SMALL AND MEDIUM-SIZED ENTERPRISES
AND
BANKING SECTOR IN TURKEY

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ABSTRACT

SMALL AND MEDIUM-SIZED ENTERPRISES

AND

BANKING SECTOR IN TURKEY

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This study has the objective of arguing the fact that the Small and Medium-sized Enterprise (SME) lending is developing, relevant to the evolution of the business environment and banking sector, during the period between 2001 – 2006 years. The thesis is testing this claim on two data sets. First; the financial data of CBRT during the period of 2001 - 2006 is evaluated. Then, the SME data of a Bank is evaluated. The thesis also covers the arguments on SME definition, the literature survey for SME development policies, SME lending infrastructure, the banking sector, as the main source of finance for SME, and the SME profile of Turkey. The thesis concludes on two things: The share of SMEs in the total credit volume is rising during the period between 2001 – 2006 years. And the share of medium-term credits is rising, while the short-term credits' is decreasing. In addition to these, the study criticizes the recent SME definition of KOSGEB.

Keywords: Small and Medium Enterprise, Banking Sector, SME Funding, SME Lending

ÖZ

KÜÇÜK VE ORTA BÜYÜKLÜKTE İŞLETMELER

VE

TÜRKİYE'DE BANKACILIK SEKTÖRÜ

Özalp, Dizem

Yüksek Lisans, Bilim ve Teknoloji Politikası Çalışmaları Bölümü

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Bu çalışmanın amacı, 2001-2006 yılları arası dönem içinde, iş çevresindeki ve Bankacılık sektöründeki gelişmelere bağlı olarak, KOBİ'lerin borçlanmalarının geliştiği konusunu tartışmaktır. Çalışma, bu iddiayı iki ana veri üzerinde test ediyor: İlki, TCMB'ye ait 2001-2006 yıllarının finansal verisi üzerinden bir değerlendirme. Diğeri ise, bir Banka'nın KOBİ verilerine dayanıyor. Tez, ayrıca, KOBİ tanımı, KOBİ gelişim politikaları, KOBİ borçlanma yapısı, KOBİ ana finansman kaynağı olarak Bankacılık Sektörü ve Türkiye'nin KOBİ profili hakkındaki tartışmalara ve akademik çalışmalara da değiniyor. Tez iki ana sonuca ulaşıyor: Toplam banka kredilerindeki KOBİ payı, 2001-2006 yılları arasındaki dönemde gelişim gösteriyor. Ayrıca, KOBİ kredilerindeki orta vadeli borçların oranı artarken, kısa vadeli borçların oranı düşüyor. Bunlara ek olarak, çalışma KOSGEB'in güncel KOBİ tanımına da eleştiriler getiriyor.

Anahtar Kelimeler: Küçük ve Orta Büyüklükte İşletmeler, Bankacılık Sektörü, KOBİ Fonlaması, KOBİ'lerin Borçlanması

To My Parents; Gülsüm Özalp, İlhami Özalp

ACKNOWLEDGMENTS

TABLE OF CONTENTS

LIST OF TABLES

TABLES

LIST OF FIGURES

FIGURES

LIST OF ABBREVIATIONS

B2B: Business to Business

CBRT: The Central Bank of the Republic of Turkey

CIT: Countries in Transition

CRM: Customer Relationship Management

CRS : Credit Reference System

DPT: Undersecretariat of State Planning Organisation

EC: European Commission

EIB: European Investment Bank

EIBG: European Investment Bank Group

ERP: Enterprise Resource Planning

EU: European Union

EUROSTAT: European Statistics Office

FDI: Foreign Direct Investment

GDP: Gross Domestic Product

ICT: Information and Communications Technology

IFC: International Finance Corporation

IGEM: Enterprise Development Centre of KOSGEB

ISO: Istanbul Chamber of Industry

IT: Information Technologies

KKB A.Ş. : Credit Bureau of Turkey

KOBINET: Small and Medium Enterprises Network

KOSGEB: Small and Medium Industry Development Organisation

KÜSGET: Small Industry Development Organisation

METU: Middle East Technical University

OECD: Organisation for Economic Co-operation and Development

OSB: Organised Industrial Zone

R& D: Research and Development (R&D)

SEGEM: Industrial Training and Development Centre

SELP: Small Enterprise Loan Programme

SME: Small and Medium-Sized Enterprise

SPK: Capital Markets Board

TBB: The Banks Association of Turkey

TEB: Turkish Economy Bank

TEKMER: Technology Development Centre of KOSGEB

TESK: Confederation of Turkish Tradesmen and Craftsmen

TESKOMB: Union of Credit and Guarantee Cooperatives for Tradesmen and Craftsmen of Turkey

TKB: Development Bank of Turkey

TMSF: Saving Deposit Insurance Fund

TOBB: Union of Chambers of Commerce, Industry, Maritime Trade and Commodity Exchanges of Turkey

TTGV: Technology Development Foundation of Turkey

TUIK: Institute of Statistics of Turkey

TSKB: Industrial Development Bank of Turkey

TÜBİTAK: The Scientific and Technical Research Council of Turkey

VAT: Valued Added Tax

VCIT: Venture Capital Investment Trusts

CHAPTER 1

INTRODUCTION

Regarding the direction, which the world economy has been pointing out since 1970s, the SME subjects and the works about their problems are under consideration for developing countries and developed countries, as well.

On 23rd April 2002, Turkey, with the other Europe-candidate countries, announced its acceptance over performing an action plan for an agreement composing of 10 main issues. "Development of SMEs' capacity of innovation and technology" is beyond those 10 issues, and is stated as Turkey's long-term homework and SME strategy document in SME Strategy and Action Plan (DPT, 2004). Development of the SMEs is underlined in the 8th development plan, as well; criticizing the recent situation since the SME has been facing the disadvantages of financing and inadequate information, roughly. This is why the SME is an important tool for national and regional development policies in Turkey, and the starting point of discussion in this thesis.

The author sets the thesis idea on a financial base, since finance is an important part of profit maximizing enterprise and all the parties of the SME development have especially discussed on this point, regarding the economical history of the country.

The author tries to investigate the relations between the SMEs and the agents of the finance market, the banks. There are critics on policies for a long-term sustainability for entrepreneurship, and growth motivation with highly standardized and qualified production for a larger share in the domestic and world market, and some contributions to them.

In order to assess the situation with respect to access to finance by SMEs in Turkey and the banking sector, this report tries to provide answers to the following questions:

- What is the SME definition, according to the national and international institutions?
- What are the major developments in the financial, economic and policy frameworks affecting SMEs access to finance?
- What are the main subjects affecting the credibility of SMEs?

The information included in the report is based on information sources, such as:

- Existing literature, publications (national as well as international)
- Cross country data and OECD database
- The national fiscal and banking values of Turkey
- The surveys conducted with enterprises
- The data set in a sample bank

In this study, the author claims that the SME lending is developing relevant to the evolution of the business environment and banking sector. The thesis is testing this claim on two data sets: First; the financial data of CBRT through the period of 2001- 2006 is evaluated. Then, the SME data of a Bank is evaluated.

The 2nd chapter is for defining the SME concept, from the side of many parties related with SME development. The 3rd chapter is about why the studies about SMEs exist in the social sciences and economics literature, the significance of them in parallel and conflicting theories, and the SME profile of Turkey, making comparisons with the other countries. Then the 4th chapter emphasizes the lending infrastructure. In the 5th chapter, the author tries to take the reader's attention to the financial infrastructure and its components as the lender and the borrower – the banks and the entrepreneurs – on a line of credit. In this chapter, the author wishes to make a deeper research in these two actors' relation, mentioning the lacking points. This part is also the part that the hypothesis is evaluated on two main empirical data sets. Thus, in this chapter, the author tries to gather some empirircal results on test data. The methodology about the research data is explained in this chapter. The last chapter is onclusion, summarizing the whole arguments, the hypothesis and the future prospects of this study.

CHAPTER 2

DEFINITION OF SME

The literature has problems to identify SME with clear-cut criteria. SMEs are active in nearly all markets and nearly all sectors of national economies. SMEs, ranging from a single proprietorship to a firm with several hundred employees or an internationally known successful and leading specialty supplier filling a market niche, are not a homogeneous group.

Basically, SMEs are distinguished from other business units mainly by size criteria. The size is measured in terms of quantitative criteria, e.g. number of staff, turnover, balance sheet total, capital intensity, R&D intensity or market share. Rather, they include firms in a variety of industries, trade, craft, manufacturing, professions and agricultural and forestry firms, etc.

In European countries, before the year of 1996, as the EU Commission had pointed out, a generally accepted definition of SME was impossible, because the term was defined differently depending on the industry and country concerned. Bearing this in mind, the EU at supranational level - for example, for the purpose of establishing a European Community frame of reference for state aid - defines those firms which meet all of the following criteria at a time as SME:

Table 1. SME definition of European Union

Staff	Turnover (ECU)	Ownership
under 250 either	*either* annual turnover under 20 million	no more than 25% of capital owned by large firm

Table 1 (continued)

	or		
	balance sheet total under 10 million		

Source: (OECD, 1997)

In Norway, a company which employed less than 100 was called medium, while which employed less than 20 was small, and less than 5 was micro. Whereas in Ireland and Czech Republic, those with more than 250 employees were defined to be large and those with 10-250 were medium (Eraydın, et al., 2003).

In Germany, as a rough classification and for further analysis of size-specific problem areas, the Institut für Mittelstandsforschung (SME Research Institute), for example, used the following criteria at national level:

Table 2. SME definition of Institut für Mittelstandsforschung (SME Research Institute)

	Staff	Turnover in DM
Small Enterprises	under 9	under 1 million
Medium-Sized Enterprises	10 - 499	1 to 100 million
Large Enterprises	over 500	over 100 million

Source: (OECD, 1997)

In practice, the countries had to rely on some sort of classification for many different purposes; certain criteria -as a rule turnover and number of staff- are combined. "Which criteria are actually used for the purpose of classification depends mostly on the perspective and purpose of the analysis. The classification varies depending on whether structural, regulatory, labor market, fiscal or competition policy issues are being addressed. Generally applicable interdisciplinary criteria have so far been rejected by policy-makers and business as well as theorists and practitioners" (OECD, 1997).

For the below purposes, the widely accepted common definition was delayed:

- Competition Law enforcement

- Market structure is decisive on the size and the turnover

- Multi-product firm's turnover

- The number of staff depends on the degree of mechanization and the availability of skilled labor of an industry or a firm

- The different aspects for sizing the turnover of a trading company and the turnover of a craft business.

- The lack of SME surveys involving most EU countries

The above view was also reflected in European SME literature and surveys till 1996. Since all the countries, which are trying to use the SMEs as the agent of development, have different and should have different policies, reflecting their socio-economic situation for now and for the future, this extensive ways of definitions are not so surprising. However, when it comes to a point of creating common EU policy and vision, and funding SMEs on supranational level with European funds, there occurs a need for an updated definition which can voluntarily be used by the member states.

In 1996, the recommendation establishing a first common SME definition was adopted by the Commission and this definition has been widely applied throughout the European Union till the revision on 6th May 2003. This revision was needed because of the economic developments and the EU enlargement policy effect. Since 1 January 2005, the revised definition is voluntary for the Member States, as a part of EU policy, applied through European Investment Fund and European Investment Bank. For promoting this revised definition, EU commission announced a guide, so that the enterprises can understand the measures and their eligibility for European, national, regional and local authorities SME funds (EC, 2005 a).

2.1 The New EU Definition

Qualifying as an SME obliges to be considered as an enterprise first. According to the new definition, an enterprise is "any entity engaged in an economic activity, irrespective of its legal form" (EC, 2005 a).

The enterprise, then, verifies its "size" according to the following three criteria:

- **staff headcount,**
- **annual turnover,**
- **annual balance sheet.**

The most important measure is that the revised definition takes the enterprise types into account. How much the enterprise is independent of the affects of the measures of headcount, annual turnover and balance sheet, thus "the size", so that the distinction between initiative enterprises and subsidiaries supported by large firms is made clear.

According to the enterprise type, an SME may then need to add some, or all, of the data from those enterprises to its own. The calculations for each of the three types of enterprise are different and will ultimately determine whether it meets the various thresholds established in the SME definition.

The enterprise types and their definitions are below:

Autonomous:
- SME is totally independent, i.e. it has no participation in other enterprises and no enterprise has a participation in yours.
- SME has a holding of less than 25% of the capital or voting rights (whichever is the higher) in one or more other enterprises and/or outsiders do not have a stake of 25% or more of the capital or voting rights (whichever is the higher) in the enterprise.

- SME has partner enterprises, even if this 25% threshold is reached or exceeded up to 50 % by any of the following investors:

  – Public investment corporations, venture capital companies and business angels.

  – Universities and non-profit research centres.

  – Institutional investors, including regional development funds.

  – Autonomous local authorities with an annual budget of less than 10 million euro and fewer than 5,000 inhabitants.

In this case, the calculations are just made on the enterprise's own headcount, annual turnover and balance sheet.

Partner:

- SME has a holding equal to or greater than 25%, of the capital or voting rights in another enterprise and/or another enterprise has a holding equal to or greater than 25% in yours.
- SME has no voting rights in the other enterprise (or vice versa) that exceed 50%.
- 25% or more of its capital or voting rights should not be directly or indirectly controlled, jointly or individually, by one or more public bodies.
- SME has partner enterprises, even if this 25% threshold is reached or exceeded up to 50 % by any of the following investors:

  – Public investment corporations, venture capital companies and business angels.

  – Universities and non-profit research centres.

  – Institutional investors, including regional development funds.

  – Autonomous local authorities with an annual budget of less than 10 million euro and fewer than 5,000 inhabitants.

In this case, the proportion of the other enterprise's staff headcount and financial details should also be included to the enterprise's own data when determining the eligibility for SME status. This proportion will reflect the percentage of shares or voting rights – whichever is the higher – that are held.

<u>Linked:</u> For this enterprise type, the wholly-owned subsidiary is a typical example. Two or more enterprises are linked when they have any of the following relationships:

- One enterprise holds a majority of the voting rights of the shareholders or members in another.
- One enterprise is entitled to appoint or remove a majority of the administrative, management or supervisory body of another.
- A contract between the enterprises, or a provision in the memorandum or articles of association of one of the enterprises, enables one to exercise a dominant influence over the other.
- One enterprise is able, by agreement, to exercise sole control over a majority of the voting rights of the shareholders or members in another.

In this case, all of the data of the owned subsidiary should be added to calculations of the enterprise (EC, 2005 a).

After the calculations are made according to the enterprise type, the thresholds, summarized below in Table 3 according to the three criteria, will allow determining whether the enterprise is a micro, small or medium-sized enterprise.

