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FINANCING OF SMALL AND MEDIUM-SCALE ENTERPRISES*

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* The views expressed in this paper are those of the author and do not necessarily reflect the views of the Secretariat of UNIDO. This document has not been edited.

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Note:

SMI, SME and SSI are used throughout as abbreviations of Small and Medium Industries, Small and Medium Enterprises and Small-Scale Industry. All other abbreviations refer to institutions and programs, the full title of which are given when first mentioned.

Introduction.

It is generally acknowledged that in all countries, developing as well as industrialised, small enterprises have limited access to financial assistance from banks and from other financial institutions. In most developing countries the capital needed to start a small enterprise, usually in the form of a micro-business, is very small. In Sierra Leone and in some other African countries it is as low as $70. It has been reported that women in Africa start micro-businesses with investments that rarely exceed $100 and may in a few cases go up to a maximum of $300 or $400. Overwhelmingly, the entrepreneurs that start such small businesses with this miniscule capital obtain this finance from their own savings or from their family.

Even in Korea, a study in 1980 showed that of a sample of 1,411 new enterprises, started between 1971 and 1973 with 5 to 9 workers, 44% began with an initial capital below US$2,500; only 6% of them required more than US$5,000. Even in this relatively advanced developing country, of the 724 enterprises surveyed that employed between 10 to 19 workers, only 3% of them needed more than US$ 75,000. It is not surprising that even including enterprises of up to 49 workers, only 8.8% had recourse to institutional finance of any sort.

The same pattern seems to apply to most other developing countries. In Jamaica, 90% of the "startup" finance for enterprises with less than 25 employees came from the entrepreneur's own savings, with friends and relatives providing another 6%. In Haiti, banks provided less than 3% of the initial investment finance, which ranged from US$100 to US$6,000 for enterprises employing less than 50 workers. The principal source of "startup" finance in Colombia was also personal savings, quite often derived from an employee's severance pay and supplemented from family loans and sometimes from supplier credit. In the Philippines, surveys have shown that the size of most "startups" involved investments in 1978 prices--of around US$800 to US$2,700, of which only 8% came from financial institutions.

Table I shows the composition of the source of finance for initial investments by small enterprises in some African countries. The Table shows that only in Ghana did the Banks provide any significant contribution to the initial investment, and in this case also it was only 10.8%. Here again the initial finance was provided from own savings and contributions from relatives.

Table 1. Sources of Finance for Initial Investments by Small Enterprises in Some African Countries

(Percentage of Initial Investment by Source

	Nigeria Western Region	Nigeria Ibadan	Ghana	Tanzania	Sierra Leone	Uganda
Own Savings	97.7	59.0	-	78.0	60.2	77.5
			90.8			
Relatives	1.9	35.0		15.0	19.5	-
Banks	.02		10.8	1.0	0.9	0.8
Government	-	2.0	-	1.0	-	-
Money Lenders	.03		-	-	0/9	
Other	-	4.0	-	6.0	18.3	21.7

Source: Cited in Small Enterprises in African Development: A Survey. (1979, p.21)

When finance from formal insitutions such as banks has proved difficult, many small enterprises unable to obtain enough from family sources when starting up, and in their early years of operation, have had recourse to the "informal credit markets". This includes money lenders, either professional or non-professional, some small unofficial private banking organisations, pawn shops and pawnbrokers and sometimes merchant middle-men who play a role of offering finance sometimes together with some other commercial function, (materials, sales,etc.).

According to Anand Chandavarkar who has studied the importance of these informal credit markets in a number of countries, these sources provided 24% of the total rural credit in Malaysia and about 37% in the Philippines as reported in 1972. All these informal credit sources are characterised by the absence of a demand for collateral, with the exception of the pawnbrokers. The informal credit sources are important enough in providing the finance for businesses, especially in the "startup" phase, to merit more careful consideration and study.They are usually dismissed as marginal elements or as money lenders, demanding usurious levels of interest, using extortionist methods in providing credit and performing little or no real service.

Reasons for Difficulty of Access.

The reasons for the difficulties of access of small enterprises to institutional finance are fairly well known. They may be categorised as follows:

(1) Lending to small enterprises is perceived as being risky. The uncertainties that face a small industry, the high mortality rate, the susceptibility to market changes, and any economic fluctuations, make banks reluctant to deal with these clients. The mortality rate of small businesses is indeed high. This was estimated in a survey in the Philippines to be over 4% a year. In the developed countries the figures are very much higher: somewhere between 20% to 50% of new small enterprises in the U.S.that fail within the first one or two years of operation. Most records seem to show that small businesses are no less credit-worthy than those of the larger enterprises. Although small-scale businessmen may take greater pains to repay their loans in order to maintain their credit-worthiness, these enterprises do depend usually on a single-owner manager and this makes them more vulnerable to what might happen to the manager, which would obviously not be the case in a larger industry.

(2) There is a parallel reluctance on the part of small enterprises to borrow from banks. The administrative formalities of obtaining bank finance, particularly the time and paper work involved, are a formidable deterrent to most smaller businesses. Some of them lack the formal education to cope with the bureaucracy and others, due to location and time

pressures have difficulties in complying with what the institutions require before they grant a credit.

(3) There is a distinct institutional bias toward lending to the larger corporate sector. In many cases there are links in directorships, joint ownerships and various other joint financial dealings between banks and the large enterprises and automatically this induces preference for directing finance to these borrowers.

(4) The administrative costs of lending to small enterprises are high, which cuts deep into the profitability of such transactions. This is undoubtedly the case and has been borne out in studies. A World Bank study in the Philippines in 1978 showed that whereas the administrative costs of handling large loans was in the order of 0.3% to 0.5% of the cost of the loan, such costs rose to a range of 2.6% to 2.7% when lending to small enterprises. Within the transactional costs one must take account of the risk element and potential losses. Despite what has been said about the credit-worthiness of small entrepreneurs, there is no doubt that several small enterprise lending programs in the past have suffered from a high level of arrears and defaults.

(5) Small enterprises are unable, or are unwilling, to present full accounting records and other documentation called for by banks. In most cases such records just do not exist, making appraisal of loan applications difficult.

(6) Usually, such small borrowers are unable to provide the collateral and security demanded by lending institutions before approving loans

Most of these problems are real, even though efforts can be made to reduce the effects of some of them. Administrative costs are high especially in dealing with new small borrowers. It has been shown in some countries that lending to small enterprises may involve costs of up to 7% to 8% of the total loan amounts, as was the case in Colombia and in some other developing countries. As an indication of the administrative burdens involved in lending to small enterprises, one may quote the example of the Development Bank in the Philippines (DBP), when a study in 1980 showed that it usually took 4 to 6 weeks for a professional staff worker to collect the necessary data to make a recommendation and to come to a decision on a loan to small or medium enterprises, largely because of the poor records kept by the borrower.

The Financial Needs of Small Enterprises.

As has been stated, most small enterprises in developing countries start as micro-businesses with only small amounts of capital. The exception might be where new small enterprises are started as part of a major government supported program. The greatest need of these very small micro- businesses is working capital. The levels of technology used is low as is productivity in these very small enterprises. The investment needs for fixed capital is consequently low as well. Even at low levels of production, increased working capital can make it possible to increase inventories and to explore more favourable market options, both as regards procurement and the selling of products. For this reason the prime financial need of a small micro-business is for working capital to enable it to expand the turnover of its operations.

As the enterprise grows there is a greater need for investment capital.The graduation from a micro-enterprise to a small-scale industry requires the acquisition of some equipment and machinery and the raising of the technological level of operations. This cannot be achieved without a significant input of fixed capital, and this is usually beyond the ability of the firm to generate from its own small-scale operations. It has to have recourse either to loan capital, that is obtaining credits from institutions, or for some form of outsider equity participation.

The attempt to finance rapid expansion of small enterprises solely from loan capital does sometimes create conditions whereby small-scale enterprises undertake financial liabilities beyond their capacity and later are unable to service its debts. In such circumstances, it would be more viable for the enterprise to seek equity finance, but here we come against an inherent characteristic of small enterprises: namely the reluctance of entrepreneurs to share the ownership of their business. On the other hand, the availability of equity finance, (which we shall deal with later), is extremely limited for small enterprises that cannot provide adequate documentation and give promise of quick, sinificant returns on any capital investment. The combination of loans and equity finance is the most desirable financial package in the case of the rapid expansion of a small or medium-scale enterprise, but in reality does not always permit the most ideal package to be implemented.

Specialised Financial Institutions.

One way to solve the problem of how to provide more institutional finance for SME is the creation of separate financial institutions to cater exclusively to the needs of these enterprises. One of the earliest examples of this was in the Netherlands, where in 1927 the Government was instrumental in amalgamating 25 smaller banks into the Netherlands Bank for Small and Medium Business (NMB). The government remained a major shareholder of this bank but gradually the institution lost its specific SME orientation and competed with other banks for larger clients as well. At the time of its creation it was felt that a special institution was needed but as all commercial banks began to lend more to SME there was considered to be less need for a special bank to do this. In addition, as NMB was mostly privately owned, it found lending to SME inadequately profitable and so the management sought to expand the range of its activities into more remunerative forms of lending.

In developing countries too, there were examples of separate financial institutions for financing SME. In Korea two such institutions were established. In 1961, as part of the Small and Medium Industries Act, the Small and Medium Industries Bank (SMIB) was established. (It was originally called the Medium Industries Bank). SMIB was fully owned by the government and was required to provide both long and short-term finance for the SMI sector in Korea. Like all such specialised institutions in Korea, SMIB was supervised by the Ministry of Finance whose approval was required for all its operations, for its operating procedures and for the appointment of its top management. Although designated a development institution to extend financial and technical assistance to SMI's, the SMIB was encouraged to engage in commercial banking such as in the mobilisation of deposits and in short-term lending operations.

Over the years, SMIB became a major instrument in the financing of SMI's in Korea. Its assets had grown by early 1985 to the equivalent of over US$4 billions of which 27% was accounted for by its long-term loan portfolio. This shows that the majority of SMIB lending operations was for short-term working capital more usual for a commercial than for a development bank. It is also significant that 43% of its assets--presumably its short-term loans--were financed from short-term deposits. Nevertheless, SMIB remained very dependent on government support.

By 1985, SMIB had a staff of over 7,000 located in 173 branches (an expansion from 116 in 1980) and its administrative expenses were around 3% of its total assets, lower than usual for such an institution but reflecting in part its large commercial banking operations.

Although SMIB when created was required to extend technical as well as financial assistance to SMI's, the institution never developed this side of its activities. Despite a UNDP/ILO/UNIDO assistance project in the 1960's and early 1970's, by 1985 SMIB's extension service was reduced to a small unit with only 36 professionals offering services only to a tiny minority of its clientele. SMIB found such services too costly, and its salary structure made it difficult to staff the unit with experienced persons. Also, in 1980, the Small and Medium Industries Promotion Corporation (SMIPC) was created which took over direct technical assistance to SMI, although coordination between SMIB and SMIPC was minimal.

