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## SME ACCESS TO CREDIT

John Rand\*, Finn Tarp\*\*, Tran Tien Cuong\*\*\* and Nguyen Thanh Tam\*\*\*\*

### *Abstract*

*The aim of this paper is to inform the reader about the access to credit of small and medium scale enterprises in Vietnam based on two SME surveys. Recent evidence from a variety of sources suggests that credit to available to SMEs has increased over the past few years. This is confirmed by the two SME surveys. Fewer firms which applied for credit in 2005 were denied credit as compared to 2002. However, the rapid development of the private sector has also increased demand for credit (especially among the larger SMEs); and it appears that the formal financial sector is just managing to keep track with growth in general. We conclude by discussing these results and formulate a set of policy recommendations.*

**Key words:** Vietnam, credit constraints, financial markets

**JEL classification:** O16, O53

### **1. Introduction**

A former Vietnamese Secretary General once stated that Vietnam has three problems related to future economic development: “Capital, capital and capital”. For small and medium scale enterprises (SMEs) this means that the key obstacles to growth for SMEs are “credit, credit and credit”. This article reviews recent research findings on SME access to credit with data collected in 2002 and 2005.<sup>1</sup>

The Vietnamese banking system has undergone significant reform since the beginning of the 1990s, but many challenges remain to be addressed. The banking sector continues to be dominated by state owned commercial banks (SOBCs), and the four major SOCBs account for 70-80% of total assets. Although the government has announced that policy-induced lending was to be phased out, “policy lending” has remained a defining characteristic of the SOCBs and the share of non-performing

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<sup>1</sup> This data was collected by the Institute of Labour Science and Social Affairs (ILSSA) of the Ministry of Labour, Invalids and Social Affairs (MOLISA) under the Business Sector Development Support Programme (BSPS) funded by Danida. Support from Danida is kindly acknowledged. See also Rand (2007) and Rand and Tarp (2007).

loans (NPLs) has remained large throughout the reform process. This has kept SOCB profits quite low as compared to the market power they have. These circumstances have kept financial innovations at a minimum and the high level of indirect government involvement in the financial system has given little incentive to improve banking performance.

For example, the lack of competitive pressure has limited incentives to improve capabilities with regards to credit analysis, and the concept of credit reporting is therefore still rather new in Vietnam.<sup>2</sup> Recent World Bank studies have shown that without access to quality corporate credit worthiness data, banks remain conservative in lending, which limits access to credit. Doing Business (2007) therefore notes that there is a strong need for improving the availability of credit information in Vietnam. This view is supported by Thanh and Duong (2006). They also argue that establishing local credit rating agencies (CRA) is especially crucial for the development of the capital market in Vietnam.

The question therefore becomes whether insufficient banking competitiveness (plus large government involvement and the legacy of NPLs) and the lack of willingness to financially innovate has affected SMEs credit access situation. Although the total amount of credit made available to SMEs has recently increased (Doing Business, 2007), credit may still be a constraining factor on the development process as suggested above.

## **2. Credit Access**

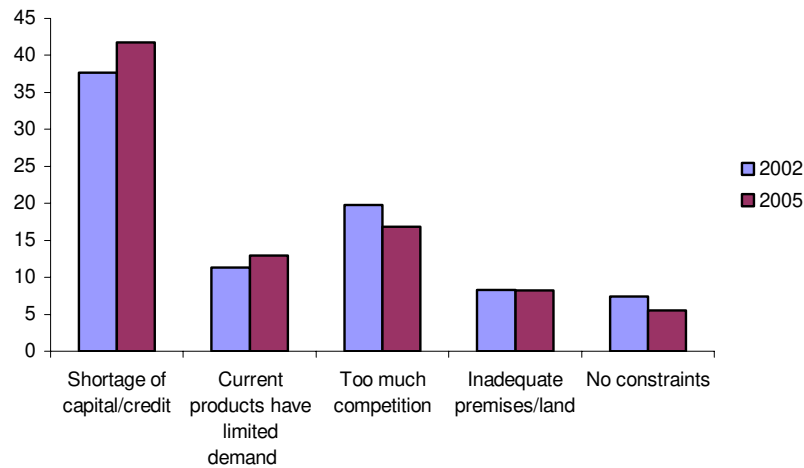
### *a) Firm perceptions*

Figure 1 gives an overview of the problems faced when doing business – as perceived by firm owners – and how these problems have changed over the time between the surveys in 2002 and 2005. Given that the questions regarding constraints faced by the enterprise were posed in exactly the same way in both surveys, we are able to give an indication of the evolution of the Vietnamese business environment from the owner or manager point of view. Figure 1 illustrates the five categories that scored the highest each year.

