

Access to Finance by Chilean Corporations

by

Sophie Sirtaine*

World Bank

Abstract

This paper assesses the extent to which Chilean firms have access to sufficient and adequate sources of funds. Access to finance has become an important issue for policy makers in Latin America. Small and medium enterprises (SMEs) in particular complain that their lack of access to adequate sources of financing is an obstacle to their growth. Chile represents an interesting case study since it has one of the most developed financial markets in the continent, and thus with great potential for using products suited to the needs and risk characteristics of SMEs. The author concludes that only the largest firms have access to the whole range of financial instruments available in Chile. All smaller firms face financing constraints. The author then analyzes the obstacles to downsizing access to the capital market and further increasing the penetration of banks in smaller segments.

JEL Classification Codes: G15, G21, G24, G28.

Key words: Access to finance, financing constraints, capital market development, microfinance, SME financing, venture capital, private equity.

World Bank Policy Research Working Paper 3845, February 2006

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent. Policy Research Working Papers are available online at <http://econ.worldbank.org>.

* When she wrote this paper, Sophie Sirtaine was a Senior Financial Specialist in the World Bank's Latin America and the Caribbean Region. She now works as Private and Financial Sector Program Coordinator for the EU8 Eastern European Countries. The author would like to thank the Chilean authorities for their kind cooperation, and express her gratitude to Augusto de la Torre, Alain Ize, Jonathan Katz, and Thomas Glaessner for helpful comments and suggestions.

Table of Contents

1. Introduction.....	3
Overview of the Chilean Corporate Sector	3
Overall Corporate Financial Performance	4
2. Firm Access to Capital Market and Bank Financing	8
Foreign Capital Markets	8
Domestic bonds.....	8
Private Equity.....	15
Bank Loans	17
Conclusion on access	26
3. Policy recommendation to Increase Access.....	27
Appendix one: Enforcement Proceedings for Secured and Unsecured Creditors	30
References.....	34

Table of Figures

Figure 1: Chilean Firm Breakdown by Size, Sales, Exports and Employment	4
Figure 2: The Sample of Firms Studied.....	5
Figure 3: Indicators of the Balance Sheet Strength of Chilean Firms, Average over 2001-2003	6
Figure 4: Comparison of Leverage and Profitability by Sector, Chile and the USA, 2003.....	6
Figure 5: Comparison of Financial Indicators with S&P-Rated Firm Averages (2003)	7
Figure 6: Financial Strength of Chilean Firms by Size, Average over 2001-2003.....	7
Figure 7: Financing Structure of Chilean Firms by Size, 2003	8
Figure 8: The Cost of Issuing Debt and Equity in Chile, Brazil and Mexico (2004)	9
Figure 9: Corporate Bonds Outstanding by Credit Ratings (9/2003)	10
Figure 10: Bond Issues and Minimum Size Requirements compared to the Financial Capacity of Firms by Size	10
Figure 11: Breakdown of Listed Firms by Size, Chile and Other Countries (2004)	11
Figure 12: Evolution of Equity and Bond Issues in Chile	11
Figure 13: Performance of Firms With and Without AFP Investments	13
Figure 14: Evolution of Bank Loans and Clientele by Size of Borrowing Firms (1994-2003).....	18
Figure 15: Financing Structure of Chilean Firms by Size (2003).....	19
Figure 16: Average Financing Structure of US Firms (2004)	19
Figure 17: Evolution of Leasing and Factoring (1990-2003)	20
Figure 18: Bank Penetration with Micro Firms	20
Figure 19: Liabilities by Size of Firms Compared to Measures of their Size.....	21
Figure 20: Average Maturities and Cost of External Financing by Size of Firms	22
Figure 21: A Regional Comparison of Microfinance Interest Rates	25

1. Introduction

The objective of this paper, which is drawn from the recently completed Financial Sector Assessment Program (FSAP) work in Chile undertaken by a joint World Bank-IMF mission, is to assess the extent to which Chilean firms have access to sufficient and adequate sources of funds. Access to finance has become an important issue for policy makers throughout Latin America. Small and medium enterprises (SMEs) in particular complain indeed that their lack of access to adequate sources of financing is an obstacle to their growth. Chile represents an interesting case study since it has one of the most developed financial markets of the continent, and thus with great potential for using products suited to the needs and risk characteristics of SMEs.

