 Waiting period between loan application and loan sanctions

	In months		
Reasons for taking loans	Min	Max	Average
To start business as capital investment	2.00	42.00	7.8462
To rent or lease premises	1.00	24.00	9.7500
To procure equipment from domestic market	2.00	12.00	5.6000
To procure equipment from international market	2.00	12.00	4.4444
To procure raw materials from domestic market	1.00	12.00	4.4000
To procure raw materials from international market	2.00	12.00	5.0000
To facilitate work in process	1.00	6.00	3.3333

5.10 Who has financed the loan? Our survey result shows that most of the SMEs got their finance from private commercial banks (66 percent). The other source is own finances. Besides SMEs used retained earnings to finance their activities. However, in terms of the preferred source of taking credit or get finances, SMEs stated that Private commercial banks and direct foreign investments are their most favored sources of finance (83.3 percent). Their next choice is the foreign commercial banks (66.7 percent). Nearly 50 percent preferred Nationalized Commercial Banks and reinvestment of profits as their third choice of finance.

5.11 When asked about the reasons for which institutional sources fail to provide loans to SMEs. The study shows that high interest rate is the most significant reason for their lack of interest in taking loan from these sources. The next barrier is the collateral requirement for loans. Many have cited that bureaucracy or too much paperwork in the banking system as another major barrier. Table 5.10 shows the details.

Table 5.10 Major barriers to get loans

Barriers	% of Responses	% of Cases
High Interest rate	19.2	85.2
High Collateral Requirements	17.1	75.9
Financial Institutions Tendency to provide small term loans	7.9	35.2
Too much paperwork and bureaucracy in the banking system	14.2	63.0
Lack of long standing credit history with the banks	5.8	25.9
Lack of special client relationships with the bank	6.3	27.8
Lack of knowledge about the requirements	6.7	29.6
Lack of information regarding how to pre	4.6	20.4
Lack of management and banking skills am	4.6	20.4
Lack of access to foreign banks	.8	3.7
Lack of FDI	1.7	7.4
Lack of access to non-bank equity capita	1.7	7.4
Lack of institutional investors and gove	2.9	13.0
Lack of knowledge about the customer and	3.8	16.7
Others	2.9	13.0
Total Responses	100.0	444.4

5.12 In terms of financing of capital investment in the SME sector, majority of the investors financed their initial investment from personal savings or from family sources (between 53 and 55 percent of the investment came from these sources) and between 20 and 25 percent of the initial investment came from friends and relatives. For others, initial investment came from NCBs, PCBs, and from profits. However, majority of the

SME entrepreneurs have mentioned that family, friends, and relatives cannot support further investments to expand their operations. Consequently, the role of commercial banks and reinvestment of profits will remain the major sources of capital investment in the SME sector in future.

5.13 Of the five most preferred choices, SME entrepreneurs have chosen the private commercial banks and the development finance institutions like BASIC, BSRS, BSB, RAKUB, etc., as their first choice to receive finances (chosen by 83.3 percent of the SME entrepreneurs). Their next choice is the foreign commercial banks (66.7 percent) and the third choice includes the nationalized commercial banks and reinvestment of profits (50.0 percent), the fourth choice is the venture capital from home and abroad, the fifth choice (chosen by only 16.7 percent) is specialized schemes like credit guarantee schemes of the government, the insurance companies, and the leasing companies. A large majority of them (90 percent) are not at all interested to raise capital through the capital market in the forms of shares or debentures. Interestingly, of the 10 percent who wanted to raise capital through shares or debentures, 40 percent of them are only interested in private placement of shares and not in the form of public offerings.

5.14 How do they get loans from the banks? Nearly 76 percent of the small and medium entrepreneurs have credit approval against the banks, which provides the credit to them. They also maintain fixed deposits with these financial institutions. 82 percent of them have mentioned that the banks or the financial institutions have changed the duration of their loan during processing. On average these institutions halved the duration of the loan.

5.15 Where are the credits used? Most of them use the credits for three or more purposes. Of them meeting salary and daily expenses of the company has been used by 66 percent of the entrepreneurs. 55 percent used them for purchase of raw materials and another 55 percent used them to pay to their creditors, and 33 percent used them as over draft facilities.

5.16 When investigating on the difficulties to get soft loans from banking and other institutions, entrepreneurs have mentioned that lack of collateral assets is the major reason for not getting loan on softer terms. Other difficulties include higher interest on government bonds, lack of their ability to draw business plans, high rate of non-performance loan at the banking sector, lack of long term relationship with the banks, and lack of initiatives at the government level to help SMEs.

5.17 Our survey shows that depending on the enterprises, nearly 12 different types of documents are required by the banks to provide a loan to the SMEs. The most frequent documents used by the banks are deed of mortgages, letter of guarantee, letter of hypothecation, letter of arrangement, letter of unconditional acceptance of terms of the loan, letter of assignment of benefits, letter of installments, irrevocable power of attorney, letter of disbursement, memorandum of the deposit of title deeds, pledges of securities, letter of lien on shipping documents, and the letter of continuity.

5.18 Ninety three percent of the SME entrepreneurs want the government to setup special fund to support SME financing. On average, the amount of capital required by these SMEs is around 62 crores. 77 percent of the entrepreneurs suggest that government should provide mortgage free loan up to a limit to support SMEs.

5.19 On legal front, non-availability of information on business laws and regulations, inefficiencies in the court system, very slow process of clearance through court verdicts, unfair court decisions, and frequent misinterpretation of laws and regulations have been cited as the major drawbacks in the financing system by the entrepreneurs. Besides, corrupt practices by the bank officials, law enforcing agencies, tax officials, also arbitrary decision making by different agencies of the government are also causing difficulties for SMEs to secure finances from institutional sources.

