THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Improving Small, Micro- and Medium Enterprises' Access to Finance (Paper submitted to the APEC Senior Finance Officials Meeting, 22 June 2011, Washington, DC)

Office of the Advisory Group Chair

PURPOSE	For information.
ISSUE	This is the report submitted to the APEC Senior Finance Officials' Meeting held on 22 June 2011 in Washington DC.
BACKGROUND	The paper was agreed to be submitted to the meeting and was presented by the Advisory Group Coordinator.
PROPOSAL	APEC can help promote SMME finance through capacity building initiatives focused on two essential components: (a) developing properly structured credit information sharing systems and (b) improving legal infrastructure for secured lending. Although APEC is not directly involved in technical discussions on the development of accounting rules and capital regulations, which are under the purview of other bodies, it can underscore important issues at a higher level to help ensure that regulatory reforms are consistent with advancing APEC's inclusive growth agenda, particularly with respect to two key areas: (a) improved accounting rules for treatment of lease financing; and (b) appropriate treatment of trade finance under Basel III.
DECISION POINT	Note the submitted report.

Asia-Pacific Economic Cooperation

ABAC

IMPROVING SMALL, MICRO AND MEDIUM ENTERPRISES' ACCESS TO FINANCE

Small, micro and medium enterprises (SMMEs) form a key component of inclusive growth, playing important roles in the economy and providing employment to the majority of the working population. Using a framework developed by World Bank staff[1] and the outcomes of various surveys and discussions, ABAC has identified certain areas in the information, legal and regulatory environments where reforms could help ensure SMMEs' continued and expanded access to finance.

A recent APEC survey conducted by the Japan Chamber of Commerce and Industry[2] concluded that inadequacies in the information and legal environments are the most serious problems affecting SMME finance, with the former cited by many respondents in developing economies and the latter by respondents in the more advanced economies. Regulatory and tax issues are seen as significant issues in more advanced economies, while the lack of government schemes to support SME finance is seen as a key issue in developing economies.

These findings suggest that regional collaboration to improve the information, legal and regulatory environments in APEC, with active participation of the private sector, could greatly contribute to expanding SMMEs' access to finance. Improvements in transparency and reliability of lien registration and perfection systems can incentivize additional financing for worthy borrowers. Changes in accounting rules and bank capital regulations need to be carefully formulated to avoid unintended consequences that adversely impact SMMEs.

Accordingly, APEC can help promote SMME finance through capacity building initiatives focused on two essential components: (a) developing properly structured credit information sharing systems and (b) improving legal infrastructure for secured lending. Although APEC is not directly involved in technical discussions on the development of accounting rules and capital regulations, which are under the purview of other bodies, it can underscore important issues at a higher level to help ensure that regulatory reforms are consistent with advancing APEC's inclusive growth agenda, particularly with respect to two key areas: (a) improved accounting rules for treatment of lease financing; and (b) appropriate treatment of trade finance under Basel III.

Developing properly structured credit information sharing systems

Credit information sharing systems are key elements of modern financial sector infrastructure. Credit bureaus have assumed a core role within such systems by helping lenders acquire a more

[1] Allen Berger and Gregory Udell, *A More Complete Conceptual Framework for Financing of Small and Medium Enterprises*, World Bank Policy Research Working Paper 3795, December 2005. This framework for analyzing factors that affect the availability of credit to SMEs explains how policies affect the availability of credit, through their impact on lending infrastructure and the structure of the financial industry, and how these two factors determine the feasibility and profitability with which different lending technologies are deployed. The lending infrastructure, which refers to the rules and conditions affecting the ability of these institutions to lend, include (a) the information environment; (b) legal, judicial and bankruptcy environment; (c) social environment; and (d) tax and regulatory environment, including capital regulation and bank supervision. Along with the financial industry structure, the lending infrastructure has a profound impact on lending technologies. Lending technologies refer to the combination of primary information source, screening and underwriting policies and procedures, loan contract structure and monitoring mechanisms. They play a key role, in that they are the conduit through which government policies and financial structures affect the availability of credit to SMEs. Lending technologies can be divided into transactions lending technologies, which are based on hard data, and relationship lending, which is based on soft data. A third category, trade credit, involves both hard data and soft information.

