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ADB Working Paper Series

**Commercial Bank Innovations in
Small and Medium-Sized Enterprise
Finance: Global Models and
Implications for Thailand**

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Abstract

In Thailand, the government has long recognized the importance of small and medium-sized enterprises (SMEs) to the economy and has given a large amount of financial support to this sector. Still, SMEs are not able to catch up with larger enterprises and the constraints to SME financing remain the main topic of policy discussion today. Against this background, the important issue for Thailand may not be about the lack of financial assistance per se but about how to design an appropriate market-friendly business model and supporting scheme to help SMEs gain access to credit on a sustainable basis. Given the success of microfinance around the world, a large number of commercial banks have made a profitable business out of this sector. This paper explores various business models by commercial banks in microfinance and provides policy implications for Thailand. By making use of commercial banks' competitive advantage, Thailand can create a more market-friendly environment for SME financing. This will also ensure that lending to small-business clients is not a burden to the government and is self-sustaining in the long run.

JEL Classification: G21, E50

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1. INTRODUCTION

Small and medium-sized enterprises (SMEs) play a central role in enhancing economic dynamism and employment opportunities in Thailand. Development of this sector has, therefore, been widely acknowledged as a crucial strategy for growth. Compared with large enterprises, which have many financial channels including capital markets, SMEs depend primarily on bank loans to finance their business operations. However, one of the main obstacles for SMEs remains the lack of adequate access to financial services (Ayyagari, Demirgüç-Kunt, and Maksimovic 2006).¹ SMEs, especially small enterprises, usually have difficulties in obtaining finance, and hence are prevented from contributing fully to economic development.

In countries around the world, including Thailand, the lack of bank financing to small enterprises is often regarded as one of the reasons for income distribution problems and poor economic performance. Past studies have also shown that financial access helps generate more new firms, which are generally vibrant and creative (Demirgüç-Kunt, Beck, and Honohan 2008). For these reasons, policies to promote inclusive finance should be prioritized as one of the most important economic development policies.

This paper focuses primarily on bank financing of SMEs and discusses possible strategies for banks to enter this market. It analyzes cross-country experience in bank downscaling² strategies and discusses the recent status of the SME financing environment in Thailand. It then provides policy suggestions to enhance SME financial access in Thailand. The study is divided into five sections. Section 2 reviews the literature and some previous empirical work. Section 3 analyzes cross-country experiences with banking business models and discusses lessons learned. Section 4 outlines the SME landscape and its financing environment in Thailand. Section 5 concludes with policy recommendations.

2. LITERATURE REVIEW

Small business formation and growth are impacted significantly by imperfections in bank credit markets. Small firms are different from larger firms because they have information constraints. Their businesses tend to be more informal and have inadequate business planning. As a result, they do not have enough information available for lenders to evaluate their performance and business potential (Berger, Klapper, and Udell 2001). Past research has shown the importance of developing relationships with banks for small business. Petersen and Rajan (1994) found that a relationship with an institutional lender increases the availability of financing to a small business. Berger and Udell (1995) found that lenders offered lower rates to firms with longer relationships and were less likely to require collateral.

There are generally two primary methods of bank lending. The first is transaction lending, which is used mostly by private commercial banks and relies mainly on quantitative data to screen loan applications. These data include information on financial status, collateral, credit history, etc. The other approach is relationship lending, which relies mostly on qualitative data collected on clients over the period of

¹ "Adequate financial access" is defined as the ability to gain access to external funding as needed at a reasonable price.

² The term "downscaling" in this paper refers to banks that have traditionally served larger clients but now make loans to microenterprises.

their relationship with loan officers. This lending approach is used for clients who may not have adequate quantitative information, such as credit history or financial statements, to be approved for loans (Berger and Udell 2004). The main drawback of this lending approach is that knowledge and information about customers are more difficult to transfer than those in transaction lending.

Lenders who lend to small borrowers tend to use the relationship lending approach. This is typical in microfinance institutions (MFIs), which play a primary role in the microfinance industry. Microfinance provides access to finance for poorer households and small businesses lacking opportunities to obtain financial services from traditional banks, and the transaction size is small. MFIs generally use relationship lending to alleviate problems of asymmetric information between bank lenders and borrowers, which gives rise to credit rationing and higher interest rates for small businesses. In this case, interest rates often cannot be used as a screening mechanism for selecting creditworthy borrowers because information asymmetries leave lenders vulnerable to adverse selection and moral hazard problems (Stiglitz and Weiss 1981). Good borrowers may not be able to obtain credit from banks because the costs of evaluating the creditworthiness of a small business are typically high compared with the risk-adjusted return to the lender.

Microfinance used to be the exclusive preserve of nongovernment organizations, cooperatives, and MFIs while commercial banks were new players in microfinance (Baydas, Graham, and Valenzuela 1998). Given the success of microfinance around the world, a large number of commercial banks have made a profitable business out of this sector. With rising competition in the traditional bank business and growing pressure from some governments, commercial banks have become interested in microfinance. Some could make profits lending to small businesses and micro clients, but some could not. The main factors for failure are often the lack of adequate understanding of the microfinance market as well as high operating costs. Some banks, however, have managed to find profitable business opportunities by downscaling to this new market, achieving both social and financial objectives.

3. CHARACTERIZING COMMERCIAL BANK ENTRY STRATEGIES AND EXPERIENCES

Efforts to develop financial services for SMEs have been growing and have evolved considerably for the past few decades. In response to a growing understanding of the financial needs of SMEs, there has been a shift toward commercializing these efforts through formal financial services. This section builds on previous empirical evidence of bank microfinance strategies in various countries. It discusses cases of successful bank financing models and attempts to draw some lessons from such experiences. While there are many ways in which banks become engaged in small business lending, previous empirical works have classified the strategies that banks normally use to enter the microfinance market into two main categories: direct and indirect. The direct approach is when banks set up internal units within the banks to serve SMEs or establish separate companies to deal with this market. The indirect approach is when commercial banks enter into an SME segment by working with existing MFIs (Isern and Porteous 2005; Sinswat and Subhanij 2010; Bounouala and Rihane 2014).

3.1 Direct Approach: Bank Downscaling

As discussed earlier, downscaling refers to the engagement of commercial banks in microfinance by expanding their product offering to low-income households and small enterprises (World Bank 2013). Some banks reach out to their small clients using their existing operations. Some banks choose to set up a separate internal unit or create a separate company. We can further classify four main types of strategies that banks use to serve small clients directly:

3.1.1 Internal Microfinance Unit

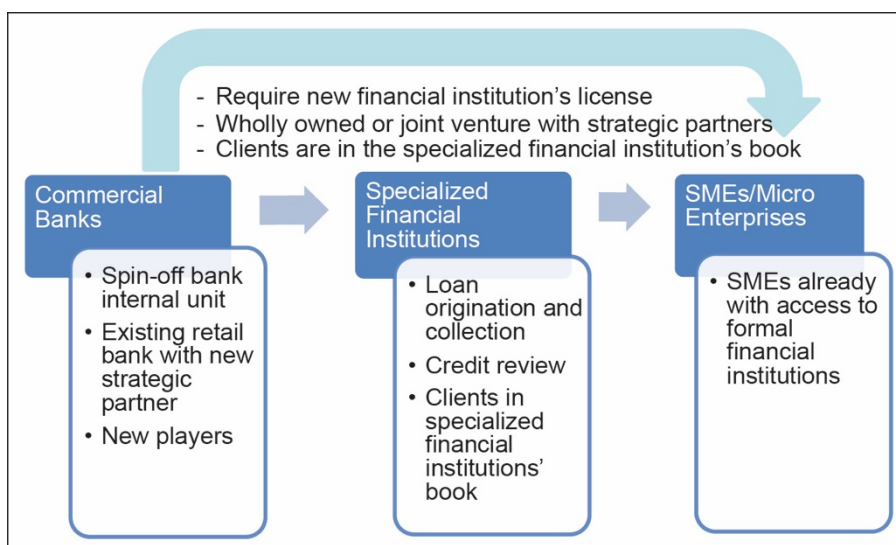
In this case, a commercial bank serves small clients internally by setting up a separate unit that specializes in microfinance. Although banks may give authority to the specialized unit for loan process decisions, systems, staff, or governance, the unit is under the same legal entity and is subject to the same regulations.

The strength of this model lies in its simplicity and ease of implementation. The bank only needs to tailor its method of operations to the requirement of micro clients. The main challenge lies in whether the bank can build an independent corporate culture and governance for the microfinance unit, ensuring that microfinance staff are not viewed as secondary to staff in other units and that important decisions are made by executives with enough interest and experience in microfinance (Lopez and Rhyne 2003). Not addressing this need could result in bad policy decisions and insufficient resource allocation to microfinance.

