



Plenary 4

Capital Markets and Economic Development -
New Avenues for the Financing of Small and Medium
Enterprises (SMEs)

Mr. Andrew Sheng

Chief Adviser,
China Banking Regulatory Commission

12 April 2007

IOSCO Annual Conference

Mumbai, India

Panel 4: Capital Markets and Economic Development: New Avenues for the Financing of SME

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Thursday, 12 April 2007**

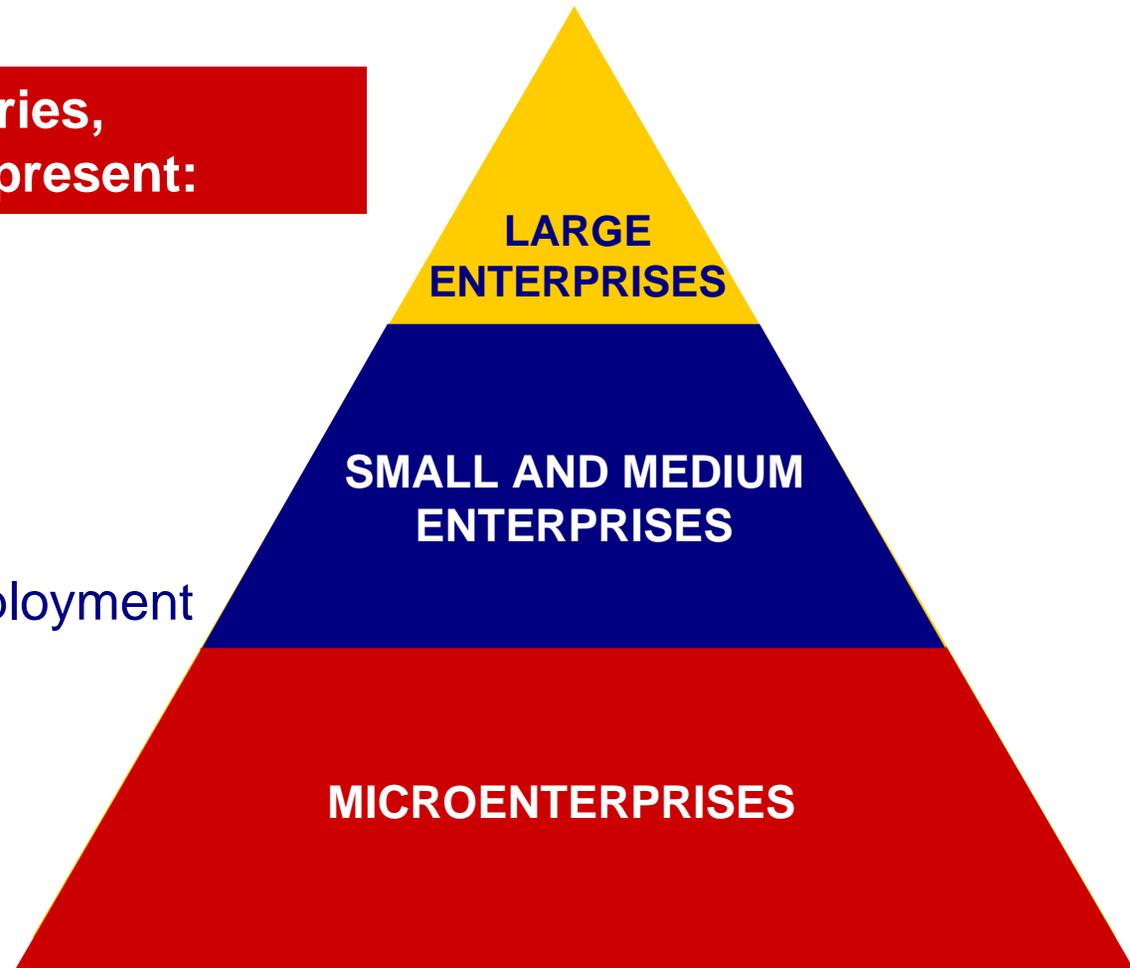
Definition of SMEs

- **OECD definition:- independent companies that employ less than 250 employees**
- **In APEC, 70-80% of SMEs employ less than 5 persons.**
- **Within APEC, there are 49 million non-agriculture SMEs, half in China and Indonesia.**
- **80% of SMEs are in services, 15% in manufacturing and 5% in agriculture.**
- **APEC Profile of SMEs 2003: “Potential to add US\$1 trillion in trade and US\$150 bn in FDI in APEC if “structural changes allow for a simpler, more business friendly, more integrated APEC economy to emerge.”**

