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## **FOLLOW UP SUMMARY**

# **THE SME FINANCING ROUND TABLE**

**ORGANIZED BY  
USAID/FINANCIAL SECTOR DEEPENING PROJECT  
ON JUNE 10<sup>TH</sup>**

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# The SME Financing Round Table

Organized by USAID/Financial Sector Deepening Project on June 10th

**Submitted by:**  
Financial Sector Deepening Project

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## EXECUTIVE SUMMARY

On June 10th the USAID Financial Sector Deepening Project (FSDP) in cooperation with Union of Banks of Armenia, SME Development National Center and other interested stakeholders organized a round-table discussion entitled “SME Financing in Armenia: Current Situation, Challenges and Opportunities”.

More than 60 well-known SME and financial market experts from different state bodies and various local and international organizations participated in the event.

Summarizing the main results of the round table on SME financing in Armenia, including presentations of all speakers as well as discussed findings and recommendations of all participants, this report describes the purpose of the round table event, the general environment in Armenia for SMEs financing and identifies certain existing challenges trying to propose certain key recommendations which might facilitate the whole process of overcoming the specified challenges. Further to the above, we can propose following generalized recommendations of the round table.

- It is mentioned necessity of development, adoption and implementation of Government Strategy related to SME assistance and development of concept and corresponding action plan. Also development/improvement of business climate and infrastructure.
- Highlighted the urgency of public policy and administration improvements in legal, judicial and regulatory systems to reduce the level of bureaucracy, corruption, monopolization in the economy.
- Declared crucial role of easing of the tax administration, accounting and reporting standards for SME finance development.
- Referred to the necessity of capacity building of financial institutions to overcome the lack of experience in SME financing and develop more appropriate financial tools (leasing, factoring etc.), particularly lower interests and longer durations, also provide guaranty or venture mechanisms to enable financial institutions to finance start-ups and newly established businesses.
- Mentioned necessity to attract through financial/donor organizations long-term financial resources and resources in Armenian Drams.



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- Emphasized necessity of more state support to SMEs, particularly state guarantees, subsidies and other supportive mechanisms (consultancy, market research, information sharing, etc.).

Stressed urgency of development of appropriate training on SME management, marketing, international trading and finance and providing (or financing) of consulting services for SME's



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## **PREFACE**

On June 10th the USAID Financial Sector Deepening Project (FSDP) in cooperation with Union of Banks of Armenia, SME National Development Center, Republican Union of Employers and other interested stakeholders organized a round-table discussion entitled “SME Financing in Armenia: Current Situation, Challenges and Opportunities” at Erebuni Plaza Business Center.

More than 60 well-known SME and financial market experts involved in the financial and real sectors of Armenian economy, experts and representatives from different state bodies and various local and international organizations dealing with SME financing and development issues, participated in the event.

During the first part of the event 8 speakers from different organizations made presentations on different aspects of SME financing. During the second part of the event participants discussed various issues related to SME needs for financial resources, SME access to finance and particularly to lending resources, current challenges, as well as existing opportunities, including all SME financing programs implemented by the government of Armenia and international organizations.

Taking into consideration current global economic and financial crisis and its influence on the economy of Armenia, as well as the important role of SME in development of the economy, increase of the employment rate and fighting of current financial economic situation, various recommendations and possible solutions have been proposed and discussed by representatives of different organizations.

Following the end of the round-table, USAID FSDP promised to summarize all presentations, challenges and recommendations and submit the summary of the event to all interested parties, as well as state organizations as a step forward in the establishment of a more favorable environment for SME financing in Armenia.



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## **I. INTRODUCTION**

This paper presents and summarizes the presentations, discussions and opinions of speakers and participants of the Round Table discussion and aims to summarize current situation in SME financing in Armenia, existing challenges, problems and opportunities for development.

Small and medium enterprises are the foundation for development of any national economy and Armenia is not an exception. The growth of a healthy, competitive SME sector is maximized when there is a strong enterprise culture in the society at all levels, maximum potential for growth of existing small businesses, and a highly supportive economic, social and stakeholder environment. The development of small business also depends significantly on society's attitude to small business and entrepreneurship. In recent years, the Armenian Government has started to actively encourage SME growth, in order to stimulate economic development.

An essential part of developing a sustainable SME environment is a legal framework that includes fully operating institutions to enforce laws. This allows for commercial growth by reducing unfair competition, providing stability and increasing trade opportunities. The legal system also ensures that SMEs have improved access to the funding that they need for investment and success.