SMIB was not the only institution in Korea catering to the needs of SME. In 1963, the Citizens National Bank (CNB) also started operations as a state owned commercial development bank to provide a range of services for its consumer and small business clientele. Originally it was planned that CNB would cater to the consumer, household and small business sector and the SMIB to SMI's which it was recognised would also include some smaller enterprises. In practise there was considerable overlap between the two institutions, as CNB's target group expanded into the intended clientele of SMIB. In an effort to reduce this overlap, CNB was allowed to finance projects employing up to 100 persons and only SMIB was allowed to finance enterprises of up to 300 persons.Despite this difference SMIB and CNB continued to compete over a broad range of SMI projects and the existence of CNB pushed SMIB more and more into financing larger enterprises, some involving investments of around US$3 million which could hardly be classified as SMI. Some indication of the size of projects financed by these institutions is given by the figures of the utilisation of World Bank loans to SMIB and CNB. The average loan size of two World Bank loans to SMIB during 1978 to 1984 was US$238,000 and US$188,000 respectively. In the case of the World Bank loan to CNB ending in 1984 this was US$112,000. In both cases the employment creation of the project was considerably less than originally estimated, indicating a tendency of both institutions towards financing larger more capital intensive projects. Interest rates on loans put out by both SMIB and CMB were strictly regulated by the government, which at times arbitrarily lowered these rates seriously affecting the profitability of the institutions.

Korea is not the only country that set up a specialised institution to cater for SMI's. Following a study by the Stanford Research Institute in Colombia in 1967, the Corporacion Financiera Popular (CFP) was created to provide loans specifically for SMI's. By 1986 CFP had 18 regional offices and claimed to cover most of the country in its operations. In general, a definition of an SMI for CFP purposes is an enterprise with assets of approximately the equivalent of US$ 500,000. Its funds came mainly from the Central Bank of the country - Banco de Republica - as well as from the World Bank, KFW and USAID. In all, the World Bank has now provided five loans for a total of US$120 millions since 1975.

The CPF operations include a variety of different credit lines - for artisans, for exports, for industrial estates, for factory buildings and for technical assistance. All but the export credit (through PROEXPO) are for SMI's only. CFP's lending operations are considered to have made a significant contribution in increasing the availability of long-term finance for SMI's in Colombia. The total volume of loans outstanding to SMI's increased from 2,199 million Pesos in 1968 (the first year of CFP's operations) to 6,875 Pesos in 1978 (all in 1978 Pesos). Of these 1978 figures, 2,122 million (30.8%) were from commercial banks, and 1,499 (21.8%) were from CFP with the remainder from some other institutions or funds. This shows that CFP not only made an important contribution in providing finance for SMI's but its operations may also have influenced both commercial and development banks to increase their lending to this sector.

In an attempt to expand and promote its activities as well as to provide technical advice to SMI's, CFP suffered from high administrative costs reaching 7.2% of its total loan portfolio in 1984. Part of this was due to the costs of setting up an extensive regional network, considered necessary to reach larger groups of SMI's. To improve its financial situation, CFP engages in more than 30% of its activities in the provision of export credit which guarantees a fixed commission for managing funds provided for this purpose by the government.

Yet another example of a separate financial institution is the Halk Bank (or more correctly the Turkiye Halk Bankasi) in Turkey. Established in 1938 as a state enterprise to extend short and long-term credit to artisans and small and medium scale industry, Halk Bank's definition of a small industry was one with less than the equivalent of about US$400,000 in fixed assets (excluding land and assets of around US$1.5 million as medium scale). By 1985 Halk Bank had 635 branches and over 13,000 employees, being the second largest state-owned bank in Turkey. Some idea of the size of Halk bank's operations is given by the fact that in 1985 it gave credits to 769 cooperatives which involved over 500,000 artisans and craftsmen. It also managed government loans for the construction of 197 industrial estates up to the end of 1985 of which 51 were completed in that year alone.

It is claimed that Halk Bank, whose SMI credits were all at subsidised rates well below commercial levels, used low-cost government funds but still adopted the same stringent collateral requirements as other commercial banks. Halk Bank has received in the last few years a KFW DM 10 million loan and a US$20 million loan from the World Bank. The high volume of managed government funds without risk and the low-cost funds made available by the Government have enabled Halk bank to operate at a low profit.

It is clear from the above that the operation of a specialised institution for lending to SMI's is not without its problems. While such institutions may increase lending for SMI's they usually have difficulties in operating profitably, because of the limited clientele and the high transaction costs. In some cases the higher risk of this clientele increases the losses and affects the institution's financial solvency. As the examples show, they tend to seek out other more profitable activities than direct lending to SMI's, either by raising the definition of an eligible borrower or by managing government funds at a fixed commission and at no-risk. They usually have continuous need for low-cost government funding, often provided by external donors.

An interesting case of an institution that started with the role of lending to SMI but changed later is the Industrial Development Bank of Pakistan (IDBP). Established in 1961 as the development institution for SMI, IDBP found lending exclusively to this sector not financially viable and by 1980 was lending to all sizes of enterprises--private and public --in competition with the other development banks in the country. IDBP claims the policy was forced on it by the poor performance of its SMI loan portfolio.

Before leaving the subject of specialised institutions for small borrowers, mention should be made of a very unique financial institition, which although it could be called a specialised finance institution, for small businesses differs completely from all those previously described, namely the Grameen Bank in Bangladesh. Grameen was started in 1976 by its founder Muhammed Yunus (now its Managing Director) as a broker acting as an intemediary to provide access for the landless poor to borrow from the state owned banks. It grew by 1983 into a fully-fledged bank and by early 1988 had around 400,000 borrowers-- 82% of whom were women. Grameen lends out monthly the equivalent of US$2.5 millions in very small loans averaging US$67 and has over 400 branches working in 8,000 villages. It combines savings and credit and by 1988, despite the extreme poverty of its clients,they had accumulated the equivalent of US$7 million in saving funds at the bank. Grameen has demonstrated clearly that the poor are bankable with a recovery rate of 97% on its loan portfolio. Grameen bank loans are used primarily for undertaking individual agricultural and non-farm enterprises. Approximately 10% of its lendings are for somewhat larger group loans for joint enterprises. Most loans for non-farming activities go for agro processing, for cottage and household manufacturing and trading activities.

Grameen maintains financial discipline and high repayments through "peer group pressure" rather than through collateral requirements. The Grameen Bank has become a model bank for micro-enterprise lending, and efforts are being made to replicate its form and its methods in other Asian and in some African countries. The Managing Director, Muhammed Yunus, believes Grameen's experience can be replicated in other developing countries, but cautions that it must be done taking into account all local factors and proceeding gradually.

One should point out that Grameen Bank has benefitted from low-cost funds provided by IFAD (International Fund for Agricultural Development), from the Bangladesh Bank (the central bank) and from grants from the Ford Foundation and from Scandinavian donors. Its administrative costs are relatively high--around 14.2% of loans and advances--but considering its clientele, its high recovery rate and the initial size of its loans this may not be surprising.

Until now, most countries have not set up separate specialised financial institutions to direct credits to SMI's, regarding such organisations as too costly in their need for low-cost funds and in having to bear high transaction costs. In addition, such institutions create a problem when SMI's graduate and grow larger. These successful SMI's then have problems obtaining the finance they can no longer obtain from the specialised institutions, often on advantageous conditions. Most countries have preferred to seek other ways of providing finance for SMI's using development finance institutions, commercial banks or in some cases separate promotional agencies.

Development Finance Institutions.

The first steps in most developing countries to direct more long-term finance to SMI's is usually through the development finance institutions (DFI). Most of these DFI's were created and developed through the World Banks' initiative, encouragement and financial assistance. There is no question that the DFI's have played an important role in industrial investment in developing countries. Many such institutions have also played a pioneering role in providing some finance to small and medium enterprises, even if on a limited basis, when it was not available from other sources.

Despite this important role, a World Bank review of DFI's in 1985 has shown that development banks have not been very successful in terms of financial performace. Many of these DFI's were in a serious financial position, which in some cases even threatened their very survival. Most such institutions were suffering from heavy arrears on their loans, with more than a quarter having more than half their portfolio affected in this way.

It is generally accepted that development banks were not created to maximise profitability and that their development orientation should remain paramount. Nevertheless, a major objective of the World Bank's lending and that of most other international financial agencies to such institutions was that they would become independent financial institutions capable of mobilising resources on their own. Without a minimum level of profitability there is no chance of mobilising commercial resources and this means that the institutions remain dependent on international aid and government funding.

Part of the DFI's problem was that they made loans that were insufficient to cover operating costs or to provide for the inherent risks of development financing, and this applies particularly to some of their earlier small enterprise financing activities. If small enterprise lending is to be profitable, the spreads have to be significantly higher than those the DFI's obtained on loans to larger firms.

There are other reasons, apart from the difficult financial situation and limited resources of DFI's that have led to the conclusion that these institutions are not always most suitable for chanelling finance to SMI. They are usually very centralised and lack the branch network that is needed to respond quickly to the demands of small business. In most countries they are either not allowed, or find it impossible, to mobilise local deposits and thus find it difficult to lend working capital to small enterprises, often the primary financial need of this clientele. Most SMI clients prefer to deal with a single financial institution that can meet all their financial requirements. Also, development banks have evolved an appraisal system that requires documentation and of data which is far beyond the capacity of small enterprises and which has resulted in the slow processing of loan requests which is quite often unresponsive to the needs of small borrowers.

Nevertheless, despite constraints, many DFI's have developed credit programs for SMI and often have done so through the creation of special SMI or SSI departments. The Development Bank of the Philippines (DBP), the Industrial and Financial Corporation of Thailand (IFCT), Bangladesh Shilpa Bank (BSB) and the Development Finance Corporation of Ceylon (DFCC in Sri Lanka), are examples of Asian DFI's that have developed separate SSE lending units. Several of the African DFI's have developed SSI lending programs through the creation of subsidiary agencies or units. The Development Bank of Zambia (DBZ), together with some other Zambian institutions and with help from donors in the Netherlands and Germany, established in 1983 the Small-Scale Enterprise Promotion (SEP) Ltd. to provide equity, loans and services for SMI. The Development Finance Company of Kenya set up SEFCO (Small Enterprise Finance Company) in 1984, with financial help from the Netherlands. Again, with financial assistance of FMO--the Development Finance Company--in the Netherlands, the Botswana Development Corporation and the National Development Bank, the two main DFI's in the country, set up Tswelolo Ltd. in 1984 to provide loans for local SMI's. In Nigeria, the NBCI (Nigerian Bank of Commerce and Industry) and CCI (Credite de Cote d'Ivoir) in the Ivory Coast, while not being fully specialised institutions for SMI only, have been given the roles by the government to act as DFI's for providing term finance for SMI.

For reasons stated above, the DFI's generally do not always perform well in directing credits to SMI's. The setting up of independent subsidiary units or organisations helps to overcome some of their problems by obtaining special low-cost funds from the government and/or from external donors, and by special staffing to offer additional services (advisory services, training programs, factory shed schemes, wholesale and marketing companies--sometimes planned by the DFI units or subsidiaries but not always implemented). Most of the African programs (SEP in Zambia, SEFCO in Kenya, Tswelolo in Botswana) are relatively recent creations (in the 1980's) and have so far only managed to assist a relatively small number of projects. It is already evident that the operating costs of these organisations are high and that there are serious management and organisational difficulties. Some of the Asian DFI's have also had major problems. IFCT has encountered difficulties in promoting SSI credits and disbursing funds made available for this purpose. DBP's SMI program has been affected by the general severe problems of this institution, has been heavily overstaffed and the repayment performance on its SMI loan portfolio has been poor. BSB is well known as a DFI with very bad portfolio problems and its repayments record on its SMI borrowers has been abysmal.

