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CCET/DAFFE(98)8



Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

OLIS : 25-Feb-1998
Dist. : 25-Feb-1998

Or. Eng.

**CENTRE FOR CO-OPERATION WITH THE ECONOMIES IN TRANSITION
DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISES AFFAIRS**

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Financing SMEs in Transition Economies

Second Workshop on Financing Newly Emerging Private Enterprises in Transition Economies

Meeting held at the Chateau de la Muette, Paris on 27-28 January 1998

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Or. Eng.

I. Overview of SME Financing

SME Development in Transition Economies

The development of SMEs in transition economies varies greatly from region to region. In the central European countries and Baltic republics, SMEs are well-developed and they play a significant role as an engine for growth. For instance, Poland has 2 million registered enterprises and the Czech Republic and Hungary have more than 1 million each. The SMEs produce about half of the countries' GDP and employ more than a half of the workforce. The development of SMEs is still minimal in the CIS, however, where Ukraine has only 100 thousand registered enterprises and Russia 900 thousand, which makes the per capita ratio of officially registered enterprises only 1/10 to 1/50 of those of Central European countries. Most of the enterprises in these countries prefer to work in the second economy.

The obstacles for the development of SMEs are manifold, but major ones can be summarised as follows: macroeconomic instability; lack of credits; lack of own capital; the burden of high and frequently changing taxes; the difficulty of finding good suppliers and buyers; imperfect laws and regulations; difficulties dealing with administrative bodies or corruption; difficulties dealing with criminal organisations; shortages of premises and production sites; and lack of entrepreneurship know-how and business specialists.

One of the most serious problems of SMEs in transition economies is financing. SMEs usually lack financial resources and are obliged to start and maintain their businesses with their own funds or by borrowings from family and friends.

Banks' Behavior

Until quite recently, banks, the main financial source of SMEs in most OECD countries, have been rather hesitant to provide substantial amounts of credits to SMEs. In addition, credit conditions to SMEs are not favourable due to high interest rates, very short maturities and insufficient lending amounts, as well as extraordinarily high collateral requirements, complicated and time-consuming loan authorising procedures, etc. Banks have other reasons for their reluctance: they enjoy low-risk investment in government bonds and have traditional lending partners in the larger enterprise sector, while continuing to suffer from existing bad loans and the lack of developed credit assessment systems and skills.

The situation is gradually changing and banks are starting to look more positively upon SME financing in Central Europe and in the Baltic Republics. This trend owes to the recovery of the savings ratio, the increasingly harsh competition in the banking sector and the gradual disappearance of favorable profit generating sources such as state bonds. But, even in such countries, the loans to the SME sector are still marginal in banks' asset portfolios. The loan amount extending to SMEs remains minimal (5-20 percent of the GDP) with very short maturities. In the most of the OECD countries, this is 50-100 percent of the GDP, with loans of longer maturities.

Credit Co-operatives

Credit Co-operatives, which put stress on local initiatives and peer group assessment of loans, could be one of the alternatives to the problem of SME financing. But the sector has experienced a sudden increase of bad loans and difficulties of asset management in rural areas after the introduction of

economic reform. The sector has been under the process of serious rehabilitation and re-organisation. In Poland, the government introduced public money to secure the system of credit co-operatives and to establish a three-tier structure consisting of a union's central bank (The Bank for Food Economy), nine regional banks and around 1,200 local co-operatives. Hungary introduced the same type of reform, establishing a union's apex bank for around 250 saving co-operatives, which have 1800 branches mainly in rural areas.

Therefore, notwithstanding vigorous public and private initiatives, the co-operatives are too weak to provide loans to the SME sector; their size is too small, amounting to only a small percentage of the banking sector, while credit assessment and risk management skills are underdeveloped. Most of the funds are sent to interbank markets or to central organs of the credit co-operatives to provide loans for larger enterprises.

Alternative and Supplementary Financing Facilities

In response to this situation, a number of SME financing schemes, which basically supplement or reinforce the weakness of bank financing to SMEs, have developed in these countries. The main schemes are: 1) credit lines from international donors; 2) credit guarantee programmes; and 3) governmental credit funds. Moreover, several alternative private facilities, including leasing, venture capital and securities exchanges, have developed rapidly. In addition to this, Foreign Direct Investments (FDIs) and direct loans from foreign banks, mainly in EU countries, have increased dramatically.

