BANK OF JAPAN–IFC WORKSHOP ON SME FINANCE

Experiences from Japan and Emerging Markets

2012 ANNUAL MEETINGS OF THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK GROUP

Bank of Japan

International Finance Corporation
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1 FOREWORD

In the midst of ongoing slow recovery from the global financial crisis, there is an increasing international urgency to create more jobs to accelerate economic growth and meet the employment demands of over 200 million people worldwide. About 600 million new jobs will be required in the next 15 years to meet the employment needs of working-age youth, especially in the emerging markets of Asia and Sub-Saharan Africa, given current trends in population growth.

Emerging markets continue to drive the recovery of the global economy, and the small and medium enterprises in these countries contribute to about 85 percent of new employment, serving as indispensable engines of job creation. The estimated 25–30 million formal small businesses and the many more informal ones face a number of barriers to growth, including access to finance, access to electricity, high taxation, and—in some cases—political instability. The extent of these barriers varies from country to country; nonetheless, access to available financing generally remains the single most limiting barrier.

Support to small and medium enterprises is a critical part of the private sector response to IFC's strategic priorities. At IFC's Access to Finance Advisory Services, we work to improve access to financial services for these enterprises through advisory assistance to our financial intermediary clients in a number of areas, including providing capacity building to bank and nonbank financial institutions, improving financial infrastructure, and providing advice to governments on improving their legal and regulatory environment to enable growth of small firms.

In addition, through IFC's work in providing advice for sustainable business, we help small and medium enterprises improve their managerial, financial, and technical skills.

The Bank of Japan has also worked to support, strengthen, and further develop small and medium enterprise finance in Japan, even engaging in its overall administration from time to time. On the occasion of the 2012 IMF–World Bank Group Annual Meetings in Tokyo, the Bank of Japan sought to share Japan's post–World War II experience in the field with practitioners and delegates from the rest of the world, which led to this Bank of Japan–IFC workshop on small and medium enterprise finance.

The exchange of ideas, best practices, and much-needed know-how during the 2012 Annual Meetings was a tremendous opportunity to identify avenues for further collaboration between Japanese and emerging market private and public institutions working in the area of small and medium enterprise finance.

Peer Stein
Director
IFC Advisory Services | Access to Finance

Atsushi Miyanoya
Director-General, Financial System and Bank Examination Department, Bank of Japan

2 INTRODUCTION

The Bank of Japan and IFC co-hosted a workshop on Small and Medium Enterprise Finance—"Experiences from Japan and Emerging Markets"—on the occasion of the 2012 IMF–World Bank Group Annual Meetings in Tokyo. Prior to the Annual Meetings, the Japanese government conducted a survey to determine those topics in which participants were interested. Many delegations expressed a desire to learn about the structure and development of small and medium enterprise (SME) finance in Japan. The present workshop was consequently organized to provide both global and Japanese perspectives on SME finance.

The workshop's objectives were threefold:

- To bring together various government officials and practitioners with experience or interest in SME finance
- To highlight and discuss the current state of and future challenges for SME finance in both emerging countries and Japan
- To share the Japanese experience and knowledge of SME finance with delegates from other countries, particularly those from emerging economies.

The event included government and central bank officials, SME practitioners, and members of the press. It consisted of two sessions with presentations from practitioners in relevant fields. The first session, organized by IFC, covered the global experience and challenges of SME finance. Speakers included IFC senior officials as well as leaders of private financial institutions from Bangladesh, Kenya, and the Philippines. The session emphasized ongoing experience in SME finance, highlighting challenges in emerging economies.

The second session, organized by the Bank of Japan, introduced Japan's experiences in SME finance, featuring speakers from the private sector, the public sector, and academia. This session looked at Japanese private and public sector experiences during the country's high economic growth era (1954–73), as well as changes in SME finance after this period. It also shed light on the current challenges Japan faces with regard to SME finance.

The workshop was conducted in a paperless meeting format pioneered by a Japanese company. All presentation slides were synced with iPads placed on participants' seats, thus requiring no print materials to be distributed at the workshop.

