SURVEY OF THE FINANCING SITUATION OF SMALL AND MEDIUM-SIZED ENTERPRISES

This article summarises the main results of two surveys[1], conducted in 1999 and 2000, on the financing situation of small and medium-sized enterprises.

I. Introduction[2]

In the aftermath of the Asian financial crisis, there was some evidence of banks in Hong Kong tightening their credit to small and medium-sized enterprises (SMEs). In order to better understand the financing situation of SMEs, the Hong Kong Monetary Authority (HKMA) conducted two surveys: one of SMEs and the other of banks and SME associations, in late 1999 and early 2000 respectively. This paper summarises the results of the surveys.

The first survey was carried out in late 1999 among 30 SMEs. It focused on the sources and availability of funds to SMEs to finance their start-up costs, day-to-day operations and business expansion, and collected information on the impact of banks' credit tightening on SMEs. Findings of the survey are summarised in Section II.

The second survey, of 8 banks and 4 SME associations, was carried out in March 2000. Supplementing the first survey, it focused on banks' lending policies towards SMEs, and assessed the likely near-term change in credit conditions. Banks' suggestions on ways to reduce the gap between the supply and demand for bank credit for SMEs were also examined. In addition, the views of SME associations on the latest financial situation of SMEs and ways to assist them in obtaining bank finance were solicited. Findings of this survey are summarised in Section III.

II. Major Findings from the Survey of SMEs

A. Sources of Financing for Starting-Up, Operations and Expansion

SMEs appear to have relied heavily on personal savings as a funding source when the companies were first set up. Over two thirds of the 30 companies surveyed revealed that personal savings were the sole source of funding, while another quarter indicated that personal savings accounted for the majority of the start-up funds. Most of the companies did not borrow from banks at all. Contrary to general belief, most respondents were also reluctant to borrow from friends and relatives.

On financing business expansion, most of the respondents would rely on retained earnings, while about one third would inject additional personal savings into the business. Over half of them indicated that bank finance would also be a main source of funding for business expansion (Table 1). Despite the fact that they had operated for some years, about half of the respondents still found it difficult to obtain bank funds to finance business development.

Table 1
Sources of Funds for Business Expansion

Source	No. of Companies (30)
Retained Earnings	26
Borrowing from Banks	17
Personal Savings	11
Borrowing from Other Financial Institutions	1

Notes: 1. Figure in parentheses is the total number of responding companies.
2. The companies may rely on more than one source of funds.

1 A complete report of the two surveys can be found at the Hong Kong Monetary Authority website (http://www.hkma.gov.hk).

2 The HKMA would like to thank the SMEs, banks, and SME associations that are covered in the surveys for their participation and co-operation. However, it should be noted that, since the survey is of a voluntary nature and the sample size is small, the results should be interpreted with caution.

The major non-equity funding sources for operation were trade credits and bank finance. As of October 1999, about half of the companies surveyed financed 50% or more of their operations through suppliers' credit, while another one third also relied on longer payment terms, albeit to a lesser extent. More than one third of the respondents financed 50% or more of their business by bank loans. About half of the respondents revealed that they were operating without any bank credit facilities. Borrowings from shareholders, friends or relatives appeared to be less important.

Bank credit facilities extended to SMEs were mainly in the form of short-term overdraft and trade financing. For the 16 responding companies that borrowed from banks, all except one had their credit facilities secured, almost fully, by collateral, mostly by real estate (Tables 2 & 3).

Table 2
Non-equity Financing by Type of Facilities as of October 1999

Type of Facilities	No. of Companies (30)
Trade Credits	25
Short-Term Bank Facilities	20
Medium and Long-Term Bank Facilities	7
Borrowing from Shareholders, Friends or Relatives	12

Note: Figure in parentheses is the total number of responding companies.