5.20 To make finances effective, entrepreneurs have suggest that a public-private partnership of financial institutions can be arranged (suggested by 75 percent of them). At the same time 95 percent have suggested that public institutions need to be restructured to cater to the needs of the SMEs.

5.21 In terms of the problems of the SME sectors, frequent power failure has been the major cause of concern of the entrepreneurs as it affects their ability to service loans. Other problems include poor transportation networks, poor communication infrastructure, lack of facilities to give tax breaks to SMEs and absence of credit guarantee schemes for SMEs are listed as points of concerns by the entrepreneurs.

5.22 85 percent of the entrepreneurs favored credit guarantee schemes using annual cash flow statements of the company, 72 percent supports creation of venture capital to finances the SMEs, 82 percent supports syndication between microfinance and banking institutions to provide effective loans to them, 89 percent favors development of a system to transfer credit history from one banking institution to the other including certification of credit history by MFIs, 95 percent want the government to help SMEs in development of skilled manpower for the sector (both within the sector and within the banking and financial institutions who deals with the SMEs),

5.23 In terms of the institutions, entrepreneurs prefer Chamber of Commerce and Industries to take leadership in training and education of the entrepreneurs, Technical institutions, Universities, and NGOs are the next in line of preferences for potential training institutions.

5.24 Finally, nearly 87 percent of the entrepreneurs want the government to negotiate a cooperative arrangements between SMEs and the large industries through a permanent subcontracting system (like that of Japan) or an agreement between them to help the economy grow rapidly.

Cry for more support: SMEs in Plastic Sector

Most of the entrepreneurs in their interview with the survey team talked against the need for employing “bank guarantee” system on bonded facilitated groups from this year by the government, where the entrepreneur would have to increase capital three times more than of present moment. Though the government has taken some bold decisions during the recently concluded “Plastic Fair 2003”, more actions need to be taken in terms of “protectionism” measures to revive this fledgling industry, which has huge export potential. In fact, the plastic industry earned Tk. 600 crore as foreign currency last year through direct and indirect export.

Despite of lots of potentials as thrust sector for the upcoming years, Plastic goods are not getting the kind of attention from the government unlike other sectors. Although the government has announced to set up a plastic EPZ soon, no firm decisions has been taken by the government to abolish the 15% import tariff on raw materials like iron mold, where only 7.5% is charged for the imported finished plastic goods from the competitive foreign countries. Thus, it is not surprising that most of the entrepreneurs harp their frustration to the interviewees while answering queries regarding access to finance problems and possible remedies.

Entrepreneurs face serious credit constraints while accessing loans from financial institutions. Almost all of these firms are small and finance their startup capital through the sale of land. Banks are not interested financing for startups. Private commercial banks and foreign commercial banks are bit conservative to provide funds to SMEs because of their previous experiences regarding fraudulent activities and tendency to hide accurate information about collateral and securities arrangements by quite a good number of entrepreneurs. For any loan greater than one lakh, these banks require real estate security and/ or guarantee from a prominent and credible person connected with the project, which puts unnecessary and extra burden on SMEs[146]. The guarantee amount some time take up one third of the project cost, which puts the SMEs in serious credit constraints when they start their operation. Any substantial fixed capital loan of medium to long-term duration takes a very long time to process. Delays of one year or more are not unknown and come with borrower equity requirements of 20 to 50 percent. All in all, plastic good manufacturers can get only short-term credit to finance either sales orders or the importation of inputs.

SMEs in Agro-processing: A sector with great potential

In the recently concluded "Agri-Invest 2003", government policy makers and the key players in this industry encouraged the entrepreneurs to go for commercial farming for more profitability and value addition as the banks are planning to lower interest rates in this export potential sector. Though government has taken some positive steps like significant amount of budget allocation after education and health care to the agro based industries through subsidies and allowing 13 types of agro-based industries 15% rebate on power tariff instead of the current 20 percent, still lots of initiatives need to be taken by the government to transform this industry to be a force to be reckoned with in the future.

SMEs under this sector face significant credit constraint for failure to meet the stringent collateral and securities arrangements by the financial institutions. Most of them have to rely on funds from informal sources, reinvestment and profits from previous business ventures to start their operation. The industry structure looks bit skewed and represent sort of oligopolistic market, where PRAN and BRAC are acting like leaders and rest are followers.

In fact, while talking with Mr. Sikander Ahmed, Director, Corporate Affairs, PRAN group, the research group came to know the kind of credit constraints they faced while asking for loans from the financial institutions. He recalled that the company needed to prove their worth in the domestic market before landing up with the large commercial loans from the banks. In fact, he conceded that they are bit lucky to establish themselves as pioneer in this industry, where the other fledgling firms will have to make significant investments in capital and R & D to catch up with them. Also, the expenditure to get the ISO 9000 and ISO 14000 from the credible regulatory body, especially in the agro-processed foods, has increased the cost of production. To cover their initial expenses

146 From the interview with Mr. Yusuf Ashraf, President, Bangladesh Plastic Goods Manufacturers and Exporters Association [BPGMEA] and to run operation smoothly, the major barriers the SMEs will face is the access to finance from the formal sources. Thus, government should take more initiatives through Bangladesh Bank to put some sort of pressure on the NCBs, DFIs, PCBs, FCBs and NBFIs to provide credit with reasonable interest rates. Raising funds through venture capital formation, bank syndication or joint ventures with foreign organizations could be other sources of finance for SMEs in this growth and huge export earning potential sector.