Table 3. The criteria of SME definition of European Union
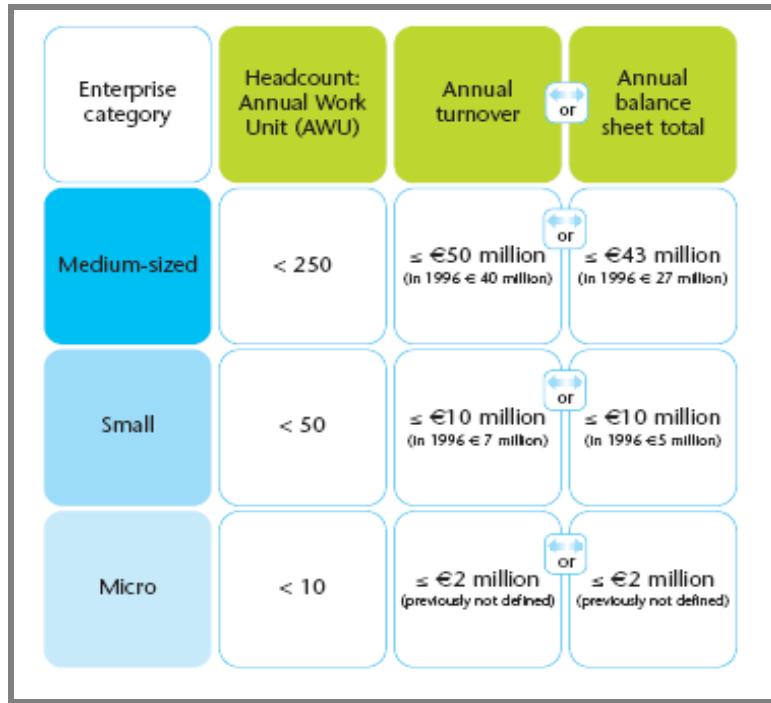
Source: (EC, 2005 a)

2.2 The SME Definition in Turkey

SME definition has been a debate since KOSGEB was founded in 1990. KOSGEB and the other institutions implementing SME policies can be regarded as the evidence of how significant SMEs are as the development agents in national economy.

After the general opening of the Turkish economy in the 1980s, the Turkish government developed a specific SME policy and created SEGEM (Industrial Training and Development Centre) and KÜSGET (Small Industry Development Organization), which were united later on under the umbrella of KOSGEB (Small and Medium Industry Development Organization) in

1990 as a major instrument for the execution of these policies, enacted the law of 3624 and commissioned this organization as the decision-maker for the national SME policy. (OECD, 2004)

In developing countries, mostly, the definition is solely based on headcount, whereas in developed countries, it is also composed of other criteria like turnover or enterprise type. On **18ᵗʰ of November 2005, KOSGEB redefined Turkish SME.**

Before that, KOSGEB defined SME as;

Table 4. SME definition of KOSGEB before November 2005

	Staff / Headcount
Small enterprises	1 - 50
Medium-sized enterprises	51 - 150

Source: (Yılmaz, 2003)

2.2.1   The Review of the Previous Definition

The SME definitions according to the different organizations and institutions, which are to be mostly referred in this thesis, are summarized in the Table 5.

Table 5. The SME definitions according to the different organizations and institutions in Turkey

ORGANIZATION	SCOPE	CRITERIA	MICRO	SMALL	MEDIUM
KOSGEB	Manufacturing Industry	Staff	-	1-50	51-150
HALKBANK	Manufacturing Industry, Tourism, Software Development	Staff			1-250
		Fixed Assets Amount (Euro)	550000	550000	550000
UNDERSECRETARIAT OF TREASURY	Manufacturing, Tourism, Software Development, Education, Health, Agricultural Industry	Staff	1-9	10-49	50-250
		Fixed Investment Amount (Euro)	550000	550000	550000
UNDERSECRETARIAT OF FOREIGN TRADE	Manufacturing Industry	Staff	-	-	1-200
		Fixed Assets Amount (Euro)	-	-	1830000
EXIMBANK	Manufacturing Industry	Staff	-	-	1-200
ISTANBUL TRADE CHAMBER	Manufacturing Industry	Staff	-	-	1-99
TÜİK	Manufacturing Industry	Staff	-	-	1-99
AEGEAN REGION INDUSTRY CHAMBER	Manufacturing Industry	Staff	-	-	1-199
ANKARA INDUSTRY CHAMBER	Manufacturing Industry	Staff	-	-	1-299

Source: (OECD, 2004)

The variations between these definitions simply show the different aspects of the organizations / institutions making policies on SME development. This is somehow a chaotic picture for a national economy, because an enterprise is eligible for SME programs according to an organization, and not for another. The reason, behind these different definitions, is told to be that the role and the weight of the SMEs in the policies of these organizations and institutions vary extensively. This is not a valid reason, because the variations can be seen even for two organizations like KOSGEB and HALKBANK, though the two of them declare the parallel visions for SMEs (http://www.halkbank.com.tr).

In the panel held at METU in 2000, three important points lacking in the Turkey's SME definition were underlined:

- The service sectors are mostly excluded from the scope of the definitions.
- The development of the national economy requires the extra criteria besides the classical headcount threshold.
- The present definitions are missing the enterprises and first-priority development regions (KOSGEB, 2000).

"Small and medium-sized enterprises (SMEs) play a very important role in the Turkish economy owing to their large share in the total number of enterprises and in total employment. Their average profile is different from that of SMEs in the European Union or in most other OECD countries in that their average workforce and turnover are much smaller" (OECD, 2004). But the problems of the imperfections are common; they also lag well behind in terms of know-how, skill levels, capital investment to support their activities, and access and ability to take advantage of modern technologies, especially in the information and communications fields. As in most other countries, they find it difficult to obtain financing (OECD, 2004). Thus, a revised and widely accepted definition is an important step for a country admiring to develop policies on SMEs and taking actions to earn a full membership of EU. This will lead to promote innovation and foster partnerships, while ensuring that only those enterprises which genuinely require support are targeted by public schemes (EC, 2005 a).

Definition by regarding only the number of persons employed is not adequate since the other criteria are also dominant on how a company manufactures and behaves in the market. A company with 100 employees is not likely to show a real SME character, if a large company owns its proprietorship with a share over 25%. The company loses its flexibility - which is the most important aspect that makes an SME an active actor in the regional development policies - in making decisions, since it has to act as a component tied with the big partner's strategy. Also very strong annual turnover, which may guarantee a good portion in the market, can bind the SME in making innovative decisions, loosing the spirit of entrepreneurship (Eraydın, et al., 2003).

A national SME definition requires being the result of wide-ranging discussions, under the head of KOSGEB, between the policy and technology driving agents for SMEs, funding sector, business organizations, experts, universities, and if possible opening consultations, so that the enterprises themselves can make contributions. A seriously designed survey, covering a big number of enterprises from different regions, sectors and market, helps to sustain the relevancy of the definition with the realities of the micro economy, sector and market shares.

2.2.2 KOSGEB's New Definition

On 18th March of 2005, the new definition was declared on the Official Gazette. KOSGEB has announced that the enterprises should submit their information so that they could carry on using SME beneficiaries supported by the agent. The criteria are the same of EU (Resmi Gazete, 2005). But the monetary terms are rebalanced according to the Turkish SME profile and economical conditions.

The conditions for an enterprise to be evaluated as SME for EU is mentioned in the part 2.1 The New EU Definition. The details will not be repeated here, but summarizing the Table 6 is helpful.

Table 6. The new SME definition of KOSGEB

	Headcount	Annual Turnover		Annual Balance
MEDIUM	<250	< 25 MILLION YTL	OR	< 25 MILLION YTL
SMALL	<50	< 5 MILLION YTL		< 5 MILLION YTL
MICRO	<10	< 1 MILLION YTL		< 1 MILLION YTL

Source: (Resmi Gazete, 2005)

On net, KOSGEB declared that the definition was declared for the sake of alignment with the EU member states SME policies (http://www.kosgeb.gov.tr). But along this, other reasons have stipulated this new vision:

- To update thresholds;
- To promote newly emerging and strategically important actors, like micro enterprises;
- To improve access to capital for the most lacking enterprises;
- To promote innovation and improve access to R & D;
- To take account of different relationship between enterprises (EC, 2005 a);
- To foster the role of private sector in the capital financing;
- Parallelism for international agreements signed by Turkey (KOSGEB, 2000).

The capabilities of the definition for national SME policy can be listed as followings:

- The declared items are directing the enterprise for self-evaluation. The new definition is announced with an SME qualification form (http://rega.basbakanlik.gov.tr).
- The clear cut between subsidiaries and real initiatives is set, so that the funding beneficiaries can be targeted towards the ones who really need.
- The share of public investment corporations, venture capital companies or business angels do not end the SME status of an enterprise. Especially, the publicly owned cooperative enterprises or initiatives which are in short of capital for investment can have benefits of SME funding more often. This may be an important step in fostering alignment of initiatives and the municipalities on the countryside and underdeveloped regions.
- The definition, will contribute to accumulate a wide SME database for Turkey, if applied by the other public and private agents. "One of the top priorities of TUIK is to compile and

publish SME statistics based on a single definition aligned on that of EUROSTAT and based on European Union conventions, factoring in not only the number of jobs but also the size of their balance sheets (up to EUR 43 million) and of their turnover (EUR 50 million)" (OECD, 2004).

- The definition covers both the manufacturing and service sectors.

However, the author thinks that the definition has still some lacking points:

- The definition is not advertised as a conclusion of national policy makers and researchers, rather an obliged outcome of European Union alignment. This is not a right way for sustaining the contribution of all enterprises.
- In EU, the thresholds can be stretched if necessary for local and regional policies (EC, 2005 a). Which organization is charged for how much the definition can be changed in first-priority development regions is not set. Most probably, KOSGEB will be responsible, but the relevance of definition and regional development level is not clear.

By the way, the author accepts the difficulty of qualifying all the issues of an enterprise for SME definition without an accumulated statistics of national SME survey.

CHAPTER 3

THE SME PROFILE

In this chapter, first the literature survey arguing on the role of SME in innovation systems will be mentioned. While doing this, conflicting arguments are also included. Then, the Turkish SME profile is drawn, with the help of some metrics and statistics. In the third part, the problems of SMEs are held in the context of national surveys and international statistics.

3.1 The Significance of SME in Development (Literature Survey)

From 1970s, many theories have been developed over the dynamics of the rising regions, which were once underdeveloped. These theories discussed, explicitly or implicitly, SMEs as the main agents of the economic growth. The neoclassical view emphasizes the importance of the SMEs because of their potential employment generation and low capital requirement, compared with the large capital-intensive companies. Also, SMEs are efficient in using indigenous resources and are said to have easiness in entrance and exit into/from production activities (Eraydın, et al., 2003). The territorial models, though they are mainly focused on the group of SMEs that are closely linked to a geographical area, suggest as the active agents of development due to their capacity of learning and innovation (Camagni, 1991). In the industrial district literature, it is stressed that collective learning among the small firms are essential part of production,

strengthening their innovative capacity (Brusco, 1982). The theory of high technology industrial clusters and the new industrial spaces literature, which concentrates on local interdependencies and knowledge transfer among firms, also give evidences about the crucial role of small firms in the clusters. In addition to these perspectives, the theory of regional innovation system defines the Regional Innovation System (RIS) as an innovative industrial cluster of small firms in an area likely to have firms with access to others in similar or complementary sectors as customers, suppliers and partners (Cooke, 1997). The research made to measure the correlation between the shares of SMEs and the regional growth gives evidence on the absolute positive relation (Eraydın, et al., 2003).

In the 6th framework program, EU emphasizes the SME as a source of dynamism and change in new markets, particularly those at the leading edge of technology (http://sme.cordis.lu/research/fp6_support.cfm). EU has illustrated the significance of SMEs in their regional policy, pointing out five main arguments about SMEs:

1. Their ability to create large number of new jobs;
2. Their ability to create a diversified and flexible industrial base by creating a pool of entrepreneurs willing and able to take risks;
3. Their ability to stimulate intense competition for small and large firms alike, leading to an energetic enterprise culture;
4. Their ability to stimulate innovation;
5. Their ability to improve industrial relations and provide a superior working environment (Armstrong and Taylor, 2000).

Although any type of economical policy or governing action having preventive consequences for a sector or group over another is forbidden along EU, EU keeps taking actions to give support to initiative and innovative SMEs by investment funds, comparatively lower interest credits, consultancy, etc. (http://www.cordis.lu/sme). Being a member state of EU obliges the Turkey governments to produce parallel policies first of all in economic area, beyond other socio-cultural targets. The union also advises the candidate countries SME centered projects in the coincidence period, which they are through, regarding the higher portion the SME in the industries. SMEs are considered to be "the backbone of the business economy, accounting for

more than 99 % of all enterprises, two thirds of employment and more than half of the value added generated in both EU and the 10 acceding countries" (Eraydın, et al., 2003). Since being an economically integrated group is the most important objective of the EU, this is not surprising for the members trying to set collaborative national policies.

Turkey has signed an agreement in Slovenia on 23rd April 2002, promising to take absolute steps to produce programs and projects and to allocate adequate resources in 10 main areas stated in the agreement. The development of the capacity of the SMEs in technology and innovation is one of those 10 areas (DPT, 2004). Turkey has emphasized the significance of SME in national and regional economic policy also in the 8th 5-year development plan. In the plan, it is stated that for the development of SMEs, the lack of legislation, qualified employee, and consultancy, the inadequacy in finance, the problems in the taxation and accessing information are going to be come over with the state regulations and funds, or market agents, supported by the state (http://ekulup.dpt.gov.tr/plan/taslak.pdf).

The significance of SME is not only important for the EU member states and the candidates, but also for the other countries, trying to design national development plan in the so-called globalization world. China, the rival country, has nowadays frightened the national firms due to its striking and enlarging share in the national and international markets, in nearly all sectors, and it sees the SMEs as the roots of the market economy. China sets the SMEs definition covering the firms in the countryside and projects its development plan along the SMEs, which are thought to perform great advantages in creating new jobs, absorption of the workforce in the countryside, innovation, and improvement in the export activities (KOSGEB, 2004 b).

United Nations has made research on the SMEs and concluded that SMEs are the engine of economic development, especially for the countries in transition to market economy, and the importance of SMEs is today acknowledged due to their stimulation power for private ownership and entrepreneurial skills; they are flexible and can adapt quickly to changing market demand and supply conditions; they generate employment, help diversify economic activity and make a significant contribution to exports and trade (http://www.unece.org/indust/sme/sme-role.htm).

On the contrary, a recent research has produced alternative ideas about the SME's contribution to development. This study claims that there is no support for the widely held belief that SMEs promote higher growth and lower poverty. But it does provide some support for the view that the quality of the business environment is the main influence for higher growth and lower poverty, and all sized firms face this environment (Ayyagari, Beck, Demirgüç-Kunt, 2003). Ayyagari, Demirgüç-Kunt and Beck's study make critical analysis on three arguments of SME policies on cross-country database, which includes Turkey, as well:

- SMEs enhance competition and entrepreneurship, and thus, have economywide benefits in efficiency, innovation, and productivity growth. Therefore, direct government support of SMEs can help countries reap social benefits.

- SMEs are generally more productive than large firms, but are impeded in their development by failures of financial markets and other institutions. Thus, pending financial and institutional improvements, direct government support of SMEs can boost economic growth and development.

- The growth of SMEs boosts employment more than the growth of large firms because SMEs are more labor-intensive. Therefore, subsidizing SMEs may help reduce poverty (http://rru.worldbank.org/PublicPolicyJournal/).

Cross-country studies of the relationship between SMEs and economic development have been hampered by the lack of comparable cross-country data. Their study provides the first cross-country evidence on the links between SMEs and economic growth and poverty reduction (Ayyagari, Beck, Demirgüç-Kunt, 2003).

The study lacks in three things: The variances of SME definitions of the research countries, the informal enterprises having effect on economies, and the excluded sectors, such as agriculture and services are outside the research data. However, their effect are taken into account as pre-calculated index (Ayyagari, Beck, Demirgüç-Kunt, 2003).

In conclusion;

- The results of the study are consistent with the view that a large SME sector is a characteristic of fast-growing economies, but not a cause of their rapid growth.

- When the analysis focuses on income growth among the lowest income quintile rather than the overall population, it again finds no evidence for the importance of SMEs. Nor does it find any statistically significant relationship between the importance of SMEs and the depth and breadth of poverty across countries. Therefore, unlike SMEs, there is evidence that an effective business environment is not just a characteristics of successful economies but also plays an important part in their success. Cross-country comparisons suggest a strong positive association between SME development and economic growth. But this relationship does not hold up when the analysis controls for reverse causation or for a third factor that might drive both growth and the emergence of many SMEs.