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<sup>2</sup> The public Credit Information Centre (CIC) established by the State Bank of Vietnam (SBV) in the late 1990s is the only credit bureau in the country, and covers only 1.1 per cent of adults.

Figure 1: Most Important Constraint to Growth as Perceived by Enterprises

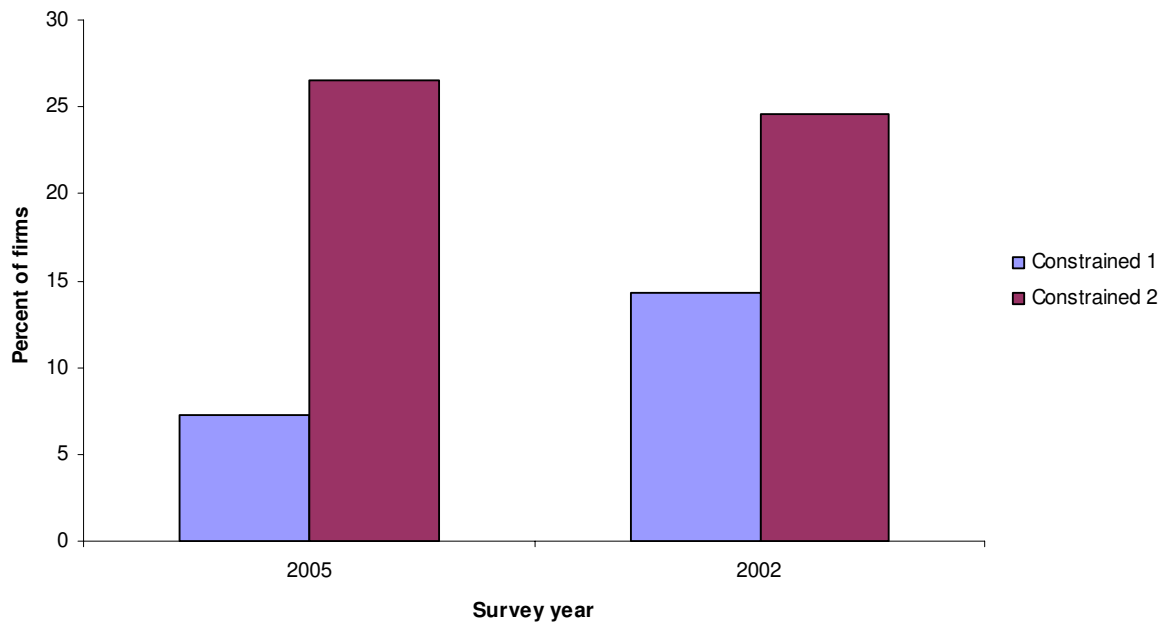


Although Vietnam has improved the firm credit access by expanding the range of assets that can be used as collateral (Doing Business, 2008), shortage of capital/access is still cited as the most serious problem facing SMEs. Interestingly, slightly more firms consider access to credit as the most severe problem in 2005 as compared to 2002.

#### *b) Formal Credit*

The SME surveys contain information on the number of enterprises applying and obtaining bank loans or other forms of formal credit during the past three years. In 2005 only 39 percent of enterprises had applied for a bank loan. However, 19 percent of these firms experienced problems with their loan application and were denied credit. These enterprises can thus be classified as credit constrained, and this amounts to approximately 7.3 percent of the sample (Constrained 1).

FIGURE 1: NUMBER OF CREDIT CONSTRAINED SMEs BY YEAR



Even though enterprises obtained some amount of credit, they still nevertheless consider themselves in need of a loan. Notably, 60 percent of the firms in this group still have need for a loan. Characterising these enterprises as credit constrained as well (Constrained 2), expands share of the group of constrained firms to 26.5 percent of the total sample. This is shown in Figure 1 where data from the 2002 survey are also reported. Using the simplest credit constraint measure (Constrained 1) shows that fewer SMEs were credit constrained in 2005 than in 2002. However, no apparent change in credit constraints is observable between 2002 and 2005 using “Constrained 2”. The two constraint measures together suggest that fewer SMEs are denied access to formal credit. However, the size of the loans obtained is not sufficient to accomplish a change over time in the second constraint measure. Thus, the size of formal sector loans remains inadequate to fulfil the financing requirements for many SMEs. At the same time it must be kept in mind that some SMEs have internal difficulties in preparing the necessary documentation to obtain loans.