Wood & Steel Furniture SMEs: A club of creative people with less capital

As peoples' tastes and preferences changed quite a bit in the last decade, the demand for high quality, fashionable and eye catching designer steel and wood furniture with reasonable price are gaining prominence. In fact, company's like Otobi, Desh furniture's etc. to name a few were able to make inroads not only in the domestic market but also in the foreign countries. If adequate support is provided to this industry in terms credit and loan guarantee schemes, credit packages with low interest rates, sizable loan through bank syndication, etc., then, the industry has a bright future ahead. With the abolishment of quota system from 2005 under WTO arrangement for the garments industry, Bangladesh has to diversify its export basket and create a strong base in target markets, both foreign and local.

Talking with the entrepreneurs of this sector, it was found that most of them have invested funds while starting their businesses with funds acquired through personal savings, family, friends and relatives. In some cases, funds are raised through moneylenders and the firm's own employees. Entrepreneurs from this sector mentioned that they face sort of discrimination from the financial institutions, as they don't possess sizable collateral, don't have credit history and strong client relationship with the banks. Rather, they are also bit reluctant to take loans even in the future from banks for capacity expansion, as they don't want to face the bitter experiences encountered while asking for loans from the banks. Only, if they can establish them as big players in the industry like Otobi, then, they might think about asking for large commercial loans from the financial institutions. Current interest rate charged on loans from financial institutions ranges from 15% to 18%, which is quite high when considering entrepreneurs mainly who fall into middle-income category are entering in this industry.

Warning signs are already there: SMEs in Footwear sector

Almost all the firms under footwear and leather sector face severe credit constraints due to huge amount of monetary injection that is essential for start-up and then, running the business. In fact, minimum investment in this industry ranges from Taka 1 crore to Taka 25 crores. SMEs in this sector face lots of barriers to access finance, mainly large commercial loans, from financial institutions due to bank collateral requirement and sectoral risk assessments. Also, the loan default culture that exist in this sector prompt the financial institutions to be stricter in assessing loan applications. In fact, the default loan in this sector is amounting to around Tk 1,200 crore (BTA, 2003). Out of 170 leather-processing units in operation, 79 industries identified as sick, 44 have already been shut down (MOF, 2003).

SMEs in the footwear and leather sector sometimes have to rely on locally made or second hand machinery to support them. For them, the ideal conditions would be to obtain credit at reasonable rates to buy upgraded machines, using the machines themselves as security. But this is only a 'dream' at the moment, since both banks and leasing companies require real estate security (including registered mortgages on a portion of the collateral), which the footwear manufacturers generally do not have available, and the banks' repayment terms of one to two years are considered too short. SMEs mainly start their business by collecting and accumulating funds from informal sources. They, then, start with known and nearby shops as customers for small amounts, and increasing these amounts while identifying additional retailers and wholesalers by building distributional network.

One of the major concerns for the leather sector according to *Leather goods and Footwear Manufacturing Exporters Association of Bangladesh* ("LFMEAB") is the lack of ISO certifications possessed by tanneries and manufacturing units. It might happen that due to not holding ISO 9000 and ISO 14000 under WTO rules, the leather export after 2004 might face a severe jolt. Government should take immediate steps in this regard. One of the positive steps taken by the government is relocating leather processing factories from Hazaribag to a newly industrial zone at Savar by the year 2005. As only a handful of companies are able to mark in this sector, it is better that the sick industries should be closed down soon or merge them together through cooperatives or joint venture to gain efficiency through economies of specialization and economies of scale.

Chapter-6

6. Recommendations

POLICY RECOMMENDATIONS FOR SMES FINANCING

Recommendation 1	**Special SME Development Fund** **Government should set up special funds to raise the required equity capital for SMEs with the potential entrepreneurs.**
Survey Results	Most of the SMEs are found to have borrowed fund for their initial setup and for procurement of raw materials. At the same time, it has been found that the initial waiting period for getting fund for these activities is the highest 8 months (average). This remains as a major obstacle for the SMEs. 93% supported the view that government should participate in these activities by setting up special funds for this. At the same time, 78.6% of the investors took credits for starting a business. Considering these, a government-sponsored fund to help SMEs to set up initial business would help the sector. Such endeavor is not uncommon in other countries that we have studied.
Selected Country Experiences	**Japanese experience** In 1953, the Japan Finance Corporation for Small Business was established with government equity to facilitate long terms funding and start–ups for SMEs[147]. Under the scheme, the local authorities provided fund to SMEs without any interest or with a very low interest rate without collateral or guarantors. Such facilities were also extended to purchase equipment or land on installment or on lease. **UK experience** UK government mostly used grants to support small businesses (94% compared with an EU average of 58%).[148] Equity based schemes like the Enterprise Fund, the Coalfields Enterprise Fund and the Community Investment Tax Credit Fund etc. are recently established to support SME financing in UK. **China and Hong Kong experience** Chinese and HK Governments have set up SME Development Fund to subsidize projects to be carried out by eligible support organizations, professional bodies and research institutions to enhance competitiveness of SMEs.[149] Government also established SME Training Fund and SME Export Marketing Fund to subsidize training facilities and export promotion activities to promote SME development and financing. **Malaysian experience**

[147] *SME Policies and Historical Development. http://www.sme.ne.jp/policies.*
[148] *Small Business Service. http://www.sbs.gov.uk*

[149] *APEC Survey o f Small Business Enterprises. Member Report of Hong Kong. APEC, 2001*

