OBSTACLES TO BANK FINANCING OF MICRO AND SMALL ENTERPRISES: EMPIRICAL EVIDENCE FROM THE PACIFIC WITH SOME POLICY IMPLICATIONS

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In recognizing on one hand the importance of the micro and small enterprise (MSE) sector for the growth and development of economies in the Pacific subregion and on the other, the financing constraints of the sector, the authors surveyed a group of MSEs in a Pacific island country and found that the sector may be particularly constrained by bank interest rates, fees and charges, and collateral requirements. This situation holds implications for policy, and the authors propose an initiative led by the banking sector to improve the situation. Keeping in mind an economy's specific financial, regulatory, economic and other structures and circumstances, voluntary or mandatory, it seems as if direct or indirect bank involvement appears vital. The implications for economic growth and development are considerable.

JEL Classification: G21, G28, O10, O16, O50.

Key words: Fiji, Pacific, financing obstacles, micro and small enterprises (MSEs), bank loans.

I. INTRODUCTION

Across countries, the small and medium-sized enterprise (SME) sector has been shown to be an essential component for economic growth. Indeed, SMEs usually account for the majority of a country's firms and a significant share of employment (Hallberg, 2001). In the United States, for example, about 40 to 60 per cent of the country's gross national product and 50 per cent of the workforce may well be

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sustained by the SME sector (Neubauer and Lank, 1998). Similarly, across 76 other developed and developing economies, SMEs may account for close to 60 per cent of manufacturing employment; in some cases, the ratios are equivalent to the entire workforce (Ayyagari, Beck and Demirgüç-Kunt, 2007). The case for an important SME-economic activity link is documented and argued in numerous other studies (e.g. Havas, 2002; Klapper, Luc and Raghuram, 2006). In essence, the SME sector has come to be regarded as the "engine of economic development" (Beck and Demirgüç-Kunt, 2006).

On the other hand, across countries, the SME sector appears to be considerably capital constrained as well; not only do SMEs face higher financing obstacles compared with larger firms, the effect of such constraints appears stronger compared with larger firms (e.g. Beck, Demirgüç-Kunt and Maksimovic, 2005; Beck and others, 2006). In view of their economic significance on one hand and perceived/documented financing constraints on the other, a spate of research has naturally attempted to examine and better understand the nature and extent of such constraints from both the demand and supply perspectives.

While studies on the financing constraints of SMEs have spanned many countries and regions, little systematically documented literature appears available on the subject in the case of the Pacific island economies, a socioeconomically disadvantaged subregion, vulnerable, small island developing States (SIDS) and least developed countries in dire need of economic activity and growth;[1] the Pacific island economies tend to be excluded even from otherwise extensive cross-country studies, such as one by Beck and others (2006), which covers as many as 80 developed and developing countries around the world. Furthermore, economies that fit the foregoing description are likely to have relatively small SME sectors (Snodgrass and Biggs, 1996; Cull and others, 2006). For such economies then, while understanding and addressing the financing constraints of SMEs would indeed be useful, apparently, it would be equally useful to better understand the reasons for the smaller SME sector itself.

Intuitively, it would be financing constraints that in the first place prevent micro and smaller enterprises (MSEs) from expanding and growing into SMEs; as detailed below (section II), in this study, MSEs include registered, licensed, formal enterprises only. Indeed, as Evans and Boyan (1989) point out, lack of access to credit services is

[1] Pacific countries have historically received sizeable amounts of aid from the international community, including the Asian Development Bank and the World Bank and countries such as Australia and France, leading to the argument for that there is little urgency in domestically driven economic activity; however, on the other hand, there is also visible evidence of efforts to improve local living standards via many government-driven reforms and policies.

likely to be an important impediment for starting up a microenterprise and for sustained growth. Accordingly, in the case of economies such as those in the Pacific, in addressing the problems of the SME sector, it appears imperative to also obtain an in-depth understanding of the problems of the MSE sector, which is precisely the purpose of the present study.

This study uses Fiji as a Pacific case study. A number of authors have used Fiji as a representative of the region (e.g. Sharma and Nguyen, 2010; Sharma and Gounder, 2011); among other reasons, Fiji affords expediency in data collection and availability, and the presence of official definitions of enterprise size tends to make Fiji a practical choice in Pacific regional studies. Moreover, Fiji is the second largest country in the subregion in terms of population, and it has a relatively more advanced economic and financial structure. Conceivably, the experience of MSEs elsewhere in the subregion is not likely to be better than Fiji's. In the light of the findings that formal external financing options for firms in Fiji may be extremely limited to bank finance, which in turn appears to be relatively inaccessible (Sharma and Brimble, 2012), this study attempts to understand the following regarding the operation and growth of MSEs in Fiji: (a) the importance of bank finance; and (b) the drivers and obstacles to bank finance. Thus, this study provides a *demand-side* view of financing constraints to the MSE-SME transition; a *supply-side* view has recently been examined by Sharma and Gounder (2011), showing that the main suppliers – banks – may not in fact have a major problem providing the business sector in Fiji with credit.

In addition to filling the above-mentioned void in the literature, our study makes other important contributions. By using survey data on an enterprise's perceived as well as actual financing constraints, we avoid having to imperfectly infer financing constraints from secondary data as some studies have attempted, including those by Fazzari, Hubbard and Petersen (1988) and Kaplan and Zingales (1997). Thus, we are able to assess more accurately the financing constraints of MSEs in Fiji. Moreover, since our survey includes both non-borrowing as well as borrowing enterprises, we are able to evaluate perceptions against actual experiences.