It can be added that also some of the enterprises in the non-applicant group may be credit constrained. The 2005 survey shows (not reported) that 30 percent of the firms not applying for formal loans did so because: a) Lack of adequate collateral; b) Found loan processes too difficult; or

c) Interest rates were too high. Adding these non-applicants to the group of credit constrained enterprises means that 44.7 percent are considered one way or the other in their access to credit.

FIGURE 2: CREDIT CONSTRAINED SMEs BY SIZE CATEGORY

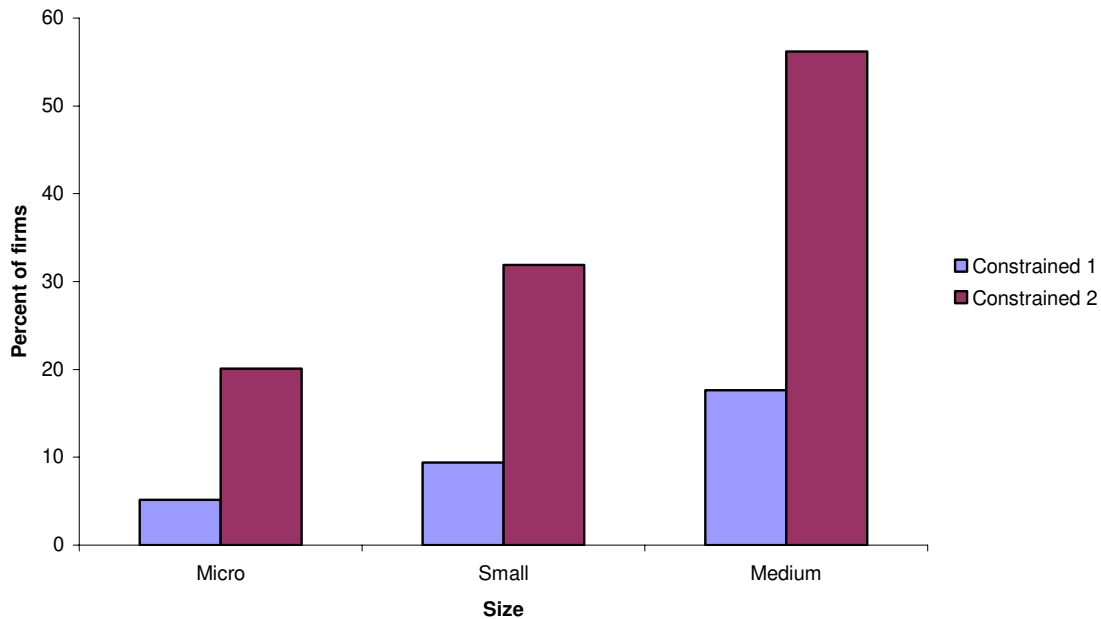


Figure 2 shows the credit constraint distribution by firm size category in 2005.<sup>3</sup> Interesting we see that the share of credit constrained firms increase with firm size independent of the credit constraint measure used. This confirms the result in Rand (2007) that credit constraints seem more binding for larger SMEs, suggesting that a shift in policy focus from micro household firms towards supporting the larger small and medium scale enterprises is needed.

