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SMALL AND MEDIUM SCALE ENTERPRISE FINANCING

IN THE PHILIPPINES

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Prepared for the

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CHAPTER I. SMALL AND MEDIUM SCALE ENTERPRISE FINANCING ISSUES

Following is a summary of the major issues regarding the conduct of SME financing programs in the Philippines, based on various studies of the financial sector, the SME sector, and the authors experience in administering financial assistance programs in the sector.

The Philippine government has taken the initiative in developing a number of SME financing programs in the wake of a lethargic response by the private sector to the financial needs of this sector. Since the SME sector is likewise the entry point of low income groups into entrepreneurship, government has given much attention to assistance programs for this sector since these SSE financing programs have a direct income redistribution effect and fits well into government programs for rural development and poverty alleviation.

Indeed there have been numerous SME financing programs, but the sector remains underdeveloped, still capital starved, while SME Funds available remain underutilized. Following identifies the major issues that may account for this situation:

A. Program Policy Inappropriate to Contend with the Basic Constraint: The Limited Savings Base of the Entrepreneur

As as a developing country most of the entrepreneurs come from the low and middle income groups, who have limited savings. It is this basic constraint, which SME financing programs seek to address.

The response to the SME's lack of capital is to establish special SME financing programs which (mostly) the government has initiated. However an analysis of these financial intervention will indicate that the SME financing programs have failed to address the basic constraint of the entrepreneur -- ie the limited savings base of the entrepreneur.

While SME financing programs have been made available thru loan programs, invariably these loan programs require that loan funds be matched with a twenty to thirty per cent equity counterpart and collateral assets to secure the financing. While the entrepreneur may have some asset (savings) base to start up the enterprise, this asset base is soon exhausted to serve as counterpart for additional loan funds needed as the company grows. The end result is while there may have been loan funds available at the start of the enterprise, this access is cut off as the company grows, notwithstanding its business potential, because the entrepreneur has reached the limit of his savings base.

In short the entrepreneur's access to external financial resources and consequently the size/scale of his enterprise is very much determined by the amount of (and even the form, ie., urban based real estate) of savings he has. The SME does not have access to capital assistance at the time or stage of development of his enterprise when it may have more potential for growth. Subsequently, the enterprise remains at its initial scale of production, and stagnates at that level of productivity, inspite of growth opportunities it may have developed.

SME access to external capital assistance is premised on this "savings matching" policy which has resulted in the failure of SME financing programs to assist the entrepreneurs overcome their capital handicap in developing larger scale enterprise. While SME financing programs may help them launch the enterprise, the entrepreneur has to rely largely on internal cash generation to finance its growth, which is seldom sufficient to support quantum growth in capacity.

This policy of lending on the basis of counterpart savings/assets (as equity and security) originates from the credit policies of a conservative private financial sector. It is said that sound financial management dictates that the entrepreneur must first of all have a financial stake as well in the project enterprise. Furthermore, in order to secure the creditor from financial losses, the standard policy requirement is obtain a mortgage in hard assets to secure the debt in case of default. This requirement is particularly imposed on SME's which are considered higher risk.

In sum, the fundamental issue is the appropriateness of the policy on access to capital which is premised on the ability of the entrepreneur to provide counterpart equity and collateral assets to secure the debt. This requirement remains as the basic premise for lending irrespective of the enterprise's business track record and demonstrated growth potential. While it is realized that credit management objectives require that "counterparting savings" is an effective instrument for financial discipline and capital recovery, the instrument eventually leads to an abdication of the very objective that the SME financing is suppose to address -- ie., to assist the entrepreneur in overcoming his capital constraint in order to increase the productivity of his enterprise, particularly at the time when the enterprise 's growth opportunities are at hand.

The rigid observance of this pre-condition (on counterpart savings) to fund access leads to a situation where the SME remains trapped in a vicious cycle of smallness as follows:

limited savings base ---> limited access to capital --> ---> limited scale of enteprise/low productivity ---> limited income/cash generation ---> limited savings accumulation.

In this situation, the small remains small precisely because of the entrepreneur's small savings base.

There is a need to find alternative approaches or instruments whereby the provision of capital assistance can be extended and debt repayment can be secured premised on some other factor besides counterpart savings which by definition of SME's in a developing country context is small. Otherwise capital assistance will not be responsive to the capital requirements of SME's for growth, which after all is the end objective of developing the sector.

B. Program Objective: Fund Utilization vs. Productivity Impact

SME financing programs are mostly government initiated, with private financial sources focussing on the more established SME's for their short-term production or export sales related financial requirements. Government has taken the initiative in SME financing where the private financial system has been reluctant to intervene.

In responding to the financial need of the SME sector, government has found that SME programs tend to benefit the low and middle income groups, and those in the rural areas because entrepreneurs in this sector come from these groups/areas. The sub-contracting network that is prevalent in the SME production systems reaches out to the rural areas, which then serve as the nucleus of rural industrialization, as well as a direct way of augmenting the livelihood of low income families in the rural areas. As such SME programs (except for the programs led by the World Bank sponsored IGLF Industrial Guarantee Loan Fund, and the Development Bank of the Philippines) have taken on a "Populist" thrust which tend to focus on smaller enterprises -- micro and small scale enterprises. The recent poverty alleviation program has launched a government wide livelihood program with the same orientation.

SME lending programs may be grouped into two basic types depending on their orientation: (a)the Populist programs which are oriented towards income redistribution particularly in the rural areas. They generally provide low cost funds with little or no collateral requirements, and are coursed thru non-goverment organizations who then take on the repayment risk. The loan interests are usually concesional and the amounts are usually very small: P25,000 to P100,000 (about $1000 to $4000) and benefit micro or small scale enterprises.

(b) Bank based or Government Financial Insitutions (GFI's) SME programs -- these are loans generally extended to the established SME's, frequently those involved in exports. These are generally larger scale enterprises, and whose borrowings are premised on their ability to counterpart loan funds with the entrepreneur's own asset or savings base. The interest rates may be lower than prevailing market rates, but the pre-condition for fund availment is strictly enforced ie.,to provide counterpart equity and collateral asset securities for the loan. SME's who have not reached the limit of their savings base access funds thru this source.

In both cases the operational objective of the Fund administrators is to see their funds quickly utilized and repaid, with virtually no regard for the growth or productivity impact of the funds loaned out. It is sufficient for the Fund administrators to see to it that the funds are disbursed, that the pre-conditions for the fund availment (regarding counterpart equity/collateral assets) are met and that the fund user comes from the low income groups or the rural areas. There is no attempt to be selective or deliberate in its financial intervention, identifying the productivity impact of the loan funds disbursed. Nor is there any monitoring done of the SME applicants who are denied access to the funding because of deficiencies in counterparting equity or collateral assets, irrespective of their productivity or growth potentials, as shown in their business track record. With this orientation, it is noted that SME financing programs tend to measure their effectiveness by the amount of funds disbursed or utilized and the amounts collected where the funds are loaned out, the number of enterprises funded.

As a result SME's who may have a high growth potential but do not have the required counterpart savings base, remain capital starved, inspite of availability of funds from SME financing programs. Such SME's would in fact yield a higher output capital ratio (because of increasing returns to additional capital), and would lead to a more efficient allocation of capital in the SME sector. But the valid needs of these established SME's are "swept under the rug" or covered by the program statistics on enterprises funded and funds disbursed to smaller newly established SME's who are still able to comply with the counterpart equity/collateral requirements. The need for capital in a developing country is so large after all that there is always a new entrant SME to be funded.

This approach to the financing requirements of the SME sector, results in a situation whereby the financing programs keep on financing new entrants into a product sector, unmindful of the capi'al requirements of the older SME's in the sector who may have the growth potential but can not access additional funds because they have reached the limits of their savings or asset base top provide the counterpart required. They stagnate at a low level of productivity unable to graduate to a larger scale operation, unable to attain the size required to penetrate the larger volume export markets. These SME's if assisted to grow could in fact serve as the nuclei of growth in their own areas of operations providing new markets and technology transfer to smaller firms linked to them as raw material suppliers or sub-contractors.

In the meantime the new entrants financed by the SME financing programs, tend only to overcrowd an already crowded product sector competing for the same limited markets. This is the end result of SME financing programs that only look at fund utilization rates as their measure of impact without regard for how and which SME's are using the funds effectively, without regard for the productivity or growth impact of loan funds provided to the sector.

The ISSUE is the need for SME Financing Programs to redefine their objectives and strategy of intervention in the SME sector.There is a tendency to mix indiscriminately the government's social objectives of poverty alleviation with the development program for a product sector, often at the sacrifice of the latter. Undiscriminating financial assistance could overcrowd a product sector with a wave of new entrants/new capacities which have no additional markets to service. In the meantime a financing program that does not assist the SME's which have the potential for growth, fail to utilize the growth forces that could help the sector.

SME financing programs need to be fine tuned to follow and support the development path of a product sector, identifying the strategic SME's in areas that should be assisted to serve as growth multipliers in the sector. A policy of selective intervention should be studied and weighed against the existing approach of making funds available to anyone who qualifies for "social" or credit reasons. The assessment of the impact of an SME financing program should not be limited to statistics on fund disbursements and number of enterprises funded, which could be counter-productive as pointed out. The productivity or growth impact of government financial interventions in the SME sector should now be inputted as a guiding principle in the design of SME financing programs.