These financial facilities mitigate several of the problems regarding SME financing; most of these facilities provide long-term financing sources, which is definitely missing from SME financing schemes in transition economies, although leasing and guarantee schemes have introduced some solutions on the collateral problem. Moreover, the facilities are one of the factors that have brought about competition among financial institutions and have increased the efficiency of the whole financial sector.

It is difficult to estimate the total amount of such facilities to SMEs, but in the most advanced transition economies the figure may reach around 5-10 percent of the GDP, which is quite substantial compared to the size of banks' credits. Among the facilities, leasing and FDIs may be the biggest vehicles, followed by credit lines and guarantees. Venture capital and securities markets, which have brought about important innovations in private sector finance in the transition economies, have played rather marginal roles in the field of SME financing.

II. Private Facilities

Leasing

Leasing is quite a useful facility to solve the collateral problem. The schemes are as follows: 1) Leasing companies buy machines and equipment and lend them to the SMEs instead of extending loans; 2) They receive rental fees instead of interest and principal; 3) The ownership right remains in the hands of the leasing companies until the end of the rental period and this plays the same role as collateral; 4) Therefore, collateral-scarce SMEs can access longer term funding sources through leasing.

Leasing is becoming increasingly popular because of its availability, convenience, flexibility and lower transaction costs. In the Czech Republic and in Hungary, where the leasing industry is well-developed, it accounts for 20 percent of all industrial investment.

Over half of the companies' business comes from automobiles, which is followed by equipment and machinery. There are three types of leasing companies: vendors' captives (usually multinational car companies), bank's subsidiaries and independent companies. As competition from captives of car companies increases, bank-owned companies are obliged to go into equipment markets and smaller enterprises.

Foreign Direct Investment

FDI has played quite an important role in providing capital to private sector development. So far, more than \$30 billion of FDIs have been invested in Central and Eastern Europe and the Baltic states since 1990. The major recipient countries include Hungary, Poland and the Czech Republic. The Baltic countries and Slovenia have also received high per-capita investment. Investors are mainly from EU countries and the US, and vary from multinationals to SMEs.

FDIs bring about various favorable effects to the recipient countries, not only capital, but also technology, management skills, employment, markets and competition. Many investments have been formed as joint ventures, which consisted of foreign investors and local partners, including SMEs. They start as rather small-sized enterprises, and then gradually increase in size if the investors assess the projects as successful. The larger investments, such as car manufacturing, need various types of parts providers, and this type of investment contributes to development of local SMEs as well as to additional FDIs of parts makers.

On the top of this, following the liberalisation of foreign currency regulation in the transition economies, loans from foreign banks to domestic enterprises, including SMEs, have increased dramatically. The money comes mainly from local banks in EU countries, which have no offices in transition economies. The match makers of such loans are foreign companies which have already invested in the transition economies, which have full information on local enterprises.

III. Venture Capital Funds and Capital Markets

Venture Capital Funds

Venture capital (VC) can also provide capital funds to SMEs. The history of VC in the transition economies is quite new. The first VC was established in Hungary in 1989 with \$120 million in private capital. Currently, most transition countries have VCs, the size of which varies from more than \$300 million to less than \$1 million. Total size of funds in Central and Eastern Europe and the Baltic States is \$2-3 billion, of which around \$1 billion is invested in Poland, \$300-400 million in Hungary, and \$200- 300 million in the Czech Republic. Major fund providers include the US government, the EBRD, and the IFC, which mainly established their funds in the early- to mid-1990s. Foreign venture capitalists, local financial institutions and local governments play rather minor roles. From the middle of 1990s up to now, foreign financial institutions have established their own venture capitals as well.

Although the total size of the funds is rather small (a small percentage of the banking sector), venture capital funds play the role of “catalizer”, that is to say: 1) they provide needed equity to the prosperous industrial and service sectors; 2) they transfer financial technology for investments and long-term loans; and 3) they attract foreign investors or business partners.

Larger venture capitals have around 10 employees and invest in 10-30 enterprises. Contrary to the investment targets of venture capitals in developed countries, most funds have invested in former state-owned companies or in joint ventures. Since investing in true start-ups is a really risky business in the transition economies, some funds which applied such a policy have experienced serious financial difficulties. Therefore, the size of the enterprises is bigger than that of normal SMEs. The funds closely monitor the situation of enterprises, try to enhance efficiency and secure their investments. They usually realise their investment by selling to strategic investors or to list to securities exchange as initial public offerings. Sometimes the realisation is in the form of bankruptcy and liquidation. These transactions are called “exit”.

