**The Republic of the Union of Myanmar**

# Preparatory Survey on Two-Step Loan Project for Small and Medium Enterprises Development in the Republic of the Union of Myanmar

**February 2014**

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## Executive Summary

A large part of private business entities in Myanmar are considered to be small-and-medium enterprises ("SMEs"), and SME development is essential for the economic growth of the country. While the government of Myanmar ("GOM") had already started a series of measures to support SMEs, such as on-going efforts on enactment of the SME Law, problems remain on SMEs' access to finance.

Responding to the financial crisis occurred in 2003, the Central Bank of Myanmar ("CBM") introduced very strict and less user friendly banking regulations, such as prohibition of loans exceeding 1 year and requirement of immovable collateral. On top of it, there are problems with banking practices that require complex and inconvenient procedures. As a result, total assets held by banks at the end of Year 2010 were very small at 10% of GDP, which was one third of levels in Laos and Cambodia and one twentieth of that in Thailand. As a part of economic liberalization since 2011, relaxation of banking regulation had been started and CBM modified a collateral requirement to accommodate export crops or gold. Major privately owned banks have started expansion of their branch networks as they see the current economic growth as a chance to grow their businesses. While both deposits and bank loans are increasing, the growth in loans is lagging behind the growth in deposits.

To find out the reason for the slower growth in bank loans, the consultant team carried out a survey on 102 SMEs and interviewed 42 to understand their business profiles, banking relationships, future business expansion and financing needs. The slower growth in bank loans is not because of the lack of demand as 72% of surveyed SMEs showed interest in borrowing from banks for business expansion. On the other hand, only 36% of surveyed SMEs were actually borrowing from banks. The reason that many SMEs do not borrow from banks are summarized below.

i. Current lending interest rate of banks, 13% per year, is considered by SME owners to be too expensive because they think that their return on assets is lower than that;

ii. Maximum lending term of 1 year is too short for capital investment and makes SME owners and managers nervous about refinancing risk; and

iii. Banks' collateral valuation is considered to be too low for SME owners and managers;

iv. Banks' procedures are too complicated and time consuming

On the other hand, while there are several SME owners who maintain that banks should lend unsecured loans, there are problems with SME's business practices as well. The most notable problem is non-transparent business ownership and the lack of proper financial statements. Many SME owners are aiming to hide their wealth from outsiders, especially GOM, by not incorporating their businesses into legal entities, and to hide earnings from tax collection authorities by not creating formal financial statements.

While many of issues above will require a combination of measures and a lengthy process to be resolved, the high lending interest rate and short tenor of commercial loans can be tackled by a policy-based lending program. The consultant team proposes the two-step-loan ("TSL") scheme for SME development utilizing JICA's Yen Loan.

The ultimate goal of the proposed TSL is to improve SME's access to finance, by not only providing the low interest and long term loans but also contributing to capacity development of local banks in terms of loan screening and other skills.

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## Abbreviations

| | |
|---|---|
| ADB | Asian Development Bank |
| ADBI | Asian Development Bank Institute |
| ASEAN | Association of Southeast Asian Nations |
| B/S | balance sheet |
| CB | Co-operative Bank[1] |
| CBM | Central Bank of Myanmar |
| CMP | Cutting, Making and Packing |
| DD | due diligence |
| DICA | Directorate of Investment and Company Administration |
| DISI | Directorate of Industrial Supervision and Inspection |
| DIY | Do It Yourself |
| ECL | Environmental Conservation Law |
| EIA | Environmental Impact Assessment |
| ESC | Environmental and Social Considerations |
| ESC | Environmental and Social Considerations |
| ESMS | Environmental and Social Management System |
| FAO | Food and Agriculture Organization |
| FDA | Food and Drug Administration |
| FSV | forced sale value |
| FY | fiscal year |
| GIZ | Deutsche Gesellschaft für Internationale Zusammenarbeit |
| GOM | Government of Myanmar |
| ID | identification |
| IDA | International Development Association |
| IEE | Initial Environmental Examination |
| IFC | International Finance Corporation |
| IZ | Industrial Zone |
| JETRO | Japan External Trade Organization |
| KBZ | Kanbawza |
| L/A | Loan Agreement |
| L/C | Letter of Credit |
| M/D | Minutes of Discussion |

[1] Co-operative Bank is usually and officially referred to as CB Bank, although the word "Bank" overlaps.

| | |
|---|---|
| MADB | Myanmar Agricultural Development Bank |
| MBA | Myanmar Banks Association |
| MCB | Myanmar Citizens Bank |
| MD | Managing Director |
| MEA | Myanmar Engineers Association |
| MEB | Myanma Economic Bank |
| MFI | Microfinance Institute |
| MFTB | Myanmar Foreign Trade Bank |
| MIA | Myanmar Industries Association |
| MICB | Myanma Investment and Commercial Bank |
| MIGA | Multilateral Investment Guarantee Agency |
| MLFDB | Myanmar Livestock and Fisheries Development Bank |
| MNPED | Ministry of National Planning and Economic Development |
| MOC | Ministry of Commerce |
| MOECAF | Ministry of Environmental Conservation and Forestry |
| MOF | Ministry of Finance |
| MOH | Ministry of Health |
| MOI | Ministry of Industry |
| MPD | Main Points Discussed |
| MSEC | Myanmar Securities Exchange Centre |
| MTEA | Myanmar Textiles Entrepreneurs Association |
| MUFG | Mitsubishi UFJ Financial Group |
| NHL | National Health Laboratory |
| NPL | Non-Performing Loan |
| ODA | Official Development Assistance |
| OTC | over-the-counter |
| P/L | profit and loss statement |
| P/M | Project Memorandum |
| P/R | Progress Report |
| PCR | Project Completion Report |
| PFI | Participating Financial Institution |
| PIU | Project Implementation Unit |
| PR | Public Relations |
| PSR | Project Status Report |
| ROA | Return on Assets |
| ROE | Return on Equity |

| | |
|---|---|
| SEC | Securities and Exchange Commission |
| SMBC | Sumitomo Mitsui Banking Corporation |
| SME | Small and Medium Enterprise |
| SME Law | Small and Medium Enterprises Development Law |
| SMI | Small and Medium Industries |
| SMIDB | Small and Medium Industrial Development Bank |
| SWIFT | Society for Worldwide Interbank Financial Telecommunication |
| Sub-loan | Loan from PFI to end borrowers |
| Sub-project | Capital investment project to be supported by TSL |
| TA | technical assistance |
| TSL | Two-Step-Loan |
| UMFCCI | Union of Myanmar Federation of Chambers of Commerce and Industry |
| UNEP | United Nations Environmental Programme |
| YCDC | Yangon City Development Committee |

## Background of this survey

Modernization of the financial sector and development of Small and Medium Enterprises (SME) are top priority areas for the Government of Myanmar (GOM) as the country heads towards full membership in the ASEAN Economic Community. For the stabilization and strengthening of financial sector, GOM has started modernization of financial rules and regulations and preparations for opening a securities exchange. At the same time, GOM established the SME Development Center in April 2012 to help SMEs gain access to banks and established the Central Committee and Working Committee for Development of Small and Medium Enterprises in January 2013, chaired by President Thein Sein, as well as the SME Development Implementation Committee, chaired by Vice President U Nyan Tun. The committees have been drafting the Small and Medium Enterprises Development Law (SME Law).

It has been pointed out that banks are not supplying enough long-term loans for the capital investment need of SMEs due to various obstacles. The first is that the current lending interest is considered to be too high by many SME owners. While GOM ordered SMIDB to offer 8.5% low interest loan to SMEs, the total budget was limited and not sustainable as it forces SMIDB to incur losses. Secondly, the Central Bank of Myanmar (CBM), a bank regulator, currently prohibits banks from extending long-term loans. Thirdly, some SMEs do not have sufficient real estate assets to be offered to banks as collateral. Lastly, SMEs are not familiar with and try to avoid complex document requirements and procedures. As a result, SMEs tend to borrow from informal sources, including relatives and friends, at very high interest rates of 4 to 5% per month for short term requirements and with profit sharing arrangement for long term requirements.

On the other hand, there are various problems on the side of SMEs as borrowers, including comingling of personal and company's assets, and inadequate financial management without preparation of financial statements. In order to increase formal financing to SMEs, improvements in managerial practice will have to be considered.

## Objective of this survey

The survey aims at surveying SMEs' potential needs for long-term financing and examining the effectiveness of a Two-Step-Loan program utilizing JICA's ODA loans, as well as designing an implementation scheme and identifying model SMEs to be supported. At the same time, we plan to explore medium-term measures to improve SMEs' access to finance.

# 1 Financial regulations and SMEs in Myanmar

## 1.1 Current situation of financial regulation

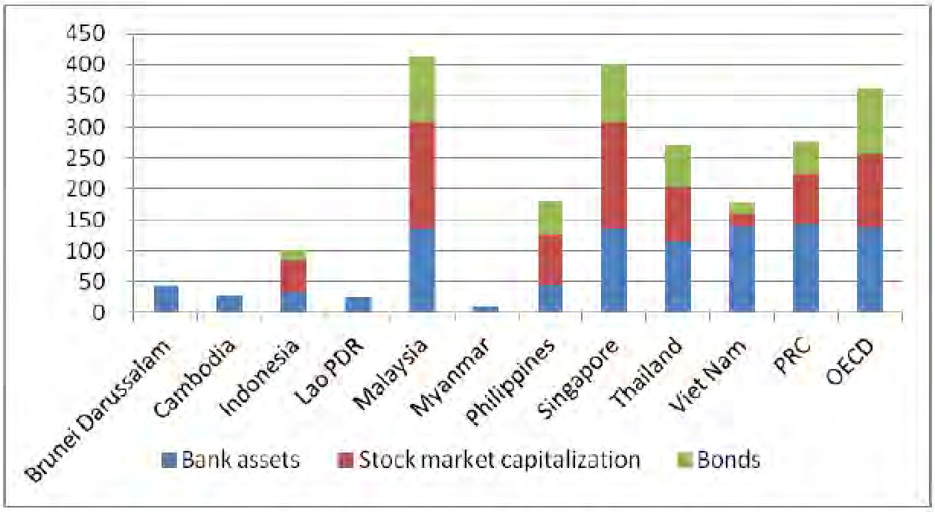
The Government of Myanmar (GOM) recognized the importance of financial markets for the economic development of the country and various kinds of financial regulations have already started to be modernized. The Foreign Exchange Law was revised in 2012, and The Central Banking Law was revised in July 2013. The Securities Exchange Law was set up in the same month as well. The Central Banking Law gives an independent role to The Central Bank of Myanmar (CBM), which had been subordinated to the Ministry of Finance (MOF), which also changed its name from Ministry of Finance and Revenue. The Securities Exchange Law is intended to establish the base of security exchange transaction rules in order to provide long term investment capital, an essential element for the economic growth, to Myanmar companies and give chances to investors. The Securities and Exchange Commission (SEC) is planned to be established in 2013 and a stock market is also planned to be established in 2015 when ASEAN market integration completes.

## 1.2 The situation of the banking sector of Myanmar today

The banking sector of Myanmar has been severely restricted by various kinds of regulations. In 2005, just after the banking crisis, MOF, the Banks Supervision Committee and CBM issued an instruction which prohibited banks from making loans without sufficient collateral, and banks were required not to lend medium-term or long-term loan and not to lend more than 20% of the combination of paid-up capital and special monetary fund (CBM instruction No1/2005) to a single party. This instruction was intended to keep financial stability, fearing bank runs and bankruptcies like those which happened in 2003. As a result of these regulations, banks cannot lend their funds without immovable collateral, or for more than one year except for some policy loans such as the term loan of MADB. Consequently, Myanmar banks have not offered sufficient financial services for their clients. Borrowers must prepare many kinds of certificates and papers in order to make the lending application form, and provide immovable collateral, normally 30 to 50% of the forced sale value (FSV). Depositors must wait for a long time to just withdraw their deposits and pay charges when they use ATMs, most of which act as no more than cash dispensers. In other words, the banking sector does not need to recognize itself as a service sector providing services to its clients.

Due to less borrower friendly banking regulations and practices as mentioned above, the banking sector is playing only a limited role in economic development in Myanmar. A report issued by the Asian Development Bank Institute (ADBI) points out that the total financial assets of Myanmar, in terms of ratio to GDP, are by far the lowest in the ASEAN economies[2] According to an ADBI working paper, the ratio of bank assets to GDP in Myanmar was 10% in 2010, while those for the second lowest, Lao PDR, was 27% and the third largest, Cambodia, was 28%. Compared to Thailand or Malaysia, size relative to GDP is less than one tenth.