	Under Industrial Development Program, special funds are earmarked for SMEs by the government established support schemes like New Entrepreneurs Fund ["NEF"], New Micro-Credit Scheme etc[150]. **Indian experience** Indian States finance corporations provide financial assistances to growth potential SMEs under the guideline developed by Indian Government[151]. **Sri Lankan experience** People's Bank (created in 1961) and the Bank of Ceylon provide institutional credit and credit facilities under special programs for SMEs.[152]
Recommendation 2	**<u>Credit Guarantee Scheme</u>** **Government should provide mortgage and guarantee free loan up to a certain limit under the credit guarantee scheme.**
Survey Results	In the survey, it was found that 75.9% mentioned that collateral requirement is a major obstacle to secure loans for them. On the top of this, 63 percent has mentioned about the long and tedious paperwork required for processing of loans as a major obstacle. Considering these, providing a state guarantee for credit to genuine small and medium entrepreneurs was considered as an option for SMEs with good standing. 77.4% of the SME entrepreneurs supported the view that the government should provide mortgage and guarantee free loan up to a certain limit. Such practice is not uncommon in other countries.
Selected Country Experiences	**Japanese experience** Through the establishment of Small and Medium Enterprise Credit Insurance Law in 1950 and the Credit Association Law in 1953, credit support system for SMEs was established to strengthen the financial weaknesses of SMEs. Today the unsecured debt guarantee facility is also extended to companies that are planning to spin off or already at that stage of productivity.[153] **UK experience** Small Firms Loan Guarantee Scheme (SFLGS) is extended to SMEs with viable business proposals or which has an annual turn over of no more than £1.5 million. The Department of Trade and Industry ("DTI") is liable to pay out all legitimate calls on the guarantee for default loans.[154] Besides, SMEs have access to different guarantee schemes initiated by the EU and European Investment Fund [EIF]. **USA experience**

[150] *Karikomi, Shunji. "The Development Strategy for SMEs in Malaysia". Institute for Developing Economies, APEC Study Center. Working Paper Series 97-98: No. 4, March 1998.*
[151] *Small Medium Enterprise of India [http://www.smeindia.com]].*
[152] *Gamage, Aruna S. "Small and Medium Enterprise Development in Sri Lanka: A Review".*
[153] *SME Policies and Historical Development. http://www.sme.ne.jp/policies.*
[154] *Small Business Service. http://www.sbs.gov.uk*

	Creation of Small Business Investment Company (SBIC) played a key role to promote equity investment in small firms and the kind of credit guarantees through private and public support organizations to promote and support SMEs development.[155] **China and HK experience** Feasibility of credit guarantee in the form of insurance for export promotion of SME products has been launched to strengthen SMEs' financing capability.[156] **Sri Lankan experience** In collaboration with the Central Bank of Ceylon through bank syndication in 1979, Institutional Development Board ("IDB") started providing credit guarantees on SMI loans with financial assistance assured by the IDB[157].
Recommendation 3	**<u>Financial Incentive Scheme</u>** **Government should develop financial incentive schemes for SMEs through a ranking system for their sound business plan and feasibility study.**
Survey Results	More than 20 percent of the small and medium entrepreneurs were found to have no training in terms of preparing a sound business plan for taking credits. Under the circumstances, the risk of running business increases. About 97.8% of the investors responded favored the idea of developing a financial incentive schemes based on ranking of sound business plan. Such practice would help the sector to mature using sound business plan and through training. We can observe from the following that Japan, USA have also used such schemes to promote sound business record keeping in the SMEs.
Selected Country Experiences	**Japanese experience** SMEs that can come up with new and innovative products, new technology, or have an acknowledged business plan for R and D, are qualified to apply for various low or no interest credit schemes offered by both public and private financial institutions.[158] **USA experience** Through SBIC, special attention is given to high risk, growth potential SMEs[159]. Financial institutions around the country uses *credit-scoring model* to assess the level of credit risk associated with the applicant or customer. SMEs with high

[155] *SBIC was established in 1960 [Information: Small Business Administration. http://www.sba.gov]*
[156] *APEC Survey of Small Business Enterprises. Member Report of Hong Kong. APEC, 2001*
[157] *Aivazian, Varouj, Majumder, Dipak, Santor, Eric. "Financial Constraints and Investment: Assessing the Impact of a World Bank Credit Program on Small and Medium Enterprises in Sri Lanka". University of Toronto, August 2001.*

[158] *SME Policies and Historical Development. http://www.sme.ne.jp/policies.*
[159] *SBIC was established in 1960 [Information: Small Business Administration. http://www.sba.gov]*

	score under the credit-scoring model would be considered for loans and credit guarantee schemes[160]. **China and Hong Kong experience** Government is providing the required support to the financial sector to develop and put in place the *credit scoring system* that would enable the financial institutions to reduce time and costs in preparing "manual underwriting"[161] of SME loan and guarantee schemes applicants. Malaysia: Based on ranking, successful entrepreneurs are provided credit guarantees by the micro credit banks so that they would be eligible for commercial loans from banks and other non-bank financial institutions[162].
Recommendation 4	**Institutional Network** **Develop an institutional network through public-private support partnership would be more effective in SMEs financing by pooling the unused or surplus funds available around the country. To make it viable, restructuring of the existing public agencies as well as private support institutions are required.**
Survey Results	Based on the results of the survey, 75.5% of the entrepreneurs support an institutional network under private-public partnership to accumulate and redistribute funds for SMEs financing. Of them, 94.7% believe restructuring of the public and private support institutions are necessary for the policy to be effective.
Selected Country Experiences	Though all the countries under the study have more or less joint collaboration between the private and public support agencies and institutions to promote SMEs financing, the scheme is widely practiced in Japan, USA, UK and Malaysia.
Recommendation 5	**Alternative Credit Scheme** **As an alternative to collateral based financing, loan should be provided to potential SMEs based on previous years cash flow statements (i.e., like project financing).**
Survey Results	84.3 % of the SMEs responded positively of the above policy recommendation based on the questionnaire survey.
Selected Country Experiences	In developed countries like Japan, USA, UK and the developing countries like China and Hong Kong, financing is sometimes structured according to the forecasted cash flows to the growth potential but credit constrained SMEs.

