Long term stable finance and SME finance

Naoyuki Yoshino
Director of Financial Research
Financial Institute, FSA
and
Professor of Economics, Keio University
yoshino@econ.keio.ac.jp

Need for corporate bond market for long term finance

1, High rate of savings in Asia

  1-1, Domestic Savings,

  1-2, Foreign reserves

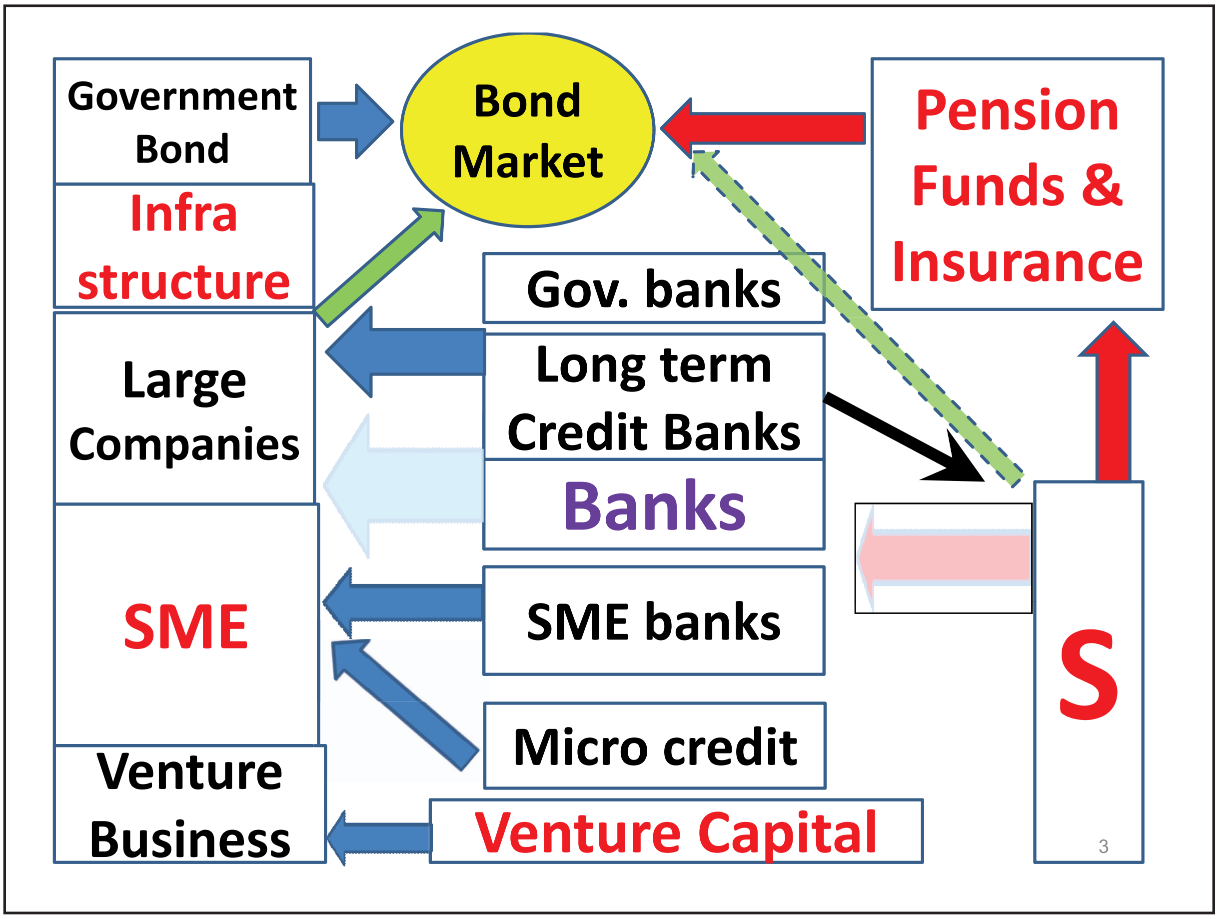
2, Invest into US and European bond market

3, Invest into Asia for short term

  Stock investment , Hedge funds

4, Not enough financial products in Asia

5, long term finance to large corporations



Discussions

1, Long term financing to corporations

Large corporations

2, large companies can access to bond market

3, SMEs and venture businesses

who will provide long term funds ?

