POTENTIAL BEST PRACTICE FOR IMPROVING THE ACCESS TO DEVELOPMENT FINANCE BY SMEs IN LAO PDR

Manivone Siharath

MBus

A thesis submitted in partial fulfillment of the requirements for the degree of Master of Business, Unitec New Zealand, 2012
Declaration

Name of candidate: Manivone Siharath

This Thesis entitled: “Potential best practice for improving the access to development finance by SMEs in Lao PDR” is submitted in partial fulfillment for the requirements for the Unitec degree of Master of Business.

Candidate’s declaration

I confirm that:

• This Thesis/Dissertation/Research Project represents my own work;
• The contribution of supervisors and others to this work was consistent with the Unitec Regulations and Policies.
• Research for this work has been conducted in accordance with the Unitec Research Ethics Committee Policy and Procedures, and has fulfilled any requirements set for this project by the Unitec Research Ethics Committee.

Research Ethics Committee Approval Number: 2011-1197

Candidate Signature: ……………………………….Date: …………………

Student number: 1368104
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Abstract

Small and medium-sized enterprises (SMEs) are important to all economies, especially emerging economies like Lao People's Democratic Republic (PDR) as they account for a majority of private sector businesses and are essential in generating wealth and social stability through employment creation and national outputs via investment. Even though globalization and trade liberalization bring vast benefits to businesses at all levels, the lack of access to finance by SMEs still poses negative consequences that largely endanger the economic development of the country. Despite the large amount of research that has been done on the access constraints for SMEs, limited studies have addressed the financial factors hampering the SME growth in Laos.

Therefore, the present research aims at investigating possible best practices to overcome factors undermining the banks' ability to expand credits to the SME segment. Hence this qualitative study is employed to explore issues hampering both the supply and demand sides. The study covers some of the perspectives from the government, the banks and the SMEs through interviews with 12 participants. Taking into account the dynamicity and wide variety of different operational practices of banks and SMEs, exploring factors hindering the two sectors is significantly important.

Regarding supply constraints, a number of obstacles such as poor implementation mechanisms, especially on collateral enforceability; inadequate infrastructure such as a lack of reliable data by the central credit information bureau; and a lack of supporting policies remain crucial impediments which are continuously perceived as a thorn for the country's government. As a result, SME accessibility is greatly damaged by the banks' low risk appetites.

Demand constraints however, range from factors affecting the SMEs' feasibility to the direct access for bank financing which is associated with the lack of know-how, limited financial literacy and the inability to present viable business plans. These issues force
the SMEs to rely heavily on informal sources of finance especially from personal wealth and private lenders.

Realizing both the demand and supply constraints; improving the legal framework in terms of enforcing current laws and regulations; providing government subsidies and special privileges are perceived as complementary to government efforts to improve satisfying levels for private, state-owned and foreign banks to focus more on increasing SME portfolios. To ensure that the ultimate goals for both banks and SMEs are achieved, it is essential to encourage and increase coordination by all related stakeholders. The government, private sector and development agencies should work collaboratively to actively adopt and maintain a holistic approach to effectively develop both banking and SME sectors in order to help achieve the government’s objectives.
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Abbreviations

ACLEDA  Association of Cambodia Local Economic Development Agencies  
ADB    Asian Development Bank  
APB    Agriculture Promotion Bank  
ASEAN FTA Association of South East Asian Nations Free Trade Agreement  
BCEL   Banque Pour Le Commerce Exterieur Lao Public  
BOL    Bank of the Lao PDR  
CIB    Credit Information Bureau  
CGS    Credit Guarantee Scheme  
FDI    Foreign Direct Investment  
GTZ    Deutsche Gesellschaft für Technische Zusammenarbeit  
GDP    Gross Domestic Product  
GOL    Government of Lao PDR  
JVB    Joint Venture Bank  
Lao PDR Lao People's Democratic Republic  
LDB    Lao Development Bank  
LDCs   Least Developed Countries  
LNCCI  Lao National Chamber of Commerce and Industry  
MOIC   Ministry of Industry and Commerce  
NEM    New Economic Mechanism  
NBFIs  Non Bank Financial Institutions  
NGOs   Non Government Organizations  
NPL    Non Performing Loans  
NSEDP  National Socio-Economic Development Plan  
SOEs   State-Owned Enterprises  
SOCBs  State-Owned Commercial Banks  
SME    Small and Medium Enterprise  
SMEPDO Small and Medium Enterprises Promotion and Development  
WTO    World Trade Organization
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Chapter 1

Introduction

1.1 Background

There is a growing number of empirical studies on small and medium enterprises (SMEs) and the difficulty of SME financing. Certainly, many researchers and policy makers have shown an increasing interest in this area in recent years (Kyaw, 2008; Shen, Shen, Xu, & Bai, 2009). Numbers of studies have revealed that in all economies SMEs are perceived as a growth engine (The World Bank, 2010a). The development of SMEs is a key mission for all economies as it helps maintain economic dynamics and could lead to national poverty reduction (Nam, 2006). Empirical evidence suggests that increased finance accessibility is “not only pro-growth but also pro-poor” (International Finance Corporation, 2010, p. 80). Barth, Lin and Yost (2011) state that the growth of SMEs helps diversify product development in the market, fostering innovation and increasing national employment rates. In the era of rapid economic expansion, in pursuing SME development, efforts should be put into the improvement of financial suppliers as well as various development policies directly relevant to the growth of this sector (Nam, 2006).

In many transitional economies, improved access to finance for firms is a driving force for growth. Business has its role in boosting and enhancing productivity. However, the banking sector remains dysfunctional because of weaknesses in legal and regulatory regimes in many transition countries. This has resulted in the inability of banks to extend loans to all borrower types (Rashid, 2011). With the move towards market oriented economies, one of the noticeable changes of this phenomenon is the increase of foreign bank presence which brings about various benefits in many developing countries (Rashid, 2011). This study further indicates that the benefits here include the reduction
of financial intermediation costs, the ability to access more financial credits, and financial sector improvement.

Banks are important for all economies, since they are perceived to be the main financiers in generating increased business activities. Beck, Demirgüç-Kunt, and Peria, (2008) show that SMEs around the world are able to access formal financial resources through credit loans from banks, and Haas, Ferreira, and Taci (2010) also confirm that effective banking systems help in promoting economic growth. Lending from banks facilitates new growth for business ventures, and banks are therefore perceived to be the key sector to drive SME development and generate increased national growth rates (Beck et al., 2008; Rahaman, 2011)

However, it is undeniable that banks have less interest in SMEs due to their unreliable business practices and weak financial strength, especially those in less advanced economies where there are poor financial institutions, high rates of corruption, and unstable economies (Le, Venkatesh, & Nguyen, 2006). Getting banks to lend in those circumstances tends to be of great concern, since SMEs are often unreliable in disclosing necessary financial information (Torre, Pería, & Schmukler, 2010) which hardly meets the bank's requirement standards. Therefore, in less developed markets, banks are less likely to lend to SMEs, at least as compared to elsewhere.

With this situation, in most transition economies, SME access constraint is cited as one of the greatest obstacles to increasing business activities and growth (Nam, 2006). In response to the urgent need for a country’s growth and the aspiration to overcome SME finance constraints, government policies with a more favorable environment for banks are vital drivers in encouraging banks to embrace the SME sector in order to meet the mutual benefits.
1.2 Problem statement

After many years of reforming its new economic process passed by the Lao People’s Revolutionary Party at its 6th National Congress in 1986, the government has actively implemented a range of economic reform agendas in order to help maintain economic momentum and social development to meet the country’s objective of poverty reduction (United Nations Development Programme, 2010). As a result of this process, the Lao People’s Democratic Republic (Lao PDR) has successfully established a two tier banking system through deregulation of financial markets. This has created many improvements in this country’s banking sector as shown by a rapidly growing number of banks there during the last three years from 13 to 23 (Asian Development Bank, 2011).

The importance of SMEs to economic and social growth is common in many countries, especially in developing economies including Lao PDR. It is widely accepted that in Lao PDR, SMEs hold the biggest share of total enterprises, as much as 95% as stated by (Southiseng & Walsh, 2010). SMEs are considered profitable businesses by most commercial banks (Beck et al., 2008; Torre et al., 2010). Torre et al. (2010) further state that SMEs play an important role in the prosperity of an economy, given that they can grow from small to become large corporations. As such, their development and investment capabilities are crucial for the growth of the country. The government is therefore actively pursuing its role in developing the business environment to promote this sector by means of improving the institutional and legal framework (GTZ, 2007).

Nevertheless, based on The World Bank (2011d) survey, SMEs in less developed nations cannot yet fully benefit, and face more access obstacles than exist in developed countries. There is also a different degree of bank lending to SMEs in high income and low income countries, shown by the average amount of loans accounting for 13% and 3% of Gross Domestic Product (GDP) respectively (The World Bank, 2011b). This implies that SMEs in developing countries are less advantaged compared to those in developed economies. In addition, Lao PDR is known to have a poor institutional
environment with a lack of transparent information; thus these factors appear as direct constraints to the feasibility of SMEs gaining access to formal financial sources. To address the potential barriers that exist, banks have an opportunity to play a key role in facilitating the development of this sector.

Notwithstanding the important role that banks play in support of the growth of SMEs, access to finance is identified as a serious obstacle to the development of the general growth of local businesses. In spite of the country’s shifting a long way from public sector monopolies, there is continued public ownership and control of firms in most service sectors (Kyophilavong, n.d.). In addition, despite the advantages from financial system liberalization, the progress of this reform has only seen a limited improvement. As a result, inadequate financial sector development still limits successful achievement of economic and social goals (Kyaw, 2008).

It is noted that the Lao banking sector has not yet fully developed, and its implementation is still under the government’s control. In addition, large firms have more advantage, in that they have more bargaining power and can source funds through debt and equity markets, while SMEs tend to rely heavily on only banks (Yavas, Babakus, & Eroglu, 2004). As a result, the future prospects for SMEs tend to be restricted. These issues put more pressure on new SME start-ups, and their choice of financing sources is likely to be dependent on non-bank financiers and private lenders who charge higher interest than banks (Torre et al., 2010). Even though the increases in foreign bank entrants help promote competition in the market, the lack of capital access by SMEs still remains a bottleneck in the path of private sector development.

Despite the fact that banking in Laos has seen a big improvement in the last two decades, it is unavoidable that non-productive borrowings, interference by regulators, incapable management, loose supervisory practice, and insufficient monitoring tools remain as negative aspects of banking operations in the market given the volatile business environment (CUTS International, 2007). With the slow progress in transition
to a market economy, and the fact that the banking sector is still at an early stage of
development, major attention should be paid to increasing prudent banking supervision
and stronger regulation regime as suggested by the Asian Development Bank (2011).

Despite the government’s significant focus on its economic development, a number of
constraints continue to stand in the way of the achievement of sustainable economic
development and thus the future prospects of the Lao economy (The World Bank,
2011a). Laos is considered an environment characterized by poorly defined property
rights, high corruption, and unreliable sources of information; getting banks involved in
supporting SMEs is not easy unless better incentives and well-developed regulations
are implemented. Thus, because the level of growth is too low, the government needs
to pay more attention to improving banking infrastructure (Asian Development Bank,
2011).

To make sure that Lao SMEs can gain full benefit from the moving trend towards a
transformation into a market economy, it is crucial to identify the issues confronting
SMEs, and to evaluate the government policies and the impact of the banking sector on
its treatment of its SME counterparts. Therefore, it is interesting to find out what the
underlying rationales that influence bank behavior are. Furthermore, creating an
environment conducive to meeting the interests of both banks and their SME customers
is perceived to be the most crucial aspect for the government to address in an effort to
develop its mandates and sustain economic growth.

1.3 Purpose and research question

With SMEs’ crucial role as a key source of economic growth and their essential role in
generating employment, the future prospects of Lao’s economy largely depend on the
expansion of private enterprises. In addition, the result of SME’s successful growth
could greatly extend the banks’ credit availabilities. Therefore, the purpose of this thesis
is to consider factors impeding both the demand and supply side of SME operations in
relation to their financial practices. It is essential to find implicit and explicit effects on banks in their unfavorable practices towards SME borrowers, which in the end have significant adverse impacts on SME’s growth. Finding the best approaches to building successful relationship between the two sectors will create advantages of both sides and this could have a direct positive effect on the overall growth of Lao economy as a whole.

Thus, this research aims to find out how the banking sector in Laos can best be strengthened in order to overcome the issue of insufficient external funding for SMEs. To do this, banking sector development in various economies has been studied, especially at the developing economies level, where there are similar situations to the Lao context. This study also aims to develop a better understanding of how the banking sector is operated and structured, and to learn from the experiences of more advanced emerging markets in order to pave the way for long term success in economic development.

Therefore, the primary research question for this thesis is:

“What is the most practical process of banking sector involvement with SME business that would meet the demands posed by a rapidly expanding SME sector in a developing market economy?”

In order to gain more detail on explicit views and address the direct issues for this paper, the following sub questions are also investigated.

- What are the key issues in the current business environment in Laos?
- Who are the main stakeholders in the relationship between banks and the SME sector?
- What are the relevant government and private sector influences over the development of the banking sector?
• What are the relevant government and private sector influences over the development of the SME sector?
• What changes to the current business environment would assist in improving the relationship between banks and SMEs?
• What can be done to help create a conducive environment for commercial banks to better meet the financial needs of SMEs?

1.4 Outline of thesis

The first chapter of this thesis starts with a general view of some broad issues related to the research topic, with the inclusion of a problem statement, and the aim and objectives of the research question. The second chapter provides relevant literature reviews that are necessary to explain and provide a thorough understanding of the research subject. Chapter three continues to outline the most suitable methodology for this research. The results from interviews are presented in chapter four, which covers the key descriptive data derived from three different views - the government, banks and SMEs. Chapter five is the heart of the research in identifying and analyzing the insights and key results from participating interviewees. The last chapter concludes with the suggested approach that could facilitate banks to become a more effective source of direct funding for SMEs. Recommendations for further research are also included.

1.5 Chapter summary

The brief overview of this study provides a foundation for a broad general survey of the banks' and SMEs' situations in transition economies as well as in the Lao business context. In order to reduce the access obstacle of SMEs, a comparison of best practices on improving availability of finance to SMEs can be done through the lessons learned from theoretically optimal practices derived from study in other transition economies. Thus, a greater insight and explanation of the current banking and SME development in Laos is further addressed in the literature review chapter.
Chapter 2

Literature Review

The aim of this chapter is to explore the financial sector development and its general practices under the current business environment in Lao PDR to gain a thorough understanding of this sector. This exploration is especially pertinent to the understanding of the banking and SME sectors’ response to Lao PDR’s fast paced movement towards a market economy. Data gathered from the reviews of empirical evidence is crucial and necessary for the researcher to be able to investigate and explore issues hampering the growth of SMEs in regards to their access to bank finance.

Thus, the structure of this chapter is designed to identify problems related to the supply side of the SME sector as well as the demand side constraints. The important perspectives from both sides are investigated. Detailed investigation of supporting government policies is also made. The findings from this investigation form a guideline for exploring ideas and developing important information to frame best business practice policies that can be used to overcome financial difficulties for SMEs experiencing rapid growth.

2.1 Overview of current state of financial sector in Laos

In 1986, the Government of Lao PDR (GoL) transformed a centrally-planned economy to a market-oriented economy. Part of this process required reform of the banking system by separating commercial bank functions from central bank functions (CUTS International, 2007; GTZ, 2007). Based on approval of The New Economic Mechanism (NEM) in 1986, a number of reforms have been established to “encourage free enterprise initiatives, the gradual liberalization of domestic and international trade and investment and greater regional decentralization in governance” (GTZ, 2007, p. 18).
The removal of centralization from the banking system is designed to help strengthen the financial sector and to increase access for local businesses to improve the economic performance of Lao PDR. In addition, it is to support the country’s desire to move towards a market based economy in an effort of “freeing the country from the status of a least-developed country (LDC) by 2020”, as outlined in the National Socio Economic Development Plan (NSEDP) for 2010-2015 (GTZ, 2007, P. 18).

The financial sector is perceived to have an important role in the economic growth of developing countries since businesses need financial resources at every stage of their business cycle (Kyaw, 2008). The role of the financial sector is to mobilize savings from depositors and channel them to borrowers to create investment opportunities and, as a result, accelerate economic growth (Green, 2008). Green also notes that, in developing countries, banking is the dominant sector in collecting individual savings for credits. Therefore an effective banking sector helps facilitate and stimulate growth and creates investment opportunities for businesses.

Countries with low and medium incomes are now moving towards market based economies, and their banking system is considered a vital tool for success. This transformation into a modern banking system marks a significant change in banking sector development in developing nations, reflected by a growing volume of foreign bank participation (Haas et al., 2010). These authors further state foreign banks are, as a result, perceived to be the main financial suppliers to households and firms in these economies. Thus, decentralization of banking operations helps stimulate the growth of foreign bank penetration, and creates various opportunities for those banks.

Bank ownership in transition economies has seen a noticeable revolution in the last two decades (Haas et al., 2010). An example of this is the collapse of the Soviet Union where, in the past, the planned ‘Soviet-style economies’ did not allow banks to engage in any economic activities (Bonin, Hasan, & Wachtel, 2008). Recently, there has been increasing competition in the banking industry, and many innovative strategies are now
therefore employed for the task. Given globalization and market liberalization, many banks have built up their competitive muscles in order to reap the benefits of this phenomenon.

The system in Laos has been historically dominated by the three state-owned commercial banks (SOCBs), who jointly account for 59% of total bank assets as mentioned in “The World Bank (unpublished report)”. This report states that private and joint-venture commercial banks shared a 37% proportion of the total asset, while non-bank financial institutions and micro-finance institutions accounted for only 3% and 1% of total assets. Further to this study, over the past two decades, one of the successful efforts of the government in its banking reform is that in 1998 the seven state-owned commercial banks (SOCBs) have been merged into three - Banque Pour Le Commerce Exterieur Lao Public (BCEL), Lao Development Bank (LDB) and Agriculture Promotion Bank (APB).

In addition, the banking sector in Lao PDR has been improved as a result of the law on commercial bank promulgated in early 2007 which created an environment that strongly encourages fair competition among other players in the banking market. This is a crucial developing step for a strong commercial banking sector (LNCCI Business Centre, 2007). In order to maintain the soundness of monetary stability and the economic growth rate, the Bank of the Lao PDR (BOL) has actively implemented a priority on monetary policy set in financial year 2008/09 (Bank of the Lao PDR, 2009). One of its mandates is to persuade banks to expand their market coverage so that consumers can better reach for banking services and access a whole range of financial products. This will also result in a transformation to a more modernized banking system, and improved linkages within and across regions (Bank of the Lao PDR, 2009).

As a result of this mechanism, according to the Bank of the Lao PDR (2009), the financial system has been rapidly growing. This is witnessed by the share of total banking assets, which went to 3,595.6 billion kip (US$451.25 million) in 2009, an
increase of 25.98% from the previous year. In addition, Non-Performing Loans (NPL) showed a downward trend (see figure 1) which in 2009 account for only 2.99% of total net credit (Bank of the Lao PDR, 2009). Growth in the Lao economy continues to be strong, irrespective of the impact from the starting global financial recovery, and is anticipated to rise to 8.5% for 2010 compared to 7.5% in year 2009 (The World Bank, 2010b).

