Plenary 4

Capital Markets and Economic Development - New Avenues for the Financing of Small and Medium Enterprises (SMEs)

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Definition of SMEs

- OECD definition: independent companies that employ less than 250 employees
- In APEC, 70-80% of SMEs employ less than 5 persons.
- Within APEC, there are 49 million non-agriculture SMEs, half in China and Indonesia.
- 80% of SMEs are in services, 15% in manufacturing and 5% in agriculture.
- APEC Profile of SMEs 2003: “Potential to add US$1 trillion in trade and US$150 bn in FDI in APEC if “structural changes allow for a simpler, more business friendly, more integrated APEC economy to emerge.”
SMEs are the Base and Backbone of Economies

In developing countries, microenterprises represent:

- Over 80% of total enterprises
- Over 50% of urban employment
- Over 20% of GNP
- Main source of employment for poor people
Domestic Financing in East Asia is Bank-Dominated

Despite the lessons of the Asian crisis and efforts to develop bond and equity markets, the Asian financial system remains bank-dominated, with still fledgling bond markets, speculative stock markets and relatively small insurance and pension and social security systems.
## Equity, Bond, Insurance + Pension Markets Remain Relatively Under-Developed

<table>
<thead>
<tr>
<th></th>
<th>Bank Deposits&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Equity Market&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Bond Market&lt;sup&gt;c&lt;/sup&gt;</th>
<th>Insurance Premiums&lt;sup&gt;d&lt;/sup&gt;</th>
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</table>

Sources: CEIC data; World Bank, Financial Structure Dataset, February 2006

<sup>a</sup> Bank Deposits/GDP
<sup>b</sup> Stock Market Capitalization/GDP
<sup>c</sup> Public and Private Bond Market Capitalization/GDP
<sup>d</sup> Life and Non-Life Insurance Premium Volume/GDP

1. 1992 data
2. 1994 data
3. 1995 data
4. 1996 data
5. 2003 data
n.a. denotes not available
Post-Asian Crisis, Banks have been cautious on SME lending

- In the search for profitability, banks have tended to concentrate on “safer” lending areas such as consumer finance, mortgage lending and asset management activities.
- SMEs find banks less “user friendly”, and so resort to:-
  - Own funding
  - Capital or loans from friends and relatives
  - Money-lenders
- Banks now entering into SME field
Strengths of Banking Network

- New Credit-Scoring Skills manage risks better
- Wide range of banking products available, from individual loans, savings, working capital and capital investment loans
- Banks can service transactions and also intermediate counter-party risks
- Banks can act as wholesale funders to microfinance and SME financial institutions
Major Problems facing SMEs

- Lack of overall business skills
- Property rights unclear - insufficient assets for collateral
- High Transaction Costs - particularly for rural areas where communications and access to formal finance is difficult
- Information Asymmetry on Counter-party risks and access to market information
- Non-standardization of SME accounting makes risk measurement difficult for creditors and investors
Hernando de Soto - Fix Six Positive Property Effects

1. Protect property rights of poor, by efficient registration and low transaction costs
2. Provide poor with access to accurate market information
3. Making officials accountable
4. Making assets fungible
5. Networking people
6. Protecting transactions (through efficient trading system)

No property rights = system is illiquid, not transparent, not accountable, not fungible, no network, no trading = no credit culture

If Property Rights are unclear, SMEs cannot issue bonds, equity and derivatives

- SMEs in both urban and rural areas suffer from lack of clarity of property rights (property registry) that cause them to have high transaction costs and are perceived to have high risks.
- Government therefore has a role to build Property Rights Infrastructure (Registry, Trading, Clearing and Payment systems) that clarify property rights and reduce transaction costs.
- Lack of Credit Culture and Counter-Party Trust is due to lack of transparency and understanding of SME and their credit history. Technology can solve this through Credit Rating Agencies and eBay-type trading bulletins with trading/credit history built in.
SMEs generally do not have access to equity markets

