Thanks to the Australian APEC Study Centre and the Association of Development Financing Institutions in Asia and the Pacific for the opportunity to participate in this Joint Regional Symposium.

Within the last year or so there has been a recognition that there are enterprises smaller than "small" enterprises -- micro-enterprises. This presentation is focused on them. They face special financing issues and challenges. Financing schemes for them may merge with provision of micro-finance. Yet in many cases that is not so and the issues facing them are the same as those facing small and medium enterprises.

Part of the reason for recognising smaller than "small" enterprises is that there is a great variation between economies as to the size of enterprises regarded as SMEs. There is no standard definition of the SME. The OECD notes: "The characteristics of a SME reflect not only the economic, but also the cultural and social dimensions of a country. Not surprisingly, very different patterns are used across countries and over time", but the main criterion that OECD countries use for statistical purposes is the number of persons employed.

However, that main criterion results in different descriptions in different economies.

In my own country, New Zealand, SMEs are defined as enterprises with 19 or fewer employees. Around 97% of enterprises are in this category.

In Japan the definition of a "small enterprise" in the Small and Medium Enterprises Basic Law is an enterprise with a regular workforce not in excess of 20 persons (or 5 persons in the case of enterprises which are principally engaged in commerce or the service industry). Thus in Japan the definition of a "small enterprise" is much the same as the definition of an SME in New Zealand. In New Zealand an enterprise employing 20 or more employees would be too big to be an SME. In Japan such an enterprise whilst not a “small” enterprise may be a medium enterprise and therefore an SME.

At ABAC in Bangkok last August we received a paper from Chinese Taipei concerning SME financing in that economy. I asked how SMEs were defined in Chinese Taipei. Answer: so far as employment is concerned, under 200 people in manufacturing, under 100 people in non-manufacturing.

The Internet tells me that in China, generally SMEs are defined by their size – less than 500 employees – and their ownership – privately held or invested by a private equity company or other financial backer.

The State Bank of Pakistan defines an SME as “an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing /service concern) and 50 persons (if it is trading concern) and also fulfills the following criteria of either ‘a’ and ‘c’ or ‘b’ and ‘c’ as relevant:

(a) A trading/service concern with total assets at cost excluding land and building upto Rs 50 million [about $US 10million].

(b) A manufacturing concern with total assets at cost excluding land and building upto Rs 100 million [about $US 20million].

(c) Any concern (trading, service or manufacturing) with net sales not exceeding Rs 300 million [about $US 60million] as per latest financial statements.

An Individual, if he or she meets the above criteria, can also be categorized as an SME."

In these larger economies enterprises which may employ several hundred people are put in the same SME category as sole traders and enterprises employing just a few people. These circumstances have given rise to the new concept of micro-enterprises, and a growing tendency now to talk about SMMEs, that is, small, micro and medium enterprises. The Australian APEC Study Centre has adopted the acronym MSME – micro, small and medium enterprises – as being more logical than the more common SMME. If they keep on doing it, and others of us copy them, that logic may eventually prevail.

Putting to one side the way we name them, the important point is that this new way of looking at enterprises will assist in the development of policies for these very small enterprises.

The first point I want to make is that in some cases provision of finance for micro-enterprises will be no different to provision of micro-finance by micro-finance institutions. As I shall explain, micro-finance will not be the right vehicle for all micro-enterprises but it will be for some.

Whilst not all will agree, in my view it is important to maintain the role of micro-finance as being made available for productive activities and to keep it separate from consumer finance. That is the way it started off.

If micro-finance is being made available for productive activities it will be finance for micro-enterprises.

Separation of finance for productive activity from finance for consumption is very important. Regulation can kill micro-finance by increasing the costs of doing business. Allowing confusion between micro-finance in its original and proper role and consumer finance gives rise to problems and creates a climate where regulation is demanded.

This is because productive activity produces, or has the intention of producing revenue to be used in the first instance to meet the costs of the business, including the costs of servicing and repaying the micro-finance advance. Only after all such costs have been met will there be profits. Only from profits may there be expenditure on non-productive consumption. This does not overlook that you need the basic human conditions to enable an economically functioning unit, so that the design of the project being financed may need to have regard to that necessity. But it must not be allowed to morph over to become financing for consumption rather than production because consumption does not produce the economic return to service and repay the micro-finance advance. Financing for consumption gives rise to different problems and dangers as can be seen from experience.

Recently, there have been reports that bad debt situations have reached epidemic proportions in the micro-finance industry in some parts of India. There have been similar accounts about Bangladesh. On 21 December 2010 the BBC News South Asia reported under the headline "Crisis hits India's small loans industry" that the southern state of Andra Pradesh, which accounts for a third of the households and nearly half of the loans within India's private micro-finance industry had become the victim of what an industry leader described as reckless lending and feckless borrowing. This had led to borrowers defaulting on payments and taking their own lives and banks ceasing to lend to the cash-strapped micro-loan companies.