Fig. 1-1 Total Financial Assets in ASEAN Economies, 2010 (% of GDP)




Notes: bank assets (claims on the domestic real nonfinancial sector by deposit money banks) come from IMF/IFS, lines 22, a-d; stock market capitalization is from the World Bank database; bonds (sum of local currency and foreign currency bonds) are from ADB's Asian Bond Online database.

Sources: IMF, International Financial Statistics database, www.imf.org; World Bank, database, http://data.worldbank.org; and ADB, Asian Bond Online, http://asianbondsonline.adb.org/index.php

[2].http://www.adbi.org/working-paper/2013/03/28/5577.deepening.asean.financial.markets/

### 1.3 Problem with financial regulation and resolutions

(1) Restriction on the length of loans (one-year rule)

In order to provide enough capital to SMEs in Myanmar, it is absolutely necessary to modernize these banking regulations. Needless to say, SMEs need longer term capital to make investments for their business expansion. The regulation on the maximum length of lending should be abolished, although this regulation has just been partially liberalized on 2 August 2013 by the CBM instruction No1, and banks are allowed to make long term loans compatible with its own long term deposits..

(2) Collateral requirement

Secondly the expansion of range of collateral should be fulfilled. The CBM has started liberalizing conditions for collateral to include gold (75%FSV; 2011/9/8), deposits (80%FSV; 2011/12/27), jewelry, government bonds, and crops for export (60%FSV; 2012/1/25), however, most Myanmar banks have not yet started accepting these kinds of non-traditional collateral due to the lack of incentives because valuation of non-traditional collateral is very time-consuming and physical maintenance is cumbersome in comparison with traditional collateral such as immovable assets. As a result, SMEs without properties cannot borrow from banks (See details in 2.1). Discussion concerning the establishment of a credit insurance system to guarantee SMEs' loans to the banks has just started between MOF, CBM and other relevant agencies and it will take some time before such a system can be launched. Reliance on immovable collateral hinders banks' capabilities to evaluate business profitability. Today all the banks do not carefully examine business plans or profitability of their SME clients, because they solely rely on such collateral for recovery of principal and interest as long as they maintain conservative lending limits up to 30% to 50% of FSV.

(3) Regulation on interest rate

Finally, competition among banks has been limited by these regulations. Interest rates have been deregulated partially under the Central Banking Law (CBM instruction No11) in 2011. Under this deregulated rule, the banks are allowed to set their lending rate between 10% to 13%, and their deposit rate between 8% to 10%. However, a few bank increase their deposit rate, such as Small & Medium Industrial Development Bank (SMIDB) who's saving account rate is 8.5%, while Kanbawza (KBZ) Bank which has biggest branch network sets the rate at 8.0%.

Table 1-1 Interest rate on fixed deposit

| | Saving account | 3-months fixed deposit | 6-months fixed deposit | 9-months fixed deposit | 12-months fixed deposit |
|---|---|---|---|---|---|
| SMIDB | 8.50% | 8.75% | 9.00% | 9.25% | 9.50% |
| KBZ | 8.00% | 8.25% | 8.50% | 8.75% | 9.00% |
| MEB | 8.00% | 8.25% | 8.50% | 8.75% | not in service |

Source: Created by the consultant team

As for lending rates, there are no differences between banks, and some banks request that borrowers pay a 1% extra service charge for annual roll over. In order to promote changes to these situations, some more steps towards deregulation are needed. However, deregulation steps should be considered very carefully and only carried out step by step. In the short term, the one-year rule for bank lending should be abolished. Practically all banks allow borrowers to roll over their lending upon maturity. If banks are allowed to enter into long-term loan agreement, it will reduce the work-load of both banks and borrowers because a tremendous volume of documents is required for roll-over procedure. If this regulation is abolished, the banks can allocate these human resources to other areas and borrowers can use the bank loans for much longer term investments, which can increase productivity.

Hopefully the banking regulation should be modified so that banks can use their discretion to conduct business at their own risk. In the final stage, financial regulations should shift to supervision of the banks. For this purpose, capacity building of the banks is needed (See details in 4.2.)

## 1.4 The SME promotion policies of GOM and the situation of SMEs today

### 1.4.1 The SME promotion policies

Historically, GOM had not taken any industrial policies for SMEs until President Thein Sein's administration because the Ministry of Industry (MOI) had many state owned enterprises (SOEs) and production of industrial goods through SOEs was a mission of MOI in the past. Even after abolishing Burmese Way to Socialism in 1988, GOM had changed neither the governmental organizations nor their missions from those for socialism to capitalism and, therefore, no systemic approach to promote private sectors had been taken. However, after privatization of SOEs and initiation of market based reform by President Thein Sein, GOM had finally entered into the phase of industrial policy making. President Thein Sein's administration had already acknowledged that it is essential to develop SMEs for economic growth.

GOM established the SME Development Center in April 2012 to promote financial inclusion for SMEs as well as to provide various training courses to increase SMEs' management capacity. In January 2013, GOM formed the Central Committee and Working Committee for Development of Small and Medium Enterprises chaired by the President Thein Sein as well as the SME Development Implementation Committee chaired by Vice President Nyan Tun. The committees supervise working groups in charge of drafting the Small and Medium Enterprises Development Law.

The enactment process of SME Law is not disclosed and, while being said to be approved by Parliament in early 2014 by many relevant officials and business people, no detailed schedule or target date has been made available. Financial assistance is necessary to ensure that the new policy can be effectively implemented for development of SMEs.

It also includes the new definition of SME. While the existing definition of Industry Law covers only small and medium industries (SMI) under the supervision of MOI, the new definition is designed to cover various sectors including service, trading and tourism (hotel and restaurant) under MOC, Ministry of Hotel and Tourism or some other ministries. Details of definition of each sector are modified to fit better to the current economic situation as shown on the next page. The proposed TSL program is to adopt the new definition to define eligibility for borrowers.

Table 1-2 Existing definition of SME (Industry Law revised in 1990)

| | Small | Medium |
|---|---|---|
| Power (horse power) | 3-25 | 25-50 |
| Employment (number) | 10-50 | 50-100 |
| Capital investment (mil kyat) | <1 | 1-5 |
| Annual production (mil kyat) | <2.5 | 2.5-5.0 |

Source: SME Development Center website (http://www.smedevelopmentcenter.gov.mm/?q=en/def_sme)

Table 1-3 New definition of SME (Discussed in the Parliament)

(1) Manufacturing, Mining and Construction

| | Small | Medium |
|---|---|---|
| Employment (number) | <50 | 51-300 |
| Capital investment (mil kyat) | <500 | 500-1,000 |

(2) Labor intensive manufacturing or CMP

| | Small | Medium |
|---|---|---|
| Employment (number) | <300 | 301-600 |
| Capital investment (mil kyat) | <500 | 500-1,000 |

(3) Wholesale

| | Small | Medium |
|---|---|---|
| Employment (number) | <30 | 31-60 |
| Capital investment (mil kyat) | <100 | 101-300 |

(4) Retail

| | Small | Medium |
|---|---|---|
| Employment (number) | <30 | 31-60 |
| Capital investment (mil kyat) | <50 | 51-100 |

(5) Service

| | Small | Medium |
|---|---|---|
| Employment (number) | <50 | 51-100 |
| Capital investment (mil kyat) | <100 | 101-200 |

(6) Other enterprise

| | Small | Medium |
|---|---|---|
| Employment (number) | <30 | 31-60 |
| Capital investment (mil kyat) | <50 | 51-100 |

Source: SME Development Center website (http://www.smedevelopmentcenter.gov.mm/?q=en/def_sme) and interview with SME Development Center as of October 2013

The Central Department of Small and Medium Enterprises Development in Yangon, also known as the SME development center, it is expected to play a role as a bridge between SMEs and banks for improving financial inclusion for SMEs. In addition, President Thein Sein ordered MEB and SMIDB to establish an SME Loan Program, in which MEB lends 5 billion kyat to SMIDB at 8.25%, and SMIDB lends it to the SMEs which need funds for their businesses at 8.5%, much lower than the normal bank lending rate (13%). More than 300 SMEs applied to this program, and SME development center selected 157 SMEs and transmitted these applications to SMIDB.

Registration and accounting systems of SMEs should also be modernized. At this moment, many SMEs have not formally registered with the Directorate of Investment and Company Administration (DICA) of the Ministry of National Panning and Economic Development (MNPED), and only 40,000 SMEs have registered with the Directorate of Industrial Supervision and Inspection (DISI) of MOI, despite the President's Office estimating that there are 127,000 SMEs in the country. It is generally believed that a large number of SMEs in Myanmar exist informally. As a result, it is very difficult to statistically estimate the total demand for funds to satisfy SMEs' needs.

In addition, most SMEs do not prepare financial statements. Even if they do make financial statements, some SMEs do not separate company accounts from owners' individual accounts as a common practice, because the owners provide their properties for the production or other business activities and for collateral in many cases. In order for banks to analyze the financial standing of the borrowing entity, financial statements correctly reflecting assets, liabilities and revenues legally belonging to the borrower are needed. For this purpose, assets and liability of SMEs must be clearly segregated from owners' personal ones. The consultant team believes that there are several reasons for commingling of personal and business assets. First, a properly functioning tax collection system had not been established and business owners cannot enjoy any tax benefit for incorporating their business assets into a legal entity, where depreciation costs can be tax deductible. Secondly, there has traditionally been a deep-rooted fear for nationalization for any assets registered under the company's name. When the Burmese way to socialism started, all business assets were confiscated while some of privately owned ones were exempted. Several business people mentioned that they intentionally register key business assets under multiple family members name to make it difficult for GOM to identify them. A number of SMEs had the factory land, buildings and machinery owned by different family members. For these reasons, encouragement of incorporating businesses is likely to take a long time and must be preceded with the establishment of the tax collection system, which can provide incentives and disincentives for business owners.

### 1.4.2 Other donors

German foreign aid agency GIZ, and Friedrich Naumann Foundation of Germany have already established their offices in the SME development center in Yangon, and started their operations. GIZ have 3 programs, Tot (training of trainers) program from September 2013 through June 2016, the two-year technical assistance program for banks, which includes assistance to the regulatory bodies such as CBM, and a financial reporting system for the development of SMEs. According to the meeting with GIZ, 7 banks applied to this program, and 3 banks were selected.

GIZ's Myanmar projects in progress

(1) Private Sector Development (33 months, budget EUR 4.5 mil)

(2) Financial Sector Development (36 months, budget EUR 4.6mil)

The budget of this program has been increased from EUR 3 mil. based upon G to G negotiation in July 2013.

(3) Technical and Vocational Education and Training (36 months, budget EUR 5 mil)

Friedrich Naumann Foundation which is a German private foundation, sponsored the SME development center to hold 7 seminars on business skills in Industrial Zone between July and October 2013.

## 2 Current funding conditions of SMEs

This section examines the current funding practices of SMEs and the obstacles they face in accessing bank loans. It is based on a literature search, review of loan applications submitted to SMIDB, interviews to banks and SME owners and a survey on 102 SMEs.

### 2.1 General observations

To understand the financing practices of SMEs, the consultant team started with a literature search and analysis of loan applications submitted to SME development center and SMIDB. Then, the team interviewed SME owners and managers to gain first-hand knowledge on their financing practices and way of thinking. Through the field survey, the team found out the following.

- SMEs do not borrow much from outside. Their business activities are funded by their own funds such as family savings and internal cash flow.
- Still, there is a large demand for SME loans with lower interest rate.
- Hurdles for bank borrowing are high for SMEs due to the need for complex procedures, requirement of immovable collateral and the disclosures of financial information.
- Proper financial reporting practice is very rare among SMEs due to the fear of taxation and other kind of government interventions, the ultimate form of which is nationalization. For this reason, informal lenders are considered more easily accessible and convenient finance sources for short-term working capital needs.
- Very strict banking regulations have been imposed since the 2003 banking crisis, but CBM had started gradually relaxing the collateral restrictions. .

Aung Kyaw of Yangon Institute of Economics published a report on this subject in 2008[3] and pointed out that 30 companies out of 167 in Yangon and Mandalay had access to bank loans. It suggested that the bank loans were generally difficult because of (i) complex bank procedures and (ii) tight collateral requirements. It also pointed out that loans for only one year term were not suitable for capital investments. The consultant team believes that this observation is still true and it will be necessary to look in detail to find out the current situation.