- Moreover, cross-country comparisons do not show that SMEs do much to boost the incomes of the poor or that they have a significant relationship with the depth and breadth of poverty. So, while a thriving SME sector is a characteristics of flourishing economies, the results do not support the contention that SMEs accelerate growth and reduce poverty, calling into question the policy of directly subsidizing their development.

Together, these findings have important policy implications. They suggest that rather than directly subsidizing SMEs and aiming for a large number of small enterprises, policymakers should focus on creating a business environment that allows easy entry and exit for firms, and assures entrepreneurs and financiers that property rights and contracts will be enforced (http://rru.worldbank.org/PublicPolicyJournal/).

The study concludes in similar arguments with the recent challenges of developing countries in 2000s. These countries are facing the dilemma; the comparative advantage of low-wage of flexible national SMEs, and consequently, lower standard of living and informal sector, avoiding taxes for keeping the advantage over the other enterprises.

Critically, the significant role of an SME is mostly dependent on its efficiency in using low-wage labor markets. By the way, this is the reason why the failure rate is very high. If that property does not exist, the SME has to struggle for being a part of the cooperative atmosphere and strategic relations to have a comparative advantage in the national or international market (Camagni, 1991, Eraydın, et al., 2003).

The SMEs in Turkey had advantages of low-labor wages, but today China, as the biggest rival, has been challenging the Turkish industry with the lowest labor wage all over the world. So the only way is creating an innovative milieu and added value that cannot be given up easily by the worldwide customers (KOSGEB, 2004 a).

To conclude, the SME's significance in global market, more often, depends on the comparative advantage of low-wage in the developing countries. Also, their dominance for the number of enterprises and working units, and the other advantages of flexible production guarantee that SME will be under focus for more years.

3.2 The SME Profile in Turkey

SMEs constitute a major part of the Turkish economy. According to the most recent estimates in 2000, the SME sector including services accounted for: 99.8% of the total number of enterprises, 76.7% of total employment, 38% of capital investment, 26.5% of value added, roughly 10% of exports and 5% of bank credit. Therefore, while SMEs dominate the economy in terms of employment, they evidently operate with comparatively little capital equipment, generate relatively low levels of value added, make only a small contribution to Turkish exports and receive only a marginal share of the funds mobilized by the banking sector (OECD, 2004).

In 2002, the share of SME in the allocation of the total enterprise number rised according to the year of 2000. This rise is shown in Table 7:

Table 7. The share of SME in the allocation of the total enterprise number in 2000

	Groups According to Staff	%
SME	1-250	99.89
Micro	0	1.38
Micro	1-9	94.94
Small	10-49	3.09
Medium	50-99	0.30
Medium	100-150	0.10
Medium	151-250	0.08
LARGE	>250	0.11

Source: (http://www.die.gov.tr)

For the same year (2000), the allocation according to SSK registered enterprises and staff is as following:

Table 8. The share of SMEsin the numbers of SSK registered enterprises and staff in 2000

	The Registered Enterprise in Number(A)	The Registered Staff in Number(B)	A (%)	B (%)
SME	7124,66	3,999,964	99.72	79.07
Micro	643,661	1,529,482	88.58	30.23
Small	69,287	1,404,594	9.53	27.71
Medium	11,712	1,068,888	1.61	21.13
LARGE	2,013	1,058,901	0.28	20.93
TOTAL	726,673	5,058,865	100	100

Source: (http://www.ssk.gov.tr)

Table 8 does not cover officially registered workers of the agriculture sector. Also, informal economy is told to be 50% of the SMEs in Turkey (OECD, 2004). Thus the data may be misleading. However, SSK, as the biggest social security organization, registers 38.6% of total

enterprises. Thus, the data can be regarded as an index for country-wide to understand their overall role in the economy.

CBRT has made survey for the enterprises and their net sales, total assets, capital. This survey represents the data along a periof of three year; 2000,2001,2002. This period is important since it covers before and after 2001 crisis of Turkish economy. The SME definition in the survey is not relevant with the definition of KOSGEB and the survey is made upon 8007 enterprises. The definition is in the Table 9, below:

Table 9. SME definition in the CBRT's survey

	Headcount	Net Sales (EUR)
SMALL	<50	<7 MILLION
MEDIUM	50-500	7-40 MILLION

Source: (Yılmaz, 2003)

But still the outcomes are striking and can give some clue about the small enterprises profile over a critique time period. Therefore, the author wishes to summarize the result of the survey in few words:

Average net sales for a small enterprise had decreased 29.9% in 2001, with respect to the year of 2000; 34.6% in 2002, with respect to the year of 2001. Average total asset sales for a small enterprise had decreased 14.6% in 2001, with respect to the year of 2000; whereas it rised 7.5% in 2002, with respect to the year of 2001. Average capital for a small enterprise had decreased 36.6% in 2001, with respect to the year of 2000, but it increased 25.85% in 2002, with respect to the year of 2001 (Yılmaz, 2003). This shows that small firms could not overcome the effect of the crisis. The small firms have shrunk for the period, and also the turnover of firms is substantial in this sector, which is highly sensitive to swings in the economy. Firms going out of business as a share of new start-ups has fluctuated as following for the same period: 1999, 26%; 2001, 84%; 2002, 95% (OECD, 2004).

OECD has summarized the size and structure of the SMEs as such: "The small size of Turkish SMEs and their relatively modest contribution to national output stand out in international comparisons. For example, the proportion of SMEs with fewer than 100 workers is higher in Turkey than in many other OECD countries (Italy is a notable exception), and most Turkish SMEs fall into the category of enterprises with fewer than 10 employees. Turkey also has the highest proportion of jobs in manufacturing firms with fewer than 10 workers (34%). Furthermore, while micro-enterprises account for 95% of Turkish businesses and 34% of Turkey's jobs, they account for a scant 7.8% of production, whereas in Italy, France and Portugal, where such firms are proportionately fewer and employ fewer people, their contribution to total output ranges from 11% to 15%" (OECD, 2004).

For the year 2003, TESK, which is the biggest agent representing a very large share of SMEs are in the trade, crafts and industry sectors, had registered more than 2.76 million trade and craft enterprises. In addition to this, TOBB, which represents the trade and industry sector, estimated the registered members as 1.2 million at the end of 2003.

According to TUIK's data, on 1st January 2001 there were around 210,000 SMEs (1-250 workers) in the sector (99.6% of the total number of manufacturing firms). Just over 1 million people are employed by these SMEs (64.3% of the manufacturing total) and they accounted for 34.5% of the sector's value added. Manufacturing sector SMEs are broken down across industries as follows: metallic goods, 26.1%; textiles, clothing and leather goods, 25.6%; wood and furniture, 24.3%; food and drink, 12.7%; paper, 3.9%; other sectors, 7.4%. Furthermore, these enterprises are generally very small. The average number of people employed by SMEs in manufacturing is 4.8%, but for the 95% of SMEs with employment of between one and nine, the average is 3.1% (http://www.tuik.gov.tr).

However, the contribution to GDP is not as expected. Turkish SMEs contribute only 27 percent to the economy's value added, significantly less than SMEs in comparator countries, as it is shown in Table 10 (World Bank, 2005).

Table 10. SMEs' Employment and GDP Share: Cross Country Comparison

Country	SME sector — share of formal employment	SME sector — contribution to GDP
Turkey	61	27
Bulgaria	50	39
Romania	37	34
Poland	63	49
Slovak Republic	57	37
Italy	80	59

Source: Ayyagari, Beck & Demirguc-Kunt, 2003.
Note: SMEs are defined as firms with fewer than 250 employees.

Unregistered firms may cause to underestimate the role of SME in the economy. However, the SME's contribution to national GDP is relatively low, and this is an important fact referring to the pure perfomance of the sector (Figure 1). The gap between the share of formal employment and the share of GDP is larger than the other countries, which Turkey competes in the international markets. This high informality has also significant impacts on the government's fiscal revenues, thus in return, affecting the overall business environment.
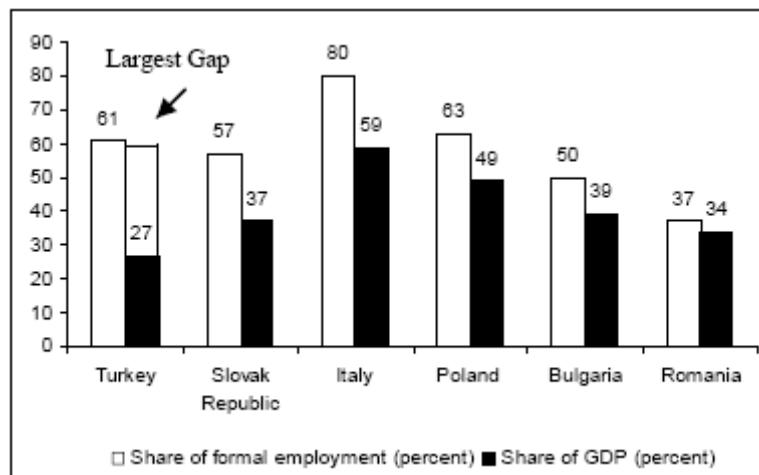
Figure 1. SME's contribution to national GDP: Cross Country Comparison
Source: (World Bank, 2006)

For geographical terms, "The distribution of SMEs reflects that of the population as a whole. They are concentrated in the coastal regions along the Marmara and Aegean Seas, with 38% and 17% of the enterprises, respectively, and in Central Anatolia, with 16%. The Mediterranean Coastal Region (11%), the Black Sea Region (9%), South-Eastern Anatolia (6%) and Eastern Anatolia have far less organised formal economic activity" (OECD, 2004).

The innovation capacity of the Turkish SMEs are very important, since the comparative advantage of cheap cost in the international market has been weakening against the rivals like China (KOSGEB, 2004 b). According to TUIK's study covering the period of 2002-2004, innovative and non-innovative enterprises in services by economic activity and size are summarized in the following table (Table 11). The survey is conducted over the variables like, the number of patents registered, Research and Development (R&D) expenditure, technologically new product or process for the enterprises, and innovation facilities (http://www.tuik.gov.tr/PreIstatistikTablo.do?istab_id=86).

Table 11. Innovative and non-innovative enterprises in services by economic activity and size

	Size(Headcount)	Total	Innovative	Non-innovative
Industry	**10-49**	100	31,20	68,80
	50-249	100	46,24	53,76
	250+	100	56,27	43,73
	Total	*100*	*34,58*	*65,42*
Services	**10-49**	100	24,55	75,45
	50-249	100	30,96	69,04
	250+	100	55,05	44,95
	Total	*100*	*25,90*	*74,10*

Source: (http://www.tuik.gov.tr/PreIstatistikTablo.do?istab_id=86)

The data above results in the followings:

▪ The larger share of the industry and services sector is non-innovative. The percentage is larger in the services sector.

▪ In both sectors, the large firms have more innovative enterprises. Since one of the variables is R&D expenditure, this is not much surprising. Also, there is not much difference for large enterprises between the sectors.

▪ The small and medium enterprises in the industry are more innovative than it is in the services sector.

3.3 The Problems of SMEs in Turkey

The improvement of the SME sector in Turkey is bounded with some problems. This thesis is mainly focused on the challenges for accessing to finance and debt financing. Before mentioning the details of access to finance, the main features of the sector's problem is summarized in this part.

The organizations like ISO (Istanbul Chamber of Industry) make surveys on the enterprises about the imperfections of the sector. According to the recent survey of ISO, the entrepreneurs declared the followings as the obstacles of capacity utilization in Table 12.

Table 12. The obstacles of capacity utilization according to ISO survey

	1999 (%)	2000 (%)	2001 (%)	2002 (%)
Insufficient demand	38.9	36.3	41.6	38
Financial difficulties	18.6	19.6	17.9	15.3
Marketing problems	13.9	14.6	17.3	16.9
Insufficient Technology	5	7.3	3.8	5.1
Energy shortage	5.8	4	3.3	3
Insufficient raw material	8.1	7.8	11.1	8.9

Table 12 (continued)

Labor problems	4.3	3.5	2	4
Competition of imported goods	5.4	6.8	3	8.7

Source: (ISO, 2004)

In Table 12, the answers of the participant enterprises are evaluated on the percentile of 100.

The research shows the reasons for insufficient capacity utilization in small manufacturing industry. In the table, the rate of complaints about financial difficulties decreases through the period of 1999-2002.

This situation may give clues about four things, which will be discussed in the following chapter:

1. Day by day, in the money market, the small enterprises can find resources due to the change in the financial agents' views, strategies.

2. Since this table reflects the results of a survey consisted of the views of the entrepreneurs, they may not see the financial problems prior to the more technical problems like marketing or insufficient demand, anymore.

3. The entrepreneurs may have developed themselves and their enterprises in finding financial resources in the finance market by strengthening their reputation or trying different tools.

4. The financial conditions for SMEs has improved; the decrease in the real interest rates in short-term has been decreasing and the inflation pressure has weakened. (OECD, 2004).

Nevertheless, the OECD report emphasizes that the improvement is not sufficient (OECD, 2004).

The problems, which are rated or not in Table 12 can be identified as:

- Lack of organizing and management: like lack of designing strategic plans and job description, leading, willingness to cooperate and growth motivation;

- Acquisition of raw material: like less discount due to disadvantages of scale, lack of long-term supply relationship;

- Demand: very small scale of production due to low demand;

- Production management: lack of technology management, product design, product development, standardization, and qualified employee, thus quality in production;

- Inadequate access to market opportunities: difficulties in defining the target market, and setting the right strategy for that market;

- In Export: lack of quality control information and standards, bureaucratic difficulties, advertisement, creating a brand label, faults in pricing;

- Accounting: lack of information and qualified employee, poor usable data formation;

- Human resources: problems due to personal relations between the employer and the employee, lack of education and qualification due to lower wage payment capacity of the enterprise and insufficient institutional environment for continuous training;

- Public relations: stereotypes about low quality;

- Research and development: lack of facilities allocated for R&D activities, high cost of R&D and R&D personnel, difficulties in accessing information;

- Decision-making: difficulties in accessing information and using less scientific method;

- Financial problems: collateral problems, high interest rates, difficulties in finding long term investment funds, the consequences of misinformation about finance market and investment opportunities;

- Workshops and well-organized worksites: the state supports the construction of such facilities, but for these areas most important thing, the cooperative and innovative milieu creation has not been achieved yet (Akgemci, 2001; http://www.unece.org/indust/sme/tr-study.htm).

Above, the author notes that the problems are not listed from more important to less important or more frequently seen to less frequently seen.

In OECD report, the weakness of the business environment is underlined as prior obstacle for SMEs to reach stabilized conditions for development and capacity utilization, regarding the

economical breakdowns Turkey has been through for years (OECD, 2004). The details of the financial structure are mentioned in the following chapter.

Web is the cheapest way to interact with the knowledge economy. TUIK's study claims that the Turkish enterprises use web mostly for banking and financing services (http://www.tuik.gov.tr/PreHaberBultenleri.do?id=275). In EU, "searching information and online services" scored over 80% in all countries, and "use of the internet for online ordering and selling goods and services, banking" came distance behind, 50% on average (Demunter, 2005). However, regarding the EUROSTAT statistics of the year 2004, EU, "banking and financial services" are at the highest rank, as internet usage purpose, for the connected enterprises with web page. Proportion of connected enterprises having used internet for banking and financial services, by size-class, reflects that the outcome is the same for the small and medium enterprises; 80% of small and medium enterprises ranks banking and financial activities as the first purpose (Demunter, 2005).

