A REVIEW OF THE FINANCIAL ENVIRONMENT OF SMEs IN MALAYSIA

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Abstract

This paper looks at issues around the financing of SMEs in Malaysia. A very frequently cited problem facing SMEs in Malaysia and around the globe is lack of access to finance. Although various steps have been taken by the Malaysian government at different times to alleviate the financial constraints of SMEs, it is debatable that these businesses find them adequate. This paper therefore reviews the sources of finance available to SMEs in Malaysia, constraints to access to these funds and government policies. It wraps up with some policy prescriptions.

Keywords: Financing, SME, Malaysia

Introduction

Since the early 1970's, the Malaysian government has committed to developing the SME sector. The introduction of the New Economic Policy in 1971 aimed to improve the people's welfare and to restructure ethnic economic imbalances (Salleh & Ndubisi, 2006) was another important effort in this direction besides the second Industrial Master Plan (IMP2) which ended in 2005 and followed by the Third Industrial Mater Plan (IMP3), 2006-2020 which coincides with the country's vision in 2020 (MITI, 2005). The Malaysian government has implemented various policies and strategies under this plan which was formulated to enhance the growth of the manufacturing sector through the entire value chain and cluster-based industrial development.

This paper examines the sources of finance available to SMEs in Malaysia, constraints to access to these funds and government policies. It concludes with some policy recommendations.

Sources of SME Financing

There are two basic types of financial assistance made available to SME's namely loans and grants. Loans in this case are provided by government financial institutions, commercial banks and finance companies. In Malaysia, there are six government financial institutions which include Bank Negara Malaysia, SME Bank, Bank Pertanian Malaysia, Malaysian Industrial Development Finance Berhad, Sabah Development Bank Berhad and ERF Sdn Bhd.

Banks remain the dominant source of capital and credit for most businesses, including SMEs in many ASEAN countries. According to statistics by World Bank and IMF, the stock of outstanding bank loans in Indonesia, Malaysia, Philippines, and Thailand was about 92% of their combined GDP, compared to around 45% in India and Korea and 4% in central Europe (World Bank & IMF, 2001). Takagi argued that bond financing is not a viable option for small businesses because of the heavy cost in the underwriting and distribution of paper securities (Takagi, 2002). In the ASEAN region efforts have been made to encourage commercial banks to lend to SMEs by means of loan quotas, interest subsidies, and guarantees against default. At the same time it has been argued that usually large-scale and capital-intensive firms in several ASEAN countries enjoyed various incentives and privileges granted by the government compared to small businesses. According to Regnier, around 70% of the big, locally owned and JV firms have enjoyed various privileges and incentives from the Board of Investment in Thailand during 1970s and 1980s (Regnier, 2000).

Financial Constraints of SMEs in Malaysia

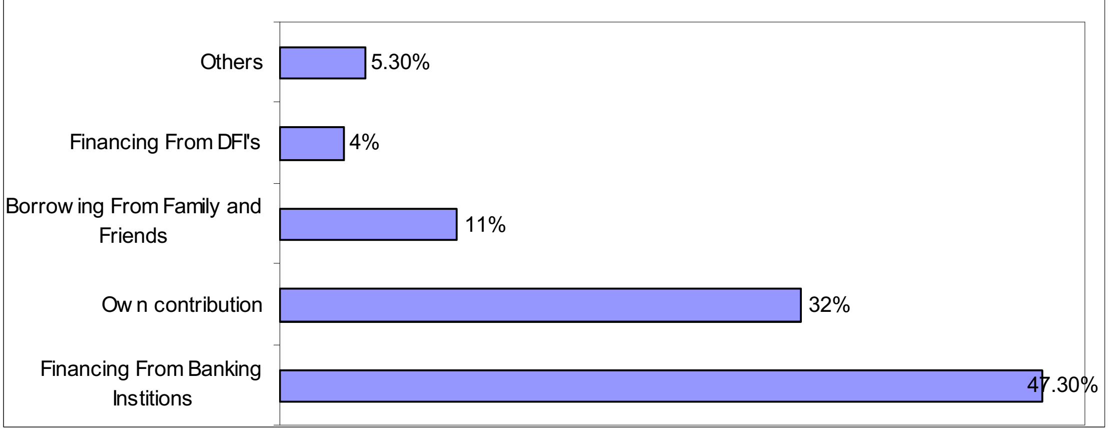
Some of the challenges for SMEs in Malaysia in obtaining finance is the restrictive terms and conditions on loans. This has contributed to the heavy reliance on own savings and other forms of private financing. In the case of ASEAN countries, between 75-90% of SME in this region rely heavily on their own savings, internal resources of the firm, short-term borrowings from friends and relatives and grey market loans