SMEs are the Base and Backbone of Economies

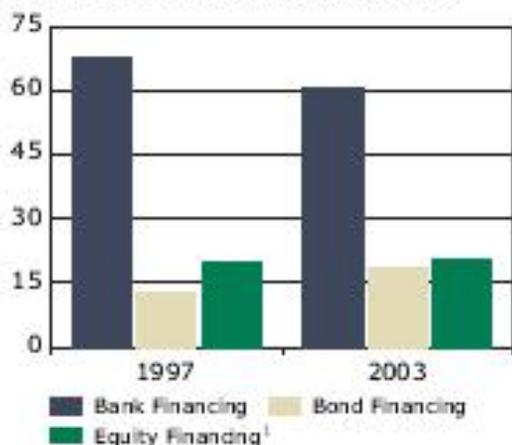
**In developing countries,
microenterprises represent:**

- Over 80% of total enterprises
- Over 50% of urban employment
- Over 20% of GNP
- Main source of employment for poor people



Domestic Financing in East Asia is Bank-Dominated

**Domestic Financing
in East Asia, 1997 and 2003**
(% of total domestic financing)



¹Stock market capitalization as proxy.
Sources: International Monetary Fund (bank financing); Bank for International Settlements, Bank Indonesia, Surabaya Stock Exchange (bond financing); World Federation of Exchanges (equity financing).

Despite the lessons of the Asian crisis and efforts to develop bond and equity markets, the Asian financial system remains bank-dominated, with still fledgling bond markets, speculative stock markets and relatively small insurance and pension and social security systems.

Equity, Bond, Insurance + Pension Markets Remain Relatively Under-Developed

	Bank Deposits ^a		Equity Market ^b		Bond Market ^c		Insurance Premiums ^d	
	1990	2004	1990	2004	1990	2004	1990	2004
ASEAN								
Brunei	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Cambodia	4.0 ³	14.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia	29.8	38.9	4.4	24.9	0.4	24.1	0.9	1.3
Lao PDR	4.0	17.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Malaysia	52.1	88.7	100.7	152.6	69.8	89.3	3.0	5.5
Myanmar	7.9	8.9 ⁵	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Philippines	24.1	48.4	20.6	30.6	22.1	28.7	2.0	1.5
Singapore	74.3	104.4	95.8	149.0	27.8	58.6	3.0	9.1
Thailand	56.8	79.7	29.2	72.3	9.7	38.9	1.7	3.5
Vietnam	10.9 ⁴	48.1	n.a.	n.a.	n.a.	n.a.	0.5 ⁴	2.0
ASIA – Others								
China	75.6	177.8	2.4 ¹	40.3	8.5	29.4	0.8	3.2
Hong Kong SAR	205.6	299.3	107.2	486.3	1.5	28.3	3.0 ¹	9.4
India	31.4	51.1	10.4	48.4	19.9	31.7	1.5	3.1
Japan	100.0	120.5	121.7	73.2	85.9	181.6	8.5	10.7
Korea, Rep. of	32.6	68.8	48.2	56.1	34.1	74.9	11.0	10.1
Taiwan	n.a.	n.a.	107.6	135.3	17.0	58.3	n.a.	14.2
LATIN AMERICA								
Brazil	15.3 ¹	21.8	6.7	46.9	2.2 ¹	55.8	1.4	3.0
Chile	28.2	32.2	38.3	108.6	29.0	44.3	2.7	4.3
Mexico	14.1	23.0	10.6	21.9	21.1	24.2	1.1	1.8
OTHERS								
South Africa	48.3	60.0	120.8	170.5	100.2	43.2	9.6	14.4
SELECTED OECD ECONOMIES								
Switzerland	102.5	133.8	70.6	217.6	57.8	67.6	7.8	11.7
United Kingdom	87.8	115.0	85.2	123.0	36.8	43.9	9.6	13.8
United States	59.6	58.8	57.5	131.6	122.0	157.2	8.3	9.4