Although many DFI's have not performed well in providing SMI finance, there are exceptions. The Development Bank of Mauritius (DBM) operated what appears to be a successful SSI or micro-enterprise lending program in the late 1970's. Its average loan size was very low--around US$830 --repayment record was good --less than 1% default -- the costs of administering the program were reduced substantially and DBM was able to assist a substantial group of SSI without impairing the institution's overall profitability. In particular, it was successful in operating a network of one-man regional offices which were able to respond quickly to SSI needs and to monitor effectively the borrower's performance.

In another example the Industrial Development Bank of India (IDBI) helped to set up the State Financial Corporations (SFC) and then acted as an apex institution in channelling funds to these SFC's. Although the performance of the SFC's in responding to SME needs and in loan recovery has varied from state to state throughout this large country, some have performed well in providing term finance especially for the larger SMI's. It should be remembered however that there are many other channels of finance for SMI's in India.

Finally, it must be recognised that in several countries there is no real alternative for government and for external donors, other than to use the DFI's as the major conduit for credit lines for SMI's. Where the commercial banking system is either unwilling or unable to become involved in lending to this sector, the DFI remains the only option apart from using non-bank channels. In many African countries the commercial bank system is mainly in the hands of conservative foreign-owned banks unwilling to lend to local SMI's and the few national commercial banks, usually state controlled, are too weak or are also unwilling to fulfil the role of SMI financing. In all such cases, the government do in fact arrange for external donor special funds for SMI credit lines to be operated through DFI's. The World Bank has tried with limited success to use DFI's as intermediaries to channel SMI-directed loans in countries such as Cameroons, Ivory Coast, Burkina Fasso, Niger, Gambia, apart from the Philippines, Thailand, India and Mauritius cases already mentioned.

DFI's have also participated as intermediaries in refinancing arrangements whereby loans from SMI are rediscounted from a fund created for this purpose in apex institutions, usually, but not always in the central bank of the country. Major DFI's have also served as the apex refinancing institution in countries as diverse as Sri Lanka (National Development Bank--NDB), Morocco (Banque Nationale de Developpement Economique--BNDE), Ecuador (Corporacion Financiera Nacional--CFN) and Pakistan (IDBP). Only in Morocco did the BNDE at the same time participate in the scheme as a direct lender. Despite early misgivings, no special problems developed on this account. DFI involvement in such schemes in the "apex" role have in some cases had the added advantage of their helping the commercial banks to build up loan appraisal capability in which DFI's usually specialise.

In such multi-institution financing arrangements, DFI participation as a lending institution has also enabled them to act as a "lender of last resort", to finance more <u>new</u> enterprises and possibly "more risky but viable projects", where the commercial banks following more conservative practise were reluctant to approve such loans. There is no doubt that DFI will always be less concerned than commercial banks with maximising profits and more with the national development aspects. Experience also shows that DFI's are probably more likely to invest in staff preparation and specialisation, which would enable them to help small business in preparing their projects properly.

The conclusion must be that while DFI's in practise have serious limitations in playing the role of exclusive or even the main channels of lending to SMI, it is desirable and even indispensable in many cases, to find ways to involve them in programs of SMI lending.

<u>Commercial Banks.</u>

As already stated, commercial banks are generally reluctant to make loans to SMI. Nevertheless, there are distinct advantages in using commercial banks as intermediaries for SSE lending: (i) They have the necessary domestic resources and as such are better able to meet both the needs for working capital and term loans for fixed assets; (ii) They offer a greater variety of banking services; (iii) They usually have a large branch network permitting contact with small enterprises on a local basis; (iv) They are better able to respond quickly to the needs of small businesses; and (v) They are more experienced in debt collection than the DFI's. Commercial banks can be attracted to lending to SME's by their interest in acquiring new clients for their other banking activities.

On the other hand, as stated, because of their greater concern for profitability, commercial banks tend to perceive loans to SME's as particularly risky and administratively expensive. Commercial banks are also wary of long-term lending preferring to lend short-term in keeping with their source of funds, which are primarily from deposits. In many cases, interest rate ceilings or credit controls or other specific financial policies may also hinder commercial banks from lending to SME's as they may prevent the banks from charging rates which will compensate for higher risk, added transaction costs and longer loan maturities. Commercial banks are also reluctant to invest in staff specialisation which would enable them to assist clients to prepare their projects properly. Commercial banks prefer to rely more on the credit worthiness of clients and on collateral than on project appraisal. Being less concerned with development aspects, commercial banks are less likely to engage in extensive supervision of clients so long as repayment records are satisfactory.

Recognising the advantages of getting the commercial banks involved in lending to SMI's, governments have tried to use a combination of incentives, inducements and pressures. These include mandating SME lending quotas, refinancing arrangements, risk sharing or credit guarantee schemes, increased margins or spreads, and assistance in project preparation and providing technical assistance to borrowers.

Some governments have indirectly only compounded the problem by following credit and interest rate policies which severely limit the lending operations of banks and their profitability. One approach of the World Bank and other donors to achieve expansion of access of SMI's through commercial bank lending has been to convince governments to ease credit restrictions, and where they exist to make provisions for SME's to operate outside the credit ceilings. This is a strong attraction for the banks to use these funds.

Mandated Lending Quotas

Some countries have tried to overcome the reluctance of commercial banks to lend to SMI by issuing government directives obliging commercial banks to allot a specific minimum percentage of their lending to small enterprises. Prior to instituting manadatory quotas, some governments or central banks demand reports on the banks' lending to domestic small enterprises as evidence of the concern felt as to what proportion of loan portfolios go to this sector.

Both India and Pakistan have had government directives calling for mandatory quotas of lending to SSE's for over twenty years. In India 40% of all banking was set in 1985 as the mandatory target for loans to the designated priority sectors, of which 12.5% was required to be lent to small-scale industries. Perhaps less known is that Korea also required commercial banks to allocate 35% of their incremental loan portfolios to SMI's every year, while regional banks in that country were supposed to allocate 55%.

In Malaysia and Indonesia, there have been orders instructing the commercial banks to direct a fixed percent of lending to the SSE's of the indigenous populations. The imposition of manadatory targets may probably be more effective where commercial banks are government owned, but the same directives are also given to privately owned banks where they exist in these countries.

Undoubtedly, such directives do make more finance available for small-scale entrepreneurs. From 1965, when the first priority sector targets were introduced in India, the portfolios of these loans increased from 74,000 accounts for a total of 2.5 billion Rupees to 1.2 million accounts for 53.9 billion Rupees at the end of 1983. This is largely ascribed to government pressures and the policy of mandated quotas. In some countries a penalty is imposed if a particular bank is not able to report that it has reached its mandated target of lending to SSE and/or indigenous businesses. It has to deposit the difference between the target and its actual lending in a special account at the central bank which bears no interest, a penalty which can cause a significant loss of revenue to a bank.

There are also indications, however, that in countries where such government directives exist, there have been problems in controlling and "policing" this regulation. Ultimately, the central bank is forced to rely on the reports of the banks concerned. Commercial banks may attempt to comply with the mandated quota by increasing short-term lending, and this is in fact what happened in Pakistan some years ago, where a survey in 1980 showed that among the bank's respective lending volumes to SMI, term lending for fixed asset investment accounted only for about 10-30% of the total. In order to overcome this, the State Bank of Pakistan then revised the mandatory targets, stipulating separated figures for fixed investment lending, and lending for working capital.

The use of mandatory targets, fixed either in percentages of loan portfolio or in global amounts, may have some merit but they would have to be judged in the light of the general financial environment and the ability to monitor the system. Most countries have preferred to use positive incentives to encourage banks to lend more to small enterprises. There is always a danger too that mandatory quotas and directives of the sort outlined can produce serious undesirable distortions in the working of the financial sector and may even deprive both the banks and some larger enterprises from using funds to the greatest national economic advantage.

Refinancing Arrangements.

These arrangements have already been mentioned. (They are sometimes referred to as rediscounting schemes). Since commercial banks are unwilling to use their own resources for this purpose, other funds have to be made available to the banks where the cost and repayment schedule would be more closely linked to the income and payment accruing from the loans made. In refinancing or rediscounting schemes, this is done through a special fund administered by an agency (or unit of the Central Bank or of a DFI), that then rediscounts loans made by lending institutions to SME's. As stated, in most countries this fund is located in the central bank which acts as an "apex institution" or refinancing agent. In the Philippines, Honduras, Portugal, Bangladesh and Tunisia, the central banks act in this way, but in countries mentioned previously a major development bank takes on this role.

Mexico was the first developing country to introduce such a two-tier refinancing mechanism in 1954 when it set up FOGAIN (Fondo de Guarantia y Creditos de Fomento para la Industria Mediana y Pequena -- Trust Fund for SMI Guarantees and Credits). Although originally intended to provide guarantees as well as rediscounting, for various legislative reasons FOGAIN never really developed a proper guarantee scheme. It was set up as an independent Trust Fund (Fideicomiso) administered under the tutelage of the Nacional Financiera, Mexico's leading national industrial development bank. Operating as a second-tier institution (it did not directly lend to borrowers but only refinanced loans made by commercial banks and other intermediaries to SMI), FOGAIN rediscounted credits made for equipment, for factory construction and for working capital. Its loan portfolio by 1985 was the equivalent of US$424 million. In its 31 years of operation, 1954-85, FOGAIN refinanced 66,925 loans of which over 80% were for what is defined in Mexico as small-scale industry, i.e enterprises with less than 50 employees. An interesting feature of FOGAIN's activity, is that not only has it financed SME lending by 30 of the major commercial banks in Mexico, but it has also rediscounted some loans from smaller intermediaries, including credit unions and credit cooperatives, thus widening the access to finance of smaller firms that might have had more difficulty in dealing with larger commercial banks.

FOGAIN has received, since the mid-1970's, several loans from the World Bank and from the Inter-American Development Bank, but most of its resources have come from the Mexican Government. Since 1982, FOGAIN has charged commercial rates for its loans, which in view of the high rate of inflation has sometimes been over 100%. Prior to 1982 it lent at highly subsidised rates, thus incurring considerable losses and producing distortions in the borrowing it was financing.

The breakdown of FOGAIN's loans for the whole period of 1954-85 show that 49% were for working capital, 46% for fixed assets, (both equipment and factory buildings) and 5% for debt restructuring. One interesting indication of the combined effects of high inflation together with the latent conservatism of the commercial banks, is that 61% of the loans were for less than 36 months,(presumably including all the working capital loans), and only 2% for more than 60 months.

FOGAIN has succeeded in spreading its loan program throughout the country, an important element in Mexico which is strongly pursuing a program of industrial centralisation and regional development. Almost 56% of FOGAIN's loans were outside the main metropolitan areas.

Despite distortions and management problems over the years, FOGAIN's record in Mexico may be considered a successful example of SMI lending through rediscounting of loans.

Another refinancing scheme in Latin America that deserves mention is that in Ecuador where the CFN (Corporacion Financiera Nacional), a state-owned development bank, created FOPINAR (Fund for the Development of Small Industry and Handicraft) in 1980 to refinance loan lending by commercial banks and other institutions to SSI. FOPINAR set up a specialised unit to administer the program. By 1986, it had provided credits of over US$80 million and promoted through its activities an estimated US$130 million in investments in the sector. This helped to finance 700-800 new small businesses and funded the expansion and modernisation of over 1200 existing enterprises. A countrywide coverage of SSI credits by FOPINAR was achieved through the branch networks of 15 participating financial intermediaries, mainly commercial banks. However, a major participant was the Development Bank, Banco Nacional de Fomento (BNF) which channelled 41.9% of the first World Bank loan of US$30 million given to FOPINAR in 1981. The average BNF loan size was US$10,900 which clearly indicates that the recipients were very small enterprises.