3.1.2 Specialized Financial Institutions

A bank may choose to set up a specialized financial institution (SFI) as a separate legal company to do microfinance business. The new company can be entirely or partly owned by the bank and is normally licensed as a nonbank financial institution. The new institution may be independent or stand-alone or utilize the bank’s existing infrastructure (Figure 1).

Figure 1: Commercial Banks Set Up Specialized Financial Institutions

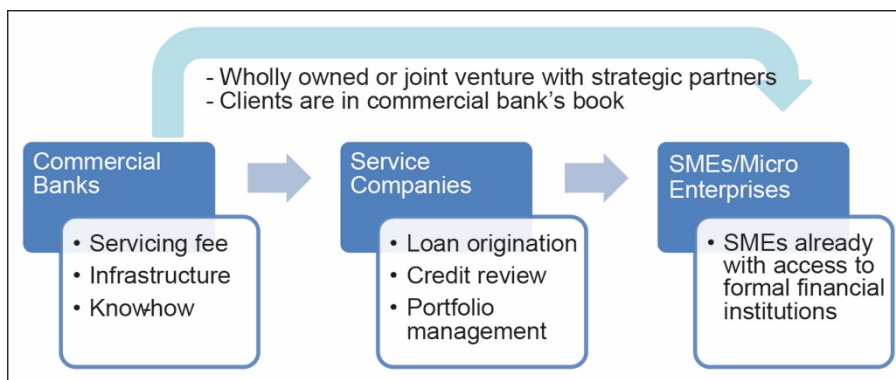


This setup overcomes some of the main obstacles of the internal unit model as it is able to have separate staff, management, and governance structure, enabling autonomy of microfinance operations. The bank will also assume less risk, as the risk is shared with other shareholders who may be able to bring in more microfinance experience. Reputation risk is also mitigated as the operations of the bank and its microfinance subsidiary are separated. However, the drawback is that the new institution will have less access to bank infrastructure and may end up with duplicate accounting, human resources, and information technology (IT) systems.

3.1.3 Microfinance Service Company

This model requires the bank to set up a service company, which is a nonfinancial company that is not overseen by banking regulators. The company is set up to originate and manage a portfolio of microloans for the banks in return for a fee and has independence in terms of management, staff, and governance. Despite more autonomy compared with the internal model, a service company has more limited operations than an SFI. Loans and services to micro customers are also recorded in the commercial bank’s accounts. The bank in return provides infrastructure such as teller support, IT facilities, etc. to the service company and receives a fee for the services. The service company typically operates within the bank branches or in separate offices nearby and can be either wholly or partly owned by the parent bank (Figure 2). This model enables the bank to include more experienced partners in microfinance as well as interested investors as financial partners.

Figure 2: Commercial Banks Set Up Service Companies



The advantage of this model is that a service company, unlike an SFI, does not require a separate banking license. Moreover, setting up a service company does not require much initial capital and is less expensive to establish than an SFI.

It also addresses some of the drawbacks of the internal model because it has its own structure, management, governance, and staff who give priority to microfinance operations. At the same time, the service company can utilize the parent bank’s infrastructure and services to operate more effectively rather than setting up an entirely new institution.

3.1.4 Correspondent Banking

Apart from the models previously discussed, commercial banks can enter into a contract with other nonfinancial institutions (e.g., convenience stores, supermarkets, post offices, lottery outlets, gas stations) to use them as an agent to process micro clients’ transactions. Rather than using a branch teller, commercial banks use retail

outlet employees or owners to handle transactions such as payments, deposits, withdrawals, funds transfers, balance enquiries, etc. Credit services, however, are often restricted to loan and credit card applications. These retailers can act as important distribution channels for the bank’s products.

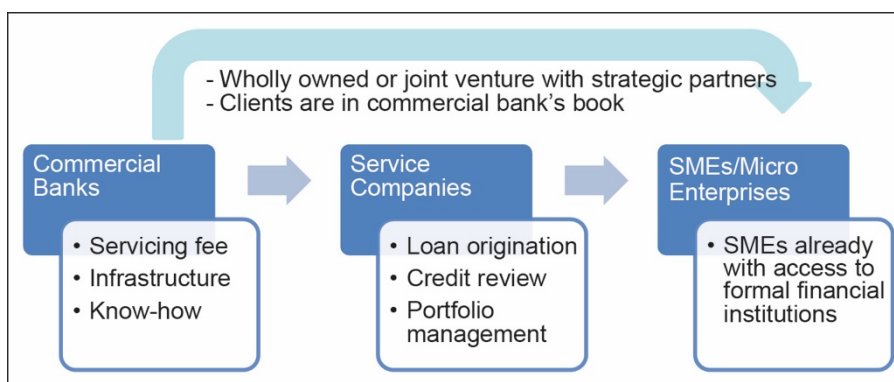
3.2 Indirect Approach: Bank Partnership with Existing Microfinance Institutions

Rather than directly entering the microfinance sector, a bank can do this indirectly by working with existing MFIs. This approach takes full advantage of these institutions’ skills in relationship lending and enables bank to gain more experience in microfinance operations. There are three main possible business models: outsourcing retail operations, providing commercial loans to MFIs, and providing infrastructure and services to MFIs.

3.2.1 Outsourcing Retail Operations

A bank can engage in microfinance business by contracting a well-performing MFI to make credit decisions and extend microloans on its behalf, in return for a share of interest income or fees (Figure 3). This model requires risk and reward sharing between bank and MFI, making sure that both parties maintain high portfolio quality. To ensure that the MFI effectively reviews and monitors the loan portfolio, the bank may require the MFI to finance some parts of its microcredit or provide a first loss guarantee which pays for the first dollar of loss up to the maximum guarantee amount. The credit decisions may be made entirely by the MFI or jointly with the bank, depending on MFI performance in maintaining a high-quality loan portfolio. These loans are then registered in the commercial bank’s book. To enter into this type of agreement, the bank may require exclusivity from the MFI, preventing it from servicing other banks. This arrangement takes advantage of MFIs’ market knowledge and credit methodology and utilizes the bank’s funding and transaction processing capabilities. In this way, the bank will not need to make significant investment or operational changes in order to lend to small clients.

Figure 3: Commercial Banks Outsource Retail Operations to Microfinance Institutions

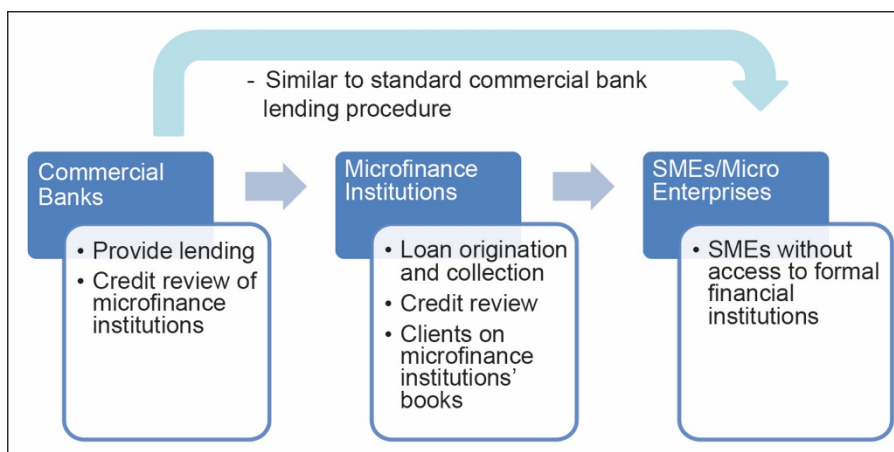


3.2.2 Providing Commercial Loans to MFIs

In this case, the bank simply provides credit to an MFI as working capital or to onlend to micro clients (Figure 4). It is, therefore, similar to normal commercial bank lending. Loans given to MFIs may be unsecured, backed by collateral, or guaranteed by a third

party. The loan agreement may come with conditions for the MFI to provide periodic financial statements, allow for bank inspection, etc. In this model, the bank should select an MFI that is ready to receive commercial funding. Criteria may include availability of financial statements, a good management team and governance, a quality loan portfolio with adequate loan loss policies, transparent and timely relevant reports, and MFI business prospects. Several banks choose this model of partnering with MFIs due to its simplicity, compared with the outsourcing model.