C. The Need to Develop a Source for the Long Term Capital Requirements of Small and Medium Scale Enterprises

It is almost axiomatic that in a capital starved developing country, the long term capital requirements of an SME will have the last priority in being satisfied by the capital market. One reason is because of the relative higher business risks of investing in SME's. On the other hand capital scarcity creates alternative lower risk opportunities, which at the same time provide options to liquify investments. Examples of these are high return investments in government treasury bills (at time of writing is offered at 22%), blue chip stocks, and real estate investments. Further it is noted that the costs of administering since this involves servicing a larger number of enterprises over a wider geographical area, requiring expertise not only in loan evaluation but also project superivision. The World Bank study on the Financial Sector (1987) notes that credit for SME's has been limited for their short term working capital requirements and to support capacity utilization. Funding is not available for expansion needs.

In the face of this situation, the SME entrepreneur has relied basically on his own savin base and profit reinvestments as the principal sources of thei ong term capital requirements for expansion or diversification. This is shown in the following Table I.A, which indicates the dependence of the SME entrepreneur on his own savings base (including inheritance) and internal cash generation from the company's operations.

TABLE I.A
SME SOURCE OF FINANCING

SOURCES OF INVESTMENT PER YEAR	SUBSEQUENT NO.	SUBSEQUENT %TO TOTAL (230)	INITIAL NO.	INITIAL %TO TOTAL (230)
OWN INVESTMENT				
OWN SAVINGS	165	71.2	206	89.6
INHERITANCE	29	12.6	38	16.5
PROFIT REINVESTMENT	203	98.2	3	1.3
OTHERS	5	2.1	-	-
BORROWINGS				
FORMAL SOURCES	90	39.1	22	9.5
INFORMAL SOURCES	52	22.6	29	12.6

Source: Financial Factors and Small and Medium Enterprise Development in the Philippines, University of the Philippines Institute for Small Scale Industries

Realizing that in the context of a developing country, the savings base of an entrepreneur coming from the low and middle income groups will necessarily be limited, and the profit accumulation of small scale enterprises are generally limited as well, the prospects of SME's obtaining sufficient capital for its growth are indeed poor. This accounts for the stagnation of SME's at a low level of productivity, in developing countries.

Unless a source of long term capital is developed for SME's in the Philippines, the growth or transformation of SME's into a larger scale enterprise remains dim. In a world market where bigness is required in order to provide the scale of volumes and quality standards needed to survive competition, the prospects for the SME sector indeed looks bad unless the long term capital requirements for growth are addressed.

D. Absorptive Capacity of SME's for Equity Investments Needs to be Developed

In the absence of an adequate source of long term debt financing for SME's, the only other source is equity financing. The experience of the Venture Capital Corporations tried out in the early 1980's, indicate however that the traditional Western approach to venture capital (which was the model followed by the VCC's) will not work in the Philippines at its present stage of modernization.

In the early 80's, a number of VCC's were established thru a series of joint ventures spear-headed by the government together with private banks. While the funds were available, virtually no equity infusions were accomplished, and only transactional financing were undertaken. Today most of these VCC's are dormant, some are in the final process of liquidation. A number of basic impediments affecting the absorpitve capacity of SME's prevented third party equity capital infusion. These are:

1. SME enterprises are generally autocratically managed by the entrepreneur, and he is extremely reluctant to share his control and ownership of the "company he has built". The sentiment has been expressed that they would rather remain small that have to contend with the "interference" of a third party investor, particularly an institutional investor whom the entrepreneur does not personally know.

2. The capital structure of SME's is such that they are typically under-capitalized, and entry of the VCC equity capital will overwhelm if not completely dilute the common stock ownership of the entrepreneur and lead to a virtual takeover of the enterprise's management.

3. There is no ready stock market to which shares in the SME could be sold, thus locking in investors into SME's for a long period, until the entrepreneur can buy out the investments, unlike in the Western context in which VCC's can sell its holdings to a ready stock market. In a financial system such as the Philippines where there is a marked preference for liquidity and a high aversion to risks in SME's, equity investments into SME's is indeed dim.

4. Equity infusion will require substantial inputs in enteprise building services to ensure a cost effective utilization of the investible funds by the SME. At present there is no institutional capacity capable of providing these services and monitoring/overseer the project management.

5. The VCC's put up were themselves undercapitalized and had no institutional infrastructure to manage the Fund for such investments in SME's and to manage the project enterprises funded.

These are among the major impediments which an equity financing facility has to contend with in order to pave the way for long term capital investments into SME's.

E. Enterprise Building and Capital Infusion

The experience with the SME financing programs, have indicated that financing programs with a strong component of technical assistance to accompany the financial assistance were the more successful ones. Technical assistance took the form of social preparation for the development and acceptance of the project, training and installation of management systems particularly in the area of financial management, product design, developemnt and production techniques.

Capital infusion for an enterprise about to transform from a smaller to a larger scale operation can be dangerous unless guided with sound management practices. The expansion of operations will dramatically change the organizational, financial and operating requirements of the SME.

The mode of equity infusion may require the modernization of the enterprise management and decision-making structures, from an autocratic entrepreneur led style transforming into a corporate form led by the company's Board which may now include the new investors who have provided the expansion capital.

The need for an integrated package of technical and financial resources getting involved financially and technically with the transformation of the enterprise into a larger scale operation, will mean new institutional requirements in the delivery mechanism these resources. The traditional financial institutions are not organized and do not have the temperament for this kind of operations. The need is for an institution that can provide or serve as the channel for equity capital infusions into SME's, but at the same time has the developmental orientation and capacity to provide a continuing technical assistance program to ensure that the capital infusion will lead to an effective transformation of the enterprise to a larger scale modernized company.

F. Higher Cost of Money vs. Availment Conditions

It is noted that SME financing programs, in particular those initiated by government have typically offered interest rates below the prevailing market rate. The concessionality of the cost is justified on the basis that the program is oriented to meet the capital requirements of low and middle income entrepreneurs. The concessional interest rates is likewise the approach taken to compensate for the stringent fund availment conditions, requiring counterpart equity and collateral assets as security. At the time when prevailing market rates are at 19 to 24, these interest rates would be from 10 to 17 per cent per annum.

It is noted however that the SME's, in the absence of financing programs, have been used to paying high costs of money from 30 to 36 per cent per annum from informal sources of funds. With this situation at hand, it is evident that fund availment conditions is the more critical parameter that must undergo policy change rather than distort the cost of capital that would only subsidize uncompetitive enterprises. The fact that SME's have been willing and capable of paying a higher cost of money, offers profit incentives to innovative financing schemes that could relax the present fund availment conditions.

CHAPTER II: SME FINANCING IN THE PHILIPPINES

The following presents an overview of the financing effort given to the SME sector as undertaken largely by the government and for short term needs by the private financial sector.

A. Definition of Small and Medium Scale Enterprises (SMEs)

SME's have been defined in varied ways. For purposes of credit programming, the following definition has been followed:

In terms of employment size, a small scale enterprise is one which employs 10 -- 99 workers, while a medium-scale eneterprise is one which employs 100- 199 workers. Enterprises with less than ten workers are considered cootage enterprises while those with 200 or more are classified as large.

In terms asset size, an enterprise with total assets of P500,000 -- P5 million is considered small scale while one with total assets of P5million -- 20 million is classified as medium scale. Above P20 million is co sidered large scale, P50,000 to 500,000 is cottage enterprise, and below P50,000 is micro-enterprise.

For purposes of market competition in its product line,particularly in the world market the above figures may be too small, and would require a larger scale in order to compete viably. Market penetration may require a certain critical size in order to produce the volumes and quality standards of the world market. This concept of size in relation to market, though difficult to measure, is used in this study.

B. Status of the SME Sector

SME's have been called the backbone of the Philippine economy. The description is apt not only because they dominate the organized manufacturing sector in terms of sheer number but also because of what they actually contribute to employment and regional dispersal or rural development effort.

Based on the National Census and Statistics 1986, of the 5,294 organized manufacturing establishments in the country, 4,581 or 83% of the total manufacturing industry are SME's. The leading SME's are food (1,902), printing, publishing, and allied products (364), garments (342), fabricated metal products (247), furniture (223), and woodproducts (219). Table II.B.1 following gives the total number of SMEs by Industry Group.

In 1986, the aggregate employment in the manufacturing sector was estimated at 636,219 of which 183,814 or 29% comes from SME's. Small scale enterprises employed an average of 28 employees while medium scale ones had 139.