In general, the first loans of participating commercial banks in such refinancing schemes are rediscounted at 100%, but later efforts are made to reduce the proportion to 80% or 70% to encourage some use of the participating institutions' own funds. In a World Bank SSI loan in Pakistan prepared in 1986 for financing SSI through a rediscounting scheme, using commercial bank lending, it was proposed to rediscount only 50% of loans, leaving the remainder for the banks to fund out of their own resources. However, for obvious reasons, institutions participating in such refinancing arrangements resist lowering the percentage refinanced, finding it more profitable to use their own funds for other lending. In Mexico, FOGAIN for instance still refinances 100% of commercial bank loans, even after over 30 years of operation.

It should be understood that in all refinancing schemes, participating institutions continue to bear the risk of default. Because of the commercial banks' preference for these institutions to make short-term loans to SMI's against collateral, in many countries a good part of small enterprise projects are financed not by term loans but by the "rolling over" of short-term credits or of extended overdrafts. This manner of funding may be convenient for a bank, which retains control over the loan and the borrower, but is not satisfactory to a borrower since the loan may be called in at any moment and the conditions may change, making financial planning difficult.

Some analysts point to a considerable amount of unsecured lending to small business by commercial banks in developed countries, but in reality a closer look shows that this is not so. In the developed countries, as well as in the developing world, commercial banks indulge mostly in collateral based lending and are not overconcerned with the viability of the project, even though they like to be sure that their money is being used for a project which will produce revenues enabling the client to service the debt. Commercial banks often demand that the borrowers maintain "compensatory deposit" accounts, as well as providing collateral in value well above the amount of the loans--sometimes up to twice or three times as much. There are some cases where clients, known to be credit-worthy, who have a track record for repaying loans are financed by commercial banks, if not without collateral then at a somewhat reduced level of securities.

It should be understood that most experienced commercial banks are not too keen to invoke securities given as collateral and would prefer to lend to clients who are able to repay their loans without problems, so avoiding the extra cost and bother involved in debt collection, loan follow-up and litigation. For this reason, many commercial banks do carry out assessments of project viability as well as of the credit worthiness of individuals in an attempt to avoid situations of loan defaulting.

Despite the general reluctance of commercial banks in developing countries to lend to SMI, there are some interesting examples where some banks have actually lent considerable sums to this sector. The Syndicate Bank of India is an outstanding example. It is reported that in 1975, 95% of its US$1 million loans were for less than US$1,200, even though this accounted for only 18% of money loaned. Since its founding in 1925, Syndicate Bank has aggressively pursued a policy of lending to small borrowers. The Bank of Baroda, also in India, has also lent extensively to SSI and was an active lender in a microenterprise lending program in the Calcutta region. There are reports that both Syndicate and Bank of Baroda have lent to small-scale borrowers beyond the required targets mandated by the government. Also, in Thailand, some commercial banks (Krung Thai Bank, Bangkok Bank, Bank of Siam) have, over the years, made significant numbers of loans to small business. In Ecuador, Banco de Pacifico started an Artisan Loan Program in 1977 and by late 1982 had lent US$1.3 million to 3,000 very small enterprises in loans averaging US$1,000 to US$1,700. Banco de Pacifico, however, reported high levels of arrears (around 27%) in this lending program.

These are only a few examples of commercial banks lending to SME. Even a foreign bank, such as U.K.'s Barclays Bank, set up the Barclays Development Fund, which loaned small amounts to African entrepreneurs. But, by and large, these cases are relatively few, and for the most part, commercial banks have found lending to SMI fraught with problems, notably difficulties with loan repayments.

<u>Participating Institutions</u>

In designing projects for lending to small enterprises through rediscounting arrangements, it is usually the practise to allow all banks, both commercial and development, that meet minimum standards with regard to their financial situation, organisation and staffing to participate in the scheme. In practise there is usually no earmarking of amounts for any specific institution in order to introduce an element of competition between the participating financial institutions for use of the funds and to achieve one of the objectives of such schemes, namely getting more commercial banks to become involved in lending to small enterprises.

Experience has shown, however, that there can be problems where banks participate only to a small extent with a few loans. Such participating banks may be unwilling, or may regard it as uneconomic, to make the investment needed to set up the requisite organisation and to prepare trained staff to handle this special clientele. To some extent this problem can be dealt with by insisting on minimum requirements of eligibility, so that an institution that wishes to take part must prove that it is in a sound financial situation, that it has an acceptable debt-equity ratio and that its loan portfolio is in a reasonably good state of performance without too many non-performing loans, and that it has made adequate provision for loan losses. The institution must also have suitable staffing, an adequate branch network and a readiness and ability to make the organisational arrangements needed to handle loan requests promptly and efficiently. It must also have suitable arrangements for supervising the borrowers after the disbursements of the loans. In many cases these demanding requirements for participation in a refinancing scheme means that such institutions intend to take part with a minimum number of lending operations. While the introduction of eligibility criteria for participating institutions usually has positive results in making refinancing their schemes more effective, care has to be taken at the same time not to make it too difficult for new banks to have access to the funds made available. This is not desirable as there have been cases where banks have started by making a few loans and then have developed into major participants. There is also evidence in some countries that smaller regional banks are more willing to participate actively in such lending schemes and are better lenders for SMI's than some of the larger national financial institutions.

Spread for Lending Intermediaries.

As indicated, one way of encouraging commercial banks to become involved in lending to SMI's is to allow them a higher margin or spread between the rate they pay for their funds and the on-lending rate to the borrower. This helps compensate for the higher transactional costs in lending to SMI and might make such lending more profitable. Most studies have shown that a spread of 4% to 5% is usually the minimum requirement for such lending to be profitable for commercial banks. In practise, in the different refinancing schemes in various countries, the spread varies widely, from 2% in some SMI credit programs in Morocco and Tunisia to 7% and even 8% in the Philippines and Bangladesh. Some lending schemes reduce the margin for medium scale borrowers and increase it for the very small. Sometimes spreads of 7% or 8% are offered for lending to micro-enterprises while lending to medium enterprises only allows a margin of 4%.

In practise many commercial banks lend to SME for reasons other than the profitability of the specific lending operation, such as the opportunity to attract new customers to their other banking services, or because it allows them to lend to their clients at a time when credit ceilings have restricted the growth of other loan transactions. In Morocco and Portugal for instance agreement was reached with the banks that loans to small enterprise from World Bank funds in the early 1980's would be allowed outside the credit ceilings then prevalent in the country. Despite these considerations, it has been found that margins of 2% or even 3% are in the long run insufficient to attract commercial banks to participate in SME lending programs, although there may be exceptions to this as in the case of Korea. In some cases, where the margin allowed may be relatively low--around 3% or 4%, the commercial banks tend to lend to medium size borrowers or regular customers thereby hoping to reduce the transaction costs.

Studies on the transaction costs of lending to small enterprises show that even efficient lending to this sector would involve administrative costs in the 2% to 4% range, and this figure would not really cover losses if repayment rates are poor. In practise, where administrative costs are found to be lower, this usually means that the financial institution is lending mainly to existing on-going enterprises of the largest size permitted under the eligibility criteria that have adequate documentation and a good track record. There is a conflict between asking commercial banks to lower administrative costs and at the same time expecting them to invest more effort in promotion of lending programs, in screening and appraising loan applications, in supervising projects and in debt collection, and at the same time end up with administrative costs that are less than 4%.

In recent discussions on lending to micro-enterprises (usually defined as firms with assets of less than US$10,000 receiving loans in the US$1000-US$5000 range or even lower), it has been suggested that spreads of 8% to 10% may be justified. To allow for these higher margins, funds have to be made available to institutions at appropriately low cost, or commercial banks have to be permitted to lend at rates higher than those to which they lend to their known larger customers. There is some rationale in allowing commercial banks to lend at higher interest rates to SME--to cover the higher transactional costs--and many believe this would not lower the demand from these borrowers, who, if they are unable to obtain access to bank loans will have to pay much more to the informal credit markets or money lenders. However, this approach usually encounters political problems. There is strong social opposition to the idea that SME may have to pay higher rates than larger borrowers for credit.

Interest Rates

The level of interest rates at which loans are lent to SMI has been a keen issue in most lending programs. The desire of governments, often for political reasons, to subsidise lending to SME's have inevitably produced distortions. Subsidised loans, (i.e.those lent at negative real rates and at substantially less than prevailing commercial interest rates) tend to reach those beneficiaries that are well-connected rather than those in real need of the funds and who can put them to the most effective use. Commercial banks have often rewarded their regular clients with such low-cost loans even when the funds are to be used for investments that are not of real national economic benefit. In general, interest rates that are negative in real terms and that do not provide adequate margins above the costs of funds, virtually exclude the possibility of banks using their own resources for such loans.

Also, lending at subsidised rates leads to the erosion of the original funds and makes it impossible for such loan programs to be self-sustaining, condemning them to rely perpetually on outside sources, usually external donors. In addition, borrowers have demonstrated less concern to repay subsidised loans, preferring, quite naturally, to pay off the more costly credits first. Although distortions and diversion of funds have appeared in some commercial bank lending too, most evidence seems to show that political influences are more prevalent in the lending operations of DFI.

Over the last 10 years or so, governments have gradually accepted that subsidised interest rates for borrowers, particularly for small enterprises, even though politically appealing, were counterproductive introducing distortions in the type of beneficiaries and encouraging investments that were not really justified on economic grounds. Gradually, most governments with a few exceptions, are moving more toward positive real interest rates, that is rates in keeping with the true cost of money in the country. They have accepted that lending to SME should be at prevailing commercial rates. In the past there were situations where such lending not only took place below prevailing commercial rates of lending but even below deposit rates offered by banks, making it possible for those who borrowed the money simply to obtain a higher return by depositing the funds immediately.

The argument that supervision and control can prevent distortions and misuse of funds flies in the face of the reality. Money in the end is "fungible" and even if the money lent was used for the purposes intended, this may have meant the diversion of other funds which the borrower could have used for the investment but has chosen to use for other purposes. It has been demonstrated over and over again that access to finance is more important for SME than the cost of the loans offered. There have been a few cases where a precipitous rise in interest rates to a real level after a period of subsidy--as took place in Mexico in 1982--has choked off demand for a period, but after an adjustment lapse the demand has returned to previous levels.

There is a real problem in countries with high inflation rates and with volatile exchange rates. It has been argued that in these countries the loans should be onlent at a variable interest rate, linked or indexed in some way to the inflation or possibly to the exchange rate. This is perhaps the only way by which lending institutions will be protected against losing heavily when making medium and long term loans. Few countries have been prepared to have long term loans lent at variable rates although there are a few cases in the last few years in Latin America--Ecuador for example--where small enterprise lending has taken place at variable rates. In general, small enterprise borrowers are unwilling to take on loans without knowing exactly their commitments in repayments which would be the case if they took on variable-rate loans. In practise, of course, in countries with high inflation, commercial banks only make short-term loans and "roll over" funds to ensure that they are protected against losses due to the effect of inflation.

Foreign Exchange Risk.