## **II. SME IN ARMENIA**

Definitions of a SME can vary from country to country, based in part on size of economy and stage of economic development. According to Armenian law, the definition of SME is multilevel depending on the sector and is defined by number of employees. Thus, for industrial and production sectors, it shouldn't exceed 100 employees, for transport, trade and services- 30 employees, etc. In 2008, the Department of Statistics recorded 130,000 SMEs registered in Armenia, which comprise 98% of all legal entities and private entrepreneurs, and produce about 42% of country's GDP.

In Armenia, as in many other CIS countries, there are a number of challenges in the overall business operating environment which affect all economic agents and in particular SMEs. The major points of concern can be highlighted, as follows.



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**Political and legal environment** – The entire system is flawed, from initial drafting of laws to actually getting a ruling enforced. Enormous concerns are raised regarding the level of education and training of judges and court officials, interpretation of the Law, independence of the judiciary, corruption of justice, low capacity, and inability to enforce fair, binding and timely rulings. In such a setting, the population and especially MSMEs distrust the courts and prefer to operate in an informal fashion, avoiding government. There are few incentives for going legal.

**Unfair Competition** – Because of the high cost of compliance and strong tendency to operate informally, those SMEs that try to operate legally, if only partly, suffer from unfair competition: where a competitor is able, by bribery or fraud, to avoid the costs of complying with the laws and official rules and thus can undercut those who try to comply.

**Shadow Economy** – Most Armenian SMEs are having some legal operations and some in the shadows; few, if any, are wholly legal. The environment is not conducive to legalization. The Armenian economy is generally made up of very large concerns and micro, marginal enterprises, there is no real medium size enterprise segment. And those who are successful have political connections and protection.

**Access to Finance** – SMEs are typically owner-managed and started with funds from friends and relatives, and this limits their growth potential. Many donor programs have looked at bridging various gaps to increase SMEs' access to finance. This includes various SME lending programs, micro financing, credit organizations etc. However, lenders demand more collateral for loans and impose onerous bureaucracy and high costs, particularly on new SMEs and startups.

**Human Resources Development** – Armenia enjoys a relatively well-educated population, but the system fails to supply the skills necessary in a modern, market-driven economy. SMEs also rely on friends and family for their staffing needs, which can further constrain growth. Donor organizations, such as KfW, BFC, etc. are also working on providing various business skills, but usually lack coordination in their programs.

**Information** – SMEs have poor access to information, either because they do not know where to find it or because there are vested interests against their accessing information. Often, SMEs are limited in their vision, being concentrated on a single buyer or seller, or looking merely at



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their local market and one product or service. There is lack of industry analysis and other comparative data publicly available for SME.

**Government Communications** – There is no avenue for SMEs to voice their joint concerns or promote their joint interests. While there are various associations and SME supporting organizations, their activities are mostly fragmented and not coordinated. Government is generally deaf to business, except where personal connections exist. Government devises policy and laws in isolation, rarely consulting the community therefore failing to build understanding or support.

**Rural Specifics** – All the above factors worsen as distance from the center increases. In the regions, problems are also recorded with rural space security, rural infrastructure, and rural production information. With a combined population of 768,000, rural territory represents nearly 25 percent of the entire population of Armenia. Analysis of 38 accumulated actual municipal expenditures for 2008 showed that these communities spent nearly 7.5 billion AMD for goods and services, capital investments, and capital repairs. Much of this is provided by local vendors serving the municipality and most of these are small businesses. Required working capital and equipment financing can be financed through commercial banks. However, many of these SMEs have lack of access to financial means to improve and expand their services.

**Infrastructure** – Infrastructure is also a common problem and represents a significant burden to the supply chain. The highly urbanized and concentrated networks make those in the rural areas truly isolated. With poor roads, limited irrigation and often no power, these areas are disenfranchised and unlikely to develop.

### **III. SME ACCESS TO FINANCE**

SMEs, whether start-ups or existing entities, need either capital or access to working capital to be able to grow. Capital can be in the form of internally generated funds (such as profits or retained earnings in the company) or external funds such as a capital contribution of some type. Working capital can come from a number of sources, including loans, credit extended by suppliers, sale of assets, or internally generated profits.



Access to financial services, is defined as an absence of price and non-price barriers in the use of financial services. Improving access means improving the degree to which financial services are available to all at a fair price.<sup>1</sup>

In Armenia, numerous business representatives express as their primary concern that loans for working capital and new investment are difficult to get and that rates are too high. SMEs' primary source of funds usually comes from family or individual capital. This heavy reliance on personal sources of funding is in great part due to a perceived or actual inability to obtain affordable financing from banks, microfinance and credit institutions, leasing companies, and other institutions that provide loans or credit.