The American Enterprise Fund, a 100% US government-owned investment fund aimed at fostering SMEs in Eastern Europe and in the countries of the Former Soviet Union, has a third of the share of the venture capital market in the transition economies. Its biggest subsidiary, the Polish-American Enterprise Funds (PAEF), established in 1990, has a capital of US \$350 million. PAEF helps to develop the Polish private sector mainly through equity investments and loans, and by targeting technical assistance. The Fund invests in private businesses, privatised enterprises and joint ventures, as well as foreign investments with businesses in Poland. Companies with a strong domestic competitive position or a high percentage of export sales are prime candidates for financing. It acquired substantial gains on initial public offerings of several invested companies in the Warsaw Stock Exchange.

Securities Markets

The first securities market in the transition economies was established (or re-opened) in Budapest in 1990, and this was followed by one in Warsaw in 1991. Currently, most of the transition economies have some type of securities market, although the markets are in an initial stage. In Central and Eastern Europe and the Baltic states, the total market capitalisation of the securities markets has increased dramatically and reached around \$50-60 billion at the end of 1997, which is around 15-20% of the GDP.

Most of the listed shares are privatised enterprises, though in several advanced economies the initial public offerings of “pure” private companies have started. Up to now, the markets have been used mostly by large enterprises and play quite a marginal role in SME financing. However, several countries have begun studying the introduction of new markets, which would serve as long term capital market for SMEs.

The development of the securities market could provide favourable effects for SME development through: 1) reducing the cost of financing in the country by introducing competition between the banking sector and the securities markets; 2) providing a good exit for venture capital funds; 3) providing various investment measures targeting SMEs, including equity investment funds; 4) attracting the interest of foreign investors. In sum, if the new markets are introduced, or the existing OTC (Over the Counter) markets become efficient financing vehicles for SMEs, securities markets will become an excellent funding resources for SMEs.

IV. Public Financing Facilities

Credit Guarantee Schemes

As lack of collateral is one of the biggest obstacles in SME financing, most of the governments in the transition economies have introduced credit guarantee schemes. The basic idea is to partly cover bank loans and to share the risk of non-payment between the bank and the guarantee fund. Although the size of the funds are relatively small, several countries successfully manage to provide guarantees to the SME loan projects. There are other types of initiatives, i.e., mutual guarantee schemes of local entrepreneurs, in which local entrepreneurs collectively guarantee their fellow entrepreneurs' loans. The latter type of guarantee schemes are well established in Poland. The followings are the examples of the former types;

In Hungary a loan guarantee system started at the end of 1991 and currently, several institutions extend loan guarantees to SMEs. The total amount of guarantees by the Credit Guarantee Co. Ltd., the country's largest guarantee fund, is around \$400 million

In the Czech Republic, the Czech-Moravian Guarantee and Development Bank is the main institution for credit guarantees. It was established in 1992 with a 49% equity participation from the government and a 51% participation from commercial banks. The main role of the bank is to provide guarantees and interest rate subsidies to SMEs.

In Romania, the Credit Guarantee Fund was established by the government in 1994. The coverage ratio of guarantees is up to 70% and the guarantee fee is 0.65%. By mid-1997, the average default rate was around 3%. However, it has not yet been identified whether or not the guarantees are viable on a commercial basis, as guarantees have so far been provided mainly for medium and long term loans. As well, the Rural Credit Guarantee Fund provides guarantees in rural areas, the coverage ratio of which is 60%.

In Estonia, credit guarantees are extended by the Small Business Crediting Fund for bank loans to borrowers lacking sufficient collateral. The coverage amount of guarantees is up to 1 million EEK and the coverage ratio is up to 50% of total lending. The guarantee fee is 3%.

Lines of Credits

International organisations and bilateral donors provide various types of credit to SMEs, and the most popular financial facility is lines of credit.

The scheme is as follows: 1) The donor provides credit lines to selected banks; 2) the banks extend loans and bear risks to SMEs; 3) the interest rate of the loans to the final borrowers consists of the bank's funding cost (i.e. lending interest of the donor) plus the risk premium and transaction fees. Major donors included include the EBRD, the World Bank, and the EU, as well as the German and Japanese Governments.