4, Evaluation of risks of SMEs

5, SME database, CRD in Japan

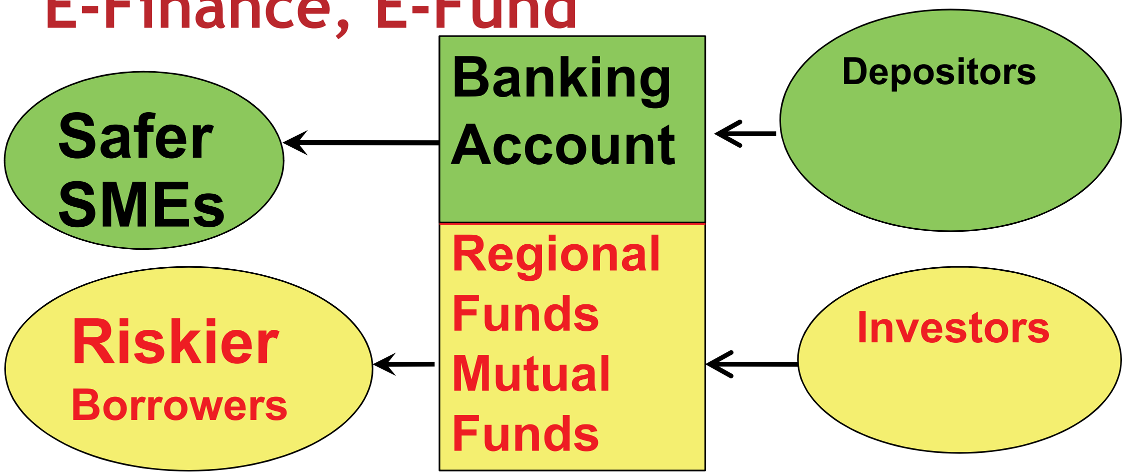
6, Regional mutual funds, E-funds

Bank based SME financing and Regional financing to Riskier Borrowers

1, Bank Loans to relatively safer borrowers

2, Regional mutual funds / Regional fund

E-Finance, E-Fund



New Basel Capital Requirement and SME Financing

Naoyuki Yoshino

Sony, Honda, Panasonic, Seven Eleven Holdings etc. all grew from small businesses. How to raise money from banks is quite important for the growth of SMEs (small and medium enterprises). For example, Honda has an interesting story about its initial financing. Mr. Soichiro Honda who became the President of Honda Corporation went to a local bank to borrow money when it was a very small business. Honda started its business from manufacturing motorcycle. A local bank denied lending money to Honda since its future was not certain, and Mr. Honda had hard time to look for lenders to his company. Finally, he was allowed to borrow money from one big bank.

Sub-prime loan crisis brought various reforms in financial rules and regulations. Basel capital requirement is one of them. New Basel III will be implemented in near future. Deposit-taking banks have to keep their adequate capital to cope with various risks. Banks will become much more cautious for riskier loans and investment. SMEs will be affected by stricter credit analysis of banks. Asian economies are dominated by their very thin banks and venture capital markets. How to finance SMEs in the new environment? There exists an information asymmetry between SMEs and banks.

Financing for SMEs

At the ASEAN+3 Finance Ministers' Meeting in May 2009, the Ministers agreed to establish the Credit Guarantee and Investment Facility (CGIF). Financing for SMEs and the infrastructure development are vulnerable to a credit crunch since it largely depends on indirect funding sources, such as bank loans.

Yet, considering SMEs' large share in many dimensions of Asian economic activities, further efforts should be made for SME financing. SMEs are often believed to be difficult to examine in terms of their financial and non-financial accounts. However, the Credit Risk database of Japan is an example of how SMEs can be rated based on financial and non-financial data. CRD (Credit Risk Database) made it possible to collect a huge amount of database from SMEs and rated SMEs based on its statistical analysis.