Table II - B - 1

Distribution of SME Firms by Type of goods manufactured
1986

TYPES OF GOODS	SSE	MSE	TOTAL SMSE	% TO TOTAL
Non-Durable Goods	2,773	353	3,126	56.9
Food Manufacture	1,055	75	1,130	20.6
Wearing Apparel	297	45	342	6.2
Wood & Cork Products Except Furniture	182	37	219	4.0
Textile	195	42	237	4.3
Footware	106	8	114	2.1
Printing, Publishing & Allied Industries	342	22	364	6.6
Others	596	124	720	13.1
Durable Goods	1,089	96	1,185	21.6
Furniture & Fixtures	205	18	223	4.1
Machinery & Equipment Including Transport	516	48	564	10.3
Non-metallic Mineral Products	128	14	142	2.6
Others	240	16	256	4.7
T O T A L	4,951	545	5,456	100.0

Source of Basic Data: Summary of Establishments, 1986
NSO

Table II-B-1

Total Number of SMSE Establishments by[1] Industry Group, 1986

	INDUSTRY GROUP	SSE	MSE	TOTAL SMSE
	Philippines	4,089	492	4,581
311	Food	1,790	112	1,902
313	Beverage	41	7	48
314	Tobacco	8	6	14
321	Textiles	195	42	237
322	Wearing Apparel Except Footwear	297	45	342
323	Leather and Leather Products	23	2	25
324	Footwear Except Rubber, Plastic or Wood	106	8	114
331	Wood and Wood and Cork Products	182	37	219
332	Furniture and Fixtures Except Primarily of metals	205	18	223
341	Paper and Paper Products	73	14	87
342	Printing, Publishing and Allied Products	342	22	364
351	Industrial Chemicals	60	17	77
352	Other Chemical Products	146	42	188
354	Miscellaneous Products of Petroleum and Coal	7	1	8
355	Rubber Products	74	12	86
356	Plastic Product, N.E.C.	131	23	154
	Pottery, China and Earthenware	16	0	16
362	Glass and Glass Products	17	1	18
363	Cement		2	2
369	Other Non-metallic Mineral Products	128	11	139
371	Iron and Steel Basic Industries	71	19	90
372	Non-ferrous Metal Basic Industries	23	4	27
381	Fabricated Metal Products except Machinery and Equipt.	227	20	247
382	Machinery Except Electrical	293	11	304
383	Electrical Machinery, Apparatus Appliances and Supplies	96	22	118
384	Transport Equipment	127	15	142
385	Professional, Scientific and Measuring and Controlling Equipt. N.E.C. and Photographic and Operational Instruments	9	1	10
386	Furniture and Fixtures Primarily of Metal	26		26
390	Other Manufacturing Industries	111		111

* Not elsewhere classified

In 1986, manufacturing sector contributed P97 billion value added, of which 16.8 billion or 17% was contributed by SME's. Of this P9 billion came from the medium scale enteprises, while P7.7 billion or 7.8% came from small industry. Table II.B.2 gives a census picture of the value added contribution of SMEs by industry group.

The SMEs dynamic role in exports has also been noted as the fastest growing non-traditional exports. Table II.B.3 following shows the leading non-traditional export manufacturers.

SME's play a major role in the economic development of the country through their contribution in the following areas:

-- Rural development, regional development and industrial dispersal.
-- Creation of employment opportunities and more equitable distribution of income
-- Utilization of indigenous resources
-- Earning of foreign exchange resources
-- Creation of backward and forward linkages with existing industries
-- Entrepreneurship development

The importance of the SME sector has been underscored recently with the government priority program on developing livelihood enterprises. This is the government's direct way of addressing the poverty situation. The financing of SME's has been given priority attention, as a direct way of creating employment and augmenting income and developing entrepreneurship in the low income groups particularly in the rural areas.

C. Financing Requirements of the SME Sector

1. Estimated Amount

Two sources of estimate are taken: One is the recent World Bank Study on the Financial Sector of the Philippines (1988), and the other is an extrapolation from the 1986 statistics on renegotiated past due loans of the commercial banks, sometimes called "evergreen loans".

The World Bank Study, commenting on the demand for term credit of business enterprises estimated that for the SME sector, "the pipeline of two development banks whose market share of the formal SME market is around 15% indicate that demand for term credit by SME's in the formal industrial sector would be around P2 billion for one year (1988). The Industrial Guarantee Loan Fund has estimated that SME's demand for long term credit would amount to about P7 billion over the next five years."

Table II - B - 2

Total Census Value Added of the SMSE Sector by Industry Group: 1986
(In Thousand Pesos)

	INDUSTRY GROUP	SSE	MSE	TOTAL SMSE
311	Food Manufacturing	2,327,739	3,013,413	5,347,152
313	Beverage Manufuctring	68,857	511,079	579,939
314	Tobacco Manufacturing	8,107	57,607	65,714
321	Manufacture of Textile	241.053	313,084	554,137
322	Manufacture of Wearing Apparel Except Footwear	173,327	218,000	391,327
323	Manufacture of Leather and Products of leather Leather substitute and for, Except Footware and Wearing Apparel	31,008	14,310	45,318
324	Manufacture of Footwear Except Rubber, Plastic or Wood footwear	41,021	28,216	69,239
331	Manufacture of Wood and Wood and Cork Products Except Furniture	294,664	330,318	624,982
332	Furniture and Fixtures Except Primarily of metals	117,551	85,147	202,698
341	Paper and Paper Products	269,421	215,685	485,106
342	Printing, Publishing and Allied Products	370,616	254,375	627,021
351	Industrial Chemicals	508,680	816,062	1,319,742
352	Other Chemical Products	894,914	1,622,892	2,459,806
354	Miscellaneous Products of Petroleum and Coal	51,418	2,105	53,523
355	Rubber Products	331,178	76,797	411,975
356	Plastic Product, N.E.C.	241,687	290,073	531,760
361	Pottery, China and Earthenware	20,460	0	20,460
362	Glass and Glass Products	15,136	22,611	17,475
363	Cement		69,754	69,754
369	Other Non-metallic Mineral Products	162,541	145,728	308,269
371	Iron and Steel Basic Industries	357,602	210,719	568,321
372	Non-ferrous Metal Basic Industries	39,426	54,559	93,985
381	Fabricated Metal Products except Machinery and Equipt.	276,803	195,329	472,132
382	Machinery Except Electrical	264,180	87,046	351,226
383	Electrical Machinery, Apparatus Appliances and Supplies	278,841	207,984	486,825
384	Transport Equipment	183,379	140,435	324,814
385	Professional, Scientific and Measuring and Controlling Equipt. N.E.C. and Photographic and Operational Instruments	62,473	7,952	70,425
386	Furniture and Fixtures Primarily of Metal	22,307		23,307
390	Other Manufacturing Industries	147,027	121,988	269,015
	T O T A L	7,725,177	9,119,267	16,844,444

Leading Exports : Non-Traditional Manufacturers
(F.O.B. Value in Millions US $)

I T E M	1983	1984	1985	1986	1987
Electronics	1,060	1,328	1,059	981	1.157
Garments	467	516	526	654	989
Metal Manufactures	368	370	320	313	299
Chemicals & Related Products	85	104	150	242	246
Gifts, Toys & Housewares	128	116	115	140	187
Processed Food	443	438	153	142	158
Fashion Accessories & Travel Goods	95	109	125	129	148
Furniture	83	88	83	89	130
Machinery & Transport Equiptment	433	416	37	44	85
Footware	55	56	49	48	56
Textile Yarns & Fabrics	44	38	30	31	51

Source: Philippines Export Performance,
Bureau of Foreign Trade,DTI,

In an analysis of arrears of 30 commercial banks as of December 31, 1986 -- P2.9 billion are classified as renegotiated past due loans. These are loans which have matured but have been renewed or extended. These are mostly secured loans from credit-worthy enterprises (otherwise their loans would not have been rolled over) who have originally borrowed short for their long term needs and have now run out of free assets to pledge for additional credits. The loans are rolled over and as such are called "evergreen loans", ie., perenially outstanding. The consensus estimate of several experienced commercial bank CEO's is that roughly 25 to as much as 50 per cent of the value of evergreen loans are accounted for by SME's.Extrapolated, the estimate would come to about P1.5 billion term credit is needed by the larger SME's in the sector. It may then be concluded that the current SME sector demand for long term funds would be about P2.5 billion.

2. Nature of the Demand

The Asian Development Bank in a study conducted on the role of SME's in the industrialization of selected member countries attempted to examine the requirements for growth of SMEs as well as the problems they face at different phases of their life cycle. An interview survey of SMEs belonging to three selected industries namely food processing, garment manufacturing and metal working were conducted in key regions and cities and supplementary data were taken from their financial statements. Certain survey results are highlighted as follows:

1. Most of the machines have an average age of five years or more; 71 per cent, 69 per cent, and 92 per cent of machines in food processing, garment, and metalworking respectively. This implies that the replacement of machines due to natural or technical obsolescence is needed. Replacement would require long term financing through borrowings or thru retained earnings if sufficient. Yet the survey results showed the scarcity of long term credits to SMEs. Thus the survey showed that majority of the respondents indicated that long-term credit is considered a major problem of the SMEs.

2. Financial statements from 1982-87 of 50 SMEs from the three industries studied, showed an almost total absence of long term credits, and a preponderance of short term credits. On the other hand the long term capital requirements of these firms are inevitable in terms of plant, machineries, specialized equipment, permanent working capital, inventories, and expansion. This only means that in the absence of alternatives, long term capital requirements are being funded by short term credits, thus leading to the perennial rollover of their loans, the evergreen loan situation.

3. Pr ate Banks were the main sources of short term

credits while the informal credit market (a higher cost source) proved to be the second most popular. Tapping this higher cost source inspite of the existence of alternative lower cost sources ie., the commercial banks and government sponsored financing programs, is indicative of the inability of the SMEs to comply with the strict collateral requirements (ie., the counterpart savings base) imposed by the formal credit sources. The requirement for counterpart collateral assets has become even more difficult with the implementation of the Agrarian Reform. This has rendered agricultural land holdings of entrepreneurs, unacceptable to banks and formal credit sources, because of the uncertainty regarding the status of ownership.

