CHAPTER 1

INTRODUCTION

1.1 Introduction

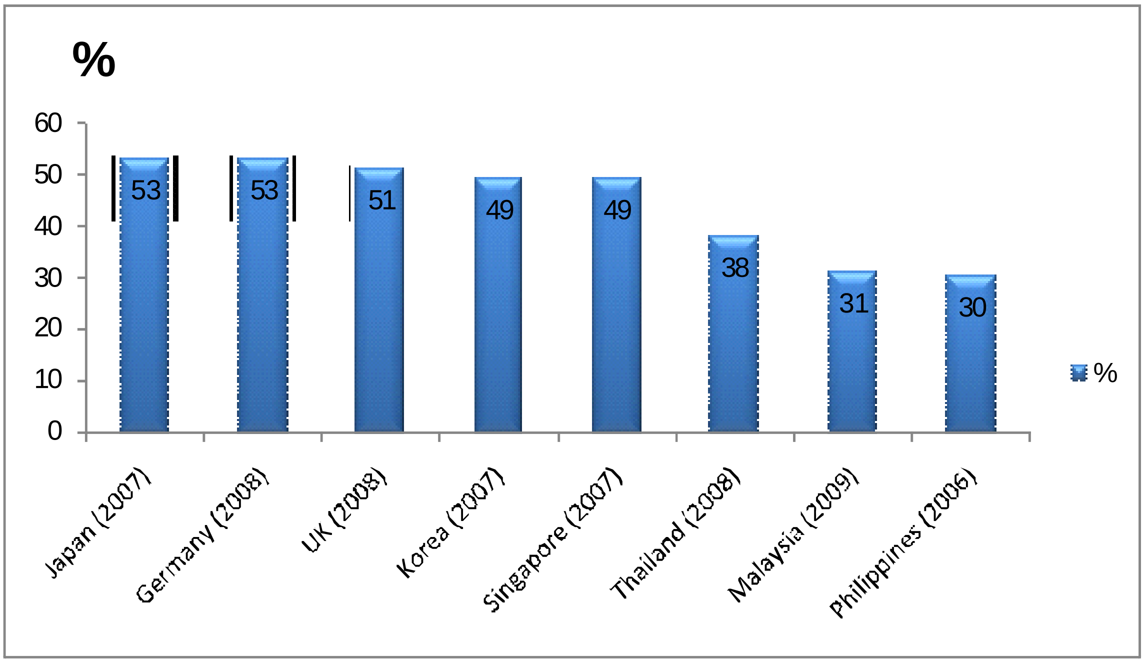
This introduction chapter gives an overview of Small and Medium Enterprises (SMEs) sector in Malaysia and bank's lending practices towards financing the SMEs. In addition, the research objectives and the research questions are also discussed. Additionally, the significance and scope of the study are also presented in this chapter.

1.2 Overview of SME Sector in Malaysia

Based on SME Annual Report 2009/2010, majority of businesses in Malaysia are SME, constituting 99% of total business set up or establishments in the country. SMEs contribute about 31% of the nation's Gross Domestic Products (GDP) and its share to total workforce and exports of the country are 56% and 19% respectively. However, contribution of SMEs to GDP and export is still considered low as compared to other developed nations as reflected in Figure 1.1. The government target is to raise the SMEs contribution to GDP and exports to 37% and 22% respectively in 2010. Since SMEs are major contributor to Malaysian economy, the development of SME has been made the national priority. To be more competitive and globally inspired SME, the government has laid down its commitment in the medium and long term development policies in the New Economic Model and Tenth Malaysian Plan.

Figure 1.1

SME Contribution to GDP in Selected Countries (% share)



Source: SME agencies from various countries (SME Annual Report 2009.2010)

87% of SMEs in Malaysia are in the services sector like wholesale, retail, hotels and restaurants, 7% in the manufacturing sector like textile, apparels, metal products and food & beverages and 6% in the agriculture sector like crop plantation, horticulture and fishing.