3 SESSION I: GLOBAL PERSPECTIVE

In his introductory remarks, **James Scriven, Global Industry Director, Financial Markets Group, IFC**, noted that SMEs are a critical part of the private sector response to IFC's strategic priorities, accounting for over 80 percent of net job creation and 67 percent of employment in developing countries. However, the SME credit gap remains large, although it varies significantly by region. IFC considers SME finance a priority and has taken a leadership role in advancing this priority, both as a partner to the G-20 and through innovative products and services. IFC supports SMEs at every stage of their development. Its current client base includes more than 500 SME-focused financial institutions globally, and IFC SME commitments totaled nearly $5.5 billion in the fiscal year ending June 2012. By the end of 2011, IFC and its financial institution clients had reached 3.3 million SMEs, collectively accounting for $181.3 billion of the outstanding loan portfolio. Important, innovative initiatives have been undertaken:

- IFC launched the Global SME Finance Initiative, a $1.4 billion catalytic investment and advisory platform.
- IFC financed winners of the 2010 SME Finance Challenge, providing $77 million to date.
- IFC established the SME Finance Forum, a global collaborative platform for inclusive knowledge sharing, and has published several flagship reports on SME finance.

Nestor Tan, President and Director, BDO Unibank, explained that BDO is the largest full-service bank in the Philippines with a market cap of $5.5 billion, active in the informal sector. Access to finance remains low in the Philippines, with an estimated 80 percent of the population without bank accounts. The informal sector is large and profitable—the emerging backbone of the country's economy. The sector is largely fed by remittances sent by Filipinos working overseas and the small businesses that support this market. BDO's primary challenge is to bring the unbanked sector into the formal banking market. While some SMEs have banking relations with BDO, they do not normally have access to loans. BDO's success in penetrating this informal sector is based on its ability to leverage existing deposit relationship information and use it as the starting point for assessing credit risk in the absence of formal financial records. BDO has a unique approach to operations that includes non-traditional credit assessment models and alternative distribution channels for financial products, such as seminars and trade fairs. Challenges exist, however: the regulatory environment continues to exclude the informal sector; balancing transparency with customer protection is problematic; and the examination process tends to be prescriptive rather than principle based, which does not encourage innovations in credit assessment methodology.

Rumee Ali, Managing Director, Social Enterprises & Investments, BRAC, emphasized that there needs to be a distinction between small and medium enterprises, as the financial requirements and characteristics of the two are quite different and their needs are therefore not the same. In Bangladesh, as in most emerging markets, financial institutions are typically quite willing to lend to medium enterprises but not as willing with regard to smaller ones. But even for medium companies, it is not clear that financing is necessarily in line with companies' real needs regarding credit tenure and structure. Thus, SMEs as a group are not a monolithic entity in terms of financing gap and needs. SMEs have additional needs beyond financing. Small enterprises need more than financial support; they also need management support that addresses both marketing and financial management. There is a skill gap in small enterprises that needs to be addressed. Provision of capacity building—in addition to access to finance—should thus be high on the agenda for helping small enterprises grow; in fact, the two types of support should go hand in hand. Several challenges face financial institutions in helping to serve small enterprises, including reducing the costs of such service; mobile banking can play a role in this regard. Better analytics are needed to assess credit risk issues; improved scoring models and the ability to control nonperforming loans should be exercised in lending to small companies. Governments need to establish appropriate regulations for financial institutions to serve small enterprises as clients, given that this segment can be a risky one. Finally, appropriate metrics should be developed to measure the social impact of small enterprises in various economies.

James Mwangi, Chief Executive Officer (CEO) and Managing Director, Equity Bank, emphasized the financial and entrepreneurial training that small companies need. In particular, small entrepreneurs need mentoring; they also need to develop linkages with larger corporations. Inadequate business and financial skills constitute a significant gap that needs to be bridged if access to finance is to bring results for small enterprises. Partnerships between government, educators, regulators, and financial institutions will help address this gap. The high costs of doing business with small companies could be addressed by exploring alternative channels in reaching out to such companies. Also, financial institutions need to improve the data, management information systems, and analytics they use in trying to reach the small enterprise market segment in order to become more effective in understanding and meeting the needs of these clients.