Post-Asian Crisis, Banks have been cautious on SME lending

- **In the search for profitability, banks have tended to concentrate on “safer” lending areas such as consumer finance, mortgage lending and asset management activities.**
- **SMEs find banks less “user friendly”, and so resort to:-**
 - **Own funding**
 - **Capital or loans from friends and relatives**
 - **Money-lenders**
- **Banks now entering into SME field**

Strengths of Banking Network

- **New Credit-Scoring Skills manage risks better**
- **Wide range of banking products available, from individual loans, savings, working capital and capital investment loans**
- **Banks can service transactions and also intermediate counter-party risks**
- **Banks can act as wholesale funders to microfinance and SME financial institutions**

Major Problems facing SMEs

- **Lack of overall business skills**
- **Property rights unclear - insufficient assets for collateral**
- **High Transaction Costs - particularly for rural areas where communications and access to formal finance is difficult**
- **Information Asymmetry on Counter-party risks and access to market information**
- **Non-standardization of SME accounting makes risk measurement difficult for creditors and investors**

Hernando de Soto - Fix Six Positive Property Effects

1. Protect property rights of poor, by efficient registration and low transaction costs
2. Provide poor with access to accurate market information
3. Making officials accountable
4. Making assets fungible
5. Networking people
6. Protecting transactions (through efficient trading system)

No property rights = system is illiquid, not transparent, not accountable, not fungible, no network, no trading = no credit culture

- *Hernando de Soto in The Mystery of Capital, 2000.*

If Property Rights are unclear, SMEs cannot issue bonds, equity and derivatives

- **SMEs in both urban and rural areas suffer from lack of clarity of property rights (property registry) that cause them to have high transaction costs and are perceived to have high risks**
- **Government therefore has a role to build Property Rights Infrastructure (Registry, Trading, Clearing and Payment systems) that clarify property rights and reduce transaction costs**
- **Lack of Credit Culture and Counter-Party Trust is due to lack of transparency and understanding of SME and their credit history. Technology can solve this through Credit Rating Agencies and eBay-type trading bulletins with trading/credit history built in.**

SMEs generally do not have access to equity markets

- **Principal reasons are Cost, Transparency and Risks**
- **Minimum costs of listings are quite high...Hong Kong Growth Enterprise Market (GEM) listing fees and costs are minimum HK\$1 million (US\$130,000), equivalent to 3.3% of costs for HK\$30 million (US\$3.9 mln)**
- **GEM entry only for companies with annual turnover of HK\$500 mln (US\$64 mln) and minimum market capitalization of HK\$150 mln at listing (US\$19 mln).**

Transparency and Compliance Costs are High for SMEs

- IASB is working on International Financial Reporting Standard (IFRS) for SMEs - still at Working Group Stage
- SMEs defined as employees not more than 50 and turnover of about \square 10 mln (US\$13 mln)
- Even OECD is working on a simplified Corporate Governance Code for SMEs
- Main Issues
 - *How to simply recognition and measurement principles for SMEs?*
 - *What to omit from IFRS for SMEs and make accounting for SMEs relevant?*