Contrary to the claims of the "pecking order" theory (e.g. Myers, 1984; Holmes and Kent, 1991), our analysis shows that MSEs in Fiji do have a preference for bank finance. At least 50 per cent of the surveyed enterprises had a bank loan and for every single enterprise surveyed, both borrowing and non-borrowing, young and old, bank finance was considered to be a very important source for operation and growth, second only to founders' own capital. For MSEs of any age, preference is not necessarily confined to insider finance. However, costs and certain terms and conditions of borrowing keep these enterprises away from banks; those with current credit contracts may have no other option.

The rest of the paper is organized as follows: section II reviews the extant literature on definitions, significance and financing constraints relating to the MSE-SME transition; section III provides a discussion of the MSE sector in Fiji and the Pacific; section IV discusses the survey; section V presents the results; and section VI contains policy implications and concludes the study.

II. FINANCING THE MSE-SME TRANSITION

Definitions and significance of the study

A micro/small enterprise is commonly defined as one with up to five (or six) employees (Snodgrass and Biggs, 1996; Cull and others, 2006). Often also, these may include unregistered and informal enterprises,[2] but in this study a micro/small enterprise is defined as a registered, licensed, formal business, capable of running a self-funded operation and qualified to obtain a commercial bank loan. Our definition does not include those whose founders or prospective entrepreneurs have little or no resources to invest in the establishment and operation of the business or those not eligible for a bank loan. An SME, on the other hand, could be an enterprise with up to 250 employees – a definition used in 54 of the 76 developed and developing countries studied by Ayyagari, Beck and Demirgüç-Kunt (2007),[3] or one with annual sales between $200,000 and $4 million (small; average midpoint, $2 million) and $2 to $16 million (medium; average midpoint, $9 million) – a definition used commonly by banks across 45 developed and developing countries (Beck, Demirgüç-Kunt and Peria, 2008). Aside from this definition, SMEs are generally regarded as formal enterprises.

While the debate on causality remains unresolved, a large body of literature shows that SMEs matter for a country's economic growth and development; proponents and policymakers are so convinced of this that the sector is widely regarded as the "engine of economic growth and development".[4] The proponents of the SME-economic growth argue that (a) SMEs enhance competition and entrepreneurship; (b) SMEs are more productive than large firms; and (c) SME expansion boosts employment more than the growth of large firms. On the other hand, numerous studies also have found the sector to be considerably capital constrained, to the extent that inadequate financial resources may well be a primary cause of failure (Van Auken and Neeley, 1996; Coleman, 2000).

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2 For more detail, see www.microenterpriseworks.org.

3 According to this study, the cut-off could actually range from 200 to 300 in some cases; for most, 250 is the cut-off. For example, in African countries, the cut-off is 200 and in Japan it is 300.

4 See Beck and Demirgüç-Kunt (2005) and references therein for a review of different views.

While accepting its economic significance on one hand and appreciating its generic financing constraints on the other, Governments around the world have assumed the responsibility of providing and facilitating financial assistance to the SME sector. A common strategy has been the partial credit guarantee (PCG) scheme. Designed to expand lending to SMEs, a PCG is essentially a risk transfer and diversification mechanism for lowering the risk to the lender by substituting part of the counterparty risk by the issuer, which guarantees repayment of part of the loan in case of a default (Beck and others, 2010). Multilateral organizations such as the World Bank strongly support government efforts to assist local SME sectors. The Bank itself allocates billions of dollars to support SME programmes worldwide; more than $10 billion over the period 1998-2002 and $1.3 billion in 2003 alone have been allocated (World Bank, 2002; 2004). The Bank is also actively involved in assisting Governments design strategies for alleviating financing constraints of SMEs.

In the light of the foregoing it would appear that, for economic growth and development, a reasonably large and vibrant SME sector would be highly desirable, especially for underprivileged economies such as those in the Pacific, which characteristically appear to have smaller and less vibrant SME sectors. Size and vibrancy in turn require, inter alia, that start-up, micro and smaller firms are able to "transit" to the next stage – into SMEs; however, financing constraints may yet again prove to be a major obstacle.

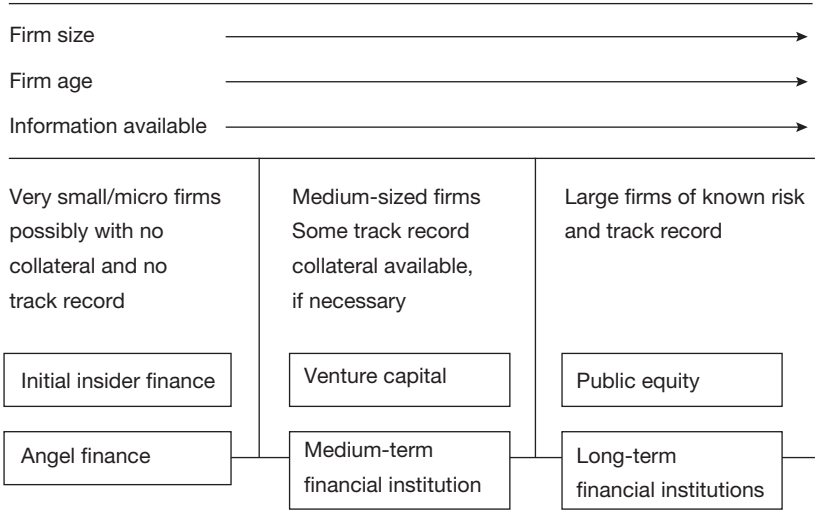
Growth stages, constraints and transitions

Despite some criticisms, life cycle or stage models offer a valuable framework for systematically understanding the lifespan of a business enterprise (e.g. Galbraith, 1982; Kazanjian, 1988). (For comprehensive reviews of stage models, including criticisms, see McMahon (2010) and Davidsson, Achtenhagen and Naldi (2005)). An oft-cited growth model in the literature is one proposed by Greiner (1972), who claims that firms pass through five distinct and distinguishable phases of development. The Hanks and others (1993) model has also received a lot of attention in the literature. Based on a comprehensive review of previous major models, including the Greiner model, Hanks and others (1993) propose four stages: (a) start-up – young, small enterprises with simple organizational structures; (b) expansion – slightly older and larger enterprises with more complex organizational structures; (c) maturity – larger enterprises than in the previous stage with more complex structures; and (d) diversification – the highest level of entrepreneurship.