The fact that the savings base limit of the SME entrepreneur has been reached is also indicated by the finding that many of the firms are highly leveraged, with the ratio of total liabilities to total assets going as high as 96 per cent. This indicates that the limited savings base of the SME entrepreneur becomes the operative constraint to access to capital, at a certain point in the life cycle of the SME enterprise.

3. The Life Cycle of an SME and the Nature of its Capital Needs

The nature of an SME's capital needs may be better understood when viewed against the back drop of its life cycle, and what happens to its financial needs as it goes thru different stages. The proposal paper of Mr. A. Alvendia on the Small Enterprise Equity Development (SEED) Fund, describes a "Diving Board Model" of the life cycle of an SME which helps in understanding the SME's capital needs and financial situation.

The life pattern of an enterprise has been traditionally depicted by Kuznets as a gradually rising curve, much like an airplane taking off.

The collective experience of entrepreneurs disclose a different pattern that may be described as a "Diving Board Model". (See Chart A).* / Typically the entrepreneur with much enthusiasm, vision and some money from his own savings, takes the plunged from the diving board. There is then a period (often unexpectedly extended) of submergence during which time the enterprise works on its product development, technical production problems, and market acceptance. After some time,(the enterprise surfaces) and it finally resolves its product acceptance, production problems, and the orders are lined up asking for a high volume of production.

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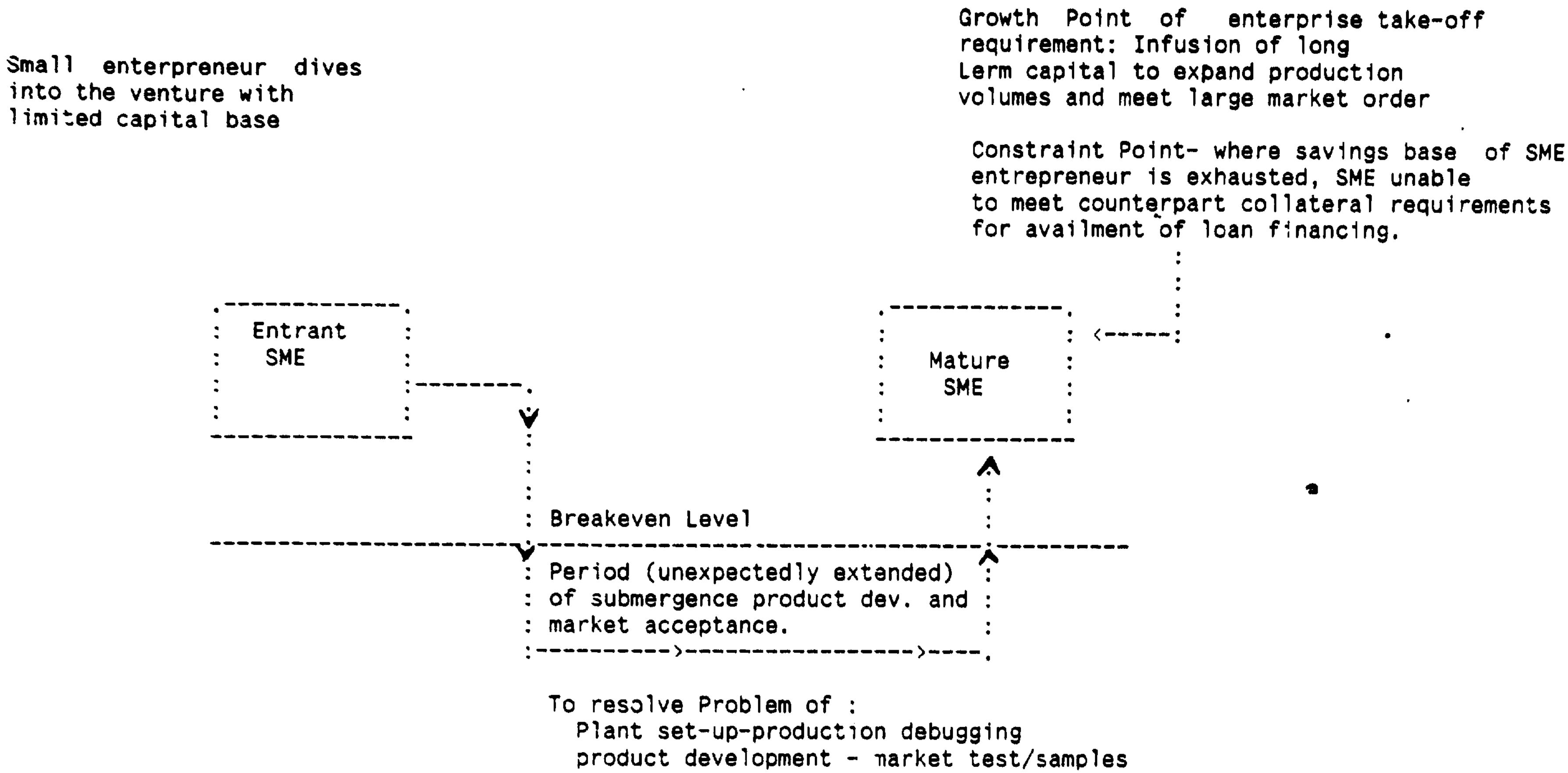
*/ A.Alvendia, A Small Enterprise Equity Development (SEED)Fund, Project Proposal Paper to UNIDO, 1989.

CHART A - DIVING BOARD MODEL



It is at this point of take-off that the enterprise is ready for growth, if capital is made available. But because of the long period of development and given the limited capital base, the entrepreneur's savings base is exhausted and he cannaot come up with additional counterpart collaterals or equity needed to access additional capital. The SME is at the point of take-off, but it is at this point that the savings constraint of the SME etrepreneur becomes truly operational. The SME entrepreneur has reached the limit of his financial capability and it is precisely at this point that SME financing programs should intervene.

However if SME financing programs insist that capital access be premised on ability to provide counterpart savings/collateral, then a financial impasse results. Eventually the market opportunities may pass and the firm stagnates at a low level of production. This is in fact is what has happened.

This model of the SME enterprise helps in appreciating the stages of life of the enterprise, during which the nature of the demand for capital and its absorptive capacity for financing differs. SME financing programs have tended to treat SME borrowers as a homogeneous group, providing financing so long as they can comply with the availment conditions particularly on providing counterpart savings as equity and collateral. In effect this financing approach tends to allocate credit only to those SME's in the early stages of their operation when then there is still sufficient savings to provide the counterpart required. On the other hand, mature SME's who have the highest potential for growth having resolved the initial technical and marketing problems, are denied access to capital assistance because of their inability to provide counterpart equity/collaterals having exhausted their savings base in developing the enterprise.

In a capital starved country, it is always easier to find new SME's or entrants to the industry, than to find the mature SMEs. In addition from a socialistic or political standpoint, government prefers to provide financing to those who are starting up their enterprise, presuming that the more mature SMEs should be able to take care of their capital needs from market sources. Hence this reinforces the tendency to allocate credit to SMEs in the early stages of the enterprise's life.

D. FINANCIAL ASSISTANCE FOR SMES

1. Evolution of Formal Sources

During the early 1970's government sponsored financing schemes formed the bulk of the program to promote smalland medium industries in the Philippines. Four government loan funds, namely the Social Security System (SSS) Fund, the Development

Bank of the Philippines (DBP), the Philippine National Bank (PNB) and the Industrial Guarantee Loan Fund (IGLF) were made available for credit to the SMEs.

In 1970 the Social Security Commission designated the University of the Philippines- Institute of Small Scale Industry (UP-ISSI) to assist the SSS in its SME financing programs under a supervised credit scheme. A special feature of the Supervised Credit Program was the supervision aspects provided by UP-ISSI to the financed firm. The program was discontinued in the first quarter of 1973, and the remaining cash was transferred to the DBP: The DBP granted loans to private industrial firms and cooperative engaged in manufacturing. Loans were also made subject to the supervised credit scheme.

The PNB program for SME began in the first quarter of 1973. The BAnk also used the Supervised Credit Scheme which was administered by the UP-ISSI.

The IGLF began operations in July 1952, and in 1973, was reoriented to cater exclusively to the fianancing requirements of the SMEs. Funds for the Program are drawn thru foreign assistance in the form of loans from IBRD and USAID and through Philippine government counterpart funds. A wide range of financial conduits participate as conduits for IGLF.

At about the same period, three private financial organizations had special departments and programs for promoting SMEs. These were the First National City BAnk Finaning Companies; Private Development Corporation of the Philippines, and Rizal Commercial Bank Corporation.

2. Present Sources of Financing for SMEs

A. The Financial System

The Philippine financial system is well developed technically for the country's stage of development, but is still highly concentrated in Metro-Manila which accounts for 43% of commercial bank branches and 96% of commercial bank loans. The system is patterned after the US banking system which features functional specialization and legal separation between commercial, savings, development, and investment banking and capital market activities. In the 1979 IMF/IBRD study, the banking system excluding the Central Bank accounts for about 60% of the assets of the financial system, 21 % for the Central Bank, while other nonbank financial intermediaries (insurance companies, pension funds and trust managers) accounted for the remaining 19 %. Table II.D.1 summarizes the Assets of the Financial System., while Table II.D.2 shows the changes in percentage distribution of assets.