This assessment coincided with our review of SME loan applications and interviews

[3] Financing Small and Medium Enterprises in Myanmar , IDE Discussion paper No. 148, 2008

with SME owners/managers as quite a few balance sheets of SMEs did not show any borrowing from outside, not even any account payable or other trade debt. While those balance sheets are not accurate and reliable, the consultant team still believes that successful SMEs had gradually accumulated wealth through their internal cash flows. Also, these interviews confirmed that the amount of borrowing of SMEs is considered to be small. One SME owner mentioned that he was still not confident in making a large investment with bank loan because of fear for the 2015 election and ASEAN market integration.

However, judging from the fact that the current SME Loan Program had attracted over 300 applications in only several months without much advertisement, the consultant team believes that there is a large demand for SME loans with lower interest rate.
From the banks' perspective, SMEs are considered a main customer segment for lending. Despite difficulties for obtaining bank loans, senior managers of all the banks mentioned that SMEs occupy a large portion of their banks' loan portfolio. This means that SMEs are not avoided by banks, but the condition or volume of bank lending is not meeting the potential needs of SMEs due to various issues including high interest rate and extensive requirements for documents, disclosures and immovable collateral.

It should be noted, however, that it is not considered possible to realize SME owners' expectations for low-interest and unsecured bank borrowing in the near future. While many SMEs complain that bank lending is too little and too expensive, the consultant team considers that their expectations for unsecured and low-cost funding is partially based on their illusions about banking practice in other countries. One SME owner was surprised when the consultant team mentioned that unsecured lending to SMEs was limited even in Japan and immovable assets were commonly required by banks. Multiple SME owners mentioned that bank lending rate should be lower than 5% because borrowing rate in Singapore or Japan are much lower. Such expectations are coming from false expectation created by fragmented information and the lack of understanding about the banking business and macroeconomics such as the relationship between interest rate and inflation. Therefore, it is important to distinguish the issues that can be addressed by a single measure, such as the proposed TSL program, and the issues that must be addressed by a combination of measures, such as banking regulation and taxation, and over a long period of time.

### 2.2 Obstacles for SMEs' access to bank loans

#### 2.2.1 High interest rate

Interest rate is the most frequently heard complaints by SME owners. While the current 13% lending rate is not considered high when considering the inflation and the economic growth rate of Myanmar and in comparison with other ASEAN countries, many SME owners mentioned that it is too high when compared to the profit margin of their businesses and the risk of volatility in economical and political situation in Myanmar. Our survey on SME owners revealed that average net profit margin perceived by SME owners was less than 12% (see 2.3 (2)).

#### 2.2.2 Prohibition of extending loans exceeding one year

As mentioned in 1.3 (1), banks are generally prohibited from extending loans exceeding one year. Many SME owners that the consultant team interviewed mentioned that they wanted to take on bank loans to replace machinery or purchase machinery but worry about the refinance risk under the one-year rule. The survey on 102 SMEs also revealed that the extension of loan term is the second largest demand from the respondents, while lower interest is the top.

#### 2.2.3 Complex bank procedures and disclosure requirements

Extensive document and disclosure requirements are the primary reasons that many borrowers opt to choose informal lenders for short term funding needs, according to a senior manager at one commercial bank. Borrowing from informal lenders is very simple in that borrowers are required to provide gold as collateral and no detailed disclosure or documentation is required. While the interest rate is high, the financial burdens from informal borrowings are acceptable if the funding need is only for two or three months. They are, however, unusable for long term investments.

SMIDB, an implementing bank of the current SME Loan Program, kindly provided assistance to the survey by disclosing detailed information about their loan procedures and introducing some of their clients.

The standard documents required for bank loan applications are as follows.

i. Submission of loan application and the following documents
ii. Multiple letters of undertakings or promissory notes
iii. Resident registrations, family member lists and related documents
iv. Tax payment certificates for the last 3 years (income tax, trading tax)
v. DICA and DISI registrations
vi. Information about the collateral, such as certificate of ownership

vii. Financial statements for the last 3 years (1 year for SME Loan Program)
viii. Pictures of factories and collateral properties

While the extensive documentation requirements above are one of the reasons that many SME owners avoid bank loans, there is no measure to resolve this problem as these documents are necessary for banks to confirm the credibility of the borrower. It is true that some borrowers, such as food processing industry businesses, have to submit many licenses and permits from multiple ministries, states/provinces and municipalities but it is not the problem with the banks but with the administrative systems. To some extent, this hurdle can be lowered by streamlining the application documents and processes to make it easier for loan applicants. Technical assistance may be appreciated on this point as well.

While the burden of collecting various certificates for registrations and licenses is high, even bigger problem for SMEs when applying to bank loan is considered to be the preparation of financial statements. Many of SMEs do not create financial statements because business owners in Myanmar do not like to disclose their financial information, wishing to avoid taxation and avoidance having long-lasting fears of confiscation by the government. For such reasons, many of the business owners intentionally created many legal entities for a single line of business, registering the properties under multiple family members' names and employing nominal shareholders for registering purposes. As a result, very few of the assets employed for business are owned by a single legal entity and it is not possible to create a financial statement that truly represent the assets and liability of such. In short, most SMEs are run as individually or family owned businesses and not formally incorporated as legal entities.

When applying for a bank loan, many SMEs create "imaginary" financial statements from a series of transactions, assets owned and liability owed by various entities and family members. This requires some time and incurs costs, including the auditors' fee. The fact that many SME loan borrowers submitted the financial statements for only one year suggests that the applicants created the financial statements for the first time. Some borrowers attached revenue-and-expenditure statement for only one year and no balance sheet, as it was allowed in the current SME Loan Program.

Such financial statements do not correctly show the true operational records or the state of assets and liabilities of the companies. Since many of the SMEs are not incorporated as legal entities, many of financial statements are not based on an actual record of assets or incomes, but based on the perception of the business owners. Based on the sample review of loan applications, the consultant team had discovered the following features.

- Most of the assets are personally owned by the owner, not by the company, but such assets are included in the company's balance sheet.
- Salaries for owners' family members are not included in expenses.
- Depreciation of machinery and/or valuation of collateral are not properly practiced
- No tax offices or bank's credit officers seemed to have examine the financial statements carefully

In the interviews with some SMEs, the consultant team discovered the existence of a bank loan that was not reported on the balance sheet.

The fact that the bank's credit officers did not review the financial statement is a reflection of distrust in the applicants' financial reporting and the banks' credit culture which focuses on collateral values. The lack of bank officers' credit analysis skill was also evident as many of them could not answer simple questions regarding financial statements attached to the loan applications.

### 2.2.4 Collateral requirement

SMEs also complain about the requirement of immovable collateral and very conservative loan-to-value ratio against collateral. CBM does not impose any specific regulation to the banks on the upper limit for collateral value, however, banks themselves are very cautious about raising loan-to-collateral value ratio and keeping it relatively low, usually 30% of forced sale value, or F.S.V., due to less developed and non-transparent real estate market. Some banks use loan-to-collateral value ratio as a method for evaluating creditworthiness of each borrower, and raise it from 30% for the first borrowing to 40% for the second, 50% for the third. Under the practically regulated interest rate without competition, the banks in Myanmar do not want to change interest rates according to the borrower's creditworthiness; so the loan-to-collateral value ratio is the only way for the banks to reflect their risk assessments in their lending practice.

In addition, there are many complaints about partial ownership of apartments, which has not been permissible as immovable collateral. Partial ownership of apartment is becoming a substantial subject for hire purchase schemes, which will be mentioned in 3.2.3.

As mentioned in the previous section, banks cannot rely on financial statements for credit analysis. While some banks are now beginning to train their employees for cash flow based credit analysis, dependence on collateral will continue for the time being. Therefore, the consultant team believes that more practical approach to expand SME lending is to increase the types of collateral and raise the loan to collateral value ratio.

There are new types of movable and other collateral recently approved by CBM, as described in 1.2. The following are banks' responses to major movable collateral and implications for SMEs. The consultant team believes that this move by CBM should improve SMEs' access to finance by giving them choices of assets to provide to banks as collateral.

(1) Gold

Gold is commonly used as collateral by informal lenders in Myanmar. While CBM has just formally approved gold as collateral on 8th September 2011 by CBM instruction No22, banks are applying a more strict valuation method than informal lenders based upon market price.

For practical concerns, gold is not considered useful as collateral for long term borrowing, either. Gold is a highly liquid asset, but does not yield any return as long while it is kept in the bank as collateral. Therefore, if SMEs have gold and need long-term funding for capital investments, it is expected that they would simply sell the gold and use those funds instead of paying high interest rates for the loan by offering the gold as collateral.

(2) Export crops

Inventory financing had been widely used by banks until CBM prohibited it after the 2003 banking crisis. In 2012, CBM approved export crops as collateral for bank loans (CBM instruction No25).

The consultant team succeeded in interviewing MCB and its clients who are utilizing a "pledge loan", with beans for export as collateral.

MCB evaluate the collateral based on the market price. The client hopes that MCB will start lending against a bill of lading or letter of credit from the importers' bank.

One rice miller mentioned that he hopes to use his rice inventory for the domestic market as collateral in future. Rice inventory was used as collateral for banks until 1962 before the start of the Burmese Way to Socialism.

### 2.3 Demand for funds by SMEs

To understand the funding needs of SMEs, the consultant team examined the applications to SME Loan Program of SMIDB, reviewed the survey result by a local subcontractor and interviewed 42 SMEs. Interviewee SMEs were selected based on their investment needs from attendances of seminars held on August 23, and September 19 at The Union of Myanmar Federation of Chambers of Commerce and Industry (UMFCCI) and introduced by banks and trading companies.

(1) Applications for SME Loan Program

According to the applicants for SME loans, SMEs need funding for business expansion and for both capital investments and additional working capital. Manufacturing companies generally need working capital to buy raw materials and to pay salaries, and they would need capital investment, especially if their machinery and equipment are old or have insufficient capacity.

(2) Survey of 102 SMEs and interviews with 42 SMEs

(a) Survey of 102 SMEs

The consultant team, in collaboration with a local subcontractor, Thura Swiss, visited 102 SMEs to examine their funding needs. Some of them were chosen from "Top 100 SME in Myanmar[4]" issued by Ministry of Industry, and others were introduced by certified accountants. The local subcontractor had physically visited sample SMEs with questionnaires because our initial trial revealed that many SME owners are not familiar with banking practices and terminology. The consultant team considered that a proper answer cannot be obtained through written survey or telephone inquiry.

Table 2-1 Sector breakdown of sample SMEs

| | Number | % |
|---|---|---|
| Manufacturing | 60 | 58.80% |
| Services | 17 | 16.70% |
| Agriculture | 12 | 11.80% |
| Fishery | 3 | 2.90% |
| Transportation | 3 | 2.90% |
| Mining | 2 | 2.00% |
| Wholesale Trade | 2 | 2.00% |
| Forestry | 1 | 1.00% |
| Livestock | 1 | 1.00% |
| Total | 102 | 100.00% |

[4] Source: http://www.smedevelopmentcenter.gov.mm/

Manufacturing includes food processing (edible oil, dry fruits, tea, and jam), engines, pumps, plastic bottles, textile, footwear, and furniture.

The sample companies are very different in size. As the chart below shows, the smallest company's total assets and annual turnover is less than 1 million kyat while the largest's exceeds 10 billion kyat. This largest company, a sugar and paper bag manufacturing factory, still qualifies as SME under the definition of draft SME Law, as the number of employees is less than 300.