Essentially, stage models commonly propose that enterprises "transit" gradually from one stage to another such that most, if not all, firms do start small. However, the models also claim that the transitional process can often be highly challenging – firms experience typical problems of a particular stage of growth; those able to resolve the problems are usually able to transit to the next stage, but others may be forced to exit the business environment altogether or remain ever small. This phenomenon appears well articulated by Berger and Udell (1998), a financial growth model to which the literature frequently refers. The authors propose a three-stage firm growth model: very small; medium-sized and large firms (figure 1).

As figure 1 illustrates, according to this model, the transition from the very small to the large firm stage is determined largely by access to "confined" sources of finance. For example, in the case of a very small firm, survival and transit to the medium-sized stage would be determined importantly by the availability and the firm's accessibility to insider finance (founder capital, trade credit, etc.) and so-called angel finance. Thus, in the absence of "angels", a very small firm can rely only on insider finance; the model predicts that at this stage, external debt, such as a bank loan, is highly unlikely due mainly to the firm's size, age and operational opacity.

Figure 1. Financial growth cycle



Source: Model adapted from Berger and Udell (1988).

Firm characteristics vis-à-vis financing constraints

The claim of Berger and Udell (1998) that size and age limit a firm's access to finance has been contested by other researchers. Gregory and others (2005), for example, find that size may be merely an indicator in decisions relating to selecting between insider financing and longer-term debt/public equity (LTD/PE), and may not even predict the use of venture capital/medium-term debt (VC/MTD) versus LTD/PE. The authors also show that younger, not older firms, contrary to the proposal of Berger and Udell (1998), are more likely to use PE/LTD than VC/MTD; the paradox can be explained perhaps by the lack of adequate growth in older firms. Birch and others (1999) agree that it is the younger growth firms that may be able to secure the more attractive financing forms. Unlike the case of their larger counterparts, financing for smaller enterprises is anything but standardized; funding sources for small enterprises may range from internal injections to debt financing. Gregory and others (2005) contend that, since small enterprises may be characteristically different, predicting financing sources based on firm characteristics may not be very useful. Essentially, the study by Gregory and others (2005) demonstrates that enterprise growth cycles cannot be collapsed into a universal model; indeed Berger and Udell (1998) admit that their model may not fit all types of small businesses.

Financing constraints and the MSE-SME transition

Notwithstanding the debate on firm characteristics vis-à-vis financing constraints, the MSE-SME transition is likely to be importantly constrained by the lack of access to external finance (Beck, Demirgüç-Kunt and others 2005; Beck and others, 2006). In a worldwide survey of 80 countries and 10,000 executives, Schiffer and Weder (2001) showed that smaller firms reported higher levels of growth obstacles compared with medium or larger firms. A 2002-2003 World Bank survey confirms that large firms generally have greater access to bank credit compared with smaller firms, which are compelled to depend largely on internal funds and retained earnings for survival and growth.[5] Arguably, a number of factors, including "relationship lending", based primarily on "soft" information gathered via extensive laborious and costly processes to mitigate opacity problems, perceived diseconomies of scale and lower profitability opportunities might discourage banks from lending to smaller firms (e.g. Beck, Demirgüç-Kunt and Peria, 2008).

The survey also shows that the level of access to external finance may differ across countries – the share of small firms with no external finance ranged from 19 to

[5] See http://research.worldbank.org/ics/jsp/index.jsp. The survey included 38 developing countries across Europe, Asia, Africa and Latin America.

73 per cent. Similarly, Beck and others (2006) found, in a study spanning 80 countries and 10,000 firms, that there was a 39 per cent probability that a small firm would rate financing as a major obstacle (as opposed to minor, moderate, or no obstacle) compared with 38 per cent for medium and 29 per cent for large firms. Further, compared with large firms, small firms finance, on average, 13 percentage points less of their investments with external finance.

More recently, Beck, Klapper and Mendozae (2010) noted that, while domestic credit to the private sector has generally been increasing in most developing countries, anecdotal and statistical evidence suggest that smaller enterprises continue to be largely left out. The higher financing obstacles reported by smaller firms across developing and developed economies is consistent with both anecdotal evidence as well as the theory's predictions. Smaller firms typically need smaller loans, but greater opacity and collateral problems usually translate into higher risk premiums. Consequently, smaller firms grow much more slowly, if at all (Beck, Demirgüç-Kunt and Maksimovic, 2005).

While these studies confirm that smaller firms may have more difficulties in accessing external finance, they do not per se show nor suggest that smaller firms are completely deprived of external finance. In this respect, a large number of studies have also attempted to examine and understand the reasons for the lower degree of access to external finance by smaller firms. Our study explores the financing situation of MSEs in the Pacific, a sector and subregion largely ignored in the literature to date; even wide cross-country studies appear to have missed out on these economies. The study examines, from a demand perspective, the drivers and obstacles to *bank* finance - the overwhelmingly dominant form of external financing option for enterprises in Fiji.