TABLE II.D.1

Philippines
SME Financial Study

Asset of the Financial System
As of December 31, 1970, 1975, 1980-86, and, June 30, 1987
(billion Pesos)

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987
Central bank	6.00	26.00	65.40	71.60	91.70	13.04	206.00	251.60	313.90	316.00
Banking System	188.80	69.90	188.80	226.00	269.80	331.50	391.80	395.20	297.00	302.60
Commercial banks	14.10	53.20	138.40	164.40	191.00	247.90	289.20	283.30	248.50	253.80
Private	8.30	35.10	85.10	103.40	111.00	141.70	160.60	168.00	166.60	177.70
Government	4.60	18.10	34.60	40.60	53.30	65.20	80.40	70.30	34.80	29.30
Foreign	1.20	-	18.70	20.60	26.70	41.10	48.20	45.00	47.10	46.90
Thrift Banks	0.90	2.10	10.60	11.60	12.60	16.10	15.00	15.10	17.60	17.20
Savings	0.70	1.40	7.40	6.90	5.90	7.40	7.60	6.80	9.10	8.40
Private Development	0.20	0.40	1.60	2.60	3.70	4.50	4.60	5.10	5.60	4.90
Stock savings/Loan Ass.	-	0.30	1.60	2.10	3.00	4.10	2.80	3.20	3.20	3.90
Rural Banks	0.70	2.80	5.60	6.60	8.10	9.50	9.00	8.80	9.30	9.50
Specialized goverment Banks	3.10	11.80	34.20	43.20	53.30	65.30	78.60	88.00	28.60	27.40
Non Financial Intermediaries	6.10	26.80	58.90	63.30	74.20	92.00	95.50	107.20	112.90	118.30
Insurance Companies	5.90	11.90	29.50	33.30	40.70	44.60	50.00	60.80	70.80	74.70
Government /a	4.00	7.70	19.50	22.00	27.00	30.90	35.90	42.70	50.50	54.40
Private	1.90	4.20	10.00	11.30	13.70	13.70	14.10	18.10	20.30	20.30
Investment institution	-	10.30	25.60	23.50	25.60	25.20	19.70	23.80	23.20	23.90
Financing Companies	-	3.50	11.90	12.10	12.90	11.80	9.60	6.20	5.60	5.60
Investment Companies	-	2.00	5.00	5.50	5.90	6.20	2.60	11.00	10.10	9.90
Investment House	-	4.80	8.70	5.90	6.80	7.20	7.50	6.60	7.50	8.30
Trust operation (Fund mangers)	-	2.60	1.70	0.80	1.10	1.50	0.90	1.60	1.30	1.60
Other finacial Intermediaries	0.20	2.00	2.10	5.80	6.80	20.70	24.90	21.00	17.60	18.20
TOTAL	200.90	122.70	313.10	360.90	435.70	436.54	693.30	754.00	723.20	736.90

TABLE II.D.2

Philippines
SME Finacial Study

Percentagde Distribution of Assets of the Financial System
As of December 31, 1970, 1975, 1980-86, and, June 30, 1987

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987
Central bank	19.4	21.2	20.9	19.9	21.1	23.6	29.7	33.4	43.4	42.9
Banking System	60.8	57	60.3	62.6	61.9	59.8	56.5	52.4	41	41.1
Commercial banks	45.6	43.4	44.2	45.6	44.9	43.4	41.7	37.5	33.4	33.7
Private	26.8	28.6	27.2	28.7	26.6	24.2	23.2	22.3	22.1	23.4
Government	14.9	14.8	11	11.2	12.2	11.8	11.6	9.3	4.8	4
Foreign	3.9	-	6	5.7	6.1	7.4	6.9	5.9	6.5	6.3
Thrift Banks	2.9	1.7	3.4	3.2	2.9	2.9	2.2	2	2.4	2.4
Savings	2.3	1.1	2.4	1.9	1.4	1.3	1.1	0.9	1.1	1.2
Private Development	0.6	0.3	0.5	0.7	0.8	0.8	0.7	0.7	0.8	0.7
Stock savings/Loan Ass.	-	0.3	0.5	0.6	0.7	0.8	0.4	0.4	0.5	0.5
Rural Banks	2.3	2.3	1.9	1.8	1.9	1.7	1.3	1.2	1.3	1.3
Specialized goverment Banks	10	9.6	10.9	12	12.2	11.8	11.3	11.7	3.9	3.7
Non Financial Intermediaries	19.8	21.8	18.8	17.5	17	16.6	13.8	14.2	15.6	16
Insurance Companies	19.1	9.7	9.4	9.2	9.3	8.1	7.2	8.1	9.8	10.1
Government /a	12.9	6.3	6.2	6.1	6.2	5.6	5.2	5.7	7	7.4
Private	6.2	3.4	3.2	3.1	3.1	2.5	2	2.4	2.8	2.7
Investment institution	-	8.4	8.2	6.5	5.9	4.5	2.9	3.1	3.2	3.2
Financing Companies	-	2.9	3.8	3.4	3	2.1	1.4	0.8	0.8	0.8
Investment Companies	-	1.6	1.6	1.5	1.3	1.1	0.4	1.4	1.4	1.3
Investment House	-	3.9	2.8	1.6	1.6	1.3	1.1	0.9	1	1.1
Trust operation (Fund mangers)	-	2.1	0.5	0.2	0.2	0.3	0.1	0.2	0.2	0.2
Other finacial Intermediaries	0.7	1.6	0.7	1.6	1.6	3.7	3.6	2.8	2.4	2.5
TOTAL	100	100	100	100	100	100	100	100	100	100

The banking system is fragmented into: a) 27 private commercal banks with 27% of the system assets, on government commercial Bank (11%) and four foreign commercial banks (6%) all of which performed full service deposit taking, lending and trade financing transaction banking; b) 114 thrift banks (3%) engaged in gathering savings deposits but not demand deposits; c) 985 rural banks (2%) engaged in agricultural lending predominantly using funds provided by the Government under agricultural development programs; and d) three specialized government banks (11%) -- the Development Bank of the Philippines (DBP), the Land Bank of the Philippines (LBP) and the Philippine Amanah Bank.

B. Commercial Banks

While the commercial banks represent the major block in the financial sector, they have not played a major role in meeting the financial requirements of the SMEs. It is only recently that commercial banks have given attention to the financial requirements of SMEs, but limited mainly to short term needs, in particular production or export related working capital needs. Term credit by commercial banks is limited and is usually done thru rollover of short term loans.

The access of SMEs to the banking system has been constrained by the following:

a) their inability to satisfy the information and collateral requirements of the banks;

b) the location of many SMEs outside Metro-Manila; and

c) perception by the banks that the risk of lending to SMEs is higher than is the case with larger firms, although it is evident that administering SME loans has higher costs. These factors translate into a premium of 7% to 8% above quoted prime rates for SMEs with good credit records and counterpart equity and collaterals.

In view of the volatility of interest rates and exchange rate during the last decade, Philippine savers prefer to invest in short term deposit instruments with maturities of three months or less. As a result banks have found it hard to mobilize and consequently lend term funds. Banks have been averse to assume liquidity risk. This has resulted in a situation wherein the main sources of medium and long term funding in the Philippines have been the government directed credit programs. Instead of lending from resources raised from the market, the banks merely acted as lending conduits for funds borrowed from foreign sources or provided by the Government.

Table II.D.3 gives an overview of interest rates in the period 1970-87. The table indicates alternative short term investment returns on capital during the period against which investments in SMEs have to compete.

TABLE II.D.3

Philippines
SME Financial Study

Interest Rates, 1970-87

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987
Treasury bills: 3 months	13.10	10.30	12.10	12.60	13.80	14.20	40.90	26.20	16.30	10.70
: 6 months	13.90	10.80	12.50	13.10	14.50	14.80	30.50	24.80	14.40	12.20
:12 months	13.70	10.90	12.80	13.20	14.90	14.90	41.50	35.20	13.20	13.70
Central Bank Bills	-	-	-	-	-	-	35.30	27.00	19.11	-
Savings Deposit	6	6	7	NA	9.80	9.70	9.90	10.80	8.60	6.00
Time deposit < 1 year	6.70	8.70	14.00	NA	14.10	13.70	23.20	21.80	12.30	7.00
Time deposit > 1 year	-	-	-	-	16.90	16.40	26.20	21.80	15.60	9.50
Bank Loans < 1 year	12	12	14	16	16.30	18.30	26.70	28.30	17.10	12.20
Bank Loans > 1 year	-	-	-	-	21.60	21.50	26.30	26.30	19.10	14.10
Inflation (GNP defl year ahead)	-	9.50	10.50	8.40	12.00	49.30	17.70	1.30	5	5
Real 12 - month T-bill	-	1.30	2.10	4.40	2.60	-23.30	20.20	32.80	7.80	8.30

C. Government Directed Loan Programs

Given the weak response of the private financial system, and in particular the commercial banking system to the financing needs of the SMEs, government has taken the lead in developing financing schemes. Two types of financial assistance are available for SMEs: First, is the traditional interest and collateral bearing loans and second, the venture capital concept which features no collateral loans and are risk-sharing ventures. (Note the latter is now a negligible source of transactional financing, as explained above in Chapter I.D and discussed below.)

Government managed credit programs have mainly been directed at agriculture which at end 1986 accounted for 71% of such programs in terms of amount outstanding with industry accounting for 29%. Funds for these programs come from a number of sources but mainly from the government budget adn foreign borrowings mainly the World Bank and Asian Development Bank.