Figure 4: Commercial Banks Lend to Microfinance Institutions



3.2.3 Providing Infrastructure and Services to MFIs

In this model, the bank is least engaged in microfinance business. The bank has the least exposure to micro clients because it only provides facilities and infrastructure to the MFI. These may include providing front office functions, such as having the bank staff in its branches serve MFI clients); granting access to bank infrastructure, such as ATMs and counter service for transaction processing, money transfers, foreign exchange transactions, etc.; providing IT services; and renting offices to the MFI. The bank will not only receive fees and income in return from the MFI and its clients, but will also be able to learn the patterns and behavior of micro clients. The knowledge and learning may come from MFI clients opening accounts with the bank directly, or from processing transactions such as loan disbursements and repayments via the MFI's account with the bank.

3.3 Cross-Country Experiences

This study focuses on commercial banks and their role in financing SMEs. We will discuss some innovative business models that banks have used to provide financial access to small enterprises. As there may be no one best way to engage in microfinance business, we discuss the entry strategies of commercial banks in five very diverse countries: Mongolia, Haiti, Lebanon, India, and Turkey.

3.3.1 Agricultural Bank of Mongolia and Rural Lending, Mongolia

The Agricultural Bank of Mongolia is a leading financial service provider for Mongolia's rural sector and is currently known as Khan Bank. It was set up in the early 1990s as the Agricultural Cooperative Bank, inheriting the assets from the former state bank. Its objective was initially to serve the agricultural sector in Mongolia. Khan Bank was fortunate to have an extensive network, a legacy from the former state bank, of more than 300 rural branches and 2,600 staff. Later, it was instructed to widen its

operational scope and make more loans, which resulted in significant deterioration in its financial position. However, because of its importance to rural Mongolians, it was granted a period of operation, rather than being closed down. The bank later recognized and used its wide branch network to reach out to the massive rural market. As a result, it went from a nearly failed bank to a very successful privatized state bank, highlighting the hidden potential of the microfinance segment to turn around even the most troubled bank.

Apart from its extensive branch network, key to the bank's achievement is its strategy to launch new products and rapidly deliver them across the country, leveraging the bank's branch outreach to achieve economies of scale. These products were tailored to suit clients' needs. An example of a successful product is the herder loan, which was designed to match Mongolian herders' irregular stream of income (Gutin and Young 2005). As herders only have income during certain periods, the product is short term in nature (usually lasting no more than 1 year) and helps cover expenses during times when herders have no cash or need to buy herd-related products.

Today, Khan Bank is the main rural financial services provider in the country, offering deposit and loan products to individuals, SMEs, and corporate customers throughout its network of 535 branches, and was Mongolia's largest retail bank at the end of 2014. In the extraordinarily challenging year of 2014, which saw a significant drop in foreign direct investment, an increase in the foreign trade deficit, high inflation, and currency depreciation, Khan Bank continued to perform well and maintained its market leadership position. Net profit after tax in 2014 increased 12.0% and return on equity registered at 28.3%. The bank is one of the best-performing banks in the country and has received many awards, including Best Bank in Mongolia by *Euromoney*.

3.3.2 Sogebank and SOGESOL, Haiti

Sogebank became interested in microfinance in the late 1990s as the management believed that this market offered opportunity to achieve both social and financial objectives. As one of the biggest commercial banks in Haiti, Sogebank has the advantage of an extensive branch network.

To reduce risk, in 2000 Sogebank enlisted Accion support to help create SOGESOL, an independent microlending institution using a service company model. Sogebank was in a good position to do microfinance business because it already had a large number of small clients' savings and the capacity to handle these transactions. Under this model, SOGESOL originates and monitors loan portfolios for Sogebank and in turn receives a net fee for these services. The loans are booked at Sogebank, but SOGESOL has primary responsibility for promoting, evaluating, approving, tracking, and collecting them. SOGESOL's first loans were issued in August 2000. It now has more than 35,000 active borrowers and outstanding loans of more than \$7.8 million.

As a service company for Sogebank, SOGESOL was able to minimize costs by setting up its branches close to or in Sogebank branches. Given very high operational costs in Haiti due to poor infrastructure, power shortages, and safety issues, the ability to leverage Sogebank branches substantially reduces SOGESOL's operational costs. As a result, SOGESOL needed little financial support to effectively launch microfinance operations and was able to reach profitability in 2002, after just 2 years of operations and amid a severe economic and social crisis in Haiti. Without having to worry about start-up and operating costs or opening full-fledged branches, SOGESOL has been able to concentrate on improving credit methodology and providing credit administration services.

3.3.3 Jammal Trust Bank Partnership with AMEEN, Lebanon

The microfinance market in Lebanon is relatively small and competition is limited. In general, banking institutions lack interest in the sector given its size, its perceived risk, the up-front investment required to enter the market, and the availability of other investment options with less risk. A small number of unregulated microfinance institutions operate with limited donor funding and lack the equity and commercial financing required to grow their portfolio and outreach. In Lebanon, the microfinance market is mostly served by three large microfinance programs: Al Majmoua, Access to Microfinance and Enhanced Enterprise Niches (AMEEN), and Al-Qard Al-Hassan. AMEEN started its pilot program in 1999 under the international nongovernment organization CHF. AMEEN first partnered with Jammal Trust Bank because the bank believed in the mission and had the right network of branches. Since then, three other banks have joined to become AMEEN's partners: Credit Libanais in 2001, Lebanese Canadian Bank in 2004, and Fransabank in 2008.

The partnership between AMEEN and the banks presents an interesting model of how local commercial banks are able to outsource client mobilization, analysis, and follow-up to an MFI, while funding the credit themselves. Through this linkage, AMEEN is able to expand outreach without building new branches and has secured a stable source of funding for onlending to microenterprises, while the commercial banks are able to enter a new market without significant investment requirements in staffing and technologies. AMEEN has credit officers going door-to-door, introducing loans to potential borrowers. This type of personal outreach is critical to the success of the project because potential borrowers are mostly from low-income groups that have no experience in using banking services. The credit officers are from the target community because they know the local needs best.

AMEEN essentially works as a service company for the banks. Credit decisions are made jointly by AMEEN and the partner bank. All payments and disbursement take place at the bank. The bank generates the loan agreement and makes the disbursement using funds from the bank or, in some cases, from both the bank and AMEEN, based on the terms of the partnership agreement. In the event that the loan goes into default, AMEEN is responsible for managing delinquency until the loan is deemed not collectable, at which point the bank takes over (Green and Estevez 2005).

3.3.4 ICICI Bank Link with Spandana, India

ICICI Bank is one of the largest banks in India. It is second in terms of assets and market capitalization and has 4,050 branches and 12,919 ATMs in India. The bank entered the microfinance market in 2002 and by early 2005 had a portfolio of about \$66 million through 27 partner MFIs (Harper 2005). There are about 1,600 MFIs in India, but few are of sufficient size and strength to be suitable partners for ICICI Bank. Therefore, the bank helped develop their capacity through training, mentoring, and regular visits by the bank's senior staff. The partnership approach remains the dominant strategy, accounting for more than 90% of the bank's microfinance portfolio. The loans are negotiated and disbursed to clients by MFI staff, acting as agents of ICICI Bank. These MFIs are paid either a flat fee or a percentage of the loan interest for originating and maintaining the accounts, and for recovering the loans. Borrowers sign loan agreements with ICICI Bank, not with the MFI.

To provide an incentive for portfolio quality management, the MFI is required to provide a "first-loss default guarantee" in which it shares risk with the bank on the loan portfolio up to a certain agreed limit. ICICI Bank also provides an overdraft facility to the MFI equivalent to the amount that the MFI is obliged to pay as the first-loss default

guarantee. The overdraft is drawn only in the case of default, and the MFI is obliged to pay a penal rate of interest on the amount that it draws from the overdraft facility (Ananth 2005).

A particular success story is the link between ICICI and Spandana, an MFI in India. Since the partnership began in 2003, the two organizations have worked very closely together. Spandana's operations are primarily concentrated in the state of Andhra Pradesh and it delivers financial services in 21 of the state's 23 districts through 216 branches. In each of these 21 districts, there is at least one branch operating under the ICICI Bank partnership model. The result of this partnership was a phenomenal increase in Spandana's borrowers—250% from 2004 to 2005, the largest jump in history. Spandana's partnership with ICICI Bank benefits both organizations. ICICI Bank, through its association with Spandana, is able to reach an underserved market segment. The partnership benefits Spandana by providing it with steady access to funds. Spandana's operating costs are much lower than comparable costs of banks and nonbank finance companies. The delinquency levels are also much lower, at less than 1% compared with over 5% for banks and nonbank finance companies.