III. THE CONTEXT OF THE STUDY: MICRO AND SMALL ENTERPRISES IN THE PACIFIC

According to the classification of the Secretariat for the Pacific Community, the Pacific subregion comprises, among others, Cook Islands, Fiji, Guam, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu and Vanuatu.[6] According to ESCAP, these economies also fall into a group of "countries with special needs"; more specifically, they are categorized as small island developing States (SIDS); some,

[6] For a full list of countries and territories in the region, see www.spc.int/en/about-spc/members.html and table A.1 in the annex.

including Kiribati, Samoa, Solomon Islands, Timor-Leste, Tuvalu and Vanuatu, are also classified as least developed countries.[7]

A small island developing State is typically an economy with a narrow resource base; small markets; heavy reliance on a few external and remote markets; high costs of energy, infrastructure, transportation, communication and servicing; little resilience to natural disasters; fragile natural environments; and limited opportunities for the private sector.[8] Similarly, a least developed country is an economy characterized typically by extreme poverty, structural economic weaknesses, lack of capacity to grow, acute susceptibility to external economic shocks and natural and man-made disasters. Generally, these economies together are also classified by the World Bank as "lower middle income" economies; table A.1 in the annex provides more information on their characteristics.

Against this backdrop, across the Pacific, it would not be hard to imagine a private sector comprising numerous MSEs, few large companies and a small SME sector; essentially, a fairly different size distribution of firms compared with developed and larger developing economies – a point made also by Snodgrass and Biggs (1996). In Samoa, for example, apart from some State-owned enterprises and a few large private companies, enterprises are usually micro, small or medium-sized. MSEs remain small for relatively extended periods of time. Most enterprises that start small also tend to stay small, with only a few graduating to medium or large size (UNCTAD, 2001).[9] Moreover, MSEs are not only important for growth and development in the Pacific but across Asia as well. Despite a lack of official statistics, available data show that in some countries up to 93 per cent of establishments in the manufacturing sector operate with fewer than five workers.[10] In fact, in some cases, such as Kiribati, Samoa, Solomon Islands, Tonga and Vanuatu, a generally held perception that most, if not all, enterprises are small or medium-sized has resulted in no official classification of enterprises.

However, lack of access to finance for MSEs is likely to be a deeper problem in these economies, resulting, among other things, in a relatively small SME sector. Indeed, AusAID's *Pacific 2020* report highlights that "credit (in the Pacific) is difficult or

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7 See www.unescap.org/pdd/about_csns.asp.

8 See www.unohrlls.org/en/ldc/25/.

9 It may be noted here that in the Pacific, considerations other than mainly profit maximization, such as social considerations, could be a reason for this, among others.

10 For further details, see http://beta.adb.org/publications/key-indicators-asia-and-pacific-2009?ref=countries/cook-islands/publications.

impossible to obtain for all but the largest businesses" (AusAID, 2006). Credit appears to be available only at affordable cost conditional upon acceptable collateral; for start-up firms as well as existing businesses with a good track record, collateral requirements may severely limit access to credit, and can raise the cost of borrowing to unaffordable levels – possibly, the problems could be compounded by foreign-based criteria for credit assessments applied by the mostly foreign, mainly Australian, banks in the subregion. To understand the financing problems of MSEs in the Pacific, we use Fiji as a case study.

The official definition of a micro enterprise in Fiji is one adopted by the Reserve Bank of Fiji (RBF), and includes the following: a "microenterprise" is one with a turnover or total assets not exceeding 30,000 Fijian dollars ($16,000 equivalent) and employs not more than five employees. Similarly, SMEs are defined as follows: (a) a "small enterprise" is one with a turnover or total assets between FJD 30,000 and FJD 100,000 ($55,000) that employs between 6 and 20 employees; and (b) a "medium enterprise" as one with a turnover or total assets between FJD 100,000 and FJD 500,000 ($272,000) that employs between 21 and 50 employees (RBF, 2009).

Apparently, the scaling is much smaller in the case of Fiji and across the rest of the Pacific – a direct reflection of the size of the economies – small island States – attributes that make this study interesting and useful. While the microenterprise definition based on number of employees appears more or less consistent with the definition used elsewhere, that of an SME is very different; the 250 employee cut-off (Ayyagari, Beck and Demirgüç-Kunt, 2007) or the annual sales (Beck, Demirgüç-Kunt and Peria, 2008) definitions of an SME used in a number of other countries may well define a large enterprise in the case of Fiji.

Formal external finance for MSEs in Fiji is likely to be synonymous with bank finance (Knapman and others, 2001; Sharma and Nguyen, 2010; Sharma and Brimble, 2012). Further, it appears that financing the private sector may not generally be a major problem for banks (Sharma and Gounder, 2011). However, it also appears that banks may not be interested in financing all types of firms; MSEs in particular may be a disadvantaged sector, which, according to the extant literature, is not surprising. Official schemes to alleviate financing constraints of MSEs in Fiji include a requirement by RBF, effective January 2010, that regulated commercial banks have in place separate "microfinance units" to focus on providing "a broad range of financial services such as deposits, loans, payments services, money transfers and insurance to .... micro and small enterprises" (RBF, 2009). In doing so, banks are expected to "work closely with the community, its leaders and potential clients and identify opportunities for extending financial services to MSEs and assisting their businesses".

In managing the microfinance-related operations, banks are expected to even adapt their systems and lending procedures, including creating separate systems, products, loans procedures, staffing policies and governance necessary to achieve the goals of the scheme. Specifically, banks' microfinance units are expected to, among others:

(a) Introduce appropriate products and services to better fit micro and small enterprise clients;

(b) Locate other points of service in areas best suited for offering microfinance products and services, and utilize part-time and mobile branches where demand does not warrant a full-time, fixed branch;

(c) Change prices (e.g. interest rates charged on different loan products);

(d) Pursue other initiatives for the achievement of the microfinance unit's core objectives.

In monitoring the requirements of the scheme, RBF requires banks to submit regular reports demonstrating how they have endeavoured to fulfil the requirements of the scheme, including the number and value of new and total loans to MSEs per reporting period (quarterly). These reports are expected to be aligned with other report items submitted to RBF, which also monitors the deposit activities of MSEs. However, while data on a broad range of bank loans and deposit activities are publicly available, those on deposit and loan activities relating to MSEs do not appear to be publicly available yet.