Hungary is quite active in utilising the credit line system, which reached 2-3 percent of the GDP in total. The providers of credit lines include the governments of Germany, Japan, and the United States, the European Union, The World Bank, and the EBRD. The terms and conditions of loans vary from a concessional (Germany, Japan) to a commercial basis (World Bank, etc). One of the most sizeable and

popular schemes is the start loan programme funded by the German government. The scheme began in 1991 and was based on DM 200 million in credit facilities, which consisted of DM100 million in credit lines given by the German Government and the equivalent of DM100 million in a co-financing facility from the National Bank of Hungary (NBH). The purpose of the loans is to support start-ups in the private sector. The interest rate is 3/4 of the base rate of the NBH plus 2 per cent of the margin. The maximum maturities are 10-15 years. The initial fund was fully utilised by the end of 1993. The Japanese government had provided similar facilities with a larger size in the early to mid-1990s.

Governmental Credit Institutions

Governments seek to create policies on SME financing by establishing special financial institutions. The organisations differ from commercially oriented ones to ones that are highly politicised subsidy-distributing machines. They usually utilise the credit assessment functions of commercial banks by means of risk sharing or co-financing, which increases the efficiency of the resource distribution function of the institutes.

In Hungary, The Hungarian Foundation for Enterprise Promotion was founded by the government in 1990 to promote development. The Foundation provides several SME finance programmes, including preferential loan schemes based on funds provided by EU/PHARE. The maturity is 2-7 years with a maximum 2 year grace period, with lower-than-market interest rates. The total disbursement in 1995 amounted to around US \$20 million.

In Slovenia, the government established the 100% owned "SME Development Fund", which provides interest rate subsidies and credit guarantees to bank loans for SMEs. The seven "Technology Funds", which provide financial facilities to enterprises for the introduction of new technology, play almost the same role. Local governments have their own SME development funds. Their total fund is around 3 times larger than that of the state, and either acts independently or co-ordinates with the state fund.

In Estonia, the government established the Small Business Crediting Fund, a non-commercial corporate body, in order to develop the SME sector in 1993. The capital of the Fund amounted to about \$5 million in the middle of 1997, a part of which is subsidised by the EU. The Fund provides SMEs with 1) direct loans, 2) loans through banks, 3) credit guarantees. Direct loans, 100% of whose risks are taken by the Fund, are being provided for start-up enterprises. By the mid of 1997, about 50 direct credits were provided. Only one enterprise has delayed repayment and is now subject to rescheduling. The average lending maturity is 3 years. Loans through banks, whose risks are taken by the banks, are now being provided through five major contracting commercial banks.

V. Conclusion: How to Develop SME Financing?

Principle of Public policy

The government should play the role of building and creating long-term sustainable institutions and infrastructures rather than implementing short-run measures. Short sighted fund provision to the sector has caused serious problems of heavy indebtedness, which may hinder the sound development of the sector. The first task for the government for SME development is to firmly establish favorable legal conditions and effective and well-functioning implementation systems, including FDI, bankruptcy,

registration, a collateral system, leasing regulations, etc. Regarding the financial measures to be taken by the government, the scheme should be designed to be commercially viable assuring a relatively small negative effect on the economy.

Strengthening the Banking Sector

The most urgent and crucial issue to enhance SME financing is to strengthen the banking system to make it competitive, as this is the basic institution for SME financing. Banks in OECD countries take up most of the responsibilities for SME financing. On the contrary, in most of the transition economies, banks are still incapable of extending sufficient credit to SMEs. Yet even in this situation, they play an important role. Most of the alternative and supplementary facilities, for instance credit guarantees or leasing and credit line schemes, depend heavily on a stable banking system. If this sector is not well developed, almost all the financial schemes would become ineffective, heavily distorted, and commercially unviable. For instance, donors and investors become hesitant in extending credit lines or FDIs. Moreover, the size and quality of the banking system loosely determines the maximum size of the public supporting schemes. Since most of the public schemes bring about certain risks to the banking sector, a banking sector with small capital bears only small credit risks. The development of credit guarantee schemes or credit lines needs a developed banking sector.