Besides, the weak infrastructure and low usage of information technology is raising difficulties for the enterprises while they are searching for solutions to other problems, mentioned above. The TUIK's study has also showed that there exists a correlation between size and level of internet usage. The survey accomplished in 2005 January, resulted in that 87.76 % of participant enterprises have computer usage and 80.43% of them have accession to web (http://www.tuik.gov.tr/PreHaberBultenleri.do?id=275). 99.22% of Large[1] enterprises have web access, whereas this percentile decreases to 77.97% for the establishments with 10-49 headcount.

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[1] In TUIK's study, the size of the enterprises is on the headcount base; small, 10-49, medium, 50-250, and large more than 250 staff.

Table 13. The ratio of computer usage and web access according to TUIK's study

	COMPUTER USAGE (%)	WEB ACCESS (%)
Small	86.03	77.97
Medium	96.33	92.29

Source: TUIK (http://www.tuik.gov.tr/PreHaberBultenleri.do?id=275)

To understand the tendencies of the enterprises for web usage, the results of the IBS and Andersen consulting survey, "Business Internet User Survey 2000", can be helpful. IBS's survey of 210 business users assist in setting Turkey's enterprises web-usage practices in an international context. The survey results are taken from Güngen's material (Güngen, 2002). In Güngen's study, a comparison between the situation in Turkey in mid-2000 with the results of a study carried out by Opinion Leader Research for Andersen Consulting in 11 EU countries and the US in mid-1999.

Table 14. The Comparison of EU and Turkey according to the results of Business Internet User Survey 2000

	Percentage Agreeing	
	Turkey 2000	Europe/US 1999
E-commerce transforms ways to do business	49	70
E-commerce offers real competitive advantage	38	70
Will be more reliant on e-commerce in 5 years	52	59
E-commerce poses severe competitive threat	20	40
E-commerce intensifying competition	38	44
E-commerce currently helps you access new markets	51	40
E-commerce enables you bring products to markets quicker	45	41
E-commerce will not take off until Internet more robust	54	37
Security is a barrier to e-commerce development	32	68
Cost reduction is key to development	66	60
Low PC penetration is a barrier to growth of e-commerce	53	49
E-commerce will assist your foreign trade	52	59
Government should promote Internet access	65	88
Your company will have gained in 5 years	41	64

Source: IBS and Andersen Consulting

Source: (Güngen, 2002)

According to this survey's results the Turkish enterprises' approach to web activities are below the international ratios. However, the survey, mentioned above, is not up-to-date. There exists an explicit development in web access as it is seen from TUIK's study since 2000 (http://www.tuik.gov.tr/PreHaberBultenleri.do?id=275). And web usage for banking, marketing or trainig activities for SMEs are supported by KOSGEB, the banks and the government since web is cheaper than applying any other intermediary agents or establishing a special department inside the firm.

Credit and financing is emphasized as "the most important problem of the SMEs" in the KOSGEB research and the many financial crisis, Turkey has been through since 1990s, supported this idea (Akgemci, 2001). According to the KOSGEB research, made in 2001, the SMEs perform 99,5% of the enterprises in the manufacturing sector, 61,1% of the overall employment, 27,3% of the overall Value Added of Turkey. However, only a small proportion (4%) of the bank credits is used by the SMEs (http://www.kosgeb.gov.tr). This ratio strengthens the idea that there exists a financial problem for SMEs. However proving that this is the most important problem should be a debate of another statistical survey.

Additionally, the 2001 crisis can be said as a selection mechanism, forcing the weak financial positioned enterprises out of the sector/business and sustaining the left ones higher market shares, and trustable positions for banking sector.

CHAPTER 4

SME FINANCING

In this chapter, the institutional and financial obstacles of SME lending are reviewed. Those obstacles are listed first, and then the supporting literature survey, country examples and Turkey's existing situation is consolidated related with each topic.

To understand those obstacles, the author wishes to find out how lending infrastructure determines the conditions of SME lending.

Lending infrastructure means the rules and conditions set up mostly by the governments that affect financial institutions and their abilities to lend to different potential borrowers (Berger and Udell, 2004).

Regarding SME credit availability is the lending infrastructure of a nation which defines the rights and flexibility of financial institutions to fund SMEs using the lending technology that best fits the institution and the borrower. This infrastructure includes the commercial and bankruptcy laws that affect creditor rights and their judicial enforcement; the regulation of financial institutions, including restrictions on lending, barriers to entry, and direct state ownership of financial institutions; the information infrastructure, including the accounting standards to which potential borrowers must comply as well as the organizations and rules for sharing information; the taxes that directly affect credit extension; and so forth that provide the economic environment in which financial institutions may lend in a given nation (Berger and Udell, 2004).

In developing countries and Turkey, as well, SME financing challenges some consequences of national lending infrastructure. These can be listed as followings:

1. Financing business activities;
2. High interest rate charges;
3. Equity contribution/ collateral/ guarantee;
4. High administrative costs;
5. Business plan;
6. Apathy of financing SME (http://www.namibian.com.na);
7. Bureaucratic hindrances;
8. Short-term lending that does not match the maturity of the investment;
9. Lack of consultancy and information in financial decision-making (KOSGEB, 2004 a);
10. The Information Environment;
11. The Tax and Regulatory Environment.

4.1 Financing Business Activities

The enterprise need finance in every phase of the business; whether they are in start-up phase or not, does not matter. But for the government and the other actors, for financing an enterprise, there exist some questions:

Question 1: A national or regional SME policy? The opportunities of the national policy and regional policy may contradict in which business type should be promoted, which part of the land should but open for industrialization, and how the funds should be allocated (Armstrong and Taylor, 2000).

Question 2: Where to provide the help: enterprise nodes or uniform help? (Armstrong and Taylor, 2000) A spatially targeted area is usually advised by the policy makers to achieve one of the objectives, which make SMEs formation an important tool for regional and national growth, increasing the disabilities of some underdeveloped regions, and differences along the country. Nevertheless, for an entrepreneur, investing in an underdeveloped region and mostly with is/her

wn savings is not easy because of the high-risk of low demand and not well-organized infrastructure provided that there occurs a niche market.

Question 1 and 2 are most confusing problems of national and regional innovation systems. The regional policy development is not one of the topics of this thesis. Thus, a detailed argument about regional policies is not made. However, Turkey's Regional SME policy should be mentioned here in brief.

Turkey has been implementing EU-supported regional development program for SMEs as a candidate country (http://www.abgs.gov.tr/indextr.html). The SME projects, which are fitting the requirements of the financial alignment made with EU, are supported. The expectation is that the projects satisfy the regional objectives and priorities set forward and gaining comparative advantages in the sector. In this respect, the SMEs in manufacturing, agricultural and service sectors are credited with non-payment funds.

The sample activities are as followings:
- The consultancy and training activities / programs for SME development ;
- Marketing initiatives, fair and advertisement;
- Marketing for agricultural products;
- Creating trademark and raising revenue in tourism sector;
- Technology transfer and innovative projects;
- Human resources development projects.
  (http://www.dpt.gov.tr/bgyu/abbp/Hibe/hibe_mekanizma.html)

In September 2005, TOBB made the annual publication about Turkey's national economy. It is mentioned that the improvement of macro indexes does not recover all the regions. According to TOBB's research, only 6 of the 49 cities claimed a positive effect of the investment incentive program, nevertheless the rest of the cities under the program and 32 cities which are not under the program made complaints about the incentive regulations. In general, the participant enterprises cited that the investment incentive system needed to be redesigned with respect to sectoral and regional development and resource indexes, so that the excess capacity in some

ectors can be inhibited. In addition, TOBB's publication underlines the ill-balanced economic situation of the regions (TOBB, 2005).

Question 3: Who to help: new starters or survivors? Regarding the belief that SMEs benefit to the country most because of the job creation, this dilemma is important because there always exists a trade-off between motivating the entrepreneurship in a business environment which has a high death rate and getting the enterprises used to external financing for projects that may never get off the ground (Armstrong and Taylor, 2000).

OECD report has concluded that budget-funded support programs to facilitate job-creating activities need to be expanded. In order to ensure the development and long-term survival of new technically and economically competitive businesses, entrepreneurs need access to finance. It is important to give the smallest enterprises, which make up the majority of Turkish SMEs, access to the support that can compensate for the operational resources they lack (OECD, 2004).

This conclusion is maintained by International Finance Corporation (IFC) SME dataset. Turkey is in the upper-middle income group, and cost of starting a legal business (% of income per capita) is 26.4 higher than the group's average of 19.9 and have the second highest rank after Lebanon (IFC, 2006).

In 2001 and 2002, the reform of the banking and financial system had adverse consequences for SMEs. The banks imposed retroactive and unilateral interest rate increases that triggered repayment difficulties and a sharp drop in the volume and use of available credit for losses on subsidized loans to tradesmen, artisans and start-ups to cover the losses (OECD, 2004).

KOSGEB provides financial incentives to encourage entrepreneurial start-ups. These incentives are for support of both fixed investment and operating expenses. Whether it is paid back or not, or the duration of pay back are determined according to the purpose of the credit, the region or the success of the prototyping (for the technology start-ups). Start-ups in developed regions are expected to pay back more quickly, while firms in less developed areas are given longer grace periods and lower paybacks in early years. A non-payback basis for counseling support, support

or R&D applications and publishing of R&D findings, for leasing space in a technopark, and for export promotion purposes are also supplied by KOSGEB (http://www.kosgeb.gov.tr).

In EU, the persistent gap in early stage finance makes it necessary that the public sector continues to work with the private sector to overcome it (EC, 2003 a).

Especially for start-ups, venture capital is an effective instrument. To foster the requirements of venture capital, KOSGEB coordinated Turkey's participation in the European Community program, Multi-annual Programme for Enterprise and Entrepreneurship and in Particular for Small and Medium-sized Enterprises (2001-05). This was the first in which Turkey has taken part, for approximately EUR 4.5 million. Under the program, Turkey aims to learn about and rapidly deploy the financial instruments and mechanisms – relating to seed capital, venture capital, guaranteed loans and "business angels"– developed by the European Union to support knowledge- and technology-based and innovative businesses. Turkey may lack some specialized funding mechanisms for start-ups and early-stage enterprises, but it does have the beginnings of an organized venture capital system. Venture capitalists generally raise capital through public or private stock issues (private issues are made only to "sophisticated" investors who meet certain wealth requirements) which are then disbursed through a company that specializes in supporting start-ups or early-stage expansion firms. Only about one in 200 firms meets the investment criteria specified by these firms. Such companies usually require an expected compound growth rate of 25% or more a year for at least five to seven years. They expect that one of every two investments will fail and the invested capital will be entirely lost (OECD, 2004).

Question 3: Who to help: manufacturing or services? (Armstrong and Taylor, 2000) The service sector has not got much fixed capital like it is in manufacturing because of the heavy equipment or the machine park. However, the service sector is not efficient as the manufacturing in long-term stability and job creation since to exit and the entrance into sector is easier. Armstrong and Taylor's claim is valid according to the survey made in Turkey for the period of 2002-2004. Below, the innovativeness of industry sector and services sector are successively in Table 15 and Table 16.

Table 15. Innovative and non-innovative enterprises in industry by economic activity and size, (%), 2002-2004, Turkey

Innovative and non-innovative enterprises in industry by economic activity and size (%), 2002-2004 Turkey				
Size (Staff)	_	Total	Innovative	Non-innovative
Total		**100**	**34.58**	**65.42**
10-49		100	31.20	68.80
50-249		100	46.24	53.76
250+		100	56.27	43.73

Source: TUIK (http://www.tuik.gov.tr/PreIstatistikTablo.do?istab_id=86)

Table 16. Innovative and non-innovative enterprises in services by economic activity and size, (%)2002-2004, Turkey

Innovative and non-innovative enterprises in services by economic activity and size, (%)2002-2004 Turkey				
Size (Staff)	_	Total	Innovative	Non-innovative
Total		**100**	**25.90**	**74.10**
10-49		100	24.55	75.45
50-249		100	30.96	69.04
250+		100	55.05	44.95

Source: TUIK (http://www.tuik.gov.tr/PreIstatistikTablo.do?istab_id=86)

Large enterprises are more innovative than SMEs in both sectors. From a sectoral point of view, industry (manufacturing) sector is more innovative than service sector in Turkey.

In Turkey, service sector is the largest employer. The statistics of the year 2005 and 2006 are given in Table 17.

Table 17. The sectoral statistics of the year 2005 and 2006 for SME enterprises

In Thousand	**May.05**			**May.06**	
	Number	**%**		**Number**	**%**
Total	**22721**	**100**		**22860**	**100**
Agriculture	7266	32%		6488	28%
Industry	4165	18%		4277	19%
Construction	1252	6%		1336	6%
Services	10038	44%		10759	47%

Source: TUIK (http://www.tuik.gov.tr/PreHaberBultenleri.do?id=331&tb_id=1)

In Table 18, the sectoral breakdown of certificates for investment and operation credits foreseen for SMEs, between 2006 (January-July) is given. For the below data, the scope of services sector involves Tourism, Health, Education and Software Development, and manufacturing covers Construction, beyond the others.

Table 18. The sectoral breakdown of certificates for investment and operation credits foreseen for SMEs, between 2006 (January-July)

SECTORS	Number of Certificates	Investment Credit (YTL)	Operation Credit (YTL)	Total Credit (YTL)	Fixed Investment (YTL)	Employment (Person)
Manufacturing	51	10,191,000	665,500	10,856,500	20,083,573	656
Agricultural Industry	28	4,741,915	399,56	5141,475	9,487,056	248
Services Sector	7	1,969,500	75	2,044,500	4,408,825	85

Source: (http://www.hazine.gov.tr/english/tug/es300.htm)

Service sector has a smaller proportion in investment incentives, relative to its higher rank in employment. The share of service sector in total number of SME is hard to measure, since in reliable statistics, this sector is mostly disregarded[2]. But a rough estimate can be made such that: "A very large share of SMEs are in the trade, crafts and industry sectors represented by TESK (Confederation of Tradesmen and Artisans of Turkey) and TOBB (Union of Chambers of Commerce, Industry, Maritime Trade and Commodity Exchanges of Turkey). As of 31 January 2003, TESK had registered more than 2.76 million trade and craft enterprises. However, turnover of firms is substantial in this sector, which is highly sensitive to swings in the economy. In the trade and industry sector represented by TOBB, the number of enterprises was estimated at 1.2 million at the end of 2003" (OECD, 2004). Thus, assuming TESK as the representative of the services sector, the ratio can be estimated as approximately 70 % of SMEs, disregarding the informal economy.

4.2 High Interest Rate Charges

Indeed, talking about 'the funding problem' may be misguiding for the reader, since the banks intend to borrow but with high interest rates for the SMEs. The smaller enterprises are disadvantaged since they have to borrow from the same market with the larger ones; those can afford to pay much for larger amount of funding. Also the rates rise because of the lack of the collaterals, higher debt financing, and perceiving to be risky (Bayraktar and Köse, 2004).

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[2] Although, the official SME policy maker, KOSGEB, is charged for all sectoral activities, the institution mainly focused on the manufacturing sector. The old definition of SME was covering only manufacturing. Therefore, the national historical statistics of SMEs for sectoral breakdown is missing.

4.3 Equity Contribution / Collateral / Guarantee

The survey conducted with Zonguldak SMEs, has shown that the collateral is among the first two reasons of why the firms does not intend to borrow from the banks (Bayraktar and Köse, 2004). The other top reason is the high interest rates.

4.4 High Administrative Costs

Instead of working with many small customer demanding little amount of credits, working with the ones which demand bigger amount of credit amounts is more profitable for the banks and crediting organizations, considering the administrative costs. This opinion, for a long time, directed the banking sector's view about the SMEs. This way of looking, that hampered the SMEs being served in equal conditions with the bigger ones, is emphasized by International Bank General Manager Melih ARAS in an interview as follows: "Tiny works cannot be handled. Our organization is not big, a letter of credit of 1 million TL acquires the same man-hours and costs as it is for 1 million TL" (Müftüoğlu, 1997).