The community of financial institutions, however, claims that there are numerous lending programs in the market place to fund inventory, capital expenditures, and even start-up businesses. The major obstacles from the some lenders perspective are the lack of credit history, poor skills and know-how in SME funding and necessity to educate the public that financing is available.

Various international donor institutions, such as EBRD, World Bank, IFC, KfW, are currently collaborating with the local banks in Armenia to provide SME lending. There has also been increased competitive pressure, for example from one of the original micro-credit banks –

### Snapshot of SME Access in Europe

According to the SME Access to Finance Survey conducted in 2005 by Eurobarometer:

- SMEs are most interested in lower interest rates, less demanding guarantee requirements and simpler procedures for granting loans.
- Leasing or renting and overdrafts are the types of financing most frequently used by SMEs to finance their activities. Over 50% of the SMEs surveyed have already made use of leasing or renting and overdrafts.
- Banks are the financial institutions that SMEs have used most in order to obtain financing. Nearly 80% of the SMEs surveyed have used a bank for financing. Leasing or renting companies were used by around 25% of SMEs.
- A substantial minority of SMEs feel that the offers from the banks are not suited to their needs. 42% of the SMEs surveyed hold this view, but 50% disagree with it.
- The view that banks do not want to take risks in lending to companies is widespread among SMEs, with 71% of SMEs surveyed holding this view.
- SMEs are most likely to turn to banks when in need of information on financing. 45% of those surveyed firstly turn to banks when they look for information or advice on financing.

<sup>1</sup> Malhotra, Mohini, et al. 2006. "Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises," Washington, D.C. : World Bank.



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ProCredit. Thus, there is now some competition for SME loans, and at the same time some of the lenders have proven to the banks that these loans are profitable, and can spread the overall lending risk for a bank into a broader base.

On the demand side, specific borrowers' problems include:

- Long lead time between application and disbursement: decisions may take only couple days, but documents require up to two weeks, a long time in SME terms.
- Over securing of the loans: because of the lack of risk information, heavy collection costs in case of default and CBA stringency, banks are overly cautious and demand high collateralization; in some cases, this is done for consistency even when the project is sound and the borrower well known.
- SMEs often experience difficulty in obtaining information on financing programs and services and most SME borrowers are not skilled in the proper method of seeking a loan and supplying the bank with enough quality financial information and plans, also very often SMEs cannot afford consultancy services for efficient business organization.

On the supply side, Armenian banks and credit organizations lack a number of basic and critical tools to extending loans:

- The Credit Bureau in Armenia is still in its infancy, and in some cases it cannot ascertain the credit history of a borrower or potential borrower.
- In many banks loan officers and administrative staff are not trained and skilled in making SME loans.
- Poor risk valuation and loan pricing mechanisms hinder local banks and NBFIs to evaluate inherent risks (FX, etc.) and appropriately price the SME loans.
- Courts and procedures required to adjudicate lending disputes are sometimes corrupt, and almost always a very lengthy and costly method of enforcing the banks' rights.

### ***Supporting Start-up Businesses***

Most start-ups cannot afford to pay for support services, especially in developing and transition countries. They hope that their basic level of knowledge and their initial resources will be enough, however often it is not. There is a high risk of failure in start-up businesses, which could be mitigated with start-up support. Because SMEs cannot afford the services they need,



Governments worldwide often enter the market to subsidize information and training for businesses that cannot afford it. Besides this, numerous donor projects provide some kind of business advisory and training services to SMEs.

### ***Government support to SME***

In Armenia, SME Development National Center (SME DNC) of Armenia was established by Government in 2002 to promote a wide range of support services for startup businesses, encourage self-employment and SME opportunities in areas of social or economic concern, and target growth in new markets. These government supported activities lower the costs of obtaining the knowledge and skills necessary for success. SME Development National Center of Armenia's activities are targeted at:

- Ensuring a dialogue between SMEs and state
- Increasing efficiency and competitiveness of SMEs
- Ensuring availability of business development services for SMEs
- Expanding the financial opportunities for SMEs
- Promoting innovations and R&D activities of SMEs
- Assistance for establishment of new SMEs
- Supporting internationalization of SMEs' activities

#### **SME DNC: Success Story of One SME**

One of the success stories of SME DNC is the "Sourcio" IT company, that was established in 2005 based on Lycos Armenia staff with support and co-financing of Enterprise Incubator Foundation and USAID. Government of the RA adopted a decree on 19th of February 2009 to enable Ministry of Finance to realize crediting of "Sourcio" CJSC through SME Development National Center of Armenia from reserve fund of the state budget of RA, aimed at intervention on further expansion of the company