A number of credits, particularly those from external donors, such as the World Bank, regional banks or bi-lateral agencies, are required to be repaid by borrowing governments in foreign currency. Most of these loans are used for small enterprises to make purchases of foreign manufactured equipment even though the loans are onlent to these small enterprise borrowers in local currency. In view of the reluctance and in some case inability of small enterprise borrowers to cope with loans in which there can be sharp changes in repayment commitments, it is agreed usually that governments take on this foreign exchange risk, Sometimes, an exchange risk fee or premium is charged, which in most cases is not adequate to cover the exchange losses, at least when there are sharp devaluations of the local currency. However, these help act as a buffer against the losses the government may incur in covering this exchange risk. In practise, where loans are given at real interest rates, such as through indexing to inflation, (as in Brazil in the 1970's) even when the loans are in local currency, account has already been taken of exchange rate changes.

One would generally recommend that in lending programs for small enterprises the foreign exchange risk is borne by the government. It is not practical in most cases for this to be passed on to the small borrower or to the lending institution either, especially when the currency has been seriously overvalued for a long period, which then results in a very sharp devaluation.

Credit Guarantee Schemes.

Among the inducements offered to commercial banks to lend to SME is the creation of a credit guarantee scheme that introduces some form of risk sharing. The aim of credit guarantee schemes is to share the risk with commercial banks in the event of a default on a loan, and so to make them more prepared to lend for viable projects for which the borrower is unable to provide adequate collateral. Unless the scheme results in increased access to borrowers who previously have not been able to obtain institutional finance, the scheme has failed to achieve its purpose.

There are differing opinions as regards the proportion which should be covered by the guarantee. There are schemes in some developed countries, notably in Japan and France, where 100% of the loan was guaranteed, and according to figures this did not produce an exceptionally high rate of default. Also, in some developing countries faced with the difficulty of getting commercial banks to become involved in lending to SMI, schemes with 100% guarantees have been proposed (with USAID support). However, these are the exceptions. In most cases the guarantee is only for 50% to 80% of the loan and sometimes for a very limited amount of the interest on which the borrower defaults. Some schemes also limit the size of a single guarantee. The prevailing view is that such guarantee schemes do increase the danger that the lending institution will feel no real commitment in appraising and approving the loan and in collecting the debt if it knows that the institution itself was incurring no risk. Therefore, in practise, guarantees are given for 80% of the loan--or less--leaving the remainder of the risk with the lender.

In most cases credit guarantees are given against a fee. Some schemes were planned with the object, as in India and the U.K., of having the fees cover all costs of administration and settlement of claims, but this has usually proved unrealistic. An additional guarantee fund is generally needed from which to settle claims.

The Indian scheme is an exception in that it forces banks to guarantee all loans once they join the scheme. It then levies a fee on total loan amounts even though the guarantee applies to only 60% of a limited amount. In this way, in some cases the guarantee fee may come to close to 10% of the actual loan size.

Where the guarantee fee in a scheme is inadequate to cover claims, there has to be some other source of income to cover payment. In a reasonably well-run scheme the fee should be enough to cover administrative costs. Claims for default are then covered from income on investments from the original guarantee fund with possibly some contribution from the fees depending on the level of claims. In some countries, the guarantee scheme is recognised as a form of subsidy to small enterprises so that the government covers defaults directly from the public treasury without any fund being created.

Handling claims efficiently is a vital element because in the end this will determine the confidence that banks have in the scheme. Gaining the confidence of commercial banks and getting them to participate seems to be a major problem in developing countries where the level of trust in government commitments is often low.

Credit guarantee schemes have been reasonably successful in Europe, Japan and North America. In Germany in particular there has been a long record of successful credit guarantee schemes covered by a fund to which the commercial banks themselves, associations of small-scale entrepreneurs (the Handwerkskammer), and local and state governments, all contribute. In Japan, where the schemes have widespread acceptance, they operate through regional credit guarantee associations who then reinsure the guarantees with the State Small Business Credit Insurance Corporations.

In all schemes there should be some form of review of banks' recommendations for guarantees, if even on a sampling basis. It is advisable to guard against the possible misuse of the scheme by the banks in passing on only their risky borrowers to the guarantee scheme. Unfortunately, in some developing countries the banks continue to require collateral from loan borrowers at the same time as requesting guarantees, in the Philippines for instance), thus defeating the whole purpose of the guarantee scheme.

Credit guarantee schemes have in the last years become popular and have been started or planned in many developing countries, in Latin America, Asia and Africa, sometimes with foreign donor help. Donor aid has been active in helping set up schemes in Africa and Latin American countries. (In Peru, for instance, FOGAPI--a credit guarantee fund--was set up with German help). Sri Lanka, Colombia, Cameroon, Jamaica, Liberia, Morocco, Nepal, Malaysia, Thailand are some of the developing countries that have set up credit guarantee schemes, in the last decade. In most of these cases they have not been very effective in persuading commercial banks to lend to small enterprises. They have either been inadequately funded or understaffed so that requests for guarantees and later the handling of claims cannot be dealt with expeditiously. As a result the commercial banks have lost confidence and interest in the schemes. Even though these schemes have not generally proved very successful until now in developing countries, this experience should not be considered as negating the use of credit guarantee mechanisms but rather the manner in which they have been designed or operated. Schemes have to be given adequate resources in funds and manpower to ensure that they can meet the commitments undertaken and can achieve and retain the confidence of the participating banks. Guarantee fees should not be set too high because this only results in increasing the cost of credit and making it unattractive for small-scale enterprises.

Recently, among donors working in this field, USAID has assisted in the introduction of some schemes, notably one in Thailand working together with IFCT. In that country the SICGF (Small Industry Credit Guarantee Fund) was created in 1985 to a slow start, encountering disinterest on the part of the banks. By end 1987, SICGF claimed that it had not yet had to pay out any claims. This may be because the scheme is still new, since claims begin to develop after two or three years, or it may be because the lending institutions have been adopting a very cautious attitude and are lending only to known credit-worthy clients. This case is similar to some others, which may mean that the credit guarantee scheme may have failed to broaden the access for those small industries unable to establish credit-worthiness rating or to provide adequate collateral.

The World Bank has made a major review of such guarantee schemes both in developed countries and in developing countries. The study, while not rejecting the value of such schemes, has pointed to the various steps needed to be taken into consideration when launching a guarantee scheme.

Grace Periods and Repayment Schedules.

For the small firm, the cash flow needed to service a loan may be more important than the level of interest rate charged. The cash flow problem for debt servicing is more a function of the repayment schedule and the grace period than of the level of interest. Even when interest rates are high, a package of appropriate grace and repayment periods can make the debt servicing well within the capacity of the small enterprise borrower. On the other hand even a low interest rate may present problems if there is no grace period and the repayment schedule is short. In general, inflation and high interest rates usually tend to shorten repayment periods and create cash flow difficulties for borrowers.

The grace periods for a given loan (i.e the period usually at the start of repayment, when only interest and no principal is repaid), are often determined by the particular needs of lenders, such as the source of funds used and the conditions imposed on the institution to repay these funds. They may also be influenced by the perceived capacity and reliability of the borrower to repay the loan. In the end, by enforcing a shorter repayment period, the lender may compound the problems of the borrower making him less able to repay.

The general financial situation and the inflationary pressures may create uncertainty regarding the future costs of funds to replace those being onlent at the time, and this may influence the lender to set a very short repayment period. This may even be less than three years for the financing of a fixed asset, as in the example of Mexico. As most loans are designated for specific purposes, there is a logic in expecting loans for working capital, which rotates faster,to be paid in less time. There is a similar rationale to relating the repayment to the life of the asset being financed. One would expect a shorter repayment schedule for transport equipment than for heavy manufacturing machinery, or for a factory building, where it is usual for lending institutions to give much longer repayment schedules. There is also a strong case for providing grace periods in loans made to finance equipment, to cover the period until the new machinery is in operation and is producing revenue. Particularly in the case of new enterprises, many arrears in repayment of loans begin from an inadequate grace period.

Commercial banks are generally against borrowing short-term and lending long-term, so that funds emanating from short-term deposits are inevitably used by commercial banks to make loans with short repayment periods such as for working capital. For this reason, if commercial banks or development banks are expected to make long-term loans to small enterprises, they will have to be provided with funds with repayment periods and at interest levels which make it possible for them to onlend these funds at conditions at which the small-scale borrower could be expected to pay.

Repayment Records.

Most opponents of lending to small enterprises point to poor repayment records in credit lines to this sector. It is true that several small enterprise lending programs in the past have been plagued by poor performance of the loan portfolios. There are some indications that programs through commercial banks have better repayment records than those through public development finance institutions. In 1975, in the Philippines, the credit program for small enterprises financed by the World Bank had two parts--one credit line through the development bank (DBP) and the other through commercial banks and other financial institutions using an industrial guarantee and loan fund. The lending program, through the development bank, had a distinctly poorer repayment record than that through the loan fund. However, in the case of commercial bank lending, there are examples of both high repayment records and of programs where loan arrears are high. Commercial bank lending in schemes in Mexico, Honduras and Ecuador have enjoyed good repayment levels, well over 90 percent, whereas in Bangladesh, Indonesia, Morocco and to some extent Pakistan, small enterprise lending programs involving commercial banks have had arrears ranging from very high (over 50 percent) to a more moderate (around 20 percent) but still an unacceptable level. As already observed, it may be that commercial banks with better repayment records are actually lending cautiously to known clients with existing enterprises and stringently demanding collateral, leaving more risky lending to more doubtful projects, for new enterprises or to borrowers with less solid collateral to the DFI.

In general, there is no hard evidence that with effective appraisal, a suitable organisation and active supervision of loans repayment, rates need be much worse in small enterprise lending than in lending to other larger industrial borrowers. In fact, the reverse is the case and defaults on large loans have been the main cause of the difficult financial situation of many DFI's. There is a problem in the high cost of supervision of a large number of small loans and the difficulty and expense of providing the type of assistance needed to deal with problems when they arise among small loan recipients. Although it is a matter of some contention as to what may be considered an acceptable level of arrears and defaults in a small enterprise lending program in a developing country, it has generally been accepted that one must expect a somewhat higher level of arrears in lending to small enterprises. Nevertheless, above a certain level, arrears reflect poor portfolio management and weak supervision, together with inadequate screening of applicants and often also the intrusion of political influence in the choice of borrowers.

Savings Banks and Cooperatives.

Many believe that there is a strong argument in favour of linking savings mobilisation and credit delivery for small enterprises. Through savings, resources are built up to expand the volume of credit of an institution and to achieve the "sustainability" of the lending program without resource to continuous inflow of external funds. The small-scale borrowers, are encouraged through savings to build modest capital reserves toward growth and as a buffer against downturns in income. Furthermore, a link between savings and credit within a similar institution can encourage greater participation of the borrowers in the management of a lending program and can ensure adequate repayment levels. The borrowers, being savers, would have a direct interest in the financial solvency of the institution.

Throughout Africa in particular, but also in other parts of the world, there have existed for some time informed groups for mobilising savings with a view to using these resources for credit. These ROSCA's (Rotating Savings and Credit Associations) have been studied at length. Hans Siebel has documented many interesting cases of "self-help" within indigenous groups in African countries, which have successfully linked savings and credit, even though in many instances this is more in the form of consumer than business credits.

There is a potentially important role here for savings banks, credit cooperatives and for credit unions. These institutions have successfully supported small business in European countries and elsewhere. The German Savings Bank Association (Deutscher Sparkassen) has played a major role in promoting savings in that country in providing both personal mortgage loans and credits for business investment. Small enterprise lending has always been a major part of the German saving bank credit programs. While the larger banks in Germany use their funds primarily to finance their large customers, it is the savings banks that have helped finance the small business community. In 1985, lending by the savings banks accounted for 38.7% of the total credit market in Germany, and this included approximately close to DM100 million of loans to small and medium scale business, almost 30% of the savings banks' total lending. The market share of savings banks lendings to the "Handwerk" (crafts, artisans and smaller enterprises) was as high as 57.2%.

