SECTION 1: The relevant background of SME Bank and CGS

The History and Current Situation of SME Bank (source: www.smebank.com.my*)*

The Bank was previously known as Bank Industri dan Infrastruktur Malaysia Berhad was incorporated under the Act on 7 August 1979 as Bank Industri Malaysia Berhad. It later changed its name to Bank Industri & Teknologi Malaysia Berhad on 28 February 2000. SME Bank assumed its present name following the merger with Bank Pembangunan & Infrastruktur Malaysia Berhad on 1 October 2005. SME Bank is a development financial institution whose function is to nurture and meet the unique needs of SMEs.

As a one-stop financial centre responding to the funding and business growth needs of Malaysian SMEs, the Bank complements existing products and services offered by commercial banks through a comprehensive and integrated financial and business advisory services. It is a wholly owned subsidiary of Bank Pembangunan Malaysia Berhad.

SME Bank has an authorised share capital of RM1 billion comprising 1 billion ordinary shares of RM1.00 each, of which approximately RM770.45 million comprising approximately 770.45 million shares have been issued and fully paid-up as at 31 October 2005.

The SME Bank is dedicated to the accelerated growth of Malaysian SMEs and designed to function ultimately as a one-stop financing and business development centre. Through better segmentation of SME financial and non-financial needs by industry, stage of growth and product and market potential, the Bank will strive to hasten the loan processing of eligible SMEs to meet their financing needs as well as support their business growth requirements through the provision of timely advisory services.

The principal activities of the Bank are to provide financing as well as financial and business advisory services to Malaysian SMEs residing within predefined categories, which have been framed within the SME classification guidelines of the National SME Development Council.

Its vision is to become the SME Hub by 2010 with the unique capability to evaluate, promote and grow Malaysian SMEs with a focus on the development of the Bumiputera Commercial and Industrial Community (BCIC) in line with the Government's aspirations. The management and employees of the Bank will collaborate with its network of strategic partners/providers to focus on becoming the centre of knowledge and expertise on the financing and growth needs of Malaysian SMEs in achieving its mission as the SME Hub.

SME Bank has list down its core values as follows:

- Efficiency – To meet customer expectations in a fast, creative, timely manner, responsible and accountable towards actions, decisions and signatures.

- Professional -To serve customers competently, ethically with integrity and honesty at all times.

- Fairness - Fair exchange in the fulfilment and delivery of expectations.

- Transparent - Openly share and communicate relevant information on policies and process.

The Credit Guarantee Scheme at SME Bank

The main objective of the Credit Guarantee Scheme is to enable SME Bank to offer the Trade Finance and Overdraft facilities that are not available at the Bank to the customers. This is a part of the plan towards SME Bank to be the SME Hub, whereby the ability to provide further variety of banking products to its customers. The conceptual and Implementation Plan of the Scheme has been approved by the Management of the Bank on 31 March 2006.

The Scheme was firstly made known to the public in November 2006, whereby the Bank has entered a Master Agreement with CIMB Bank (also known as the Participating Financial Institution). The Participating Financial Institution shall grant the facilities and disbursed funds to the customers against the Guarantee provided by SME Bank. The Bank will issue the Letter of Guarantee to the Participating Financial Institution and assume the credit risk. The Participating Financial Institution will disburse and manage their facilities in accordance to their normal banking practice and assumes the operational risks. SME Bank will perform the credit evaluation and consideration before the approval to Scheme is granted.

<u>The Benefits of Credit Guarantee Scheme</u> (source: www.smebank.com.my*)*

These are few of the advantages of Credit Guarantee Scheme at SME Bank, namely:

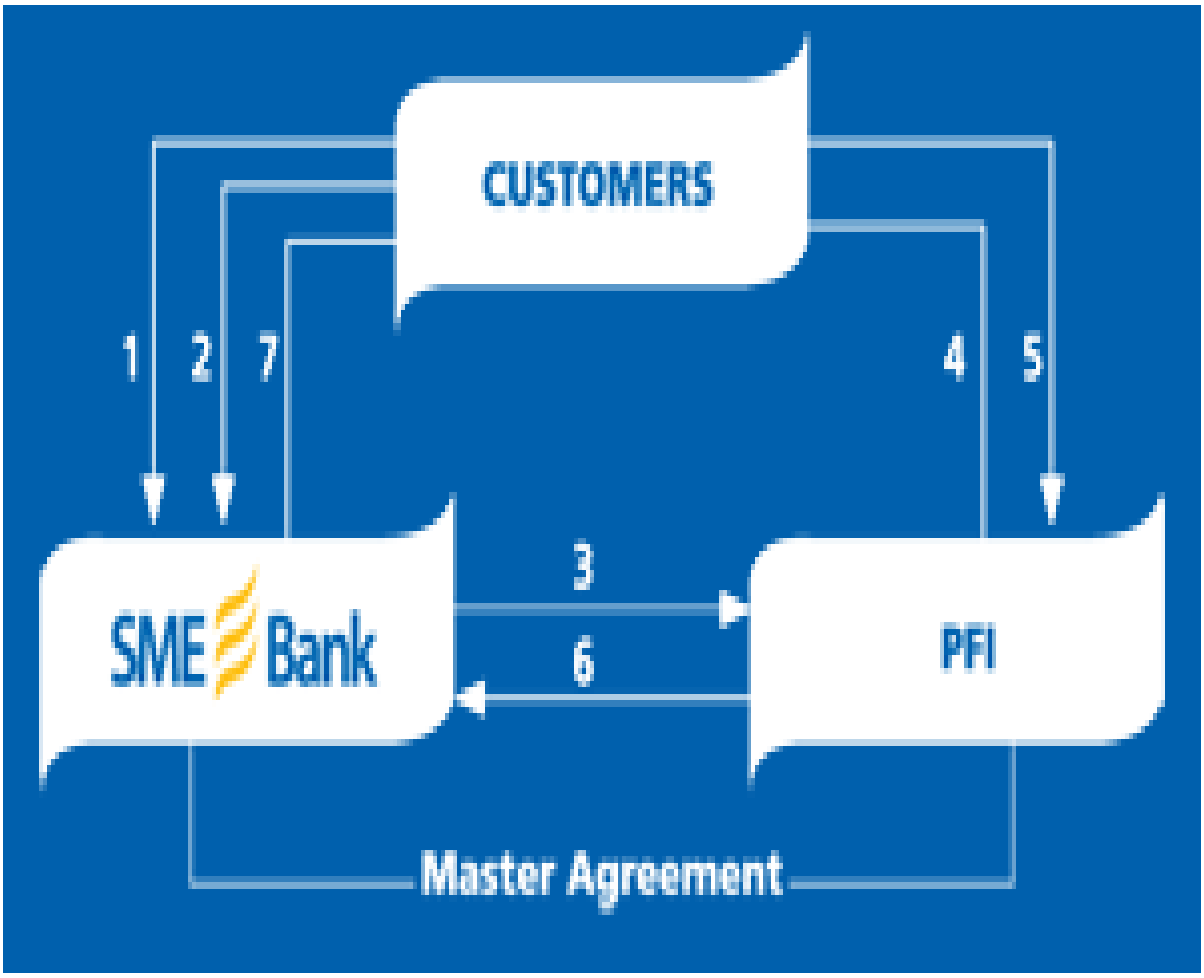
- As a 'SME HUB', SME Bank is now able to offer a complete range of banking products that caters to customer's business needs.
- Capitalizing on commercial bank infrastructure through its product expertise, human resource and banking network.
- Ease funding issue
- Capitalizing 'Multiplier Effect' of guarantee mechanism
- 'Win-win' situation between Participating Financial Institution and Customers
- Availability of SME Bank potential customers with good track record for Participating Financial Institution
- Enhancement of customers business credit capability with the complete products offered by SME Bank and Participating Financial Institution

The Mechanism of Credit Guarantee Scheme (source: www.smebank.com.my)

The Credit Guarantee Scheme at SME Bank is the collaboration between the Bank with the Commercial Bank. The guarantee will act as the mechanism between SME Bank and the Participating Financial Institution. SME Bank will be issued a Letter of Guarantee to Participating Financial Institution for customers guaranteed facilities.

The diagram below illustrates this relationship.

Relationship A Tripartite Arrangement between SME Bank, Participating Financial Institutions & Customers



1 Apply financing

2 Process & approval

3 Issue notification letter and Guarantee letter

4 Disbursement

5 Repayment

6 Claim & Settlement / Subrogation

7 Follow up & Recovery

The Eligibility Criteria for this scheme are as follows:

- Existing customers with satisfactory payment track record
- All registered Malaysia controlled SMEs with at least 51% Malaysian Shareholding. (sole proprietorship, partnership and private limited companies)
- Small and Medium SMEs, Micro SMEs are not eligible
- Customer with credit rating between 1-5
- Sectors/ Activities cover Manufacturing & manufacturing related activities, Services - Information Communication Technology, Construction, Tourism and Other sectors determined by SME Bank from time to time. For Syariah Facilities, the activities must be Syariah compliance

The Guaranteed Facilities (Conventional and Syariah) is between RM 100,000 to RM 1 million, and margin of financing is maximum of 90% of the working capital costs requirement, subject to current single customer limit. The Financing (principal/ purchase price, profit, penalty/ compensation of late payment and other charges per banking practice) is covered 100% by the Credit Guarantee Scheme and the duration of the facilities extension up to 3 years, case-by-case basis.

Justification for the selection of the Credit Guarantee Scheme and SME Bank

SME Bank is specialising in providing advising services and financing to the Small and Medium Sized Businesses in the country. These companies are not as strong as the established large corporations that could easily get financing from any Financial Institutions. Most of the Small and Medium Sized Companies do not have the ability to provide collateral for them to get financing from the commercial banks. Therefore, SME Bank has taken the effort to introduce the Credit Guarantee Scheme that is expected to provide the solution and fill up this gap.