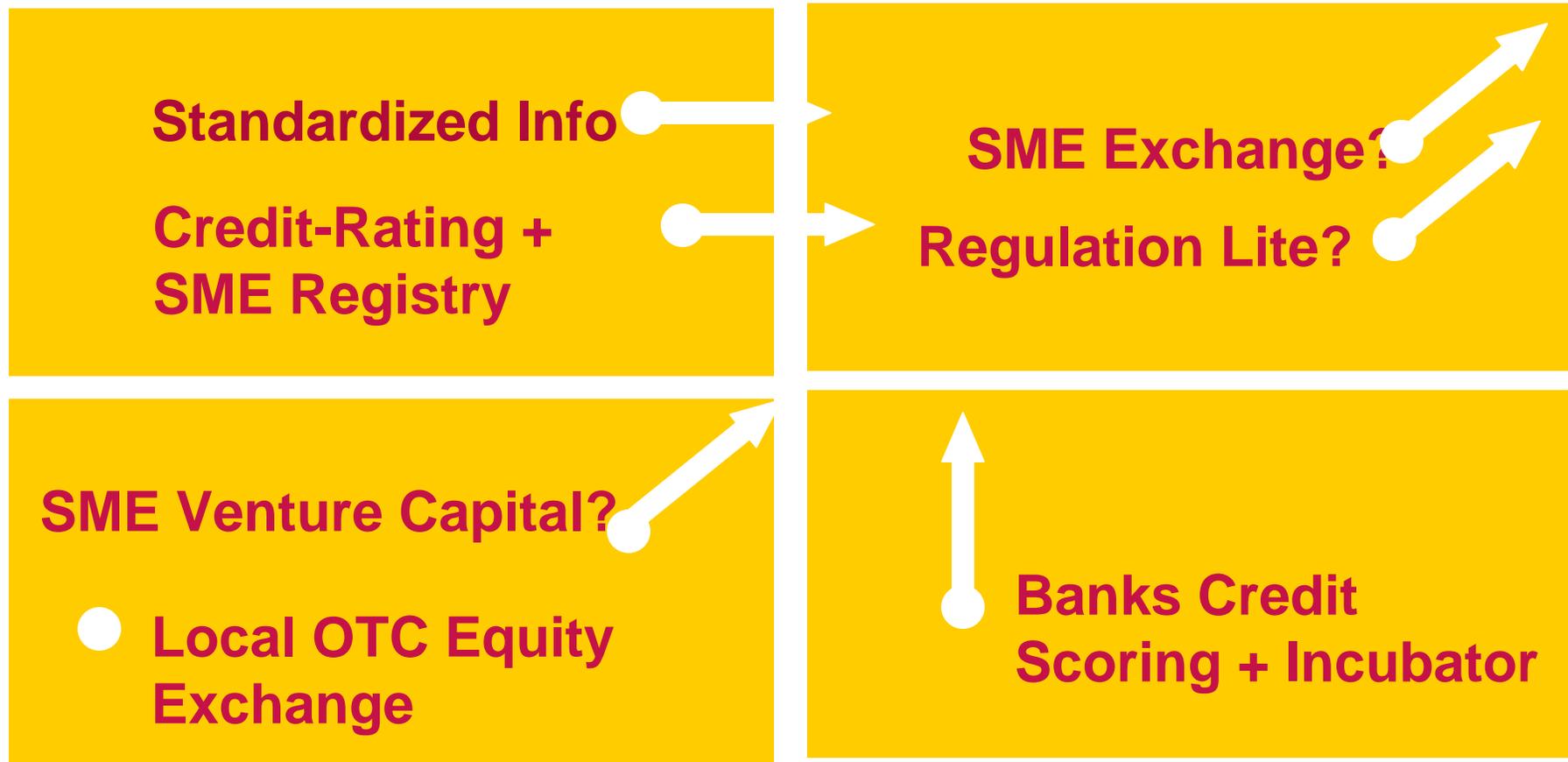
Using Technology to Overcome Transparency and Cost Barriers

- **Extended Business Relationship Language (XBRL) allows business reporting that is standardized to help reduce filing, analysis and reporting costs**
- **XBRL adopted for Chinese listed companies**
- **Creating Web-based Trading, Clearing, Settlement and Payment infrastructure for SMEs is now possible (variants of Business to Business webmodels for SMEs)**

Creating OTC market for SMEs

- **Tianjin City China is applying to State Council to create an OTC market for trading of equity in SMEs that do not qualify to meet requirements for listing on exchanges.**
- **Bohai Industrial Fund (US\$2.5 billion) to create direct fund raising for modern, innovative manufacturing, high-tech projects and infrastructure construction.**