1.3 Analysis on SME Performance in Malaysia

Based on time series data from Department of Statistics Malaysia (DOSM) on GDP at 2000 prices, noted that growth of SME in the initial years of the decade is a reflection of the overall economy. From 2004, value added growth of SMEs have continuously over performed the overall GDP growth. SME Annual Report 2009/2010 highlighted that the main reason for improved in GDP trends for SME is attributed to the government policies. In 2004, SME policy was announced as national priority with the establishment of the National SME Development Council (NSDC). In addition, SME Development Framework was established to coordinate various Ministries and Agencies in all sectors. There are also other supportive policies for the SMEs like Special Task Force to Facilitate Business (PEMUDAH), Visit Malaysia Year 2007 and Ninth Malaysia Plan (9MP).

Figure 1.2:

Value Added Growth of SMEs versus Overall GDP Growth, Annual Change in % (constant 2000 prices)

Source: Department of Statistics, Malaysia

From the above chart, noted that value added growth of SMEs increased to the highest of 10% in 2007 before reducing to 6% in 2008 and subsequently contracting by 0.4% in 2009 due to global financial crisis. The average annual growth rate of SMEs in the period 2006 to 2009 was 5.7%

above the average growth of the overall economy of 3.8%. SMEs continued to record a better performance than the overall economy despite the economic slowdown. Based on sectorial review, time series data from DOSM (2000-2009) show a strong correlation between the performance of value added growth of SMEs and the value added growth of the services sector due high concentration of SMEs in that sector.

1.4 Definition of SME in Malaysia

Malaysian SMEs can be grouped into three categories i.e. micro, small and medium. The groupings are decided based on either the number of people a business employs or on the total sales or revenue generated by a business in a year as shown in the following table :-

Table 1.1

Definition of SMEs in Malaysia

a) Annual Sales Turnover :

Size	Manufacturing (including agro based) & Manufacturing-related services	Primary Agriculture	Services Sector (including ICT)
Micro	Less than RM 250,000	Less than RM 200,000	Less than RM 200,000
Small	Between RM 250,000 and less than RM 10 million	Between RM 200,000 and less than RM 1 million	Between RM 200,000 and less than RM 1 million
Medium	Between RM 10 million and RM 25 million	Between RM 1 million and RM 5 million	Between RM 1 million and RM 5 million

b) Number of Full Time Employees:

Size	Manufacturing (including agro based) & Manufacturing-related services	Primary Agriculture	Services Sector (including ICT)
Micro	Less than 5 employees	Less than 5 employees	Less than 5 employees
Small	Between 5 and 50 employees	Between 5 and 19 employees	Between 5 and 19 employees
Medium	Between 51 and 150 employees	Between 20 and 50 employees	Between 20 and 50 employees