**Figure 1: NPL ratios for SOCBs, Joint Venture (JV) banks and private banks:**

**Banking system NPL ratios 2004 – 2006**

![NPL ratios at Lao Banking System](Image)

*Source: Lao PDR investment climate assessment: Policies to promote growth in the non-resource sectors (The World Bank, 2011c)*

Because of this change in the economic process, there has been an influx of both international and new local banks into the country (U.S. Department of State, 2011). The new approved banking law allows an expansion of numbers of foreign branches that are now permitted throughout the country, where previously they were restricted to the capital city of Vientiane. With this effort to improve the banking sector, a number of restrictions on foreign-owned banks have recently been removed and the new law on commercial banks has encouraged foreign banks to participate (U.S. Department of State, 2011).
An important outcome of this phenomenon is the involvement of the Australia and New Zealand Bank (ANZ) in a joint-venture agreement with a privately owned bank named Vientiane Commercial Bank Ltd (VCB) in March 2007 (International Finance Corporation, 2008). Since then banking licenses have been issued to a large microfinance bank from Cambodia named the Association of Cambodia Local Economic Development Agencies (ACLEDA) Bank, for the aim of providing opportunities for small businesses and individuals to better access their needed funds. Furthermore, two other foreign banks - Korean and Malaysian - have also been issued banking licenses, and the current Public Bank of Malaysia was allowed to expand more of its branches in the country (International Finance Corporation, 2008).

Besides the entrance of foreign banks into the country, local banks have also established firmer footholds. Phongsavanh Bank, a 100% privately-owned bank, was also opened in 2007 with a registered capital of US$ 10 million (International Finance Corporation, 2008). Banking products and services are offered in various means such as SME lending, consumer lending, payroll facilities, financial leasing, ATM and credit cards services (International Finance Corporation, 2008). Table 1 outlines a summary of commercial banks operated in Lao PDR.

**Table 1: Ownership of banks in Laos**

<table>
<thead>
<tr>
<th>Name</th>
<th>Inception</th>
<th>Ownership</th>
<th>Branches</th>
<th>Strategic focus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SOCBs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BCEL</td>
<td>11/1/1989</td>
<td>Government of Laos, 100%</td>
<td>12</td>
<td>Corporate banking, SOEs</td>
</tr>
<tr>
<td>LDB</td>
<td>18/12/2002</td>
<td>Government of Laos, 100%</td>
<td>18</td>
<td>SMEs, SOEs</td>
</tr>
<tr>
<td>APB</td>
<td>19/6/1993</td>
<td>Government of Laos, 100%</td>
<td>17</td>
<td>Agricultural focus, diversifying</td>
</tr>
<tr>
<td>Nayobai Bank</td>
<td>5/09/2006</td>
<td>Government of Laos, 100%</td>
<td>5</td>
<td>No information available</td>
</tr>
<tr>
<td><strong>State Joint Venture Banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint</td>
<td>03/10/1989</td>
<td>Bank of Lao PDR, 30%,</td>
<td>1</td>
<td>All sectors; business flow</td>
</tr>
<tr>
<td>Bank Name</td>
<td>Establishment Date</td>
<td>Ownership Details</td>
<td>Number of Branches</td>
<td>Focus Description</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>--------------------</td>
<td>------------------</td>
<td>-------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>Development Bank (JDB)</td>
<td></td>
<td>Thai private interest, 70%</td>
<td></td>
<td>from proximity to market</td>
</tr>
<tr>
<td>Banque Franco-Lao Ltd</td>
<td>24/11/2010</td>
<td>A joint venture between BRED Bank of France and BCEL</td>
<td>1</td>
<td>No information available</td>
</tr>
</tbody>
</table>

### Private Sector Banks Incorporated in Laos

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Establishment Date</th>
<th>Ownership Details</th>
<th>Number of Branches</th>
<th>Focus Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acleda</td>
<td>8/7/2008</td>
<td>No information available</td>
<td>1</td>
<td>All sectors</td>
</tr>
<tr>
<td>ANZ Vientiane Commercial Bank Limited</td>
<td>12/6/1992</td>
<td>60% ANZ, 15% Thai private, 10% IFC, 15 % Lao private (replaces entry in original table)</td>
<td>1</td>
<td>Top service focus at high price; SMEs &amp; individuals; expect ANZ will expand focus</td>
</tr>
<tr>
<td>Phongsavanh Bank</td>
<td>02/02/2007</td>
<td>Private Lao interest, 100%</td>
<td>2</td>
<td>Focuses on the provision of SME lending, consumer lending, salary advance facilities, hire purchase/leasing,</td>
</tr>
<tr>
<td>ICB</td>
<td>2008</td>
<td>International Commercial Bank (ICB) Malaysia</td>
<td>3</td>
<td>No information available</td>
</tr>
<tr>
<td>Indochina Bank</td>
<td>2009</td>
<td>Private Korean-owned bank</td>
<td>2</td>
<td>All sectors</td>
</tr>
<tr>
<td>ST Bank</td>
<td>2011</td>
<td>Private Lao-owned bank</td>
<td>1</td>
<td>No information available</td>
</tr>
<tr>
<td>Booyong Lao Bank</td>
<td>2009</td>
<td>No information available</td>
<td>1</td>
<td>No information available</td>
</tr>
</tbody>
</table>

### Foreign Bank Branches

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Establishment Date</th>
<th>Ownership Details</th>
<th>Number of Branches</th>
<th>Focus Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangkok Bank</td>
<td>25/2/1993</td>
<td>Foreign bank branch, Thai</td>
<td>1</td>
<td>Transaction business, not loans; Thai corporate</td>
</tr>
<tr>
<td>Krung Thai Bank</td>
<td>25/02/1994</td>
<td>Foreign bank branch, Thai</td>
<td>1</td>
<td>SMEs &amp; Thai-related business</td>
</tr>
<tr>
<td>Bank of Ayudhaya</td>
<td>18/4/1994</td>
<td>Foreign bank branch, Thai</td>
<td>1</td>
<td>No information available</td>
</tr>
<tr>
<td>Siam Commercial Bank</td>
<td>30/11/1992</td>
<td>Foreign bank branch, Thai</td>
<td>1</td>
<td>Mostly FDI-related &amp; Thai corporate</td>
</tr>
</tbody>
</table>
Thai Military Bank  7/9/1992  Foreign bank branch, Thai  1  No information available

Public Bank  10/4/1995  Foreign bank branch, Malaysian  3  SMEs & individuals with loans secured by property

Sacombank  2008  Foreign bank branch, Vietnam  1  No information available

Vietnamese Military bank  2011  Foreign bank branch, Vietnam  1  No information available

Sources: Based on the table in Laos: Services Trade, Development, and International Cooperation ("The World Bank, unpublished report") and updated using information from (U.S. Department of State, 2011) and banks’ websites.

As of December 2009, there was an improvement in the total deposits of commercial banks. These have shown an increase from 10,073.43 billion Kip (US$1,264.23 million) in 2008 to 12,087.19 billion Kip (US$1,516.96 million), or up by 20% and representing 25.82% of GDP (Bank of the Lao PDR, 2009). Likewise, the total loan to the economy as of December 2009 was 8,740.42 billion Kip (US$1,096.94 million) or equal to 18.68% of GDP (Bank of the Lao PDR, 2009) where in the past the total bank loan to GDP accounted for only 11.1% in 2003 (RAM Consultancy Services Sdn Bhd, 2005).

The report from the bank of Lao PDR (2009) also revealed that an improvement in interest rates on loans has also occurred. In Laos the three main currencies include the Kip, the US dollar and the Thai Baht. The improvement of ratio on interest rates has reflected on the level of increasing domestic lending and the healthy economic conditions in the country. The average rate of interest for Lao’s kip has now moved from 17.55% in 2008 to 15.25%, the US dollar down from 9.89% to 8.99% and the Thai baht reduced from 11.34% to 9.55% respectively (Bank of the Lao PDR, 2009).

Continuing improvement and modernizing banking products and services is crucial to enable the Bank of the Lao PDR to develop a better banking system and stronger financial institutions. To improve financial infrastructure, the Lao Stock Market opened in early 2011 (ASEAN Bankers Association, 2011). In an effort to overcome the lack of
access to finance for small firms and individuals, the Nayoby Bank (a nonprofit “policy bank”) was created from the Agriculture Promotion Bank (APB) to “provide loans for trade, production, and agriculture” in which bonds and capital are used to finance instead of deposits (United Nations Development Programme, 2010, p. 9).

However, financial accessibility still remains limited since Laos is classified as one of the world’s lowest in terms of its dispersion of bank branches, with only 10 branches per 1,000,000 people. Only 5% of people have an account with banks and almost 90% use cash (International Finance Corporation, 2008). This implies that banks are less aggressive in lending and mobilizing deposits, and their credit availability tends to be limited. This has hampered the accessibility of SMEs to their needed funds.

In addition, due to the lack of available business information, insufficient credit information and the perception of high risk in SMEs, the interest rate is usually higher than the recommended ceiling (United Nations Development Programme, 2010). Due to the high risk involved, charging a high interest rate is one of the profitable techniques to compensate on the banks’ lending costs. It is noted that the interest range between lending and deposit rates in Lao PDR is 8-9 percentage points which is higher than those countries where best practice prevails - such as the Republic of Korea, Malaysia, and Singapore where the interest range is 3.1 percentage points on average (United Nations Development Programme, 2010).

Lao PDR is one of the lower Mekong countries still facing challenges that result from the legacy of a centrally planned economic process, where banking systems are still dominated by state-owned commercial banks while private ownership banks serve as niche operators in the financial sectors (International Monetary Fund, 2004). The financial sector has just started developing its reforms, so has not yet fully implemented its role as a financial intermediary. The Lao banking sector is considered very small, with deposits of $1,091 million (27% of GDP) and loans of $416 million (11% of GDP) in 2007 (“The World Bank, unpublished report”) and total assets accounting for less than

Financial infrastructure and financial institutions in Lao PDR are still at an initial stage of development and the supervisory capacity of BOL remains weak (International Finance Corporation, 2008). The practice of rotating roles by senior management between the Central Bank and other state financial institutions such as SOCBs is a significant problem which could create conflict in organizations independently managed by the SOCBs (International Finance Corporation, 2008; United Nations Development Programme, 2010).

Despite the commitment to liberalizing its banking sector by 2015 (“The World Bank, unpublished report”), the banking sector in Lao PDR is still underdeveloped and at an evolving stage compared to other neighboring countries. It is affected by several shortcomings such as high transaction costs impacted by weak payment systems, unreliable businesses, and the slow growth of SOCB reforms (United Nations Development Programme, 2010). In addition, the defective regulatory environment is a main constraint to the growth of the insurance industry, the leasing industry and other non-bank financial institutions (NBFIs).

Furthermore, with the absence of any monitoring framework such as rating companies, the banking system has become fragile and this has led to lower confidence among foreign bank investors (United Nations Development Programme, 2010). In short, the banking sector in Lao PDR is vulnerable as a result of the continued support of state-owned enterprises (SOEs) by SOCBs (Siackhachanh, 2007).

With the government’s aim of greater involvement in economic development, the participation of recent Association of South East Asian Nations Free Trade Agreement (ASEAN FTA) should help increase foreign bank presence as well as other providers in the financial market as outlined in “The World Bank (unpublished report)”. This will lead
to many new opportunities for banking sector development and increased local benefits. However, both the negative as well as the positive consequences of foreign banks’ presence in an unstable business environment should be considered. While foreign banks have contributed to the increased loan supply to Lao nationals, there seems to be a huge gap in benefits gained by large and smaller firms (Havrylchyk & Jurzyk, 2010). In order to effectively exploit the benefits of foreign banks’ entry into the country, appropriate regulations on fair treatment towards all types of firms should be encouraged to ensure long term development and future growth.

In Lao PDR, there is still a lack of financial instruments to effectively operate and develop the banking sector in a safer and sound manner. Therefore, with the need for a modernized banking sector, it is also vital to effectively resolve the weakness of regulatory frameworks and ensure the long terms benefits from the new foreign bank entry. It is also vital to gain assistance from aid agencies to help Laos achieve sustainable development of the financial sector (“The World Bank, unpublished report”).

### 2.2 Problems on supply side of SME Sector

As outlined in the Law on Commercial Banks, in Laos “banking business refers to the currency business of accepting deposits and using such funds to extend credit, to buy and sell foreign currencies, to provide payment services or to make investments” (Law on commercial banks, 2007, p. 1).

As defined by Huang (2007) banks are in principle perceived to be a crucial element in the financial sector, playing a role as intermediaries between depositors and borrowers, and are characterized by providing banking services on the basis of taking deposits from customers and lending to other clients. In this way, as Fitzroy and Hulbert (2005) have noted, one important aspect of financial market participation is the banking function of taking savings from individuals and businesses, and using those reserves to finance others into making new investments.
Banks are distinct in structure, character, and size, and different banks have different strategies in relation to corporate/institutional businesses, SMEs, and the retail sector – the type of customer served may affect how banks perceive their lending criteria, and a better understanding of the characteristics of banks helps determine the most suitable process to support the needs of banks and their customers.

Generally, bank ownership patterns include both domestic and foreign banks (Hass el al., 2010), and ownership status can see local banks more likely to extend credit exposure to local businesses based on their insights into local market conditions – who the customers are, what they do, who they are related to, how reputable they are in the community, and how strongly connected they are to the local business/political communities. In contrast, foreign banks are more interested in what current business performance is like, and will lend based on organizational track record. In short, and based on the conservatism that results from a modest appreciation of local market conditions, foreign banks base their lending on the nature of transactions rather than on a long term relationship-building orientation (Haas et al., 2010).

Another important aspect of bank character is size. A common perception is that, on the whole, SMEs are not a primary focus for larger foreign banks, and this has made room for smaller local banks to use relationship-oriented lending within a well understood local environment (Haas et al., 2010; Torre et al., 2010). However, SMEs have recently become a favorable market for large foreign banks, due to their profit potential (Beck et al., 2008; Haas et al., 2010; Torre et al., 2010; Yavas et al., 2004), and the conventional view of big international banks being only interested in big customers is no longer true (Torre et al., 2010). Torre et al. (2010) state that, in spite of lower profit growth of SMEs compared to bigger firms, commercial banks can now see the benefits of providing services to SMEs through the adoption of a holistic approach based on a clear competitive advantage in providing multiple ranges of products and services.
Banks can therefore further develop their networks and extend their services by developing relationships with established SMEs (Torre et al., 2010), and “large banks can have a comparative advantage at financing SMEs through arms-length lending technologies such as asset-based lending, factoring, leasing, fixed asset lending, credit scoring and the like, instead of relationship lending” (Beck et al., 2008, p. 2). From empirical evidence of a previous study in China, it is shown that SMEs can gain better bank credit through security over tangible assets (Wu, Song, & Zeng, 2008). Beck et al. (2008) state that all kinds of banks take real estate as the most important collateral for loan decisions, while cash and other liquid assets are considered as the second most valuable asset.

It is believed that banks can be successful if they maintain well established relationships with their customers while, at the same time, SMEs can achieve their capital requirements by maintaining more effective networking with the banks (Yavas et al., 2004). Therefore, not only can small banks facilitate growth in SMEs, but other large commercial banks can also view SMEs as a strategic sector and build longer term relationships with them (Torre et al., 2010).

2.3 Problems on demand side of SME sector

SMEs are differently defined from one country to another, though generally a small business is defined as a small scale entity that is independently managed by an owner manager in both its finance and operation and is also characterized by its small number of staff, limited financial resources and assets (Schaper, Volery, Weber, & Lewis, 2011).

There are differences in SME definitions among ASEAN countries. These differences exist in the way financial and other lending institutions view SMEs (RAM Consultancy Services Sdn Bhd, 2005). As per RAM Consultancy Services (2005), in the ASEAN context SMEs are generally classified by employment - such as a small enterprise being defined as one whose employment does not exceed 100 people, and a medium
enterprise as one with employment not exceeding 250 people. In Laos, the definition of SMEs uses “criteria such as turnover, assets or staff” according to the Prime Minister’s Decree No. 42/PM (GTZ, 2007, p. 23). Further definition of these concepts is included as Appendix 1.

Countries worldwide perceive SMEs as the backbone of their success (Beck et al., 2008; Singh, Garg, & Deshmukh, 2010). Singh et al. (2010) further state that much of the growth in the global economy is contributed by SMEs, currently accounting for around 80% of total growth rate. In order to strive for economic development, ASEAN countries have identified SMEs as among the driving forces for growth, since many economies are more than 90% based on SMEs that employ between 75% and 90% of the local labor force (RAM Consultancy Services Sdn Bhd, 2005). SMEs are then perceived as a crucial engine for the country’s development (Beck et al., 2008; Nguyen, Le, & Freeman, 2006), and further support from SMEs can result in them becoming a dominant sector in all economies and the main contributors to national incomes and employment creation.

Lao PDR is considered the poorest of the Mekong region countries, where more than 70% of the population is employed in agriculture, and just 11% of population is employed in manufacturing (GTZ, 2007). In addition, the total population is nearly 7 million with only 31% living in urban areas (Mai, n.d.) and the rest sparsely populated throughout the nation with only 27 persons/sq km, compared to 256 persons/sq km in Vietnam (United Nations Development Programme, 2010). However, since Laos abandoned the policy of centralized control, SMEs have become a growing sector and now account for the majority of private firms in the country (GTZ, 2007).

The success gained from adopting a new economic process means that there has been an increase in privatization in the Lao market. Numbers of dominated State-owned Enterprises (SOEs) declined from 800 in the early 1990s to 149 in 2004 (Kyophilavong, n.d.). The new economic mechanism also allows for increasing private ownership of
domestic and foreign-owned enterprises. Nevertheless, even though there has been a decline in the number of SOEs, “financial sector, utilities and some industrial sectors such as cement, steel, pharmaceuticals, food processing and beverages are still state-owned” (Kyophilavong, n.d., p. 167).

According to Southiseng & Walsh (2010), the economy consists of 5% large firms, 16% medium enterprises, 58% small enterprises, and a micro sector of 21%. With support from the Government of Lao PDR (GOL), Non-Government Organizations (NGOs) and international organizations, the number of SMEs in Laos significantly increased by 13.6%, amounting to 10,543 enterprises between 2005 and 2007 as per an Enterprise Survey conducted by GTZ (2007). This represented a total registered enterprises count of 88,193 in this year (GTZ, 2007). Agriculture is the main economic sector in Laos and accounts for 44% of GDP, equaling 2.8US$ billion of that economy. This is followed by the industrial sector which accounts for 30% of GDP, then the service sector which accounts for 26% of GDP (Kyophilavong, n.d.).

Lao SMEs have experienced rapid growth as a result of the economic integration of the regions (Kyophilavong, n.d.). In an effort to integrate into the regional and international economies, recently Laos began working on World Trade Organization (WTO) accession with an aim to attract more foreign investment and liberalizing its international trade (Southiseng & Walsh, 2010; The World Bank, 2009). However, despite a recent improvement in business performance, SMEs in Laos still face a number of challenges.

Schaper et al (2011) state that great business ideas, well-developed products or services, and sound marketing policies and good management do not always imply the businesses’ success. There is another success tool and that is financing. Without sufficient finance, businesses ventures are likely to be faced with business failure and are hardly able to meet their expansion goals. In Lao PDR, the nature of businesses is generally characterized by informal management and independent ownership by inexperienced managers with limited cash (Southiseng & Walsh, 2010).
In addition, SMEs tend to have fewer advantages than the larger firms given their limited access to finance, equipment, credits and raw materials (Southiseng & Walsh, 2010). These factors further pressurize SMEs into experiencing complicated and lengthy administrative procedures and corrupt practice by officials. Unfair practices in business operations in Lao PDR are likely to enlarge the gap between the large and small firms. This results in small firms having weaker competitive power than their larger business fellows in terms of “price, quality and distribution” caused by their “limited knowledge in business, laws and taxation” (Southiseng & Walsh, 2010, p. 60).