[2] A Survey on Actual SME Business Conditions in the APEC Region, Japan Chamber of Commerce and Industry 2010.

precise knowledge of a borrower's likelihood of repaying. However, the extent to which this result is achieved depends on the structure of credit reporting, bureau ownership and the type of information reported. In this context, distinctions between the following need to be made:

- Negative-only reporting versus full-file reporting. Negative-only reporting is the reporting of only negative data. Full-file reporting is the reporting of both negative and positive data (which may include information on the timeliness of payments, account type, lender, date opened, inquiries, credit utilization rates, credit limits and account balances).
- Segmented versus comprehensive reporting. Segmented reporting is a system in which only data from one sector or a limited number of sectors, e.g., retail or banking, are contained in reports. Comprehensive reporting is a system in which payment and account information contains information from multiple sectors, e.g., utilities payments.
- Public versus private credit bureaus. Public bureaus have been set up largely for supervisory purposes, to monitor the safety and soundness of the financial sector and determine whether reserves are sufficient. Private bureaus, by contrast, are set up to ease lending, and collect data primarily to reduce information asymmetries and improve risk assessment in lending. By this account, private bureaus are complements rather than substitutes to public bureaus.

A number of studies summarized in surveys undertaken by the Political and Economic Research Council (PERC)[3] and in the Advisory Group's report of the APEC Public-Private Sector Forum on the Development of Bond Markets and Financial Inclusion (*see Annex A*) underscore the benefits of credit reporting regimes with full-file and comprehensive reporting to private credit bureaus. Under such regimes, broader-based lending and wider access to capital improve economic growth, growth in the capital stock and productivity, while contributing to lower income inequality.

The development of full-file and comprehensive credit reporting systems requires robust legal and regulatory frameworks governing important procedures, including the type of information that can be collected, the rights of data subjects (access, notification, dispute resolution and redress), acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users. The Organization for Economic Co-operation and Development (OECD) Fair Information Practice Principles provide a useful reference point in developing legal and regulatory framework.

Properly structured credit information sharing systems can be developed by observing key principles: (a) Positive and negative payment data should be reported to private credit bureaus. (b) Bank, non-bank and non-financial payment data should be reported and data should not be segmented by sector. (c) Consumer rights and protections are paramount, as spelled out in the OECD Fair Information Principles. (d) Private credit bureaus and public credit registries are complementary, with private bureaus focused on making lending efficient. (e) Reporting of payment data should be voluntary. (f) Data use should be limited to well-defined permissible purposes.

An APEC initiative could also discuss the regional dimension of credit information systems to support cross-border business activities involving SMMEs. Such discussions could include subjects such as collection of SME data across the region and developing an accurate data base to facilitate securitization of SME loans and strengthen SMMEs' ability to raise funds from capital markets.

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[3] Michael Turner, Robin Varghese and Patrick Walker, *Financial Inclusion through Credit Reporting: Hurdles and Solutions* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), April 2010. See also Michael Turner, Robin Varghese and Patrick Walker, *The Structure of Information Sharing and Credit Access: Lessons for APEC Policy* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), July 2008.

Improving legal infrastructure to promote SMME finance

In general, security enforcement regimes in most APEC jurisdictions are intended to encourage provision of credit to commercial borrowers by recognizing and protecting the expectations of senior-secured lenders and providing legal certainty in the event of borrower insolvency. However, a number of important gaps remain. The absence of clear legal frameworks to enforce rights of secured lenders is an impediment to credit availability, disproportionately affecting SMMEs and other businesses that have historically had difficulty accessing bank credit. Systems for creating and perfecting valid security interests in the first instance are often not exclusive, universal and accessible to prospective lenders. Legal rules often do not clearly contemplate various forms of structured finance that are useful to providing SMMEs with operating liquidity.

Key issues related to the legal infrastructure for secured lending that need to be addressed in various member economies are the following:

- Absence of exclusive security interest registry, giving rise to the "hidden lien" problem
- Voidable conversion/preference
- Unclear perfection rules for certain types of collateral, such as movables, receivables and goodwill
- Absence of blocked account security precedence
- Untested debtor-in-possession process
- Treatment of floating charges or absence of such concepts
- Lack of broad licensing authority for commercial lending.