Fig. 2-1 Total assets of sample SMEs (96 respondents)

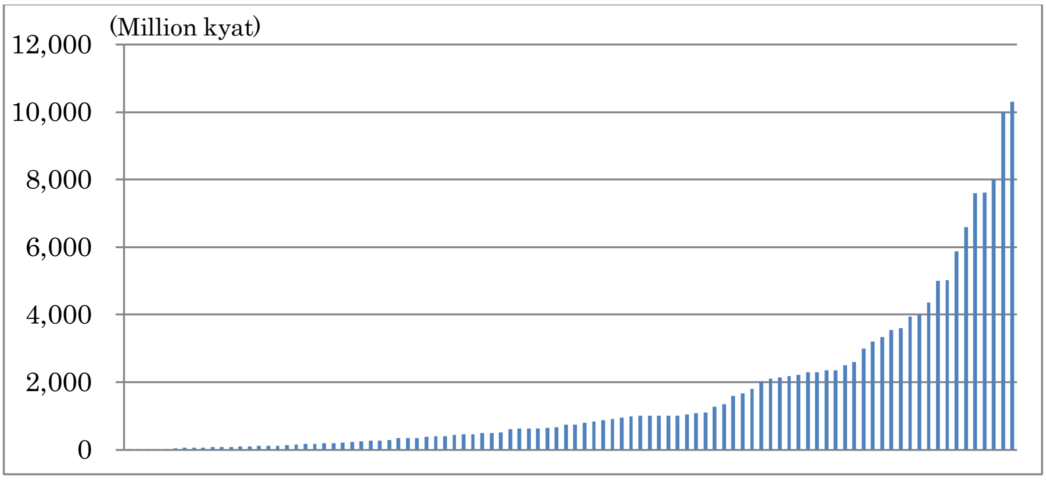
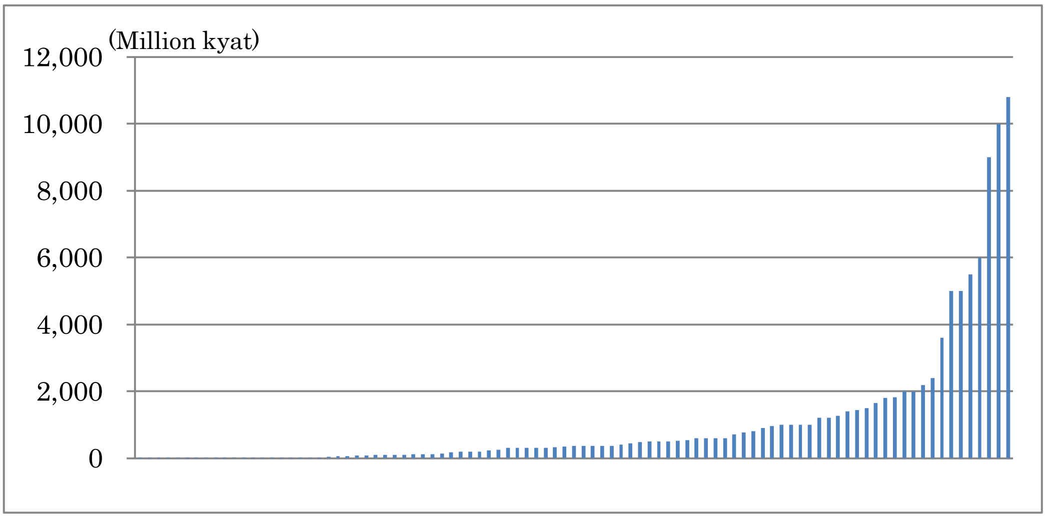
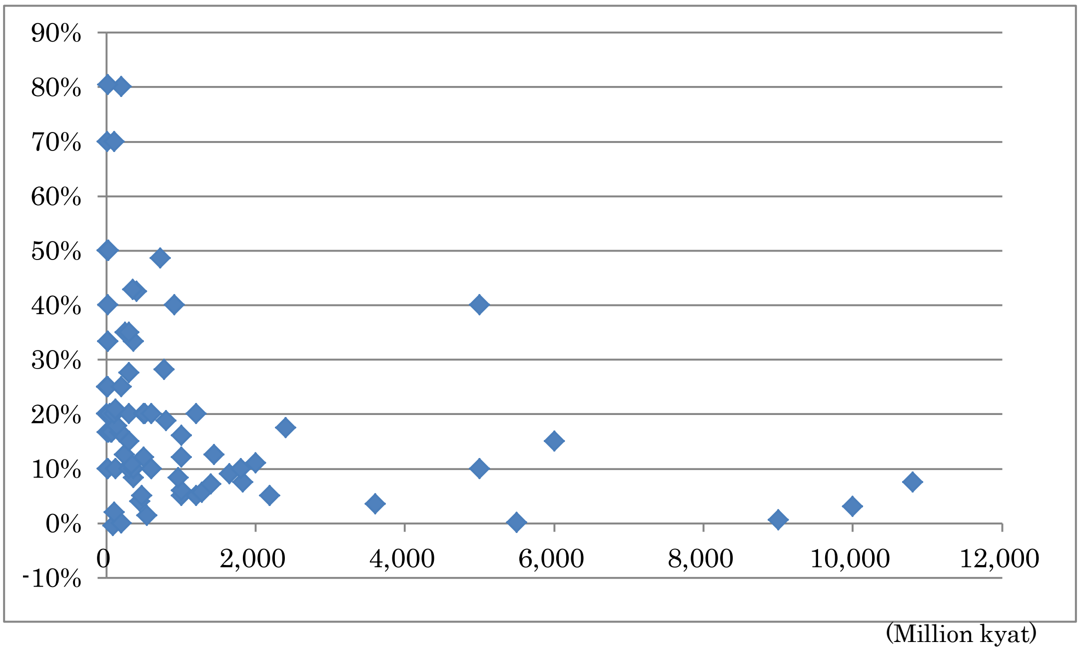



Fig. 2-2 Annual turnover of sample SMEs (93 respondents)




Profitability of the respondents varies but 59 of 86 SME owners considered their profit margin to be equal to or less than 20%, and 39 replied that their profit margin is equal to or less than the current commercial lending rate of 13%. The chart below shows the distribution of profitability based on annual turnover and there is no correlation between the size and the profitability. However, it should be noted that this profitability figure is based on the perception of SMEs and not based on properly recorded financial statements.

Fig. 2-3 Distribution of net profit margin based on annual turnover (86 respondents)




As for the number of employees, 86 out of 96 respondents replied that they had equal to or less than 100, while only 5 replied over 200. 3 respondents replied that they had over 300 employees but they can be regarded as an SME if their paid-up capital is less than 100 million kyat.

Fig. 2-4 Number of employees at sample SMEs (96respondents)

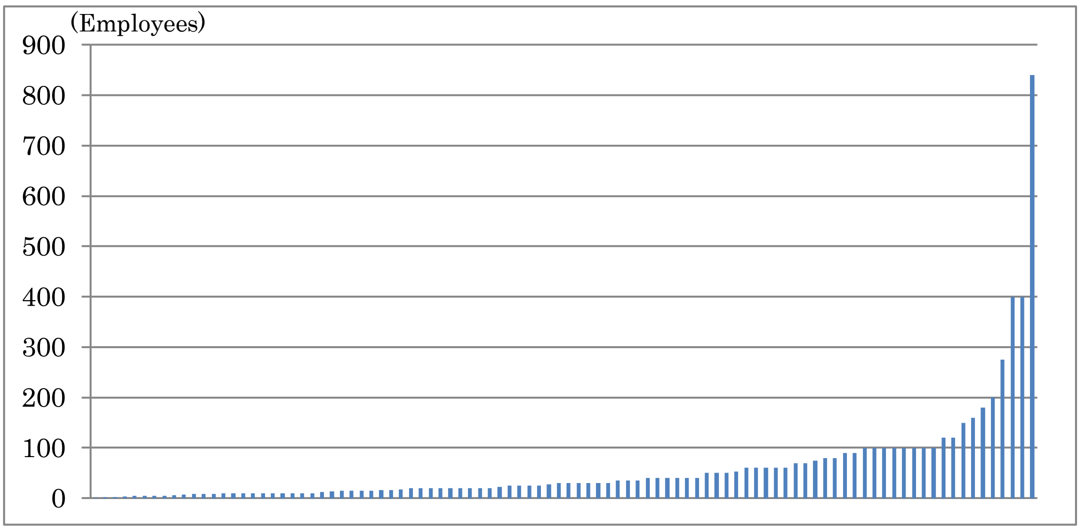


Table 2-2 Size & Profitability of sample SMEs

| (million kyat) | All samples | Manufacturing |
|---|---|---|
| Total assets<br>(93 responses, manufacturing 53) | Mean 1,618<br>Median 745 | Mean 1,322<br>Median 620 |
| Turnover<br>(86 responses, manufacturing 49) | Mean 1,054<br>Median 360 | Mean 970<br>Median 355 |
| Profits<br>(96 responses, manufacturing 57) | Mean 125<br>(11.6% of turnover)<br>Median 55<br>(15.2% of turnover) | Mean 93<br>(9.6% of turnover)<br>Median 48<br>(13.5% of turnover) |
| Return on assets ("ROA")<br>(82 responded to both profits and assets, manufacturing 47) | Mean 22.7%<br>Median 5.3% | Mean 24.6%<br>Median 6.8% |
| Number of employees<br>(96 responses, manufacturing 57) | Mean 61 employees<br>Median 30 employees | Mean 76 employees<br>Median 30 employees |

The turnovers and profitability of manufacturing SMEs are slightly smaller than total samples, while the number of employees is larger. This would suggest the labor intensive nature of manufacturing SMEs. The asset size of manufacturing SMEs is slightly smaller but not very significantly.

While many SME owners mention that they do not borrow from banks because the current 13% interest rate is higher that their profit margin, the survey above also exhibits that the median profit margin of manufacturing sector is 13.5%, meaning that about half of surveyed small and medium sized manufacturers earn less than the banks' interest rate. ROA, which can be obtained by dividing annual profit by the total assets, turns out to be even lower than the net profit margin, with a median figure of only 6.8% for manufacturing SMEs. While the figure is based on SME owners' perception and not based on properly prepared financial statements, only a small portion of profitable SMEs can enhance the return on shareholders' equity by borrowing from banks. If ROA figures above represent the true perception of the business owners, the current bank lending rate of 13% is considered too high. If the interest rate is higher than ROA, the return on shareholder equity ("ROE") will be squeezed by an interest payment higher than the return on borrowed funds[5]. Out of 46 manufacturing companies, only 16 showed ROA higher than 13%, while 22 showed ROA higher than 8%. Therefore, if TSL provides lower interest loans, the pool of candidate borrowers shall be expanded.

### Use of bank loans by sample SMEs

We asked SME owners as to their usage of bank loans and obtained the following result.

Table 2-3 Use of bank loans

| | All SMEs | Manufacturing |
|---|---|---|
| Number of SMEs with outstanding bank loans (101 responses, manufacturing 57) | 36.3% | 28.3% |
| Size of existing loans (37 responses, manufacturing 17) | Mean 175<br>Median 150 | Mean 181<br>Median 200 |

As can be seen from the table above, 36.2% of 101 respondents replied that they had existing bank loans. The consultant team broke down 101 respondents based on the size of total assets and found that upper middle sized SMEs have a higher ratio of usage of bank loans. On the other hand, only 5 out of 20 SMEs are using bank loans.

Table 2-4 Utilization of bank loans by SMEs based on the asset size

| | # of SMEs | Total Assets (million kyat) | | Employees | | Existing Bank Loan (million kyat) | | |
|---|---|---|---|---|---|---|---|---|
| | | Mean | Median | Mean | Median | # of SMEs | Mean | Median |
| Group 1 | 20 | 78 | 80 | 18 | 13 | 2 | 6 | 6 |
| Group 2 | 20 | 331 | 340 | 16 | 15 | 5 | 113 | 50 |
| **Group 3** | **21** | **834** | **848** | **45** | **40** | **14** | **139** | **110** |
| **Group 4** | **20** | **2,057** | **2,160** | **82** | **90** | **11** | **242** | **200** |
| Group 5 | 20 | 5,919 | 5,013 | 145 | 75 | 5 | 260 | 300 |

[5] If ROA is 10% and all the business assets are purchased by owners' own fund, ROE is the same as ROA at 10%. If the owner borrows 50% of the required funds from banks at 8%, ROE is enhanced by 2% (10%-8%), and becomes 12%. However, if the owner does the same with borrowing cost of 13%, ROE is reduced to 7% (10%-13%).

Funding needs and availability of immovable collateral

Then, we analyzed the companies' funding needs and intention of borrowing bank loans. As depicted in the table below, 71.6% of all SMEs answered they would like to borrow bank loans (for both working capital and capital investment), while the proportion of SMEs which actually have outstanding bank loans is 36.2%. This suggests that almost half SMEs that wish to do not have bank loans.