3.3.5 Garanti Bank, Turkey

Turkey's economy has faced a series of financial crises since 1992, leading to high inflation and devaluation of the Turkish lira. Although the economy stabilized in 2000, it again went into financial chaos in 2001. The reemergence of financial uncertainty weakened domestic demand, hurting small and micro enterprises. The rise in unemployment in 2003 severely affected some areas where income was already very low. One of the main factors slowing the country's economic recovery in the medium to long term is high unemployment. Closer examination reveals that there is a large financially unserved and unrealized workforce consisting mainly of unemployed women. This means there is huge potential for women to engage in entrepreneurial activities, leading to a reduction in the unemployment rate (Dincer 2014). Therefore, increasing women's participation in the labor force is the most practical long-term solution to overcome the structural unemployment problem in Turkey. As a result, the country has turned to microfinance to empower small companies, and especially women, to support economic development. Turkey's government is the driving force behind the shift in banking business decisions.

Garanti is Turkey's second-largest private bank, with consolidated assets of around \$100 billion. Garanti provides a wide range of financial services to 13.7 million customers across an extensive distribution network of 998 domestic branches. The bank has invested heavily in a large network of alternative channels, including 4,260 ATMs; an award-winning call center; and internet, mobile, and social banking platforms. Garanti's strategy has long focused on SMEs in Turkey, a segment that drives growth and employment. In 2006, Garanti became the first bank in the region to offer products and services specifically targeted toward women entrepreneurs, in line with a new Turkish government policy supporting women entrepreneurship (IFC 2014). Garanti Bank has 1,600 staff across 998 branches looking after SME business segments. The ability to quickly develop and roll out convenient and effective products is at the core of Garanti's success with the SME segment. Successful product development is a result of regular market research, close interaction with SMEs, and feedback from business line staff. Garanti's turnaround times are some of the fastest in the industry, with time-to-yes decisions for small and mass clients made in as few as 3 hours, and disbursements in a single day. For medium-segment clients, time to disbursement can be as quick as 1 day for existing clients, while new client applications are processed within a week. Today, Garanti is a market leader in the SME segment,

with approximately 1.5 million customers. SME loans constitute approximately 32% of its business banking loans.

In terms of partnership with MFIs, Garanti entered into a relationship with Maya Enterprise in 2001. While Maya helped local businesses fill out forms and negotiate deals, Garanti provided branch network banking, access to ATMs, and electronic banking facilities to Maya's customers. Garanti benefited from the increased revenue from the fees while Maya's costs were reduced and efficiency was increased by taking advantage of existing bank infrastructure and systems (Isern and Porteous 2005). This is an example of a successful relationship between a bank and an MFI in Turkey.

The summary of each bank business model and key success factors are summarized in Table 1.

Table 1: Bank Business Models and Key Success Factors

Bank/MFI	Country	Model	Key Success Factors
Agricultural Bank	Mongolia	Internal microfinance unit	<ul style="list-style-type: none"> • Extensive rural branch network • Tailored products
Sogebank/ SOGESOL	Haiti	Microfinance service company	<ul style="list-style-type: none"> • Extensive branch network • Reduced operating costs • Focus on credit methodology
Jammal Trust Bank/AMEEN	Lebanon	Outsourcing retail operation	<ul style="list-style-type: none"> • Nationwide branch network • Hands-on loan officer • MFI access to low funding cost
ICICI Bank/ Spandana	India	Outsourcing retail operation	<ul style="list-style-type: none"> • MFI training and mentoring • Reduced operating cost • MFI steady access to funding
Garanti Bank/ Maya Enterprise	Turkey	Internal microfinance unit/Providing infrastructure	<ul style="list-style-type: none"> • Tailored products • Quick loan decision time • Reduced operating cost • Increased fee

MFI = microfinance institution.

3.4 Lessons Learned

Cross-country case studies have demonstrated that banks, MFIs, and customers can all benefit from microfinance. The case studies contain a number of messages for policy makers and bankers to extend outreach to smaller customers who lack access to formal financial services. Here we highlight and draw important lessons from these experiences.

- (i) To succeed in microfinance, a bank must understand the requirements of small customers to be able to design products that match their financial preferences. In general, micro clients prefer simple products and financial procedures and do not have the resources to travel frequently to the bank. Ag Bank, for example, has addressed these issues by designing financial products tailored to its customers' needs and delivering them profitably even in the remote rural areas.
- (ii) Despite its perceived high risk, the business of microfinance can help diversify risks. This is because a microfinance portfolio typically consists of a large pool of small clients with small loan sizes, so default by one of them would hardly affect the total portfolio. As a result, returns from this market can be high

despite higher transaction costs, as demonstrated by the case of Ag Bank, which was able to achieve high return on equity even during a difficult economic period and was regarded as one of the best-performing banks in Mongolia.

- (iii) In an increasingly globalized world where banks will face more competition from international banks, the best way to compete is not to compete in the market for high-income customers, but rather to focus on rural and low-income market segments. Although risk may be high, with the right partnership and the fact that small customers typically value ongoing financial access and often try to maintain or improve their credit record, the delinquency rate for microfinance can be low, even when compared with the traditional line of banking business. This is illustrated in the case of the ICICI Bank partnership with Spandana where the bank was able to maintain very low delinquency levels for the microfinance portfolio.
- (iv) Small borrowers require different credit methodology than large borrowers. Banks need to maintain regular contact with these customers and ensure that an appropriate mechanism is in place to promptly detect loan payment problems for further recovery actions. There is also the need for a system to ensure that borrowers realize that intended default will have consequences. Because of the unique credit methodology and collection efforts required, banks such as ICICI Bank, Jammal Trust Bank, and Sogebank have realized that by utilizing MFIs' strength in this area, banks can enter the microfinance sector without having to significantly invest in or change their operational procedures.
- (v) Small clients do not like complicated banking processes and are put off by complicated financial products and long loan disbursement time. Developing easy-to-understand products and offering timely approval are therefore the keys to success, as demonstrated in the case of Garanti Bank. The bank is able to quickly develop convenient loan products and its decision time is one of the shortest in the industry. Loan decisions for small and mass clients are usually made in as few as 3 days, and disbursements within 1 day.
- (vi) The costs of assessing new customers are usually high. But in many places, MFIs have already invented methods and provided assistance to make sure that poor customers have enough credibility to receive credit. In other words, MFIs have done the prescreening of banks' customers for them, and with the right partnership, banks can readily bring these customers into the banking system at little or no cost. Successful examples can be found in many places, such as the partnerships in Lebanon between AMEEN and banks such as Jammal Trust Bank. Despite high interest rates, few borrowers actually defaulted. The microfinance portfolio default rate was less than 1% and a large number of borrowers returned and became repeat clients, reflecting the success of the programs.
- (vii) Setting up a new institution specializing in microfinance to reach out to small clients is more costly and time-consuming than doing the same thing through established banks and their branch network. This is because creating new institutions requires large start-up equity and is a complicated process. Although most countries have strict regulations on banks that mobilize savings from small clients, only small changes to regulations are needed, especially with regard to unsecured loans, before a bank can engage in microfinance

business. It is easier to overcome these regulatory barriers than to create an entirely new microfinance institution.

- (viii) A bank may choose to enter the microfinance market directly, rather than through partnership with MFIs. In this case, there are many successful examples of setting up a service company, rather than creating new specialized financial institution. Sogebank, for example, decided to engage in the microfinance business by using a service company model. This model allowed the bank the flexibility to involve other partners for technical and financial support. Because the service company can also take full advantage of the parent bank's branding and infrastructure, it can therefore dedicate more resources to microfinance operations.

4. SME FINANCING AND MICROFINANCE IN THAILAND

4.1 Overview of SMEs and Challenges

SMEs represent the largest share of Thailand's businesses. In 2014, 99.7% of enterprises (around 2.74 million) in Thailand were SMEs. SMEs' contribution is equivalent to B5,212,004 million, or 39.6% of gross domestic product (GDP). Most SMEs are family-run or owned by an individual. The largest portion of SMEs are engaged in services (41.3%), followed by trade and maintenance businesses (27.9%) and production (23.5%). SMEs play an important role in employment, accounting for around 10.5 million employees, or as much as 80.3% of total employment. SMEs also make significant contributions to Thailand's exports, accounting for 26.3% of the total export value (OSMEP 2015).

Thai SMEs face many challenges, including lack of technology and innovation, proper management, marketing channels, and financial access. For financial access, the main constraints are found to include lack of financial institution advice, complex loan procedures, inadequate collateral, high interest rates, inadequate SME business plan and experience, unqualified accounting system, high operational costs per loan, restricted government regulations, and an unlevel playing field (Wesaratchakit et al. 2010). Meanwhile, the capital market is relatively underutilized for SME finance and only a few SMEs are able to list on the Market for Alternative Investment.