Source: Bank Negara Malaysia

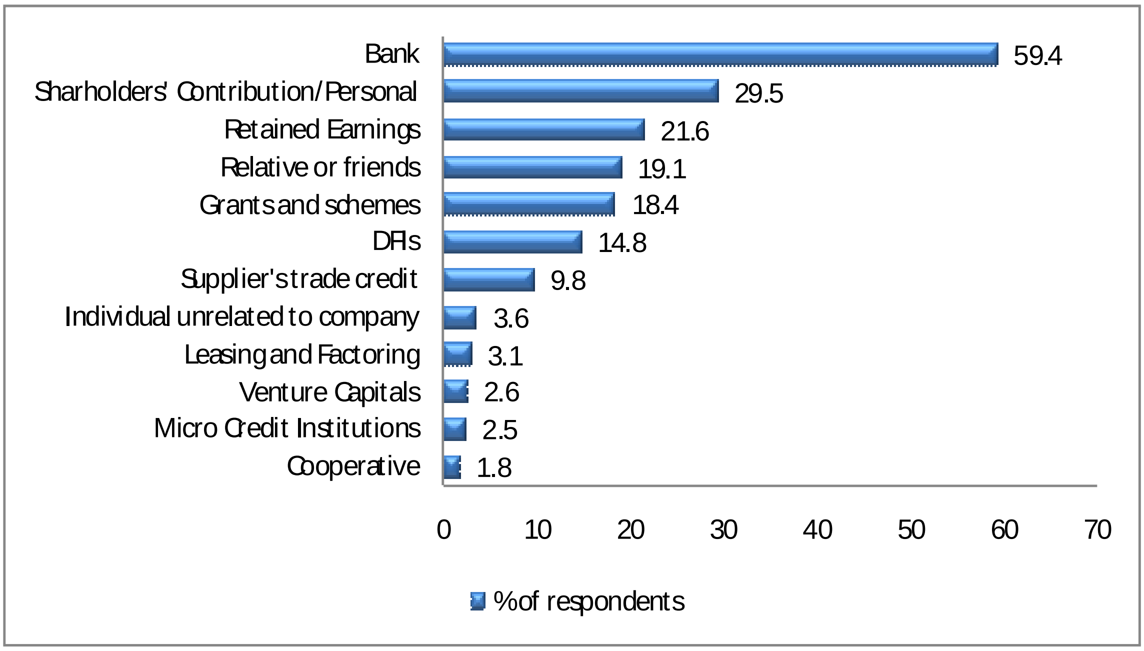
1.5 Sources of SME Financing

Sources of SME financing are various. SMEs rely mostly on internal savings, retained earnings, borrowing from families, friends and money lenders (informal sector) and financial sector (banks, capital markets, venture capitalists). For startup companies, the rate of financing from financial sector is even lower. For example, 12% of SMEs in Indonesia had access to bank financing while in Singapore between 20-25%. In Malaysia, 47.3% of SMEs had access to bank funds compared to 32.4% that relied on internal funds and 11% from family and friends (RAM Consultancy Services Sdn Bhd, July 2005). Despite the low penetration, financing by financial sector, forms the most vital source of external financing for SMEs. This is attributed by the dominance of the banking sector as the main financial intermediaries in the financial system.

Recent Survey by SME Corp Malaysia conducted in April/May 2010 (SME Annual Report 2009/2010) highlighted that SMEs mainly dependent on external sources of financing especially from banks and development financial institutions (74%) , owners' fund (30%), retained earnings (22%), borrowings from relatives or friends (19%) and grants as per Chart below:-

Figure 1.3

Sources of Financing



Source: SME Annual Report 2009/2010

1.6 Bank's Lending Practices in determining financing for SMEs

Based on RAM Report, 2005, most banks in Malaysia have specialized or dedicated SME lending units which are wholly devoted to lending to SMEs. Lending to the SMEs is guided and administer by the government through government agencies like Credit Guarantee Corporation (CGC) and Bank Negara Malaysia.

The report suggested that factors in influencing the overall bank lending directions to SMEs includes industry sector, collateral, bankable business plan and financial statements, experience and track record of the firm/owner and information on the SMEs. Banks usually target or avoid industries based on the current economic performance and its own credit policies. Most banks prefer manufacturing, trading and construction and more adverse towards high risk financing like shipbuilding.

From the report, it is noted that banks are still demanding collateral from SMEs as they are not willing to finance SMEs on a clean basis compared to large corporate. In Malaysia, 73% of SME loans were secured as opposed to 37% for large loans in 2004. Most common types of collateral for SME loan are plant and property (49%); cash (30%), debtors (20%) and home mortgage (1%). Collateral requirements is a priority for SME financing as banks perceive SME loans as high risks due to lack of capital, skills and professionalism, poor transparency and limited market access. Additionally collateral is required to avoid legal barriers in doing loan recovery. The report further suggested that to compensate for higher risks, banks in turn charge higher margins/interest rates in comparison to corporate customers.