In light of the industrialization and modernization of economies, SMEs help increase production and diversify economic activities by providing inter-firm linkages with other large companies (Kyaw, 2008). They help increase competition and ultimately become the main generator of employment, contributing 90% of the domestic workforce in many Asian countries (RAM Consultancy Services Sdn Bhd, 2005). Thiengthepvongsa (n.d.) states that in least developed countries (LDCs) SMEs are a strategic sector as they contribute to fuller domestic employment. He further says that many SMEs operate outside the urban areas therefore giving people who live in rural areas a greater chance of employment, especially women.

Various studies on SMEs also reveal that women have better engagement in business operations and play more crucial roles in business management and ultimately become owners or managers (Southiseng & Walsh, 2010). Thus, SMEs help generate a more equitable distribution of incomes for all individuals (Thiengthepvongsa, n.d.). Therefore SME development leads to poverty reduction and reduces disparities in society (Southiseng & Walsh, 2010; Thiengthepvongsa, n.d.). According to a data survey conducted in 2006, the SMEs in Lao PDR contributed to the majority of that country’s domestic employment and accounted for 83% of the total Lao workforce (Walsh & Southiseng, 2011).
Nevertheless, the Lao SMEs still face a number of constraints to business growth due to their lack of access to long term capital, limited management skills and unequal treatment by relevant authorities in various ways such as higher administrative costs and a large amount of process and paper work (Southiseng, Ty, Walsh, & Anurit, 2007). Furthermore, Laos is suffering from logistic constraints due to its landlocked structure, and most of the products available in its market are imported from neighboring countries. Knowledge, technology and capital capacities are other limitations impeding Lao businesses from successfully competing in regional and international markets (Southiseng et al., 2007).

The study by Southiseng et al. (2007) reveals that in the current situation, economic integration has brought many substitute products/services from cross-border trade and this leads to high competition by plenty of players in the market. As a result, sales of local products on the domestic market are undermined by the overflow of imported products. Lao PDR is classified as one of the most rurally focused countries in the world where 80% of the population live in the countryside. Due to this geographical constraint, and with a low level of technological development and poor economic dimensions, the prospect of business development is further pressured and becomes a significant risk (Southiseng et al., 2007).

The development path of the Lao economy is still reliant largely on assistance from various aid agencies, government bodies, non-government organizations (NGOs) and growth from resource extraction by large foreign corporations (Walsh & Southiseng, 2011). It is also crucial to note that persistent red-tape, widespread corruption and administrative barriers stand in the way of private sector development in a sound and effective manner (RAM Consultancy Services Sdn Bhd, 2005). In transition economies such as Lao PDR, the ability to enhance SME access to finance remains challenging. In order to understand what can be done to overcome this, it is important to look at both the demand and supply constraints of SME financing (Nam, 2006).
2.4 Demand side constraints for SME’s access to bank finance

Generally, firms tend to depend largely on internal sources to finance growth, and most of the time investment capital is usually provided by family members, given that many businesses in Lao PDR are family based (Southiseng & Walsh, 2010). Apart from using self-generated wealth, their alternative sources of financing can be obtained from an informal sector such as friends, suppliers and money lenders - see figure 2 below (International Finance Corporation, 2008; Kyaw, 2008; Southiseng & Walsh, 2010; The World Bank, 2011c; United Nations Development Programme, 2010).

Figure 2: Limited access to bank lending compared to non-bank financing options: Share of loan sources as of 2007

According to the World Bank (2011c), in an underdeveloped banking sector, retained earnings are significantly employed as working capital (96% of retained earnings) and investment capital (97% of retained earnings). This implies that businesses lack accessibility to bank financing. Without the ability to acquire bank credits, the private small firms undoubtedly depend largely on the informal sector (Nam, 2006). Even though internal sources of finance do not fully satisfy all the funding needs, many small firms are unwilling to borrow from banks, possibly due to overly complex application procedures – see figure3 (The World Bank, 2011c).

**Figure 3: Reasons for not applying for credits**

Source: Lao PDR investment climate assessment: Policies to promote growth in the non-resource sectors (The World Bank, 2011c)
The informal sector is perceived to be the main source for SME credits in the “ASEAN-4” countries, Cambodia, Lao PDR, Myanmar and Vietnam (RAM Consultancy Services Sdn Bhd, 2005). The evidence suggests that despite most firms having bank accounts, in terms of the number of loans given to such firms, Lao PDR is considered the lowest among other countries in the region as revealed in figures 4 and 5.

**Figure 4: Share of firms with a bank account (%)**

![Graph showing share of firms with a bank account.](image)

*Source: Lao PDR investment climate assessment: Policies to promote growth in the non-resource sectors (The World Bank, 2011c)*

In addition, access to external financiers in Lao PDR accounted for only 3% of sourced funds to SMEs, while 97% of sourced funds came from personal resources (The World Bank, 2011c). This is quite different to the figures for sourced funds for SMEs in Vietnam where funds from the formal sector accounted for 20-30% of sourced funds and the rest (70-80%) came from informal channels (The World Bank, 2011c).

Furthermore, funding available in transition economies is short term and the chance of accessing for longer duration tends to be limited given the high level of weak legislative frameworks and the inherent bias of banks towards small firms (RAM Consultancy Services Sdn Bhd, 2005). This report further suggests that in Lao PDR more than 70%
of financing instruments are short term. It is also noted that access channels for SMEs are hampered by common problems such as the inability to prepare financial statements or comply with bank requirements (Mandeep, Goyal, Kumar, & Thiruvengadam, 2008).

**Figure 5: The share of firm with loan in the lowest among competitors**

![Bar chart showing the share of firms with a bank loan in various countries.](source: Lao PDR investment climate assessment: Policies to promote growth in the non-resource sectors (The World Bank, 2011c)

Cultural barriers can also be a reason for poor credit rating; some business owners are women but in poor countries women tend to be limited in accessing finance given the gender inequality that still largely remains in under-developed nations (Nam, 2006). Nam further says that gender inequality restricts women from gaining finance for their business because of their lack of legal identity to hold property and asset titles.

Another problem faced by small firms is the lack of ability to prepare business plans (Kyaw, 2008; Nam, 2006). Kyaw (2008) indicates that the lack of ability to form a business plan limits the level of bank confidence in SME management and repayment abilities. This has resulted in banks rarely relying on this information as a means of
verifying the feasibility of the project. This becomes the reason why in this economy banks have to rely solely on collateral for loan decisions (Kyaw, 2008). In Lao PDR, critical factors such as sophisticated lending procedures and inadequate collateral undermine a firm's ability to gain access to bank loans (The World Bank, 2011c).

The bottleneck of SME financing is commonly associated with the degree of poor quality or insufficient collateral; inability to make a business plan; poor business track record; lack of reliable financial data; inadequate management knowledge; and poor information from SMEs about their industries (Mandeep et al., 2008). These authors (Kyaw, 2008; Nam, 2006) conclude that banks therefore require high collateral and charge higher interest rates for additional safeguards to protect themselves from bearing the high cost of bad debts.

2.5 Supply side constraints in SME financing

Besides the demand problems, there are some common shortcomings and constraints of supply that significantly exacerbate the access obstacles for SMEs. Firstly, the impediment to SMEs in accessing needed funds is impacted by the government’s involvement and intervention such as "lending subsidies for state-owned financial institutions, state-owned development institutions, and restrictions on foreign institutions" (RAM Consultancy Services Sdn Bhd, 2005, p. 25) which could lower overall credit availability to private SMEs. Mandeep et al. (2008) further indicate that the process of banking reform is relatively slower in Asian nations compared with other developed nations, and commercial banks in these economies tend to have less experience in the use of sophisticated financial instruments and lending technologies.

One of many hurdles for bank finance links back to poor business information. In ASEAN economies, the sufficiency and reliability of information provided by the Credit Information Bureau (CIB) institution is still doubtful (RAM Consultancy Services Sdn Bhd, 2005). Likewise, in Lao PDR, even though the credit information bureau was
established under the Bank and Financial Institution Supervision Department of the Central Bank, information stored by the centralized database is not sufficient (International Finance Corporation, 2008). Given that data available from this tool is not yet reliable, banks hardly ever rely on information provided by the CIB (International Finance Corporation, 2008). Thus, attention should be given to improving stronger credit databases to create trustworthiness and accuracy in a centralized database for SMEs, together with improving and enforcing all measures for implementing the CIB.

Firms need funds for the whole business life cycle, from the initiated stage right through to when they become large corporations. The studies from (Mandeep et al., 2008; RAM Consultancy Services Sdn Bhd, 2005) reveal that high risk associated with SMEs, as well as legal barriers, are forcing banks to insist on use of high collateral. In Lao PDR, without sufficient collateral both newly established and existing enterprises are hardly meeting their credit needs (The World Bank, 2011c). This study adds that in Lao PDR, collateral requirement is very high and is determined by the collateral value which on average accounts for 3 times of the loan value. Yet in Cambodia and Vietnam, the coverage is only 2 times (The World Bank, 2011c).

Haselmann and Wachtel (2007) state that collateral is indicated as “the signal device” for banks in an environment with poor business data. The higher the value of collateral, the better for firms in their access opportunities (Kyaw, 2008). To increase banks’ engagement for small business lending, collateral law and effective risk management techniques are needed, and there should be continued enforcement of these techniques.

Another common credit constraint on SMEs in ASEAN economies is the lack of credit skills available to evaluate a firms’ creditworthiness. In Vietnam, given the domination of SOCBs, loan officers are seen to be familiar with evaluating and focusing on lending to state-owned enterprises, which are perceived as a lesser risk compared to the private enterprises (Mandeep et al., 2008). In addition, being a slow mover to a market based
environment and its short time in banking development, credit staff are likely to be disadvantaged in fully developing their expertise in credit evaluation, risk analysis and effectively following up on borrowers’ performance. Thus, the consequences could be particularly dire for SMEs which are perceived to incur a substantial amount of cost in processing loans (Mandeep et al., 2008).

It is worth noting that even though venture or equity capital markets are considered to be alternative sources that allow firms of all sizes to gain access to long term finance, the equity and venture capital markets in ASEAN are generally insufficiently developed (RAM Consultancy Services Sdn Bhd, 2005). Despite the successful establishment of the first Lao capital market in early 2011, in an effort to promote alternative avenues for external financing, weak financial institutions and regulatory frameworks remain critical barriers for implementation of the capital market. Thus, the lack of access to capital for many fast growing SMEs greatly impedes their expansion and could ultimately threaten their survival.

2.6 Relationships of banks and SMEs in emerging market economies

Market institutions are another aspect that needs to be taken into account in developing economies. The study of Hasan, Wang, and Zhou (2009) from China reveals that the impact of institutions by means of effective law enforcement and property rights awareness proves to be essential for banking efficiency. Nguyen et al. (2006) confirm that, from an analysis of developed nations where there are effective institutions, loan applications can be analyzed and approved based on data that are available from financial services firms, related government bodies, and other banks. Commercial banks are therefore able to calculate risk when lending to new SMEs, based on standard information (Nguyen et al., 2006).

Further insight from Barth et al. (2011), shows that access obstacles for SMEs can be reduced through increasing firm transparency by exploiting international accounting
standards. However, they point out that SMEs appear to be charged higher rates; especially where markets are dominated by private foreign banks that place little reliance on relationship based lending. “A bank based financial system is hereby proved to outweigh a market based financial system at the current stage for transition markets” (Barth et al., 2011, p. 36).

Generally, in transition economies, it seems likely that banks could benefit from using relationship oriented lending as an approach to extend their SME customer base. Hernandez-Canovas and Martinez-Solano (2010) argue that SMEs in a European oriented banking system tend to gain better access by extending and strengthening relationships while simultaneously being required to pay higher interest rates; and the authors further explain that keeping relationships with at least two banks helps to increase bargaining power and reduce the cost of debt. As argued by Hainz (2009), it is likely that firms can achieve better lending conditions and bear lower cost in an environment of increasing competition and better quality market institutions.

In Vietnam, where there is a lack of business data and weak business institutions, the exploitation of trust-based strategies tends to be a practical option for the banks to provide finance to their clients (Nguyen et al., 2006). Shen, Shen, Xu, and Bai (2009) suggest that, in order to cope with unstable business environments, banks can reduce credit risk by taking more asset security, and by creating a specific risk management department to assist in obtaining better information about customers' histories.

From the study in China, it is shown that SME financial issues can be overcome by loans lending from small banks (Shen et al., 2009), and therefore increasing competition in the local markets tends to encourage more lending to SMEs. Hence, though seeking to improve the quality of banking institutions is ambitious, the government has a key role to play in strengthening the banking system, and enhancing the law and regulations, in order to foster the required improvement in market institutions (Shen et al., 2009).
2.6.1 Financial infrastructure

Lending infrastructure is an important factor for the availability of credit for SMEs. The prospect of financial accessibility for SMEs can be gained through improving the country’s financial sector infrastructure to give a best fit between institutions and their borrowers (Kyaw, 2008). To increase a level playing field for all commercial banks, clearer regulations are the crucial means to determining the rights and flexibility of financial services to the business community (Mai, n.d.).

However, in transition economies, the level of social acceptance and banking attitudes towards small private enterprises is not yet fully supported (Mandeep et al., 2008). The imbalances of available funding and excessive demand for domestic credits are normally affected by the poor economic structure and inefficient legal and regulatory frameworks. Improving transparency is perceived as an essential element to reducing the information gap; this is determined as one of the main challenges in lending to SMEs (The World Bank, 2011c).

Lao PDR also faces challenges in the lack of enforcement of the Secured Transaction Law which is still the main cause for banks’ reliance on fixed and high collateral coverage (The World Bank, 2011c). Conservative lending by banks continues to apply since protection on creditor rights and loan guarantees are of concern (RAM Consultancy Services Sdn Bhd, 2005). Thus, the consequence of poor enforcement in collateral rights affects SMEs in achieving the long term finance necessary for investment. To ease SME financial issues, improving the asset registration system and legal rights on property ownerships are important to improve lending by commercial banks (The World Bank, 2011c).

In addition, dispute resettlement mechanisms in Laos are still weak through lack of adequate independent arbitration venues (U.S. Department of State, 2011), so that banks become risk adverse and avoid being involved with this circumstance. Continuing
improvement of banking infrastructure and alternative sources of finance may help improve access to finance. Promoting technology based on lending is perceived as a critical mechanism to increase opportunities for access to finance of SMEs (Mai, n.d.).

Apart from legal constraints, technology development is another concern. Technology is perceived to be a crucial means for the modernization of banking operations but in most leading economies in ASEAN, the core banking system used by many major banks are still at first a generation level and not yet exploiting its full capacity despite their ambitious goals (Mai, n.d.). Up until now in Lao PDR, the IT system for all the banks has remained very basic (International Finance Corporation, 2008).

Financial markets in the four Mekong countries (Cambodia, Myanmar, Lao PDR and Vietnam) are still at a basic stage of development and the governments are now working on improving and building up their financial infrastructure in order to catch up with other countries in the region like Indonesia, Malaysia, Philippines, Singapore and Thailand (RAM Consultancy Services Sdn Bhd, 2005). Thus it is necessary to improve the legal infrastructure and financial institutions for an effective banking industry and to ultimately better facilitate the SME segment (Mai, n.d.).

2.6.2 Legal, regulation and policy frameworks

Even though the Lao government has made a big effort to liberalize the banking sector and improve legal and regulatory frameworks, Laos’ legislative system remains incomplete in many regards (U.S. Department of State, 2011). The central bank's works are often determined by inconsistency, and conflicting elements of government regulations, decrees, rulings and presidential orders issued from time to time (International Finance Corporation, 2008). Therefore a consequent lack of clear accountability in the management of the financial sector, and inconsistency in implementing laws and regulations, remain weaknesses and challenges for an effective
banking operation and could lead to ambiguity for other business operators in Lao PDR (International Finance Corporation, 2008; U.S. Department of State, 2011).

Various constraints for business investment are characterized by informal red tape, unclear implementation mechanisms and a lack of transparency in financial markets (RAM Consultancy Services Sdn Bhd, 2005). In addition, due to weaknesses in the registration and licensing processes in Laos, a large number of small businesses are not yet fully registered (RAM Consultancy Services Sdn Bhd, 2005). This has been affected by the amount of work required by many government bodies involved in the registration process that often creates administrative costs and difficulties in dealing with all related stakeholders (RAM Consultancy Services Sdn Bhd, 2005).

2.7. Business process and development strategies to overcome SME financing constraints

Most banks avoid giving credit to small firms because such firms are considered costlier and riskier. However, given the crucial role of SMEs, government policies are necessary to help reduce potential barriers for new start-ups and disadvantaged SMEs. It is noted that a healthy banking sector is often determined by elements of supporting business operations, stronger economic foundations, comprehensive sets of regulations and supervision, and the existence of sophisticated infrastructure and reliable human resources (Mai, n.d.).

By acknowledging the issues currently facing the banking sector in Lao PDR, and noting an urgent requirement for SME growth, a study conducted by RAM Consultancy Services (2005) has suggested some strategies that can be a good starting point to help government meet the development needs of both demand and supply dimensions.

Firstly, the study suggests the creation of the type of Credit Guarantee Scheme (CGS) that has been a proven success for SMEs gaining access to finance in Japan, Chinese
Taipei and Germany. Taking into account a shared responsibility from three main stakeholders (the government, banks and borrowers) will increase firms’ opportunities in pursuing bank credits. According to the study in Chinese Taipei, a source for direct funding for SMEs can be enhanced through creating the SME Development Fund aiming at assisting SMEs with a guarantee of up to 100% for their loan approved by banks (RAM Consultancy Services Sdn Bhd, 2005).

Nam (2006) states that the government’s credit guarantee scheme makes bank credits more available to other small and new business ventures. However, he further points out that the negative effect from this scheme should also be taken into account. The scheme is known to be very expensive with high administrative costs. Limited experiences and lack of credit risk management knowledge are critical factors hampering the effectiveness of this scheme, especially compared to banks already operating in the banking market environment (Nam, 2006).

Nam (2006) adds that there is a concern about equitable benefits to all groups by the use of credit guarantee funds since some groups may gain more favorable terms than others. Therefore, it is important to be aware of advantages and disadvantages of this scheme in order to effectively implement this mechanism and sustain long term finance for SMEs. The key success of CGS is determined by creating a favorable business environment with an open, competitive banking market, initiating necessary legal frameworks and creating a well-developed central credit database (Nam, 2006).

Secondly, SME’s access constraints can be eased by enhancing financial institutional capability by improving credit skills for bank officers, encouraging banks to set up SME units, and providing tax incentives to banks who engage in SME lending (RAM Consultancy Services Sdn Bhd, 2005). Creating capacity building in terms of “streamlining credit processing, standardizing product offering and segmenting the SME market” gives banks greater success in serving their SME clients (International Finance Corporation, 2010, p. 86).
To tackle SME capacity constraints, it is crucial to encourage the participation of development agencies and SME associations (International Finance Corporation, 2010). Training by means of providing business development services, forming proper financial statements, and preparing loan applications is one of the most powerful tools to enhance business knowledge and management.

Thirdly, setting up a central credit information bureau may be a useful approach that can help banks gain more up to date and transparent information to improve credit review (RAM Consultancy Services Sdn Bhd, 2005). Credit information bureaus can help bridge the information gap for banks when verifying loan applications (Nam, 2006). The government is required to develop and improve the central database with more electronic accessibility, and reliable information available in real time (RAM Consultancy Services Sdn Bhd, 2005). Thus it can be useful for all commercial banks to use a comprehensive credit reporting system for effective credit risk management (International Finance Corporation, 2010).

In summary, the correction of market failure should be a responsibility of the government, especially in the financial sector, in order to better serve SMEs and help them turn from domestic-based production to an industrialized orientation (Kyaw, 2008). The future prospects of SMEs are determined by the extent of access to long term sustainable finance from banks. Thus, improving policy development can help maintain the economic momentum and continue to diversify growth for both banking and private sector development.

