Institutional barriers to SME finance: A telling case of Thailand

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Political culture in Thailand generally supports the financial needs of the poor and small and medium-sized enterprises (SMEs). There have been extensive government support schemes to provide financial services to these people through government specialized financial institutions and the Village and Urban Revolving Funds (VRFs). Compared to other microfinance schemes worldwide, the VRFs lend more money to more people than any other schemes, making it the most ambitious microfinance program initiative in the world. Against this background, however, a large number of small enterprises and households still rely on loan sharks (or moneylenders) which charge cut-throat interest rates. SMEs, for their part, are also gradually losing their positions in the competition to large corporations and the obstacles to SME financial access remain an important issue for policy makers today.

In a number of countries around the world, including Thailand, lack of sustainable financing for SMEs and their inability to catch up with larger enterprises is often considered one of the main reasons for increasing income inequality. Financial access has been shown to help create new firms, which are generally dynamic and innovative. For these reasons, effective policies to promote inclusive finance should be prioritized as one of the most important economic development policies.

This paper examines the environment of SME financing in Thailand and finds that the real issue may not be about the lack of financing per se but about the lack of proper regulations and incentives for private sector involvement in the SME sector. Given the institutional settings of tight banking regulations, restricted business security law, high cost of bankruptcy procedures, weak judicial process and enforcement, interest rate caps on microfinance lending and tough competition from government-subsidized credit, commercial banks have no incentives to downscale into small-client segment. The lack of private sector participation in the SME sector has limited the efficiency and quality of financial services, making Thailand's microfinance industry lag behind its peers in the region.

Credit market failures driven by information asymmetry and imperfect contract enforcement often result in the difficulty of SMEs in gaining access to external finance. Appropriate and incentive-compatible legislations, therefore, can help mitigate these problems and facilitate the lending process between financial sector and SMEs. Firms face lower obstacles in starting and maintaining businesses in countries with efficient and market-friendly legal frameworks, strong creditors' rights and efficient bankruptcy procedures. For banks, the degree

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of law enforceability is directly related to their confidence in counterparties and consequently the decision to extend credit by banks.

As a bank-based economy, Thailand should benefit a great deal by improving its lending infrastructure and designing incentive-compatible institutions to capitalize on competitive advantage of commercial banks and existing microfinance institutions (MFIs). The paper attempts to analyze and provide recommendations on how to create a market-friendly financing environment. Policy recommendations include: (1) more active involvement of commercial banks in SME financing via gradual phasing out of government support schemes and effective partnership with existing MFIs, (2) unlocking credit flow between players in the financial system by increasing transparency of information in the credit market, such as enhancement of information coverage of the credit bureau to include semi-formal and informal sectors as well as credit scoring scheme for both SMEs and MFIs, and (3) improving the legal framework in facilitating lending process, such as improvement of creditor's right and necessary legislations in addressing insolvency as well as effective expansion of the types of collateral which can be pledged for loan application.

Going forward, an appropriate role for the government may not necessarily be about taking a central role in providing credit directly, but about strengthening the institutions underpinning financial transactions and eliminating any existing frictions or inefficiencies in the financial system. With efforts from the government and all related parties, lending to SMEs will ideally be more market-driven and sustainable in the long run.