Database Provided by Credit Risk Database (CRD)

The CRD Association was established in 2001, at the initiative of the Ministry of Economy, Trade and Industry (METI) and the Small and Medium Enterprise Agency (SMEA) by 52 credit guarantee corporations as well as financial and non-financial institutions. Its aim was to facilitate fund-raising of SMEs and improve their operational efficiency. With the increasing importance of the fund-raising of SMEs, the membership increased from 73 institutions at the end of March 2002 to 200 institutions at the end of 2010.

The CRD database provided by the CRD Association covers SMEs exclusively. It covered 14.37 million corporations and 1.737 million sole proprietors as of March 2010, which was more than 50% of all SMEs in Japan. The database for default covered 3,289,000 corporations and sole proprietors, and it is so far the largest database for SMEs in Japan.

Member financial institutions use scoring models to enhance the efficiency of credit evaluation, check the validity of internal based rating systems, and make loan pricing in line with credit risk. In addition, the CRD Association provides the consulting services for SME management support. These services have been developed based on the thought that the improvement of SME management will contribute to the reduction of credit risk for member financial institutions and to the strengthening of the business operation of SMEs. They have also been offered to member financial institutions to help them promote the implementations of Basel II and Basel III.

If such kind of systems could be established in other parts of Asia to accumulate and analyze credit risk data and measure each SME's credit risk accurately under the same criteria, SMEs will be not only able to raise funding from the banking sector but also gain access to the debt market through liquidation and securitization of their claims.

Despite its relevance and dynamic growth, the SMEs industry sector is never immune to problems. SMEs are hit hardest by economic crises and other unfavorable market conditions, such as unfair competition in the marketplace. But the most persistent challenge to SMEs is the inadequate access to financing because of the relatively lack of financing availability in the developing economies where these SMEs operate, and "many financial support measures for SMEs have limited outreach at disparate costs". Capital markets in the regions are far from adequate for SME debt and equity financing. The financing problems of SMEs are rooted in the information asymmetry problem facing both lenders (mostly banks) and borrowers and in the existing market imperfections as well as the nature of the financing transaction itself.

As an issue of demand and supply, financing may only be successfully consummated if the lender finds the risk acceptable and is given promise of return by the borrower. This acceptable level of risk depends on the accuracy and timeliness of information that the borrower is able to present or convey to the lending bank. The development of credit infrastructure such as credit bureaus would serve both the lending banks and the SME borrowers by bridging the gap between these two parties. A credit information system is an indispensable infrastructure for credit market development.

The provision of credit information helps lenders understand better the risk profile of their borrower clients and enables them to expand their credit services. Recent availability of new technologies such as credit scoring has facilitated the ability of banks to service SMEs better. The information-capturing platform of a credit bureau makes it possible to measure SME borrowers in a number of ways. What gets measured gets managed, and the metrics provided by credit bureaus serve the needs of both banks and SMEs.

Better credit granting and risk management are based on better information provided by a credit information system. By disseminating captured information about SMEs and its suppliers, SMEs could build up their track records. Even though these SMEs have no banking relationships, if their credit bureau record indicates a good credit standing among their suppliers, such information may be used to their favor to support necessary financing applications. SMEs with good track records may also be able to access credit in more favorable terms, and obtain faster decisions on their financing applications.

The negative and positive data (especially positive one) from credit bureau will benefit SME loan applicants by providing a more balanced view of SME credit ratings. By knowing how the credit bureau presents information about them, SMEs (which were rejected by banks) will also gain a better understanding of their financial deficiencies through the credit bureau reports and ratings. These reports would also serve as a convenient tool for SMEs to carry out a self-evaluation to identify areas that need improvement and initiate adequate remedial actions to increase their competitiveness. SMEs are thereby empowered to improve their own profile, with correspondingly enhanced prospects for the SME sector as a whole. (The author is Professor of Economics, Keio University.) SCMO