### *c) Informal Credit*

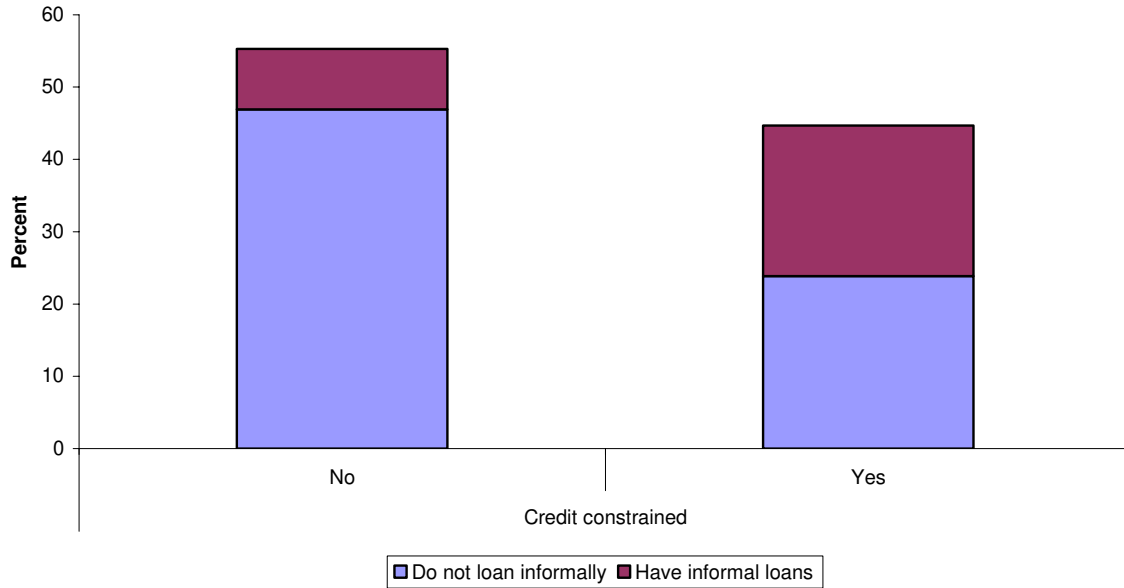
Enterprises that are credit constrained in the formal credit market have the possibility of trying to go for informal credit. This market is fairly well developed in Vietnam. Figure 3 confirms that around

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<sup>3</sup> The World Bank SME Department currently operates with three groups of small and medium-sized enterprises: micro, small, and medium scale firms. Micro firms have up to 10 employees, small enterprises up to 50 employees, and medium companies up to 300 employees. These definitions are broadly accepted by the Vietnamese Government (see Government decree no. 90/2001/CP-ND on “Supporting for Development of Small and Medium Enterprises”). In the following, we apply these definitions.

half of the credit constrained enterprises have informal loans as compared to only 15 percent for the non-constrained enterprises.

FIGURE 3: SHARES OF FORMAL AND INFORMAL CREDIT FOR CREDIT-CONSTRAINED SMEs



Rand and Tarp (2007) show that informal loan amounts and interest rates are on average much lower than for formal loans. There is normally no interest charged on loans to family and friends. Informal loans are on average only one-third the size of formal loans, but firms do not pay interest on over half the informal loans (median zero). This is caused by the fact that around two-thirds of informal loans are obtained from friends and relatives. Moreover, informal loans are also characterized by not requiring collateral, whereas around 90 percent of formal loans need collateral.