2.8 Problems in relationships among the three parties

After investigating a range of different literatures, this study presents the main problems and issues from the point of view of government, of banks and of SMEs. Firstly, the drawbacks related to the government involve weaknesses within the supervisory structure as well as within the capabilities of the financial sector. Factors influencing the
government’s effectiveness include the situation of the country being a small market with a narrow based economy. Additionally, a number of laws and regulations are not formally functioning due to the level of inconsistency in the implementation of laws and regulations, and a lack of clear accountability in management. The financial sector in Lao PDR is still a very small structure and is still evolving in the development of its banking market.

Secondly, the problems hampering banks in their lending to SMEs link to the country’s slow development in the financial sector due to its lack of experience and ineffective financial management. Financial sector policy distortion is a critical indicator that discourages extending loans to the small business segment. Inadequate and unreliable business information is another factor, given the poor credit information affecting the ability of banks to identify sound information about small borrowers and their repayment abilities. A lack of good credit records creates barriers in terms of cost and time for loan management and risk assessment process. In addition, sluggishness in banking reform and the domination of state owned commercials banks undermine the confidence of foreign banks in terms of receiving equal treatment in the market. Legal and regulatory constraints implied by weak enforcement on the use of movable collateral are critical factors disadvantaging SMEs in acquiring bank loans. As a result, banks remain risk adverse to the SME sector.

Thirdly, the problems of accessing external finance for SMEs are associated with a lack of business capacity development and limited competencies by entrepreneurs. Numbers of businesses still engage in low productivity and informal activities. In addition, even though SMEs are recognized as the growth engine for socio-economic development, their limited access to finance remains a challenge compared to larger firms. Although SMEs are granted credits by banks, their lending is usually in short supply, high interest rates and high collateral coverage. The lack of ability to fulfill the bank requirements cause them to rely heavily on the non-bank sources. Thus, in order to maintain growth for business, their sources of finance usually are derived from
personal assets and borrowings from private lenders which charge even higher rates than banks. The limited access to finance from banks therefore affects SME’s ability to meet their growth stage requirements.

Therefore the effect of financial institutional impediments and policy distortions poses a great threat to local SMEs in their attempts to yield benefits from accessing bank finance. The attitude of banks in their favoritism towards larger businesses tends to enlarge the gap of supply and demand on the part of banks. The disparity in accessing finance by all borrower types creates an unfavorable business environment which to a degree adds to an ineffective economic development. Hence, it is essential to bridge the gap among the three parties in order to adopt and identify a potentially useful process by which sustainable access to bank finance is made easier in order to balance SMEs’ growth demands.

This research therefore aims to identify real practices and barriers that hamper the access of SMEs to finance in the Lao business context. The study of government, banks and SMEs helps to gather necessary data that can best be utilized in minimizing the gap directly impeding SMEs’ access abilities and changing the unfavorable attitudes of banks towards SMEs.

2.9 Summary of the chapter

In order to get a clear understanding of the research subject, the literature review is an important element in the task of gathering necessary data around this topic. The information that emerged from this review provides a grounded knowledge for a comparison of demand and supply constraints. Having reviewed a wide range of literature, this study reveals that, overall, by adopting the new economic mechanism; the nation’s economy is bound to be more market-based. However, the financial sector is still at an early stage of development, implied by sluggishness in banking reform and the fact that the banking sector is still dominated by SOCBs. Thus, there is still a long
way to go before the government’s efforts on economic development reach the standards of other countries in the region. From the scholarly evidence, a number of external factors impeding the growth of SMEs have been identified. This can be determined by the inherent risk of SMEs themselves that disadvantage them from gaining bank finance. Banks are still in favor of large firms due to their better financial strength and the fact that they are easier to manage.

Hence, a variety of different perspectives from the government, banks and SMEs have been taken as critical factors for a starting point in discussing and identifying those banking and SME constraints. Thus, a range of literature about remedies for SME access barriers is a foundation for the researcher in determining and modifying a practical process to be suitably utilized in extending and balancing high credit demands for the SME segment. Building on the various studies noted as part of the literature review, the researcher attempts to provide a best process or framework to facilitate the ability of banks to cope with the demand created by a rapidly expanding SME sector.
Chapter 3

Research Methodology

3.1 Chapter outline

The information gathered from a number of empirical studies in the previous chapter review has been used to identify some preliminary evidence about banking and SME problems and the factors hampering SME access to finance. In addition, research into the real business context and banking practices in Lao PDR enables this study to provide valuable data that can assist the researcher to meet the research aim of developing a useful practical process that could help increase access to finance by the SME sector. Thus, selection of an appropriate research methodology is perceived as a crucial means of gathering necessary and relevant data to answer the research question.

This chapter has been written to present the methodology adopted in this research. Given that the research aims to gain insightful ideas and perspectives, a qualitative research approach is employed. Therefore, this chapter starts by introducing the research paradigm and the rationale for why a qualitative investigation is appropriate to this research. The next part continues by outlining the criteria used in selecting research participants. The section after that follows with information about the data collection and analysis methods used. The last part concludes with key concerns from this method.

3.2 Research approach

Before discussing the details of the approach used in this research, it is worthwhile to understand the actual meaning of the term research. According to Polonsky and Waller (2011, p. 13), “research is the process of thoroughly examining and analyzing the situational factors surrounding a given problem in order to seek out a solution or
alternative solutions to it”. Further suggestions from Collis and Hussey (2009) show that there is a tendency for the research method used by the researcher to be determined by the best match of the research problem, the researcher’s skills and experience, and the audience of the research.

Ideally, the research on business issues should reflect human perspectives (Coviello, 2005), for people who are part of a society can provide the best knowledge about the dynamic environment that they belong to over a period of time. In addition, the qualitative method essentially provides an understanding of the social phenomena through the form of data collection method used (Malina, Nørreklit, & Selto, 2011). These authors further point out that qualitative studies can be exploited to modify or develop existing theory based on field data used for building new theory. Qualitative data may cause a problem in retaining the integrity of the information gathered, but it does preserve the validity of the results to a high degree (Collis & Hussey, 2009).

Normally, qualitative research is associated with addressing research questions related to how and why; a kind of rich description and strategic comparison across cases is collected through qualitative research (Malina et al., 2011). Qualitative research methods normally allow for study based on a small number of respondents. These people can contribute to research through information about their thoughts and perception. However, qualitative research also has its own negative aspects, as a small number of involved participants may not present the broadest view held by the majority of people (Polonsky & Waller, 2011).

Likewise, to gain a better understanding of the context of the banking system and SME development in Laos, qualitative research using interpretative paradigms is the most appropriate methodology. There are many methodologies related to the interpretative paradigm, but the most suitable approach for this research is the case study method, since this involves an in-depth understanding of a single setting using multiple sources of evidence (Collis & Hussey, 2009). As agreed by Noor (2008), case study methods
help to deeply comprehend real life situations with an emphasis on acquiring subjective perceptions of social phenomena. To generate the in-depth information necessary for building the research outcome, the technique used by case study allows evaluation and highlights the real setting of data collected. Thus, in this investigation, the qualitative research by case study is adopted, supported by the following reasons:

- Instead of just exploring what is happening in a certain issue, case studies help to also gain knowledge and focus on a specific domain (Collis & Hussey, 2009)
- The required richness of information can only be obtained through qualitative research, allowing researchers to gain in-depth information to assess and analyze data with more adequate support for their answers (Weischedel, Matear, & Deans, 2005)
- Qualitative data is diverse, and may include perspectives, opinions, emotions and behaviors (Collis & Hussey, 2009). The research used by qualitative methods effectively allows observation of the individual's feelings, motivations, and attitudes. All of those are part of the research (Polonsky & Waller, 2011).

These given reasons are aligned with the purpose of the research in aiming to get insightful understanding into the real causes of SME’s financial constants in an emerging market like Lao PDR. In-depth interviews give real time information about the current situation of both the banking and business sectors in the country, from various perspectives of involved respondents. Additionally, the subject area of this study is narrative in nature, calling for researcher interpretation rather than trying to objectively test hypotheses or quantify a set of objective results (Noor, 2008). Moreover, Noor emphasizes that, while the generalization of data using the case study method is not strongly supported by scientific rigor, the strengths are meaningful in terms of understanding a contemporary phenomenon within its real life context.

In this research, the researcher wanted to study the lessons learned from other transition economies in order to determine a more appropriate method that met the
research’s aim. Since there is little research related to the development of the banking sector in Lao PDR, especially in terms of its impact on SME capital constraints, this research then seeks to explore further insightful ideas that helped gain a more holistic view of the banking industry and its operations.

An exploratory research programme based on data collection by interview was therefore proposed. In addition, the exploitation of a comprehensive literature review helped the researcher acquire more relevant background information associated with the topic area and in constructing a framework to better assist in obtaining and analyzing data. Despite acknowledging the time consuming and cost concerns of data collection using in-depth interviews, the kind of descriptive data required can best be obtained through this methodology (Weischedel et al., 2005). Therefore, the qualitative methodology is argued to be most appropriate, and is justified by the reasons given above.

3.3 Population and sample of the research

To explore the context of the banking and business sectors in Lao PDR, different types of business entities and banks were selected in order to gain views from different contexts. Vientiane is the main economic centre, and the capital city of Lao PDR, where all of the banks’ headquarters are located and most of its businesses are operated. Thus, the researcher has chosen respondents from Vientiane to participate in this research. To better obtain information from different angles, this research has been comprised of a three part process.

The first part of the process started with a series of interviews with government and other related stakeholders as a third party perspective for banking and SME sectors. The first one was the SME Promotion and Development Office (SMEPDO). This organization was established according to the aim of government to take a leadership role in promoting the sustainable development of SMEs in Laos, working under the Ministry of Industry and Commerce. Their duty is to set up and develop SME
development programmes and policies that can help create an enabling business environment and sustainable development of SMEs.

In addition, the Lao National Chamber of Commerce and Industry (LNCCI) was the second organization chosen for interview, as it is an independent private sector body which represents the business community in Lao PDR. Apart from providing assistance for its business members in dealing with problems, and making sure all concerns of its members are reported to the government, it also helps communication between state and private enterprises and represents employers, groups and joint ventures across all agencies. It acts as an intermediary between the business community and the government to help develop business policy and legislation, which ultimately helps improve the business environment in Lao PDR.

Moreover, since Lao PDR is heavily reliant on development assistance by many donors and development agencies, to gain a view from this dimension is crucial to the value of data for this research. Development agencies technically work closely with the government, and have a significant role to provide assistance by means of funding and technical advisory services to the government in achieving development priorities and development objectives. Hence, one respondent from the development sector was selected as the third respondent to take part in the interview system. The author believed that three selected respondents from each agency would provide sufficient information which would lead to an achievement in answering research questions. Therefore, views gained from those third party perspectives are crucially beneficial to the validity of the research.

The second part continued with interviews with five banks (two state-owned commercial banks, a locally owned bank and two foreign banks) and involved face to face interviews in order to gain situational perspectives from the bank’s point of view. Therefore, to gain a variety of answers, the researcher has selected two state-owned commercial banks with the aim of gaining information regarding any support from government to SMEs via
the state owned banks. The local private Lao-owned bank perspective was also
gathered since this entity may well understand both business environment and cultures.
The two additional foreign banks were also added to identify those banks' treatment of
SME businesses.

In Lao cultural practice, it's difficult to get an organization involved without networking.
Thus, the researcher has used her own network of friends who may know the right
individuals and can help refer her to potential respondents for this research. Therefore,
a friend or friends can help make necessary recommendations. However, to avoid any
conflict of interest, the researcher has made sure that there is no direct involvement by
friends in this research. In addition, interviews were conducted with top management
levels in the banks, especially at the credit department where top managers know the
important issues around SME lending. This was done in order to make sure that quality
information was obtained and to prevent misrepresented information. As a result, the
comparisons between various types of banks helped the researcher in analyzing and
comparing data from different contexts in different situations.

The third part identified the actual practice, local business characteristics and current
state of financing of SMEs in Lao PDR. Four entrepreneurs were selected to participate
in personal interviews. Various types of businesses were selected for interview by using
client lists from the banks, and according to the convenience of the respondents. The
client list here is not considered confidential information so long as there is no sensitive
information (borrowing amount, interest rate, purpose of borrowing and etc) disclosed
by the bank. Therefore, this technique allowed the researcher to capture the SME
lending issues and to well understand the current credit practice imposed by banks. The
involved entrepreneurs included those from the rice mill and rice trading industries,
furniture trading and furniture manufacturing, an alcohol and drink factory, and the steel
industry and manufacturing. By doing this type of cross sector study, the researcher
could make more informed decisions when generalizing data and concluding results.
Table 2 shows the sample design for interviews in this research.
Table 2: Interview sample

<table>
<thead>
<tr>
<th>Segment</th>
<th>Name of institutions</th>
<th>No of interviewees</th>
<th>Time spent</th>
</tr>
</thead>
<tbody>
<tr>
<td>SME stakeholders</td>
<td>SMEPDO, LNCCI and development agency</td>
<td>3</td>
<td>Between 30 min and 90 min</td>
</tr>
<tr>
<td>Banks</td>
<td>2 SOCBs, 1 private owned Lao bank, 2 foreign banks</td>
<td>5</td>
<td>Between 30 min and 90 min</td>
</tr>
<tr>
<td>SMEs</td>
<td>Business owners</td>
<td>4</td>
<td>Between 30 min and 90 min</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>12</td>
<td></td>
</tr>
</tbody>
</table>

3.4 Data collection method

The research was designed to generate primary data by using a qualitative interview technique based on the three respondent dimensions of government and its stakeholders, banks, and SMEs. Building on a case study approach, the research adopts a series of exploratory and in-depth interviews based on a semi-structured panel of open-ended questions (Noor, 2008).

In depth interviews allow for direct interaction with respondents on a one-to-one basis which can be conducted in various ways, ranging from highly structured to unstructured interviews (Polonsky & Waller, 2011). Polonsky and Waller (2011) further state that an issue can be probed by raising questions during discussion through this in-depth interview method. Unfortunately, the drawback of the in-depth interview comes about when comparing responses as different terms or themes can be used to explain the same things by participants (Polonsky & Waller, 2011).

Face to face interviews allow one to engage in both verbal and non-verbal communication (Wilson, 2010) whereby the researcher can observe the responses through the answers and actions on a particular subject. To make sure an appropriate documentation of interviews was implemented, a note-taking technique was used to allow the researcher to retain the important ideas and key results.
Data was gathered through a three part process. Interviews were conducted between August and October 2011. Questions were prepared in English then translated into Lao, as the use of the native language helped to reduce any misunderstandings that might have arisen during interviews. To do this, a peer review method was employed, in which the set of translated questions were rotated among other Lao speakers in order to ensure accurate translation into the right meaning and the right context.

Before conducting interviews with banks, letters and information sheets were first sent to the potential banks to seek their approval. After receiving the organization’s admission, interview arrangements were made with the potential respondents, (mainly those from credit departments) in order to arrange to meet at mutually available times. These respondents are considered appropriate to this study as they have sufficient experience in the lending context and deal directly with all business types. An arrangement for interviewing business owners and other stakeholders was also made by using telephone calls and emails to ensure their availability.

Written consents by participating interviewees were obtained before each interview was conducted. The interviews were usually conducted at the office of participants, which were considered neutral locations, though two interviews were done in a coffee shop; but this was still perceived as a neutral place for discussion. The time taken for each discussion was between 30 minutes to two hours.

Two set of questions were prepared; one set was used for the participating banks and SMEPDO, LNCCI and for the respondents from the development sector. The second set was used for asking owner managers, because the questions employed in the first set may not have been suitable to their business context. The actual questions that were asked are shown in Chapter 4 –Findings.
3.5 Data analysis

In this thesis, data was interpreted using the written notes from the interviews. Initially the researcher aimed to use a voice recorder for data collection. However, after asking a few respondents whether it was possible to record their voices during our discussion, permission was not given and they said that they did not feel comfortable using it. Friends from the network, who are in the financial sector, said that normally in the Lao context, freedom of speech to talk openly in the public is not yet common. In addition, talking about financial issues is still considered a sensitive topic by the general population. Thus, the researcher believes that avoiding using a voice record enabled a more open discussion with respondents and a better airing of their views. If the voice recorder was used, the respondents may have been overly sensitive about what they were saying rather than focusing on divulging their perspectives and feelings on the studied subject. As a result only note-taking was used to better gain insightful data.

Analysis of qualitative data can be undertaken by a number of different approaches, and different methods are employed to suit the specific needs of the research question. Given that the majority of data is in the form of opinions obtained through in-depth interview, along with documentation from various secondary sources, reducing and restructuring data was used to help maintain a focus on the research topic and avoid distraction from irrelevant data (Collis & Hussey, 2009). In order to analyze the raw data generated from data collection, the researcher used a coding technique which allows for categorizing data (Wilson 2010). After that, collected data was broken down into a number of themes in order to help make comparisons between the responses from each participant, and within and between these categories (Wilson 2010).

Firstly, the researcher structured the report based on reviews of earlier research papers, identifying appropriate key words to help shape the area of focus. Unnecessary information was then discarded to avoid any misleading direction, thus allowing the researcher to stay within the scope of research. Different respondents could be
approached differently by the use of semi-structured interviews while at the same time maintaining a focus in the same area (Noor, 2008).

In addition, any common patterns could be identified by comparing the similarities and differences for the research outcomes with those achieved by earlier researchers (Collis & Hussey, 2009). Thus, outcomes from interviews could be partially generalized, based on any common events or replicated results that both banking and SMEs sectors are facing in other similar environments. By doing this, the researcher could develop a useful process in meeting the needs of both banks and SMEs and in enabling an improvement in the quality of relationship from the perspective of both parties.

3.6 Summary of the chapter

In conclusion, there are a number of research methods that can be used, but the qualitative approach using in-depth interviews to inform a specific case study is perfectly matched to this type of research according to the reasons outlined above. Three main dimensions were followed in the interviews in order to gain a wide variety of perspectives and results. Data gained from a total 12 of respondents, represented by the government, bank and business sectors, was collected.
Chapter 4

Findings

4.1 Chapter outline

This chapter presents outcomes from the qualitative data obtained through in-depth conversation using face to face interviews with 12 selected participants. The interesting information and insightful ideas presented here were gathered by applying a semi-structured interview guide focusing on the real practices of banking and business operations regarding access to finance for business investment in Lao PDR.

Two main sections are presented, in which the first section combined views from both bank and government respondents in order to find key results from these two sides towards relationships of banks with their SME counterparts. The issues facing banks in terms of SME lending were also identified. The second section identified the opinions of business owners on business behaviors, their capital requirements in business expansion, and other difficulties facing them when applying for bank credits. A summary of key points from the interview results is also included to enable further exploration and explanation in the discussion chapter.

4.2 Insightful ideas interviewed from bank and government sides

This research used structured open-ended questions in order to help define the scope of interview and areas of interests of this project. These questions are shown as sub-headings of the sections that follow.
4.2.1 What do you think about the business environment in Lao PDR?

Two respondents said that the government’s open-door policy allows more local and foreign investment and the country’s economy is driven by growth in the resource sector. The influx of regional and international banks leads to increased competition in the banking market, and this results in the rapid growth of deposits and credits volume. Four respondents proposed that the increase in foreign bank entry encourages local banks to improve their banking products and services. However, two respondents contended that despite rapid growth in the banking market, the challenges of this phenomenon are of great concern.

One respondent further stated that these challenges are impacted by the dominance of state owned banks, which leaves many players to fight for a small number of shared customers. At the same time the availability of banking products and services is relatively basic due to the population’s lack of financial literacy. Common responses about the lack of banking knowledge by the general population, and lack of law and regulation enforcement, showed that these are the main issues affecting the effectiveness of banking development - as proposed by three respondents.