Table 2-5 Future funding needs

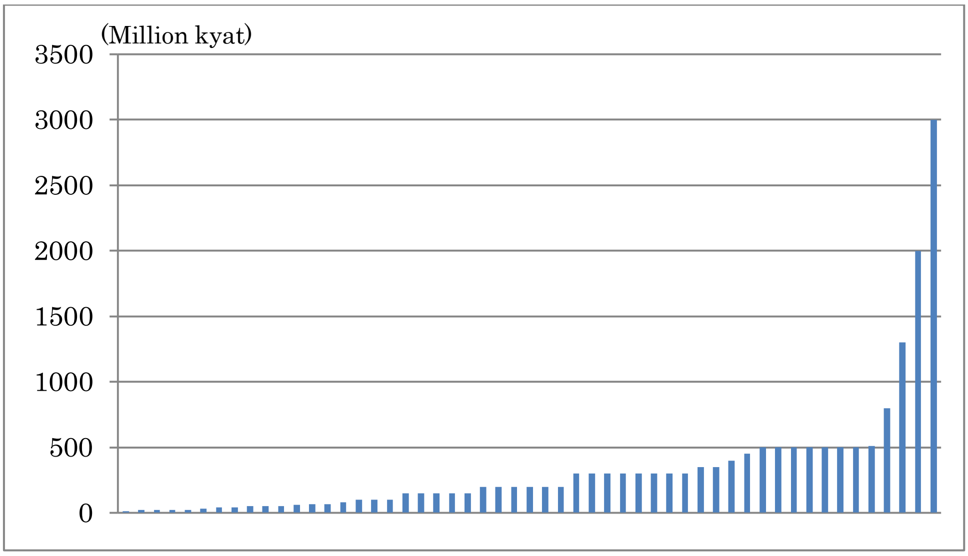
| Million kyat | All samples | Manufacturing |
|---|---|---|
| Demand for bank loans | | |
| ➢ Percentage of SMEs that are in need of banks loans | 71.6% | 73.3% |
| ➢ Funding needs<br>(73 responses, manufacturing 44) | Mean 551<br>Median 300 | Mean 626<br>Median 318 |
| Demand for bank loans (capital investment) | | |
| ➢ Percentage of SMEs that are in need of banks loans for capital investment | 61.8% | 65.0% |
| ➢ Funding needs<br>(63 responses, manufacturing 39) | Mean 395<br>Median 250 | Mean 469<br>Median 300 |
| Demand for bank loan (to purchase machinery and equipment) | | |
| ➢ Need banks loans to purchase machinery | 52.0% | 56.7% |
| ➢ Funding needs<br>(53 responses, manufacturing 34) | Mean 252<br>Median 100 | Mean 271<br>Median 100 |

Out of 71.6% of all surveyed SMEs, 61.8% wish to have bank loans for capital investment, including machinery and equipment. For example, food processing companies mentioned that they would like to purchase packaging machines, refrigerators, or dryers to make dry fruits. Other companies answered that they wish to purchase vehicles. The consultant team observed that most of the machinery in surveyed SMEs is outdated, and they wish to upgrade the machines in order to compete with imported products.

The table above does not show much difference in the financing needs between manufacturing sector and others. The financing needs of manufacturing SMEs are bigger than those of all SMEs, but the difference is not significant. This might suggest that other industries including agriculture and services also have needs for replacing existing machinery and equipment.

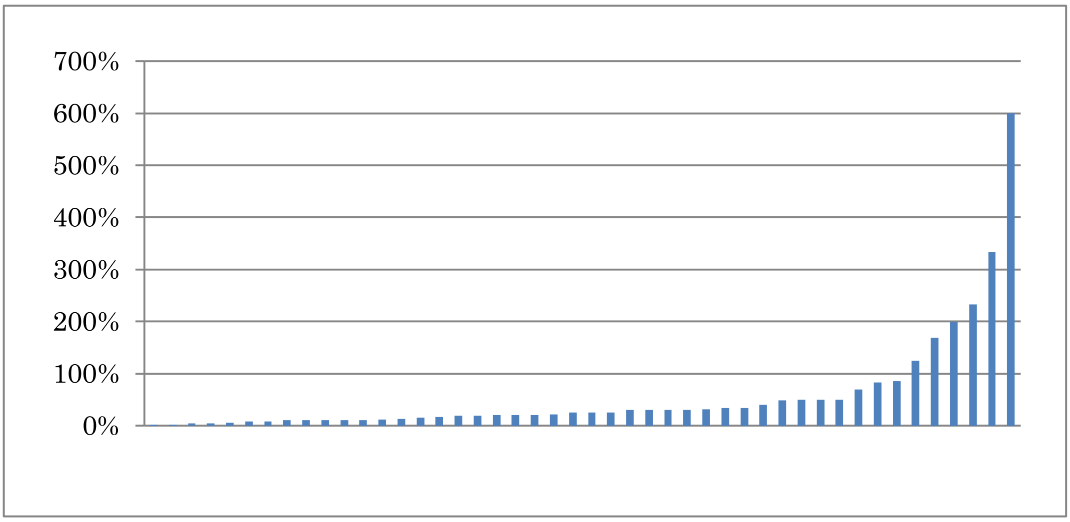
The amounts of bank loan desired by SME owners are as follows.

Fig. 2-5 Desired loan amount for new investment at sample SMEs (53 respondents)




While many SMEs are considering the use of bank loans, there is the issue of immovable collateral requirements. The survey asked SME owners the value of land that they can provide to banks and obtained answers from 83 respondents, out of which 46 has the intention of applying for bank loans. As can be seen from the chart below, 40 SME owners think that their land value is bigger than the planned borrowing amount, and 32 respondents, 70% of 46 in the sample, consider that the value of their land is more than three times the planned borrowing amount. Therefore, it is considered that there are SMEs who have immovable assets for collateral and ready to borrow if the interest rate is considered reasonable.

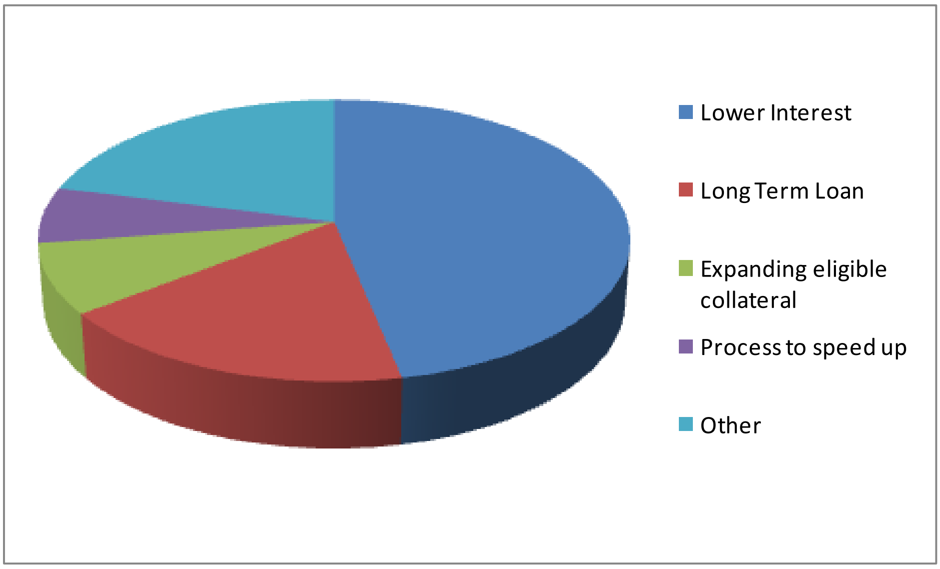
Fig. 2-6 Ratio of planned bank borrowing amount to perceived value land owned by SMEs (46 respondents)




### Desired improvement in bank loans and banking services

Lastly, the survey asked SME owners about improvements that SMEs seek in banks or bank loans. As the following chart shows, 46.8% of all requests were for lower loan interest rates, followed by the loan term.

Fig. 2-7 Improvements that SMEs expect from banks




Source: Created by the consultant team based on survey on 102 SMEs

(b) Interviews with 42 SMEs by the consultant team

The consultant team also had interviews with 42 SMEs with funding needs for capital investment, in order to gain a deeper understanding of their funding needs and to identify model SMEs to be supported by this project. The 42 SMEs were selected from participants of the seminar organized at UMFCCI on August 23 and September 19, 2013, and from respondents to the survey on 102 SMEs, as well as companies introduced by financial institutions and trading firms.

Because the loans under the TSL program are supposed to be provided for capital investments by SMEs, the 42 SMEs were mainly selected from the manufacturing sector, which is expected to have larger demands for capital investments than service or trading sectors. The sector breakdown of the 42 companies is as follows:

Table 2-6 Sector breakdown of 42 companies

| | |
|---|---:|
| Manufacturing | 66.7% |
| Services | 14.3% |
| Wholesale Trade | 4.8% |
| Agriculture | 2.4% |
| Livestock | 2.4% |
| Retail Trade | 2.4% |
| Others | 7.1% |
| Total | 100.0% |

The main questions asked by the consultant team are as follows:

- Overview of the business
- Current funding conditions
- Demand for lower interest loans
- Demands for capital investment loans

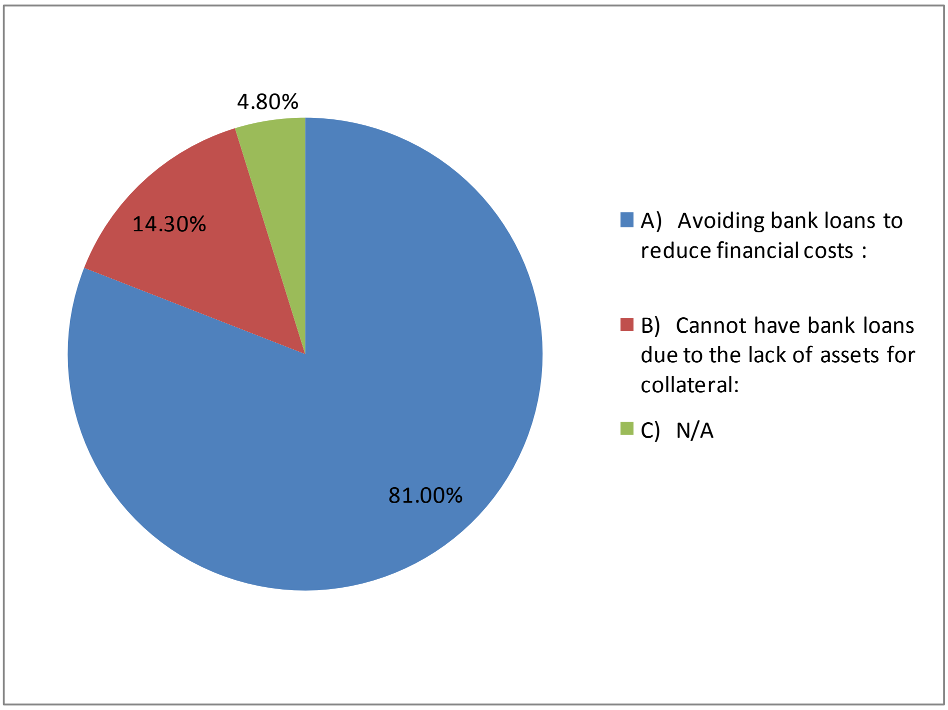
Findings from the interviews with 42 SMEs can be summarized as follows.

<u>Current funding conditions</u>

40.5% companies out of 42 interviewee SMEs answered that they have outstanding bank loans, while 50.0% answered that they do not (the remaining 9.5% did not give clear answers).

The reason why 50.0% of interviewee SMEs do not have bank loans is largely due to the high cost, followed by the lack of assets for collateral.

Fig. 2-8 Main reason why SMEs do not have bank loans

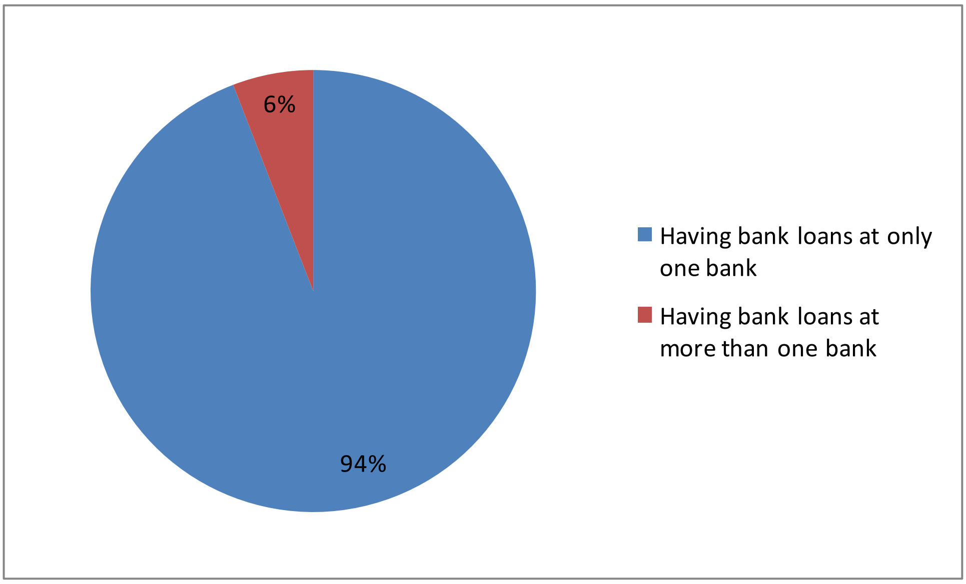



Those SMEs which answered “avoiding bank loans to reduce financial costs”, hereinafter referred to as “Group A”, use their own funds for operations and capital investments. Such “own funds” are basically funds from internal cash generation, but are sometimes provided by their relatives or family members. The relatives and family members receive part of the profits as dividends, instead of receiving fixed interests. None of the SMEs in Group A were borrowing from informal lenders. Some SMEs in Group A have shown an interest for lower interest loans to be provided by the TSL program (to be explained later in this section).