FIGURE 4: SHARE OF SMES OBTAINING CREDIT FROM INFORMAL SOURCES BY FIRM SIZE

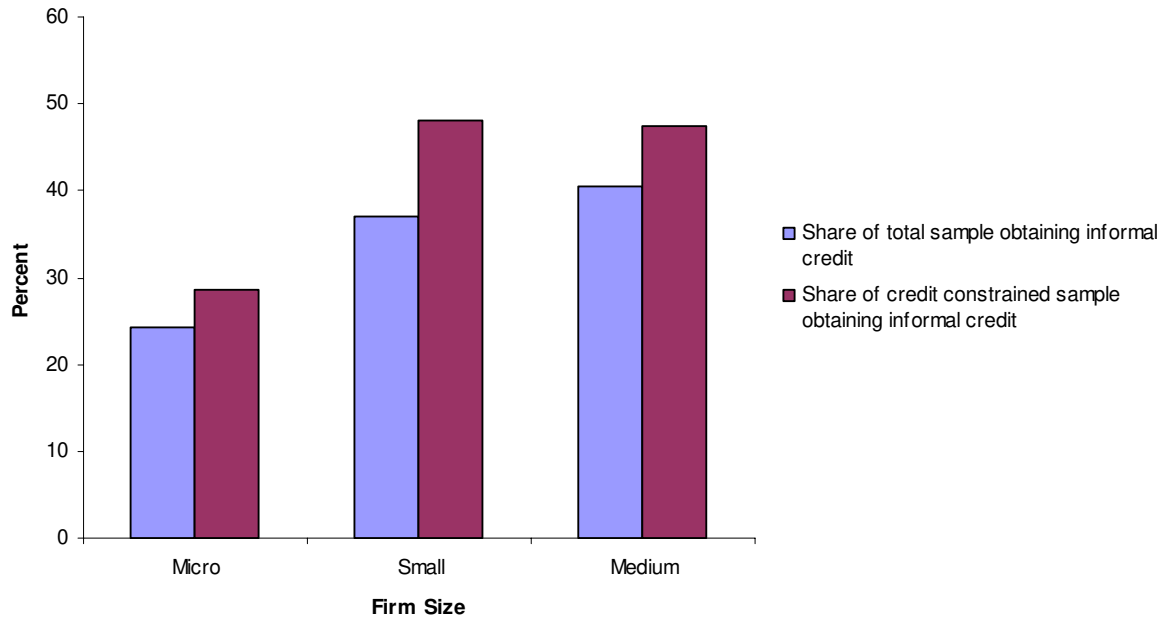


Figure 4 demonstrates that there also exists a positive association between firm size and the probability of getting an informal loan; and Table 1 checks the robustness of this firm size result. Besides firm size, an indicator variable for firm age (new entry = 1 if firm age less than five, zero otherwise) and location and sector dummies we use our indicator variable for being credit constrained and a growth indicator (in this case we use employment growth) as potential determinants of using informal credit. First of all, fast growing enterprises use informal credit more frequently. This confirms the result in Rand (2007) that informal credit plays a crucial role for successful enterprises in expanding and trying to “seize the day” of present market opportunities. As expected, enterprises constrained in the formal credit market more often seek to informal credit sources. New entrants are also more likely to obtain informal loans than incumbents. Most surprisingly is the fact that the firm size effect remains. Larger firms seek informal credit more frequently than their smaller counterparts. However, column 3 suggests that this size effect exist due to not controlling for firm size heterogeneity in the credit constraint measure described above.



Table 1: Who Uses Informal Loans?

		(1)	(2)	(3)
Firm size	(No. of employees)	0.0014***	0.0011**	0.0007
		(2.58)	(2.15)	(1.43)
Firm age	(New entrant = 1)	0.0819***	0.0767***	0.0728***
		(3.33)	(3.09)	(3.08)
Firm growth	(Employee growth)		0.1668**	0.1571**
			(2.51)	(2.45)
Credit constraints	(Constrained2 = 1)			0.0986**
				(3.56)
Including location dummies		Yes	Yes	Yes
Including sector dummies		Yes	Yes	Yes
Observations		2,602	2,602	2,602
Pseudo R-sq		0.06	0.07	0.07

Note: Probit, marginal effects. Weighted estimates and cluster robust standard errors. \*, \*\*, \*\*\* indicates significance at a 10%, 5% and 1% level, respectively. Base: HCMC and Food processing (ISIC 15).

### 3. Conclusions and policy recommendations

Recent evidence from a variety of sources suggests that credit to available to SMEs has increased in Vietnam over the past few years. This is confirmed by the SME surveys. Fewer firms which applied for credit in 2005 were denied credit as compared to 2002. However, the rapid development of the private sector has at the same time increased firm demand for credit (especially among the larger SMEs). Accordingly, the number of firms which do not get their demand for formal credit fulfilled seems unchanged since 2002. About one-fourth of the SMEs remain credit constrained. From the overall SME point of view it therefore appears that the formal financial sector is just managing to keep track with growth in general. The structure of credit remains unchanged.

- It is recommended that government takes concerted steps towards breaking new ground in promoting formal credit for SME development.

In addition, the SME surveys show that larger SMEs are those which face binding credit constraints. These firms therefore seek financing more frequently on informal credit markets.

- A shift in policy focus from micro household firms towards supporting the larger small and medium scale enterprises would from this perspective promote growth.

Finally, our research shows that fast growing firms are today forced to rely on the informal credit market if they want to seize investment opportunities to promote enterprise growth and success. How to help them get more access to formal credit is a key challenge.

- Establishing local Credit Rationing Agencies (CRAs) would be highly efficient in increasing transparency and creating a faster formal credit allocation system. This would benefit fast growing firms, in particular.

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