Overview of the Chilean Corporate Sector

Chile's corporate sector is highly pyramidal, with just above 200 generally exporting, efficient, and well managed "mega large firms" at one end of the spectrum, and one million, mostly non exporting, labor intensive, and unprofitable, micro firms at the other end. Chile's 6,469 large and mega large firms account for only 1 percent of the number of formally registered firms, but generate about 78 percent of total corporate sales and 96 percent of exports. Among them, there are just above 200 mega large firms dominating the scene. At the other end of the spectrum, the country's 535,537 formal micro firms account for the vast majority of firms (82 percent), but contribute only 3 percent of corporate sales and less than 1 percent of exports. However, micro and small firms are the largest generators of employment, accounting together for 70 percent of total private sector jobs. These numbers ignore more than 500,000 informal micro firms.

Figure 1: Chilean Firm Breakdown by Size, Sales, Exports and Employment

Firms	Companies		Sales		Export		Employment	
	Number	%	US\$ million	%	US\$ million	%	'000 of people	%
Micro	535,537	82%	7,041	3%	14	0%	2,124	50%
Small	96,842	15%	19,920	9%	176	1%	845	20%
Medium	13,597	2%	18,632	7%	527	3%	539	13%
Large/ Mega large	6,469	1%	164,393	7%	17,477	9%	713	17%
Total	652,445	100%	209,985	100%	18,194	100%	4,221	100%

Source: Government of Chile

Note: Data are for 2001, except exports (2000)

Definitions: Mega large firms are defined as those with annual sales net of VAT above UF600,000 (US\$17,172,000), large firms have sales between UF100,000 (US\$2,862,000) and UF600,000, medium firms have sales between UF25,000 (US\$715,500) and UF100,000, small firms have sales between UF2,400 (US\$68,688) and UF25,000 and micro firms have sales below UF2,400.

Overall Corporate Financial Performance

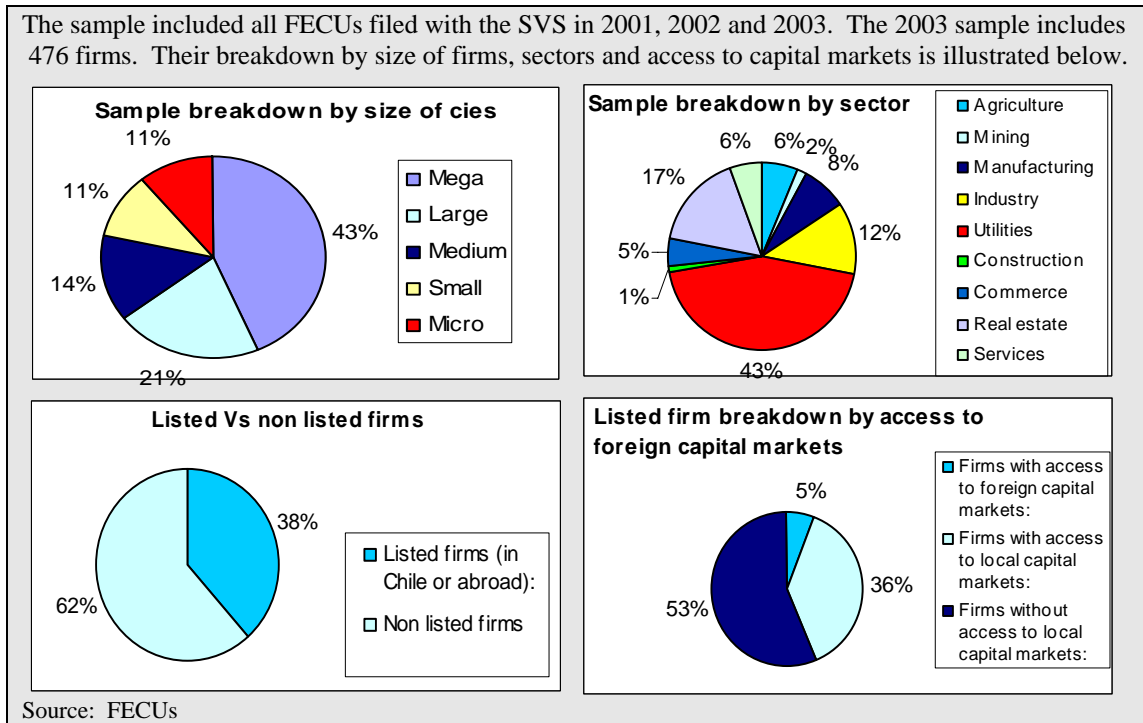
An analysis of the financial statements of some 500 firms that file annually with the Chilean Superintendence of Firms and Insurance (the SVS)¹ was carried out. These statements include detailed financial accounts and notes in a standard format (the Uniformly Codified Statistical Form or FECU)². Only private limited firms (Sociedades Anónimas SA), listed and non-listed, are required to file their accounts with the SVS (public firms and closed companies are not required to do so, while insurance companies have distinct requirements). Beyond this legal requirement, filing is also useful to get access to external funding, in particular to capital market financing. Therefore, filing firms are concentrated among Chile's largest firms and among those which have issued bonds or listed equity (such as infrastructure concession companies). They include only a minority of Chile's large universe of smaller firms, probably the top ones in terms of openness and access to external financing. While the sample can be considered representative of Chile's large, and mega large universe of firms, the same is not true for medium, small and even more so micro firms. For these, the sample is likely to include the most open firms.