Some of the SMEs which answered “not being able to have bank loans due to the lack of assets for collateral”, hereinafter referred to as “Group B”, rely on financing by informal lenders, as well as fixed interest rate borrowing from relatives and friends. Interest rates of such informal loans vary from 2% to 6% per month. SMEs that have sufficient profits can have access to lower interest rate (2% per month), while others have no choice but to access funds at high interest rates (5-6%).

Almost all SMEs that have outstanding bank loans answered that they have bank loans at only one bank, although they have bank accounts at multiple banks. Only one interviewee SME (6%) answered that it has outstanding loans at more than one bank.

Fig. 2-9 Number of banks which interviewee SMEs have outstanding loans




This would be due to the collateral practice in Myanmar. When a bank takes collateral from a borrower, the bank keeps the certificate of the real estate until the loan is repaid. Therefore, it is not easy for a SME to apply for additional loans at other banks, especially if they have outstanding loans and if they do not have many assets.

Due to this collateral practice in Myanmar, it is recommended that the number of PFIs should be expanded so that more SMEs can apply for additional loans under TSL program to banks from which they have existing borrowing.

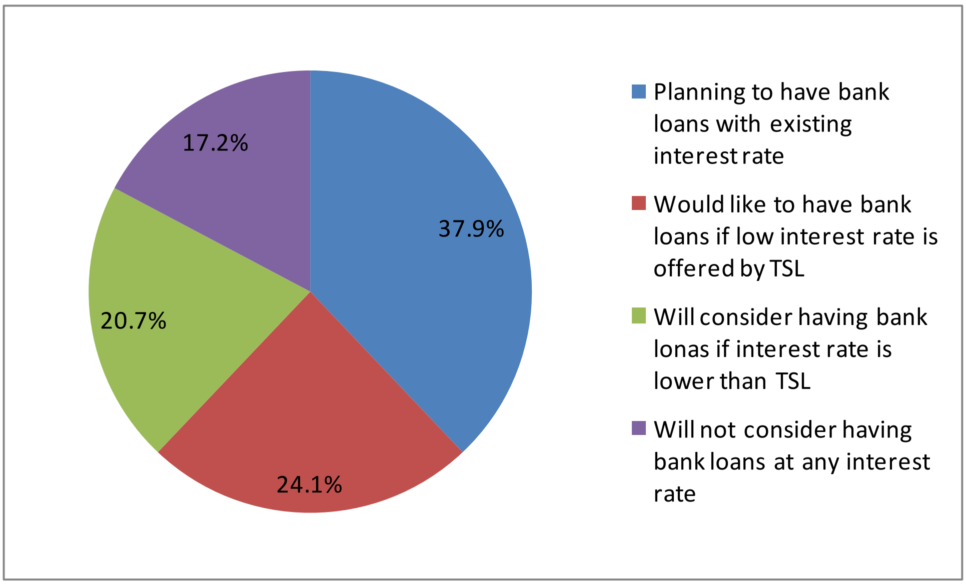
Demand for lower interest loans

The consultant team asked SMEs in Group A, those currently do not borrow from banks, whether they are interested in lower interest loans. The answers were divided into four groups, as depicted in the figure above. 37.9% of SMEs answered that they are planning to have bank loans at the existing interest rate (13%) but they wish to have lower interest rate.

More importantly, 24.1% of interviewees answered that they would like to have bank loans if the loan interest rate is 8.5% as offered by the TSL program. All SMEs in this group have no outstanding bank loans, avoiding bank loans to reduce financial expenses.

Nevertheless, 20.7% of interviewees believe that the interest rate to be offered by the TSL program is still too high. Typically, they answered that they will be interested in having bank loans if the interest rates are around 4-5%.

Fig. 2-10 Reactions of SMEs to lower interest loans




17.2% of interviewees answered that they would not have bank loans at any interest rate. The reasons why they are not interested in bank loans are;

- They do not have any demands for external financing, because they are not planning capital investments in the near future, and they have sufficient cash for working capital, and/or
- They avoid the bank charges for loan contracts, and also avoid complicated loan application processes

<u>Demands for capital investment loans</u>

Almost all SMEs which wish to have bank loans in the future are planning capital investments to expand their production or to increase the quality of the products. The consultant team observed that many SMEs have been using their equipment for 20 -30 years.

Fig. 2-11 Examples of outdated equipment of interviewee SMEs

The consultant team also observed that most interviewee SMEs do not always have a clear distinction between capital investments (e.g. purchasing machinery and equipment) and working capital (e.g. purchasing materials for productions), although they understood the difference after the consultant team explained.

Bank officers might not have clear understanding on the difference either, because the banks in Myanmar usually do not examine the loan purpose during the appraisal process.

Because the loans under the TSL program are for the capital investments of SMEs, bank officers, who receive the loan applications, should be instructed on the difference between capital investment and working capital in order to avoid any confusions in the application process. This point shall be covered by the training sessions provided by the PIU.

Others

The consultant team observed that around 50% of interviewee SMEs had audited financial statements. However, only one interviewee SME mentioned that they use financial statements for their business management. Some SMEs seem to have prepared audited financial statements, only because they were required by banks upon applying for loans.

When the consultant team reviewed several financial statements of the interviewee SMEs, the team observed that the financial statements do not fully cover their business. A typical example is that fixed assets and inventories which are owned by business owners do not appear on their balance sheet. In this case, it is not possible for bank officers to carry out loan appraisals based on the financial status but banks still accepted them and granted loans, as long as the borrowers provide sufficient collateral.

### 2.4 Government supports on the financing of SMEs

In general, government support for financing of SMEs includes (i) funding support to financial institutions that provide low-interest loans, (ii) provision of interest subsidies to SMEs, (iii) credit guarantees by governmental organizations, and (iv) direct lending by policy-based financial institutions. GOM started its "SME Loan Program" in late 2012, which was intended to be a category (i) type measure but it is limited in size, vague in policy objective and economically unsustainable. As for the interest rate subsidy, bank managers mentioned that there has not been any program in the past and no discussion has been initiated. Credit guarantee programs and establishment of policy-based financial institutions are being discussed by some people in the banking industry and certain government officials, but no concrete step seemed to have been to taken.

<u>SME loans by SMIDB</u>

As mentioned in 1.4, SMIDB started providing “SME loans” in 2012 by the order of GOM. The interest rate is set at 8.5%, which is significantly lower than the commercial lending rate of 13%. Also, the SME loan is exempted from CBM’s one-year rule and can be borrowed for up to three years. Except for the maximum lending limit and the need to visit the SME Development Center in Yangon to be interviewed and also to receive on-site inspection on the existence of the business, all other requirements are the same as for commercial loans. The comparison between commercial loans and SME loans is as follows.

Table 2-7 Comparison between commercial loans and SME loan

| | Commercial loans | SME loan by SMIDB |
|---|---|---|
| Interest Rate | 13.0% | 8.5% |
| Lending limit/recipient | None (single lending limit by regulation = 20% of capital) | 500 million kyat |
| Maximum Term | 1 year | 3 years |
| Funding support | None<br>Minimum deposit rate 8% | GOM ordered MEB to lend to SMIDB at 8.25%<br>(Loan/deposit < 80% apply)<br>(Collateral required) |
| Fund size | Loan balance of all banks as of 2012.3 was 3.1 trillion kyat, (Annual increase in 2011-2012 was 1.2 trillion kyat) | Currently 10 billion kyat<br><br>(Limit is 30 billion kyat) |
| Eligibility criteria | Not applicable | None |
| Additional procedure | | Recommendation by SME Development Center |
| Bank selection rule | | Not clear |
| Participating bank | | SMIDB |
| Use of funds | No restriction | |
| Collateral | Based on banking regulation and bank's policy | |

As mentioned in section 1.4, this program attracted a lot of SMEs and the 10 billion kyat of loans had already been disbursed. However, due to the fatal issue with the implementation structure, the remaining 20 billion kyat has not been planned for deployment and the acceptance of new loan applications has been stopped. The consultant team considers that biggest problem is the lack of economic incentives for SMIDB, a government related but privately owned commercial bank, to implement this project.

As mentioned at the beginning of this section, a low-interest loan program through commercial banks must provide the commercial banks with adequate compensation for their work. Under the SME Loan Program, SMIDB processes loan application and takes the credit risk of borrowers in the same way as commercial loans, while the gross interest margin SMIDB obtains is only 0.25%, which is only 5% of that for commercial loans.

Instead of disbursing necessary funds from the government budget, GOM ordered MEB to loan the fund to SMIDB at 8.25% interest rate. This interest rate is more expensive than the deposit rate, the normal funding cost for SMIDB. At the same time, SMIDB is required to provide collateral to MEB because CBM did not allow exceptional treatment under its collateral requirement regulations. For MEB, lending at 8.25% is a loss making business as well. While MEB is wholly owned by the government, it is a regulated deposit taking agency and loss making business poses risks to the depositors.

For these reasons, the consultant team considers that neither SMIDB nor MEB has an incentive to continue with this project. At this point, the timing to restart new lending is not known.

The consultant team believes that there are several other shortfalls in this program. First, there is no clear eligibility criterion for the borrower and big companies could borrow this low interest loan. The consultant team identified one case of SME loan disbursed to the company which is currently registered as a big company and does not fit to the definition of SME at the draft SME Law.

Secondly, since the use of fund is not restricted to the new investment, many of borrowers used this low interest loan to refinance their existing commercial loans. If no new investment is encouraged by this loan, its effect on economic development will be limited.

Lastly, the selection of implementing agency, SMIDB, is not clear. While SMIDB has a strong tie with the MOI, it is a privately owned commercial bank with no special legal status. Some of SME owners complain that a single window in low interest loan provision gave unfair advantage to existing SMIDB clients.

# 3 Status and issues in banking sector

In this chapter, the status and issues in the banking sector, especially for candidate PFIs of the TSL program is discussed.

## 3.1 Framework

In Myanmar, there are 24 banks, 4 of which are state owned banks and the other 20 banks are private ones. Some private banks have a relation with the government, e.g. shareholding, appointment of board member(s) and so on.

Table 3-1 All Banks in Myanmar

| |
|---|
| State-owned Bank (4) |
| Myanmar Agricultural Development Bank (MADB) |
| Myanma Economic Bank (MEB) |
| Myanmar Foreign Trade Bank (MFTB) |
| Myanma Investment and Commercial Bank (MICB) |
| Private Bank (20) |
| Asia Green Development Bank |
| Asia Yangon Bank |
| Ayeyarwady Bank |
| Co-operative Bank (CB Bank) |
| First Private Bank |
| Innwa Bank |
| Kanbawza (KBZ) Bank |
| Myanmar Apex Bank |
| Myanmar Citizens Bank (MCB) |
| Global Treasure Bank |
| Myanmar Oriental Bank |
| Myawaddy Bank |
| Nay Pyi Taw Development Bank |
| Rural Development Bank |
| Small & Medium Industrial Development Bank (SMIDB) |
| Tun Foundation Bank |
| United Amara Bank |
| Yadanarbon Bank |
| Yangon City Bank |
| Yoma Bank |

Note: Myanmar Livestock and Fisheries Development Bank changed its name to "Global Treasure Bank" in May 2013.
Source: JICA' Study on the Growth-Enterprises Development in Myanmar, July 2013, and Eleven Media Group, "Eleven Newspaper", 29 July 2013

### 3.2 Assets

#### 3.2.1 Outline of loan

As shown in fig 3-1, both deposit and loan amounts of all banks have strongly increased for several years, with average annual growth rate of 33% from FY2007 to FY2011.