An APEC initiative to improve and harmonize standards for perfection and enforcement of security interests in collateral, as part of a system for developing a robust commercial finance market, would promote innovative financial products, enhance overall liquidity for the SMME sector, and advance the goal of financial sector inclusion and sustainable growth. In addition to facilitating financing for SMMEs, a harmonized approach would promote regional investment and trade in financial services in the APEC region. Such an initiative could focus on the following activities:

- A survey of key enablers of financing availability
- Developing model elements of an APEC or region-wide code of security interest creation, perfection and enforcement, which could include clear perfection rules, broad coverage of collateral types, exclusivity to eliminate the "hidden lien" problem, and provisions for debtor-in-possession financing.
- A model treatment of floating charges/accounts receivable financing
- Establishment of a public-private dialogue to validate improvements
- An APEC checklist for statutory/regulatory implementation
- Promoting broad licensing authority for commercial finance, such as non-bank financial company charters.

Improved accounting rules for treatment of lease financing

Lease financing is an important component of funding for SMMEs, which generally lack the alternative funding sources normally available to larger corporations through established banking relationships or access to capital markets. It is a significant component of overall liquidity available to businesses. In Japan, for example, the lease market accounted for 8% of all private capital investment in plants and equipment on average between 2005 and 2009, with SMEs comprising almost half of the market.

During this period, however, the Japanese lease market contracted by 38% (from \7.9 trillion to \4.9 trillion) as finance lease transactions were re-characterized as on-balance sheet transactions.

SMEs' total share of the market also went down from 48.7% to 42.7% during this period.[4] This demonstrates the very significant impact that changes in accounting rules can bring.

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) are currently working on new accounting rules for treatment of lease financing that are being proposed to be finalized in 2011. The exposure draft released for public comment in August 2010 contains portions that can potentially have a significant negative impact on the availability of lease financing for SMMEs. Among the concerns expressed by various respondents to the call for public comment on the draft that are particularly shared by ABAC are the following:

- Proposed new rules would artificially expand balance sheets of lessees by requiring the capitalization of options and contingent rentals, which will inflate gearing ratios without any actual increase in assets or liabilities.
- Front-end loading of lease expenses, even as the underlying financial positions of lessees remain unchanged, would lead to impairment of financial ratios, an increase in loan covenant breaches and higher cost and reduced availability of lease financing.
- Current proposals also take little account of circumstances in many economies in the region, particularly in Asia, where commercial property lease terms are generally much shorter and renewal options do not create financial obligations until exercised.
- Implementation of the proposed standard is likely to be costly and cumbersome.

The IASB and FASB, at their joint meeting in London in February, acknowledged the large volume of comments generated by the proposal, and the many concerns raised. They have expressed openness to address some of these concerns, including those related to accounting for lease renewals and acknowledging other types of leases besides finance leases, and are undertaking continued efforts to reach out to the business community. While no forum in APEC is presently constituted to provide detailed financial accounting input at a technical level to the changes being considered by standard setters, it would be appropriate for APEC to underscore that sufficient time must be allowed for an economic impact analysis of how proposed new accounting rules for treatment of lease financing would affect credit availability, especially for SMMEs, and for appropriate revisions to be made before the rules are finally adopted.

Appropriate treatment of trade finance under Basel III

Changes in supply and pricing of trade finance have considerable impact on SMMEs, which typically have limited trading and credit history and are generally considered to involve higher counterparty risks compared to large corporations. Trade finance has historically been considered a low-risk operation, with the underlying presence of willing buyers and sellers suggesting high completion rates for transactions, fixed short-term maturities of products and the practice of liquidating exposures by cash upon maturity. Data recently collected and analyzed by the International Chamber of Commerce (ICC) confirm the low risk profile of trade finance, pointing to the short tenor of trade transactions, low default rates across all product types, relatively few defaults through the recent economic downturn, good recovery rates for all product types and limited credit conversion from off- to on-balance sheet.[5]

This low risk profile has not been reflected in the capital requirements for trade finance transactions that were introduced under the Basel II framework, as little empirical evidence has

[4] Data provided by the Japan Leasing Association.