Effective Use of the Credit Guarantee Scheme

The credit guarantee system has several advantages: 1) it contributes a substantial increase in bank credits to SMEs, since it reduces the credit risks of the banks; 2) loans can be extended on a commercial basis; 3) the government can reduce the cost of SME policy, compared with direct subsidies or grants; 4) it provides banks a good chance to exercising credit assessment.

However, this scheme can also cause problems of moral hazard, if the conditions and/or assessments and monitoring are too generous. For instance, if the coverage of guarantee is too high, banks tend to extend loans to high-risk, high-return projects. In the case of default, banks can recover most of the loans from the guarantee scheme. The loss made by the generous guarantee scheme should finally be covered by the budget. Therefore, the design of the scheme is quite important. The controlling factors are as follows:

Coverage ratio

This means risk-sharing between banks and the guarantee fund. If the coverage ratio is 60 percent, the final credit risk is shared by the bank and the fund with a ratio of 40:60. It is safer to avoid too high a coverage ratio in the first stage, as otherwise banks will seek "high risk-high return projects" and ask the fund to cover them.

Guarantee fee

Guarantee fee is a price of the guarantee and major revenue to the guarantee fund. If the price is too low, even low-priority loans projects will ask for guarantees and crowd out the good projects. Moreover, since the revenue of the fund is minimal, it cannot be commercially viable. If the guarantee fee

is too high, the borrowers (and banks) have little incentive to ask for guarantees, and the fund cannot play its expected role in facilitating the management system.

Risk Management System

As the credit guarantee system is considered a type of financial institution, it should be managed for the most part in the same manner as commercial banks. Risk management is of utmost importance, and includes the following factors: an assessment system and the skill of each loan project, portfolio analysis, asset liabilities management and the decision making procedure.

Utilisation of Lines of Credit

Credit line schemes provided by international donors are also quite useful measures for the fund-scarce banking sector in transition economies. The scheme has some favourable side effects. Credit lines are provided only to financially and technically eligible banks. Since the eligibility standards are rather high and severe, banks can achieve some desirable modernisation through a struggle for acquiring eligibility. Moreover, the schemes involve technical assistance, which enable technology transfer of credit assessment and monitoring for SMEs. Participating banks should quickly establish a well-functioning credit assessment and monitoring system. If not, they will accumulate a bulk of non-performing loans caused by SME projects.

The concessional loan schemes have advantages and setbacks. They help SME development and enhance the banks' ability to assess loans to SMEs. However, highly concessional loans could cause several problems, including: 1) an easy-going attitude in banks regarding credit assessment to SMEs; 2) moral hazard and heavy indebtedness in SMEs. Therefore, the terms and conditions of concessional loans should be well-studied.

Effective Implementation of Government Funds

Since government funds are not big enough compared with the enormous funding needs of SMEs, effective implementation is crucial. In general, the following measures are taken in OECD countries and some transition economies:

- 1) The decision to extend credits are made based on the commercial viability of the projects, not by political influence.
- 2) The funds are co-financed by other financial institutions, including banks, credit guarantees and venture capitals, to maximise the leverage effect of the core fund of the government.
- 3) The selection criteria and procedures of the funds are firmly established and potential applicants are informed in advance.
- 4) The funds are independent and bear full financial responsibility of the result of their credit activities.
- 5) Some countries have established the funds in the form of banks, which have their own professional staff and developed sophisticated credit assessment and monitoring systems.

Develop the Securities Market

As mentioned, the development of the securities market could provide favourable effects to the SME development through: 1) reducing the cost of finance in the country through competition between the banking sector and the securities markets; 2) providing a good exit for venture funds; 3) providing various investment measures targeting SMEs, including equity investment funds; 4) attracting the interest of foreign investors. Moreover, if the new markets introduced, or the existing OTC markets become an efficient vehicle for the SMEs, securities markets will become an excellent funding sources of capital.

For the sound development of the securities market, measures would include: 1) gaining credibility on the market from the general public; 2) improving the market infrastructure, including: stock exchanges, OTC market, registry, depository and clearing systems; 3) enhancing the regulatory and supervisory capability of the securities authorities; 4) fostering the sound development of market participants, such as securities brokers and investment companies; 5) increasing the transparency of the market through measures of disclosure, the market information system and regulation on insiders' transactions and price manipulation; 6) facilitating the participation of new issuers; 7) the gradual introduction of capital market instruments, including mutual funds, futures and options; and 8) activating the participation of foreign portfolio investors.