Fig. 3-1 Loan to deposit ratio of total amounts of all banks


Source: JICA Study on the Growth-Enterprise Development in Myanmar, July 2013

While the 2012 statistics are not available, all the banks that the consultant interviewed mentioned that their assets size is growing rapidly. However, increase in deposits has been stronger than in loans since FY 2012 and it resulted in severe competition for banks to find borrowers. Some banks said that they had difficulty in finding good companies for lending, while their deposits were increasing more strongly than their loans.

The consultant team considers the reason of this increase in deposits is that people in Myanmar increased their trust in the banking system, and savings which had been out of banking system came back, which encourages some banks to enlarge their business, e.g. by focusing on loans to SMEs and introducing hire purchase.

### 3.2.2 Loan to SMEs

The breakdown of a bank's loan portfolio has not been disclosed by many banks. Especially regarding to the loans to SMEs, many banks do not categorize their portfolio based on the size of their clients. However, since most of businesses in Myanmar are SMEs and there are not so many mortgage loans to individuals, many banks mention that majority of their loans are considered to be for SMEs.

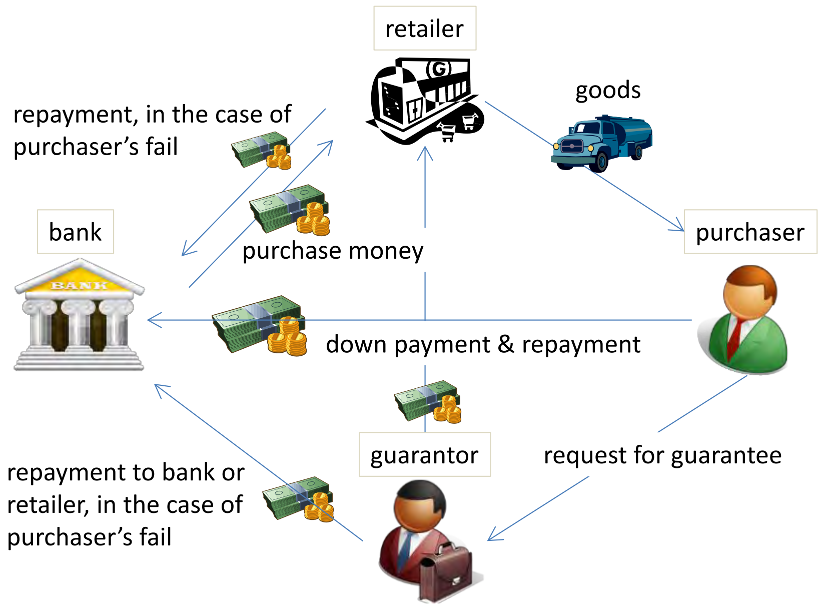
### 3.2.3 Hire purchase

Hire purchase is a contract among a purchaser, a retailer and a bank as shown figure 3-2, and was admitted by CBM on 21 October 2011. (CBM instruction No23). Purchaser must pay 20 to 50% of the price for good(s) as down payment, and the bank pays the rest of the payment to the retailer based upon a contract. The bank keeps ownership of the good(s) until the contract is completed. The purchaser must repay the bank with interest, while the retailer has an obligation to pay the bank the remaining balance if the purchaser fails to pay. After repayment by the retailer on behalf of the purchaser, the bank transfers the ownership of the good(s) to the retailer.

The standard documents required for hire purchase applications are as follows.

- ✓ Submission of hire purchase application and the following documents
- ✓ Agreement between retailer and bank
- ✓ Lease agreement
- ✓ Ownership right transfer agreement to bank
- ✓ Applicant's agreement
- ✓ Guarantor's agreement
- ✓ Bank's agreement

Fig. 3-2 Hire purchase scheme




Source: Created by the consultant team

As shown above in Fig. 3-2, hire purchase looks very similar to a bank loan based upon movable collateral but is completely different from a bank loan in two points. Firstly, the ownership must be kept by the bank, for example, "the ownership board" of the automobile must be registered under the retailer's name and the "owner book" is physically kept by bank, while the automobile (collateral) is used by the borrower. Secondly, the bank relies more on the creditworthiness of the retailer rather than the purchaser. Unlike the bank loan where the purchaser is a borrower, bank does not have to analyze the creditworthiness of the purchaser as long as the retailer guarantees the purchaser's obligations. Rather, creditworthiness of the retailer is more important from the bank's viewpoint. Therefore, banks usually sign a contract in advance with retailers who want to use hire purchase. From the retailer's viewpoint, hire purchase is a strong sales tool for its customers. Since retailers know the exact resale price of good(s), they can take a bigger risk than banks.

Hire purchase is a good finance tool not only for banks but also for retailers and purchasers; however, use of hire purchase is relatively limited.

There are several reasons for the hire purchase not being a major product for banks. The biggest one is hesitation of retailers in taking the risk of collateral, because machines or movable assets like gold, jewelry are not registered by the authorities. Unlike automobiles, the ownership is only recorded in a contract between the retailer, bank and the purchaser. If the collateral were illegally sold to an innocent third party, there is no perfection or protection against acquisition. Therefore, retailers request purchasers to get one or two guarantors in order to prevent such a situation. However, the hire purchase can be a very strong sales tool. Once retailers recognize the usefulness of hire purchase, the consultant team believes the number of retailers which introduce hire purchase as a sales tool will definitely increase.

Historically, Myanmar Oriental Lease Company, subsidiary of Myanmar Oriental Bank, was the only provider of this service. However, CBM started issuing permission to some banks in October 2011[6]. After that, the number of banks and the volumes of hire purchase have increased steadily.

The consultant team believes that hire purchase can be a very good finance tool for SMEs and farmers who do not have immovable properties to be provided to banks as collateral

According to interviewee banks, the interest rate applied for hire purchase is 13% although they advertise it as low interest rate, such as 9% for the first year, and 5% for the succeeding years. The advertised low interest rate is calculated by dividing the interest amount by the price of the good(s) including down payment, while the actual interest rate is calculated by multiplying the outstanding balance by 13%.

Average down payment is 20-50% which differs according to the creditworthiness of retailers and price volatility of the good(s). The term is usually 2-3 years.

### 3.2.4 Other loan products

MCB provides "pledge loan" as mentioned in 2.2.2, which collateralizes crops for export and was permitted by CBM on 25 January 2012 (CBM instruction No25). In order to control collateral, traders entrust the key of warehouses to MCB. The maximum term of pledge loan is 6 months, but many of the transactions are for 3 months.

No housing loan service is currently provided, except through hire purchase.

### 3.2.5 Non- performing loan

According to CBM, definition of Non-performing loan (NPL) is 6-12 months in arrears for substandard and 24 months for NPL. Excluding state owned banks, all banks must keep their NPL ratio under 10%. According to one bank, if NPL ratio is over 10%, CBM requires these banks to submit to improvement plan.

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[6] Myanmar Times, November 7-13, 2011

NPL ratio is usually good index to check the ability of credit examination. However, NPL ratio in some banks differs from each other even the definition of NPL. For example, MEB's definition is 6 months and its NPL ratio is 1.68%.

#### 3.2.6 General provision for loan losses

According to CBM, all banks excluding state owned banks should book 2% of the loan outstanding at the end of fiscal year as general provision for loan losses. Hearing from a bank, this regulation for provision is reasonable and does not disturb any banking business.

### 3.3 Funding

Most of banks depend on deposit as main funding source. JICA's "Study on the Growth-Enterprise Development in Myanmar" showed that deposit to total asset ratio of all banks was 83% in FY2011. As mentioned at section 1.3, some banks provide fixed deposits. However, at the current moment, fixed deposits account for a low proportion of total deposit value.

According to CBM, banks must keep the loan to deposit ratio under 70-80% by regulation, but the ratio differs from bank to bank. As a result of this regulation, banks have to increase their deposits in order to expand their loan businesses. At this moment, this regulation is not considered a barrier for the loan growth because there are only a few banks with loan to deposit ratios being higher than 60%.

### 3.4 Term Structure of Interest Rate, and Collateral/Credit Standard

Loans provided by commercial banks are limited to the short term of 1 year at the interest rate of 13% plus commission fee of 1% and in practice required immovable property as collateral. SMIDB is exempted from some of those conditions by the government for the execution of SME loans with the interest rate of 8.5%. Recently private banks started offering hire purchase service of specific consumer goods as well as industrial machinery.

#### 3.4.1 Interest rate regulation and practice

The interest rates set by local banks are the same at 13% per year for loan and 8% per year for deposit, while CBM regulations only set the maximum lending and the minimum deposit rate at 13% and 8% respectively. The CBM regulation on interest rates (instruction No 11 on 27th December 2011) stipulates:

i. CBM sets 10% as Central Bank interest rate
ii. The lowest interest rate applicable for saving deposit, saving account and

fixed deposit is not to be set less than 2% below the Central Bank rate (10%-2%= 8%)

iii. The highest interest rate collectible from loans and overdrafts is not to be set more than 3% above the Central Bank rate (10%+3%=13%)

iv. This instruction goes into effect as from 1st January, 2012

v. Banks may make changes to interest rates within the determined framework mentioned in paragraph

vi. It is instructed that banks get permission from the Central Bank and make changes only upon receipt of the permission (CBM instruction No 11).

Through this instruction, CBM has allowed local banks to set their own lending rate within a range of 10 to 13% and deposit rates within a range of 8 to 10%. However, no bank has started lending below 13% and only few banks like KBZ changed the deposit rate from 8% as shown in Table 1-1.

Based upon special permission of CBM, there are some exceptional "policy based" lending rates such as MEB loans at 4% to MADB and 8.25% to SMIDB as well as SME loans by SMIDB at 8.5% to SMEs. There are other policy based lending programs carried out by private banks, such as the loan for livestock and fishery firms at 12%.

#### 3.4.2 Collateral/Credit Standard

Immovable property is the dominant collateral in commercial banking sector in Myanmar. The subject of appraisal is limited to land and buildings in practice. The loan amount is capped at 30-50% of the forced sale value appraised by the bank.

Recently CBM relaxed its collateral policy and approved a wider variety of collateral, e.g. gold, jewelry, crops for export, government bonds and deposits[7]. Although CBM has relaxed the collateral policy, the consultant team confirmed that only a few private banks had started accepting such non-traditional collateral as of August 2013.

MCB is one of the few banks. MCB accepts export crop stored in warehouse as collateral for Pledge Loan. In this case the warehouse is to be locked and the key is kept by MCB.

### 3.5 Credit Control System (application screening entity, employees ability for credit

[7] Based on the following instructions from CBM: instruction No. 22, 8 September 2011 (attachment 1-2), instruction No. 25, 25 January 2012 (attachment 1-3), instruction No. 27, 8 June 2012 (attachment 1-4) and instruction No. 24, 27 December 2011 (attachment 1-4).

analysis, monitoring)

### 3.5.1 Screening method of loan application

Loan screening officers also check for the business licenses, recommendations from the municipality, resident registration and other documents. While financial statements are provided by some of the loan applicants, they are not examined thoroughly as bank officers consider that they do not correctly represent the financial standing of the applicants.

### 3.5.2 Ability of Employees on Credit Control and Monitoring

Capacity developing for employees in charge of credit control and monitoring system is among the urgent issues in the process of sector modernization. Some private banks such as SMIDB, KBZ and CB started training employees in cooperation with foreign donors or partners.

## 3.6 Business Plan to Increase SME Loans

Most banks remarked that SMEs are important clients because most of companies in Myanmar are actually SMEs. However, from the view point of effective banking business, having large borrowers is desirable in general.

The following 4 banks have noticeable business plans to approach SMEs as potential borrowers.

(1) SMIDB

SMIDB has been traditionally expected to have a role of SME support, because of its close relation with MOI, c.f. section 3.1, although it is not state owned bank. The management has been enthusiastic about promoting SME policy. SMIDB has a track record as an implementing agency of SME loan as well.

(2) KBZ Bank

KBZ Bank, which is the largest private bank, seeks to expand its customer base in order to increase loan amounts further by increasing branches in rural area to improve its outreach. In addition, it has a clear corporate strategy to expand the target segment, e.g. small companies and farmers.