[5] International Chamber of Commerce Commission on Banking Technique and Practice, *Report on findings of ICC-ADB Register on Trade & Finance: Statistical analysis of risk profile of trade finance products* [Document No. 470/1147 (Rev) – 21 September 2010].

been available to convince regulators. New rules being introduced under Basel III are likely to exacerbate the situation and induce banks to reallocate more capital away from trade financing, thus reducing supply and driving up prices. Among the relevant features of Basel II and Basel III are the following:[6]

- Current rules treat trade finance transactions similarly as longer-term, higher-risk types of corporate lending such as project finance, derivatives and term loans, even as trade finance transactions have lower default rates and higher rates of recovery in cases of default, which reflects businesses' preference to keep trade finance facilities available to continue generating cash flow.

- Current rules allow domestic regulators to require a minimum tenor of 1 year, and most regulators have opted to implement this minimum tenor. However, the average tenor of trade transactions is only 90-115 days.[7] With capital reserves required for such transactions being the same as those for 1-year import letters of credit, businesses face unnecessarily higher prices and reduced availability of trade financing.

- Basel III introduces a leverage ratio that limits the amount of banks' off-balance sheet exposures in high-risk products such as derivatives. This requires a 100% leverage conversion for letters of credit and guarantees, which are also classified under accounting standards as off-balance sheet items, although such low-risk products deserve much lower leverage ratios.[8]

- Industry conversion estimates for determining capital requirements do not take sufficiently into account the diversity of financial institutions with widely varying sets and levels of risk arising from geographical scope of operations, customer and loan portfolios and loss recovery experience. Capital buffers based on such conversion estimates, which do not necessarily apply in various markets, raise the prices of letters of credit and guarantees.

- Basel III allows domestic regulators to set the required stable funding ratio that is applied when off-balance sheet trade finance exposures like letters of credit and guarantees convert into actual funding requirements when called upon by beneficiaries. This is likely to result in high ratios (e.g., 100%) being applied by regulators given a natural inclination to conservatism. It also leads to a complex variety of ratios across jurisdictions that global businesses will need to deal with, adding to the factors that hinder international trade.

Various proposals from the private sector have been made that, together with others, regulators could consider to address these issues. These include, for example, a separate risk weighting for trade finance vis-a-vis longer term and higher risk forms of corporate lending; computing risk weights based on actual tenor with no minimum; the use of credible industry data for setting leverage conversion ratio; developing an option for banks to determine capital requirements based on their own conversion estimates; and stipulating liquidity requirements for off-balance sheet trade finance based on the probability of conversion of off-balance to on-balance sheet exposure to harmonize treatment of global transactions.

With implementation of Basel III being seen increasing the price of trade finance by as much as 40% and reducing capacity by around 6%, adjustments are needed to avoid unintended consequences that unnecessarily restrict access to finance of SMMEs that APEC is encouraging to become more engaged in international trade. APEC Finance Ministers can encourage banking

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[6] International Chamber of Commerce Banking Comission, *Basel III Impact on Transaction Banking* [Presentation to ABAC by Mr. Tan Kah Chye, Chair, ICC Commission on Banking Technique & Practices, Yokohama, 3 November 2010].

[7] Data from ICC-ADB Register on Trade and Finance.

[8] ICC-ADB data suggest ratios of 14%-50% as appropriate for trade products.

regulators and the Basel Committee to work with the private sector in making appropriate refinements to Basel rules on capital, leverage and liquidity that recognize the low-risk nature of trade finance.

Suggested recommendations:

Regional collaboration with active private sector participation can help expand SMMEs' access to finance. ABAC recommends capacity building activities with two essential components: (a) the development of credit information sharing systems based on full-file and comprehensive reporting supported by robust policy frameworks governing obligations of credit bureaus, data furnishers and data users; and (b) a regionally harmonized approach to addressing the lack of clear legal frameworks governing rights of secured lenders and various forms of structured finance that can provide SMMEs with operating liquidity.

ABAC also recommends that APEC Finance Ministers underscore the need for financial sector standard setters and regulators to address unintended consequences of regulatory reforms affecting SMMEs' access to finance. In particular, they could encourage: (a) the IASB and FASB to allow sufficient time for an impact analysis of new accounting rules for treatment of lease financing before appropriate revisions are made; and (b) banking regulators and the Basel Committee to consider appropriate refinements to Basel rules on capital, leverage and liquidity that recognize the low-risk nature of trade finance.