As part of it campaign on poverty alleviation, government has undertaken a P 3 billion livelihood program. The program consists of direct investments (about 60%) and financing (40%) for micro and small scale enterprises. Financing is done thru NGO's and cooperatives who take on the credit risk for funds on-lent. Thru this livelihood program there has been a proliferation of small lending programs in the rural areas which have little productivity impact because of the smallness of the amounts on-lent and the kinds and scale of enterprises created. These programs are directed towards direct poverty alleviation. Whether or not they lead to sustained employment or production, is still a big issue that has to be settled.

Financing Programs for industry are substantially smaller than those for the agricultural sector: 10 programs provide credit, one provides guarantees and one provides a combination of loans and guarantees. Target sectors include the entire range of industrial enterprises, from micro to large-scale, with special attention to the exporting and export-oriented enterprises. Seven of the programs are goverment funded with the reminainging five provided by foreign sources. This indicates the need for development financing to intervene for the capital requirements of SMEs.

The two largest programs, the Industrial Guaranty and Loan Fund (IGLF) and the Apex Financing Program, are both administered by the Central Bank of the Philippines (CBP). Total IGLF funds available for lending as of July 1987 were P2.1 Billion, P1.99 billion of which came from World Bank funds. Medium and small scale enterprises account for 61% and 39% respectively of IGLF lending over the period 1982-86. The Apex fund was a commercial US$150 million borrowed by the CBP to finance medium and large scale enterprises. Due to a feature making the borrower assume the exchange risk, utilization of the Apex Fund was very slow and unsatisfactory such that on September 1987, the unutilized balance of $97 million IBRD loan had to be cancelled. The Department of Trade and Industry and the Technology and Livelihood Resource Center implement relatively smaller programs catering mostly to micro,cottage and SMEs.

Table II.D.4 provides a listing of the SME financing programs, their objectives and implementing agencies. Following are the highlights: Except for two programs which provide venture capital and loan guarantees, the balance of the programs are basically lending programs which require collateral counterpart as condition for fund availments. The condition for collateral securities, has become a government audit requirement, which deems it irregular for loans to be extended without proper collateral securities, unless the loan program is a socialized lending program which forms part of the poverty alleviation program. In this case however the loan amounts are generally too small for the requirements of the SME enterprise.

The Tulong sa Tao Program of DTI and Urban Livelihood Financing Program are socialized programs. Small socialized loans are extended thru non-government organizations (NGOs) as conduits who then take on the financial accountability for the repayment of the loan, as well as supervising the credit to the micro- or small enterprises financed.

The Industrial Guarantee Fund (of IGLF) as originally designed had a noteworthy feature wherein it tried to address the issue of collateral deficiencies (up to 25% of the loan amount) of the SME enterprises. The World Bank Study however notes that the guarantee mechanism has failed and is now inoperative, because of two reasons: one, the guarantee fee of two per cent paid by the private financial institutions can not be passed on to the sub-borrowers; and two, the guarantee is a loss sharing guarantee, ie., PFIs must take steps to foreclose on all collaterals and recover what they can before IGLF will consider settling claims for losses -- a very time consuming and costly procedure.

At the time of writing of this report another SME financing program has been launched by the Social Security System (SSS), with a fund base of P2.0 billion. The program called KASAPI is geared to provide long term debt financing to SMEs particularly those in the export market. The program will provide up to five years money, at a fixed interest rate of 16 per cent. However the availment condition is again premised on the ability of the SME entrepreneur to present counterpart equity and collaterals to secure the loans. Under this arrangement the limited savings base of the entrepreneur becomes the operative constraint in fund availments.

Table II.D.4

Government - Supervised/directed credit Industry

Name of Program	Fund Source	Major Objectives	year Implemented	Implementing Agency	lending Channels
Urban Livelihood Financing Program (ULFP)	WB/National Treasury	To provide soft-term loans for relending to micro and small to meduim enterpreneurs in low-income communities of Metro Manila	1981	TLRC-DBP	TLRC
Apex Development Finance	WB/National Treasury Lloyda Bank	Productive investment financing for medium - and - large-scale enterprises throug multple financing intermediaries	1981	CB/Apex	Accredited banks
Textile Rehabilitation program	WB	To provide financing for the rehabilitation, modernization and expansion of textile subsectors and training and technical requirements of individual firms with a view to improving their technical operations and reducing costs.	1982	DTI	Join BOT/DBP Evaluation Team
Industrial Guarantee Program - Locally Funded Philippine Export and Foreign Loan Guarantee corporation(Philguarantee)	National Treasury	To provide Guarantee coverage to Pilipino exporters on their borrowing whether obtain from local or foreign source and to issue guarantee and counter guarantees for bid bonds, preformance bonds and advance payment arrangements.	1974	Philguarantee	Philguarantee, Accredited banks
Equity Programs Venture Capital programs	Venture Capital Corporation (VCC)	To provide additional capital/equity financing in cottage, small and meduim business.	1980	VCC	KS-VCCs
Philma Venture Capital Corporation (PVCC)		To provide growth fund on a equity basis		PVCC	PVCC

PHILIPPINES
FINANCIAL SECTOR STUDY

Table II.D.4

Goverment - Supervised/directed credit Industry

Name of Program	Fund Source	Major Objectives	year Implemented	Implementing Agency	lending Channels
Urban Livelihood Financing Program (ULFP)	WB/National Treasury	To provide soft-term loans for relending to micro and small to meduim enterpreneurs in low-income communities of Metro Manila	1981	TLRC-DBP	TLRC
Apex Development Finance	WB/National Treasury Lloyda Bank	Productive investment financing for medium - and - large-scale enterprises throug multple financing intermediaries	1981	CB/Apex	Accredited banks
Textile Rehabilitation program	WB	To provide financing for the rehabilitation, modernization and expansion of textile subsectors and training and technical requirements of individual firms with a view to improving their technical operations and reducing costs.	1982	DTI	Join BOT/DBP Evaluation Team
Industrial Guarantee Program - Locally Funded Philippine Export and foreign Loan Guarantee corporation(Philguarantee)	National Treasury	To provide Guarantee coverage to Pilipino exporters on their borrowing whether obtain from local or foreign source and to issue guarantee and counter guarantees for bld bonds, preformance bonds and advance payment arrangements.	1974	Philguarantee	Philguarantee, Accredited banks
Equity Programs Venture Capital programs	Venture Capital Corporation (VCC)	To provide additional capital/equity financing in cottage, small and meduim business.	1980	VCC	YS-VCCs
Philma Venture Capital Corporation (PVCC)		To provide growth funds on a equity basis		PVCC	PVCC

TABLE II.04

Goverment - Supervised/directed credit Industry

Name of Program	Fund Source	Major Objectives	year Implemented	Implementing Agency	landing Channels
Indusrial Credits - Locally funded Technology Utilization Support System (TUSS)	National Treasury	To provide concessional lending through a technology devlivery fund for preinvantment and project development requirements of a technology application project and tap available tecnical and managerial expertise for development and implementation of technology ventures	1980	TLRC- DBP	TLRC
Industrial Loan Program	CR/National Treasury	Initially, to match advances made by cetral bank to troubled quani-banks and over the long run, fucus on the general problems and and difficulties encountered by private enterprises taht are to be rehablitated. Funds are on-lant partly of a financial orgt'n package that will enable them to pay quant-banks who in turn can reply their CB advances.	1981	CB-Apex	Accredited/Lend Banks
Balikatan Sa Kabuhayan Program (BSKP)	National Treasury	To encourage livelihood programs among urban reatents by providing fundling assistance	1986	TLRC-DBP	TLRC
Tulong sa Tao	National Treasury		1986	Department of Trade and Industry (DTI)	DTI
Industrial Credits - Foreign Assisted Industrial Guarantee and Loan Fund (IGLF)	WB/NEDA	To meet financing needs of collateral deficient small and medium enterprises	1952	CB-DLC	Accredited banks
Export Industry Modernization programs	OECV	To improve and/or modernize operation and facilities of small - to medium - scale enterprises by providing funds to that their products can be competitive in international markets.	1990	TLRC-DBP	TLRC

PHILIPPINES
FINANCIAL SECTOR STUDY

Table II.D. 4

Goverment - Supervised/directed credit Industry

Name of Program	Fund Source	Major Objectives	year Implemented	Implementing Agency	landing Channels
Urban Livelihood Financing Program (ULPP)	WB/National Treasury	To provide soft-term loans for relending to micro and small to meduim enterpreneurs in low-income communities of Metro Manila	1981	TLRC-DBP	TLRC
Apex Development Finance	WB/National Treasury Lloyda Bank	Productive investment financing for medium - and - large-scale enterprises throug multple financing intermediaries	1981	CB/Apex	Accredited banks
Textile Rehabilitation program	WB	To provide financing for the rehabilitation, modernization and expansion of textile subsectors and training and technical requirements of individual firms with a view to improving their technical operations and reducing costs.	1982	DTI	Join BOT/DBP Evaluation Team
Industrial Guarantee Program - Locally Funded Philippine Export and Foreign Loan Guarantee corporation(Philguarantee)	National Treasury	To provide Guarantee coverage to Pilipino exporters on their borrowing whether obtain from local or foreign source and to issue guarantee and counter guarantees for bid bonds, preformance bonds and advance payment arrangements.	1974	Philguarantee	Philguarantee, Accredited banks
Equity Programs Venture Capital programs	Venture Capital Corporation (VCC)	To provide additional capital/equity financing in cottage, small and meduim business.	1980	VCC	KS-VCCs
Philma Venture Capital Corporation (PVCC)		To provide growth funds on a equity basis		PVCC	PVCC

TABLE II.D.4.