IV. THE SURVEY

The data for this study were gathered via an opinion survey of MSEs in Fiji. Given that banks are the main, and usually sole, source of external finance for these enterprises, the questionnaire was designed to capture views of respondents on obstacles to *bank* finance. It may be that an MSE may or may not have a bank loan; accordingly, questions were designed to capture views relating to both possible situations. To determine if a respondent had a bank loan or not, we asked the question: "does your business have a loan with a bank?" A "yes" response directed the respondents to a particular set of subsequent questions where opinion was sought on issues relating to having a loan or applying for more loans. Specifically, participants were asked to respond to the following overall question: "do you consider any of the following to be a problem with your current loan or in applying for more loans?",

followed by a list of possible problems, including costs, collateral and disclosure requirements; these are commonly included in studies examining financing obstacles (e.g. Beck and others, 2006)

Where the answer to the question: "does your business have a loan with a bank?" was "no", the respective respondent was directed to a different set of subsequent questions; in addition to a "yes" or "no" option, respondents could also decide not to participate in the survey any further by taking a third option, "not relevant". In this case, the intention was to understand the reason(s) for not having a bank loan; specifically, the question asked was: "if you do not have a bank loan, is it because or due to...." followed by a list of possible reasons, including, self-exclusion, lack of information, unfamiliarity with banks, and loan processes and procedures, and costs. To guard against the bias of respondents, more than one question was created for a particular response. The question was phrased in different styles and consistency of answers was checked to ensure the responses were unbiased.

In responding to the specific questions in relation to either situation, as described above, respondents were asked simply to select the choice that best expressed their response from a pre-determined set of options, confined to "yes", "no", or "maybe" with an option also of not answering a question if it was not relevant or the respondent was not sure of the response. As required by Griffith University's Ethics Committee, respondents were conspicuously advised that the interviews and data processing would be strictly confidential, that their anonymity would be safeguarded at all times and that only aggregate results would be published; these assurances considerably facilitated the data gathering exercise – respondents felt practically unconstrained in sharing their views.

In addition to the above, the survey endeavoured to ascertain the importance of bank loans, relative to other sources, for the operation and growth of an MSE. Respondents were asked to rate, on a scale of 1 (not important) to 7 (very important), the importance of a number of sources of funds expected to be used by MSEs in developing economies, including founder's capital, loan/equity from family/friends, trade/other creditors, money lenders, bank/non-bank finance and retained earnings.

Recognizing that enterprise characteristics may influence external funding opportunities, an attempt was made in the survey to obtain information also on such issues as business type/sector, date of incorporation, place of business, number of employees, ownership type, ethnicity of founding owners and education level of main owners/managers. Opacity and information asymmetries are likely to be particularly large for young and newly established enterprises compared with older and more established ones as they may not have had sufficient time to develop the desirable

long-term relationship with banks for financing purposes (Gertler, 1998).

In total, we obtained complete and valid data on 77 enterprises operating in the wider capital city area of Suva and neighbouring business areas. Of the 77, most turned out to be owned by people of Indian ethnicity (69 per cent); this is hardly surprising as it is common knowledge that the Indian community dominates commerce in Fiji. What is surprising though is that almost half (45 per cent) of those interviewed had tertiary education, with the rest (55 per cent) having at least secondary education. Of the enterprises surveyed about 44 per cent turned out to be relatively new (up to 5 years old); 39 per cent were 6 to10 years old; 17 per cent 11 to15 years old and one was more than 15 years old. All of the surveyed enterprises had up to five employees.

V. RESULTS AND DISCUSSION

Importance of bank finance

To understand the importance of bank finance relative to various other sources, we asked the question: "on a scale of 1 (not important) to 7 (very important), how would you rate the importance of (the listed) sources of funds for the operation and growth of your business?", where the term banks included Australia and New Zealand Banking Corporation Limited; Bank of Baroda; Bank of South Pacific Limited; and Westpac Banking Corporation Limited, that is, all banks in Fiji. Overall, founders' own capital appears to be a very important source of finance; the average score here was 7.00, or very important for each and every enterprise surveyed. The next more important source appears to be retained earnings; the average score here was 6.94, almost on par with founders' capital, followed by trade creditors at 6.73. Although ranked as the fourth (out of nine) most important source overall, the average of 6.61 indicates that bank finance is also regarded as a relatively important source of finance for MSEs. For fully three quarters of the enterprises, bank finance was very important (score of 7); if we include the score of 6 in the very important category, the proportion of enterprises indicating bank finance as very important jumps to an astounding 97 per cent. Thus, by and large, bank finance is a relatively important financing source for MSEs in Fiji.

In the light of this observation, the above-mentioned results indicate that having a bank loan or not does not materially influence an enterprise's opinion regarding the importance of bank finance for the operation and growth of business; bank finance appears to be important regardless. Further, 77 per cent of those currently without a bank loan indicated that they would borrow from a bank if they could. These findings lead to the questions of (a) why may many MSEs be without a bank loan; (b) can the

experience of those currently with a bank loan be used to encourage those without, to obtain a bank loan; and (c) what would be the implications of answers to the foregoing for economic activity?

Why are many microenterprises without a bank loan?

To understand why an enterprise may not have a bank loan even when a bank loan is considered relatively important regardless, we asked respondents a set of questions compiled via a review of the literature; about 22 possible reasons were listed.