[160] *Under credit-scoring model, it delivers a number, where data on an applicant are passed through an analytical model embedded in software. [Asch, Latimer. "Credit Scoring: A Tool for More Efficient SME Lending". SME Issues, Vol.1, No.2, November, 2000.]*
[161] *Involves collection and review of financial statements and other labor intensive works.*
[162] *Ibid.*

Recommendation 6	**<u>Venture Capital</u>** **Venture capital formation for SME financing should be highly encouraged through enforcement of proper rules and regulations by the Stock Exchange Commission ("SEC") and other key players including the Bangladesh and private support organizations.**
Survey Results	The survey result shows that most of the SMEs support venture capital formation through SMEs financing (72.3%).
Selected Country Experiences	<u>Japan and USA:</u> By promoting investors confidence in the well organized capital markets through proper implementation of policies, SMEs were able to generate funds through venture capital formation by targeting venture capital firms and venture capitalists like private and public pension funds, endowments, foundations, foreign investors and wealthy individuals in countries like Japan and USA[163]. In USA, angel investors, who are wealthy individuals and entrepreneurs, are encouraged to pool funds through mutual funds so that the money can be invested at the early stages of development of SMEs before the rollout of products and expansion phases. <u>UK</u>: Though gaining ground, venture capital has not yet developed into a main source of SMEs financing compared to US in terms of volume of transactions. China and Hong Kong: Policies are in place to enhance SMEs' knowledge of various types of equity financing, including venture capital funds. <u>India and Malaysia</u>: Both India and Malaysia are more or less successful in venture capital formation for SMEs financing. In India, the fledgling but high growth potential IT companies were quite successful in procuring the necessary funds through venture / equity capital formation[164].
Recommendation 7	**<u>Bank Syndication Scheme</u>** **Forming bank syndication between micro finance institutions and commercial banks for SMEs financing. Micro finance institutions should provide recommendation and credit history to commercial banks for SME development.**
Survey Results Selected Country Experiences	82 percent of the respondents support syndication between micro finance and banking institutions to provide effective loans to them, 89 percent favors development of a system to transfer credit history from one banking institution to the other including certification of credit history by MFIs. <u>Malaysia:</u> Micro credit banks transfer credit history to other banks and non-bank financial institutions so that they can be graduated to commercial loans.

[163] *Small and Medium Enterprise Ministerial Meeting, Thailand. "The Continuum of Capital Formation in the United States". Member Report: USA, APEC, August 2003.*

[164] *Narain, Dr. Sailendra. "Financing SME Technology: Public Sector Initiatives in India", 2002.*

Recommendation 8	**<u>Entrepreneurship Development</u>** **Government should contribute for Human Resource development and training program for entrepreneurship development.**
Survey Results	94.6 percent of the entrepreneurs suggested HRD and training programs for entrepreneurs through government initiatives.
Selected Country Experiences	<u>Japan:</u> In collaboration with Japan Small and Medium Enterprise Corporation (JASMEC) and other private support organizations, the government of Japan came up with training programs to develop necessary expertise among the entrepreneurs, especially the ones representing the SMEs[165]. The program is initiated from the reconstruction period (1945-1954). USA: Different training programs are conducted through SBIC for entrepreneurship development in the SMEs sector[166]. <u>UK:</u> Administered by Department for Education and Skills (DFES), small firms training program is developed to encourage more vocational education and training to take place in the small firms sector[167]. <u>China and Hong Kong:</u> SME training fund is created by the Government to subsidize training programs developed by the SMEs for their employees[168]. <u>Malaysia, India and Sri Lanka:</u> Entrepreneurship development programs are developed in these countries so that the SME entrepreneurs have the know how to prepare a sound business plan, conduct feasibility studies and come up with innovative products and services.
Recommendation 9	**<u>HRD in Financial institutions and in Government offices</u>** **Government should provide Human Resource development and training program for financial institution employees and related government officials to smooth out the SMEs financing process.**
Survey Results	95 percent want the government to help government agencies and financial institutions in development of skilled manpower to deal with SMEs more efficiently and effectively.
Selected Country Experiences	In all the selected countries under study, government impart training programs to develop the necessary skills among the employees of the government, banks and financial institutions in dealing with SMEs finance and development.
Recommendation 10	**<u>Training and Development</u>** **Relevant associations of Chamber of Commerce and Industries should take the leadership role in promoting SMEs training and development.**
Survey Results	In the survey, around 80 % of the entrepreneurs prefer Chamber of Commerce and Industries to take leadership in training and education of the entrepreneurs. Technical institutions, Universities, and NGOs are the next in line of preferences for potential training institutions.

[165] *SME Policies and Historical Development. http://www.sme.ne.jp/policies.*
[166] *SBIC was established in 1960 [Information: Small Business Administration. http://www.sba.gov]*
[167] *Small Business Service. http://www.sbs.gov.uk*
[168] *APEC Survey of Small Business Enterprises. Member Report of Hong Kong. APEC, 2001*