Meanwhile, financial statements, business plan and bank statements are required in evaluating SME loans (RAM, 2005). Absence of such documents will not attract rejections but will result in conditional approvals. Other pertinent documents for processing include proof of income, ownership, contracts as well as payment habits. Preliminary checks will be done on SME in order to note that they are bankable in the first place. Banks also rely on other informal checking with other banks as well as using central database maintained officially or by private providers for verification.

It is further noted in the report that most bank officers will pursue large corporate loans as their main clients since large loans will enable the banks to grow faster in terms of market size and profitability. SME loans are seen as less attractive as the cost and time for processing the loans are similar with large loans. As per actual lending practices, bank officers are not only concern with personal incentives and profitability to the bank but are also apprehensive on making bad loans.

Financial information on SMEs for the purpose of granting financing is significant because banks rely on such information to analyze the credit worthiness of potential SMEs, price the loans as well as manage the SMEs portfolio. In Malaysia, Bank Negara Malaysia, established the Credit Bureau in 1982 to collect credit information on borrowers and provide the information to lenders (RAM, 2005). Credit Bureau obtained information from most financial institutions in Malaysia and gathers credit information on borrowings of private individuals and businesses that have borrowings with banks**. "**In 2001 the Central Credit Reference Information System (CCRIS) was established by the central bank to provide a comprehensive credit database of all borrowers in the banking system." (RAM, 2005).

Credit reports from the computerized database are available to the financial institutions at any time. The report highlighted that private company like CTOS Sdn Bhd also provides information on borrower by undertaking bankruptcy checks on businesses and individuals. Other available sources of information reported include the Companies Commission of Malaysia (CCM) and the Federation of Malaysian Manufacturers (FMM).

1.7 Government Programs for SMEs

The Malaysian government has initiated and implemented various commercial credit programs which include subsidies, credit guarantees, insurance schemes, loan quotas and export financing. These programs are delivered to the SMEs via financial sectors, non-bank institutions like cooperatives and associations linked to the government and its agencies. The government also provides direct intervention via grants, tax breaks and creation of business development services to promote the SME's competitiveness and skills. In 2009, 162 SME development programs were implemented with a financial expenditure of RM 3.05 billion which benefited 600,000 SME nationwide (SME Annual Report 2009/2010). Further the government has given financial commitment of RM 6.9 billion whereby 267 programs are under implementation in 2010. In order to become a high income and knowledge-based nation as highlighted in the New Economic Model, the Malaysian government felt that the roles of SMEs are very important

1.8 Research Problems

Even though the banking sector form the largest and most significant role in sourcing for external financing for the SMEs, the banking sector is perceived as not sufficiently servicing the SMEs. SMEs are constrained in terms of access to financing due to its size and financial strength**.** Thus SMEs do not have the bargaining power to demand or negotiate for competitive rates and terms of their loans**.** Even though financial institutions offer wide range of financial tools and instruments, these tools are limited and do not depend on the credit worthiness of the SMEs**.** This resulted in reliance of internal funds like accumulation of retained earnings which is a slow process to grow the business. Firms require continuation of funding as they move from start up to eventually large corporations.

Improving bank's attitude towards financing the SMEs are necessary as offering diverse range of financing instruments and tools to meet the financing needs of SMEs at each growth stage are important. Shortage of financing could impair SMEs' competitiveness and growth. The studies and empirical evidences on finance consistently highlighted that inadequacies in access to finance are key obstacles to SME growth. Beck, Demirguc-Kunt and Maksimovic (2004, 2005 and 2006) and others show that SMEs find assessing financing more difficult than larger firms.