One respondent pointed out that, from the government’s side, mining and hydropower are seen as two main drivers for the growth of Lao economy, which also encourages the large extent of foreign investments. Additionally, three respondents revealed that the banking sector is growing as a result of the rapid influx of foreign bank participation. Two respondents said that the increase in numbers of banks contributed to the rapid growth of domestic credits and competition, which helps improve banking products and services. An interesting point raised by one respondent was that a credit boom may impact the potential growth of non-performing loans (NPLs) if adequate risk management is not yet in place.
The findings show that bank and government sectors have similar views about the resource sector. They show that this is the main contributor to growth in the Lao economy and brings about the inflow of foreign investments. In addition, the two sides agree that the banking market has been growing rapidly, which affects the rise in credits and increasing competition. However, the bank respondents mentioned there are challenges such as the domination of SOCBs in the banking market, poor financial literacy on the part of the general population, and weaknesses in law and regulation. On the other hand, respondents from the government sector raised awareness about the potential growth of NPLs from fast growing domestic credits. These results are discussed further in the next section.

4.2.2 What are strengths and weaknesses of SMEs in Laos?

From the perspective of the banks, three out of five respondents agreed that SMEs are the main driver for economic growth. However, one of them argued that SMEs are still at an early stage of development, constrained by limited local knowledge and low quality technology. One respondent indicated that Lao export businesses are inferior to those in neighboring countries, and local businesses are also affected by competition generated from greater economic integration in the regional market. This person added that the value of local products can deteriorate as a result of the inflow of imported products, and persistent exploitation of hydropower and mining. This is likely to pose risks in the long run. In addition, four respondents mentioned that limited access to finance becomes a crucial constraint for SME development. Two respondents also pointed out that SMEs are viewed as small scale, with high uncertainty, and a lack of know-how and financial skills disadvantages them from access to bank loans.

Three respondents from the government sector stated that SMEs are a vital actor in driving national economic growth. One of them added that SME’s contribution to Lao employment accounted for 83% of the total workforce. Expansion of the SME sector is reflected in government policy and promotion enhancing the business environment.
Nevertheless, two respondents revealed that the Lao export market is not yet active enough to compete with overseas markets. One of these respondents further indicated that the intensive expansion of the natural resource sector tends to pose a serious problem on long term sustainable development. This respondent added that the domestic market is growing because of growth in the resource sector, while there is slow development in exports of non-resource sectors. The crucial point raised by another two respondents was that limited access to finance is a common issue for SME development. These two respondents added that SMEs are very small scale, dominated by family owned business types, and perceived as having limited management knowledge.

Considering the answers from the two sides, it is noted that the two sectors have similar views towards the vital role of SMEs as a driving force for employment and economic growth. However, the two sides have raised two important issues. One is that the resource sector is not sustainable, and may pose a significantly negative impact on economic growth in the future, while the export market is still lacking competitive advantage. Another issue is that SMEs are perceived as lacking management knowledge, given their small scale nature and family-owned structure. However, the bank respondents disclosed a different view, saying that lack of financial knowledge is the main reason why banks are not interested in lending to SMEs. In addition, greater economic integration tends to create some negative impacts on local businesses in the current market. Further explanations of these responses are explored in this study’s discussion section.

4.2.3 What changes have been happening in the banking industry in response to the growth of SMEs?

From the bank’s perspective, two respondents stated that the importance of SMEs is shown by the fact that state owned banks still continue to serve these small firms through the government’s support sector, but three respondents indicated that banks
are risk averse and give less favor to SMEs. An additional view from the other two respondents showed that foreign banks always focus on big corporate businesses where small firms remain a minority in the total bank portfolio. A vital idea mentioned by one respondent was that SME is the main strategic sector for that person’s bank. As a local private owned entity, the bank sees itself as an SME bank which, by creating a SME unit helps it to maintain long term relationships and increase customer loyalty.

The government side pointed out that limited access to bank credits impedes the speed of growth of SMEs and their business development. One of the respondents emphasized that banks are profit oriented, and are all aggressively fighting for the same big businesses. Further responses proposed by three respondents were that the ability of firms in accessing bank finance depends on the size of the enterprises and usually small firms tend to face greater access constraints compared to big enterprises.

Based on the findings above, bank and government respondents found that larger enterprises are more favored by banks than smaller firms. These respondents added that all banks fight for the same big companies as they are more profitable businesses. However, an interesting point raised by the bank respondents was that local private and state-owned banks appear to be more interested in SME lending, where in foreign banks SMEs have only minimal share of total bank portfolio.

4.2.4 What are risks involved in financing SMEs? What are issues encountered by bank when funding/lending to SMEs?

From the bank point of view, four out of five respondents demonstrated that the majority of enterprises in Laos are small type businesses, often family based with a simple management structure in which owners are found to have limited knowledge in managing business. Three respondents indicated that a lack of ability in preparing business plans, lack of know-how, and lack of accounting skills are main bottlenecks undermining SME performances. Two respondents further indicated that as far as poor
financial knowledge is concerned, banks have to work even harder in order to evaluate the business’s trustworthiness. Another issue encountered was that the available business information is still incomplete and sometimes ambiguous.

From the government opinion, two respondents said that the lack of management skill is the most discussed problem and is often cited as an obstacle for credit access. Most of the SMEs source funds from their own savings, as well as from profits generated, friends, and other informal lenders. However, one respondent pointed out a crucial thought as many small firms are allowed to apply for a lump sum tax payment. This means that entrepreneurs can negotiate tax paid with government tax officials, based on the estimation of business profits. This has discouraged business to use formal accounting standards, because they do not have to keep accurate records for tax purposes.

The two sides have presented a common answer in that SMEs have the basic structure as a family type business and their management skills are known to be limited. However, the two sides have raised different interesting points. The bank side pointed out that most SMEs are associated with poorly presented business plans, lack of know-how, and inadequate financial records which become the main access constraints. However, the response from the government emphasized that the practice of using lump sum tax payments encouraged entrepreneurs to avoid applying a proper accounting procedure to their businesses.

**4.2.5 What criteria do banks adopt in deciding how to grant loan to SMEs?**

All of the bank respondents agreed that collateral is derived as the basic criteria of loan evaluation. Three of these respondents further added that quality of fixed collateral such as land and building is the most required by banks. However, two respondents said that, in general, banks usually focus on business performance, financial status, and quality collateral as a basis for loan evaluation. Two respondents emphasized that commitment
of business owners is of importance to a banks’ decision making. One respondent added that market recognition, good business reputation, demanding businesses and long operating history of firms are crucial elements for loan decisions. A different idea raised by one respondent was that, given that the deposit rate in the market is quite high, the interest charge on loan must be higher.

Because this was a lending policy question aimed particularly at bank respondents, government interviewees were not asked this question.

4.2.6 What is government policy on the relationships between banks and SMEs?

From the bank perspective, all respondents agreed that there is not much intervention in bank operations by the Bank of Lao PDR (BOL). Three respondents added that to support the SME sector, the Lao Development Bank (LDB) is assigned as an SME bank. However, two respondents commented that unclear accountability by the LDB is still a great concern. Furthermore, one respondent raised the significant point that commercial banks still need to comply with BOL’s reporting requirements and operational rules; for instance, loan reclassification after three months of defaults and NPL rates. Another point raised was that the CIB is established, but the system is not yet functioning.

In the view of government, two respondents demonstrated that improved access to finance for SMEs is one of the crucial mandates of the government. The Credit Information Bureau (CIB) was established with an aim to provide business data for all commercial banks, but the function is not yet fully operational (as indicated by two respondents). The government is also working on enforcing the secured transaction law to allow removable assets to be used as a guarantee against bank loans. In addition, two respondents pointed out that, to facilitate the accessibility of SMEs, the government in 2008 established the LDB to be the SME bank, but the progress on that issue is not yet clear.
The interview results from the government point of view provided the information that access to finance is identified as a key government mandate in order to reduce capital constraints for the SME sector. However, the bank respondents demonstrated that, even though there is improvement in bank operation reflected by less intervention by the BOL, commercial banks are still required to comply with BOL’s rules and regulations. A common agreement between bank and government respondents was that, to overcome SME access difficulties, the government has assigned LDB to be a SME bank but currently there is still unclear guidance on the implementation of that role. The government side also mentioned that the two elements of the secured transaction law and the CIB system are two favorable drivers for increasing SME access. Nevertheless, the effectiveness of CIB is still pointed to as a major concern.

4.2.7 What are your opinions on foreign and local bank attitudes towards the SME sector?

There was a common consensus among all interviewed bank respondents in that SMEs appear to be the most cited interest by local banks. Three respondents proposed that the local government banks would be more SME friendly because SMEs are viewed as a government support sector. Conversely, as seen by two respondents, foreign banks usually serve businesses from their own countries, and big companies or foreign enterprises become their preference because they are perceived as creditworthy firms which are able to comply with existing rules and complex procedures. One different point mentioned by a respondent was that all types of banks focus on SME businesses, given that SMEs share the biggest part of the Lao economy.

From the government perspective, different types of banks have their own distinct focuses, such as the local banks tend to better serve the local small businesses while the foreign banks put emphasis on the bigger businesses. This is because, given the stringent lending criteria of larger banks, small firms are likely to be unable to meet
those sophisticated procedures. Another interesting point raised by one respondent was that most of foreign banks in Laos serve mostly their own existing clients who already have business in the local market.

The interview results showed that SMEs have a better opportunity to gain the supply of loans by local banks, and this is agreed by both the bank and government sides. In addition, the two sides have similar views that foreign banks often lend more to large enterprises and serve mostly their existing customers who operate outside their countries of origin. Nevertheless, the bank side put forth a different point in that the majority of banks, regardless of being local or foreign in this market, are supposed to distribute loans to SME borrowers, given that these businesses are still perceived as a favorable sector reflecting the country’s typical SME-base.

4.2.8 What are your suggested improvements for helping SMEs with their funding requirements?

From the bank side, four respondents believed that improving business capacity in the form of stronger management and financial knowledge is one of the most promising approaches to increasing the supply of loans by banks. Three respondents suggested that establishing an SME or entrepreneurial development centre may help strengthen the capacity of SMEs. In addition, four respondents noted that it is an obligation of the government to create appropriate policies on SME development in order to overcome their access obstacles. These policies may include waiving of certain ratios usually required by the banks, the provision of a tax exemption, and reduction of the long list of conditions and compliances required to access a loan. A supporting viewpoint from another respondent was that improving the performance of CIB would help banks to obtain more transparent business information. A government subsidy through a guarantee fund should be created.

From the government side, two respondents stated that increased business capacities are recognized as beneficial to SMEs in their credit needs. Enforcing collateral by
focusing on effective implementation of the secured transaction law should be mandatory as recommended by two respondents. Changing the practice of relying on lump sum tax payments into a more formal accounting regime may help increase banks’ lending. Another change can be made by promoting financial leasing which may be an alternative source of finance for SMEs. Continued strengthening of the LDB role as an SME bank is of prominent importance for better serving SMEs. In addition, one respondent commented that the creation of a risk sharing facility by government would be an option for extending bank loans to the SME segment.

The result of the interviews showed that the banks and the government have the same point of view in that enhancing the capacity of SMEs was perceived as the key to improving business abilities to meet bank requirements. The two sides said that, in order to increase access to bank finance, government subsidies through a credit guarantee fund or a risk sharing facility would be useful for SME’s accessibility.

There are some different focuses from bank and government sides. As proposed by the bank side, tax exemptions, reducing the long list of bank conditions, and improving CIB performance may help increase banks’ ability to finance. The government side pointed out that enforcement on collateral, strengthening the role of LDB, promoting accounting standards, and financial leasing may reduce SME access difficulties.

4.3 Interviews from business owners

In the second series of interviews, four respondents were chosen to represent a selection of SMEs in Vientiane municipality, which is the capital city of Laos. A slightly different set of questions was asked to these four respondents, and these questions are shown as sub-headings of the sections that follow. Brief profiles of each respondent are shown in Table 3.
## Table 3: Business profiles

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Business</th>
<th>Type of business</th>
<th>No. of employee</th>
<th>Capital</th>
<th>Turnover/year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Business A</td>
<td>Rice mill and rice trading</td>
<td>7</td>
<td>US$ 251,004</td>
<td>US$ 37,650</td>
</tr>
<tr>
<td>3.</td>
<td>Business C</td>
<td>Alcohol and Drink factory</td>
<td>110</td>
<td>US$ 197,038</td>
<td>US$ 3 million</td>
</tr>
</tbody>
</table>

E-rate: 1USD= 7968 LAK @ date 13/12/2011

### 4.3.1 How do most new businesses fund their capital requirements?

From business perspectives, all of the respondents revealed that personal assets and savings are the main sources of finance for their start-up capital. In addition, three respondents pointed out businesses were formed as family based businesses which were inherited from parents, except one respondent said that his business started as a partnership.

### 4.3.2 When business wants to expand, how does business mobilize funds?

All respondents stated that banks are the best sources of finance for businesses to grow, with better interest rates and more availability of larger loans compared to the informal sector. While businesses can gain access to bank loans, one respondent emphasized that lending procedures from banks have intensified in recent years.

### 4.3.3 What are average loan interest rates? Do banks charge lower interest rate compared to other suppliers?

60
Table 4: Summary of loan interest rates for interviewed businesses

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Annual interest rate</th>
<th>Currency</th>
<th>Loan term</th>
<th>Type of loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business A</td>
<td>15%</td>
<td>LAK</td>
<td>2 years</td>
<td>Fixed loan</td>
</tr>
<tr>
<td>Business B</td>
<td>12 to 10%</td>
<td>USD</td>
<td>5 years</td>
<td>Fixed loan</td>
</tr>
<tr>
<td>Business C</td>
<td>14%</td>
<td>LAK</td>
<td>1 year</td>
<td>Over Draft</td>
</tr>
<tr>
<td>Business D</td>
<td>12 to 10%</td>
<td>USD</td>
<td>1 year</td>
<td>Working Capital</td>
</tr>
</tbody>
</table>

Table 4 shows that different businesses are offered various lending products and interest rates, though all respondents agreed that banks are the main suppliers for firms’ credit. The informal lending sector is perceived as less desirable due to overcharges on interest rates - two respondents said that interest rates provided by private lenders may start at 3% per month and can go up to 7% per month. However, because the banks administrative requirements and lengthy lending processes are a concern, many small firms prefer to borrow from informal sectors. Another crucial point was that that loan supplied by banks usually is in a short term form, which creates difficulties for business operations. However, three respondents further proposed that maintaining business relationships, and constantly complying on credit contracts, helps reduce interest rates.

4.3.4 Does business use supplier credit or other means instead of using loan from banks?

Supplier credit is commonly used in the current business context with a view to maintaining business relationships, though most businesses agreed that business still heavily relies on bank lending for their business operation. Another two respondents revealed that no supplier credits are used by the firms, because they are not suitable for the type of business and may discredit business images.

4.3.5 What are the main issues of businesses when requesting a loan from the banks?
Three respondents proposed that a lack of proper financial statements is the most cited issue facing businesses. These three respondents further revealed that the practice of using lump sum tax payments allows businesses to avoid following formal business accounting standards. In addition, one respondent presented a different view by saying that the short term of credit supplied was a major business constraint.

4.3.6 What are main collaterals requested by banks?

All respondents strongly agreed that land and buildings are the most needed and important collaterals for bank loans. One respondent further indicated that land and building is evaluated at 75% of total asset value, but machinery and equipment is appraised as just 15% of total value. Other respondents added that properties in the urban areas are likely to be the most preferred security by banks.

4.3.7 What are the documents required by banks when businesses request a bank loan?

Business plans, financial statements and other legal documents, related business licenses and collateral, especially real estate titles, are the main documents required by lending banks. In addition, one respondent pointed out that, to avoid loan defaults, strict collateral requirement on loans is applied in this current business climate.
4.3.8 Is it difficult to set up your business? What government bodies do you have to deal with in setting up businesses?

Three respondents agreed that start-ups were easier in the past when compared to the present. Recently, a number of concerns have been raised, especially for manufacturers, such as environment, high standards requirement for machinery used in manufacturing, and legal issues. Document processing is time consuming, since there are many government bodies involved in the process of approving business licenses. Usually the time taken to get all the document work done is around one to three months. As far as the procedure of setting up business is concerned, one respondent pointed out that the use of a middle person/agent to run all documents is common in the Lao business context, and many businesses still continue to make use of this service.

4.3.9 Are there any changes by government recently that have significant impact on your business (eg: tax rates, accounting requirements, change of policies, etc)?

All business respondents stated that increasing support policies by the government can contribute to the growth of businesses. There is a concern by the local manufacturers around the promotion of foreign direct investment (FDI), as this may pose some negative impacts for local businesses. Given that a lack of available raw materials in the local market exists, businesses related to production have to rely heavily on imported raw materials from overseas. As a result, local producers tend to have a problem with price competition, and two respondents further indicated that increased tax rates are another issue facing businesses. The effect of this situation has caused damage to domestic products in the country.
4.3.10 Are there any similarities and differences of requirements between local and foreign banks? If yes what are they?

All respondents agreed that banks usually require similar documents for loan applications, such as collateral properties, tax payment records, financial statements, a business plan and other related business documents. Three respondents further pointed out that there are differences in the practice of local and foreign banks. The foreign banks are seen to have long and complicated lending procedures, given their stringently high credit criteria, while the local banks have a simpler process which is considered faster for lending approval. Two respondents further indicated that interest rate charges on lending loans by the foreign banks tend to be higher than the local ones.

4.3.11. What supports are needed to help better business operation?

All respondents pointed out that increasing government’s efforts on business development can better support the credit accessibility of firms. One respondent further emphasized that the government subsidies on interest rates may help businesses achieve more effective bank lending. In addition, two respondents believed that creating a simpler lending process may increase the ability of businesses to gain more bank financing.