(3) Yoma Bank

Yoma Bank has a strategy to specialize in specific borrowers, i.e. SMEs, because it resumed lending business in just 2012 and it falls behind in approaching customers. It has launched an “SME Banking Department” to focus on SME finance in 2013.

(4) Myanmar Citizens Bank

MCB has traditionally been supporting small and medium rice millers and agricultural traders.

(5) CB Bank

CB Bank, which is the second largest private bank, has been serving SMEs since its establishment and the majority of its clients have been SMEs. The management is aware of the importance of promoting SME finance and has willingness to increase loans to SMEs.

## 3.7 Local banks receiving assistance from other donors and international financial institutions

Various donors and international financial institutions are offering technical and/or financial assistance to local banks. Major assistance is as follows:

### 3.7.1 Banks receiving assistance from foreign donors

(1) SMIDB

SMIDB submitted a proposal to GIZ program for technical assistance and was selected as one of three recipients. The program will begin on March 2014.

Also, another German Aid Agency, KfW is in negotiation with SMIDB on technical assistance and the provision of credit line.

(2) KBZ Bank

KBZ Bank submitted the proposal for possible technical assistance to GIZ.

(3) Yoma Bank

Yoma Bank, which restarted lending operation in 2013 after a decade of intermission, has brought in Mr. Hal G Bosher, a former regional representative of MIGA in Hong Kong, as CEO, and advertises itself as an “SME Bank”. Yoma Bank is in negotiation with GIZ for possible technical assistance. Yoma Bank submitted the proposal to GIZ in August.

### 3.7.2 Banks receiving assistance from International Financial Institutions

(1) CB Bank

Bank of Tokyo-Mitsubishi UFJ (BTMU) is providing training such as FX operation.

(2) KBZ Bank

Based on the cooperation agreement, Sumitomo Mitsui Banking Corporation (SMBC) is providing technical assistance.

# 4 Technical assistance for future improvements in SME finance

During the course of the survey, the consultant team identified various issues in GOM, banks and SMEs for improvement in SME's access to finance. We would like to recommend the following for the future technical assistance to GOM (4.1), local banks (4.2) and SMEs (4.3).

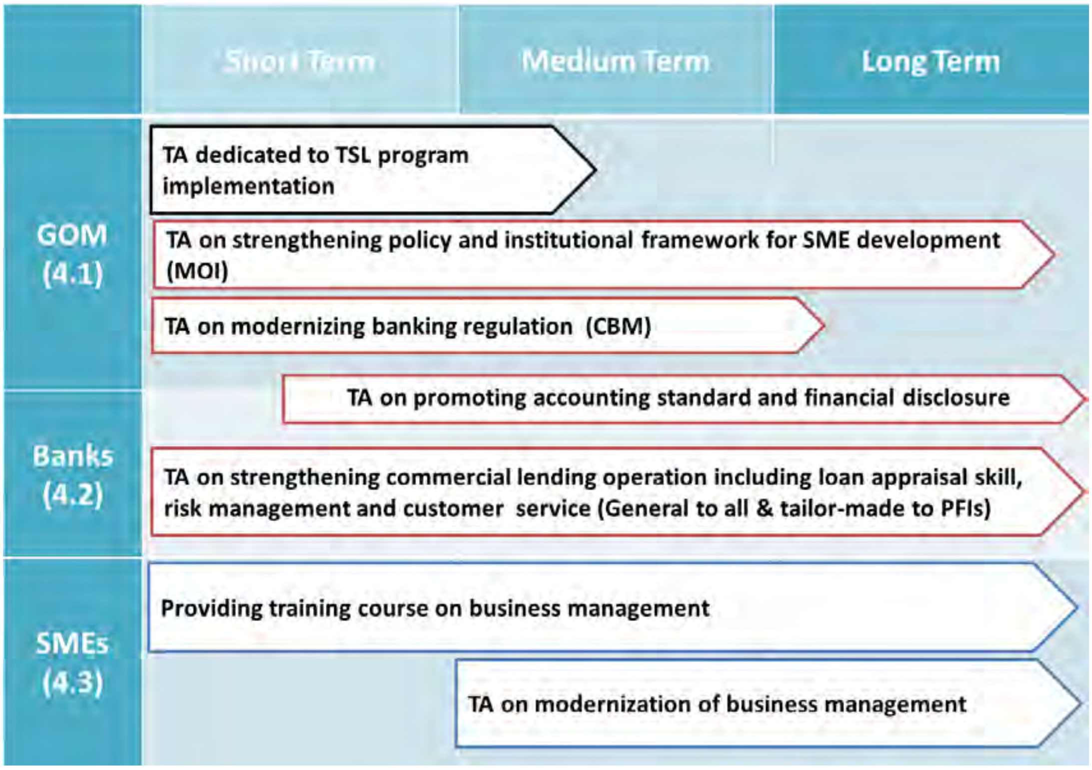
i. Institutional constraints
   - Weak policy and institutional framework for SME development
   - Strict banking regulations from the banking crisis of 2003 are still in force
   - Accounting systems exist but are not widely practiced

ii. Conservative and less flexible lending practices by banks
   - Immovable property is still predominantly used as collateral in practice
   - Not many banks are aggressively marketing to SMEs

iii. Lack of knowledge and experience by SMEs on:
   - Formal lending procedure
   - Modern business management

Possible technical assistance by timeline is shown below.

Fig. 4-1 Possible Technical Assistances by Timeline



## 4.1 Technical assistance for GOM

### (1) Strengthening of policy and institutional framework for SME development (MOI)

During the course of the survey, the consultant team had difficulty understanding GOM's various initiatives to support SMEs because there is no unit in charge with a controlling position. Because of the historical reasons of past Myanmar socialist regime, GOM had not applied any kinds of industry policies until 2011 and the organizational framework to plan, coordinate and implement policies to develop SMEs has not yet established. While MOI is considered to be the ministry in charge of SME development policies and the SME development center is an implementing unit, they are understaffed, lacking expertise and do not seem to understand what other ministries are doing on SME development.

The consultant team recommends that technical assistance on organizational framework on SME development should be provided. Japan's experience from SME-related organizations under METI can be a great input to GOM.

### (2) Modernization of banking regulations (CBM)

The consultant team had multiple discussions with CBM concerning banking regulations and understood that CBM was aware of the need for overhaul of banking regimes. CBM has been receiving training from IMF and other ASEAN members but should welcome additional help as there are so many areas for improvement.

As mentioned in 1.3., the banking regulations of Myanmar today are aimed at maintenance of financial stability and preventing bank runs and bankruptcies like those that happened in 2003. In order to satisfy the needs of borrowers and depositors while maintaining the stability of banking sector, the Japanese liberalization process for the banking sector will be a good example for reference when making liberalization policy for Myanmar.

### (3) Accounting system exists but not widely practiced (Multiple ministries)

Establishing a viable corporate accounting system in conjunction with financial disclosure practice is essential in the process of modernization of financial sector. There are "Myanmar Financial Reporting Standards (MFRSs)", which are the country's own accounting standards, based on International Financial Accounting Standards. The consultant team noticed that MFRSs are rarely used in practice in the country. As mentioned in 2.2.1, most SME owners do not prepare the financial statements that are necessary for loan applications.

The consultant team recommends giving consideration to a TA program to coordinate the efforts of relevant ministries, such as MOF, CBM and MOI, for the promotion of MFRSs to be employed by SMEs.

## 4.2 Technical assistance for Myanmar banks

Most Myanmar banks the consultant team interviewed have already recognized the need for improvements in many aspects of their operations, especially in credit evaluation skills. Other areas that banks pointed out for potential assistance include governance and service modernizations, strategy setting and system modernization.

There are two ways to provide technical assistance to local banks; provision of training sessions for multiple banks or assignment of experts to a specific bank for a certain period to design and implement tailor-made solutions. The former has the benefit of providing assistance to many financial institutions at the same time, while the impact on banks' capacity developments would be smaller than the latter.

Several banks had already started receiving tailor-made TA programs provided by foreign donors and their partner banks from abroad, as mentioned in sections 3.5 and 3.7. However, many of such local banks mention that their ongoing TA programs are not exclusive and would welcome any additional assistance. Other foreign donors also mentioned that they would welcome JICA's additional assistance to banks that they are assisting.

Therefore, the consultant team recommends two of the possible TA programs. One is the classroom training for credit evaluation for all the banks. The detailed program and implementation plan should be discussed with the Myanmar Banking Association or Central Bank of Myanmar. Also, potential coordination with other donors should be explored.

The second one is an extensive program for PFIs with a view to achieving certain goals, such as enabling them to accept a new type of collateral. Concrete topics should be considered after the start of the TSL program and the issues have been identified for better implementation of the program. Since many of PFI candidates have already been receiving assistance from other donors and international banks, an extensive survey on the status of their programs and discussion with the assistance providers should be conducted before the start of the program.

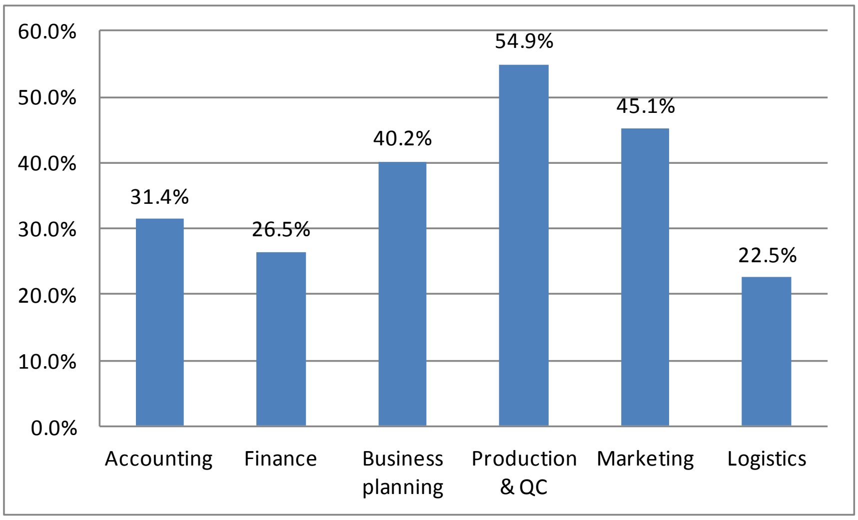
### 4.3 Technical assistance for SMEs (business management and business plans)

In the long run, it is desirable that banks carry out loan appraisals based on the assessment of business operations and financial status of loan applicants. At the same time, it is essential for SMEs to formally incorporate their privately owned businesses and properly disclose their assets and earnings, as well as prepare written business plans.

Most of the SMEs that the consultant team visited in this survey are individually owned and the personal assets and revenues are not clearly separated from the businesses. In many cases, SME owners do not prepare financial statements and written business plans. Even if financial statements are prepared, they do not reflect the true ownership of assets or liability. Some business owners confessed that they do not know exact amounts of their turnovers and profits. This would suggest that the business managements of most SMEs in Myanmar remain underdeveloped.

Through the survey carried out from August through September 2013, demand for technical assistance by SMEs was identified as shown below.

Fig. 4-2 Demand of SME for technical assistance




Source: JICA consultant team

As depicted in the figure above, many interviewees answered that they wish to receive technical support on accounting (31.4% of all SMEs), finance (26.5%) and business planning (40.2%).

SMEs also seem to face challenges in production and marketing, as more SMEs answered that they wish to have technical support on production and quality control

(54.9%) and marketing (45.1%).

Support on the modernization of business management of SMEs would therefore be beneficial for the development of SMEs in Myanmar. Such support for the modernization of business management can be provided through business management seminars, which should be organized at several locations including Yangon, Mandalay, other local cities, and industrial zones. It is recommended that such seminars are organized in the evening or during the weekends, so that more business managers, including managing directors or chief executive officers, of SMEs can participate in them.

Seminars can be either (i) one day session, or (ii) short term courses. One day session can be organized (e.g. for 2 hours) for business owners to explain the importance of the financial management and business plans. (ii) Short term courses can be organized for a few days for several topics including (i) financial management and accounting and (b) business planning.

One of the candidates of seminar providers is SME Development Center. GIZ has provided technical assistance to the Center and has trained and certified trainers. The certified trainers are due to give lectures to SMEs in the seminars which are started in November 2013.

Support on SMEs can be also provided through collaborations with the Myanmar – Japan Center. The Japan Center can be an arranger or a provider of short term business courses, and also longer term business management courses (e.g. for a few months) for SMEs. Possible subjects of such training course are;

- Business strategy
- Marketing
- Operation management
- Financial management
- Human resource management

(end)