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## IV. SUMMARY OF CHALLENGES AND RECOMMENDATIONS

During the Round table discussion participants addressed number of issues and provided different recommendations that have been grouped as follows:

- Institutional level,
- Supply side,
- Demand side,

### A. CHALLENGES AND MAIN ISSUES

#### **Institutional/Policy Barriers:**

- *Absence of Government Strategy related to SME assistance and development concept and corresponding action plan:* uncoordinated and abrupt steps of government
- *Weak Judicial, Legal and Regulatory Frameworks and Lack of Property Rights:* legal and regulatory inefficiencies prevent the smooth development of the SME sector and unequal rights for all market players
- *Bureaucratic system:* bureaucratic barriers and lack of the enabling environment create different obstacles and risks for SME development
- *Corruption:* public and private sector corruption prevents the effective development of the SME industry
- *Monopolies:* unequal competition and strong concentration of certain industries prevent SME development.
- *Tax administration:* regular tax inspections are increasing time-cost of SME's spent on paper work
- *Accounting and Reporting:* In many cases MSME's are not able to comply with all accounting and reporting requirements
- *Market polarization:* production, services and markets have regional concentration, which inhibits SME development in certain parts of the country
- *Economic instability:* volatile economic situation, exchange rate and other fluctuations disrupt the effective development of the SME's
- *Business Infrastructure:* under developed and a weak business infrastructure is increasing direct and non-direct expenses of SME's and decreases their efficiency



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### **Supply-Side (Financial Institutions) Barriers:**

- *Financial sector inefficiencies:* lack of the appropriate financial tools (in terms of duration and price) and limited financing opportunities of financial institutions hinder the development of SME sector
- *Lack of expertise:* some of the local banks and other NBFIs lack appropriate expertise in SME lending
- *Reluctance to finance start-ups:* banks prefer to finance already operating companies rather than start-ups that cannot prove their financial solvency
- *Lack of transparency:* borrowers have 'black accounting' and are usually reluctant to disclose the actual figures to a financial institution
- *Lack of the financial history:* inability to forecast future cash flows and financial stability of SME's
- *Lack of industry analysis:* poor statistics and lack of the evaluation mechanisms for industry trends leads to inability to properly assess creditworthiness of the SME customers
- *Poor risk valuation and loan pricing mechanisms:* local banks and NBFIs often lack appropriate expertise to evaluate inherent risks (FX, etc.) and appropriately price the SME loans
- *Problems with assessing credit risks:* due to low trustworthy information provided by SMEs
- *Lack of financial resources in Armenian Drams:* Banking system's deposits are highly dollarized and not available to provide financing in national currency
- *Lack of long-term financial resources:* Banks' liabilities are mostly short-term or even on demand that leads to shortage of long-term financing for SMEs
- *Duration of the loan approvals:* Approval/rejection processes are too long.

### **Demand-side (SMEs) Problems:**

- *Lack of appropriate skills and educational opportunities:* poor education and lack of appropriate training in SME development and management leads to a high rates of close-downs
- *Information asymmetry:* difficulty in obtaining information on financing programs and services



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- *Lack of business running skills, lack of financial background:* heads of SME's often don't understand how much funding they really need
  - *Lack of consultancy services:* SME's often cannot afford consultancy services for efficient business organization
  - *Lack of availability of collateral:* SME's often do not have sufficient collateral
  - *Poor quality business plans:* Lack of expertise in business planning and management
  - *Activity in the shadow market:* coming out of the shadow market equals an SME closing down
  - *Lack of working capital:* full disclosure of financial data ('white accounting') is not enough to receive the loan financing
  - *Corporate governance/culture:* small businesses do not realize the importance that corporate governance has for their businesses
  - *Difficulties of doing market research:* there is lack of information on SME's for market research
  - *Low productivity of business:* inefficient use of credit resources leads to lower outputs for business enterprises

## **B. RECOMMENDATIONS AND SUGGESTIONS**

### **Institutional/Policy Recommendations:**

- *More comprehensive definition of SME:* Provide changes in current legislation to have more comprehensive definition of SMEs
- *Creation of the enabling environment:* ease to open and close the business; 'one-stop shop' licensing procedures to stimulate SME development
- *Government Strategy:* obtain national strategy (strategic program) of SME development for providing sustainable growth of SME sector
- *Legal amendments:* make amendments in the Law of the RA "On State Support of Small and Medium Entrepreneurship" with regard to elaboration and approval of Five-year Strategic Program by Government which should be conducted with annual programs. Annual programs is also should be elaborated and approved by Government on the basis of the Strategic Program and considering priorities for the current economic situation. Also necessary segregation of the Annual Programs' funding into a separate account in state budget
- *Bureaucratic system and corruption:* lowering bureaucratic barriers and public/ sector corruption will increase the efficiency of SMEs' functioning and reduce transaction costs