The Credit Guarantee Scheme is developed due to the followings:

- Small and Medium Sized Industries are in demand for variety of financing product, in which the SME Bank has a limitation to fulfil all of its customers' needs.
- SME Bank as a one-stop centre for financing and advisory for Small and Medium Sized Industries.
- As a compliment with Credit Guarantee Corporation Malaysia whose main objective is to provide guarantees to Small and Medium Sized Businesses who lack in collateral to secure trade lines from the commercial bank.
- The banking network also becomes a factor in meeting this requirement since some of its customers are located in remote areas.

Purpose of Credit Guarantee Scheme

Credit guarantees are advocated for many developing countries as a means to entice reluctant lenders into lending to clientele groups of interest to governments and donors, such as agriculture, small farmers, women, microenterprises, and the poor. It is usually assumed that a major impediment to formal sector lending is the perceived risk associated with such loans. By reducing default risk through a guarantee, it is expected that lenders will make more loans to credit rationed clients. By offering partial guarantees, more borrowers are benefitted than would occur if the same funds were used to rediscount targeted loans. Furthermore, it is expected that the lenders will learn that these clientele groups are not so risky, so they will lend to them in the future without the need for guarantees. (Meyer and Nagarajan (1996))

Guarantee programs are funded in several ways. An external source often provides the initial capital for the guarantee fund. Recent innovations, based on the concept of mutual credit associations, use group-based savings deposited in a bank account to guarantee loans made to group members. Donors and NGOs may complement these local savings with a second tier guarantee to leverage the funds lent. Women's World Banking, for example, deposits funds in local banks to leverage the funds deposited by local WWB affiliates for use as loan guarantees. (Meyer and Nagarajan (1996))

In view of the growing interest in micro finance, small enterprises with growth potential, as opposed to microenterprises, may be missing out on donor credit programmes. Credit guarantee schemes can be seen as filling this gap, since they are aimed at the SME sector, and are intended to help banks learn about lending to SMEs, while being cushioned from the risks involved. (Levitsky (1997))

One important objective of a Credit Guarantee Scheme is to provide (under conditions of reduced risk) an opportunity for banks to learn more about SMEs, their problems and their operations, to help improve their handling of SME loan portfolios. The lenders will gradually learn how to lend profitably to SMEs without guarantees. Guarantees may help lenders realize that the perceived higher risk of lending to SMEs may not be so real. Banks have never been keen on Credit Guarantee Scheme, fearing increased costs and bureaucracy and governments have had, in some cases, to exert pressure and even threats of penalties for non-participation to get banks to take part. (Levitsky (1997))

Banks and other financing institutions perceive a high risk in lending to entrepreneurial firms. Instead of addressing their higher risk perception by just charging higher, banks respond by rationing lending to entrepreneurial firms (Stiglitz and Wiss, 1981). Entrepreneurial firms are often denied of access to funds because they are unable to come up with collateral. Loan guarantee schemes are designed to help entrepreneurs, without access to own collateral, obtain access to bank loans with the state or a state aided agency acting as a guarantor. Loan guarantee schemes have been implemented in several developed countries including UK, USA, Canada, France and Netherlands. Loan guarantee schemes seek to ensure that good projects are not denied access to finance because of lack of access to collateral. (Roy)

Access to bank loans is particularly difficult for these SMEs because of insufficient collateral. Certain developments in the European financial sector may also increase the difficulty for SMEs to obtain sufficient amounts of bank lending at reasonable interest rates, such as the forthcoming capital adequacy accord (Basel II). The problem of insufficient collateral can be overcome by guarantees given by public or private guarantee or mutual guarantee institutions. (Szabó (2005)

The Basel Committee has published a revised framework agreement that aims to make the international financial system safer by having the riskiness of banks' loan portfolios to be reflected in the capital charges they need to set aside against unexpected losses. The agreement (called "Basel II") sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations. The Basel II framework is an important issue for SMEs and small banks to the extent that it affects bank behaviour and their willingness to lend to SMEs. (Szabó (2005)

Focus of the Study Research

The Credit Guarantee Scheme is relevant to SMEs who have constraint in providing collateral in obtaining financing as highlighted above. Due to this significance, the scheme needs to be operated effectively and efficiently in order to achieve its objective. The study will focus on the problems or issues that are faced by SME Bank on the Credit Guarantee Scheme that are identified during the research. At the end of the research, the author will provide recommendations and suggestions that will assist SME Bank in handling these hindrances.

Problem Statement

An interview has been conducted with the relevant management and personnel in SME Bank to identify area of concerns on the Credit Guarantee Scheme.

The issues are as the following:

- The number and amount of approval under this scheme is reducing, since it was introduced in Year 2006

- The accounts under this scheme have high tendency turning to Non-Performing, whereby this will lead to higher and frequent claims submitted by the Participating Financial Institution.

- The scheme is not able to derive the expected profit, but in fact it is making losses from the huge sum of claims paid.

- The Bank's capacity to issue Letter of Guarantee has been depreciated due to reducing balances available in the Guarantee Fund Account.