Selected Country Experiences	Relevant associations representing SMEs plays an active role in providing training facilities to SMEs for skill and HR development in the selected countries under study.
Recommendation 11	**<u>Sub-contracting arrangements</u>** **Government should come up with policies in collaboration with private support organizations to link up SMEs and suppliers of manufacturers and raw materials under the same industry (both backward and forward linkage service providing firms) based on subcontracting / outsourcing agreement. If developed and implemented accordingly, this types of cooperatives would lead to higher value addition and economies of scale.**
Survey Results	Nearly 87 percent of the entrepreneurs want the government to negotiate a cooperative arrangement between SMEs and the large industries through a permanent subcontracting system or an agreement between them to help the economy grow rapidly.
Selected Country Experiences	<u>Japan:</u> The law on the Cooperative Association of SMEs was enacted in 1949 with the purpose of correcting the social and economic disadvantages of SMEs and of uplifting their social status by linking them with large firms through subcontract agreement[169]. From the study, it was found that due to success of joint agglomeration and cooperative among small and large industries in Japan, many countries like USA, UK, China and Malaysia are adopting or trying to implement the policy.
Recommendation 12	**<u>Credit Database</u>** **Government, associations of Chambers of Commerce and Industry, credit information bureau (CIB), Bangladesh Bank and Stock Exchange Commission (SEC) and renowned auditing firms should jointly prepare a reliable database, where necessary information about the existing and potential entrepreneurs and formal creditors will be available. The date base will be accessible only to the concerned authorities. This would ensure transparency and accountability while choosing the right entrepreneur and the right project among the pool of applicants.**
Survey Results	In the survey, 26 percent of the investors feel that lack of special client relationships with the management of the financial institutions and lack of knowledge about the customer and the bank (nearly 17%) are one the five key factors why SMEs finding it hard to get loans from financial institutions.
Selected Country Experiences	<u>Japan, USA, UK and Hong Kong:</u> Due to sound database on both clients and the financial institutions that exists in the countries, SME entrepreneurs with good credit record have the option to apply for loans in financial institutions even if they do not have any account with them[170].

[169] *SME Policies and Historical Development. http://www.sme.ne.jp/policies.*
[170] *Based on the study on the selected countries by the researchers.*

	Other selected countries like China, India, Malaysia and Sri Lanka are also making preparations to come up with client and financial institutions database that are accessible to relevant authorities.
Recommendation 13	**Specialized Financial Institution** **Create a separate financial institution to deal exclusively regarding SME financing and promotion of their goods and services, both in domestic and foreign market.**
Survey Results	In the survey, though on average 40% of the loan is taken from financial institutions like BASIC, NASCIB and other support services from private institutions, most of the investors expressed the view of getting more financial support from institutions that would exclusively deal with SMEs.
Selected Country Experiences	Japan: In addition to Shuko Chukin Bank, which extends loans to SMEs, Japan Finance Corporation for Small Business was established in 1953 with government equity to facilitate long term funding[171]. UK: Small Business Service of UK and the different organizations that offer venture capital and guarantee facilities under European Union allows SMEs to obtain funds from sources that exclusively deals with SME activities[172]. China and Hong Kong: Under the Small Medium Development Committee, funds are allocated for business start-ups, training, and business development and export promotional activities of SMEs[173]. India: Small Industries Development Bank of India (SIDBI) and Small Industry Development Corporations provide long and medium term loans to SMEs [SME India website]. Sri Lanka: Under special programs for SMEs promotion and development, Bank of Ceylon and Industrial Development Board (IDB) created separate departments to deal with SMEs financing [Ranasinghe, 1996].
Recommendation 14	**Exit mechanism** **Making entry/ exit policies easier to avoid market failure so that resources from sick industries, especially SOEs[174], can be transferred to growth potential SMEs.**
Selected Country Experiences	In the study, it was found that countries like USA, UK, Japan, Malaysia and India have policies to make the entry/ exit strategies quick policies easier so that funds are allocated efficiently.

[171] *SME Policies and Historical Development. http://www.sme.ne.jp/ policies*

[172] *Small Business Administration (SBA). http://www.sba.gov .*

[173] *APEC Survey of Small Business Enterprises. Member Report of Hong Kong. APEC, 2001*

[174] *State Owned Enterprises (SOEs).*

Recommendation 15	**Reduction of Interest Rate** **Restructuring and clean up of NCBs and other financial institutions with questionable performance to improve management and get rid of the non performing loans so that lower interest rate can be provided to the SMEs. Single digit interest rate would be desirable to promote and develop SME sectors, like the ones available in the developed and developing countries.**
Survey Results	85.2% of the entrepreneurs ranked high interest rate as the main reason for their lack of interest in taking loan from these sources.
Selected Country Experiences	Based on the study, it is found that the average lending rates is in single digit in countries like USA, Japan, UK and Malaysia. Thus, it could indicate the kind of incentives that create among potential entrepreneurs to resort to different forms of loans from banks.
Recommendation 16	**Credit rating system** **Alternative to existing financial tools and leasing, the " downgrading" of banks to preferred target groups, especially SMEs and "upgrading" of successful non-governmental organizations (NGOs) and private support organizations could help to provide finance to Microenterprises and SMEs. Such approaches can eliminate the need for credit guarantees.**
Selected Country Experiences	By implementing analytic soft wares like credit scoring model based on available data from reliable sources, banks and financial institutions in countries like USA, Japan, UK, Malaysia and China and Hong Kong are providing loans to growth potential SMEs with good track record[175].