In summary, Table 5 shows the main points raised by all three groups of participating respondents.
**Table 5: Summary of key findings**

<table>
<thead>
<tr>
<th>Banks/government views</th>
<th>SMEs' views</th>
<th>Consensus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>What do you think about the business (banking in Laos)</strong></td>
<td><strong>How do most new businesses fund their capital requirements?</strong></td>
<td><strong>• Growth in resource sector boosts economic growth such as banking and FDI</strong></td>
</tr>
<tr>
<td>• Economic growth is driven by the rapid expansion of resource extractions, resulting in the rapid inflow of foreign investments including banks.</td>
<td>• Personal assets and savings &lt;br&gt;• Family financing of business</td>
<td><strong>• Weak legal and regulatory framework, lack of financial literacy by locals, domination of SOCBs in banking market.</strong></td>
</tr>
<tr>
<td>• Weak in legal and regulatory framework, financial literacy by locals, domination of SOCBs in banking market.</td>
<td><strong>• High credit boom. With consequent increasing in the NPL rate.</strong></td>
<td><strong>• High credit growth leads to the rise of NPL</strong></td>
</tr>
<tr>
<td>• High credit boom. With consequent increasing in the NPL rate.</td>
<td><strong>• Growth in resource sector boosts economic growth such as banking and FDI</strong></td>
<td><strong>• Businesses rely heavily on personal savings and properties</strong></td>
</tr>
<tr>
<td><strong>What are strengths and weaknesses of SMEs in Laos?</strong></td>
<td><strong>When business wants to expand, how does business mobilize funds?</strong></td>
<td></td>
</tr>
<tr>
<td>• SMEs are sources of economic growth and national employment</td>
<td>• Banks are the best source of finance &lt;br&gt;• Informal sector charges higher interest rates but still a major source for small firms &lt;br&gt;• Difficult lending procedure by banks</td>
<td><strong>• Banks are the preferred source of financing</strong></td>
</tr>
<tr>
<td>• Growth in SMEs is derived from the boom in natural resources extraction which is unsustainable development. Export market is still uncompetitive</td>
<td></td>
<td><strong>• SMEs are a source of economic growth</strong></td>
</tr>
<tr>
<td>• SMEs are small scale in nature with family owned structure and lack of financial knowledge</td>
<td><strong>What are average loan interest rates? Do banks charge lower interest rate compared to other suppliers?</strong></td>
<td><strong>• Impact from greater economic integration and natural resources extraction is unsustainable development.</strong></td>
</tr>
<tr>
<td>• Impact from greater economic integration</td>
<td>• Maintaining good relationship with bank helps reduce loan rates &lt;br&gt;• Informal sector charges 3-7% per month, but faster &amp; less documentations, while there are complicated administrative and lending process by banks</td>
<td><strong>• Export market is still uncompetitive</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>• SMEs are small scale with lacking of financial knowledge, family business structure</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>• Informal sector has higher interest rates but simple and faster</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>• Many small firms rely on informal sector who charge higher interest rates</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>• Bank lending procedure is complicated</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>• Building relationship with lender bank is able to access better loan rates</strong></td>
</tr>
</tbody>
</table>
| What changes have been happening in the banking industry in response to the growth of SMEs? | Does business use supplier credit or other means instead of using loan from banks? | • Large enterprises are perceived as more profitable lending by banks  
• Most foreign banks are aggressive to fight for the same big enterprises.  
• SMEs are a small minority of total bank portfolios  
• Local private and state-owned banks are more SME friendly. | • Business still rely on bank loans  
• Suppliers credits is seldom used by businesses | • Large enterprises are the most favored by all types of banks  
• The supply of loans to SMEs is mainly from local and state-owned banks  
• There is still a lack of supplier credits available to businesses  
• SMEs are a small minority of total bank portfolios |
|---|---|---|---|---|
| What are risks involved in financing SME? What are issues encountered by banks when funding/lending to SMEs? | What are the main issues of businesses when requesting loan from the banks? | • The root cause of SME problems is associated with inability of preparing business plan, a lack of know-how, and inadequate financial records  
• Persistent SME practice of using lump-sum tax payments | • No formal financial statement  
• Using lump sum tax system  
• Loans in short supply | • SME businesses are viewed as having a lack of know-how, an inability to prepare business plans, and a lack of accounting records  
• Loan to SME businesses is mainly in the short term  
• Persistent SME practice of using lump-sum tax payments |
| What criteria do banks adopt in deciding how to grant loan to SMEs? | What are main collaterals requested by banks? | • Collateral is the main criteria of loan evaluation especially land and building  
• High interest charge on loans  
• Business performance and financial status, market recognition | • Land and building are most required by banks | • Banks usually charge high interest rate on loans  
• Collateral is the main criteria of loan evaluation especially land and building  
• Business performance and financial status, market recognition |
| What are government policies on the relationships between banks and SME? | Is it difficult to set up your business? What government bodies do you have to deal in setting businesses? | • Access to finance is the key mandate of government  
• Less intervention by the BOL but compliance on reporting and procedure | • There is much administrative work required by involved government | • Great deal of administrative and process work from involved government bodies  
• Businesses often rely on a middle person to run document work  
• The promotion of secured transaction law and CIB |
<table>
<thead>
<tr>
<th>What are your opinions on foreign and local bank attitudes towards the SME sector?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• SMEs gain better supply of bank lending from local banks</td>
</tr>
<tr>
<td>• Foreign banks serve mostly large enterprises and foreign customers</td>
</tr>
<tr>
<td>• Both domestic and international banks are supposed to distribute loan supply to all types of borrowers, reflecting the country's typical SME-base</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Are there any similarities and differences of requirements between local and foreign banks? If yes what are they?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Similar in terms of documents required</td>
</tr>
<tr>
<td>• Different in that foreign banks require a long lending process with complicated procedures and higher interest rates</td>
</tr>
<tr>
<td>• Local banks are faster and easier</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What supports are needed to help better business operation?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Government subsidizes interest rate on loans</td>
</tr>
<tr>
<td>• Simplify lending process for businesses</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What are your suggested improvements for helping SME with their funding requirements?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Improve management capacity of SMEs</td>
</tr>
<tr>
<td>• Government subsidies via credit guarantee funds</td>
</tr>
<tr>
<td>• Tax exemptions and subsidies</td>
</tr>
<tr>
<td>• Enforcing existing collateral law on moveable assets</td>
</tr>
<tr>
<td>• Improve information sources through CIB</td>
</tr>
<tr>
<td>• Promote financial leasing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What are the impacts of recent changes by the government?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Less intervention by the BOL but compliance on reporting and procedure still required</td>
</tr>
<tr>
<td>• LDB is formed to help SME</td>
</tr>
<tr>
<td>• Challenges from taxation rates, and high competition from local businesses</td>
</tr>
<tr>
<td>• Negative impact from integration into regional markets for local manufacturers</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What are your opinions on foreign and local bank attitudes towards the SME sector?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Foreign banks serve large enterprises and foreign customers, have long lending processes, charge higher interest rates</td>
</tr>
<tr>
<td>• Local banks are faster and easier</td>
</tr>
<tr>
<td>• Given country’s typical SME base, most banks should distribute loans to all type of borrowers; but, in practice this does not happen</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What are your suggested improvements for helping SME with their funding requirements?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Improve SME management capacity</td>
</tr>
<tr>
<td>• Government subsidies via credit guarantee funds</td>
</tr>
<tr>
<td>• Provide simple lending process by banks</td>
</tr>
<tr>
<td>• Provide tax exemptions for banks</td>
</tr>
<tr>
<td>• Improve the implementation of collateral law</td>
</tr>
<tr>
<td>• Improve access to business information via CIB</td>
</tr>
<tr>
<td>• Promote financial leasing</td>
</tr>
</tbody>
</table>
4.4 Summary of the chapter

The broad objective for this research is to investigate, and gain insights and descriptive results, from participating respondents. This chapter began by comparing perspectives from the government and bank sides, and many valuable insights were discovered about similarities as well as differences in attitudes to the questions posed. The perspectives from the business side were also presented, and compared with the other two stakeholder groups. Common views on SME business and banking practices, along with key insights and different thoughts from the three stakeholder dimensions, were outlined in a summary table.

Overall, several common access barriers to effective SME development were recognized as important issues that affect the general growth of business in Lao PDR. In the next chapter, this study continues with a discussion of those barriers and an attempt to identify possible solutions.
Chapter 5

Discussion

5.1 Chapter outline

In this section the researcher seeks to analyze and discuss key research findings described in the previous section, especially key opinion differences between stakeholders. In order to gain a deeper understanding of general practices and factors hampering access to finance of SMEs, there is a need to pull together the views from three dimensions, and support from important empirical evidence from relevant literature, in order to provide sufficient information related to SME and banking development.

Thus, this chapter is organized into five main parts. The first part identifies common concerns about the general SME position in regard to their financial needs. The second part follows with different key viewpoints from all three sectors in relation to the business environment in Lao PDR, particularly that which impacts on banking and the SME sector. In light of the changing banking environment, attitudes of both local and foreign banks and their practices towards SME businesses are highlighted in the third part. Focusing on government involvement in banking and the SME sector, government efforts and support policies are discussed in the fourth part. The last part identifies key impediments and important practices affecting both SMEs and banks in their loan supply.

Key suggestions for improvements are also investigated, in order to help develop a useful and practical process for dealing with SME access barriers. At the end of the chapter, some suggestions are made to help the government create a more favorable environment for banks and SMEs in order to help them achieve their aims.
5.2 Financial supply for SME expansion

Most respondents recognized that SMEs account for the majority of total enterprise in the economy and take the role of a critical engine to boost the success of economic development. Respondents believed that the important growth of economy and the growth rate of national employment have both been driven by improvement in the SME sector. This corresponds with the literature noting the critical role of SMEs in creating job opportunities and generating domestic household income, thus contributing to poverty reduction (Southiseng & Walsh, 2010).

It is believed that increased household incomes are generated by growth in the SME sector, and this mechanism in turn contributes to the generation of national income through tax collection and business fees (Southiseng & Walsh, 2010). Hence, if the government wishes to boost the performance of SMEs, it should facilitate and strengthen the competence and ability of local entrepreneurs.

The business respondents mentioned that banks are the most preferred sources of finance for all business types. They further indicated that banks can provide a larger amount of money with a lower interest charge on loans compared to the informal sector. However, they stated that during their start-up stage, they mostly used their own personal funds for business establishment. Access to bank credits was still cited as the greatest obstacle to SMEs gaining finance, and businesses still rely heavily on their personal wealth or borrow from immediate family and friends, especially during their initial stage of development (Burns, 2011; Kyaw, 2008). Burns further states that most small businesses source funds from their personal savings, and they try to avoid borrowing from external sources since creditors will not accept borrowers without a good record of business history. At the initial stage, business is very uncertain, unreliable and has a perceived lack of ability to repay (Southiseng et al., 2007).
However, Burns points out that, at some point in the business life cycle, most firms need to borrow money from external lenders. In order to continue growing every year, access to formal sources of credit still acts as a crucial driver in improving SME performance. Having sufficient resources, business can further explore market distribution and product development. As agreed by the business respondents in this study, firms chose to borrow from banks when they needed funds for their growth stage, given that using the retained earnings from business and supplier credits is not sufficient to fulfill the significant amount of money required for expansion purposes.

While there is a need for bank credits, bank and government respondents on the other hand argued that SMEs are known to be very small scale businesses, and often these are family-owned. However, their owners are usually perceived to be lacking in financial knowledge and professionalism. The rationale for this is that a typical SME in many transition economies is perceived as uncertain and characterized as “a domestic-market-oriented and independent family business producing low-entry-barrier, low-margin products” (Yang, 2006, p. 1). Key factors hampering SME growth include limited management skills, limited financial knowledge, and limited ability to access modern technology.

Yang also agrees that the high level of perceived risk in dealing with SMEs places them in a vulnerable and disadvantaged position, especially start-up businesses which are considered riskier than established ones. In practice, banks generally perceive small firms as riskier compared to the larger firms, and this is due to a view of the high rate of business failure and greater uncertainty in small businesses (Burns, 2011). Burns further explains that the failure of a business operation impacts on the banks because they are then faced with bad debt. As a result, banks become risk averse in terms of SME borrowers, and the resulting limited access to finance is the most significant growth-hampering factor for SMEs. If local SMEs do not have sufficient funds to improve product development, innovation, marketing, market distribution, product
channels, and novel technology, they face more challenges to survive in a highly competitive environment.

Therefore, for SMEs to play any meaningful role, building a business friendly environment by means of creating favorable conditions and encouraging fair treatment among banks towards their SME counterparts is of prime importance. In addition, boosting the capacity of SMEs may help banks to increase their practice of extending credits to SMEs. Improving the legal system is also critical, as banks have a very conservative mind-set on lending to SMEs. Thus, improving and strengthening legal and regulatory frameworks may help facilitate and settle any contract disputes that occur. Increasing the accessibility of SMEs to finance can be done through improving business networks (Kyophilavong, n.d.), and banks and SMEs can gain mutual benefits by developing their relationships; this also helps reduce the risk in terms of the lack of available business information.

Being able to increase SME performance would be a positive way of increasing and continuing the growth of entrepreneurship development in the country. Having said that, to improve the ability of businesses to meet their growth potential, government must find creative ways to provide a conducive environment in facilitating the growth of SMEs, especially in terms of reducing their financial limitations.

5.3 Business environment

Building a more business friendly environment should be one of the government’s main objectives, to help boost the country’s economy and to facilitate business investment from both domestic and foreign investors. As mentioned earlier, economic growth is currently derived from the high growth of hydropower and mining, which continue to grow as shown by the 200 proposed mining and hydro projects in Lao PDR (The World Bank, 2010a). Hence, local businesses from small scale to larger enterprises are also
growing as a result of the boom from this important sector - as recognized by the respondents.

However, this not only brings benefits, it also poses some problems that negatively impact on the socio economic development of the country. There are several reasons for concern about economic growth driven by resource sector expansion. Firstly, given that domestic businesses need credits to diversify growth, banks are now required to meet this need and have shown a lot of improvement in this area over the last three years. The growth in the banking industry has resulted in the fast growth in domestic credits which rose of more than 100% consequences to increase bank credits for SMEs from 8% to 20% during the year 2006 to 2010 (ASEAN Bankers Association, 2011). If credits are growing, it also affects the growth of bad debts.

Thus, if effective regulations are not yet in place to help with management of bad debts, the banking sector faces challenges on how to clean up its record of high bad loans. Lao banking faces a history of high NPL rates, especially for SOCBs where the records of NPL accounted for over 30% of LDB’s portfolio and 80% of BCEL’s portfolio as identified in the audit 2005 (International Finance Corporation, 2008). Even though the central bank made a big improvement in NPL control, in a fast growing credit environment, risk is not entirely represented by the numbers of loan records in a bank’s portfolio (The World Bank, 2011c). Rather, it should reflect on how well the bank risk management capacity and the government’s supervision regime function (The World Bank, 2011c).

Thus, it is important to re-examine banking measures and the supervision regime, in order to ensure the better management of high risks incurred by bad debts. It is important to ensure effective supervision and prudent regulations in relation to this problem. Control on the growth level of banks may help manage the floating of credit in the markets, and by being able to improve banks’ entry conditions, the government could select more quality-focused and trustworthy banks. Therefore, by doing this, it
would not merely improve the banking sector but would also avoid risk resulting from too rapid a pace of bank entry. In this way the country could balance growth of businesses and growth of the banking market.

Secondly, high growth in the resource sector requires more attention, for over-exploitation leads to unsustainable development, and a downslide in economic growth. It is noted that 90% of FDI is invested in the natural resources sector, as reported by the World Bank (2010a). Therefore there is a need to carefully use natural resources in a sustainable way in order to help achieve long term benefits, as the excessive use of natural resources may pose a harmful effect on future economic growth as the country is scarce in capital, skilled workforce and facilitated infrastructure (The World Bank, 2010a).

Therefore, the balance of development is taken into account and the promotion of a non-resources sector such as manufacturing is vital to sustainable national economic development as it helps produce tradable goods and export diversification (The World Bank, 2010a). Economic stability under this momentum depends on how credible and effective the country’s legal and regulation regimes are. Therefore, special attention must be given to strengthen the government’s capacity to enforce effective implementation of existing legal regulations (The World Bank, 2010a).

Thirdly, it is noted that doing business in Lao PDR is more a plus than a minus for firms, given the different issues involved. Areas that are well-endowed with natural resources give rise to firms from other nations entering into both regional and international markets in Lao PDR. Thus, due to increasing trend of inflows from foreign direct investment into the country, the local market is now growing, and this phenomenon can also bring about a trade-off by increasing the exchange of trade with both regional and international investors.
In addition, given a shift of manufacturing jobs that take advantage of cheap labor and unexploited natural resources, the number of both local and overseas traders is growing. Increased trade liberalization provides better selection choices for local consumers, as they can enjoy imported products at low prices and more availability of goods in the markets. The effect of this is to create more business opportunities, as the greater savings obtained from buying cheap goods can be further utilized for a diverse range of commercial purposes. As a result, the country can improve trade competitiveness, and this movement towards a market economy helps to accelerate the process of the country’s growth and development.

However, increased competition from economic integration tends to create a negative impact on the local manufacturers as well as a positive one. Despite trade integration with other countries, neighboring countries in particular not only bring benefits to the domestic trade, but also can create trade barriers for local producers. As recognized by the business respondents, most raw materials for businesses are sourced from other countries given the lack of available quality and quantity materials in Laos, and this impact is intensified due to the high cost of transportation in what is a land-locked country.

In addition, sometimes businesses have to deal with inflation and foreign exchange rate movements which can impose a higher cost on production (Southiseng & Walsh, 2010). The rationale for this implies that any weakness in local currency makes imports of raw materials more expensive and creates a higher cost for locally produced goods. On the other hand, imported products are likely to be cheaper and more widely available due to their capitalizing on better technology and qualified workforce to produce low cost and value-added products. Southiseng and Walsh further point out that those customers are then provided with more bargaining power due to a wide variety of options in the market. As a result, domestic businesses face greater price competition from this flow of imported products.
Moreover, domestic products still lack a competitive advantage so that, instead of promoting local manufacturing, it is better to import given that local capacities are not able to compete effectively in the market. The high cost of production from imported materials is also of concern. Exports of products are further pressured, given that product development in other nations is well ahead of Lao production goods. And the scenario can only exacerbate if the country has to import more than export, given the lack of production capacities determined by a shortage in modern technologies and skilled workforce. Apart from exporting in minerals and energy, the other main export products from Laos are associated with garment and furniture trades (Stirbat, Record, & Nghardsaysone, 2011), which are still disadvantaged in many regards.

Due to an enormous amount of imports from neighboring countries and far fewer goods exported from Lao PDR, the Lao economy tends to suffer a trade deficit. Empirical evidence affirms that a high economic shortfall in Lao PDR is a great problem as indicated by exports of 53% while imports accounted for 84%. The main partner countries are China, Thailand and Vietnam (The World Bank, 2009). Stirbat et al. (2011) also support the fact that exports in developing countries have a very short life cycle and usually last within 2 to 3 years. If this is the case, both domestic and export oriented firms are facing another tough challenge, and are involved in competitive pressures that require an improvement of the quality of their offering. Thus, local firms, especially SMEs, are in great danger as a result of trade integration, if protection and support policies are not in place to protect them.

The successfulness and effectiveness of business depends largely on the competence level of entrepreneurs (Southiseng & Walsh, 2010). Capacity development through training provision is critical to the improvement of business competencies and competitive skills in order to help businesses improve performance and productivity. Providing necessary development programs is crucial, and the government and policy makers are required to ensure that SMEs are given appropriate assistance to take full advantage of the country’s opening to a market oriented economy. Therefore, factors
affecting firms should be taken into consideration in order to enhance entrepreneurs’ skills and capacities in becoming healthy and larger enterprises in the future. As stated in GTZ (2010), “the bigger the enterprise, the better its performance” (p. 15).

5.4 Attitudes of both local and foreign banks and their practices towards SME businesses

The age of globalization not only gives easy access to new know-how, which helps boost local businesses by means of foreign direct investment, it also opens doors to the benefit of novel technologies which help improve and diversify business development (Awuah & Amal, 2011). Recently, many countries are now connecting to each other more effectively, and thus the diversification of a market may also be affected by growth patterns in other economies (Cárdenas, Graf, & O’Dogherty, n.d.). Likewise, in many emerging market economies as well as in Lao PDR, there is growth in foreign direct investment (FDI) in the financial sector as a result of the removal of policy and institutional impediments. Respondents from both the bank and government sides agreed that increasing foreign participation can contribute to the development of the banking sector.

There is a rapid growth in private ownership of banks, both from local and foreign banks in Laos. This phenomenon has resulted in the emergence of new opportunities for the banking market, in the sense that it creates competition which stimulates the local banks to adopt a wide range of banking products and services in forms of online banking, visa cards, and expanding of ATM services, all in response to the newly competitive environment (Degryse, Havrylchyk, Jurzyk, & Kozak, 2009).

Not only can urban businesses have access to banks but people throughout the country can also access them because of expansion of bank branches. In addition, increasing numbers of banks also allow a growth in credits available to the market. Customers can also enjoy better access to financial services and developed financial products via this
mechanism. Hence, government is enthusiastic about encouraging the growth of foreign banks’ participation in the country.

Many transitional economies have experienced high growth of foreign bank entrants as a result of adopting a new economic model (Bonin et al., 2008), and it is believed that the financial systems of an economy can be enhanced via the entrance of foreign banks. This brings new technology, and stimulates competition in the market (Cárdenas et al., n.d.). Therefore, it can be concluded that foreign banks’ presence not only brings benefits in terms of increasing financial resources, modern technologies, and management knowledge, but also forces greater competition in a local market as it generates growth and upgrades banks’ standards (Cárdenas et al., n.d.).