4 SESSION II: JAPAN'S EXPERIENCE

Atsushi Miyanoya, Director-General, Financial System and Bank Examination Department, Bank of Japan, spoke of the important role SMEs play in the Japanese economy, currently accounting for 44 percent of overall sales and 71 percent of overall employment in the country. Financing SMEs remains critical to the Japanese economy; however, challenges such as greater credit risk, a lack of reliable information on financial statements, difficulties in securing loans with collateral, and associated increased monitoring costs remain.

During Japan's high economic growth period, the Japanese government undertook three major policy initiatives aimed at supporting the development of SMEs in the context of these challenges:

- Establishing private banks specializing in SME finance, thereby creating a multilayered financial intermediation system
- Enhancing public support for SME finance via government institutions and prefecture-level credit guarantee corporations
- Implementing regulations on maximum deposit interest rates.

The Bank of Japan also provided private banks with the funds needed for SME development; these were secured with commercial bills and other obligations. These policies and actions contributed to a steady increase in outstanding balances of lending to SMEs during the period. However, the gradual abolition of deposit interest rate regulations beginning in 1985 led to smaller lending spreads and further development of capital markets, making the SME lending market more competitive.

Following the burst of the economic bubble, SME default rates increased, decreasing the profitability of SME lending. In present-day Japan, although private financial institutions hold a sufficient amount of deposits to advance SME loans, government-affiliated financial institutions continue to maintain their direct, long-term concessional lending to SMEs. This situation raises questions as to how the public sector can complement the private sector while preventing moral hazard.

Masahiro Owaku, Executive Officer and General Manager, Credit Division, Chiba Bank, discussed Chiba Bank's lending stance during Japan's high economic growth period. Headquartered in Chiba Prefecture, adjacent to Tokyo, Chiba Bank has the second largest volume of operations in the country among regional banks in terms of nonconsolidated deposits and loans. Domestic corporate lending accounts for approximately 59 percent of the bank's lending activities as a whole, and 72 percent of its domestic commercial lending consists of loans to SMEs. The bank experienced the highest growth in the amount of loans it provided during the high economic growth period, with an average annual growth rate of 20.3 percent.

To evaluate customers' creditworthiness comprehensively, Chiba Bank makes regular visits to customers, monitors their deposit transactions, and collects nonfinancial information on them. The bank also uses physical security, personal credit guarantees, and public credit guarantees if necessary. These efforts mitigate the SME finance issues identified by IFC, such as poor customer knowledge, poor business enablers, lack of collateral or capital, lack of credit data, low profitability, and lack of SME skills and literacy. Chiba Bank also engages in "business matching" through industry fairs and seminars, including those that highlight international expansion.

Takatoshi Miura, Director, Finance Division, Small and Medium Enterprise Agency, elaborated on current Japanese financial policies and regulations on SMEs. The SME Agency within the Ministry of Economy, Trade, and Industry was established after World War II to support the development of the then-weak Japanese SME industry. The SME industry soon grew to become the backbone of the Japanese economy during the high economic growth era. This success can be attributed to comprehensive government policies including on financing, taxation, consultation on business management, and technical innovation. Among these policies, public SME financing—such as direct loans extended by government-affiliated financial institutions and guarantees by credit guarantee corporations—played a significant role. Although direct loans can be easily adjusted to meet specific policy goals, they may distort market function. On the other hand, credit guarantees can use the capacity of private financial institutions while creating potential difficulties for the government to fine-tune credit to meet certain policy goals.

The Japanese government has made use of both of these public financing tools to adjust its policies toward the continuously developing SME industry. However, the public sector–based structure of SME finance has raised concerns regarding moral hazard and excessive costs. In response to these criticisms, the SME Agency is working to shift the paradigm of public sector involvement in SME finance to a more holistic managerial support structure.

Yoshiaki Shikano, Professor, Doshisha University, provided a historical perspective, summarizing SME finance during Japan's high economic growth period and the financial sector reforms that took place after World War II to reconstruct the economy and expand employment. The reforms established long-term financial institutions and SME financial institutions as financial intermediaries. This in turn led to the creation of a multilayered structure of banks and business relationships in Japan, composed of city banks, regional banks, *shinkin* banks, credit unions, and trust banks. Financial institutions in the different layers catered to different sizes of corporations, preventing the emergence of the "missing middle" in SME finance. Supply-chain finance (i.e., intercompany credit) also played an important role in SME finance. During periods when money was tight, supply-chain finance was used to ease SME funding shortages. Extension of credit terms was commonly used to cope with tightening.