Table 3
Shares of Bank Credit Facilities Secured by Collateral

Secured by Collateral	No. of Companies (16)
100%	13
90%	1
85%	1
0%	1

Note: Figure in parentheses is the total number of responding companies.

B. Impact of the Tightening of Bank Lending on SMEs in the Aftermath of the Asian Financial Crisis

About half of the companies possessed credit lines before the crisis. Some of them experienced cuts in these facilities during October 1997 to September 1998, and continued to suffer from reductions in the period from October 1998 to October 1999 (Table 4). The cuts in credit facilities in the former period ranged from 10% to 20%, while in the latter period they ranged from 20% to 80% (Table 5).

The companies experiencing reductions in bank credits attributed the cuts to the fall in value of the collateral, mainly properties. Most of the companies were of the view that banks had adopted conservative credit policies. Instead of

Table 4
No. of Companies Experiencing Reductions in Bank Credit Facilities by Type

Reduction in	No. of Companies	
	Oct 97 to Sep 98	Oct 98 to Oct 99
Short-Term Facilities		
- Overdraft	3 (11)	3 (11)
- Trade Financing (letters of credit, trust receipts, etc)	4 (9)	3 (9)
Medium and Long-Term Facilities		
- Mortgage Loans	1 (3)	1 (3)
- Term Loans	1 (2)	2 (2)
- Hire & Purchase	1 (3)	1 (3)

Note: Figures in parentheses are the numbers of companies which have specific credit facilities.

Table 5
Reduction in Bank Credit Facilities

Reduction	No. of Companies		
	Oct 97 to Sep 98 (5)	Oct 98 to Oct 99 (5)	Oct 97 to Oct 99 (6)
10% to 25%	5	3	1
>25% to 50%	0	0	3
>50% to 80%	0	2	2

Note: Figures in parentheses are the numbers of all responding companies.

assessing the viability and business prospects of the companies, banks in general focused on the availability of collateral. Also, some respondents felt that banks lacked the expertise for assessing the credit standing of SMEs.

Most of the companies that had credit facilities agreed that the fall in property prices had made it difficult for them to obtain sufficient bank finance. This was particularly obvious when property prices plunged sharply in late 1997. Although there seemed to be a moderate recovery in economic activity by late 1999, they continued to be subject to liquidity shortage due to the property situation and banks' reluctance to lend.

The affected SMEs said that with a lack of bank credit, they were forced to scale down their operations, sell assets or halt expansion. However, they would mostly be reluctant to cut their trade credits to customers as this would risk losing business to competitors.

C. Outlook and Constraints

Notwithstanding the seemingly improved credit conditions[3], over one third of the companies surveyed[4] were concerned about the possibility of a further reduction in credit facilities by banks in the coming 12 months, of which some thought that this could impact on their operation seriously. More than a third of the companies worried that they would not be able to obtain sufficient bank credit to finance expansion. About half of the companies also expressed concern over persistently high real interest rates, and some believed that this would have a serious impact on their business.

If bank financing is insufficient, about two thirds of the companies surveyed would consider injecting more personal funds to meet their financial needs. Most respondents found it difficult to obtain financing from sources other than from their own savings.

On constraints affecting SMEs' operations, half of the companies ranked 'insufficient bank finance' as the major constraint, while about a third cited 'unstable supply and demand conditions'. 'Shortage of skilled staff' and 'inadequate administrative or infrastructure support' were not considered to be major constraints.

III. Major Findings from Surveys of Banks and SME Associations

A. From Meetings with Banks

a. Lending Policies toward SMEs

While most of the banks surveyed did not explicitly state that their lending policies toward SMEs were different from those for large companies, their general lending practice and perception of the weaknesses of SMEs, as revealed during the interviews, indicated that there were differences in treatment. In assessing the creditworthiness of customers, most banks

3 Note that the survey was conducted in December 1999.

4 Of these eleven companies, nine have bank credit facilities, while one of the other two plans to obtain loans from banks.

appeared to apply the same range of factors, including financial strength, profitability, net worth, track record, management quality, relations and payment records with other banks, business prospects, business risks (such as the degree of concentration of suppliers and customers), and opinions from trade counterparties.