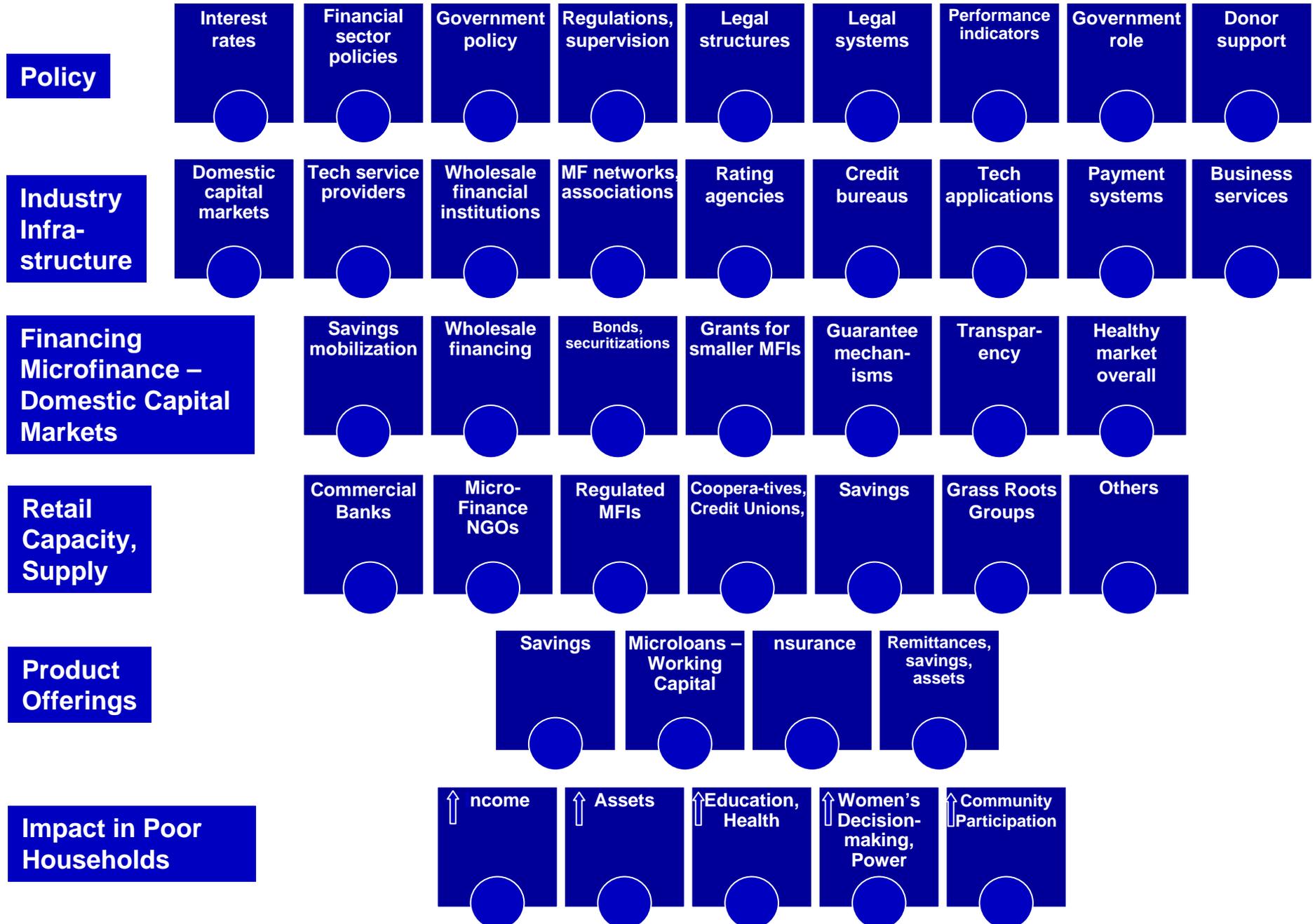
Potential Technology Solutions to SME Access to Capital Markets



Key Policy Measures for SMEs

1. **Train SME through SME Business Schools**
2. **Liberalized interest rates**, relying on competition and transparency to lower costs and rates
3. **Build Financial Infrastructure that clarify property rights and reduce transaction costs**
4. **Use Market forces (banks, rating agencies, NGOs) to impose market discipline - regulatory burden on SMEs should be light but firm**
5. **Allow different types of SME legal structures to evolve (no ONE SIZE FITS ALL model)**
6. **Legal and judicial systems** that support secured and unsecured lending
7. **Common basic performance indicators**, definitions and standards
8. **Government's role** Is enabler, not provider and competitor
9. **Donor support to complement private capital**, e.g., financing younger institutions, capacity building, innovation, institutional infrastructure and policy change

Building Blocks of Domestic Financial Markets That Work for the Poor Majority



Conclusion

- Much can be done in the capital markets to service better the needs of SMEs, but reforms cannot be done by regulators alone
- Policy-makers need a holistic approach and focused policy towards SMEs. Regulators can help by simplifying rules and regulation applicable to SMEs and allowing market forces and discipline to foster SME growth and innovation.
- IOSCO can help push IASB, OECD and other standard setters to expedite work to help SMEs.

THANK YOU