5 WORKSHOP SUMMARY

During the Q&A session, many questions were raised from the floor regarding the finance structure for small start-up enterprises in Japan, the balance between public and private sector involvement in SME finance, and lessons for emerging economies. Chiba Bank's operations were cited as an example of small enterprise financing in Japan. Small local enterprises can receive loans from a bank branch if they are located within a three-kilometer circumference, as local proximity allows for assessments that replace credit history, such as personal knowledge of the small enterprise and its management. In terms of involvement in SME finance, panelists agreed that there should be a balance between public and private sector involvement, and that the public sector should complement the private sector. As a lesson for emerging economies, panelists agreed that public sector involvement in SME finance must be flexibly revised according to the development and conditions of the private sector. The public sector should be more involved in SME finance when private financial institutions are not as established, and should step out of the picture to complement the private sector as it becomes stronger.

In summarizing the key experiences from both the Japanese and emerging markets perspectives, it became evident that addressing both the financial and nonfinancial needs (particularly the skills gap) of SMEs is critical. Both sets of experiences showed that the challenges in serving SMEs are very common:

- Segmentation of the SME sector is vital, drawing distinctions particularly between small and medium enterprises but also within subsegments and subsectors of the economy; such segmentation requires good data and analytics.
- Service costs, and the need for alternative channels to more efficiently serve SME clients, must be addressed.
- Credit risk assessment should be improved, and better data, approaches, and models are needed. These needs are highly relevant from an emerging markets' perspective in access to finance for SMEs in the informal sector.
- SMEs need more than financing, although credit remains the linchpin; the skills gap must be addressed, but—as the Japanese experience particularly highlighted—additional services could extend to business matching and helping SMEs improve access to markets. Thus, there is an overall need to develop advisory services for SMEs.
- Government policies and the role of the regulator are key in promoting access to finance for SMEs. Government policies should be complementary to, rather than crowd out, the efforts of the private sector.

A concept that arose from the Japanese experience is the use of a multilayer system to provide financial services to SMEs. An important element in this system is a reliance on regional/local financial institutions, as they have better information on local clients. The need for local knowledge about clients is validated by experiences in several emerging markets. Whether this knowledge requires a regional bank or a larger nationwide bank will depend on the country context. In any event, the need for data and analytics in understanding clients is vital. Another lesson of the multilayer system is the active participation of the public sector in playing a more complementary role to the private sector, thus enabling private sector participation rather than preempting it.

Finally, both the Japanese and emerging market experiences highlight that SME financing remains a developing story. It is clear that one size does not fit all in serving SME clients, and multiple approaches may be needed depending on the local context. At the same time, these experiences indicate that there is an improved understanding of some of the key ingredients and building blocks that contribute to improving access to finance by SMEs.

6 SPEAKER BIOGRAPHIES

MUHAMMAD A. (RUMEE) ALI
Managing Director, Social Enterprises & Investments, BRAC, Bangladesh

Prior to joining BRAC, Muhammad A. (Rumee) Ali served as the Deputy Governor of Bangladesh Bank. With his appointment as Country Head and General Manager of Grindlays Bangladesh in 1997, he became the first Bangladeshi to head a major international bank in that country. He received both his BA (with honors) and MA in economics from Dhaka University.

HIDEO HAYAKAWA
Executive Director, Bank of Japan, Japan

As Executive Director of the Bank of Japan, Hideo Hayakawa currently is mainly responsible for financial stability matters. He became Executive Director in 2009, and held the position of General Manager of the Osaka Branch until 2011. He held many leadership positions prior to this, including General Manager of the Nagoya Branch and Director-General of the Research and Statistics Department. He joined the Bank of Japan in 1977, and has a BA in economics from the University of Tokyo.