Dr C Rangarajan is the Chairman of the Economic Advisory Council to the Indian Prime Minister. At a speech given in December 2010 he said "The MFI's need to change their business model. They have been indulging in multiple loans and also extending credit for unproductive purposes". On January 5 he amplified his views. He said that MFI's must extend credit only after taking into account every borrower's repayment ability.

For myself, I would put it this way. If you are in the business of lending money, you want the loan to be repaid. If the loan is not repaid and has to be written off as a bad debt, it is necessary to make many profitable loans to compensate for that loss. Consequently it is bad business to lend to people who will be unable to repay. Likewise, it is bad for the borrower to get herself (and most micro-finance borrowers are women), to get herself into a position where she is struggling to repay the loan or loans (as multiple lending has occurred).

But Dr Rangarajan made the point that "It is basic business strategy to ensure that the rate at which any institution lends must be such as to enable the borrower to repay the principal amount. If it is not possible then it is a self-defeating exercise. Therefore MFI's must introspect and decide on the level of margin they want to keep given their cost of borrowing from banks and ensure that greater effectiveness is involved in the process of lending". He then went on to identify what seems to be the major cause of the problem in Andhra Pradesh, when he said that MFI's have resorted to multiple lending predominantly for the borrower's consumption purposes. "This", he said, "is self-defeating and inconsistent with the repayment capacity of the borrowers. The provision of credit for consumption purposes has to be a small part of the total MFI credit".

The traditional means of dealing with such problems is regulation – but as I have said, regulation may impose so heavy a cost burden as to make the micro-finance operation unsustainable. With Dr Rangarajan was the Chief Economic Adviser to the Finance Ministry, Dr Kaushik Basu. He said that the MFI's should not be regulated too heavily as that would affect their very existence.

Micro-finance is a positive initiative with multiple advantages. It increases participation in the domestic economy in areas where the output will largely be consumed within local communities with cascading economic advantages for those communities. Provided it is done for proper purposes, it is a win-win initiative.

Financing micro-enterprises may be no different to micro-finance when the latter is used for proper purposes. For the reasons I have touched upon we should be seeking to develop infrastructures to facilitate and encourage microfinance, but also mechanisms to guard against the dangers resulting from lending for the wrong purposes. I would like to see capacity building which successfully educates micro-finance providers to act in their sustainable self-interest rather than heavy-handed regulation which might stifle something of such overwhelming benefit.

Having made that point, I need to emphasise that the micro-finance model is not appropriate for all micro-enterprises. Micro-finance operates at a grassroots level and without the institutions that the middle class expect or if those institutions exist they have cost structures that inhibit operating with the poorest of the poor, the traditional domain of the MFI. MFIs are part of the 'bottom of the pyramid' economies.

Many other micro enterprises have needs more akin to those of small and medium enterprises. The main difference is in resourcing. It is self-evident that the smaller an enterprise is the fewer the human resources available to it. It is a matter of division of labour. If I am on my own, I must do everything myself. But if I employ people, others can do some of the work freeing me up to concentrate on what I can do best. As dealing with resource constraints gets well away from the access to finance focus of this symposium, I shall say no more about it, and move on.

In the ABAC 2009 Report to Economic Leaders in Singapore in November 2009 in connection with SMEs, ABAC recommended Leaders to undertake initiatives to promote a more predictable legal architecture for secured lending, including an exclusively available system for registering and perfecting security interests in both movables and receivables as collateral, efficient judicial procedures for enforcement of security interests, and clear regulations around asset-based lending requirements to further enable both lenders and borrowers to assess risk and enhance sound credit and lending activities.

In support of that recommendation, made during the depths of the global financial crisis, ABAC said that the development of financial system infrastructure as well as appropriate supporting regulatory and legal frameworks, will be vital to facilitating the financing of enterprises, particularly SMEs, and eventually to restoring confidence and growth. We said that key areas that should be given attention are promoting commercial lending through an enhanced secured lending framework; promoting improved risk management through modernised credit information; and improving the regulatory process, transparency and predictability of the judicial system. We referred to secured lending noting that secured lending requires legal and judicial infrastructure to ensure predictability. Asset-based lending and secured financing remain in many cases at less than their full potential to provide needed corporate liquidity, particularly for SMEs.

Whilst recommending to Leaders that they should undertake initiatives, ABAC has continued with its own initiatives.

ABAC 's Advisory Group On APEC Financial System Capacity Building has identified that the two key problems in lending infrastructure affecting SME finance in the region are information environment (particularly credit reporting) and legal framework (particularly for secured lending). The former is likely to be of greater importance in relation to micro-enterprises and certainly those micro-enterprises seeking finance within the micro-finance environment.