However, there is clearly still a mismatch between supply and demand of financial products to SMEs throughout the country, and attitudes of banks to financing represent a major problem for many of these small firms. Although SMEs support the economic flows, small businesses are not seen as viable investments by the majority of banks, for larger enterprises are still the banks’ most preferred sector. This is clearly because lending to this sector is more profitable and involves lesser management costs, and there is less risk involved because of their proper financial records and well established systems. It seems that size does matter for business in accessing bank lending, and SMEs seem to have more severe constraints as compared to their large enterprise fellows (GTZ, 2010).

Overall, bank respondents agree that SMEs occupy only a minority share in the total bank loan portfolio. Even though different banks have different focus on their customer types, most banks are interested in big corporate businesses, and foreign banks tend to be the biggest fans of those bigger firms. Moreover, foreign banks are perceived as “cherry picking the best borrowers” (Degryse et al., 2009, p. 3), though this may be explained by the lack of reliable data on those smaller firms and the fact that banks want to protect themselves from unnecessary financial loss. Hass et al. (2010) note that
foreign or big companies are considered more transparent and more secure than smaller firms and this becomes a reason why they are desired as clients by all banks. Therefore, as supported by Cárdenas et al. (n.d.) and given the lack of local connections in the host country, foreign banks ultimately choose to serve only larger and more transparent customers.

In addition, big companies are more profitable borrowers than smaller firms, as the profit gained from lending to one big firm may equal to the total value of lending to many more small firms; and the time and money spent on management of those multiple smaller businesses is also significantly difference. In this context, foreign banks avoid using relationship lending and their typical approach to loan decisions is to use by arms-length lending (Degryse et al., 2009; Haas et al., 2010). Thus, it can be said that large foreign banks have complex structures with novel technologies, but tend to face difficulty in coping with soft information from SMEs, especially SMEs in transitional economies (Degryse et al., 2009).

In addition, foreign banks have more sophisticated and more lengthy processes than local ones in terms of approving loans, and small firms tend to face difficulties in meeting documentation processes required. Thus, for much of the time, their lending ends up with higher interest rates. This coincides with the view of Torre et al. (2010), that large and foreign banks have their own standard lending criteria that may be too sophisticated for the general practice followed in the domestic market. In addition, a common weakness in local knowledge makes it harder for foreign banks to assess and quantify soft information when their head offices are far away (Torre et al., 2010).

For those reasons, foreign banks in Lao PDR, whether they are big or small, are likely to serve only their own clients. For instance, Thai banks or Vietnamese banks usually emphasize service to the businesses that are owned and operated in their own country. The services provided can be quite basic, as they serve branch rather than head offices (International Finance Corporation, 2008), and this can perhaps explain a lack of foreign
bank engagement, connection, or involvement with any parties to the domestic market (Cárdenas et al., n.d.). In addition, foreign banks may be accused as “cut and run” traders, because international banks are profit-oriented and usually look for the investment alternatives and opportunities which provide higher returns (Cárdenas et al., n.d., p. 2). Thus, they say that unlike the domestic banks, these banks will be quite prepared to leave the market at any time their outcomes do not meet their expected goals.

This implies that, in spite of creating positive effects on reducing the financial burden of SMEs, the promotion of foreign bank entrants may not correspond with the purpose of improving financial sources for SME development. The conservative nature of commercial banks towards SMEs tends to be the major constraint, as the high perceived risk of dealing with SMEs has made banks more risk averse. Burns (2011, p. 282) indicates that “banks do not share in the success of the business but stand to lose all their capital if the business fails”. He further states that SMEs not only create the potential of higher bad debts, but management of the small firms is a time-consuming process that creates extra cost in monitoring and completing required documentation.

Nevertheless, the change in market dynamics forced by foreign bank entrants tends to stimulate greater competition for domestic banks to better serve SMEs (Degryse et al., 2009), and it is fair to say that smaller local banks tend to better serve SMEs compared to the foreign banks. In addition, SOCBs focus more on SMEs given the main development focus of the government. The extent to which many bank players choose to focus on the SME sector depends to a large extent on the degree of comfort each bank has in the SME market, reflected by the level and length of its experience and its management. SMEs can be risky, given the size of their balance sheet and their expertise in managing their financials efficiently, and their revenue tends to be small, which implies a limited loan repayment capacity.
Therefore, in order for SMEs to facilitate the country’s growth and diversify economic activities, the government needs to make loans more readily available. Improving financial infrastructure is vital, as it helps increase banks’ ability to verify necessary data and have more protective facilities and tools when they have to lend to SMEs. Business information can be improved by enhancing the CIB, so that the lack of reliable and transparent data is reduced, while at the same time banks’ confidence is enhanced.

### 5.5 Government support policies on banking and SME sectors

Owing to globalization, the flow of investment across borders, which enables businesses to more easily exploit business opportunities, also benefits host countries commercially. Recently, given a past history of rapid growth in natural resource investments as the main impetus, the government is now actively developing policies to facilitate growth in the private sector. Improving law and regulations, and removing barriers to trade and investments, are crucially important for the general growth of the economy.

There is a strong commitment by the government of Lao PDR to ensure a level playing field within the business sector (Southiseng & Walsh, 2010), and this being implemented to make sure the economy functions efficiently and the community can benefit fully from its operations. At the same time, this will also help to disseminate power which is currently centralized within certain business elites, and will also help to create fairer treatment for consumers in terms of prices, choices, quality of products and services (Southiseng & Walsh, 2010). An example of government action is revealed in the successful introduction of a Small and Medium Enterprise (SME) development strategy, a new accounting law, and a law on commercial banks approved in 2007 (International Finance Corporation, 2008).

In order for businesses to grasp the full benefit of this phenomenon, increasing access to finance is one of the government’s priorities toward SME promotion, and this importance can be seen in the form of improving banking laws, enhancing creditor
rights, court enforceability, removing all financial distortion policies, promoting fair
treatment for all investors, enhancing accounting and auditing standards and promoting
In addition, foreign banks operating in Lao PDR are currently under pressure from
policies related to financial sector development imposed by the local government,
usually focusing on policies of protectionism and equal treatment for local competitors.
Thus, facilitation of the banking sector per se is also crucial, as the better the banking
sector the more available are sources of finance for business.

It is worth mentioning that the bank respondents in this study agreed that there are
fewer interventions in bank operations from the Bank of Lao PDR, suggesting that the
government wants to foster an effective banking industry and stimulate bank
competition in the country. The presence of foreign banks is also perceived to help
mitigate negative impacts resulting from high market concentration, while at the same
time promoting the private ownership of banks in the domestic market (Cárdenas et al.,
n.d.). However, despite significant progress made in terms of laws and regulations,
weaknesses remain in promoting integration of large investments with the local market
(GTZ, 2010). Within the supervisory regime, unclear accountability in government
offices still remains and brings constraints for future opportunities and prosperities of the
financial sector (International Finance Corporation, 2008). Weak legal and regulatory
frameworks are considered to remain as a main hurdle to SME access to finance and to
the overall development of the banking sector per se.

Periodic market interference by the central bank, as well as the government, still
occasionally occurs. Government intervention methods include, but are not limited to,
involving commercial banks with controlling and reporting such as the NPL rate,
classification on loans, foreign exchange transactions, issuing of bonds with attractive
interest rates, and randomly utilizing foreign reserves to absorb market pressures. In
addition, laws and regulations are not fully implemented, and this reflects a lack of clear
accountability and enforceability by government authority – for example, there is no
clear accountability imposed on the Lao Development Bank as the nominated SME bank, although to date that bank has yet to fully engage in its facilitation of SME borrowers; and the enforceability of the secured transaction law which was promulgated in May 2005 is not yet complete (International Finance Corporation, 2008; U.S. Department of State, 2011).

This law aims at removing collateral constraints by allowing banks to accept removable assets as security against bank loans. This can help many smaller firms who face difficulty in providing sufficient collateral (International Finance Corporation, 2008). Most of the time, fixed assets are the most acceptable guarantee since they can easily be tradable compared to other forms. In Lao PDR, as empirical evidence suggests, land and buildings are regarded as the most acceptable type for bank security, and accounts for 90% of all collateral provided, but the approved lending term still remains short in duration —usually one year (The World Bank, 2011c). Therefore, small firms face more barriers in acquiring bank loans if they fail to provide adequate collateral.

Another reason why banks become risk averse is mainly associated with issues round remedies at court, which are seen as doubtful, with high costs in time and money (International Finance Corporation, 2008). This skepticism is based on misgivings about likely judicial outcomes, given problems of transparency and lack of clarity in terms of creditors’ rights to claim or seize secured assets from borrowers (International Finance Corporation, 2008). As such, banks are very conscious of carefully assessing credit worthiness of their SME borrowers and avoiding involvement in any issue dealing with the court.

Another crucial point is the effective implementation of the role of a Credit Information Bureau (CIB). Even though the BOL recognizes the importance of improving transparency and providing business information for commercial banks in a timely fashion, the CIB is not yet functioning (International Finance Corporation, 2008). Since data is not easily accessible, most commercial banks are less likely to rely on the CIB
mechanism which is still perceived as outdated and unreliable. CIB is not yet anywhere near effective in terms of serving its purpose, mostly due to the regulator’s incompetence, and outdated means of communication between commercial banks and CIB (like fax machines) are still used. Thus, lack of timely communication stands in the way of how commercial banks interact with the CIB on a daily basis, and weaknesses in IT infrastructure result in unreliable and out of date credit information data which does not fulfill user requirements (International Finance Corporation, 2008).

In recent times, there have been a number of agencies involved in requesting a business registration process that would reduce the administrative burden reflected in the number of required processing steps and bureaucracy in the government work system. This implies high transaction costs for businesses when they need to get their business running quickly. According to a World Bank survey, starting a business in Lao PDR requires at least 93 days for completion of all required transactions, which is considered a lengthy process compared to other countries (The World Bank, 2011b). This report shows that Lao PDR was recently ranked 89 out of the total 183 countries for speed of business set-up.

Pressure from government requirements tends to force businesses to rely on the use of a broker or middle person in order to achieve their business license as fast as possible. This occurs despite the fact that business owners involved in documenting a new business registration are typically charged with 3% of the total cost of investment (Walsh & Southiseng, 2011). This is realized to be an unhealthy culture that can easily generate an environment that is open to for abuses by authority; and, if those issues persistently exist, the current lack of transparency and inappropriate records of business data remain serious constraints to growth. Thus, to promote the private sector development, intensified efforts by the government is crucial in order to simplify and streamline administrative procedures for SMEs (The World Bank, 2010a). This can only help to improve the investment climate and create a more business friendly environment.
To sum up, it is noted that the lack of firm transparency, and weakness of financial infrastructure, are two major factors hindering SME financial accessibility. These factors are evidenced by a lack of reliable creditor information, poor collateral rights, and weaknesses in the protection mechanism for creditors (International Finance Corporation, 2010). Therefore, in order to ensure the effective exploitation of the new economic model, and to promote an enabling business environment and financial sector, continuing improvement on all recently approved legal and regulatory frameworks is of prominent importance (The World Bank, 2010a).

Enforcing the acceptance of moveable assets as collateral is one of the critical factors enabling further engagement in SME finance. It is also considered as one of the important mechanisms for improving the financial infrastructure of the country (International Finance Corporation, 2010). Just as growth in the banking sector results in growth of flows of capital for SMEs, removing institutional constraints and improving legal and regulatory frameworks would provide a big spur for SME growth and productivity. Therefore, the two sectors could enjoy a complementary strength from each other which would ultimately lead to a higher economic output.

5.6 Key constraints affecting the supply of bank credits to SMEs and suggested improvement by respondents

It is noted that certain firm-specific constraints for access to finance must be deliberately considered. Because of different capacities and business natures, discrimination of banks towards the SME segment remains a challenge for small firms seeking sustainable access to formal credit facilities. Important issues were discovered in the data collected from participating bank and government respondents, in that the SME access burden is mainly associated with an inherent risk associated with poor business plans, uncertainty and lack of ability to quickly adapt to a changing and competitive
environment, low incidence of keeping accounting/bookkeeping records in a systematic manner, a lack of management skills, poor business structure and misuse of loans. Most banks require similar documents from borrowers in order to be eligible for bank loans, and one of the biggest concerns links to the inability of small businesses in preparing financial statements. This is considered to be a critical barrier for businesses when seeking a bank loan. But most SMEs in Lao PDR do not use proper accounting systems, and it is therefore hard to see the real balance sheet position of businesses. At the same time, business’ financial statements are sometimes formed with assistance from credit officers, so many small firms tend to confuse financial details and sometimes may deliberately distort the truth about the financial health of their business in order to reduce business taxes (Nam, 2006). In Lao PDR, the availability of access to a lump sum tax payment system enables entrepreneurs to avoid using formal accounting standards but depend largely on negotiating with tax officials about the amount of tax to be paid (The World Bank, 2011c). In fact, around 40,000 out of a total 47,000 registered enterprises remain under this category (The World Bank, (2011c).

The reason why this practice is allowable is that the government wants a tax system that will achieve its tax collection purpose from all operated businesses in Lao PDR, despite an agreed lack of ability in preparing financial records by micro and small firms. This simplified tax payment system is then used for those small businesses with an annual turnover of less than $24,000 (The World Bank, 2011c). However, the availability of a simplified tax payment system may create abuses of its authority, as many larger businesses operating above threshold still opt for this method (The World Bank, 2011c). Having said that, while this practice allows the government to collect business taxes, in the long term it creates an unfair burden on sustainable development for business. As long as inadequate accounting standards exist in the SME environment, this will continue to be a major impediment for SMEs, since banks appear to be reluctant to accept loan applications if proper accounting is not consistently maintained (Barth et al., (2011).
Overall business performance, financial status, and market recognition are also critical factors for businesses to more easily gain bank credits, with more power to negotiate better interest rates. Without good business track records, and a demonstrated ability to repay their loan, SMEs hardly ever meet investment capital requirement. Business respondents indicated that lending procedures required by banks are very complicated, and even harder for foreign banks, that sometimes small businesses face difficulties in completing loan applications. From the supply side, banks have sophisticated lending procedures and high credit criteria, so that applicants need to be able to present the viability of their proposed projects to banks. From this perspective, there is still a mismatch of supply and demand in the finance for SMEs sector.

It can be concluded therefore that, even though SMEs play a critical role in boosting economic development and reducing the unemployment rate, access to finance by small firms is still largely disparate and their growth level is still limited. In summary, SMEs are faced with the disadvantage of high interest rates, short-term loans, and a requirement of high collateral against lending.

In response, Torre et al. (2010) comment that the SME sector can be enhanced through a government subsidy fund such as the credit guarantee fund, a device that is also seen as important to encourage banks’ engagement in SME lending. The current requirement of high collateral provision can also be minimized through the introduction of this scheme (RAM Consultancy Services Sdn Bhd, 2005). But to do this, the government needs to take a leading role in actively implementing such a scheme. Realizing the lack of budget for government priorities, and mobilizing funds through international assistance from donors who are working on this sector, will help achieve this project and ensure the on-going monitoring and developing of the scheme (International Finance Corporation, 2010; RAM Consultancy Services Sdn Bhd, 2005).

Continuing support to banks that are already targeting SMEs is another crucial technique to increase SME finance facilitation (International Finance Corporation, 2010;
RAM Consultancy Services Sdn Bhd, 2005). Realizing this fact, the government could collaborate with development agencies through subsidizing capacity building for SMEs by creating an SME unit to operate under the banks. Borrowers could then improve their skills in preparing business plans, and their knowledge of financial projection or accounting, through assistance from banks (RAM Consultancy Services Sdn Bhd, 2005). This can be an alternative way of improving firms’ management and financial skills, and SME capacity can therefore be enhanced in a more sustainable way.

In addition, relationship banking is one practical way to minimize the information gap for SMEs in transition economies (Yang, 2006). Once a good working relationship has been developed, firms tend to be assured of long term access to bank credit. If this is the case, firms can also increase their negotiation power if they can maintain good relationships with their lender banks. Relationships can be developed through trust and respect, which is still widely used in these economies (Burns, 2011; Nguyen et al., 2006); conversely, if firms move to new banks, they may experience other transaction costs and have to go through the whole credit validation process again which is very time consuming. Therefore, using relationships will help SMEs increase the length of lending terms and enhance their negotiating power to bargain on the interest charged on loans. In Vietnam, where high uncertainty and unreliable availability of business information remain important issues, networking has been suggested as the most effective tool to help create business connections with other people (Nguyen et al., 2006). The authors say that this is especially true for young firms or new start-ups.

Another potential SME channel for external finance could see the poor credit risk obstacle being overcome by exploiting trade financing and leasing (RAM Consultancy Services Sdn Bhd, 2005). Izumi (2006) says that leasing gives benefits to SMEs in the sense that it does not require well-developed balance sheets or credit histories, as it allows the use of capital equipment instead of approving bank credits through the traditional lending process. Izumi adds that leasing is suitable for use in countries with uncertain environments, weak creditors’ rights, and inadequate collateral, but effective
enforcement on contract and collateral laws is crucially important to increase the level of guarantee for banks in an event of default.

Government and bank respondents agreed that improved SME capacity would help small firms improve their access to credit, so one possible solution could be through strengthening the role of the Lao National Chamber of Commerce and Industry (LNNCI). SME capacity development should be a high priority for the LNCCI, with support from government agencies, and it should be quite simple to provide business members with knowledge management training, the ability to deal with loan applications, and achievement of improving accounting skills. Business competencies would therefore be enhanced, as would firms’ ability to complete necessary documentation required by lending banks. It would however be necessary to improve coordination between the government and the LNNCI, in order to make sure of an effective implementation of their joint SME development objectives, but the technical knowledge of SMEs can also be developed through advisory services derived from development agencies that are already supporting this sector (for example, IFC, GTZ and ADB).

Tax incentives would create a major encouragement for banks to lend to SMEs, and this is perceived as a more concrete and pragmatic action (RAM Consultancy Services Sdn Bhd, 2005) in terms of compensating for the risk taken from lending to this sector. Granting of new taxation incentives could be one valuable stimulation package for banks (Mandeep et al., 2008), and attention should be given by regulatory authorities to ensure the implementation of this approach towards promoting SME financial access.

Continuing improvement of the services provided by the CIB is another crucial instrument to provide business information for commercial banks and to allow banks to shift from “collateral based lending to information based lending” (Nam, 2006, p. 11). Ideally, all data should be collated from both the financial service industry and other players outside the financial service industry, to ensure availability and updated data for
sharing between financial institutions (International Finance Corporation, 2010). Poor quality business data is likely to be a major obstacle for banks to identify and develop good credit risk management tools, and the effectiveness of central credit information needs to be improved and strengthened by the related authorities, especially the central bank (Mandeep et al., 2008). The Lao CIB unit is not yet well developed, and an enforcement measure hasn’t been well-established, so that strengthening the capacity of the CIB is of extreme importance (International Finance Corporation, 2008). Different issues discouraging the effectiveness of this function should be urgently discussed, and stronger co-ordination between commercial banks and the staff at CIB may help identify problems impeding the CIB’s function.

Government is considered the main moderator in reducing the SME supply and demand constraints. In this case, the SMEDPO is a main SME stakeholder in developing and creating support policies in order to cut all red tape, and remove policies and institutional impediments to the development of the SME segment. In addition, apart from being the policy makers, setting up the government SME centre is considered as a key factor in referring potential or bankable SMEs to commercial banks (RAM Consultancy Services Sdn Bhd, 2005). As long as the awareness of, and preparedness to deal with, the above-mentioned challenges exist, access to long term bank finance tends to be reasonably mitigated.