The German savings bank movement ascribes its success in small enterprise lending to the close relationships it develops with its clients who are also savers within the institution. This enables the saving banks to advise customers on the size of credit and in some cases where borrowing may be inadvisable. In recent years, the German Savings Banks Association has made contacts in developing countries in the Middle East, in Asia and in Latin America, to try and develop the saving bank concept and to help them to provide small loans to small enterprises. One particular successful activity was in the setting up of a Municipal Saving Banks in Peru.

The Credit Mutuel of France and Canadian savings and credit organisations have also helped set up savings and credit cooperatives in Zaire, Rwanda and Burundi. In the first stages these organisations are more successful in mobilising savings than in meeting the credit needs of small and micro-businesses. They also lend only to members. There is also a tendency to keep savings in income bearing deposits rather than to use them to make loans. Still, these institutions offer hope for the future in providing new sources of small loans especially to micro businesses. They can achieve a reduction in transaction costs by engaging in both the activities of mobilising savings and delivering credit at the same time.

There are some who believe that the strengthening of such savings and credit institutions, whether in the form of cooperatives or as credit unions or associations may prove to be the best way of delivering credit in an effective manner to small and micro-enterprises in Africa, especially in rural areas, where often the banking system has no outlets. On the other hand, Chandavarkar has observed that the informal credit markets are better geared to the giving of credit than in the collection of savings, which is better left to formal financial institutions that are supervised by the central bank. The problem of supervision becomes important particularly when savings institutions provide development credits. However, where clients have to save in order to borrow, credit organisations have to prove first to their customers that they are trustworthy places to put one's savings.

Equity and Venture Capital.

Clearly the provision of loan capital alone will not answer all the needs for finance for small enterprise development. There must be some equity stake or risk capital invested by the entrepreneur himself in his enterprise and also possibly from some other sources. In most small enterprise lending schemes there is an insistence that the loans only cover a percentage of the cost of a project, usually not more than about 70%, which means that 30% will have to be produced as equity in some form by the entrepreneur or small business owner. This is necessary to ensure there is an adequate amount of own resources at risk on the part of the owner entrepreneur who will manage the venture. It also helps to ensure that the enterprise is not burdened with debts beyond its capacity to service, which happens in some over-generous schemes, where 90% or even more of the cost of the project is provided as loans. Some people even argue that no more than 50% should be provided as credit, but in conditions in developing countries, particularly in those in early stages of development this would provide a major constraint on new entrepreneurs starting small businesses, since capital is not readily available and the resources of potential entrepreneurs are very limited.

Apart from the equity provided by the entrepreneur, risk capital is, in some countries, made available through equity financing organisations or venture capital groups. Venture capital companies have existed in industrialised countries for some time now, particularly in the U.S., the U.K., and other Western European countries, in Japan, Australia, Canada and elsewhere. These companies screen very carefully the ventures in which they make minority investments in the developed countries, and generally invest in high technology projects.

In the United States, the 1958 Small Business Investment Act created the Small Business Investments Companies (SBIC's) which were targeted to provide equity capital together with development finance for small and medium size companies. In reality SBIC's gradually developed more into organisations making loans to SMI who were empowered also to take some equity positions, rather than real equity financing organisations.

Recently, venture capital companies are starting operations in some developing countries. The International Finance Corporation, the private sector investment corporation of the World Bank, has played a key role in promoting interest in the venture capital idea in the developing world. In 1978 it invested in SEFINNOVA, the first venture capital company established in Spain, and later helped in developing venture capital organisations in Brazil, Korea, Kenya and the Philippines. As far as the developing world is concerned, venture capital, may be defined as a search for investment opportunities (usually minority holdings) able to generate economic value-added and substantial returns for investors. Venture capital operations tend to incorporate a higher than average risk element and as a result such companies expect to obtain substantial rewards on at least some of the investments to make up for those that do not succeed.

Support for venture capital in developing countries is still relatively new and most of the small number of such investments have been in the medium-size category of enterprises. Equity financing of this sort has faced strong resistance of SMI entrepreneurs to sharing the ownership of the business with others, whether public or private partners. In Spain, the average project investment of SEFINNOVA was US$81,000 while in the Philippines it was only US$24,000* In Brazil and Korea, the equity taken was higher

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* VIBES (ventures in Industries and Business Enterprises) in the Philippines is not really an equity financing company. For example, it makes short-term agreements with very small concerns to provide working capital to enable them to meet an order upon completion of which the profits are shared.

(in the US$200,000 to US$300,000 range) but still in the medium-scale category.

The experience of the U.S. and the U.K. venture capital organisations show that the number of investments of each remains low. Venture capital companies are highly selective and may go through hundreds of possible ventures before actually deciding on an investment. There are also, in all cases, a number of failures and write-offs -- this has been the case with the SEFINNOVA experience in Spain and with some of the Brazilian venture capital companies too -- and the few successful ventures must cover the losses.

The above refers to private sector activities-- usually initiated by commercial banks--in the venture capital field, even though some public funds or external donor support (e.g. IFC) may be involved. In some cases, governments have created state funded equity financing organisations. One such example is FOMIN--Fondo de Fomento Industrial in Mexico. FOMIN, established in 1972, is a government trust fund administered by NAFIN--National Financiera--with the role of helping to create new small enterprises or strengthening existing ones by contributing equity capital as a minority shareholder (initially less than 30% and from 1980 less than 49% of the company's equity). In the period 1980-85 FOMIN took equity and gave loans in 72 enterprises. A successful program of divestment of equity holdings at real value is a real problem for all venture capital companies who are usually forced to sell the majority holding enterprises. FOMIN did succeed in disposing of a number of its investments by selling the holdings share to the majority partners. Valuation of the shareholding of FOMIN for selling back the shares has proved a major problem. There is some doubt whether in every case FOMIN was able to obtain the full market value for its shareholding.

Another example of public equity financing for SME is the Korean Technology Development Corporation (KTDC) an organisation to which the World Bank gave a US$50 million in 1981. The predominant form of technology transfer in Korea prior to this was through the import and purchase of technological and management know-how through royalty and licensing agreements. As Korean industry expanded and became more sophisticated, Korea was faced by ever-rising payments of royalties which rose from US$2 millions a year in 1960 to more than US$80 million in 1979. KTDC tried to help industry by commercialising the results of the research and development efforts carried on within the country. Those small and medium enterprises who were the prime innovators in Korean industry were given equity participation by KTDC and some loan capital to put the new products into manufacture. KDTC is an interesting example of the use of an equity financing organisation to encourage innovations into more risky types of investments in new technologies.

In general, venture capital and equity financing are usually confined to the larger end of SMI, namely to medium-scale enterprises. However, in Africa, entrepreneurs are unable to mobilise even the very small amounts of equity needed to start a new small enterprise. Some West African countries have therefore created small funds--"Fonds de Participation"- in which small equity contributions are made to enable an individual entrepreneur who has the skills and a viable business plan, but cannot raise the minimum capital needed to start his business.

In general, some type of source of equity and venture capital is needed to broaden the entrepreneurial base in a developing country and to encourage "new start-ups" or even the expansion and diversification of existing SMI. Loan capital alone is usually not sufficient. A few DFI's have recognised this and in addition to providing loans have agreed in some cases to take a small amount--usually less than 10%--of equity in the small or medium enterprise they are helping to finance. Such equity participation, as in all the other cases, generally does not involve intervention in the daily management of the enterprise.

Leasing and Hire Purchase.

An innovative manner of providing finance to a small or medium enterprise, may be through the leasing of capital assets. Leasing may be defined as when one party, called the "lessor", conveys the use of capital to another party, called the "lessee", for a specified rate, for a limited term. The ownership to the asset throughout remains with the lessor. Such leasing arrangements have very definite advantages. In some countries, they help reduce the tax burden on an enterprise since the leasing fee can be considered as an on-going enterprise expense. Leasing can also improve the cash flow of the lessee insofar as one can usually enter into a leasing agreement with a very small down payment as distinct from the much larger investment that needs to be made in acquiring the ownership of a fixed asset.

Leasing also requires the enterprise usually to make the initial leasing payment only when the equipment is delivered so that there is no cost burden during the period of constructing the asset nor during its installation period. Usually, the leasing fee has much less impact on the book earnings than the effects of depreciation and interest payment in the case of direct purchase. Sometimes, leasing can take place under special agreements whereby payments can be adjusted to the earnings generated. Most of all, leasing liberates unused capital that can be put to other uses.

For all these reasons, leasing is often an attractive alternative to purchase of equipment. However, it should be pointed out that there are some disadvantages to the arrangements too. Overall, the cost of leasing is higher than purchasing especially if the tax system gives benefits in the form of an "investment allowance". There are also definite obligations regarding the maintenance and insurance of the equipment and limitations on the disposition of the equipment without the special permission of the "lessor". Above all, a leased piece of equipment cannot be used as collateral for any additional loan financing, no more than can a rented building. This may explain why leasing is less popular among small and medium entrepreneurs, who for one reason or another, attach a great deal of importance to ownership.

Leasing is not as widespread as it might be expected except for special types of equipment, such as transport vehicles, computers and in some cases construction equipment. However, there are cases where because of the tax regime and because of credit ceilings which limit the bank's lending possibilities, leasing has taken hold to a greater extent. This is true in Morocco, where approximately 7% of financing of equipment for SMI is through leasing and most of the major banks have leasing subsidiaries. There are also leasing companies, usually as subsidiaries of banking institutions, in Korea and in some Latin American countries.

There has been an increase in the last 20 years or so in Western Europe, particularly in Germany, in the leasing of equipment, which has now reached around 7%, but again this applies more to special types of equipment. Most leasing arrangements end, after a number of years, with the equipment being passed over to the ownership of the "lessee" for a small payment.

Hire purchase is another form of financing to help an enterprise purchase an asset. It is similar to leasing, except that usually in such hire purchase arrangements there is a clear agreement from the start that the ownership will be transferred at the end of the period to the user who is generally required to pay a higher deposit than in the case of leasing, possibly up to 40% of the equipment cost. In most cases, hire purchase term agreements are of shorter duration than leasing arrangements.

Leasing and hire purchase may be suitable arrangements where the client has inadequate collateral. However, this has its risks, since the control by the "lessor" can be difficult and usually leasing or hire purchase arrangements are only made with known credit-worthy clients.

Target Groups and Eligibility Criteria.

One of the major issues in designing a lending program for small enterprises is how to define the target group and to determine which enterprises should be eligible to benefit from the credits made available. Most external donors, including the World Bank, have followed the practise of leaving the government of each country to determine how to define the small enterprise sector in keeping with the conditions prevailing in that country. The policy paper of the World Bank in 1978 indicated as a general guide that such enterprises should have fixed assets of less than the equivalent of US$250,000 in 1976 dollar values. Most thinking nowadays has been against using an employment limit as a major criterion of eligibility, since employment creation is one of the major objectives of support for the sector, so that credit programs should not be designed in a way to discourage enterprises from increasing employment for fear of losing access to a credit line.

Most countries nowadays have definitions for small and medium, and some for micro-enterprises as well. Definitions of micro-enterprises are generally set at assets of around US$S10,000, sometimes rising up to US$20,000. In many cases an employment limit of up to 10 employees is added as a second criterion. Small enterprises may have upper asset limits of US$50,000 to US$250,000 and employment limits that may vary from 50 to 100. The biggest variations come in defining the limits of a medium-scale enterprise, where some countries are prepared to consider enterprises with US$1 million to US$2 million assets and employment of up to 200 to 300 as a medium enterprise eligible for special lines of credit.