In general, the responding banks claimed that, compared with large companies, SMEs were financially weaker and the quality of their management was poorer. As a result, lending to SMEs was riskier than other loan business, such as mortgage loans and large corporate finance. The banks noted that, on average, the delinquency and failure rates of SME loans were higher than for other loan services.

There appeared to be a consensus among banks interviewed that the financial and operational transparencies of SMEs were relatively low, and the accounting standards of some companies were poor. The financial and other information that SMEs were willing and able to provide was often inadequate or inaccurate. All these factors contributed to banks' difficulties in assessing the SMEs' creditworthiness. The banks were also concerned that some less-disciplined SMEs might abuse the loan contract by using the loans for purposes other than those agreed on, such as for the purchase of stocks or properties instead of the operation of their business. The banks thus claimed that it was justifiable for them to request collateral as an additional requirement, or to require personal guarantees for SME loans.

The majority of the banks surveyed considered themselves as active players in the SME loan market. Two banks, however, indicated that SMEs were not their target customers. One bank observed that it had been aggressively expanding its business in SME loans after the Asian financial turmoil. It believed that those SMEs that survived the crisis were mostly sound companies. It also perceived that the potential for growth in the SME loan market was high, and the profits from this business could be substantial.

Most banks indicated that the availability of collateral was just one of the factors determining loan decisions, albeit an important one. They emphasised that loans were not granted if the borrowers did not meet the required financial and management standards.

For newly established SMEs, as they could not provide useful track records for reference, banks would be more cautious in approving loans, especially for those new entrants to an industry. Collateral naturally played an even more important role in these cases.

b. Near-Term Change in Banks' Credit Stance toward SMEs

Findings about the possible near-term change in banks' credit stance towards SMEs are summarised in Table 6. On the whole, it appears that banks have begun to turn their focus to SMEs. However, factors hindering bank lending to SMEs will continue to constrain the flow of credit to this

Table 6

Possible Change in Banks' Credit Stance toward SMEs

Credit Stance		**No. of Banks (8)**
Positive:	Has increased lending to SMEs	2
Neutral to Positive:	Planning to increase lending to SMEs	1
	Unchanged; may increase in view of improvement in economic conditions and fierce competition in mortgage loans	4
Neutral to Negative:	Remain not focusing on SME loan business	1

Note: Figure in parentheses is the total number of responding banks.

sector. To the extent that loan demand of large companies also increases as the economy recovers, SMEs may have to compete for limited credit facilities with their larger counterparts, although that situation is unlikely to arise in the immediate future.

c. *Suggested Ways to Reduce the Gap between Supply of and Demand for Bank Credit for SMEs*

Against the background of the hindrances to bank lending to SMEs discussed in Section IIIAa, a number of ways to reduce the credit gap were suggested by some of the banks during the meetings:

i) Credit Reference Agency

A comprehensive study on this issue is being carried out by the HKMA in a separate exercise. Some preliminary views were collected in this survey. Most banks supported the idea, believing that such a system would help banks to obtain the information they needed about potential SME borrowers. With adequate information, they would be more willing to lend to the sector.

ii) Enhancement of Financial and Operational Information Disclosure and Accounting Standards

All banks suggested that SMEs should improve the disclosure of their financial information, track records, etc, and enhance the transparency of their operations, as well as accounting standards (e.g. report inter-party claims and liabilities, and actual profits).

iii) Availability of Market Information

A few banks suggested the HKMA to collect and disseminate relevant statistical information about aggregate SME lending by banks, so that they could assess how their competitors were doing in this area. This could help them in developing a fair loan portfolio which would be consistent with market practice.

iv) Credit Scoring System

Some banks suggested that the use of a credit scoring system[5] could be instrumental to reduce the credit gap, as it offered the possibility for a consistent, quick, and cost-effective evaluation of the riskiness of SMEs.