Today, this opinion is invalid. The survivals learned many things from the experiences of the collapsed ones. The banks should do real banking operations and try to make money from the commissions of those operations since lending to the state with high interest rates in an inflationist environment is over anymore, and trying to avoid crediting which is a profession acquiring real sector experience and scoring.

In the last few years, there exist an incredible race and product development in the commercial banking, which focuses on the SMEs. Comparing the 2001 and 2003 market shares of the first 9 banks in the sector, in the average a rise of 73% can be seen. SMEs are carrying high potential of sales for the bankers since it is expected them to have 40-50 % share in the banks credit portfolios soon. However, that share is below 5% nowadays. This is not so unrealistic due to the SMEs export potential and investment capacity (Levent, 2004).

4.5 Business Plan

In the case of medium size enterprises, the entrepreneurs are usually businessmen or professionals with considerable industrial experience, whereas for small workshops the owners originate from the shop floor. Industrial experience may not be enough to supply a business plan to a lender. Also in most SMEs in Turkey, the concentration of managerial and production functions is in the person of the owner (http://www.unece.org/indust/sme/tr-study.htm). A business plan is like an advertisement telling people the firm's prospects and future plans, and describing the credit need explicitly to an outsider. So, the inexperience in such plans will cause negative impression about the borrower. The lender has to suspect every point to guarantee the credit return and allocate the resources equally whether this lender is from a private bank or state bank.

The entrepreneurs of the SMEs are mostly not eager to grow and invest in new ideas, and prefer the traditional ways not only in keeping financial records but also in technological and managerial way, which are beyond the most important things the banks care while distributing already scarce funds.

For an investment credit demand, a feasibility study must be included in the business plan, but this is also mostly missed. The bank with its professional credit scorers and sector experts may investigate the feasibility to secure the investment and thus the credit return.

4.6 Apathy of Financing SMEs

It can be said that for the last few years there exits an incredible development in funding SMEs with credit. Thus, apathy of financing SMEs has decreased, but still occurs.

Turkey's first 9 banks are eager to work with the SMEs, but with the stronger ones, while the micro ones cannot easily find financing, except the European Funds.

Since 1999 the European Commission has been supporting capacity building in the financial markets of the accession and candidate countries through the SME Finance Facility, which has been funded by the Phare and Meda programmes. This facility has been managed by the European Bank for Reconstruction and Development, the Council of Europe Bank in cooperation with the KfW banking group, and by the EIB, which have offered credit lines to local banks for SME lending. These banks have also received financial incentives to train their personnel and to lend to SMEs. The adoption of the body of European Union legislation and the implementation of the Financial Services Action Plan will help the accession and candidate countries to solidify their legal environment, which will facilitate the development of financial markets (EC, 2003 a).

The banks try to get in the SME market first with the products like deposits or letter of credit carrying less risk. In that sense, the SME crediting through the sector chambers are also more preferable for the banks. It is obvious that the banking sector is not very willing to invest in the venture capital market. It is stated in the KOSGEB-HALKBANK express SME support credit program, the SMEs which have a history in the sector the firm has been in (http://kosgeb.gov.tr).

4.7 Bureaucratic Hindrances

It is mentioned about the character of the entrepreneur in Turkey while arguing about the business plan. For the same reasons, the bureaucracy is a hindrance for them. The owner does not have much knowledge about the workflow in these kinds of applications, and this is why the lenders turn down most of their credit applications. The scarce budget of the small firms does not let the job description and recruiting the employee according to professions. Most of the manufacturing firms outsource or do not employ any one for the marketing or the organization works.

KOSGEB serves the SMEs in these professions and consult them for their applications for the European funds.

4.8 Short-Term Lending That Does Not Match The Maturity Of The Investment

The entrepreneurs are in need of funding mostly in the start-up phase (Bayraktar and Köse, 2004). At that stage, it is hard to find financing from the banks, since venture capital is not a mature product for them and it is risky. Even if they find some credits showing their own savings as guarantee, they face the mismatch between the credit maturity and product life cycle. Banks prefer short-term lending whereas an idea, turning into a product and making profit, takes longer than 3-6 months period.

4.9 Lack of Consultancy and Information in Financial Decision-making

This is one of the top reasons why the firms are standing away from the bank credits (Bayraktar and Köse, 2004). Traditional credit lending is not the only way to finance a firm. The SMEs are comparatively away from the information sources due to unqualified employee, finance and managerial faults. In this manner, banks are seen as the interference in informing the entrepreneurs about the credit opportunities, types and requirements. This is because the SMEs have already an interaction for daily financial operations with the banks, and this relationship is open to be improved for sustaining long-standing cooperation. In EU, the EIB relies on a network of commercial banks that are in direct contact and have wide spread branches already with the SME customers, instead of using its own employee dealing directly with the SME customers spread throughout the EU (EIBG, 2004).

4.10 The Information Environment

The information infrastructure likely has a significant effect on the availability of credit to SMEs. The more the lenders share information about performance, the more credits are ailable

or enterprises (Jappelli and Pagano 2001, Love and Mylenko 2003). The important aspect of the information infrastructure is the accounting environment. For example, financial covenants are not feasible if the financial ratios calculated from bank financial statements are not reliable. The other important aspect of the information infrastructure is the availability of information on payment performance. Third-party information exchanges or business credit bureaus provide a formal organizational mechanism for the exchange of commercial payment performance information. Moreover, they have been shown to have power in predicting firm failure beyond financial ratios and other descriptive information about the firm (Kallberg and Udell, 2003). Survey data also indicate that without credit bureaus the time to process loans, the cost of making loans, and the level of defaults would all be higher (Miller 2003). These exchanges can be privately owned – such as the worlds largest, Dun and Bradstreet – or they can be publicly owned – such as the national credit registries in Italy and Argentina (Berger and Udell, 2004).

In the United States, to standardize all the accounting facilities, The General Accounting Office serves SMEs. The US Small Business Administration has an Inspector General, whose staff conducts both programmatic and fiscal audits and evaluations within the agency, and is subject to investigation by the General Accounting Office, which is an arm of the US Congress and which conducts programmatic evaluations as requested by the Committees of the Congress to support their oversight of the Executive Branch (OECD, 2004).

SMEs need counseling and assistance to produce the information required by the lenders. Small enterprises usually have very small accounting departments and often they have no accounting department at all. The entrepreneurs themselves may lack financial administrative skills and they are so involved in day-to-day business matters that the documents required by the bank (e.g. cost accounting documents or business plans) are often neglected. In some countries standardized business plans, simulation software, etc. are provided by banks to support SMEs in preparing loan applications and business plans (EC, 2003 b). In Turkey, many banks offer these kinds of services (http://www.garanti.com.tr).

In Turkey, the standardization for accounting systems and information sharing has not been managed yet. In Turkey, to evaluate payment performance, and to provide the exchange of

information among financial institutions for the purpose of monitoring and controling of consumer credits information (including credits cards) KKB A.Ş. (Credit Bureau of Turkey) was established in 1995. KKB was established one of the most important and the largest databases of Turkey. Credit Reference System (CRS) is an Information Sharing System developed by KKB A.Ş. (Credit Bureau of Turkey) in line with its objective of foundation through which its 28 members can share information on personal credit operations (http://www.kkb.com.tr). This bureau covers only consumer credits, and can be enlarged for the enterprises' payment performance database, as well, in future. Works aiming at enabling the sharing of information required for the monitoring and control of corporate credits within the KKB have also been started (TBB, 2005 a).

4.11 The Tax and Regulatory Environment

SMEs' retained earnings are the best form of financing for growth and investment. However, retained earnings often suffer from unequal tax treatment, thus, a review for fiscal arrangements on taxation is needed to promote firm growth. Furthermore, experience shows that investments by informal risk investors like friends, family and business angels can effectively be promoted through tax breaks (EC, 2003 a). This regulation also promotes institutions like business angels, as well.

In Turkey, to promote investment, tax reduction is implemented by the Undersecretariat of Treasury. This regulation works in the same way both for local enterprises and for foreign ones. "Specific elements vary depending on the location and size of the firm as well as the nature of the investment. Location criteria define three categories: developed regions, first-priority development regions and normal regions. Investment assistance takes a variety of forms: exemptions from customs duty, VAT exemption for machinery and equipment imported or purchased on the domestic market, and credit allocation from the budget. The investment allowance, which is the type of assistance most appreciated by businesses, and the exemption from certain taxes, duties and fees were previously among the incentive measures offered under the General Investment Encouragement System. The investment allowance, which is a form of

corporate tax deduction, has been automatically available since April 2003 and the exemption from certain taxes, duties and fees, which are levied on transactions relating to the process of obtaining investment credits through banks, has been available automatically since January 2004 and thus, no longer carries the obligation to have an incentive certificate" (OECD, 2004).

Taxation is an effective tool among SME development policies and show its effect in the short run. The SME policy makers can use this tool to directly channel the enterprises towards specific financial instruments.

Turkish governments have also used tax incentives as state aid for investment to SMEs. Those incentives are as followings:

- The VAT paid in machinery purchases shall be reimbursed to the investor. For the reimbursement of the VAT, the machinery must be brand-new.
- Fund-based loan transactions will be exempt from stamp and duties.
- If raw materials, machinery and equipment are imported for the realization of the project covered by the incentives, such imports will be exempt from customs taxes (Söğüt, 1997).

The financial systems of the accession and candidate countries supply less equity investments and bank lending than in the current Member States. The average ratio of domestic bank lending to GDP in the accession countries is around 40%, whereas the average for the euro area is 140%. Small firms suffer most from underdeveloped financial and legal systems, including unclear bankruptcy laws. In particular, if corporate performance is not transparent and creditor rights are weak, collateral-based lending is not attractive for banks. Weak legal protection also discourages the use of trade credit and long-term lending, which is at a low level in the accession and candidate countries.

Credit constraints limit the growth of SMEs in most accession and candidate countries, but there are differences. In countries that have a business environment favorable to financing, also the SME sector is numerically stronger. Furthermore, foreign bank penetration has improved financing conditions for all firms, including SMEs. Venture capital markets in the accession and

andidate countries suffer from the weak and illiquid stock markets that limit investors' exit possibilities and the preferred exit option of venture capital funds in these countries is to find foreign strategic investors. The venture capital investments have concentrated on later stage investments, mature enterprises and low-tech companies. The countries lack high-tech entrepreneurship, but the foreign dominated and young venture capital industry might also lack the means like local knowledge and informal networks to find potential entrepreneurs. Furthermore, there are administrative and cultural barriers to entrepreneurship emanating from universities and research institutions and links between them and businesses are weak. Overall, the accession and candidate countries need to pay attention to the further development of their financial systems. This includes capacity building throughout the financial sector making it easier for banks to become more acquainted with SMEs and more willing to provide medium and long-term lending. Furthermore, a gradual emergence of an equity culture will open the way for a more developed venture capital industry (EC, 2003 a).

Especially the state banks, have been offering comparatively low rate credits. Not only in Turkey, but also in many underdeveloped countries, the conditions of these kind of credits were always argued (http://www.namibian.com.na). Direct public funding ways prohibit the SMEs to take corrective action in investment, and inhibit achieving a sustainable SME funding financial environment in the long-term. Today, the fund allocation is done by KOSGEB interference, to keep the record of the credited enterprises more healthy and driving the enterprises along the development policy.

"In Turkey, banks do not lend money accounting to the feasibility study or the work plan of the start-up companies" (http://www.unece.org/indust/sme/tr-study.htm). Many start-ups enter into the business with their own savings or relatives' or friends' and cannot access credits due to lack of track record. This is also true for many countries like Ghana (http://www.worldbank.org/afr/findings/english/find26.htm) and China, and the Eastern Europe (Allende, Klapper and Sulla, 2002), where the World Bank have set up some projects to make accessing finance easier for the small enterprises, as well as Europe, where the starters are supported as a strategy of European Investment Bank (EIBG, 2004).

The author determined the lending infrastructure indexes of Turkey and evaluated those determinants according to OECD data. Among upper middle income countries, the indexes are as followings:

- Starting a Legal Business: This index is evaluated with respect to "time to start a business (days)" and "Cost (% of income per capita)". The values are, 9 and 26.4, successively. In Turkey, the bureaucratic applications take shorter time than the same group OECD countries (approximately 40 days), whereas, the cost to establish a business is higher than the average, 18 % of income per capita (IFC, 2006).

- Credit Markets: The credit adequacy is evaluated on "Private credit as % of GDP (2003)", "Private bureau coverage (borrowers per 1000 capita)" and "Cost to create collateral (% of income per capita)". The values are, 16.3, 300, and 19.9, successively. In Turkey, private credit usage is lower than the same group OECD countries (approximately 42%). Private bureau coverage ratio is also under the average of the income group, 211 borrowers per 1000 capita. The collateral problem is challenging. The higher cost to create collateral, over the average of 9.1% per capita, supports the idea claimed before (IFC, 2006).

- Alternative Funding instruments: The usage ratios of leasing and factoring for the year of 2003 constitute a view for Turkey's alternative funding index. Leasing as % of total private credit factoring as % of GDP, are 3.76 and 1.94, successively. Turkey has ranked higher than the other OECD countries. Most of the countries does not have data in these categories, thus the averages are not taken into account for the evaluation (IFC, 2006).

CHAPTER 5

SMES AND THE BANKING SECTOR

Financial institution structure means the market presence of different types of financial institutions that provide credit, as well as the competition among these institutions. The differences in the financial institution structure and lending infrastructure may significantly affect the availability of funds to SMEs by affecting the feasibility with which financial institutions may employ the different lending technologies in which they have comparative advantages to provide funds to different types of SMEs (EC, 2003 a). The banks are the most important actors of national financial infrastructure.

Turkish banking sector, under the financial liberalization policies of after 1989 period, had a mission of financing the state, which has lost the ability to borrow abroad directly. This mission was very profitable in those days' inflationist environment and has caused the sector to loose the mission of the supply funds to the real sector. The portion of the credits of the deposit banks in the GDP was not as expected for an industry supposed to improve under the liberal policies, supporting the import and export facilities (Yeldan, 2001).

Not only for the banking sector, but also for the real sector, the speculative ranting methods to earn money were popular and turned the situation into a cycle without any exit. In that period, the real sector was also making money not from their core facilities, but from the money market. These two players, the banking sector and the real sector, hand in hand gave rise to the speculative saving instead of real economy profits (Yeldan, 2001).

With the crisis the Turkish economy went through, both sectors shrank and could not find any other way than performing the core facilities, for the bankers, crediting, and for the enterprises investing in core facilities and financing their investments. This is why the development policies are so popular for all the actors of the economy; the state, the enterprises, the bankers, and the other financial or non-financial organizations and the institutions.

Today, the banking sector is in a rush to strengthen its position in funding the SME development, but the portfolios of the banks have been forcing them to keep the maturity short since the unstable market conditions let the bankers collect savings with less than one-year for a long period since 1980s. With respect to the statistics of June 2006, 70% of total assets, and 72% of total liabilities have shorter maturity than 1 year (TBB, 2006). With the assumption that the investors are in a way the savers, the orientation towards short-term is not the fault of the banking sector alone. As it is said before, the money supply from the enterprises, which keeps the money in state-bonds or short-term deposits with high interest rates rather than investing the money into business (http://www.worldbank.org/afr/findings/english/find26.htm). Therefore, this thesis claims that the financial problem of SME is not just as a lack of credit with low interest rates, and besides the management weaknesses are limiting their ability to use credit effectively. The SME credit financing, and cross-country analysis is given in Table 19.