(Wattanapruttipaisan, 2003). There is a need to mention that bank financing often does not cover all the finance needs of SMEs. In Malaysia, funds from commercial banks met 62 and 21% of working capital and long-term investment requirements respectively according to a survey of 221 SMEs conducted by Japan Bank for International Cooperation. It found that public financial institutions and private finance companies remain a minor source of SME financing in Malaysia. Development finance institutions (DFIs) have played only a minor financing role as well. For example, around 4 percent of each SME credit for working capital and long-term investment came from these institutional sources in 1999. Perhaps, DFIs lending resources are very limited compared to commercial banks as a result of their typical lack of adequate and independent resource base. Grey market funds are another source of funds for SMEs, this has become important in the wake of the financial crisis during 1997-98, providing SMEs with 13.6% of working capital and 6% of investment requirements in Malaysia (Wattanapruttipaisan, 2003).

According to Wattanapruttipaisan (2003), the unsatisfactory outcomes of SME financing in the ASEAN region could be as a result of various factors, which can be summarized as follows: (1) Most financial institutions are not able to operate profitably in financing SMEs, this could be due to higher risk and transaction cost; (2) Many SMEs avoid using commercial banks for payroll management and day to day working accounts. Hence, most of these banks do not have enough information relating to cash flow, business performance, credit history and business commitment of the concerned SMEs; (3) Bank lending decisions based on the availably of fixed asset on offer as collateral and a sound business plan.. Land and buildings are most often required. Hence, collateral requirements by commercial banks have been a contentious issue in SME financing. Real estate collaterals provide an incentive and justification for the banks to lend as this a way to offset losses in case of default; (4) Most SMEs are owned and operated by the entrepreneurs and their family members. Thus, SME access to institutional finance is further constrained as a result of the excessive dependence on the founding groups; and (5) Limited success so far to establish an equity market that is dedicated to SMEs. The response from SMEs has been not that enthusiastic because of the tight listing requirements (such as authorized capital, two years of positive net operating income etc).

The banking institutions or the banking system are the main players in financing SMEs in Malaysia (see figure 1 below) and there is the tendency for them to prefer and focus on financing more established SMEs. According to Bank Negara Malaysia's survey in 2004 (see figure 1), 47 percent of SMEs in Malaysia obtained finance from banking institutions, 32 percent from their own contribution, and 11 percent from family and friends.