1.9 Research Objectives and Research Questions

The main purpose of this study is to increase our understanding of the relationship between the bank's attitude and access to financing by the SMEs in Malaysia. Besides, the study also considers the effect of lending technologies and government initiatives towards bank's attitude in assessing SME financing. Therefore, this study attempts to discuss the following:

Research Question	**HOW DO BANK'S ASSESS SME'S BEFORE PROVIDING FINANCING FACILITIES**
Objective/Aim	**To discover factors influencing banks' assessment prior to financing SME'S**
Objectives (Sub-research questions)	***1. What are the banking rules and practices in determining bank's decision prior to financing SME's?*** ***2. Does documentation process affect approval for SME's financing?*** ***3. Do lending technologies affect bank's attitude towards financing the SMEs?*** ***4. Do lending technologies support the problems of opaque SMEs and their creditworthiness?*** ***5. Are government funded and support schemes successful in improving access to SME financing?*** ***6. Do government initiatives increase approval rates and growth in SME portfolio?***

1.10 Significance of the Study

Access to financing is an important aspect in the business operations of SMEs. SMEs on the other hand, are the engine of growth for the country. It is pertinent to alleviate the growth constraints of the SMEs by providing sufficient support in terms of funding and financing schemes. Shortages of financing and poor implementation of funding program will directly impair SMEs competitiveness in terms of business opportunities. SMEs need working capital and external funds to expand production and capacity. Failure to expand production capacity will result in limitation of SMEs to grow. Persistent dependency on informal financing will be costly for SMEs in the long run.

On the other hand, banks treat SME similar to large corporate in terms of assessments and standards of compliance. SME would fail to meet the expected standard of banks as it is actually the standard of large corporate borrowers. Thus banks perceive SMEs as riskier than large corporate and subsequently require additional safeguards in the form of collateral, higher interest rates and more documentation. It is significant that banks examine the financing processes in order to treat SME as a distinct business segment in order to reap the profitability from this sectors and its potential.

1.11 Scope of Study

The study investigates the significance of bank's attitude and practices on the access to financing for the SMEs. For the purpose of this study, the fieldwork was conducted by interviewing a number of financial institutions from the private sector. The fieldwork included interviews with several officers with different ranks. Survey questionnaire were also distributed to cater to mostly local financial institutions. The study will emphasizes on the practices and attitude by the private banking sector because rationally private banking sectors are more concerned on creditworthiness of SMEs.

1.12 Organization of Report

The report consists of five chapters which are organized as below:

Chapter 1: The introduction chapter comprised the overview of SME in Malaysia, the overall bank practices in assessing SME loans, the research problem and the purpose of the study. This chapter also presents the significance and the scope of the study.

Chapter 2: The chapter review previous literature and articles that support the study relates to SME access to bank financing. The chapter starts with literature review on the importance of SMEs and their constraints in accessing bank financing. Finally the literature review also touches on the lending technologies and the role of government in supporting the SMEs.

Chapter 3: This chapter discussed the research methodology employed in the study. This research employs a mixed methods sequential explanatory design approach. It consists of two phases i.e. quantitative then followed by qualitative. In this research, we first distributed structured questionnaires to the lending officers. We then collected and analyzed the quantitative data. The qualitative data are collected and analyzed in the next sequence of phase in order to explain and elaborate the quantitative results obtained in the first phase. It is to be noted that the first quantitative data and the second qualitative data are connected in the study because the quantitative data provide the general understanding of the research problem whilst the qualitative data refine and explain those statistical results by exploring the participants view in more detail.

Chapter 4: This chapter documents the empirical results and discusses all the findings of this study. First of all, the results and analysis will be presented based on research questions identified. Summary of the results will be presented at the last of this chapter.

Chapter 5: The final chapter presents the conclusion and summary of this research. Then, limitation of the study is presented. Subsequently, suggestions for further research and implications are discussed. Finally, this chapter ends with recommendation to improve the bank's attitude.

1.13 Conclusion

The first chapter discussed the introduction of the study. The introduction covers the research problem, research objectives, research questions, significance of the study and scope of the study. Lastly, the chapter presents the structure or organizations of the remaining chapters in this study. In the following chapter, the literature related to the SME access to bank financing is reviewed.