Table 19. The SME credit financing, and cross-country analysis according to OECD data

Cross-country	% of Total Enterprises	% of Total Employment	% ofTotal Investment	% of Value Added	% of Export	% of Credits
USA	97.2	58	38	43	32	42.7
Germany	99	64	44	49	31	-
Japan	99.4	81.4	40	52	38	50
The United Kingdom	96	36	29.5	25	22	27

Table 19 (continued)

France	99	67	45	54	26	29
Italy	98	83	52	47	-	-
India	98.6	63	27.8	50	40	15.3
S.Korea	98.8	59	35	35	20	47
Thailand	98	64	-	47	50	-
Singapore	97	44	27	43	10	27
Turkey	99.8	76.7	38	26.5	10	5

Source: (OECD, 2004 ; http://www.kosgeb.gov.tr/kos.htm)

With respect to the comparison in Table 19, SMEs have a smaller proportion in credits relative to the numeric dominance in economic values. The lower ratio in export is meaningful. International markets demand better informational structures. Thus, the export-driven SMEs may have higher capability in bank lending.

5.1 The Role of Banking Sector in SME Lending

In the history of today's developed country, Germany, there is an important bank: the German Groβbanken. In literature, this bank is told to have a great role in industrialization of the Germany before the World War II. This was achieved by sustaining great support to the enterprises, depending on the theory that in the world of perfect information and no agency costs, firms can borrow and invest optimally (Paulet, 1999).

Basically, the money market agents can be listed as: The bank, the shareholders of the bank (the savers in a way, business angels, and the shareholders of the bank) and the enterprises. A bank-firm relation is considered to be profitable for both parties in a large part of the liberal theories, "because:

    1.   The bank prevents the firm from undertaking projects that are too risky;

2. The firm signals its reputation to the market by having a regular relation with a bank" (Paulet, 1999);

3. The bank signals its reputation to the market by having more credit customers with highly performing credits;

4. The shareholders earn profit in a less speculative environment and in a secure way.

"Financing SMEs is a local business." (EIBG, 2004). SMEs need direct access to the financial partners with high quality local and sectoral information that is able to monitor closely the changing demand and carry out appraisals of proposes projects. The weaknesses of the SME management and its consequences were mentioned before. Thus, with the qualified employee trained for the financial activities and their impact on the business, the banks are proper to be used as intermediaries, regarding their wide branch network. The point here is that analyzing the dilemmas of the lender and making proposals to overcome these difficulties.

According to the surveys of the World Bank and the European Union, funding through the banking sector is the most proper way to support the SME development in the EU, in the underdeveloped, and in the transition countries, and this funding method is parallel with the liberalization policies applied in the economies of those countries (World Bank, 2005; http://www.worldbank.org/afr/findings/english/find26.htm; EIBG, 2004; World Bank, 2000; Allende, Klapper,and Sulla, 2002).

In EU, basically two funding SME systems can be observed: A bank-based system, as in Germany and Austria, and a market-based financial system as in the United Kingdom. The importance of bank financing varies among the member states, while the majority of European SMEs depend on bank financing and the other funding resources are not wide-spread (EC, 2003 b).

For the Turkish SMEs, the credit financing from the banks are among the first two methods for funding their investments. This order may change according to which phase the enterprise is in - start-up or growth- and the strategies of the entrepreneur. But most SMEs have direct

relationships with the local bank offices and see the bankers not only as a source of finance but also as a source of information (Bayraktar and Köse, 2004).

In Turkey, primarily two main groups perform the SME banking:

1. Public sector banking: Halkbank leaded this sector for long years. "Halkbank was established in 1933 to act as a financial agent for petty traders, artisans and small industries. Following 1963, by which Turkey has marched into planned periods Halkbank has begun to play a more pronounced role in giving financial support to SMEs." There are also other public banks with some other non-banking financial organizations giving financial support to the SMEs; Vakıfbank, TKB, TSKB, and Eximbank (http://www.unece.org/indust/sme/tr-study.htm). However, there have been some problems of the scope of those funds, and the performance of the credits distributed in political side, and economical side. Halkbank is crediting the SMEs, which demand the KOSGEB funds (http://www.kosgeb.gov.tr). As it is in other countries like India, the Turkish public sector banking also faces key challenges; expanding the loans while improving the quality of the portfolio and taking supportive actions while not inhibiting the private sector development in the SME market with lower interest rates or direct funding.

2. Private sector banking: These commercial banks, though they were not regarding the SMEs for long years, finding them too risky, view SME lending as a profitable business and offer them many products in a wide-range (KOSGEB, 2004 a). In the survey conducted with the 1200 SMEs in Turkey, the usage ratios and popularity of those financial services (check book, check cashing, check collection, transfer, EFT, personal credit cards, business credit cards, letter of guarantee, letter of credit) is very high (Güngen, 2002). However, SME portfolio is under %5 in the all credit volume of the banking sector. The sector is very selective and cautious in their SME lending because the banks want to keep their record of good quality loan while maintaining a larger share in the SME market.

European Investment Bank (EIB), also manages funds with local banks and joins its forces to support SMEs in Turkey as the Community's financing institution. Since December 2005, EIB

is lending to 5 national banks, namely TSKB, Vakıfbank, TKB, Ziraat Bank and Halkbank a total of EUR 250 million to enable SMEs to gain access to more finance to build or expand xisting or new businesses (http://www.deltur.cec.eu.int/!Publish/en/PR%20-%202005-PressRelease-73.doc).

EIB is a wholesale provider of capital EU capital market funds, but it reaches SMEs through a network of commercial local banks. The advantages of global loans are as followings:

- By operating with local banks in Turkey, the EIB is promoting competition that will benefit the banking sector as well as the clients.
- The loan will be available across the whole of the country to finance projects in the industry, tourism, and services sectors, including health and education (EC, 2003 a).
- Assuming the global loans will be used wide-spread, because of the desirable lending conditions; the banking sector uses and widens its experience in monitoring, scoring and segmenting SMEs through credit lines.

5.2 The Evolution of Banking Sector in Turkey

First of all, the banks hesitate because of the obstacles of the lending structure, which were previously mentioned in Chapter 4. In addition to the lending structure, the features of the financial institutions should be taken into account to comprehend the challenges of the banking sector in SME lending. According to Berger and Udell, there are five issues effecting SME lending:

1. Large vs. small financial institutions
2. Foreign-owned vs. domestically-owned financial institutions
3. State-owned vs. privately-owned financial institutions
4. Market concentration (Berger and Udell, 2004)

In this chapter, the first three subjects of this theory will be argued.

Large vs. small financial institutions:

It cannot be simply concluded that a larger market share for small financial institutions is needed to supply credit to SMEs. According to the literature, large institutions have a comparative disadvantage in relationship lending, and have comparative advantages in some transactions lending technologies –such as small business credit scoring and asset-based lending – that are well-suited for funding opaque SMEs. Large institutions are able to provide credit to opaque SMEs using some of the transactions technologies. These technologies require high amount of investments and standardization, offsetting their disadvantage in relationship lending. However, because lending technologies are generally unobserved, it is difficult to distinguish this hypothesis from the alternative hypothesis that market forces efficiently sort the opaque SMEs to small institutions in the market (Berger and Udell, 2004).

Foreign-owned vs. domestically-owned financial institutions:

Foreign-owned institutions, which are typically part of large organizations, face additional hurdles in relationship lending because they may have particular difficulties in processing and transmitting soft information over greater distances, through more managerial layers, and having to cope with multiple economic, cultural, and regulatory environments. Moreover, in developing nations, like Turkey, foreign-owned institutions headquartered in developed nations may have additional advantages in transactions lending to some SMEs because of access to better information technologies for collecting and assessing hard information. For example, some foreign-owned institutions use a form of small business credit scoring to lend to SMEs in developing nations based on the SME's industry. Other institutions provide home-nation training for loan officers stationed in developing nations. (Berger and Udell, 2004).

State-owned vs. privately-owned financial institutions:

State-owned institutions generally operate with government subsidies and often have mandates to supply additional credit to SMEs or entrepreneurs in general, or to those in specific industries, sectors, or regions. Although in principle this might be expected to improve funding

of creditworthy SMEs, it could have the opposite effect in practice because these institutions may be inefficient due to a lack of market discipline. Much of their funding to SMEs may be to firms that are not creditworthy because of this inefficiency. The credit recipients may also not be creditworthy because the lending mandates do not necessarily require the funding be applied to positive net present value projects, or that the loans be expected to be repaid at market rates. The allocation of the funds for political purposes to inefficient credit lines, relatively weak monitoring of borrowers, avoiding from aggressive collection procedures as part of their mandates to subsidize chosen borrowers or because of the lack of market discipline, higher non-performing loan rates are claimed for state-owned financial institutions. The empirical findings, stated in Berger and Udell's study, claim that individual state-owned banks are relatively inefficient and that large shares of state bank ownership are typically associated with unfavorable macroeconomic consequences with less SME lending. In addition to this, the study also argues that the privatization may improve the performance (Berger and Udell, 2004).In Turkey, the mentioned characteristics of the financial institutions can be overviewed in the banking sector. As of June 2006, there are 47 banks in the sector. In Table 20, the size of banks in total assets is given.

Table 20. The size of banks according to total assets

USD Billion	+0-1		1-2		2-5		5-10		10-20		20-40		40+
	99	June 2006	99	June 2006	99	June 2006	99	June 2006	99	June 2006	99	June 2006	June 2006
Number													
Commercial	37	15	10	3	7	3	6	4	4	3	1	4	2
State-owned					1		1		1		1	2	1
Privately-owned	15	4	6	3	5	2	5	2	3	3		2	1
Foreign banks	17	10	1		1	1		2					
Banks in the Fund	5	1	3		1								
Non-depository	17	10	1		1	3							
Total	54	25	11	3	9	6	6	4	4	3	1	4	2

Source: (TBB, 2006)

According to the data in Table 20, following findings can be achieved, with the assumption that a bank with total assets lower than 5 is small, between 5 and 20 is medium, and higher than 20 is large:

1. In the sector, there are 6 large banks, 7 medium banks, and 34 are small, as of June 2006. Turkish banking sector has a bigger share of larger institutions (6 of 47 banks) with respect to 1999. The closing rate of small banks (54%) is higher than any other size category; 40 of 74 banks have been closed since 1999.

2. The evolution of the banking sector is given in Figure 2.
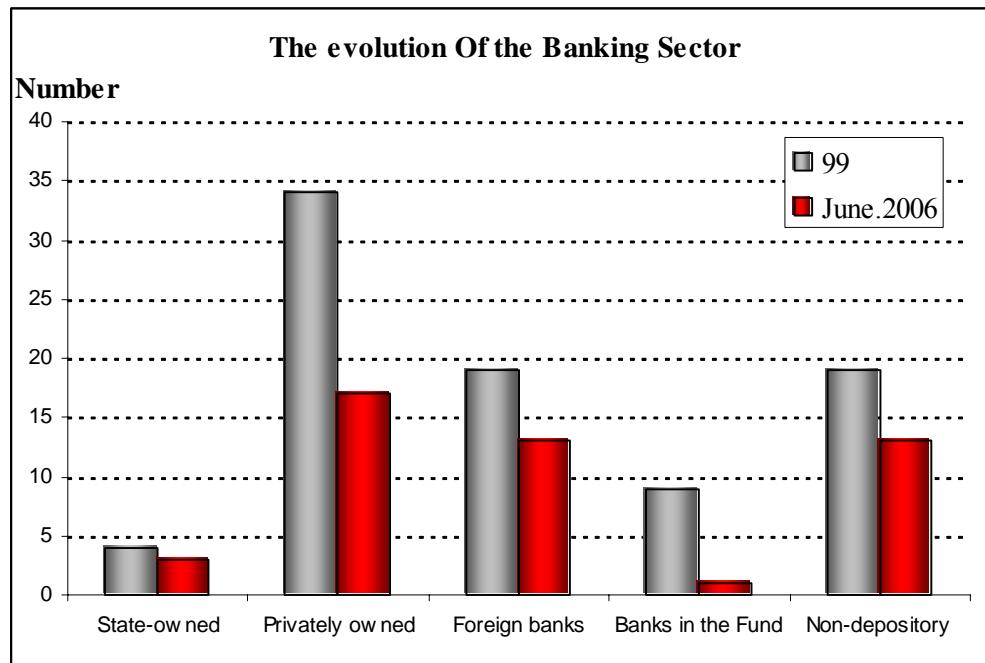
Figure 2. The evolution of the banking sector Source: (TBB, 2005 b; http://www.tbb.org.tr/english/TBBBrosur10032005englishi.pdf)

With respect to Figure 2, it is simply concluded that the number of actors in the sector has decreased dramatically since 1999. However, with respect to the total assets, the sector has grown as shown in Table 21.

Table 21. The total assets of banking sector in Turkey, 2001-2006

YTL Million	2001	2002	2003	2004	June 2006
Commercial	206,589	203,237	239,423	295,138	440,43
State-owned	70,813	67,831	83,134	106,932	133,957
Privately-owned	118,163	119,471	142,270	175,910	277,999
Foreign banks	10,823	9,310	7,075	1,940	27,406
Banks in the Fund	6,790	6,624	6,944	10,356	1,068
Non-depository	9,918	9,438	10,270	11,327	14,813
Total Assets	216,508	212,675	249,693	306,464	455,244

Source: (TBB, 2005 b; TBB, 2006)

The banking sector's scale has decreased in numbers of actors, whereas it has increased in total assets. The state-owned realized a growth of 25%, the privately owned banks realized the growth at around 60%, and the foreign banks realized over 1000%, as of June 2006, with respect to the year of 2004.

In conclusion, the foreign bank entry into the national market is rising since 2001. The market is dominated by the privately-owned banks. The actors, which are sidelined from the sector during the crisis, are bought by private banks and foreign banks. The large banks are standing out with large total assets portfolio, performing over 60% of total market (TBB, 2006). According to the claims of Berger and Udell, a significant raise in SME lending can be expected in lending structure, based on the changes of financial structure.

Any detailed statistics of SME lending in the breakdown of the financial institution classification, mentioned in Udell and Berger's study, is missing for Turkey. However, the author argues that the relevant national lending data are not adequate to prove the development of the SME lending.

The below Figure 3 is taken from CBRT's Monetary Policy Report of 2005, Third Quarter, and the numbers on the Y axis are representing the ratio of total lending capacity of the banking sector to GNP.
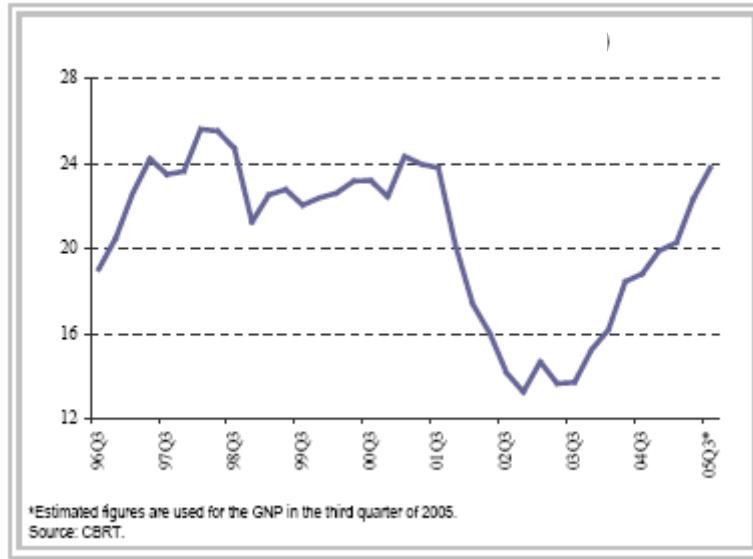

Figure 3. The ratio of total lending capacity of the banking sector to GNP; Cross Country Comparison. Source: (CBRT, 2005 a)

In the CBRT's monetary policy report, it is mentioned that the rising tendency roots from the followings:

- Restructuring of the financial system;
- Positive effects on macroeconomic expectations of the converging with the EU;
- The eagerness of foreign banks to expand their individual loan bases in the country;
- The efforts of domestic banks to protect their consumer bases;
- The efforts of the banks to protect their profitability, in the face of narrowing interest rate margins.