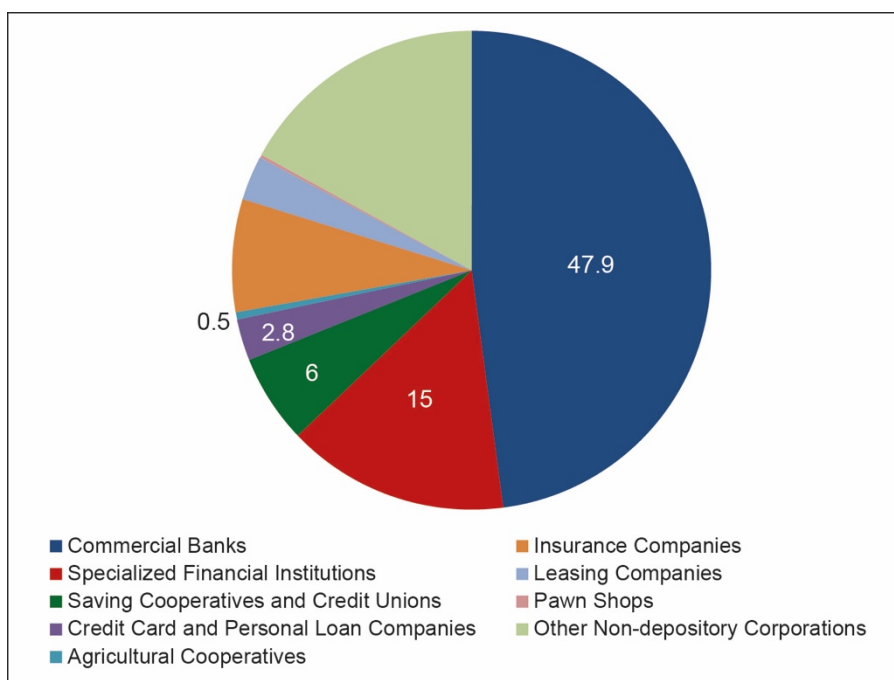
4.2 Structure of Financial System and the Role of Commercial Banks

Thailand's financial sector is dominated by banks. Therefore, loans and financial services are mainly intermediated through commercial banks. The country has a strong and developed commercial banking sector that has little to do with small-scale lending. Compared with other countries, the Thai private sector plays a small role in the microfinance business and it is the Thai government who has been taking leadership as a provider of small-scale credit. In fact, the business and legal environment in Thailand is not conducive to private sector investment. As a result, private sector initiatives are generally small and target specific groups of people. They are also scattered across a range of institutions, including banks, specialized financial institutions (SFIs), nonbank financial institutions, cooperatives, and informal financial service providers.

To understand the state of SME financing in Thailand, it is useful to classify financial institutions according to three main categories: (i) formal financial institutions, which are those operating under prudential regulations, including commercial banks, finance companies, credit fonciers, government SFIs, retail banks, credit card companies, and personal loan companies; (ii) semiformal financial institutions, which consist of legal financial institutions operating under nonprudential regulations—these include cooperatives, credit unions, and the Village and Urban Revolving Fund (VRF); and (iii) informal financial institutions, which consist of financial institutions without legal status and that are not regulated by any authorities. These are community-based organizations that provide financial services to community members; they include savings groups, moneylenders, village banks, nongovernment organizations’ MFIs,³ and other unspecified financial providers.

For the Thai financial system as a whole, commercial banks and SFIs play the most prominent role, especially in the formal sector. At the end of 2014, there were 30 banks and 6 specialized financial institutions (SFIs), with asset shares of 47.9% and 15.0%, respectively (Figure 5). Other financial institutions such as saving cooperatives and credit unions, credit card and personal loan companies, and agricultural cooperatives accounted for only 6.0%, 2.8%, and 0.5% in terms of asset size, respectively.

Figure 5: Structure of Financial System in Thailand (by asset size)
(%)



Source: Bank of Thailand. Thailand Financial Landscape. www.bot.or.th/English/FinancialInstitutions/FIStructure/Pages/default.aspx

It should be understood that the political culture in Thailand strongly supports the financial needs of the poor, SMEs, the rural population, and farmers. Consequently, there have been extensive formal government schemes aiming to provide financial services to these groups. This has been done through large and influential government

³ In Thailand, MFIs include cooperatives, credit unions, village banks, and VRFs. These institutions deliver financial services including microloans to poorer household and small businesses. MFIs are normally in the semiformal and informal sectors.

SFIs and the VRFs. These SFIs, which are subsidized and closely controlled by the government, are generally considered a policy vehicle to bring economic and social benefit to villagers through programs such as loan, savings, and insurance programs. While some SFIs offer the same deposit-taking and loan products as the commercial banks, they have a greater presence than commercial banks in rural and remote areas. The village and urban revolving funds penetrate even further into rural areas than commercial banks and SFIs, bringing microfinance services in the form of loans to lower-income clients in the remote areas. The latest Bank of Thailand and National Statistical Office survey revealed that indebted Thai households indeed borrow most frequently from SFIs (37.8%), followed by village and urban revolving funds (23.6%). The percentage of households that borrow from VRFs have also increased over the years, from 19.2% in 2009 to 22.4% in 2011 and 23.6% in 2013 (Table 2). Commercial banks, meanwhile, provide only 9.3% of credit to indebted Thai households.

Table 2: Source of Funds for Indebted Households in Thailand (2013)

Source of Funds	% of Indebted Households
Bank of Agriculture and Agricultural Cooperatives	30.8
Government Housing Bank and Government Savings Bank	7.0
Commercial banks	9.3
Other formal financial institutions	19.6
Village and Urban Revolving Fund	23.6
Cooperatives and loans from employer	4.5
Informal borrowings	5.2

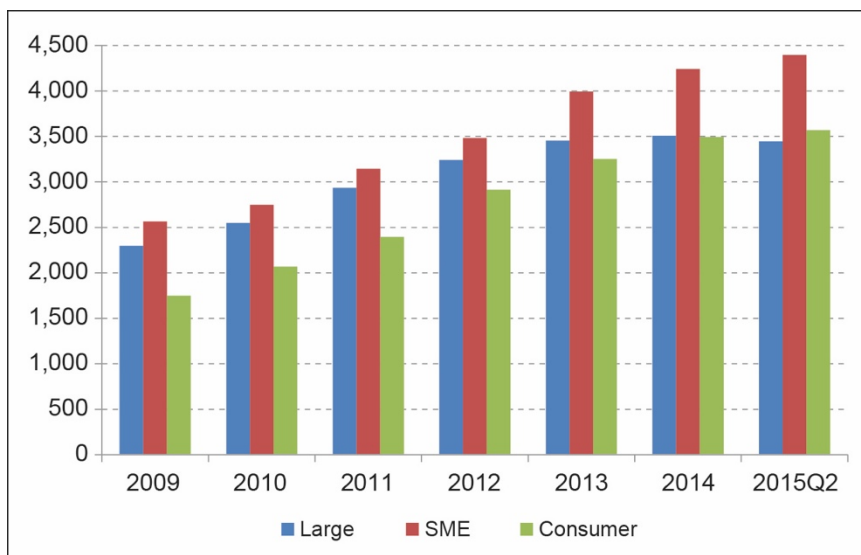
Source: Thai Parliament. 2015. *Village and Urban Revolving Fund*. Bangkok.

For SME financing, the landscape is also characterized by credit and interest rates subsidized by the government, either directly or indirectly, via the VRF and the SFIs, particularly the two most prominent SFIs, the Bank of Agriculture and Agricultural Cooperatives (BAAC) and Government Savings Bank (GSB). SFIs are the biggest formal players in the Thai microfinance market, and carry out various government programs in this area. While both BAAC and GSB target low-income groups, BAAC's main customer base is farmers while GSB has a larger share of urban customers. BAAC was established to provide affordable loans to Thai farmers and small entrepreneurs in rural areas. Its most important feature is its extensive network capable of reaching low-income people in the rural areas, as well as its large savings mobilization. In addition to offering microloans directly to low-income customers, several SFIs, especially BAAC and GSB, also provide loans to semiformal financial institutions such as village funds and cooperatives at below-market interest rates (Meagher 2013). These institutions form partnerships with MFIs along the lines discussed in section 3.2.2.