[175] *Asch, Latimer. "Credit Scoring: A Tool for More Efficient SME Lending". SME Issues, Vol.1, No.2, November, 2000.*

Appendix

List of References:

1. Ahmad, Shamsuddin. "Bangladesh Banking System: Issues & Challenges" World Bank, 2002.
2. Al-Husainy, S.M. "Policy Towards Investment and Industrialization". DCCI-CIPE/ ERRA Project, 12 August 2003.
3. Bangladesh Institute of Development Studies (BIDS). Trade Cooperation and Economic Policy Report in South Asia: Country Study: Bangladesh, March 2003.
4. Bangladesh Enterprise Institute (BEI) and The International Bank for Reconstruction and Development, The World Bank. *Improving the Investment Climate of Bangladesh*. World Bank Publication: 2003.
5. Bangladesh Bank. Annual Report, 2001-2002.
6. Bank Survey Bangladesh. "Consolidated Report on Commercial Banks of Bangladesh: SME Financing". SME Department, World Bank Group; October 2000.
7. BRAC Bank. *Appraisal Report*. IFC, February 2000.
8. Centre for Policy Dialogue, 2003. "Task Force report on Industrialization". CPD Task Force Report, Dhaka.
9. Centre for Policy Dialogue, 2003. "Task Force report on Trade Policy". CPD Task Force Report, Dhaka.
10. Choudhury, Toufic A. "Financial Sector Reforms: Reflections of Recent Measures". 2003.
11. *Policy Environment for Financing Small and Medium Enterprises: Demand and Supply Side Issues.* Workshop on Financing of Small Enterprises, Bangladesh Institute of Bank Management (BIBM), 2003.
12. Chaudhury, Abdul Jalil. "Financing of Small Enterprises: Experience from Abroad and Some Innovative Tools for Finance". BIBM, 2002.
13. Dhaka Chambers of Commerce and Industry (DCCI). *Annual Report 2002-2003.*
14. Economic Relations Division, Ministry of Finance, Bangladesh. *A National Strategy for Economic Growth, Poverty Reduction and Social Development (PRSP).* Ministry of Finance, March 2003.
15. Government of Bangladesh (GOB). *Industrial Policy 1999.*
16. Government of Bangladesh (GOB). *Proposed Industrial Policy 2002.*
17. Martin Holtmann et al. "SME Financing: Lessons from Micro finance". *SME Issues*, Vol. 1, No. 1 November 2000.
18. Mahajan, V and Dichter, T.W. "A Contingency Approaches to Small Business and Micro enterprise Development". *Small Enterprise Development*, Vol. 1(1), pp.4-19.
19. Meagher, Patrick. "Secured Finance for SMEs in Bangladesh". Institutional Reform and the Informal Sector (IRIS), Job Opportunities and Business Support (JOBS) Program, June 1998.
20. South Asia Enterprise Development Facility (SEDF), IFC, 2002. *Bangladesh SME Finance: Macro-economic overview of Bangladesh's financial sector.* Dhaka, Bangladesh.
21. United Nations Development Program (UNDP). *Human Development Report*, 2002.
22. Vaart, Bert Van Der. "Investing in SMEs: The SEAF Model". *SME Issues*, Vol. 2, No 1 March 2001.

Country wise SME Profile Background Papers and Databases:
Japan
1. SME Policies and Historical Development. http://www.sme.ne.jp/policies.
2. Small and Medium Enterprise Agency, METI, Japan. http://www.chusha.meti.go.jp.
3. APEC Survey of Small and Medium Enterprises. *Member Report of Japan.*

United Kingdom
1. Small Business Service. http://www.sbs.gov.uk
2. SME Knowledge Network, University of Bradford. http://www.bradford.ac.uk/smenetwork
3. Domestic Finance Division, Bank of England. *Quarterly Report of Small Business Statistics.* January 2001.
4. SMEs in UK. http://www.sme.co.uk

United States
1. Asch, Latimer. "Credit Scoring: A Tool for More Efficient SME Lending". SME Issues, Vol.1, No.2, November, 2000.
2. Small Business Administration. http://www.sba.gov
3. Small and Medium Enterprise Ministerial Meeting, Thailand. "The Continuum of Capital Formation in the United States". *Member Report: USA*, APEC, August 2003.
4. US Chambers of Commerce and Industry. http://www.uschambers.com
5. US Department of Commerce. http://www.doc.gov

China and Hong Kong
1. APEC survey of Small Business Enterprises. *Member Report of Hong Kong.* APEC, 2001.
2. Hall, Chris. "APEC and SME Policy: Suggestions for an Action Agenda". University of Technology, Sydney [2001].

Malaysia
1. Karikomi, Shunji. "The Development Strategy for SMEs in Malaysia". Institute of Developing Economies, APEC Study Center. Working Paper Series 97-98:No.4, March 1998.
2. Kassim, Yang Razali. "Entrepreneurship drives shift to high gear". *Business Times*, May 29, 2003.
3. Small and Medium Enterprise Ministerial Meeting, Thailand. "Business Creation, Capital Formation, and Financial Access for SMEs and Micro Enterprises". *Member Report: Malaysia*, APEC, August 2003.
4. Bhumiputra Commerce. "Malaysia: The Economic Package. Special Economic Services". Vol.4, May 24, 2003.
5. Levitsky, Jacob. "SME Guarantee Schemes: A Summary". The Financier. Vol.4, No. 1 & 2, Feb/May 1997. [http://www.thefinancier.com]

India
1. Small Scale Industries (SSI). [http://www.laghu-udyog.com/ssiindia]
2. Small Medium Enterprises of India. [http://www.smeindia.com]
3. Small Industries Development Organization (SIDO). [http://www.laghu-udyog.com/sido.sido.htm]
4. Narain, Dr. Sailendra. "Financing SME Technology: Public Sector Initiatives in India", 2002.