Figure 1 Types of Financing available for SMEs in Malaysia



Source: Bank Negara Malaysia, 2004

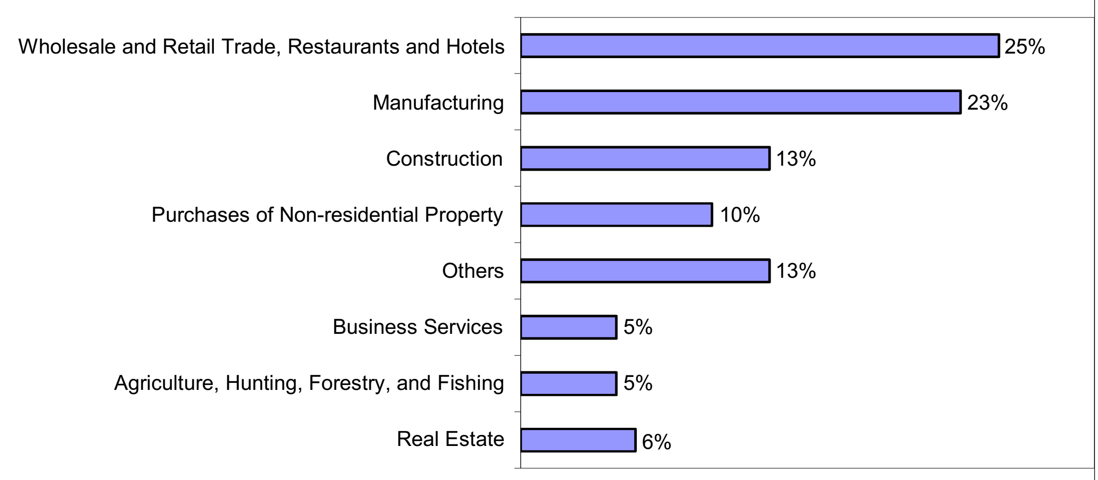
Own contribution is a key source of finance for SMEs in Malaysia. SMEs in the manufacturing sector rely quite heavily on their own contribution to finance their business operations. SMIDEC's survey in 2003 showed that SMEs are still domestically orientated, significantly dependent on internal funding. It has been documented that 72 percent of SMEs rely on internal sources of funds to satisfy 40% of their financing needs. Other important sources of finance are from friends and family.

Government Policies

The Malaysian government had initiated many schemes to assist SMEs in obtaining funds. As part of the Malaysian government effort to enhance the development of Malaysian SMEs, Bank Negara Malaysia (BNM) initiated the establishment of the National SME development council in 2004, which is responsible for formulating strategies and future direction for the development of SMEs in the country. The council since its establishment has initiated many programmes to improve the infrastructure of SMEs in terms of accessing finance, training and human resources, marketing and other areas (BNM, 2005).

The BNM is responsible for allocating the resources made available to upcoming SME's in Malaysia. The Bank has two types of financial support available. They include special funds and guarantee schemes. As shown in Table 1, special funds consist of New Entrepreneurs Fund 2, Fund for Small and Medium Industries 2, Fund for Food (3F), Bumiputera Entrepreneurs Project Fund and Small Debt Resolution Scheme. Guarantee schemes consists mainly of Islamic Banking Scheme, Franchise Financing Scheme, Direct Access Guarantee Scheme, New Principal Guarantee Scheme, Flexi Guarantee Scheme and Small Entrepreneur Guarantee Scheme. Furthermore, in reinforcing the financial assistance for Malaysian SMEs, BNM has increased loans to SMEs by 7.7% and registered 40.3% of total outstanding loans to businesses by the end of 2004 compared to 27% in 1998 (BNM, 2005). Figure 2 shows the sectoral allocation of BNM loans.

Figure 2 Loans to SMEs across major industries



Source: Bank Negara Malaysia, as at December 2004

Furthermore, in line with the government's effort to enhance the financing options available to Malaysian SMEs, the government has established the first SME bank in the country in October 2005 to provide financial facilities and advisory services and to improve the competitiveness of SMEs internationally as well as locally. The bank operates through out Malaysia with 15 branches nation wide (SME Bank, 2005).

Another source of funds for Malaysian SMEs is the Malaysian Industrial Development Finance Berhad (MIDF) which provides Soft Loans for SME's, Soft Loan Scheme for Factory Relocation, Small and Medium-Scale Industry Promotion Programme, Fund for Small and Medium Enterprises 2 (FSMI 2), Japan Bank for International Cooperation/Fund for Small and Medium Scale Industries (JBIC/FSMI), New Entrepreneurs Fund 2 (NEF 2), and Soft Loan for ICT Adoption (MITI, 2002).