5.7 Summary of the chapter

The aim of this chapter was to analyze data collection from the previous section, focusing mainly on the key points of difference between stakeholders. With the support of views from those three stakeholder dimensions, and empirical evidence from literature reviews, this chapter has identified some practical process to cope with SMEs financial burden. Overall, even though the SME sector plays an important role in job creation and contributes to the country’s economic growth, the level of SME access to finance for their expansion is still limited. Access to finance by small firms has been a
thorn in Lao PDR’s side and, despite government’s diverse range of actions, a number of SME access constraints still currently exist because of different facilitating factors.

Firstly, banks are not interested in SMEs despite their current rapid growth. Banks generally are very risk averse to SMEs, because of inherent weaknesses including limited financial literacy and inability to prepare loan applications. These are found to be significant shortcomings, and this has forced SMEs to rely heavily on personal wealth and the informal sector as alternative sources for their start-up and expansion finance.

Secondly, banks have their own complex lending procedures, and there are even more complicated processes if businesses want to acquire loans from foreign banks. SMEs inevitably have to work harder to fully comply with the required rules and, although bank credits may indeed be granted, SMEs are usually charged with high premium interest rates, short-term lending, and high collateral needed for bank guarantees.

Thirdly, despite credit booms in Laos, access to finance is still cited as the main obstacle to small businesses compared to their larger enterprises. High competition in the local market has caused damage to domestic manufacturers, and there are major problems in terms of business productivity, technology and technical skills in the workforce.

Therefore, as far as ease of access to finance by SMEs is concerned, weaknesses in banking sector development, and other institutional impediments, require further investigation. Improving banking infrastructures is a crucial factor in increasing banks’ commitment to the SME sector but, with appropriate supporting policies and protection measures in place, access to formal sources of SME finance can be improved.

One significant concern relates to the effectiveness of legal and regulatory frameworks, and the perceived lack of enforcement of crucial law, along with current policy actions towards the development of both bank and SME sectors, implies a gap in Laos’ banking
law and regulations. However, with due attention to the identified factors that hamper both bank practices and SME development facilities, the researcher believes that continuing support policies, better enforcement of existing law and regulations, and increased stakeholder co-ordination are crucial for any substantial improvement in funding for SME sector. This belief is further illustrated in the conclusions and recommendations chapter.
Chapter 6

Conclusions and recommendations

The overall aims of this research are to achieve potential best practice for improving the access to development finance by SMEs in Lao DPR, and therefore this chapter focuses on answering the research question as outlined below:

“What is the most practical process of banking sector involvement with SME business that would meet the demands posed by a rapidly expanding SME sector in a developing market economy?”

This study suggests that moving towards a market economy is an indicator of the government’s far-sightedness about future economic prospects. Economic integration results from globalization and trade liberalization, which have become significant policy mandates of the government of Lao PDR as well as in many transitional economies. Globally integrated production and markets have the potential to generate difficulties for multinationals to deal with, due to a range of differences in languages, cultures, political regimes, and specific values. These differences require that overseas investors possess a great deal of sensitivity and comprehension, for approaches to doing business in different countries may significantly vary.

In order to promote FDI and effectively exploit a new economic process, the government’s development policies are critical factors. To generate growth in the country’s economy, specific policies and legislative reforms are necessary to encourage and promote fair competition and greater business awareness in Lao PDR. In an environment of rapidly growing economic development and trade integration, business in Lao PDR at all levels should be able to enjoy the benefits of this phenomenon.
An important contribution to this growth can be derived from the speedy expansion of the SME sector, which plays an important role in Lao socio-economic development through greater levels of production and related job creation. These are core elements of a better standard of living for Laotians, setting a foundation for the country to become more modernized and industrialized, while diversifying its economy through the application of modern technology and improved productivity. As a result, the country’s economy can be boosted and poverty can be minimized.

But the negative side of this phenomenon should also be taken into account. Laos has a long history of being controlled by a centrally planned economic model, and there are still remnants from previous management practices which pose significant hurdles today. Obstacles facing the country’s development arise from the lack of implementation of existing legislations, and from a lack of transparency and accountability amongst government authorities. There is also concern about the readiness of the country’s resource management for, in spite of possessing abundant natural resources, management capacity and legal frameworks are still well behind other countries in the region.

Although the government has made some effort to introduce deregulation of private sector development, especially in the SME sector, development capacity is still limited by a lack of access to formal financial institutions like banks. SME’s access to finance is found to be a major obstacle in emerging economies, especially in Lao PDR where the financial sector is still at an early stage of development. Together with the lack of reliable legal protections, this is still a major concern.

It has been noted that the government has taken crucial steps to further recognize and address SME finance constraints, shown by reform in a number of laws and policies that have occurred as a result of the government’s intensified efforts. However, there is no significant change to market conditions, as the enforceability of laws still remains a problem. This issue could lead to national and international investors questioning the
efficiency of the Lao government’s policies development, and to doubt the quality of legal and regulatory regimes. Doubled with the above-cited, the lack of appropriate financial infrastructure, a less than effective supervisory regime, and some quite severe banking policy measures are nevertheless considered impediments that pose a serious risk to SME access ability.

The conservative nature of banks, especially foreign banks, is a critical factor hampering SME growth due to their inflexibility and unfriendly lending rules. Besides, a typically limited financial knowledge by business owners is of great interest, given that SMEs are known to be very small scale with family owned roots, and a lack of formal management, financial and business skills is the main cause of their inability to access bank loans. For loan decision methods, a tight collateral requirement is considered as a core credit assessment technique, and the perceived high risk of SME lending means that their granted loans are usually of short term duration with high interest rates charged.

Since business capacity constraints are critical factors, achieving the government’s obligations in private sector development is proving to be very challenging. Taking into account its policy on improving the investment climate through equal treatment of all operators, it is even more difficult for the government to force bank players to relax well-established standards that are grounded in different sets of compulsory banking rules and policies. If the government tries to promote the SME segment through bank intervention, it may discourage investors’ confidence in the effectiveness of the financial sector under the current country’s new economic mechanism. Nevertheless, some new policies and measures, supported by the government, do need to come into practice.

As it is widely agreed that financing difficulty is often the most serious issue, and the government and its policy makers have always paid great attention to it, a short-to-medium term remedy to satisfy the SME sector should be considered. The government is considered to be the main stakeholder in reducing the gap between banks and the
SME sector, for the development of more productive SMEs helps maximize the output from flows of investment and maintains appropriate economic momentum. Therefore, though achieving private sector development objectives is an ambitious goal, meeting the urgent needs for SME growth is crucial to the country’s long-term social and economic development. This proposition reflects the main direction and commitment of the Lao government in terms of economic policies which aim to address SME issues.

Lessons learned from experience in other emerging economies can be taken into account in order to provide a guideline for the researcher in developing a practical process to cope with current access difficulties. Therefore, to spur and maintain growth for the SME sector, a combination of policies for both banks and SMEs is significantly important, and the following are some useful suggestions for enhancing those two dimensions.

First, to speed up the growth of SMEs and to build their competitive power, government subsidies though allocation of soft-interest loans to disadvantaged SMEs may help reduce the reliance on informal sources of finance such as personal incomes or private lenders. In the shorter term, subsidies could at least help reduce the burden of relying on internal and informal sources for funding. This could be an attractive policy for commercial banks, as it helps reduce the risks that may occur from lending to those small firms, and a large number of small enterprises can be stimulated and supported with more confidence from banks.

One common method of subsidy is the Credit Guarantee Scheme (CGS), and this is something that could be considered to overcome SME constraints. However, this type of scheme requires a significant amount of seed funding, and it may be that assistance from international development agencies is needed, as facilitation from these agencies could help achieve the government’s aim in introducing this scheme. In addition, the set-up of a supporting legal and regulatory framework is needed in order to measure and monitor progress of the scheme, and considerable time is also required to
strengthen relationships and build up trust among involved parties. To take those associated issues into consideration, there will need to be more work and more research done on the positive and negative impacts of such a scheme.

Second, and further to the above scheme, one important concern is the enforcement of the currently existing laws and regulations, since the quality of the Lao legal system implementation, accountability, and management are still problematic. Reducing collateral constraint is crucial to SME business, and this can be pursued in the form of reviewing and enforcing the existing secured transaction law to ensure its effective implementation. An adequate legal and regulatory framework provides a guarantee for creditor rights but, without proper legal rights and effective registered assets, problems of collateral can hardly be reduced.

Engaging external parties like development agencies is of vital importance to mitigate issues around the lack of funding and technical advice. Currently, a number of leading aid agencies are helping the Lao government to improve policies for the government’s key priorities development, in order to help achieve long term sustainable economic development en route to poverty reduction. With continuing support from this sector, the efforts of improving SME access barriers could be overcome.

Third, there is a need to increase coordination among SME stakeholders, both from the government side as well as the private sector side. The lack of coordination within inter-government authorities could exacerbate the progress of important development policies, and slow down the effective implementation mechanisms of all of the government’s law and regulations. In addition, the private sector at all levels faces a number of administrative burdens as a result of ongoing problems in the government's administration.

For SMEs to be able to raise their voices, it is important to improve the discussion platform for government and private sectors so that it functions in a more coordinated
fashion. Promoting stakeholder consultation among the three main dimensions (the government, commercial banks, and private enterprises) is a useful method, for this can help to reduce tension between commercial banks and firm owners, and to create and develop effective relationship networks. Strengthening the role and capacity of the LNCCI is crucial here, as it is the main independent agency helping business communities raise issues and deal with government policies for better business development. This is a key mechanism to identify and overcome policy and institutional barriers to future SME development.

Fourth, taking into account the government’s role in referring bankable SMEs to commercial banks is crucial. Due to serious concerns about the lack of reliable business information, the government can help increase banks’ confidence through recommending some potential businesses to commercial banks, especially to SOCBs and local banks that are considered more SME friendly. The government should set up a specific unit or office to deal with the access constraints of SMEs, where business performance data can be maintained in a more systematic manner. Strengthening the role of SMEPDO is important here, as it is highly likely to be the directed stakeholder to deal with SME issues.

Fifth, improving capacity is considered one of the critical aspects for a successful business operation. Without adequate management capacity, SME firms cannot react flexibly and quickly to the fast changing environment. Taking into account different skill sets, such as business management, innovation, product development, and financial literacy, firms’ abilities can be enhanced in order to maximize benefits. Governments can help here by intensifying efforts to reduce access burdens for SMEs, and an increased focus on improving SMEs’ accounting ability, and their capacity to prepare well-conceived business plans, could be a powerful tool to resolve overall financing difficulties for SMEs. In the end, firms would be able to complete the necessary paperwork and documentation required by lender banks, as well as increase their ability to negotiate for a better interest rate to be charged to them.
Sixth, assistance from banks is agreed to be essential to enable SMEs to achieve their immediate operational needs and their future business expansion. Thus, government support by providing special privileges, such as tax exemptions and the removal of long lists of reporting requirements and controls, is essential and could lead to a greater attention and focus on the SME sector by both local and international banks. Therefore, in order to speed up the supply of SME financial loans, assistance and support policies from the government will be necessary.

Seventh, support and provision of business advisory services, through banks that already focus on SMEs, is one of the most popular tools used to promote SME development in many developing economies. A greater effectiveness in SME lending can be encouraged by establishing dedicated SME lending units under banks. Simplified lending processes and standardized documentation may help reduce the difficulties in preparing necessary documents for loan application. The government and development agencies should pay more attention to providing assistance and advisory services through standardized business plans and financial projection templates.

Eighth, the provision of alternative lending tools like leasing and factoring may be helpful in increasing access opportunities. However, it is also important to have legal and regulatory policies in place to effectively support the implementation of this tool and to avoid any defaults that may occur. The availability of insurance companies and the enforceability of an assets registration system still remain challenges for the Lao PDR, and asking appropriate security on assets is still demanding.

Finally, improving financial infrastructure and legal protection for creditors rights are the main considerations that will encourage and enable banks to better serve the SME segment. Financial infrastructure such as the credit information bureau, accounting standards, auditing requirements, secured transaction law and modern technology should be given greater attention, and reformed where necessary to promote more effective lending by banking institutions.
In this respect, BOL should display a strong commitment to strengthening the capacity of the CIB in both its IT systems and technical supports, to allow it to effectively collect and update necessary business information that commercial banks can use to verify borrower information. In addition, promoting the use of international accounting standards may help to improve the banks’ willingness to lend. If privileges were made available to firms who apply standard accounting rules, it might be possible to offer access to government subsidy by means of tax concessions. This will help change the current financial practices adopted by many small firms, and this would not only help them to access more bank loans but would also improve the government’s tax collection processes. If the government is able to collect more accurate quantities of business taxes, then budget allocations for government development projects can also be increased. This would help develop the government’s prioritized projects to meet their aim of short term poverty reduction and long term sustainable development.

In conclusion, after investigating a numbers of issue surrounding SME operations, it is believed that government subsidies and support policies could at least reduce the financial burden of relying on internal and informal sources for funding. The banking industry will continue to grow as a number of policy developments and legal regulations are revised and implemented, for it is noted that the root cause of an unhealthy economy can often be found in unrealistic economic policies with flawed implementation. Thus, sound development policies will help strengthen a healthy and robust business investment environment. Once the maximum development of SMEs is achieved, Laotians will also benefit from SME growth through increased job opportunities for local residents, which will in turn result in the government achieving its overall goal to progress beyond LDC status by 2020.
6.1 Limitations and future research

It is unavoidable that every research has its own set of limitations and this research is no exception. Given that the research captured the views of a very small sample, it is not possible to generalize its findings to the whole population. The research in this study gathered the views of just five banks out of the total of 23 in Lao PDR. In addition, only four SME firms were interviewed, representing just two main industrial sectors. All participants were selected from only one location, Vientiane, and other parts of the country were not chosen for the research. As different geographical areas may face different issues, some valuable opinion from other locations is not included. The limited timeframe and funds available to support the research could also have been a limitation.

Despite being at a relatively early stage of market development, the banking sector is still cited as the most significant credit supplier for SMEs, and the data collected through this research presents useful and interesting results which also coincide with past scholarly studies. However, given that Lao PDR has just embarked on a review of its financial sector operations, one factor impinging on the quality of data may have been a limited technical knowledge of this area by the local participants. Thus, the level of data obtained from participating interviewees may also be slightly limited.

The study of SME access to finance is a critical issue that needs serious attention from all parties in order to further investigate appropriate and effective policies to overcome access constraints and challenge banks distrust of the SME sector. Therefore, and noting the limitations of this research in the relatively small sample, it would be good for future researchers to capture larger samples in order to gain a wider variety of perspectives. Despite increasing numbers of foreign bank entrants to the country, SME access difficulties still remain, and it would be useful to further investigate the impact of growing foreign bank presence on the ability of SMEs to grow.
In addition, different types of businesses may have different access opportunities even if they fall under the SME category. Thus, to promote SME lending by all borrower types, policies for establishing a more level playing field for commercial banks (including private, state-owned and foreign banks) should be carried out for further research. By doing this, government can then develop suitable policies to address direct issues hampering each business category, and create appropriate mechanisms to support banks for further credit expansion in SME sector.
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### Appendix 1: SME definition in ASEAN countries

<table>
<thead>
<tr>
<th>ASEAN Country</th>
<th>Number of workers</th>
<th>Capital investment</th>
<th>Assets (millions)</th>
<th>Annual sales</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Singapore</strong></td>
<td>• SME</td>
<td>• Less than 200</td>
<td>• Less than US $15</td>
<td></td>
</tr>
<tr>
<td><strong>Malaysia</strong></td>
<td>• Microenterprise</td>
<td>• Less than 5</td>
<td></td>
<td>• Less than RM 250,000</td>
</tr>
<tr>
<td></td>
<td>• Small</td>
<td>- Between 5 and 50</td>
<td></td>
<td>- Between RM 250,000 and RM 10 million</td>
</tr>
<tr>
<td></td>
<td>- Manufacturing</td>
<td></td>
<td></td>
<td>- Between RM 200,000 and less than RM 1 million</td>
</tr>
<tr>
<td></td>
<td>- Services</td>
<td></td>
<td></td>
<td>- Between RM 10 million and RM 25 million</td>
</tr>
<tr>
<td></td>
<td>• Medium</td>
<td>- Between 5 and 19</td>
<td></td>
<td>- Between RM 1 million and RM 5 million</td>
</tr>
<tr>
<td></td>
<td>- Manufacturing</td>
<td>- Between 51 and 150</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Services</td>
<td>- Between 20 and 50</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Thailand</strong></td>
<td>• Small</td>
<td>- Less than 50</td>
<td>- Less than 1.7 USD</td>
<td>- Less than $0.7</td>
</tr>
<tr>
<td></td>
<td>- Manufacturing and services</td>
<td>- Less than 25</td>
<td>- Less than $0.7</td>
<td>- $0.7 to $1.4</td>
</tr>
<tr>
<td></td>
<td>- Wholesale trade</td>
<td>- Less than 15</td>
<td>- $1.7 to $4.47 million</td>
<td>- $0.7 to $1.4</td>
</tr>
<tr>
<td></td>
<td>- Retail trade</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Medium</td>
<td>- Between 51 and 100</td>
<td></td>
<td>- $0.7 to $1.4</td>
</tr>
<tr>
<td></td>
<td>- Manufacturing and services</td>
<td>- 26 to 50 persons</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Wholesale trade</td>
<td>- 16 to 30 persons</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Retail trade</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Country</td>
<td>Type</td>
<td>Person Size</td>
<td>Revenue Range</td>
<td></td>
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<tr>
<td>--------------</td>
<td>---------------</td>
<td>----------------------</td>
<td>------------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Indonesia</strong></td>
<td>Small</td>
<td>5 to 19 persons</td>
<td>• Less than $20,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>2 to 99 persons</td>
<td>• $20,000 to $50,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Less than $0.1 million</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• $0.1 to $5 million</td>
<td></td>
</tr>
<tr>
<td><strong>Philippines</strong></td>
<td>Cottage</td>
<td>1 to 9 persons</td>
<td>• $1.9 to $28.8 thousand</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Small</td>
<td>10 to 99 persons</td>
<td>• $28.8 to $287.9 thousand</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>100 to 199 persons</td>
<td>• $287.9 thousand to $1.15 million</td>
<td></td>
</tr>
<tr>
<td><strong>Brunei</strong></td>
<td>Small</td>
<td>Less than 10</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>10 to 100 persons</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Viet Nam</strong></td>
<td>Small</td>
<td>Less than 30 Persons</td>
<td>• Less than $65,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>30 to 200 persons</td>
<td>• 65 to 260 US$</td>
<td></td>
</tr>
<tr>
<td><strong>Myanmar</strong></td>
<td>Cottage Industry</td>
<td>Less than 9</td>
<td>• Up to 1 million kyat</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Small</td>
<td>10 to 50 persons</td>
<td>• Between 1 and 5 million kyat</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>50 to 100 persons</td>
<td>• Up to 2.5 million kyat</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Between 2.5 and 10 million kyat</td>
<td></td>
</tr>
<tr>
<td>Cambodia</td>
<td>112 persons</td>
<td>Between 11 to 50 persons</td>
<td>Between 51 to 100 Persons</td>
<td>Less than $50,000</td>
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<tr>
<td>----------------------------------------------</td>
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<tr>
<td>Microenterprise</td>
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<tr>
<td>Small</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medium</td>
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<td></td>
<td></td>
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<tr>
<td>The Lao PDR</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Small</td>
<td>Less than 19 persons</td>
<td></td>
<td></td>
<td>Less than 250kip</td>
</tr>
<tr>
<td>Medium</td>
<td>Less than 99 Persons</td>
<td></td>
<td></td>
<td>Between 250 and 1, 200 kip</td>
</tr>
</tbody>
</table>

Source: Financing small and medium enterprises in Myanmar, (Kyaw, 2008)