5. General Review Study of Small and Medium Enterprise (SME) Clusters in India, SSI, 2002. [Available: http://www.laghu-udtog.com/ssiindia]

Sri Lanka

1. Aivazian, Varouj, Majumder, Dipak, Santor, Eric. "Financial Constraints and Investment: Assessing the Impact of a World Bank Credit Program on Small and Medium Enterprises in Sri Lanka". University of Toronto, August 2001.
2. Gamage, Aruna. S. "Small and Medium Enterprise Development in Sri Lanka: A Review". 2003.
3. Ranasinghe, S. "Entrepreneurship Training and Education in Sri Lanka". *Sri Lankan Journal of Management; Post Graduate Institute of Management*. Vol.1, No.3, 1996.
4. Richards, Peter et al. " Towards and Employment Strategy Framework for Sri Lanka". Employment Strategy Department, ILO, January 2002.
5. Wickramasinghe, V.K. "The Development of Small Scale Industries in Sri Lanka: Experience and Prospects". *Sri Lanka Economic Association*, Colombo, 1993.

APPENDIX I
GLOSSARY OF TERMS

Bank Guarantee
An institutional commitment to repay a loan.

Bank Syndicate
A group of banks that acts jointly, on a temporary basis, to loan money in a bank credit (syndicated credit) or to underwrite new issue of bonds.

Credit Database
A database developed by Credit Information Bureau of the respective country, that provides credit history of consumers so that creditors / financial institutions can make decisions about granting of loans.

Credit Guarantee
Credit guarantee is usually purchased by a company to protect itself against specific losses that could impair the performance of the company. In the case of credit guarantee, protection is offered to the supplier against the risk of the debtor going into liquidation (Insolvency); delayed or non-payment (Protracted Default) and in respect of export risks, the unilateral cancellation of contract (Repudiation) as well as a myriad of Political related risks.

Credit Rating System
An evaluation of an individual or company's ability to repay obligations or its likelihood of not defaulting. The rating system helps the financial institutions to assess credit risks of the business entities, especially growth potential SMEs, which lead to extension of loans and credit guarantees.

Credit Scoring Model
A statistical model / technique used by the banks that combines several financial characteristics to form a single score to represent a customer's creditworthiness [i.e., eligibility of an individual or firm to borrow money].

Direct Investment by the government
Direct participation by the Government in financing start-up and working capital for growth potential SMEs by providing grants, small business loans, guarantees etc. In USA, Small Business Administration (SBA) loans offer competitive rates and tend to have longer terms, no points, no balloons and no pre-pay penalties with terms under 15 years.

Equity Capital
Capital that is mainly raised through owners in the company.

Entrepreneur
A person starting a new company who takes on the risks associated with starting the enterprise, which may require venture capital to cover start-up costs.

Exit Mechanisms for firms and stock investors
Under efficient regulatory framework and legal enforcement in the financial sector, effective exit mechanisms for loss making small and medium enterprises encourage institutional/ individual investors participation in financing good projects. This will allow

transferring of physical as well as financial assets from loss making private or state owned enterprises (SOEs) to companies that are doing well in the market through effective utilization of resources.

Government investment in Venture capital or equity capital financial schemes
Government participation in SMEs financing through venture capital or equity capital to encourage more entrepreneurship development in areas that are considered to have export potential or can meet domestic demand.

Leveraged Buyout Financing with government participation
Leveraged buyout financing (LBO) is typically provided for the strategic purchase of other product lines, divisions, or companies. They can also be used for, but not limited to management buyouts, acquisitions, divestitures, valuations and refinancing. In USA, Japan and UK, LBO with government participation is widely practiced to provide support for SMEs promotion and development [Haque and Sakib, 2004].

Strong legal and regulatory framework for the capital market
In Bangladesh, a weak legal infrastructure is largely responsible for non-recovery of default loans and thus for deterioration in the quality of overall credit management (TRACE-BIDS, 2003). If the quality of the overall credit management is poor, it discourages investors' participation, especially when financing SMEs. It is found from the survey [Haque and Sakib, 2004] that the existence of a strong legal and regulatory framework in USA, UK, Japan, Malaysia and India is mainly responsible for substantial small business enterprise growth and development.

Subcontract
A contract between a party to an original contract and a third party, especially one to provide all or a specified part of the work or materials required in the original contract. In most cases, subcontracts must be approved by the sponsoring agency. Subcontractors should be identified in the research proposal, including the subcontractors' budget, indirect rates, scope of work, and approval from their administration.

Training Programs for SMEs
Human resource development and training programs through private-public initiative to prospective or potential entrepreneurs for successful launching and subsequent growth of their projects. Programs mainly incorporates preparation of a good business plan, methodologies associated with feasibility studies / cost-benefit analyses of different projects, management training, information regarding existing rules and regulations in the financial sector, etc. This would reduce transaction costs and increase transparency and accountability of the financial system.

Training programs for Government and Bank officials
Training programs provided to government and bank officials to identify viable growth potential projects can help increase their capacity to SMEs lending through reduction of transactions costs and identification problem [IFC, 2003]. Ability to evaluate the cash flows of SMEs provides the bank officials to come up with a full set of small business finance products that optimize revenue opportunities while minimizing costs [IFC, 2003].

Venture Capital
Financing for new businesses. Start-up companies that receive venture capital are perceived to have excellent growth prospects but don't have access to capital markets because they are private companies. In return for venture capital, investors may receive

a say in the company's management, as well as some combination of profits, preferred shares or royalties. Sources of venture capital include wealthy individual investors, investment banks, and other financial institutions that pool investments in venture-capital funds or limited partnerships. The risks and rewards of venture capital investing can be extreme.

Venture Economics uses the term to describe the universe of venture investing (i.e., Private Equity). It does not include buyout investing, mezzanine investing [A fund investment strategy involving subordinated debt (the level of financing senior to equity and below senior debt)], and fund of fund investing [a fund, which takes minority equity positions in other funds. If the focus is primarily investing in new funds this is a Primary or Primaries fund of funds and if focusing on investing in existing funds this is referred to as a Secondary fund of funds] or secondaries. Angel investors or business angels would also not be included in the definition.