There have been tendencies for the limits for medium enterprises to move upwards. There has been evidence that the introduction of limits that are too rigid or too low has tended to reduce demands for loans. They also discourage commercial banks from participation in these credit lines. If limits are set too low they discourage growth of SMI, for fear of losing access. Despite the desirability of using a fixed asset definition, either in the value of equipment or capital employed, in practise it is often difficult to monitor these values. For this reason, some countries still use employment as a definition, despite its inadequacy for the reasons mentioned above. The use of two criteria together--the value of fixed assets and employment--can give closer indication of the real size of an enterprise.

Apart from setting the eligibility as regards asset size or employment, there is also the question of loan size. In most cases permissible loan size is close to the accepted asset size, which would mean that in a credit line defined as helping small and medium enterprises with fixed assets of less than the equivalent of US$250,000, the loan limit size would be the same. Some credit lines introduce quotas to ensure that the smaller end of the target group obtain their share. This means that 20% or 40% of a particular fund may be earmarked specifically for small enterprises and cannot be used for lending to medium scale. Micro-enterprise funding has usually benefitted from distinct credit lines for this purpose often through non-governmental organisations, and in some countries they may allow--or even encourage-- the lending of very small sums of a few hundred dollars.

In most World Bank SME lending projects, loan sizes have in practise been in the range of US$20,000-US$50,000 although in some projects the average loan has been above US$100,000. Credit lines with average loan sizes around US$20,000-US$30,000 may be considered a small enterprise lending project and average loan sizes of US$100,000 to US$200,000 or more as medium-scale enterprise lending.

Employment creation is a major objective in small enterprise lending, and efforts have been made to discourage projects with high capital intensity by making such sub-projects ineligible for financing. The eligibility of a sub-project would then be determined not only by the size of the borrower in fixed assets or employment, but also by investment cost per job created in the project to be financed. This criterion has been used in some countries when it has been felt that there was a tendency for the institutions to finance high investment projects and where there is need to focus more specifically on employment creation. In practise, the purchase of machinery, where utilisation would be low and not economically justified, is more often than not because the credit is being offered at subsidised interest rates.

The use of investment cost per job as a criterion for eligibility for financing, in addition to the fixed asset and/or employment size of the borrower, must be used with caution so as not to restrict the small enterprise projects financed to traditional labour-intensive sectors, which are the areas where most small enterprises operate. Investment costs per job limit are usually difficult to monitor. On-lending at the real interest rate is usually the best guarantee that funds will not be used for unjustified investment in excessive equipment. In addition, there are cases where refusing to finance additional equipment, even without employment creation, may prevent a small enterprise from becoming competitive, particularly in export markets, by using a more efficient technology.

<u>Additionality</u>

This is one of the most difficult problems in developing a special lending program for small enterprises. It is the question of whether one can ensure that the finance made available for lending to small enterprises will not replace other funds, such as personal family savings and will represent a net increase in resources for the sector. Clearly, it is very difficult to determine this "additionality". However, where funds are made available through arrangements which rediscount 50% to 80% of project costs, and the remainder is financed from the equity of the promotor or from the lending institution's own funds, then this can be considered as the generation of additional funds for the sector beyond those made available through the credit program. It is important to monitor programs continuously to ensure that special funds made available are additional to resources that can be mobilised through savings and other domestic resources

Lending Procedures.

All lending programs should be implemented with simple and efficient procedures, ensuring that due care is taken in assessing both the borrower and the project for which financing is being sought. There have been many criticisms of lending programs that have taken an unduly long time to reach a decision on a loan application and finally to disburse it. Horror stories are told of where a borrower has had to wait 9 or even 18 months or longer before finally receiving a decision on a loan. Decisions, especially rejections should be transmitted to the client without delay. In many cases rejections do not amount to a final decision but rather a request for further information or for modifications of the project.

Most lending procedures in such credit programs start with an interview. In programs with trained loan officers the interview may be decisive and lead to a speedy decision on the loan, especially if the applicant has a clear business plan and the financial records of his business and if he is alerted to bring with him this documentation on the proposed investment.

The interview is usually followed by the completion of an application form. While application forms may differ according to the situation in the country concerned, care should be taken not to overload the form with questions requesting information which is of only marginal interest. Some suggest that all applications should be accompanied by audited financial statements of the business for the last three years and the most recent financial records, of accounts receivable and payable, a forecast of earnings for the next three years and of the cash flow over this period as well as a plan of the land, buildings and machinery involved. This, it is suggested, should be accompanied by all the details of the technical staff, the managers, the employees and so on. All this may be very desirable, but compliance can prove an impossible burden for many small-scale entrepreneurs who may have viable projects and are competent to carry them out if they are given the required financing. There is no justification for demanding excessive information. Afterwards the analysis and verification of the information only contribute to further delays in the approval and disbursement of the loan. The delays may make the records and figures, probably not very reliable in the first place, out-of-date and no longer applicable to the situation. In countries suffering from rapid inflation all delays in the processing of loans and in the analysis of financial records make it even less likely that a real appraisal can be made on the viability of the loan application.

Loan Appraisal.

The appraisal of the loan is really the most important step in the procedure. This generally consists of several steps, if possible merged together to save time. In most cases it is suggested that a visit is made to the proposed site for the intended business operation, whether this is an existing enterprise or planned as a new investment. A further check is also usually made on the credit record of the applicant where this is feasible.

As regards the project itself it is usual to analyse the technical aspects such as the appropriateness of the scale of operations of the machinery and equipment proposed, size of the premises, the availability of the right type of labour, technical skills, management, supplies of raw materials and of any auxiliary operations that may be needed. Marketing provides one of the more difficult aspects in the appraisal. Clearly, a full-scale market research is not appropriate for a small-scale project but there should be some analysis of what the expected market might be. In the appraisal a review should be made of the applicant's marketing strategy, of the extent of the competition and whether the annual sales in the business forecast is realistic. Finally, there is a need for an analysis of the financial statements, of growth trends, cash flow, profitability, and of debt equity ratios. The ability of the project to service the debt is of paramount importance. For this purpose, more emphasis should be placed on the projected cash flow than on the projected balance sheet determining the ultimate profitability. The approval of a project may finally depend on the assessment of the capacity of the management and of the entrepreneur to carry through the proposed project.

Loan Disbursement.

The disbursement should be as simple as possible but unfortunately, as most banks demand collateral, this can be a major source of delay. In most cases, the equipment and other assets being financed are inadequate collateral for the banks which, in most countries, prefer land as security.

There are many cases where title to land is unclear. Many times the provision of adequate documentation to show that the client has clear title to the land or to other chattels offered as collateral is a major source of delay.

In addition to the problems involved in the adequacy of the collateral offered, the steps before disbursement provide assurance for the lending bank that the funds are to be used for the purpose for which the application was made.

Another problem may arise when the entrepreneur has undertaken to provide financing from other sources, either to meet an agreed debt-equity ratio, or because the bank loan is inadequate for the financing needs. Care has to be taken that the additional financing is available before disbursement, otherwise the whole project may be in doubt and may never be implemented. Together with the collateral, the provision of the complementary financing can be a major source of delay in disbursement.

Disbursement for equipment purchases is usually made in the form of direct payment to the supplier upon evidence that the equipment is to be delivered. When equipment is ordered from overseas, it is the usual practise to relate disbursement to the opening of an irrevocable letter of credit in the name of the supplier. In some cases, loans are provided for equipment that already has been ordered and partially paid for, and in such cases the disbursement would be made against the evidence of receipted invoices or other documentation certifying the payment.

Loan Supervision.

Most commercial banks tend to minimise supervision which they find unnecessary and costly in the cases where the loan is being paid regularly. However, there are many reasons why regular supervision of the project is desirable if only to give advance notice of problems that may arise.

Where there are some arrears in debt payment, it is not unusual for banks to break down the loans portfolio into three or four categories. The first category may be loans in which the situation is totally satisfactory and there is no evidence of any danger of a default. The second might be accounts where some difficulties are being encountered but there is reason to expect that they can be overcome without culminating in a loan default. Category three might be what is called in India "sick accounts", namely those in which arrears are mounting and there is no evidence as to how problems will be resolved. And the last category four, (sometimes combined with category three) would probably be those loan accounts where legal action has already started and there is really no chance of any turnaround in the situation.

It is interesting to see on what basis banks categorise their loans. A point usually to be watched is whether the working capital is considered adequate for normal business operations, or whether the earnings have fallen. It is usual practise for arrears up to three months to be allowed before placing the loan into a lower category. A constant review of the arrears situation is required if the lending bank is to administer its loan program efficiently.

There is some justification in the view of commercial banks that if loans are being paid there is little need for the extra cost of plant visits or project reviews. However, it can been shown that where some limited supervision is not carried out, portfolios tend to deteriorate suddenly without the lending bank being in a position to act to forestall a worsening of the situation. Rescheduling of loans can at some times be a suitable way of forestalling a deterioration into a default. Excessive use of rescheduling, as has been in the case of some development banks, may however lead to a general fall-off of discipline in loan repayments as clients begin to expect such rescheduling and make less effort to meet their repayment commitments.

Inter-relationship of Finance and Other Development Assistance.

For some time it has been recognised that the SMI sector cannot be promoted only through the provision of finance. These enterprises require information, guidance and advice if they are to make the most effective use of finance. As a result, in most small enterprise assistance programs efforts are made to introduce some form of extension aid or technical assistance for the enterprises as well as finance.

The technical assistance provided may vary depending on the size, type and characteristics of the beneficiaries and the degree of development of the country and the entrepreneurs. Primary among the subjects in which help is needed is the correct choice of technology, to help entrepreneurs to select the most appropriate equipment and processes. In many cases, however, technical assistance programs give little advice on technology and concentrate more on managerial assistance where most institutions engaged in the delivery of technical assistance consider themselves better qualified to help.

There is often a problem in coordinating financial and technical assistance. Most promotional institutions and technical assistance agencies have difficulty in gaining the confidence of the financing institutions. Banks are usually not prepared to rely on the selection and evaluation of projects recommended by the agencies concerned. In part this is due to the customary institutional rivalry, but in many cases,it is due in part to the limited expertise of the staff of these development agencies.

Some exceptions might be noted as in the case of Mexico where FOGAIN helped to establish the extension service, PAI, in 1978. For some years this arrangement operated quite well and hundreds of projects were referred by PAI to INFOTEC (Servicio de Informacion Tecnologica - Technological Information Service) for technical advice and information. PAI arranged training programs developed by its own staff and also by other institutions. Enterprises needing loans were referred directly to FOGAIN and for equity financing to FOMIN. PAI also helped to arrange industrial estate facilities and, apart from providing direct help itself, acted as a referral agency for assistance from other specialised agencies. Due to its close link with the financing agencies the cooperation was successful.

Another case is that of IAPMEI (Instituto d'Apoio a Pequena y Media Empresa Industriais--Institute for Support for SMI) in Portugal. This promotional and technical assistance agency of the government was set up in 1975 to help small enterprises adapt themselves to the 1974 policy changes. It helped entrepreneurs deal with their technical problems and prepare their projects in a way acceptable to the commercial banks. IAPMEI also operated a guarantee fund. The commercial banks in Portugal were the direct lenders of funds provided by the World Bank in two loans in 1979 and 1982, and even though they did not always accept IAPMEI's recommendations and reviewed and appraised credit applications independently, a reasonable working relationship did develop between the banks and IAPMEI.