TAKATOSHI MIURA
Director, Finance Division, Business Environment Department, Small and Medium Enterprise Agency, Ministry of Economy, Trade, and Industry, Japan

Takatoshi Miura joined the Ministry of International Trade and Industry in 1992, and has since held various positions in the ministry, including Counselor to the Minister of State for National Policy (2010–11); Chief Deputy Director, Policy Coordination, SME Agency (2007–08); and Deputy Director, Finance Division, SME Agency (2006–07). He has served in his present position since October 2011. Mr. Miura is a graduate of the University of Tokyo, Faculty of Law.

ATSUSHI MIYANOYA
Director-General, Financial System and Bank Examination Department, Bank of Japan, Japan

Atsushi Miyanoya has held various positions related to bank examination and prudential policy matters since 2002, except for two years when he served as Senior Secretary to the Governor. From 1999 to 2002, he headed a division responsible for open market operation, involving him directly in the first phase of the Bank of Japan's quantitative easing. Mr. Miyanoya joined the Bank of Japan in 1982 after graduating with an LLB from Tohoku University.

JAMES MWANGI
Chief Executive Officer and Managing Director, Equity Bank, Kenya

James Mwangi is the Chairman of Kenya's Vision 2030 Delivery Board, charged with the responsibility of ensuring that Kenya becomes a middle-income country with global high standards of living by the year 2030. He holds five honorary doctorate degrees in recognition of his contributions to Kenyan society. Mr. Mwangi has a bachelor of commerce degree and is a certified public accountant.

MASAHIRO OWAKU
Executive Officer and General Manager, Credit Division, Chiba Bank, Japan

Masahiro Owaku joined Chiba Bank in 1984, and has held various positions in his career there, including General Manager of the Shinozaki Branch, General Manager of the Anegasaki Branch, and General Secretariat. He was appointed to his current position in June 2011. He holds an LLB from Tohoku University.

JAMES SCRIVEN
Global Industry Director, Financial Markets Group, IFC

James Scriven is head of financial institutions, insurance microfinance, and private equity funds in IFC. The Financial Markets Group accounts for about half of IFC's new investments each year. In 2012, it invested $9.9 billion in financial institutions, $6 billion of which was for on-lending to local micro-, small, and medium enterprises in developing countries. Mr. Scriven is a member of IFC's Corporate Operations and Corporate Equity Committees and an Investment Committee Member of the IFC Asset Management Company's Capitalization Fund.

YOSHIAKI SHIKANO
Professor, Faculty of Economics, Doshisha University, Kyoto, Japan

Yoshiaki Shikano assumed his current position in 1999, after holding various research-related jobs at the Bank of Japan, the University of Tsukuba, and the 21st Century Public Policy Institute. He is a leading academic in the field of Japanese finance and is well known as the author of *Japanese Financial System*, a source book on the system and workings of Japanese finance. He graduated from Doshisha University in 1977, and received his PhD from Osaka University in 1994.

PEER STEIN
Director, IFC Advisory Services | Access to Finance

Peer Stein joined IFC in 1996, and has worked in Asia, Africa, Latin America, the Middle East, and Eastern Europe on both the investment and advisory sides of IFC. Prior to joining IFC, he worked in Germany as a management consultant in enterprise restructuring, and as a partner in a strategic market research firm covering Eastern Europe. He currently teaches at Johns Hopkins University School of Advanced International Studies on financial sector reform and development.

NESTOR TAN
President and Director, BDO Unibank, the Philippines

Nestor Tan joined BDO as Executive Vice President in 1997 and became President of the Bank in July 1998. His extensive banking experience spans over 15 years in the United States and Europe, acquired from institutions including the Mellon Bank in Pittsburgh, Bankers Trust Company in New York, and the Barclays Group in New York and London. He holds a BS degree (cum laude) in commerce from De La Salle University and an MBA from the Wharton School, University of Pennsylvania.

PANAYOTIS VARANGIS
Head, Small and Medium Enterprises and Businesses, Access to Finance Advisory Services, IFC

Panayotis Varangis leads IFC's work in advising financial institutions on providing financial services to SMEs. He served as Deputy CEO of the Agricultural Bank of Greece from 2004 to 2009. From 1987 to 2004, he held various positions in the World Bank. He has a master's degree in economics from Georgetown University and a PhD in international economics from Columbia University.

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