As discussed earlier, commercial banks are not prominent players when it comes to the market for microfinance. To be fair, however, following the Financial Sector Master Plan Phase 1 (2004–2008) and Phase 2 (2010–2014), the banking sector has entered into the SME segments. In fact, most commercial banks currently have retail banking operations and have launched many new products tailored for SMEs, resulting in increased lending to SMEs over the years (Figure 6). Still, the majority of SMEs, particularly small enterprises, do not have access to bank credit. According to the survey on debt burden and financial access of Thai SMEs by the Office of Small and Medium Enterprises Promotion, the major source of funding for large enterprises (53.3%) and medium enterprises (72.0%) is loans from financial institutions, while only 35.7% of small enterprises' funding is from bank credit (OSMEP 2012). As a result,

many small businesses end up using their own funds or borrowing from loan sharks (or moneylenders), which charge very high interest rates (Fiscal Policy Office 2015).

Figure 6: Commercial Bank Loans by Types of Borrowers
(billion baht)



SMEs = small and medium-sized enterprises.

Sources: Bank of Thailand. 2013. *Supervision Report 2013*. Bangkok; Bank of Thailand. 2015. *Performance of the Thai Banking System in the 2nd Quarter of 2015*. Bangkok.

The government and the Bank of Thailand have initiated a number of rules and regulations to provide an enabling environment for commercial banks to enter the microfinance industry. These include, for example, allowing commercial banks to extend microfinance loans for SMEs not exceeding B200,000 per borrower, allowing retail banking licenses, and allowing new players for nanofinance for loans not exceeding B100,000 per borrower.

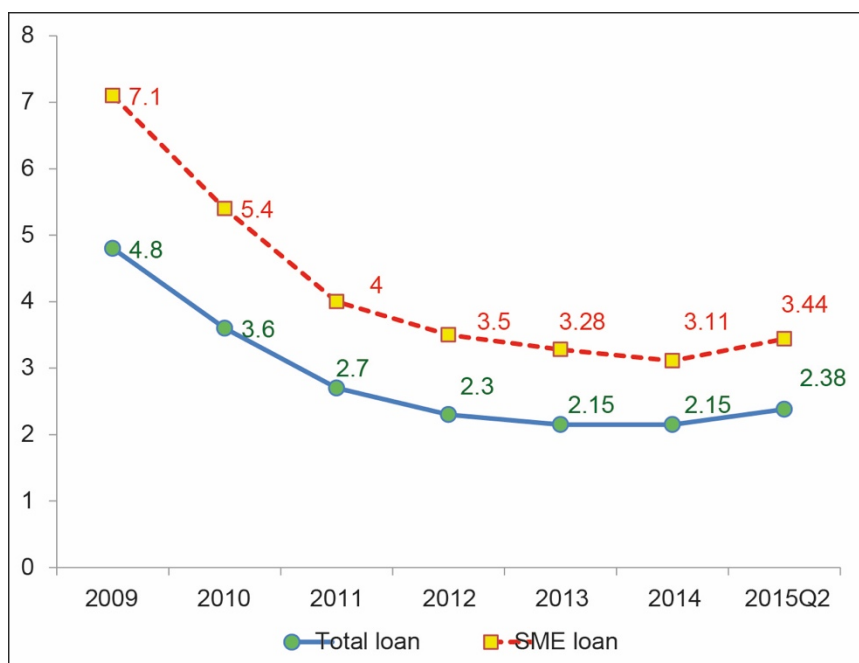
These microfinance guidelines have not provided enough incentive for banks to downscale due to high operating costs, with the exception of Krug Thai Bank, a state-owned commercial bank, and Thai Credit Retail Bank. In terms of outreach, however, the contribution of retail banks in microfinance has not been significant since their establishment; only 0.3% of SMEs are reported to frequently use services from retail banks (OSMEP 2012). Meanwhile, other nonbank institutions such as personal loan companies, which play an important role in retail lending, are allowed to provide loans only for consumption purposes at an interest rate not exceeding 28%, including all fees, and cannot provide business loans (Fiscal Policy Office 2015).

In the past, one of the efforts to involve private banks in microfinance was the establishment of retail banks with features similar to SFIs (discussed in section 3.1.2) to act as a niche player in microenterprise and SME financing. A retail bank is basically a limited-charter commercial bank focusing on retail and SME finance, and may not operate in high-risk areas such as forex and derivatives. In 2005, the Ministry of Finance approved four retail bank licenses under policies adopted in the Financial Sector Master Plan, but only one (Thai Credit Retail Bank) remains open for business today. Although Thai Credit Retail Bank aims to serve small businesses and customers whose loan sizes are too small to qualify for loans with other commercial banks, its average loan size is still around B400,000 (approx. \$11,428), above the B200,000 threshold used by the Bank of Thailand as the definition of microcredit.

Another active player is Krug Thai Bank, which is a state-owned commercial bank. Apart from its own microfinance initiative via the Community Bank project, Krug Thai Bank's main involvement in microfinance is the government-affiliated activity. Through its link with the government, the bank provides financial services to village and urban revolving funds and serves as a financing channel for well-performing funds to finance their expansion, using a financing approach similar to the one discussed in section 3.2.2. The loans are wholesaled to these funds, which in turn provide loans to their members for income-generating purposes.

As of the second quarter of 2015, SME loans account for 38.5% of commercial banks' outstanding loans, most of them geared toward medium-sized enterprises (Bank of Thailand 2015). The ratio of nonperforming loans for SMEs is also reported to be relatively high at 3.44%, compared with overall banking nonperforming loans of 2.38% (Figure 7), and is much higher than that of large customers (1.19%). Although commercial banks are the main provider of credit in Thailand, they have no real interest in servicing small customers, given the much greater volume and profits to be found in the business sector, foreign exchange services, and high-income and middle-class customers.

Figure 7: Nonperforming Loans
(% of total loan)



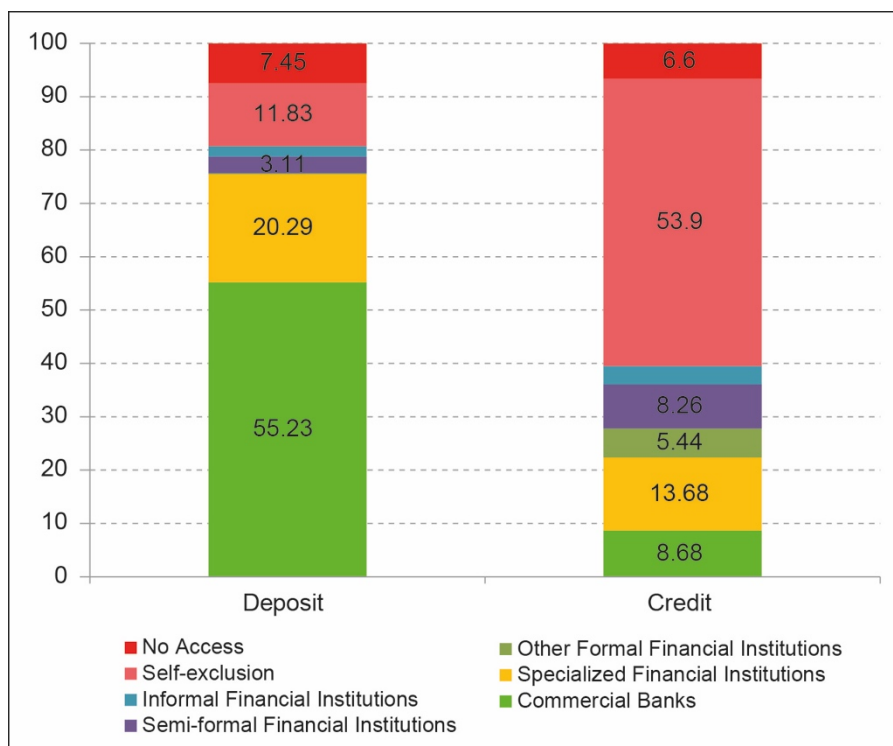
SMEs = small and medium-sized enterprises.

Sources: Bank of Thailand. 2013. *Supervision Report 2013*. Bangkok; Bank of Thailand. 2015. *Performance of the Thai Banking System in the 2nd Quarter of 2015*. Bangkok.

In fact, despite official efforts to bring more people and businesses into the financial system, it appears that the overall situation of financial access in Thailand has not improved. According to a 2013 survey by the National Statistical Office and the Bank of Thailand, while 80.7% of households surveyed use deposit services from financial institutions, only 39.5% reported taking out loans from the financial system (Bank of Thailand 2013a and Figure 8). This means that as much as 60.5% of households in 2013 do not use credit services from financial institutions, higher than the 33.9% recorded in 2006. The majority of those who do not use credit services are self-

excluded. The main reasons are no credit need and preferences for credit from SFIs and VRFs. Households without access to formal and semiformal sectors account for around 10% of the total. The main reasons for having no access include inadequate financial status and lack of collateral, fear of rejection, and complicated loan procedures (Bank of Thailand 2013a). The breakdown also finds that only around 27.8% of households reported actually taking out loans from formal financial institutions in 2013, compared with 43.3% in 2006.