In most countries, financial institutions do not have the staff needed to appraise the suitability of the technology or machinery to be used in the project for which finance is being sought. Some financial institutions have recognised this limitation and have added engineering staff so as to be able to analyse the technical aspects of the project, but others look to technical assistance agencies to help them.

Technical assistance or extension arrangements usually involve the use of public institutions as delivery systems and are often staffed with inexperienced personnel, have suffered from budgetary problems, management and staff turnover and generally are unable to offer the conditions of employment needed to attract competent professionals. Staffing remains a serious problem of most technical assistance and promotional agencies.

As stated, most of the agencies set up to help SMI with advice and information have thought themselves better able to provide help in the management field than in matters of technology. In Morocco, the Philippines and Colombia, for instance, advice given to SMI has been mainly in improving financial records and some help in the preparation of projects for financing. Entrepreneurs have been assisted to develop feasibility studies and to apply break-even analysis to the projects for which they are seeking finance. There have been less cases of these agencies providing help in the field of technology. In practise, most of the machinery bought with sub-loans financed by external donors, has been imported, and most of the guidance and advice on equipment choice has been provided by agents and representatives of the equipment manufacturers. In the case of bi-lateral donors these equipment suppliers have usually been nationals of the country providing the funds. In some SMI support projects funds were made available for assistance in finding the most appropriate technology to be used and in the selection of equipment. Such a component was introduced by the World Bank in a project in Colombia. In practise there were delays in disbursing these funds, most of which failed to provide the kind of assistance which was originally planned.

Also in Colombia, the World Bank carried out a study of the type of technology used by small firms. The findings seemed to show that technical efficiency was highest with firms that used neither the most simple nor the most sophisticated but rather an intermediate type of technology. The Colombian study also showed the widespread use of second-hand machinery amongst small enterprises. It found that up to one quarter of all the equipment used in the firms surveyed had been acquired second-hand.

The purchase of second-hand equipment has been a controversial issue in most financial assistance programs for SMI. The recipient governments who are keen to use external funding for purchasing more up-to-date machinery have been reluctant to use such funds for the acquisition of used machinery. There has been a fear that the price and quality of such equipment might be difficult to control. It is nevertheless a fact that in many countries small enterprises do make effective use of second-hand machinery. The cost of such used equipment is much lower than new imported machines and in some cases they are technologically more suitable for the needs of SMI than more modern sophisticated versions.

In some more recent credit lines of the World Bank, in Chile in 1986 for instance, where there has been a special situation making a lot of equipment in good condition available for SMI, arrangements have been made for the use of external funds to purchase such machinery with some safeguards as regards quality and price.

Organisation of Technical Assistance.

There are no clear conclusions as to the most appropriate form of organising technical information, advisory or extension services for SMI or on the most suitable relationship between such agencies and those providing credits.

Some have advocated that technical assistance should be given directly to enterprises by financial institutions. This could prove a financial burden on such institutions and it might be necessary to provide subsidies to cover the cost. The existence of such a technical assistance service within a financial institution might ensure coordination but might prejudice the independence of the financing decision. The institution may feel obliged to finance projects in which some of its staff have been involved in providing advice and assistance. Technical assistance may also be limited to those receiving credits. Entrepreneurs might go through the motions of appearing to accept advice in order to secure the loan that they really seek. This might lead also to confusion in the minds of the recipients between the provision of technical assistance and the supervision of a loan or debt collection. There have been situations where extension services of financing institutions, while supervising projects to find out why the enterprise is in arrears in repaying the loan, have found themselves more in the role of debt collectors. In some situations, however, particularly in less developed countries the provision of some technical assistance by financial institutions may in fact be the most efficient and direct arrangement and possibly the only one that can ensure some form of coordination between a credit program and the provision of non-financial help.

The more usual organisational arrangement is to have a separate technical assistance promotional or extension agency, usually supported by public funds, either under the direction of the Ministry of Industry or in some cases of an independent institution, but still subject to some public control. The organisational weaknesses of such an arrangement have already been described. Such agencies have also been accused at times of turning a blind eye to economic deficiencies, technical shortcomings and doubts about viability in projects in their efforts to promote more SMI. Often smaller technical assistance agencies, possibly locally or regionally-oriented and/or sector-specific (for clothing, footwear, metalworking,etc.) can have a greater degree of success.

In this form, less bureaucratic organisations can be achieved with a higher professional standard of staff and a closer relationship with clients on the basis of common technical expertise in the particular sector or through local contacts. Such agencies can establish closer links with local branches of financing institutions that offer credits for SMI and can deliver suitable technical assistance and advice both to the loan officers and to their clients.

Clearly, institutional structures and organisational arrangements will have to differ from country to country. There obviously will be a difference between countries covering a wide geographical area and small island economies. But in all cases there is considerable merit in involving the private sector through associations of small industrialists, chambers of commerce, sectoral groups and, where they are available, private consultants.

Kenya offers an interesting example of both an integrated institution and one in which a financial institution provides some promotional and technical assistance. The Kenya Industrial Estates (KIE) was founded in 1967 as a subsidiary of the Industrial Commercial Development Corporation (ICDC) that was then running a very limited credit program for small enterprises. KIE was established--as the name suggests--to construct industrial estates for small-scale African enterprises. After constructing an estate in Nairobi in the early 1970's, it went on to construct further estates in Mombasa, Nakuru, Kisumu and Eldoret, the main cities of Kenya. Until 1976, when it was separated from ICDC, KIE's main activity was the development and management of these industrial estates for small-scale enterprises mostly with funds originating from the government and from bi-lateral donors and transferred to KIE as grants or loans by the government. In 1977, largely as a result of a World Bank/IDA credit for US$10 million, KIE was removed from ICDC and transformed it into an autonomous financial intermediary to provide an integrated program of both financial and technical assistance to small enterprises.
By mid-1982, KIE had made 501 loans and had an outstanding portfolio of Kenyan Shillings 197 million (at that time around US$20 million). KIE aimed to provide full technical services for all the small African industries developed on the industrial estates and rural industrial development centers set up in small towns after 1974. After 1978, KIE supported small African enterprises whether they were located on the estates or not. KIE identified projects, helped the entrepreneurs to prepare and analyse their projects, and offered direct help at all stages.

The results have been mixed. KIE has been severely criticised in that despite the very considerable external assistance it received from bi-lateral and multi-lateral donors, including the Germans, the Swedes, the Norwegians, the Japanese, the World Bank, UNIDO and ILO, its loan portfolio suffered from a high level of arrears. Between 20% and 25% of its projects failed completely and had to be written off as losses. Furthermore, a large number of projects prepared by KIE's technical staff were never implemented.

KIE's experience led to considerable rethinking. One of the reasons for KIE's difficulties was generally considered to be that its promotional role conflicted with that of a development financial institution. Until 1985, KIE did not succeed in organising a standard of financial management required to run a successful credit program. Its level of project appraisal, supervision and debt collection were all less than effective. The situation improved somewhat in the mid-1980's after some reorganisation. Viewed in retrospect, it can be said that despite many problems, including political interference, KIE did succeed more than any other African institution in developing several hundred small African enterprises. By the mid-1980's, 400 or so small-scale industrial projects were operating either successfully or with minimal problems as a result of KIE's activities. This, however, should not minimise the extent of its losses or the number of projects facing difficulties or which failed completely.

There was another example in Kenya of a limited technical advice and management assistance provided by the Kenya Commercial Bank (KCB) which helped to advise SME clients on how to improve their business performance. This Business Advisory Service (BAS) of KCB, set up in 1977 undertook a number of feasibility and consulting studies mostly for fees. KIE's assistance was without charge. As distinct from KIE, in which efforts were made to convert a promotional agency to a development financial institution, in the KCB example, a separate advisory service was developed within a financial institution. The BAS, in keeping with the whole of the KCB-SMI lending program, to a great extent helped non-African medium-scale enterprises at least in its early stages.

Apart from the KIE example, there have been a number of other cases where small enterprise development, or promotional agencies, have been given limited funding to provide credits or small amounts of equity for entrepreneurs who wish to start enterprises. Such examples, as in Jamaica, Zimbabwe, and Lesotho, have generally encountered difficulties in running an effective credit program with good repayment records. An integrated agency has problems, especially if it starts first as a promotional institution and then has to convert itself into a development finance institution in which projects and clients have to be regarded in a much more critical fashion.

There is no clear organisational form that suits all situations. Where possible separate institutions are probably desirable, and where this is not possible the option of organising a technical assistance advisory service within a financial institution has to be considered. In situations where commercial banks or DFI's are unwilling to undertake the credit roles, the creation of an integrated institution, may be the only option. It is as well to recognise the problems that may arise in such cases.

Finally, technical assistance or extension programs for SMI's cost a great deal. No completely satisfactory way has been found to overcome this problem of high costs. In an integrated institution, part of the cost can possibly be covered through an extra margin on loans or a special fee, but it is doubtful if this will ever be able to cover all the costs. It is argued by many that it is desirable to require those who benefit from technical assistance to make some contribution toward the costs. Inevitably some subsidies from public funds will be needed in one form or another, but efforts can made to reduce costs by communicating technical information or advice to groups in a collective fashion, rather than the more costly way of providing help to each individual enterprise.

While there are differences of opinion as to the importance of providing technical assistance, most seem to agree that it is a need and that a good advisory or extension program could help the growth and development of small enterprises in all developing countries. There are some who would reduce the emphasis on such programs and would confine them to the more dynamic small and medium-sized enterprises. The larger units poised for growth would certainly need help in very specific fields, such as new technologies, promotion of exports or quality control. There is some doubt whether the introduction of simple bookkeeping, especially in situations where the entrepreneur is not fully convinced of its use or need, is worth a costly effort. However, prevailing opinion still believes that if an effective technical assistance program can be developed it will ensure greater effectiveness in the use of financial assistance programs. Without help in technology, management and marketing advice in addition to financial assistance, small enterprise development will face serious constraints.

Conclusions.

The main conclusion must be that even when the financial sector in a country operates independently and relatively efficiently, SMI will have problems in obtaining access to institutional finance for all the reasons stated. The need is recognised, even in developed countries, for special programs aimed at directing more finance to this sector. This may be through special credit lines directed through DFI and/or commercial banks or through the use of inducements to financial institutions to lend to SMI, such as refinancing arrangements, credit guarantee schemes, higher spreads, less controlled interest rates or assistance to potential clients in preparing bankable projects.

While small enterprise lending will always appear less profitable to profit-oriented commercial banks, such institutions do have at their disposal a variety of new ways of benefitting from such lending in the long run. By offering various financial services to their clients, they can in fact make their associations with the small business sector profitable. Furthermore, it is thought, although not generally agreed upon, that in some countries banks should be prepared to cross subsidise, namely accept a lower level of profitability from small enterprise lending to be covered by high profits from some larger borrowers, particularly in the trade and commerce sectors.

Government intervention may be needed, but this may be more by following the current policies with relation to credits, interest rates, reserve requirements and foreign exchange levels than in mandating banks to lend to SMI or any other specific group.

Wherever it is feasible, the multi-institution approach, where funding is channeled through both commercial banks and DFI's, seems to be the most effective arrangement. The projects financed must be viable and must make a contribution to the economic and social development of the country. Finally, it should be an objective for lending programs to become self-sustaining without continued external assistance.

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