Figure 4 is taken from the CBRT's Monetary Policy Report of 2005, First Quarter. In the report it is stated that the rise of the SME loans is as expected and pursue its acceleration.
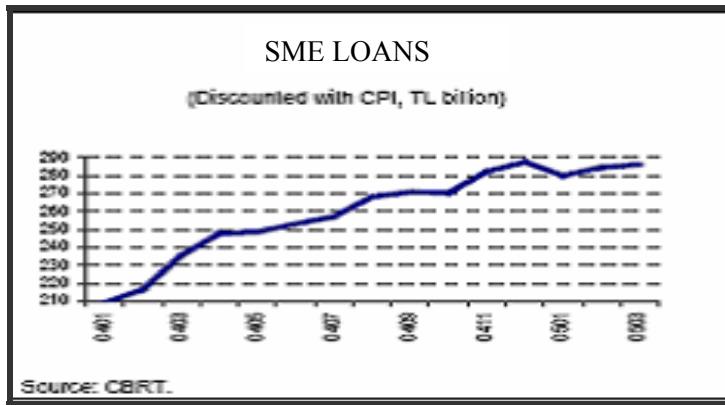
Figure 4. The rise of the SME Loans btw. 2004-2005. Source: (CBRT, 2005 b)

CBRT's conclusions are not conflicting with Berger and Udell's theory, but also, they are not proving. Since Turkey's business environment is in an evolutionary process in the same period, the credit market enlargement cannot be simply depended on the banking sector characteristics.

For, SME lending statistics, CBRT is the only relevant source at national base for Turkey. Although it is not totally adequate to test this hypothesis, to have an idea, the trend of the working capital loans for the period of 2001-2006 can also be investigated. To manage working capital is among the most important reasons why the SMEs apply the external financing (Müslümov, 2002). Halkbank was established to supply working capital needs of the petty traders, artisans and small enterprises. Also the customized credits for SMEs are mostly used as working capital, except the credits for foreign investment, export and import facilities (http://www.halkbank.com.tr; http://www.garanti.com.tr; http://www.tcmb.gov.tr).
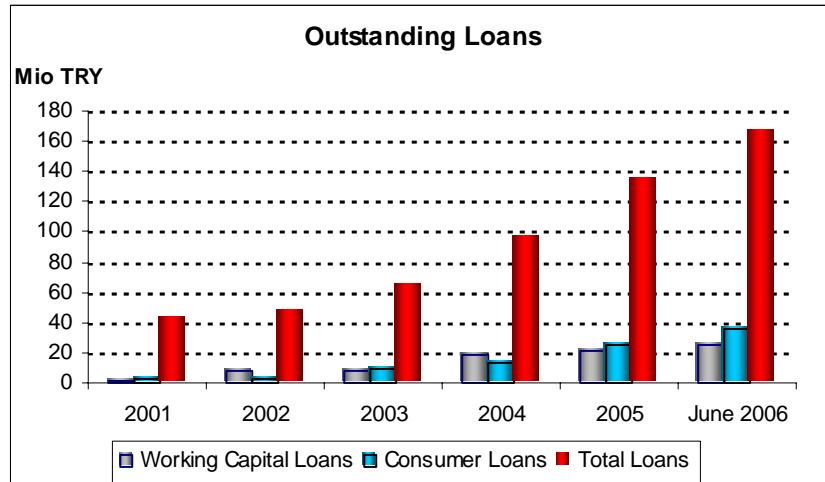
Figure 5. The Outstanding Loans btw. 2001-2006, according to CBRT data. Source: (http://www.bddk.org.tr)
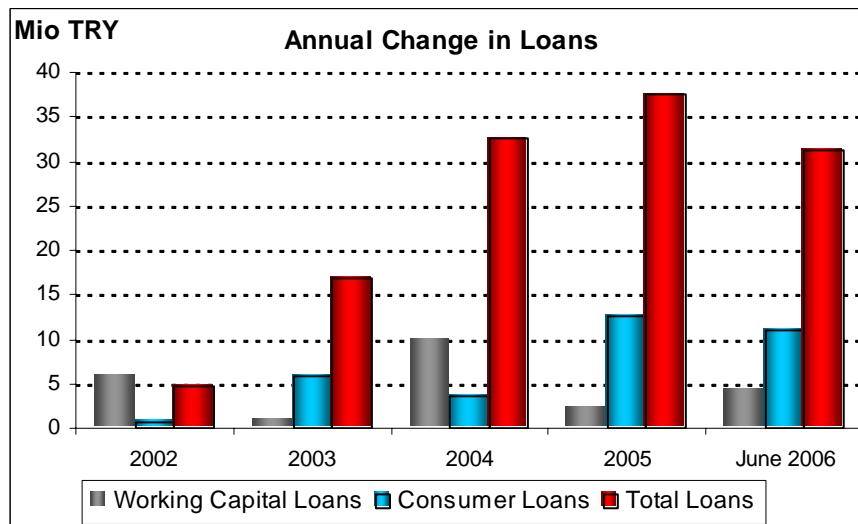

Figure 6. Annual Change in Loans btw 2001-2006, according to CBRT data. Source: (http://www.bddk.org.tr)

While total loans are enlarging, working capital loans are also enlarging. However, from the Figure 5 and 6, it can be concluded that consumer loans have increased more rapidly than working capital loans during the last two years. The evolution in business environment and the lending infrastructure has affected the consumer loans more positively than working capital loans.

Also, the empirical results of Clarke, Cull and Peria's study in developing countries strongly support the assertion that foreign bank penetration improves firms' access to credit. They conclude on the following statement: "Enterprises in countries with high levels of foreign bank penetration tended to rate interest rates and access to long-term loans as lesser constraints on enterprise operations and growth than enterprises in countries with less foreign penetration. Further, the benefits of high levels of foreign bank penetration do not appear to accrue only to large enterprises. Although some evidence suggests that entry by foreign banks benefits large enterprises more than small ones, there is strong evidence that even small enterprises benefit in some ways and there is no evidence that they are harmed by foreign bank entry. At first sight, this result might seem inconsistent with developing country case studies that find that foreign banks lend smaller shares of their portfolios to small and medium-sized enterprises than similar domestic banks. There are a number of reasons why this is not necessarily so. First, cross-country evidence suggests that increased foreign bank entry is associated with lower interest margins and overhead costs. If improved efficiency results in an expansion in total lending, the amount of lending to SMEs might increase even if the share of lending to them falls. Second, increased foreign bank participation might cause domestic banks to modify their behavior. In particular, foreign competition for larger clients might force existing domestic banks to seek new market niches, which could benefit small borrowers in the medium term" (Clarke, Cull and Peria, 2001).

In conclusion, the author admits that there exists a rise for the SME lending at the same time with the evolution of the banking sector. But since SME lending is also affected by the macro indexes, the simple relation between two variables is not concluded in this thesis, due to the lack of enough empirical evidence.

5.3 The Risk Factors for Banking Sector in SME Lending:

In EU, in favor of innovation and new technologies, global loans, the contracted banks in association called European Investment Fund have distributed seed capital and venture capital funds. The Fund uses the banks, especially due to the banks' network of branches. There are other advantages of such fund allocation and participating such organizations for the banks, like experienced gain, especially trained personnel and financial profit, information sharing via credit scoring with the other participant banks (EIB, 2004).

In Ghana, India and Kosovo, the World Bank set a project to improve a private banking sector, first stimulating the funds through the state and the public banks, but at the end targeting a stable banking sector, supportive for SME development, part of these countries national development plans (World Bank, 2000; World Bank, 2005).

In Turkey, the banking sector contribution has been improving (KOSGEB, 2004 a); also international funds like SELP (Small Enterprise Loan Program) have been set out in many commercial banks. Besides these improvements, the OECD reports mention that the state directed aids are not governed efficiently. Halkbank distributes KOSGEB credits; while the private banks distribute the Eximbank credits. Also the alliances occur between TTGV and the private banks like TEB (Turkish Economy Bank) (http://www.ttgv.org.tr/page.php?id=102#).

However, the subjects mentioned below cause the banking sector approach the SMEs as more risky borrowers:

- Corporate performance is not transparent;
- Low level of productivity;
- Lack of historical records of the SMEs;
- Lack of better legal protection for both side;
- Lack of standard financial reporting system;
- SMEs mostly do not have standard and proper accounting system;
- High risk that SME lending carries due to high failure rate;
- Low SME employee qualification and management skills.

The effects of Basel II standards are becoming more important at this point. In Turkey, the evolution of risk management, accompanied by structural changes, like intensified competition and the banking sector evolution, has forced banks to pay more attention to measuring and managing their credit risks and their capital adequacy with respect to risks taken, as it is in the other developed and developing countries. In the view of these developments, the Basel Committee for Banking Supervision decided to reform the framework about capital adequacy regulation. Since the lending conditions of the banks are undergoing a change, SMEs are also facing with a transformation, like all the other borrowers. In short, under the new Basel II framework, the minimum amount of capital that banks are required to set aside will no longer solely depend on the amount of the loan, but also and significantly on the risk of the loan. For SMEs, the expected consequences are:

- More attention to risk assessment and rating of SMEs;
- Ranging price and credit conditions according to the risk of loan, SMEs demand.

The rating will decide on the amount, payment period, interest or the collateral required. And this rating is depended on the information about the borrowers' current financial condition and historical payment performance (EC, 2005 b).

Under this regulation, it is obvious that for opaque SMEs, access to finance is hardening. However, it can be expected that the ones willing to share information and have more straight information and accounting structure can lend in better conditions.

However, Özdemir concludes in his study that the good ratable credit portfolio is not relevant. The state bank, Halkbank, which is in the process of being privatized, makes most of the loans to small enterprises. During the crisis, the government assisted small businesses, including those in the agricultural and SME sectors, using public banks (Halkbank for SMEs and Ziraat Bank for agriculture), which offered subsidized loans. These led to heavy losses for the public banks, thereby exacerbating the problems of the financial sector. One important factor for SME financing in Turkey is that with continuing efforts to control government expenditures and reduce inflation rates, the government will be obliged to limit further its current SME financing programs, whose scope is not very large and Halkbank does not seem to be able to continue with its current mission. Banks who will want to benefit from the lower capital requirements of

Basel II approach may provide retail businesses with attractive incentives such as larger credit lines and smaller interest margins. Özdemir claims that the banks cannot give up corporate portfolios because eligible retail borrowers do not constitute enough potential. Also, Halkbank's portfolio, made up of SMEs, has a worse performance than the average commercial loan portfolio in the system. The commercial loans are not only bigger in size but also accepted more open to fraud. Özdemir also claims that the developed countries have similar problems. According to the surveys conducted by KfW two-thirds of the SMEs in Germany are estimated to be of non-investment grade, stated in Basel II (Özdemir, 2004).

In addition, since smaller enterprises generally do not have either the collateral or cash flows of their larger competitors, they will have less financing opportunities. In Turkey, since alternative financial instruments such as venture capital, business angels and equity financing through the stock exchange are not well developed (OECD, 2004). Thus the lending opportunities may not widen especially for small enterprises, even can narrow.

5.4 The Analysis of SME Lending Data, and the Methodology

To test the hypothesis, a sample of SME is needed to be evaluated. The banks may be addressed as the main sources of information in this respect, since the SME customers are assumed to be willing to share information about their business, organization and financial issues, since the banks are creditors. CBRT has been gathering information about the banks' credited customers in periods. However, the banks evaluate the SMEs in different definitions and categories and this truth also prohibits forming a standardized data for the banks' customers.

In Table 22, there is a summary of these different SME definition of the banking sector. The data is composed according to the benchmark study accomplished by the SME Banking professionals in Turkish Economy Bank.

Table 22. The different SME definition of the banks

The Name of The Bank	TURNOVER	CREDIT LIMIT
GARANTI	0-5 000 000 USD	0-600 000 USD
FORTIS	0-5 000 000 EUR	0-1 000 000 EUR
HSBC	0-10 000 000 USD	NO LIMIT
DENIZBANK	0-5 000 000 USD	NO LIMIT
FINANSBANK	0-7 500 000 YTL	0-250 000 YTL
AKBANK	0-3 000 000 YTL	NO LIMIT
OYAKBANK	0-3 000 000 YTL	NO LIMIT
TURK EKONOMI BANKASI	0- 2 700 000 YTL	0-150 000YTL

The data evaluated in this part belongs to a privately-owned small-medium bank. The Bank's shares are held by public, Financial Subsidiary Group and an international bank, which has been performing over more than 50 countries. The partnership with the international bank was signed at the beginning of the 2005. The Bank has a definition upon turnover and credit limit.

The sample Bank is chosen for some reasons:

1. The bank has focused on core banking activities since its establishment, supported the SME customers with a wide range of credit and saving products, and directed all its efforts and investments on these activities. Even before the 2001 crisis, the Bank's portfolio was not based on the government bonds, was heavily based on the credit-deposit balance. Thus, the Bank and the related professionals have a reliable experience on SME lending.

2. The Bank has been using the same SME definition criteria for two years. (Table 22) (*The criteria are refreshed only according to the inflation and foreign exchange rate*.)

3. The Bank has an information technology structure, feeding a warehouse, which is an important aspect for gathering the data related together.

4. The Bank is innovative and initiative about developing SME specific products, other than crediting. Thus, the professionals in the Bank have a wider scope for SME banking.

5. The Bank has a widely known reputation about commercial customer scoring and being conservative about crediting. The detailed financial analyses about the customers and the records of this analysis have been kept in the Bank's warehouse.

The methodology is as;

1. First the critic issues for SME and banking were evaluated by the author and the bank professionals to set the topics of this analysis;

2. Then, the related data under these topics were consolidated, based on the Bank's confidentiality and approved definitions.

3. The sum up data was summarized and some results were concluded. The summary of the raw data and the conclusions are mentioned in this thesis.

All the sample data belong to the date of 10/31/2006. Only for some topics, the date is 09/31/2006. (*In those cases, the date is specifically mentioned in the related text body*.) Also for the confidentiality of the Bank, some amounts are not given in exact precision, and the rise and decreases are declared only as percentages or ratios.

5.4.1 Overview

The Bank has a Commercial customer portfolio of approximately 70 thousands. This number belongs to a portfolio of the commercial customers, which have at least one open account relation with the Bank, on the date of 10/31/2006. Over 26,000 of these customers are relevant to the SME definition of the Bank itself. They are treated by specific portfolio managers, their credit approval flows are managed by different units, and the upper and lower credit limits of them are different from the Corporate customers and Retail customers.

The new definition of KOSGEB is based on the turnover and the headcount. The Bank has a definition upon the turnover and the credit limit. The author investigated the sample data, according to the KOSGEB's definition:

- Turnover: Some firms have declared the turnover at the end of the 2004 year and not renewed it yet. And some firms have declared the amount at the end of the 2005.

- Approximately 87% of the Bank's total SME portfolio has declared the turnover information, and 73% has declared the newest completed financial year's (2005) turnover.

- Headcount: The ratio of the firms, which have declared their headcount, is very small. 6% of the sample has shared this information with the Bank. Only 3% of the sample has shared the turnover of 2005 and the headcount records.