Goverment - Supervised/directed credit Industry

Name of Program	Fund Source	Major Objectives	year Implemented	Implementing Agency	lending Channels
Indusrial Credits - Locally funded Technology Utilization Support System (TUSS)	National Treasury	To provide concessional lending through a technology devlivery fund for preinvantment and project development requirements of a technology application project and tap available tecnical and managerial expertise for development and implementation of technology ventures	1980	TLRC- DBP	TLRC
Industrial Loan Program	CB/National Treasury	Initially, to match advances made by cetral bank to troubled quani-banks and over the long run, fucus on the general problems and and difficulties encountered by private enterprises taht are to be rehablitated. Funds are on-lant partly of a financial orgt'n package that will enable them to pay quant-banks who in turn can reply their CB advances.	1981	CB-Apex	Accredited/Lend Banks
Balikatan Sa Kabuhayan Program (BSKP)	National Treasury	To encourage livelihood programs among urban reatents by providing fundling assistance	1986	TLRC-DBP	TLRC
Tulong sa Tao	National Treasury		1986	Department of Trade and Industry (DTI)	DTI
Industrial Credits - Foreign Assisted Industrial Guarantee and Loan Fund (IGLF)	WB/NEDA	To meet financing needs of collateral deficient small and medium enterprises	1952	CB-DLC	Accredited banks
Export Industry Modernization programs	OECF	To Improve and/or modernize operation and Facilities of small - to medium - scale enterprises by providing funds to that their products can be competitive in international markets.	1980	TLRC-DBP	TLRC

D. Equity Financing and Venture Capital Corporations

A noteworthy attempt to provide long term funds to SMEs thru equity infusion were the Venture Capital Corporations. Government took the lead in forming these venture capital corporations with participating commercial banks who then formed a joint venture to form the VCCs. Capitalized at P5 million (about US$250,000), the VCCs were to infuse equity capital in SMEs with a demonstrated growth potential and willing to accept the VCCs entry into the equity structure of the company.

The VCCs failed to accomplish their objectives because of a number of basic conditions:

1. SMEs were reluctant to accept the entry of VCCs into the common stock equity of the enterprise, because they are afraid to yield or share control and fear a take-over. The VCC approach failed to consider that SMEs in a developing country are generally managed in an autocratic manner by the entrepreneur-owner who acts as the chief executive officer and the Board. He is not used to a modernized corporate board with whom he has to share decison-making powers.

2. The VCCs were not ready to be lock in their funds for a long recovery period. With officers coming from the commercial banks which have a cultural bias for a high liquidity preference and immediate returns, the enterprise development perspective required for equity investments was not appreciated by the VCC managers.

As a result the VCCs went mainly into transactional financing which had a quick recovery of funds. This provided short term working capital, but was such a cumbersome and high cost scheme that eventually failed to develop a regular clientele.

3. There is no stock market wherein the shares of the SMEs funded could be sold. The VCC which was patterned after their developed country counterparts, is premised on the existence of a market for the stocks of the SME which would serve as the mechanism for liquifying and recovering investments in the SME venture. In a developing country such as the Philippines, there is no such capital market for SMEs.

4. The equity capital base of the SME entrepreneur in the enterprise is usually too small while the equity capital to be infused to meet the expansion requirement is much larger. Thus entry into the common stock of the enterprise would swamp the entrepreneur's shares and in effect take over the company. On the other hand VCC's do not want to have a majority of the company realizing the importance of the entrepreneur's presence. Given the situation both the entrepreneur and the VCC have found it difficult to enter into a mutually acceptable financial arrangement.

5. The capital base of the VCCs were too small to take on actuarially sound investment portfolio in SMEs and neither could it afford the high costs of enterprise building and/or supervision which necessarily must accompany equity investments in an SME enterprise.

With the start of the new administration in 1986, there was an initial flurry of foreign investment initiatives into the country. This included the entry of foreign private VCCs. While these firms did not have the problems of a small capital base, the same constraints (1-4) prevented them from participating in SMEs in any significant way.

CHAPTER III: SHORTCOMINGS OF THE SME FINANCING FACILITIES IN THE PHILIPPINES; INITIATIVES NEEDED

A. SUMMARY OBSERVATIONS ON SHORTCOMINGS OF SME FINANCING FACILITIES

1. Shotgun Approach

While the Philippine Development Plan for 1987-92 consistently reflects the government's recognition of SE promtion as an important program for economic recovery and development, there is a pervasive lack of focus and coordinatin so far in the various schemes and programs initiated by the government. SME financing programs in the Philippines generally have taken a "shotgun" approach in their financial intervention. Eligibility is set in terms of size of assets (either small or medium scale) and the basic availment condition -- counterpart equity and collateral assets. The eligibility conditions are set in general terms and any enterprise that can comply with the availment conditions can be a fund recipient.

The lack of capital in the SME sector is indeed so large and there are always new entrants, that a funding approach like this will always find a ready clientele. The issue is whether or not this is the most productive use of capital in the SME sector. A deeper analysis of the SME need for capital (as presented in section II.C.3 on the nature of SME's capital needs), differs according to the enterprise's stage of development. The more developed the eneterprise, the greater the productivity and economic dividends (to the enterprise and its linkages) derived from additional capital infusion. However the more mature the enterprise, the greater the likelihood that the entrepreneur's savings base will be fully utilized, and can not comply with the fund availment conditions. The presumption that there will be enough internal cash generation from profits, generally is not true, particularly in an environment where raw material inventories have to be built up and the time gap between production and sales collections is at least three months.

There is a need therefore for SME financing programs to recognized that the capital demand situation in the sector is not homogeneous, and that the program design and fund availment conditions should be adjusted accordingly. There is a need to follow more closely the stage of development of the enterprise and the product sector, and to fine tune the program's financial intervention, so that capital assistance in the sector is allocated to the most productive users.

2. Fund Availment Policy Begs the Issue of Savings Constraints

Capital assistance is supposedly a response to the lack of savings of SME entrepreneurs and yet the basic condition for fund availment imposed is his ability to provide counterpart savings, irrespective of how much capital he has already infused. The primary concern of SME financing facilities has been to exact sufficient control or security to ensure repayment. While it is recognized that this condition is a general standard used for sound credit management, it must be recognized that this policy need to be modified and adapted to the conditions of SMEs in a developing country where savings deficiency is precisely the need to be addressed.

The fact that there have always been SME clients who have complied with these availment conditions, have served to justify the SME programs' insistence on these requirements. What is not monitored however, is the large number of opportunity losses both to the enterprise and the product sector, caused by foregone growth of mature SMEs denied access to capital who could not comply with counterpart requirements. Dialogues with SME sector groupings always yield the same complaint of lack of capital, inspite of the existence and continuous launching of new SME lending programs. The conclusion is that the financing programs have not been responsive or appropriate to the actual demand situation. This is reflected in the slow disbursements of such SME funds, inspite of the apparent large demand for capital by this sector.

3. NO Program Track Record on Unsecured SME Financing

One of the major impediments to changes in the basic fund availment policy -- is the lack of an institutinal track record for unsecured SME financing programs. Financing institutions are loathe to venture out in in this unchartered area of unsecured financing. In the meantime there are many more loan clients with lower risks and lower administrative costs. Given the traditional conservatism of the Philippine financial sector, it is difficult to draw out financial institutions to participate in an unsecured lending program even if this is the obvious need of the sector.

While there are indeed no program track record on unsecured lendings, nevertheless there are many instances of SMEs which have achieved growth because of the capital support given to them at the time when they needed it to expand or continue operations. Successful SME entrepreneurs have related how they were helped by material suppliers or large market buyers (often foreign companies) who had faith in their company and provided large trade credits that helped them in a critical period in their development. In the Philippines, among the Chinese community, there is a well known practice among wealthier community members who help out new entrant SME entrepreneurs providing them long term unsecured capital on the basis of business and personal confidence. This is one principal reason why the Chinese community have been progressive entrepreneurs though they may be subject to the same capital constraints that Filipino entrepreneurs face.

While there are many such stories among successful SMEs, financial institutions have not taken these experiences as sufficient basis to launch unsecured long term financing programs, although in the past before the financial debacle of 1983, on a very selective basis commercial banks have extended short term trade credits to long standing clients. This practice has likewise been stopped when a few large scale clients defaulted on these kind of arrangements and caused a financial debacle among related banks.

4. Inadequate Mechanisms for Risk Sharing

The persistent lack of collaterals among SMEs is a well-known fact. One initiative that has been undertaken to respond to this need is the institution of Guarantee Funds usually covering a percentage of the default risk (in the Philippines up to 25 % of the loan amount) have been established by governments. The guarantees have been extended to participating banks in order to encourage them to lend to SMEs. However it has been noted that such guarantee schemes have been unsuccessful in securing the banks confidence that claims will be honored without delay, without arguements on the quality of banks supervision, and without the cumbersome mechanics of asset liquidation before guarantees are honored. While the schemes are still there on paper, actual use of these guarantee schemes have not been undertaken.