Table 1. Responses of respondents to the question: "if you *do not* have a bank loan, is it because or due to (list provided)"

Panel A

Response	Interest (percentage)	Fees (percentage)	Collateral (percentage)	Paper (percentage)	Disclose (percentage)	Contribute (percentage)
Yes	91.89	90.19	94.59	94.59	91.89	91.89
No	0.00	2.70	0.00	2.70	0.00	2.70
Maybe	8.11	8.11	5.41	2.70	8.11	5.41
Not sure	0.00	0.00	0.00	0.00	0.00	0.00

Panel B

Response	Get loan (percentage)	Loan type (percentage)	Apply (percentage)	Info (percentage)	Repay ((percentage)	Refused (percentage)
Yes	27.03	10.81	5.41	16.22	8.11	21.62
No	72.97	89.19	94.59	81.08	89.19	78.38
Maybe	0.00	0.00	0.00	2.70	0.00	0.00
Not sure	0.00	0.00	0.00	0.00	2.70	0.00

Panel A of the table shows that most respondents (over 90 per cent) were concerned with interest rates, fees and charges, collateral, paperwork, disclosure and own contribution requirements in obtaining a bank loan. For example, 91.89 per cent were concerned with the level of interest rates.

Panel B of the table shows that, on the other hand, most respondents were not too concerned that they would not be able to get a loan (get loan), knew what loan type they required (loan type), knew how to apply (apply), could collect the required information (info) and did not appear to have major concerns regarding the repayment process (repay). For example, only 5 per cent were not sure how to apply and 8 per cent were not sure about the repayment process.

It is clear from the responses obtained that the surveyed enterprises currently without a bank loan are concerned mainly about the banks' collateral, paperwork, disclosure and own contribution requirements, interest, and fees and change; with respect to each of these, more than 90 per cent of the responses was an emphatic "yes" to the question: "if you do not have a bank loan, is it because or due to (list provided)". In the case of interest rates, collateral and disclosure, every single respondent believed that these were unreasonable. Approximately 3-8 per cent of the respondents appeared undecided on paperwork, own contribution and fees and charges; where a "no" response was recorded, these constituted very small proportions – only about 3 per cent did not believe that fees and charges, paperwork and own contribution were unreasonable (table 1, panel A). Other issues of concern related to terms and conditions of bank credit (83 per cent) and repayment schedule/method (81 per cent).

On a positive note, the surveyed enterprises without a bank loan appeared relatively knowledgeable and optimistic about getting into a credit contract with a bank. For instance, only 5 per cent appeared to have difficulties in applying for a loan. Similarly, only about 11 per cent appeared to be ill-informed about the type of loan for which they would like to apply (table 1, panel B). Further, 16 per cent indicated they would have trouble gathering the required information. About 27 per cent had doubts about being successful in obtaining a loan if they applied. Past refusal did not appear a major deterrent; only 21 per cent may have been refused a loan in the past.

The experience of microenterprises *with* a bank loan

Our analysis shows that many of the surveyed enterprises would like to borrow from a bank for the operation and growth of their businesses but adverse perceptions regarding loan requirements and cost structures appear to keep them away from banks. It is possible that these perceptions are not valid, and that the actual

experience of those with a bank loan may be different and positive, which could be used to encourage enterprises without a loan to borrow. Accordingly, this section analyses the experience of the surveyed enterprises currently *with* a bank loan.

With respect to the major perceived concerns of the enterprises without a bank loan, it appears unlikely that the experience of those with a bank loan would be of much help; the perceptions of the former may, in fact, be valid. Of the surveyed enterprises with a bank loan, every single respondent considered interest rates to be problematic; the answer to the question: "if you have a bank loan, do you consider (interest rates) to be a problem with your current loan or in applying for more loans" was an emphatic "yes" for fully 100 per cent of the respondents (table 2). Equally concerning were banks' disclosure requirements; again 100 per cent of the respondents considered this to be a problem. Collateral and paperwork requirements also seem to be major problems; in both cases, while less than 100 per cent, i.e. 97.5 per cent considered these to be problematic, none of the respondents believed that they were not problematic – the others (2.5 per cent) were undecided.

Among other major concerns were own contribution requirements (95 per cent) and fees and charges (90 per cent); the remaining respondents (5 per cent and 10 per cent, respectively) were undecided, i.e. again none considered these to be trouble-free. Moreover, the practical experiences of the borrowing enterprises regarding some other issues appear also not to be very encouraging. For instance, 75 per cent indicated that complying with the terms and conditions of the loan was constantly challenging and 65 per cent were unhappy with what they described as very rigid repayment policies; only 5 per cent and 22.5 per cent, respectively, did not agree. Also, at least half of the borrowers believed that the attitude of banks was not desirable.

Table 2. Responses of respondents to the question: "if you *have* a bank loan, do you consider the following to be a problem with your current loan or in applying for more loans (list provided)"

Response	Interest (percentage)	Fees (percentage)	Collateral (percentage)	Paper (percentage)	Disclose (percentage)	Contribute (percentage)
Yes	100.00	90.00	97.50	97.50	100.00	95.00
No	0.00	0.00	0.00	0.00	0.00	0.00
Maybe	0.00	10.00	2.50	2.50	0.00	5.00
Not sure	0.00	0.00	0.00	0.00	0.00	0.00

As the table shows, those with a bank loan have or may have greater concerns regarding interest rates, fees and charges, collateral, paperwork, disclosure and own contribution requirements in obtaining a bank loan. For example, every single respondent (100 per cent) indicated that interest rates were a concern, compared with 92 per cent of those without a bank loan (see table 1, panel A).

Additional analysis: regression results

In addition to the above analysis, we conducted a regression analysis of the determinants of bank loans. Since the respondents included both enterprises with and without a bank loan, we were able to utilize a discrete choice model to determine the factors that may be significant in explaining the chance of getting a loan. Thus, to examine if business characteristics, such as age, ownership (family or non-family) and founder's ethnicity, might have any significant influence on perceptions, we ran a regression using the following probit model:

$$y^*_i = x`_i \beta + \varepsilon_i$$

where, y^*_i is the unobserved latent variable, $x`_i$ is a set of observed characteristics, and ε_i the unobserved characteristics. The dependent variable y^*_i is a discreet variable that represents a choice from a set of mutually exclusive choices. The probit model is a popular tool for explaining binary choice decisions, such found as in our survey.