Other government institutions/agencies, which provide support to SMEs via incentives and grants are Small & Medium Industries Development Corporation (SMIDEC), Malaysia External Trade Development Corporation (MATRADE), National Productivity Corporation (NPC), Malaysia Industrial Development Authority (MIDA), Ministry of Entrepreneur and Co-operative Development (MECD), Ministry of Agriculture and Agro-Based Industry (MOA), Ministry of Science, Technology and Innovation (MOSTI) and Ministry of Rural Regional Development (MRD). While the Malaysia External Trade Development Corporation (MATRADE) provides grants such as Market Development Grant (MDG) and Brand Promotion Grant (BPG), the National Productivity Corporation (NPC) offers programmes like Quality Management Programmes, Productivity Management Programmes, Human Resources Programmes, Production Management Processes, International Programmes and Business Management Excellence Programmes.

SMIDEC provides grants and incentives such as Grant for Business Planning and Development, Grant for Product and Process Improvement, Grant for Productivity and Quality Improvement and Certification, Grant for RossettaNet, Factory Auditing Scheme, Special Assistance for Women Entrepreneurs, Soft Loan Scheme for Factory Relocation, Soft Loan for SME's, Soft Loan for ICT Adoption, Grant for Enhancing Marketing Skills of SME's, Grant for Enhancing Product Packaging, Design and Labeling Capabilities of SME's and Grant for Development and Promotion of Halal Product.

In sum, the Malaysian government has established 72 financing schemes for SMEs mainly for nurturing and development purposes by the various ministries/agencies via soft loans grants, equity financing and venture capital schemes. Table 1 below shows that the utilization rate of the government funds of RM14.92billion as at 31 December 2004 was 145 percent (BNM, 2005).

Table 1 Government Financial Assistance for SMEs

Type of assistance	Amount	Allocation RMbil	Approved RMbil	Disbursed RMbil	Repaid RMbil	Outstanding RMbil
1.Soft loans	40	8.09	12.58	11.68	0.32	3.35
2.Grants	21	1.24	0.75	0.50	0.0	0.0
3.Equity	4	0.27	0.27	0.23	0.04	0.19
4.Venture Capital	7	0.68	0.32	0.17	0.01	0.16
Total	72	10.28	14.92	12.58	8.37	3.70

Source: BNM (2005)

Conclusions

This paper has reviewed the financing issues of Malaysian SMEs; their various sources of funds; obstacles in obtaining funds; as well as programmes and incentives offered by the government and its agencies to address these obstacles. The review indicates that obtaining finance is still a major obstacle for Malaysian SMEs as they face difficulties to meet the collateral requirements and conventional banks prefer to lend to larger businesses, as they are less risky. The review shows as well that the SMEs in Malaysia are still domestically oriented and rely heavily on internal sources and banking institutions. The main internal sources of finance are own contribution, friends and family. It was also unveiled that Malaysia has several development finance institutions that are responsible to provide medium to long-term loans, equity capital and guarantees for loans, albeit this source still plays a minor role in financing SMEs in Malaysia.

Clearly, the Malaysian government puts significant effort to enhance the financing options available to Malaysian SMEs through the various schemes by various ministries/agencies such as soft loans, grants, equity financing and venture capital schemes. The BNM SME special funds (e.g. new entrepreneurs fund 2; funds for small and medium industries; etc) as well as SME special unit of BNM, and the SME bank (October 2005) also play important roles in providing financial facilities and related advisory services. Nonetheless government grants comparatively still play a very minor role in financing Malaysian SMEs.

As the Malaysian government continues to look into the various ways to enhance the development of SMEs and access to finance there has been frequent expressions of dissatisfaction by the Malaysian SMEs on the bureaucracy involved in policy execution by government departments and agencies. Many believe that the incentives and schemes which are available are complicated and that they are unable to meet the requirements. Although the government of the day in Malaysia is determined to annihilate red tape in government departments, a lot more need to be done to increase the efficiency of these units and to deliver the financial schemes to SMEs to ensure that many (if not all) have access to them.

In addition to that, DFIs should be promoted further in the country as they currently play only a minor role in financing SMEs. Interest free finance institutions should be encouraged through favourable government policies in order to enable these institutions to be effective as finance options for SMEs. Lastly, we see the need to further stimulate competition among SMEs lenders so as to make the sector more efficient.

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