Figure 8: Thailand’s Financial Access Structure
(% of households)



Source: Bank of Thailand. 2013. *Report on Household Financial Access*. Bangkok.

4.3 Recent Developments in SME Support Schemes in Thailand

Amid very slow economic growth, and slower than the average in the Association of Southeast Asian Nations (ASEAN) region, the Government of Thailand and the Bank of Thailand have implemented several policies and measures to revive the Thai economy. One of these policies involves financial support for SMEs. It is believed that with a more vibrant SME sector, the Thai economy will be able to grow faster and become more resilient. This section discusses recent official measures and progress.

4.3.1 Nanofinance

The nanofinance scheme is a recent effort by the government to address the problem of loan sharks (or moneylenders) faced by SMEs that do not have access to formal lenders. About 600,000 households in Thailand are reported to borrow from the informal sector, while 1.3 million households cannot gain access to formal credit (Bank of Thailand 2013a). In early 2015, the government together with the Bank of Thailand launched a nanofinance scheme to help start-up firms gain access to credit. Operators

with registered capital of at least B50 million are eligible to become nanofinancial institutions under the Bank of Thailand's criteria, and their debt-to-equity ratio may not exceed seven times their registered capital. Interest rates for nanofinancing are capped at 3% per month, or 36% a year, with the principal not exceeding B100,000 for each borrower. One important feature of nanofinance is that there is no collateral or statement of income required for borrowing (Fiscal Policy Office 2015). Commercial banks and registered institutions can operate the nanofinance scheme immediately without seeking permission from the finance minister, but nonbank lenders must apply and obtain the minister's approval. Currently, nine companies have won licenses to become nanofinance lenders and five companies have started operations.

Although it may be too early to evaluate the success of the nanofinance scheme, progress in terms of lending to SMEs has been slow. The first nanofinance companies started operations in May 2015, and by November 2015 the portfolio of outstanding loans was reported to be only B59 million (approx. \$1.69 million) for 3,141 borrowers, much less than the government expected. New operators have been cautious in lending to these high-risk borrowers with no collateral. It is reported that nanofinance companies are choosing to lend primarily to existing customers, rather than to new customers or start-up entrepreneurs, due to concern over the quality of new borrowers. Operating costs in processing a new loan application are high relative to the size of the loan. If default occurs, the costs to recover the loan are also considered too high for companies to bear. Meanwhile, one company that chooses to extend loans mostly to new customers has a nonperforming loan ratio of 16%, much higher than expected. Therefore, with the current average loan size of less than B20,000 (approx. \$571) and possible risk of default, nanofinance companies view the 36% interest rate cap by the government as too low to cover operating expenses. Nanofinance companies consider this interest rate low, especially when compared with underground lenders or loan sharks, which normally charge interest rates of 15%–20% per month, or almost 200% or more per year.

4.3.2 Village and Urban Revolving Fund

In 2001 the Village and Urban Revolving Fund (VRF) program was initiated by the government. It aimed to provide B1 million (approx. \$28,571) to every village and urban community in Thailand to create locally run microfinance banks. It is estimated that of all 120,000 microfinance initiatives worldwide, Thailand's microfinance scheme in the form of the VRF lends more money to more people than any other scheme (*The Economist* 2013). The total initial capital injection amounted to B78 billion (approximately \$2.2 billion), equivalent to 1.5% of GDP. A recent study found that since 2001 the government has injected over B151.6 billion (around \$4.3 billion) to set up and increase capital for the VRF (Vichienplert 2015). While the scheme is funded by government grants and funds are handled by intermediaries such as the Bank of Agriculture and Agricultural Cooperatives, each village has a pot run by an elected local committee that has some discretion in setting loan amounts and interest rates.

Recently, in the face of economic slowdown, the Thai government decided to revive the VRF scheme by investing an extra B60 billion (approx. \$1.7 billion) into existing village funds. The loans are given for the purpose of livelihoods, start-ups, or business expansions. Only well-performing village funds have the right to participate in this initiative, which offers interest-free periods for 2 years and a 1% interest rate after that. Only about 60,000 village funds are currently qualified to get loans under this government initiative.

The original intention of the VRF scheme was to create self-sustaining microfinance banks in each of Thailand's villages. Villagers are eligible by residency to take out a

loan, typically limited to B20,000 without collateral. As of September 2013, there were 79,255 funds, including 74,989 village, 3,528 urban, and 738 military community funds. These funds currently have as many as 11.7 million members and have lent a total of about B546.5 billion (approx. \$15.6 billion) to 10.3 million active borrowers across the country (Vichientplert 2015). Village funds have the potential to transform themselves into village banks if they get good and capable executives, adhere to their founding principles, and have mechanisms to ensure villagers truly understand the purpose of such funds. With the VRF scheme, villagers have convenient access to funding that comes with a very low interest rate and therefore have a better chance of seeing their start-ups take off. The scheme, however, has its drawbacks. Private providers are unable to compete with the VRFs on cost. Regulations and licensing requirements in Thailand are so strict that nongovernment organizations have stopped setting up microfinance business. In the environment of widespread government-subsidized microfinance programs, there are very few private-driven MFIs with legal status in Thailand. This is in stark contrast to many middle-income countries where private sector organizations have taken the initiative to be the main providers of microfinance.

4.3.3 Other Recent Measures and Development for SME Support

Other recently approved measures to support SMEs are (i) extension of B100 billion in soft loans via SFIs. Government Savings Bank (GSB) extends a 0.1% interest rate loan to commercial banks, which will then relend to SMEs at no more than 4.0%. The government will subsidize the interest for GSB to meet its costs; (ii) improvement in criteria and conditions of guarantee on loans in the portfolio guarantee scheme by Thai Credit Guarantee Corporation; (iii) a B6 billion venture capital fund to be set up by Krug Thai Bank, SME Bank, and GSB; (iv) reduction of corporate income tax for SMEs registered as juristic persons with profit above B300,000 from 15%–20% to 10% for two accounting periods (2015 and 2016); and (v) exemption of corporate income tax for new start-ups in sectors in demand (e.g., innovative technology) that are registered between 1 October 2015 and 31 December 2016 for five consecutive accounting periods (Bank of Thailand 2015).

In addition to the above measures, the recently approved Business Security Act makes the taking of collateral in Thailand more practical and covers a broader range of assets. This should open up new access to finance for many SMEs. Under the previous law, only mortgages and pledges could be used as security to ensure performance under contracts. Pledging is not business-friendly because the law requires borrowers to hand over collateral to lenders, which means a business that depends on that collateral can no longer continue. Mortgaging is more business-friendly as SMEs can continue to utilize their collateral after the loan contract is signed. The previous law, however, only allowed certain types of assets to be mortgaged, including immovable assets (land and buildings) and some types of registered movable property (e.g., ships of 5 tons and over and floating houses). Therefore, assets that SMEs own, such as machinery, receivables, inventory, intellectual property, and ownership of business, were considered unacceptable for mortgaging. This issue has long been recognized as one of the obstacles for taking collateral in Thailand and has obstructed SMEs' ability to get loans from banks.

The recently enacted law, which attempts to solve this problem and unlock financing for businesses, should open a new window of opportunity for SMEs. Movable assets are now accepted as collateral to secure lending. Assets that are considered collateral include a business, a claim, movable property used in the security provider's business (e.g., machinery, inventories, and raw materials), real property if the security provider is

in the real estate business, intellectual property, and other assets as provided in the ministerial regulation (Ministry of Commerce 2015). The law has been announced in the Royal Gazette and will be effective in July 2016.

5. CONCLUSIONS AND POLICY RECOMMENDATIONS

Thailand's SME financing landscape is full of diverse financial service providers ranging from formal to completely informal institutions—from commercial banks, state-owned banks, retail banks, and nanofinance companies to cooperatives, village funds, and various savings groups. These providers are also subject to differing interest rate regimes, capital requirements, and consumer protection norms.

In this environment, there is also a widespread use of loan sharks (or moneylenders), which charge interest rates of around 15%–20% per month, or 180%–240% per year. Despite a large amount of effort to support SMEs in various forms and commercial banks' increased focus on SME lending, SMEs still have difficulty in accessing the needed credit. The main reasons are from both the demand and supply sides. On the supply side, banks have no incentive to downscale into the small-client segment largely because of the lack of knowledge in these markets, especially in the rural areas. The situation was further aggravated by interest rate caps on microfinance lending and tough competition from government-subsidized credit, making profitability almost impossible. As the private sector plays a small role in providing financial services to SMEs, Thailand's microfinance industry is underdeveloped compared with other countries in the region, particularly in terms of providing good quality and creative financial products to poorer households (Bird et al. 2011). Given that Thailand is a bank-based economy with relatively strong and healthy commercial banks, the potential role of banks in promoting financial access should not be taken lightly.