In tables 3 and 4, DATE represents the year of incorporation of the firm; EDUC equals 0 if the firm's owner/manager obtained a primary education, 1 for a secondary education and 2 for a tertiary education; NON-FIJIAN is a dummy variable which equals

1 if the founding owner is non-Fijian and 0 otherwise; and FAMILY-OWNED is a dummy variable which equals 1 if the firm's ownership type is family-owned and 0 otherwise.

The results from the binary probit regressions are shown in table 3. The only variable which is significant (at the 5 per cent level) is the type of ownership (FAMILY-OWNED). We checked the robustness of the results through binary extreme value regressions. The results from binary extreme value are shown in table 4. The sign and significance of the variables remain the same, except that the FAMILY-OWNED variable is now significant at the 10 per cent level. These results suggest that non-family-owned businesses are likely to be relatively more disadvantaged when applying for a loan, i.e. the probability of not getting a loan for this group may be higher. One possible reason for this result could be that family-owned businesses may be able to provide family assets as collateral to enhance the chances of getting a loan.

Table 3. Binary probit

Variable	Coefficient	z-Statistic	Prob.
Constant	-1.970791	-1.853820	0.0638
DATE	-0.190641	-0.966116	0.3340
EDUC	-0.229862	-0.943473	0.3454
NON-FIJIAN	0.276028	1.156788	0.2474
FAMILY-OWNED	1.426407	2.035871	0.0418
McFadden R^2	0.078469		
No. of firms	77		

Table 4. Binary extreme value

Variable	Coefficient	z-Statistic	Prob.
Constant	-2.241803	-1.489235	0.1364
DATE	-0.176159	-0.799731	0.4239
EDUC	-0.302731	-1.028828	0.3036
NON-FIJIAN	0.329087	1.088199	0.2765
FAMILY-OWNED	1.910078	1.684370	0.0921
McFadden R^2	0.076984		
No. of firms	77		

VI. POLICY IMPLICATIONS AND CONCLUSION

The wide acceptance that the SME sector matters for economic growth and development and the findings at the same time that the sector may be considerably capital-constrained has resulted in many single and cross-country studies examining the nature and extent of such constraints from both the demand and supply perspectives. However, little systematically documented literature appears available on the subject in the case of the Pacific, a socioeconomically disadvantaged subregion, with vulnerable, small island developing States and least developed countries in dire need of economic activity and growth. Furthermore, economies that fit the foregoing description are likely to have relatively small SME sectors. For such economies then, while understanding and addressing the financing constraints of SMEs would indeed be useful, apparently equally useful would be to better understand the reasons for the smaller SME sector itself.

The smaller SME sector in turn is a result of financing constraints that in the first place prevent micro and smaller enterprises from expanding and growing into an SME; an in-depth understanding of the financing problems of the MSE sector then is equally important, and is the purpose of this study. In this study an MSE is defined as a registered, licensed, formal business, with up to five (or six) employees, capable of running a self-funded operation and qualified to obtain a commercial bank loan; excluded are unregistered and informal enterprises and those founders or prospective entrepreneurs with little or no resources to invest in the establishment and operation of the business or those not eligible for a bank loan.

Fiji is selected as a representative of the Pacific island economies; the choice was influenced also by the expediency of data collection and presence of official definitions of enterprise size – many economies in the region do not have official definitions. Data were collected via a survey of 77 MSEs. In recognizing also that commercial banks would constitute the major source of external finance for MSEs in Fiji, the survey focused on financing constraints of these enterprises with respect to bank credit.

Of the surveyed enterprises, 97 per cent indicated that banks were a very important source of funds for the operation and growth of their businesses. Analysis of the data clearly shows that, for both enterprises with and without bank loans, the main concerns relate to banks' collateral, paperwork, disclosure and own contribution requirements, and interest and fees and charge. For example, in the case of those without a bank loan, with respect to each of the foregoing variables, more than 90 per cent of the responses was an emphatic "yes" to the question: "if you do not have a

bank loan, is it because or due to (list provided)". More interestingly, 90 per cent of those currently with a bank loan indicated that they would borrow from anywhere but a bank if they had a choice. The proportion of enterprises with or without a bank loan turned out to be about the same.

Does this indicate that these MSEs (and perhaps other firms) are stuck with banks? Perhaps they would like to terminate the contract but are not able to do so. We also note that founders' capital, retained earnings, creditors and loan from family/friends are, on average, relatively important sources of funds for both current bank borrowers as well as non-borrowers. Perhaps the non-borrowers do as much as they can with these internal sources of funds, i.e. any expansion to the business would have to be limited to available internal funds. Perhaps the more venturous would endeavour to seek funds from non-internal sources such as banks but expansion becomes constrained by adverse experiences.

While our survey is limited to only 77 MSEs and confined to a particular geographical setting, we believe that MSEs across not only Fiji but elsewhere in the Pacific subregion might have similar experiences, or possibly worse ones. An important implication of our findings then is that MSEs across the Pacific, with little track record, little or no "acceptable" collateral and little or no contribution to make towards the loan, would have considerable difficulty in obtaining finance from the formal financial sector. If banks are the main source of formal external finance, such as in Fiji, then many SMEs are likely to remain ever small and/or gradually die. More importantly, this would not help the MSE-SME transition. Accordingly, the SME-sector-stimulated economic activity for these economies is likely to be considerably limited, having adverse implications for economic growth, an issue already of major concern for these economies.