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- *Monopolies*: implementation of equal competition policy in domestic market will stimulate SME development
  - *Tax administration*: developing of simplified tax and accounting mechanisms, tax breaks, limitation of allowed tax inspections
  - *Information asymmetry*: Creation of SME's data base centre will help to perform market research, segmentation and forecasting; improve quality of available statistics on SME's
  - *Decentralization*: create effective mechanisms to enhance the development of SMEs outside of Yerevan to spread SME development to various regions
  - *Business Infrastructure*: evaluate/assess business infrastructure and improve it on the basis of established priorities and national strategy
  - *Economic instability*: stimulation of consumption for creating new markets and capacities for SME development.
  - Improved access to electricity, water, telephone and IT facilities – countrywide.

#### **Supply-Side Improvement Recommendations:**

- *Funds from International Donor Organization*: increase and coordinate of financing in AMD from international financial/donor organizations (KfW, GAF, EBRD, IFC, WB, etc.), that are specifically targeting development of SME sector
- *Know-How*: more active steps on enabling international financial/donor organization technical experience and knowledge in SME lending
- *Venture capital funds*: development of the investment mechanisms for early-stage, high-potential, growth companies
- *Specialization of financial institutions*: supporting the financial institutions highly specialized on the SME financing, including UCO's
- *New financial products*: develop leasing and factoring products that do not require collateral
- *Financial decentralization*: make access available to the experienced credit organizations to government supporting programs and international donor organization's financial resources
- *Competition*: creation of the healthy competitive environment in SME lending among the banks and NBFIs
- *Interest rate policy*: support banks and NBFIs to develop efficient risk pricing mechanisms and sound risk management systems



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- *Currency risks:* make available financial resources in Armenian Drams to exclude currency risks from credit pricing.

**Demand-Side Improvement Recommendations:**

- *State support:* state guarantees, subsidies and other supportive mechanisms (consultancy, information sharing, etc.) are to be directed to sectors selected by the GoA as priorities vs. selected businesses that may give rise protectionism and corruption.
- *Educational opportunities:* develop appropriate training on entrepreneurship, SME management, marketing, international trading and finance. Particularly providing more wide training and technical assistance program for SMEs directed towards upgrading SME accounting capabilities and ability to create financial statements and business plans acceptable to local commercial banks, as well as towards the ability to make creditworthiness self-assessment to apply for a bank loan
- *Consultancy services:* providing or financing of consulting services for SME's by Government or International financial/donor organizations
- *Information asymmetry:* provide advertising of financial, educational, consultancy, assistance and other opportunities for SME's
- *Flexible collateralizing:* improve alternative collateral assessment mechanism
- *Setting defined terms regarding loan approval/rejection periods:* rejected loans need shorter time, so SME's can instead find alternative way of financing
- *Corporate governance/culture:* support those SME's that are implementing corporate governance principles in their business

Difficulty in doing market research: governments should regularly finance and publish market research and surveys to reduce transaction costs of SME's



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## V. CONCLUSIONS

Summarizing the main results of the round table on SME financing in Armenia the following broad recommendations are pertinent:

- The Government of Armenia should have a Strategy related to SME assistance based upon a clear concept and action plan covering particularly problems and steps for development/improvement of business climate and infrastructure.
- The Government of Armenia should urgently take steps to improve public policy and administration in legal, judicial and regulatory systems to reduce the level of bureaucracy, corruption, monopolization in the economy.
- The Government should ease the tax administration, accounting and reporting standards to foster SME development.
- The capacity of financial institutions must be improved to overcome the lack of experience in SME financing and develop more appropriate financial tools (leasing, factoring etc.), particularly with lower interests and longer durations, also provide guaranty or venture mechanisms to enable financial institutions to finance start-ups and newly established businesses.
- Financial/donor organizations need to urgently develop long-term financial resources so that funding for SMEs can be provided in Armenian Drams.
- Strengthen State support to SME's particularly state guarantees, subsidies and other supportive mechanisms (consultancy, market research, information sharing, etc.).
- Develop and conduct appropriate training on SME management, marketing, international trading and finance and provide (or finance) consulting services for SMEs.