However, ABAC has given no specific consideration to the question whether there should be custom-made prudential requirements for lending to SMEs. I referred to the State Bank of Pakistan's definition of SME. This definition comes within the Bank 's Prudential Regulations for Small and Medium Enterprises Financing (Updated on January 31, 2011). These can be found at <http://www.sbp.org.pk/publications/prudential/PRs-SMEs.pdf>. They are said to be aimed at encouraging banks/DFIs to develop new financing techniques and innovative products which can meet the financial requirements of SMEs and provide a viable and growing lending outlet for banks/DFIs (Development Financial Institutions).

One of the factors inhibiting lending to SMEs is the requirement for banks to allocate additional capital to this form of lending. For example, in an Australian Parliamentary Joint Committee on Corporations and Financial Services report, the Committee noted

"3.11 Additionally, Treasury advised that ADIs '[authorised deposit-taking institutions, which includes the banks] are likely to need to hold more capital against SME loans, relative to residential mortgages.' Similarly, ANZ reported that:

[t]he higher probability of default and loss given default for small business customers when compared to mortgage customers requires banks to hold a higher level of capital and reserve more for bad debt expenses for small business lending. A requirement to hold three times as much capital for small business customers than residential mortgage customers is typical and is required by APRA.

3.12 NAB also reported greater capital requirements for SME loans, stating that 'the amount of capital required to be held by banks is generally three times higher than for residential loans, and in some instances can be up to seven times higher for certain products.'"

See <http://www.aph.gov.au/senate/committee/corporations_ctte/sme_finance/report/c03.htm>.

The need for additional capital, compared to other lending, creates reluctance to lend and higher pricing. A common complaint from SMEs is that they are inhibited from undertaking innovative enterprise because they cannot find the finance and the banks will not lend.

A leading expert in this area is Prof Yoshino from Keio University in Tokyo. He has provided significant input to the work of ABAC's APEC Advisory Group particularly in relation to a credit information database to promote SME lending. He has also come up with an innovative idea to try to overcome the reluctance of traditional lenders to provide more risky types of finance to SMEs which I first heard about when the professor gave a speech at an Apec Ease of Doing Business seminar in Sendai, Japan in September 2010.

I will conclude this address by giving you Prof Yoshino's description of his innovative idea which he included in a Background and Discussion Note prepared for the OECD-ADBI 12th Roundtable on Capital Market Reform in Asia which was to have taken place on 17-18 March 2011, but was postponed because of the earthquake and tsunami. This is what he said

***(Creation of trust funds)***

58. Under the bank-dominated financial systems in Asia, it would be helpful to create regional funds (or a regional trust fund) to promote lending to start-up companies and riskier borrowers such as SMEs, thereby helping to maintain the soundness of the banking sector, as banks would not be exposed to these types of risks. If these regional trust funds are sold through branch offices to regional banks, post offices, credit associations, and large banks, it will enhance opportunities for regional companies to raise funds.

59. However, these regional trust funds will not be guaranteed by the Deposit Insurance Corporation and risks must be barred by investors. The trust fund must be fully explained to investors, in terms of where it is invested and the risks associated with the investment, otherwise once the unexpected losses of the trust fund investors increase, then the trust fund market will not grow.

60. Examples of regional funds in Japan are (i) Wind power generators, (ii) Musicians’ fund, and (iii) Japanese wine (‘Japanese Sake’) brewery funds. There are about 20 wind power generators. In order to construct these generators, private and public partnerships were introduced. Local residents invested about USD 1000 to 5000 for the project. They receive dividends every year through the sales of electricity by each wind power generator invested. Musician’s funds are collected by many investors. Each investment unit is about USD 150 to 500. If one of the musicians becomes successful, its DVD can sell very well and the funds earned from the sales will be able to pay a high rate of return. There are both successful funds and failed funds.

61. Project evaluations are quite important in the creation of regional funds. Some of the regional funds which had invested in risky business ventures did not go well. Bankers in the world will be much more concerned about their risks after the implementation of Basel III. It would be much more difficult to raise venture capital investments and risky projects in the Asian region, since it is dominated by bank loans and capital market is not well developed.

63. Bankers face a critical point in the lending process when they are faced with various projects. Some of the projects will have high expected rates of return, but with high risks. Bankers have to refuse these loans. However, if such projects are financed by regional funds rather than by deposits, they will notcreate non-performing loans for banks. Bankers can collect their money through sales of regional funds from their branch offices. It has to be apparent for investors in these funds that their investment is not guaranteed, but at the same time, they might receive a high rate of return. It will widen the project investment from safe projects to riskier projects.

64. Banks can compete on the basis of successful regional funds. If some banks sell successful regional funds, they can attract much more investors in the future. On the other hand, if some banks sold bad funds, they will lose investors in future. Competition will work to produce better expected projects for investors.