B. From Meetings with SME Associations

a. *Background of the SME Associations*

Four major SME associations in Hong Kong were visited and their views on SMEs' financing situation gathered. These are non-profit making organisations and their combined membership size is around 10,000.

b. *Financing Situation of SMEs*

All associations reported that credit conditions for SMEs had stabilised recently, having gone through a difficult period following cuts in banking facilities in 1998 and the first half of 1999. However, the credit situation had only improved modestly.

c. *Views on Banks' Lending Policy*

There appears to be a general perception among the associations that banks were too conservative in lending to the SMEs. In the view of their members, collateral was almost a must when SMEs borrowed from banks. They commented that, while banks had increased consumer lending recently as the economy recovered, no significant improvement in banks' lending to SMEs was witnessed.

Concerning financing to new SMEs, all the associations claimed that banks were reluctant to lend to these companies. They thus had to rely

5 Credit scoring is an automated process by which information about an applicant is used to predict that applicant's likelihood of repaying a loan. Credit-scoring models use information such as previous late payments, default on personal loans, or the level of financial reserves, and the financial condition of the business, etc, to generate a credit score, which is a scaled representation of the applicant's estimated probability of loan default or delinquency.

on equity financing. The associations agreed that the lack of track records made it more difficult for banks to arrive at loan decisions. But they felt that banks should lend on rigorous assessments of the prospects of these companies.

d. *Suggested Ways to Assist SMEs to Obtain Finance*

There were diverse views among the associations on the usefulness of a Credit Reference Agency. Some associations favoured the establishment of such a system as they believed that banks would become more confident in lending to SMEs with more information. Other associations expressed concern over the possible loss of privacy of SME and the disclosure of aggregate borrowings of SMEs.

In addition, all associations suggested that the Government should make efforts to educate SMEs about the need of having good financial and operational records, which were essential for obtaining bank financing. One association suggested that the HKMA should introduce guidelines requiring banks to lend to SMEs. Some associations also suggested that the Government should introduce effective policies to encourage venture capitalists to invest in local SMEs.

IV. Conclusion

The survey results suggest the existence of a gap between the demand for bank credit by SMEs and the supply of funds by banks, in line with general perceptions. Broadly speaking, SMEs consider that banks are unnecessarily restrictive in the provision of finance to them. The fall in property prices made it difficult for SMEs to obtain adequate bank finance, which in turn restricted SMEs' operations and growth.

Banks interviewed acknowledged that they adopted a more conservative lending stance toward SMEs than toward large companies because of a number of unfavourable characteristics of the SME loan market. These included relatively high delinquency rates; inadequate disclosure of financial and other information; low transparency of operations and poor accounting standards; lack of discipline in the use of credit facilities; and the low level of cost-effectiveness of such lending.

Given ample liquidity in the banking system and fierce competition in the mortgage market, market forces seemed to have begun to work to direct more credit to the SME sector. Banks and SMEs were somewhat more sanguine during the March survey about the short-term prospects for an increase in bank credit to SMEs than were the SMEs whose views were collected from the prior survey carried out in late 1999. In particular, it is encouraging to note that most banks interviewed indicated a neutral to positive attitude in their future lending stance. The difference may mark some turnaround in the financing situation of SMEs in the intervening period, although the different composition of the samples may also have had an effect.

While there was no universal consensus among the survey respondents on means to relieve the financing situation of SMEs, a number of possible measures were suggested by some of the respondents to help remove the hindrances for bank lending to SMEs and reinforce the work of market forces. These include: the setting up of a Credit Reference Agency for SMEs; the dissemination of information about the SME loan market; further efforts to promote adequate disclosure of financial and other information of SMEs; enhancement of SMEs' accounting standards; and the development and use of a credit-scoring system in the SME loan market.

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