Alternative approaches to the risk-sharing issue is now being examined with the projected formation of solidarity groups among entrepreneurs in certain product sector associations. It is not clear where these initiatives will lead. It should be noted though that the creation of these risk-sharing mechanisms does not mean that the collateral norm for fund availment has been relaxed. Rather these are mechanisms that try to provide a comfort mechanism yielding to the immovable conservatism of the financial sector on this policy.

5. Inadequate Supply of Long Term Capital Funds

The survey of SME lending programs indicates that government treasury or foreign development assistance funds have been the principal source of funds for SME lendings, particularly for term credits. Although the financing schemes tend to use private financial institutions as lending channels, the commercial banks do not use their own generated funds for SME lending, except for short term export financing and this only recently. This is because the capital market forces at work militate against SME long term lending. Reasons include: the banks' high liquidity preference, in the face of volatile interest rates, fluctuating foreign exchange rate, and alternative lower risk capital investment opportunities, high transaction administration costs for SMEs lendings. All these work against the creation of an adequate supply of long term capital for SME requirements from the private commercial banks, which is still the major bloc in the financial system (about 34%).

Commercial bank involvement in SME lending programs have been premised on asking for a premium on spreads on funds on-lent from government/foreign concessional sources, because of the above factors. On the other hand, government/donor agency directed lending programs for SMEs have been focussed on giving concessional interest rates and the social objectives of the poverty alleviation campaign of government. Maintaining these subsidized interest rates and non-market orientation, will in the long run work against the evolution of a real market based source of long term capital for SMEs. The bright source of hope however is the indication that mature SMEs can afford to pay a much higher interest rate and in fact continue to do so in order to tap funds from the higher cost informal sources.

The direction of change is clear: interest rates for long term capital requirements of SMEs can be raised, but it is the availment conditions, ie., the collateral requirements which should be liberalized. Alternatively if appropriate guarantee schemes can be developed and interest rates adjusted upward, private financial institutions have began to indicate their willingness to participate in the SME capital market. Government funds for SMEs should consider intervention in these strategic areas, in order to mobilize capital from the financial system for SMEs.

6. Absence of an Appropriate Approach to Equity Financing of SMEs within the Context of a Developing Economy

The other alternative source for the long term capital requirements of SMEs is equity financing. However it has been noted that the equity financing schemes that have been tried out in the Philippines follows the mold and presumes the capital market conditions of a Western developed economy with a fully developed financial system . The repeated failure of venture capital corporations to undertake equity into SMEs in the Philippines, confirms the inappropriateness of this equity financing approach in a developing country environment.

The equity financing scheme has to be approached from different dimensions of the problem. The equity financing scheme has to consider the absorptive capacity, the attitudes, values of the SME entrepreneurs towards external sources of equity. The financial instrumentation must be adapted to the concerns and objectives of both the fund user and the investors or supplier of capital funds. The institutional delivery mechanism should be prepared to supervise the credit or equity infusion into the SME enterprise, and anticipate the organizational transformation that the SME has to go thru as capital is infused and the operations of the enterprise grows in scale and is modernized. Financial mechanisms should also be developed to respond to private investors concerns in the funding scheme, such as liquidity preference, guaranteed returns, capital recovery, and a ready capital market for take-out of their investments in SMEs.

B. THE NEED FOR NEW INITIATIVES

1. Reallocation of Concessional SME Capital Assistance to Mature SMEs

The study has indicated that the present allocation of capital assistance to the SME sector is provided to entrepreneurs who have counterpart savings to match the loan funds. This biases the allocation to new start-up entrepreneurs because these are the ones who would still have their savings base intact. On the other hand, more mature companies who have used up their savings base in developing their enterprise and its growth potential, are denied access to capital assistance, despite the fact that their use of capital would have a higher productivity. The bias against the mature SMEs is implicit in the program design which is premised on the requirement of providing counterpart equity and collateral as the basis for fund availment.

There is a need to reallocate a portion of capital assistance to the capital needs of mature SMEs, by focussing an SME financing program specifically to the requirements of SMEs with a growth potential. The objective is to actualize the growth potential of these mature SMEs and transform them into a larger scale enterprise with a higher level of production and employment. More importantly growth SMEs will generate new markets and production to other smaller SMEs through their backward supply linkages particularly in the rural areas. As such "selective intervention" focussed on growth SMEs would serve as a new strategy for the development of the SME sector and the rural sector where the majority of smaller SMEs are located. Focussed capital assistance to growth SMEs would utilize these enterprises as the nucleus of growth for smaller, rural based SMEs.

This will require however that the SME financing program must be designed to suit the conditions of the growth enterprise. The following points should be considerd:

a) Selection Criteria -- instead of the usual eligibility criteria focussed on asset size, financial strenght and collaterals, the empahasis now will be on business track record, growth potential, and entrepreneurial acumen.

b) Alternative collateral -- in the absence of hard assets as collateral to secure payment of the financing, an alternative collateral to exact financial discipline could be an option to share in the profits and common stocks in the company upon default.

c) Cost of money -- a higher cost of money can be charged particularly if it is against profits ie., profit sharing. It is noted that mature SMEs do pay much higher cost of money (compared to bank rates) to informal sources, provided the terms of availment are liberalized. Higher returns could serve to compensate for the absence of hard assets, and encourage investors to participate in financing schemes for mature SMEs.

d) Technical Assistance for Enterprise Building -- the experience with SME lending schemes show that programs can be more effective if accompanied by technical assistance particularly for a company that will undergo a transformation in scale of operations.

e) Equity intervention -- in the absence of collateral assets to secure long term debts, an equity mode of intervention as a means to maintain a degree of control or supervision of the capital assistance given to an SME.

2. Need for an SME Equity Financing Approach Appropriate for a Developing Country

It is clear from the experience of venture capital corporations in the Philippines, that the equity financing approach now operational in developed countries can not work for the SME sector of a developing country. Considering that equity financing is precisely what is needed to respond to the savings constraints of SME entrepreneurs, there is a need for initiatives in developing an appropriate equity financing scheme for SMEs in a developing country.

The importance of this initiative in SME equity financing can not be over-stressed, because it holds the final solution and provides a long overdue response to the fundamental savings constraint of SME entrepreneurs in a developing country. The need for equity financing is most productive and most needed in mature SMEs which face a good growth potential but whose entrepreneur owners have reached the limit of their savings base and therefore can not access additional loan financing. The urgency of this gap in the SME financing effort has so far been hidden by the large capital requirement as well of SMEs, who have not reached the limit of their savings base and can still meet the counterpart savings requirement for fund availment posed by the financing programs. Furthermore the politics of a developing country make it "unpopular" to devote attention to the needs of mature SMEs, where the need for equity financing is most justified and productive. As a result SME financing programs have not really addressed the savings constraints of SME entrepreneurs, because they have not addressed the need at the point in time where the primordial savings constraints becomes operative. It is only thru an equity financing approach that this fundamental constraint -- of an entrepreneur in.a developing country facing a world market where size and capital makes the vital difference, can now be addressed.

The following basic parameters must be considered in developing the approach:

(a). Demand Considerations -- From the point of the users of equity financing, the following points have to be considered by the design of such an equity financing program:

-- Selection criteria for mature SMEs where the equity financing infusion is productive and effective.

-- The entrepreneur's aversion for the entry of external parties in the control and common stock owenership of his enterprise.

-- The absorptive capacity of the enterprise to make effective use of additional capital to ensure that capital infusion is effectively utilized and leads to a higher level of production and enterprise development.

-- A divestment mechanism which will give the entrepreneur an option to recover full ownership of his enterprise.

(b) Supply Considerations -- From the point of view of would be suppliers of funds for the equity financing program, the following points need to be considered. It is noted that these are market based considerations, that is they represent concerns of a private investor. While it is realized that governmental or foreign assistance funds may initiate such an equity financing program, it must be realized that the final objective should be to tap the main source of capital funds for SMEs, that is the private sector savings thru the financial sector. To develop this capital market for SMEs equity financing needs, the following points should be addressed:

-- Capital recovery mechanism -- in the absence of a stock market for SMEs in developing countries, there needs to be a financial facility where investments in individual SMEs can be readily redeemed. Considering the liquidity preference of investors, the mechanism should provide for exit mechanisms, which will enable individual investors to liquify their investments, without disrupting the investment commitment to the equity recipient.

-- Financial Instrumentation -- considering the concerns and attitudes of both the equity user (the SME entrepreneur) and the investor (to an equity finanacing fund or enterprise), there is a need to develop a financial instrument of investment that will reconcile these concerns, and attain the objective of an equity financing program for SMEs.

-- Institutional Infra-structure for Supervision of Investments -- equity investments necessarily means a deeper and longer term involvement in the development of an SME, which existing financial institutions may not be organized for. There is a need for a market oriented development insitution to take care of the twin objective of protecting the interests of the investors, and at the same time assisting in the growth transformation of the enterprise and making effective use of the capital infused.

-- Capital Base for Investment Portfolio and Institutional Infra-Structure -- An equity financing scheme for SMEs needs a critical size investment fund in order to be actuarially feasible. The investment funds need to be supported by substantial capital outlay as well for the institutional infra-structure for managing the fund, the individual investments and undertaking enterprise building activities. This requires subsidy or grant funds, otherwise loading these costs on the investment fund portion could raise the hurdle investment return rate, which may render the fund unfeasible.

All these concerns and an equity financing approach appropriate for a developing country are discussed in a paper developed by A. Alvendia entitled -- A Small Enterprise Equity Development (SEED) Fund, prepared for UNIDO, 1990.