- Principal reasons are Cost, Transparency and Risks
- Minimum costs of listings are quite high...Hong Kong Growth Enterprise Market (GEM) listing fees and costs are minimum HK$1 million (US$130,000), equivalent to 3.3% of costs for HK$30 million (US$3.9 mln)
- GEM entry only for companies with annual turnover of HK$500 mln (US$64 mln) and minimum market capitalization of HK$150 mln at listing (US$19 mln).
Transparency and Compliance Costs are High for SMEs

- IASB is working on International Financial Reporting Standard (IFRS) for SMEs - still at Working Group Stage
- SMEs defined as employees not more than 50 and turnover of about $10 mln (US$13 mln)
- Even OECD is working on a simplified Corporate Governance Code for SMEs
- Main Issues
  - How to simply recognition and measurement principles for SMEs?
  - What to omit from IFRS for SMEs and make accounting for SMEs relevant?
Using Technology to Overcome Transparency and Cost Barriers

- Extended Business Relationship Language (XBRL) allows business reporting that is standardized to help reduce filing, analysis and reporting costs
- XBRL adopted for Chinese listed companies
- Creating Web-based Trading, Clearing, Settlement and Payment infrastructure for SMEs is now possible (variants of Business to Business webmodels for SMEs)
Creating OTC market for SMEs

- Tianjin City China is applying to State Council to create an OTC market for trading of equity in SMEs that do not qualify to meet requirements for listing on exchanges.
- Bohai Industrial Fund (US$2.5 billion) to create direct fund raising for modern, innovative manufacturing, high-tech projects and infrastructure construction.
Potential Technology Solutions to SME Access to Capital Markets

- Standardized Info
- Credit-Rating + SME Registry
- SME Exchange?
- Regulation Lite?
- SME Venture Capital?
- Local OTC Equity Exchange
- Banks Credit Scoring + Incubator
Key Policy Measures for SMEs

1. Train SME through SME Business Schools
2. Liberalized interest rates, relying on competition and transparency to lower costs and rates
3. Build Financial Infrastructure that clarify property rights and reduce transaction costs
4. Use Market forces (banks, rating agencies, NGOs) to impose market discipline - regulatory burden on SMEs should be light but firm
5. Allow different types of SME legal structures to evolve (no ONE SIZE FITS ALL model)
6. Legal and judicial systems that support secured and unsecured lending
7. Common basic performance indicators, definitions and standards
8. Government’s role Is enabler, not provider and competitor
9. Donor support to complement private capital, e.g., financing younger institutions, capacity building, innovation, institutional infrastructure and policy change
Building Blocks of Domestic Financial Markets That Work for the Poor Majority

**Policy**
- Interest rates
- Financial sector policies
- Government policy
- Regulations, supervision
- Legal structures
- Legal systems
- Performance indicators
- Government role
- Donor support

**Industry Infrastructure**
- Domestic capital markets
- Tech service providers
- Wholesale financial institutions
- MF networks, associations
- Rating agencies
- Credit bureaus
- Tech applications
- Payment systems
- Business services

**Financing Microfinance – Domestic Capital Markets**
- Savings mobilization
- Wholesale financing
- Bonds, securitizations
- Grants for smaller MFIs
- Guarantee mechanisms
- Transparency
- Healthy market overall

**Retail Capacity, Supply**
- Commercial Banks
- Microfinance NGOs
- Regulated MFIs
- Cooperatives, Credit Unions,
- Savings
- Grass Roots Groups
- Others

**Product Offerings**
- Savings
- Microloans – Working Capital
- Insurance
- Remittances, savings, assets

**Impact in Poor Households**
- Income
- Assets
- Education, Health
- Women's Decision-making, Power
- Community Participation
Conclusion

- Much can be done in the capital markets to service better the needs of SMEs, but reforms cannot be done by regulators alone.
- Policy-makers need a holistic approach and focused policy towards SMEs. Regulators can help by simplifying rules and regulation applicable to SMEs and allowing market forces and discipline to foster SME growth and innovation.
- IOSCO can help push IASB, OECD and other standard setters to expedite work to help SMEs.
THANK YOU