A number of policy implications emerge. Given the Pacific subregion's adverse geographic, demographic and other socioeconomic structures, financing the widely dispersed and sometimes isolated MSEs might create formidable challenges to any service provider. However, there would also be many MSEs which are more "reachable", such as those surveyed in this study. The latter group constitutes those located within a reasonable proximity to the local business centre. We provide policy suggestions for this group.

With respect to the "reachable" MSEs, banks, via their branch operations, may be required to provide affordable and suitable financial products, including credit to these enterprises. Requiring banks to allocate credit to a particular sector is not a new concept across the Pacific, including in Fiji; mandatory sectoral lending has been

used in the past to create jobs and enhance economic growth. In fact, a recent survey by the Consultative Group to Assist the Poor identified many banks and other financial institutions engaged in microfinance; many are entering the market attracted by sustainable profits and growth opportunities.

While existing and established branch networks, among others, give commercial banks a comparative advantage in reaching out to the more "reachable" MSEs, prudence requires that banks properly understand the underlying characteristics of the MSE market. Generally, banks may increase (voluntarily or otherwise) their involvement in the SME market directly or indirectly. Selecting the approach most suitable for the bank and the local circumstances is important, since each has a particular set of rational, risk profile, success factors and costs (CGAP, 2005).

Under the direct approach, a bank may form a specialized unit (an internal microfinance unit) to manage SME-related activities – the Fiji model; a bank may also form a separate legal entity (specialized financial institution) to undertake SME activities or it may form a non-financial legal entity (service company) to provide loan origination and portfolio management services. The indirect approach involves working with existing providers. Here, a bank may contract a credible monetary financial institution (MFI) to originate and service loans in return for an income (outsource retail operations, similar to outsourcing automated teller machine (ATM) transactions) or provide a term loan or line of credit to an MFI for working and/or lending capital (providing commercial loans to MFIs) or provide infrastructure and services to an MFI.

All of the above approaches are feasible and there are many examples of success. The success of the Fiji model is yet to be determined; the Reserve Bank of Fiji has not disclosed the rationale for selecting the direct, internal unit approach for the country. It may also be noted that the new regulations are likely to increase costs of banks, which in turn are likely to be passed on to customers. Perhaps there has been a need to better understand the MSE market, as this study highlights. Perhaps the banks need to work in partnership with existing MFIs, which have an extensive knowledge base and good rapport with the target clients. Perhaps, wider consultation in selecting the approach would have been useful.

The selection of the approach may indeed take into account an economy's specific financial, regulatory, economic and other structures and circumstances but, in alleviating the financing constraints of the MSE sector in the Pacific, including in Fiji, a banking-sector-led initiative appears workable and vital. While banks may voluntarily wish to take advantage of the opportunities in providing financial services to the sector,

the seriousness of the situation justifies mandatory involvement. Bank involvement implies developing products appropriate for the target clientele. Effective delivery in turn would require adapting systems and procedures and providing specialized staff training and incentives. Moreover, the vision and commitment of the bank management and board, and the regulator appear vital.

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ANNEX

Table A.1. Pacific island countries

Country	Capital	Land (sq. km.)	Population [year]	GDP ($) [year]	Political status
American Samoa	Pago Pago	199	67 242 [2011]	462.2 million [2005]	Dependent territory
Cook Islands	Rarotonga	236	13 200 [2009]	206.5 million [2009]	Freely associated state
Federated States of Micronesia	Pohnpei	702	110 000 [2010]	269.7 million [2009]	Freely associated state
Fiji	Suva	18 300	900 000 [2010]	3.3 billion [2011]	Independent republic
French Polynesia	Papeete	4 000	267 000 [2009]	5.6 billion	An overseas country within the French Republic
Guam	Agaña	544	183 286 [2011]	..	Dependent territory
Kiribati	Tarawa	811	100 000 [2010]	163.0 million [2011]	Independent republic
Nauru	Yaren	21	9 771 [2009]	55.0 million [2009]	Independent republic
New Caledonia	Noumea	18 600	245 580	8.9 billion [2010]	“Special collectivity”
Niue	Alofi	260	1 536 [2009]	15.8 million [2009]	Freely associated state
Northern Mariana Islands	Saipan	464	40 050	633.4 million [2000]	Dependent territory
Palau	Koror	458	20 397 [2009]	179.6 million [2009]	Freely associated state

Table A.1. ***(continued)***

Country	Capital	Land (sq. km.)	Population [year]	GDP ($) [year]	Political status
Papua New Guinea	Port Moresby	463 000	6.5 million [2010]	11.0 billion [2011]	Constitutional monarchy
Pitcairn Islands	Adamstown	47	48 [2011]	..	Dependent territory
Republic of Marshall Islands	Majuro	181	54 000 [2009]	161.7 million [2008]	Freely associated state
Samoa	Apia	2 944	187 000 [2010]	606.0 million	Independent republic
Solomon Islands	Honiara	28 900	500 000 [2010]	770.0 million [2011]	Constitutional monarchy
Tokelau	Administrative centres are located on each atoll	12	1 384 [2011]	..	Dependent territory
Tonga	Nuku'alofa	748	103 000 [2010]	378.0 million [2011]	Independent kingdom
Tuvalu	Funafuti	26	11 093 [2009]	32.0 million [2010]	Constitutional monarchy
Vanuatu	Port Vila	12 200	200 000 [2010]	767.0 million [2011]	Independent republic
Wallis and Futuna	Mata-Utu	142	15 398 [2011]	..	Dependent territory

Source: Adapted from Australian Strategic Policy Institute, *Our Near Abroad: Australia and the Pacific Islands Regionalism* (Australia, 2011). Available from www.aspi.org.au/publications/publication_details.aspx?ContentID=319 (accessed December 2011).