The main obstacles to bank downscaling lie in three areas. First, banks are unaccustomed to serving the special needs of small borrowers, and therefore the high unit costs and inadequate information about small-scale finance pose unfamiliar risks. The traditional commercial banking model is not designed for small-scale credit or for the kind of relationship lending commonly used in microfinance that helps build the necessary record of information and trust over time. Banks generally cannot afford to visit borrowers or properly assess risk in rural areas. Second, interest rate caps on personal loans and microcredit (currently 28% for personal loans and microcredit and 36% for nanofinance) add more constraints as operating costs for small loans are high. Third, banks are unable to compete on cost with government-subsidized SFIs and village funds. These factors reinforce the perception that microlending is too expensive and too risky for banks to incorporate as a profitable line of business.

Against this background, this study proposes that rather than providing subsidized credit to SMEs or creating entirely new types of financial licenses, the government should not overlook the possibility of engaging mainstream commercial banks in microfinance, possibly via partnerships with existing MFIs. There is a need to explore ways to utilize the competitive advantage of existing banks to promote more financial access in Thailand. This study provides three main recommendations:

5.1 Recommendation 1

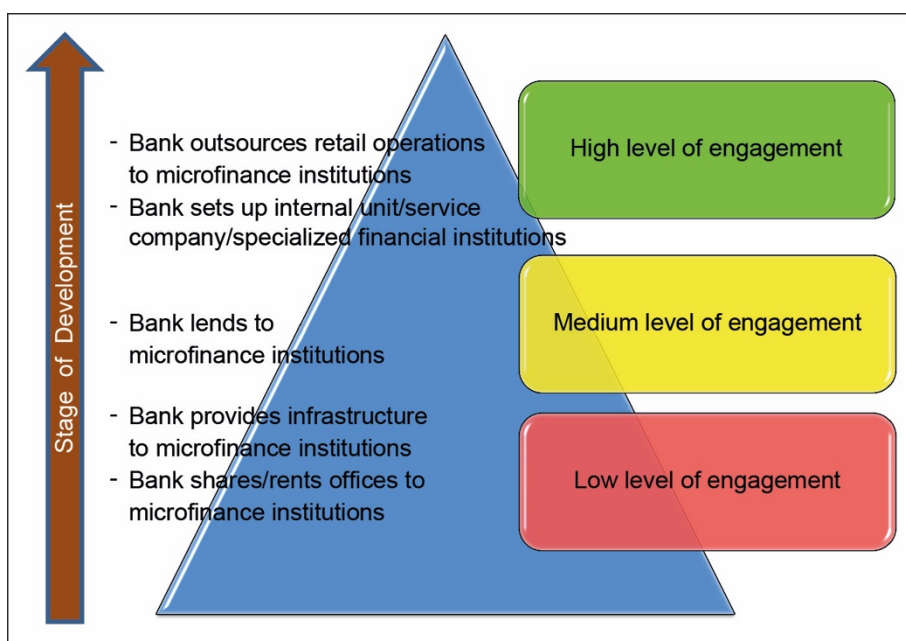
Facilitate partnerships between commercial banks and MFIs and phase out government support schemes: To a large extent, the very existence of state support of SMEs and microlenders is owed to the inability or unwillingness of banks to serve small customers. But banks have enormous potential for making financial systems truly

inclusive. Commercial banks in Thailand have wide branch networks, the ability to offer a range of services, and the funds to invest in systems and technical skills. Commercial banks can use these strengths to reach massive numbers of small clients, both on their own and in partnership with other MFIs such as VRFs, cooperatives, and various savings groups in the country. Currently, there are as many as 148,000 semiformal and informal MFIs in Thailand (Lewis et al. 2013), representing a vast market opportunity for business partnerships.⁴

To enable commercial banks to compete with SFIs on cost, the Thai government should gradually phase out SME financial assistance via existing SFIs and allow a competitive level playing field for commercial banks. SFIs in Thailand such as the Bank of Agriculture and Agricultural Cooperatives and Government Savings Bank already have a large number of savers and extensive branch infrastructure as well as links with semiformal financial institutions such as village and urban revolving funds and cooperatives (Meagher 2013). In addition, SFIs enjoy preferential treatment in terms of tax and regulatory requirements. The government should allow these SFIs to compete or partner with commercial banks based on market mechanisms without subsidized credit. It is also necessary to phase out microfinance support schemes through other institutions such as cooperatives and village funds.

A bank entering the microfinance market may start with the lowest level of engagement, providing infrastructure to MFIs for a fee. By providing services to MFIs such as cashier services, an ATM network, or office rental in return for fees or rents, banks have an opportunity to learn more about small clients and their transaction patterns. This learning process should enable banks to progress as appropriate toward the highest levels of engagement in the microfinance business, where they outsource retail operations or set up their own subsidiaries (Figure 9).

Figure 9: Commercial Banks and SME Financing



⁴ These estimates include cooperatives and occupational groups (13,000), savings groups for production (24,000), village funds (80,000), and self-help and community financial organizations (28,000).

5.2 Recommendation 2

Liberalize interest rate requirements for microfinance: The Bank of Thailand has set a 28% cap, inclusive of all fees, for lending from nonbank financial institutions as well as microcredit loans from commercial banks. Recently, even though the Bank of Thailand has allowed the new nanofinance license, regulations require the new operators to charge interest of no more than 36%. However, this interest rate may be too low for nanofinance companies to break even, as reflected by a very low loan disbursement rate since its inception. As the average size of nanoloans has so far been smaller than the maximum allowable limit (around less than B20,000), nanofinance companies view high unit cost as an important obstacle. Therefore, the interest rate cap should be either lifted for microfinance loans or allowed more flexibility in terms of the interest rate charged. Rather than imposing a flat-rate ceiling, the interest rate should be allowed to vary according to loan size, giving nanofinance companies some room to cover costs. It is reported that microfinance interest rates in other countries vary from 27% to 75% per year (Fiscal Policy Office 2015).

5.3 Recommendation 3

Develop SME and MFI credit information systems: Information is key to reducing transaction costs in SME lending and monitoring. Whether banks choose to lend directly to SMEs or partner with existing MFIs, there is the need to build an SME lending database and centralized information on MFIs. A credit rating scheme for SMEs could be developed and implemented using data on lending by banks to SMEs. From the lender's point of view, it is costly to examine the financial health of each SME. This cost is passed on to SMEs, thereby increasing their borrowing costs. Centralized information on MFIs, including credit ratings, should also reduce information costs for banks looking for viable MFIs as business partners.⁵ Formal documentation and operating procedures of MFIs should be established to facilitate matchmaking between banks and MFIs. For this, it may be necessary for the government to establish formal and legal procedures for MFIs, while ensuring that these do not impede MFIs' existing flexibility in lending to local clients.

To conclude, the Thai government has recognized the importance of SMEs to the economy and has provided a substantial amount of support to this sector. It has been more than 10 years since the start of the Financial Sector Master Plan, which aimed to provide an enabling environment for more financial access in Thailand. Still, SMEs have not been able to catch up with larger enterprises. SME contribution to GDP has been declining, with its share in 2015 (39.6% of GDP) still lower than what it was 20 years ago (44.2%), and the constraints to SME financing remain the main topic of policy discussion today. The real issue, therefore, may not be about the lack of financing and support per se but about how to design appropriate business models and market-friendly supporting schemes to help SMEs gain access to credit on a sustainable basis. For this, it should no longer be assumed that the private sector is not willing to provide financial services to SMEs at a reasonable price, and that government support is needed as a result. The private sector should, for their part, become more involved in SME financing as an alternative to public financial assistance. To facilitate this process, the government should explore the possibility of providing the necessary infrastructure and incentives to encourage commercial banks to become more active players in the microfinance market, either by expanding

⁵ Currently, the National Credit Bureau of Thailand, established in 2005 as a result of a merger between two existing credit reporting agencies at the time, collects personal information on the loan and credit card products from formal financial institutions but does not have credit information from MFIs.

their retail operations or by partnering with existing MFIs, or both. As a bank-based economy, Thailand will benefit a great deal from making use of commercial banks' competitive advantage to create a more market-friendly environment for SME financing. This will also ensure that lending to small-business clients is market-driven, not a burden to the government, and self-sustaining in the long run.

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