5.4.2 The SME Credits

The Bank has structured a credit approval flow system since 2005. This flow begins in the Branch and approved by the Head office units or the Branch, according to the limit of credit. The Bank has the definition of SME Credit, as "the credit allocated to the SME customer". The share of the SME credit proposals in the total commercial credit proposals is an index of SME's relation with the Bank. The shares of SME credits, in the credit proposals made between 01/01/2005 and 10/31/2006, are as followings:

- For the year of 2005: approximately over 10%;
- For the year of 2006: approximately over 35%;
- The rate of rise between two years is 350%.

The rejection proportion of the SME credit proposals sample and reasons are another topic in this investigation. Investigating the SME credit proposals, presented between 01/01/2005 – 10/31/2006, the below records are concluded:

- For the year of 2005: approximately over 4.4% of the SME credit proposals are NOT approved.

- For the year of 2006: approximately over 3.8% of the SME credit proposals are NOT approved.

The rate of decrease between two years is approximately 14%, which is an important index for the development in the SME credit rating in the Bank's SME credit proposals pool.

The reasons of disapproval of the SME credit proposals and the proportions are also important indexes to have some clues about the SME –Bank relation.

- For the year of 2005, the records are below in Table 23

Table 23. The reasons of disapproval of the SME credit proposals and the proportions of the year 2005

Negative information about the Firm	2005	7%
Inadequacy in the financial situation of the Firm	2005	29%
The Firm do not accept the limits allocated by the Bank	2005	4%
The subject of the credit proposal	2005	9%
Others	2005	51%
Total		*100%*

- For the year of 2006, the records are below in Table 24

Table 24. The reasons of disapproval of the SME credit proposals and the proportions of the year 2006

Negative information about the Firm	2006	4%
Inadequacy in the financial situation of the Firm	2006	8%
The Firm do not accept the limits allocated by the Bank	2006	12%
The subject of the credit proposal	2006	3%
The risk of the Firm's sector	2006	0%
Others	2006	72%
Total		*100%*

For both years, there exist an important proportion of records, not classified and named as "Others". For the classified records, "Negative information about the Firm", "Inadequacy in the financial situation of the Firm", and "The subject of the credit proposal" show a decreasing rate, whereas "The Firm do not accept the limits allocated by the Bank" has a rising rate.

The distribution of the risk of the sample SMEs according to the maturity is also another important index. The related data is given in Figure 7
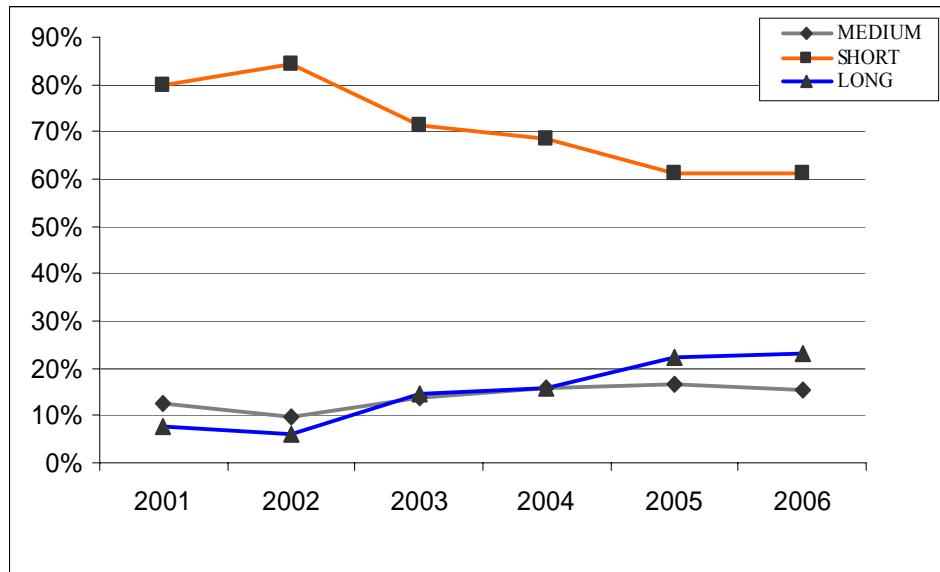

Figure 7. Distribution of the risk of the sample SMEs according to the maturity

The ratio of Non-cash credit to Cash credit is another important issue for this investigation. In the Bank's SME credit, this ratio is 1 to 3. This ratio is also 1 to 3, examining the Bank's SME customers' credits in other banks. This ratio is found from the CBRT Credit pool, which is fed by the sample Bank, and the other banks credit records.

5.4.3   The Tendency of the Firms

The Partners of the Firms and their relation with the Bank, is an important index for SMEs sample. It is declared that most of the SMEs do not have a corporate financial and management strategy. Thus, the choices of the partners, as retail customers may affect the SME – Bank relation.

In the sample data, whether the partners/managers has contacted with the Bank, earlier than the Firm itself, was investigated. (*This investigation is made among the sample Firms' data, which declared the partnership or management relation to the Bank*.) The result is that approximately 70% of the Firms have contacted with the Bank, after the related manager or partner contacted.

5.4.4   The Tendency of the Firms to Non-traditional SME Products

The Bank has offered a customized "Assistance" service for the SMEs. This is a package product and no extra commission is charged. This product is offered nearby the other core banking products, and includes services like market or accounting information.

The usage ratio of this product may be an important index for measuring the SMEs tendency towards **non-traditional** relationship with the Bank.

From the date of this service first launched till 10/31/2006, the usage ratio of this product is approximately 2%. Since this service is not based on the profit gaining, the Bank does not offer this product to every SME.

The other non-traditional products of the Bank also show low ratio of usage. The share of the internet service user in SME is approximately %2, and only 0,5% of the SME sample uses automatic salary payment system.

CHAPTER 6

CONCLUSION

First of all, in the thesis, a common definition for SME is argued. In Turkey, a national SME definition was accepted by KOSGEB in December 2005, and advised to the participant agents in SME development policy to change their definitions. The author argues the lacking points for this definition as followings:

- The definition is not advertised as a conclusion of national policy makers and researchers, rather an obliged outcome of European Union alignment. This is not a right way for sustaining the contribution of all enterprises.

- In EU, the thresholds can be stretched if necessary for local and regional policies (EC, 2005 a). Which organization is charged for how much the definition can be changed in first-priority development regions is not set. Most probably, KOSGEB will be responsible, but the relevance of definition and regional development level is not clear.

In addition to these, the big variances between manufacturing and service sectors in Turkey are missing in this definition. While, service sector is a larger employment area than manufacturing, the banks, local agents and the government representatives in SME policy has not made an SME definition, covering service sector. Most of the statistics are based on the manufacturing.

However, a nationally defined SME glossary benefits for all sides. The statistical data for SMEs are lacking for such analysis: The share of SMEs in the service sector, the detailed performance

analysis of export SMEs, the preferences of national SMEs for external financing, or the detailed analysis of the performance of lending technologies in the SME lending technologies.

Second, the author argued on the researches about the SME's contribution to national and regional innovation systems. There are two main streams on this topic: One is supported regional innovation and industrial district theorist like Cooke (Cooke, 1997), Brusco (Brusco, 1982) and Eraydin (Eraydin, 2003). They claim the positive effect of SMEs in regional development due to high flexibility, learning capacity, and job creation performance. The other hypothesis is more recent, and claims that there is no support for the widely held belief that SMEs promote higher growth and lower poverty (Ayyagari, Beck, Demirgüç-Kunt, 2003).

The author mentions that Turkey has been loosing its comparative advantage of cheap cost, and the rivals, like China, will carry on narrowing the profit margins in the international market. Thus, the author concludes that the policies targeting SME development for national and regional development in Turkey should be revised according to the internationally set key performance indexes, like the performance for new job creation, innovation capability; share in the national export and value added, whereas the thesis is not explicitly on one of these theories' side.

As the third argument, SME profile of Turkey is mentioned with its outstanding characteristics. Development of SMEs could be an important factor in sustaining Turkey's growth, creating employment, maintaining social stability, and integrating the Turkish productive sector with the EU and the global economy. However, Turkish SMEs' current value added, productivity and exports are very limited. Many small firms also prefer to remain informal (World Bank, 2005).

Fourth, the thesis argues about the problems of SMEs' on national and international scopes. The insufficient demand and ranking problems come before the financial problems. 2001 crisis can be said as a selection mechanism, forcing the weak financial positioned enterprises out of the sector/business and sustaining higher market shares, and trustable positions for the rest in the market. Besides, the first two problems, SMEs need cheap information for external financing possibilities, markets, technology and more qualified employee. The author states that the

eakness of internet access, thus computer usage, hardens overcoming these difficulties. The SME statistics support that SMEs use web mostly for marketing and banking activities.

As the fifth argument, the author argues about the conditions restricting SME's external financing:

- Financing business activities;
- High interest rate charges;
- Equity contribution/ collateral/ guarantee;
- High administrative costs;
- Business plan;
- Apathy of financing SME (http://www.namibian.com.na);
- Bureaucratic hindrances;
- Short-term lending that does not match the maturity of the investment;
- Lack of consultancy and information in financial decision-making (KOSGEB, 2004 a);
- The Information Environment ;
- The Tax and Regulatory Environment;

The author concludes that SME lending is depended on the overall economic conditions. Relevant causes of SMEs' limited access to credit are underdevelopment of the Turkish financial sector and the lack of a sound financial information infrastructure (World Bank, 2005). The SMEs are lack in supplying the information needed for formal applications and the financial structure has yet restructured.

In Turkey, the most important actor in the financial structure is the banking sector. According to the report published by The Banks Association of Turkey in March 2005, the banking system has a majority share in the financial sector. Total assets of the banking system accounts for 90 percent of total assets of the institutions in the financial sector (TBB, 2005 a). Therefore, in SME financing, the banks have a major role.

The other supportive argument is the expected outcomes of Basel II. Since smaller enterprises generally do not have either the collateral or cash flows of their larger competitors, they will

have less financing opportunities. In Turkey, since alternative financial instruments such as venture capital, business angels and equity financing through the stock exchange are not well developed (OECD, 2004). Thus the lending opportunities may not widen especially just for small enterprises.

The thesis investigates that Turkey lacks the financial infrastructure to support start-ups. Thus, the state-aids should continue for these types of enterprises. Even if the infrastructure is in place and funds are sufficient, banks are usually reluctant to fund start-ups because the entrepreneur usually has no established track record and business start-ups are inherently risky. Entrepreneurs also generally lack sufficient capital to be used as collateral. Most businesses even in the more highly developed countries are started with the entrepreneur's own funds or with investment capital or loan funds provided by families and friends.

In conclusion, after these supportive arguments, summarized above, the author concludes about the hypothesis and tests the hypothesis on two main data sets:

The first data source is about the banking sector, and used for gaining some clues about the lending environment SMEs have been in. The evaluation is mentioned in the "5.2 The banking sector's evolution in Turkey" part. The data set covers the evolutionary period Turkish banking sector has been through, since 2002. The fact is that the proportion of the state-owned banks is decreasing, while the shares of the foreign-owned and privately-owned banks are increasing. In the same period, the SME credit volume has increased, as well. But this increase is also affected by the macroeconomic developments and evolution in the business environment. Therefore, this thesis does not conclude on the empirical evidence of the positive effect of privatization or foreign penetration for Turkey's case, according to the first data set. However, the empirical evidence is evident that SMEs have a rising credit share in the banking sector.

The other data investigation is declared in the "5.3 The analysis of SME and SME lending data". The sample data belong to a privately-owned medium bank. While mentioning about the findings, this bank is expressed as "the Bank".

The first finding is achieved by the benchmark study. It is that the non-standard SME definition also exists in the banking sector. The banks in the study, define SME on the base of turnover and credit limit.

The other finding is that the sample SME data are not appropriate for making an SME definition based on the turnover and headcount. Since only 3% of the sample has not declared these two critical information to the Bank, though the Bank has set an information structure to keep these kinds of data. (*However, it is possible that the headcount info is available but not entered into the application by the portfolio managers*.)

The other finding is about the share of the SMEs in the Bank's total credit proposals. The rate of the rise between the two years (2005-2006) is 350%, which is an important index for the developing interest of the Bank upon the SME portfolio and developing interest of the SMEs on the Bank's crediting.

The other finding is about the rejection rate of the credit proposals for SMEs. The rate of decrease between the two years (2005-2006) is approximately 14%, which is an important index for the development in the SME credit rating in the Bank's SME credit proposals pool. This result may be interpreted as the sample SMEs have stronger financial situation, higher reputation in the market and they are more willing to share information with the Bank. Since the rate of the reason as "The Firm does not accept the limits allocated by the Bank" shows that the SMEs (in the sample) have other options in the banking sector other than the Bank. This conclusion is also supported by the rise in the long-term lending between the years 2001 and 2006. The maturity of the SME lending let the author conclude that the longer term lending opportunities have developed during this period.

However, the traditional aspect of the SMEs is not much developed in the sample. The tendency towards non-traditional products is very low. From the date of this service first launched till 10/31/2006, the usage ratio of this product is approximately 2%. Since this service is not based on the profit gaining, the Bank does not offer this product to every SME. This may also be one of the reasons behind the lower ratio of these types of product usages.

The other finding is that the partners and managers mostly lead the Firms in their banking choice. 70% of the Firms have contacted after the managers or partners contacted and began working with the Bank. To conclude on a development or decline about this attitude, a periodical data is needed. However, that kind of data is not available for this sample.

After summarizing the findings, the policy suggestions may be stated as: SME lending is improving in Turkey, with the recovery of the business environment and changing financial and lending infrastructures, but below the market development. The main reasons are that the lending conditions still lacks the adequate informative infrastructure and funding opportunities are dependent on mostly the macroeconomic conditions. In the long run, the state aids should target not directly financing the SMEs and the related organizations, but taking conducive steps for overcoming this obstacle and supporting to create a code of conduct between the financial institutions and enterprises. The enterprises should not be reluctant to share information, so that the risk awareness fostered by Basel II will also benefit for SME lending market.

Even under very favorable conditions, the start-ups continue to be dependent on the public sector. The cost for starting a legal business (% of income per capita) is 26.4, and over the average of the upper-middle income group (IFC, 2006). Thus, the public banks should direct these enterprises, but with the development of venture capital market, they may transform its role as a facilitator.

An additional and supportive policy suggestion may be as the following: The widening web usage and the fact that the SMEs use web mostly for marketing and banking activities are important. This fact should be used to improve relation between the enterprises and the banks, and thus to achieve financial opportunities and gain more standardized accounting information in the SME sector. Most banks already offer accounting packages to their customers (http://www.garanti.com.tr; http://www.teb.com.tr). This service is especially important since banks are avoiding risks of opaque SMEs. This alternative channel will standardize the informative infrastructure for the existing SME customers, while shortening the cost of lending. These systems raise the technological knowledge of the employee, control of the bank on the SME transfers, and other banking operations, and saves man-hour for the both parties. If the

bank set an objective to reach the SMEs on the same supply-chain and join them on the same platform, the network will be promising in *learning* for all the participants. Therefore, saving man-hour in rating will let the banks share information with the new SME credit customers, about the lending procedures and alternative lending technologies.

The surveys show that the SMEs, which intend to create their comparative advantages and sustain higher profits, will invest in internet infrastructure, ERP solutions, IT security, and CRM applications soon. The banks can lead the market to credit the projects like constructing common IT and R&D facilities (like B2B portals) for the parties, who are likely to contribute. SMEs, although they have serious problems like mismanagement and misinformation, etc., show a surprising interest on the e-commerce. The e-commerce volume is behind the industrialized countries but the rate of increase is worth of discussion (Güngen, 2002). The portals serve the participants on net and also by call center and consult them about sectors, markets, and possible alliances (IT Business Weekly, 2003).

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