¹ Superintendencia de Valores y Seguros

² Ficha Estadística Codificada Uniforme

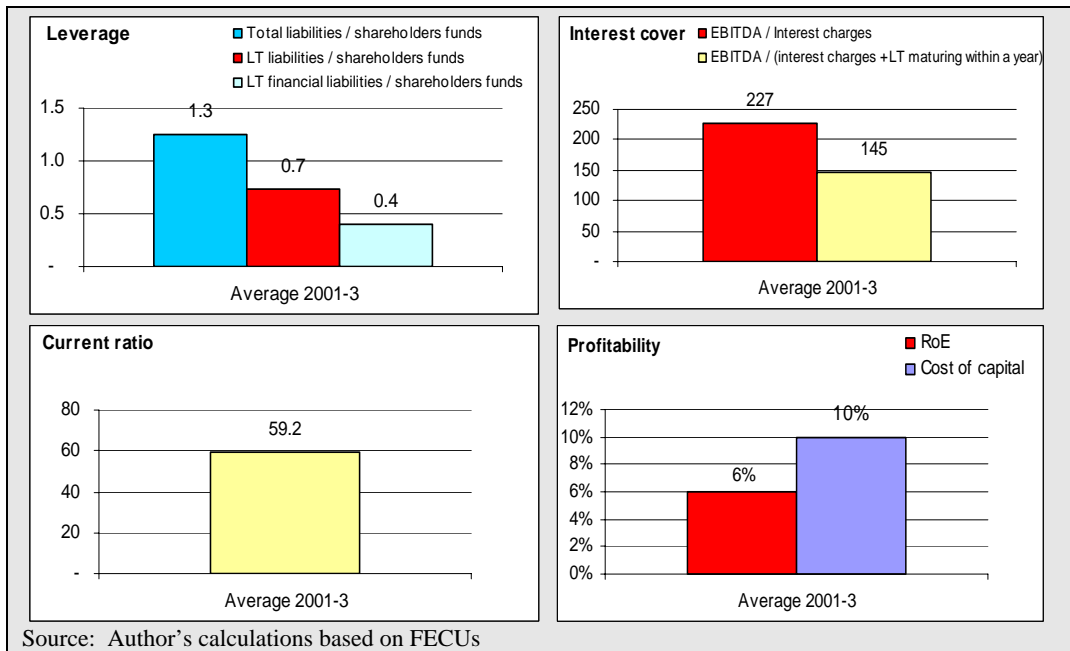
Figure 2: The Sample of Firms Studied

The sample included all FECUs filed with the SVS in 2001, 2002 and 2003. The 2003 sample includes 476 firms. Their breakdown by size of firms, sectors and access to capital markets is illustrated below.

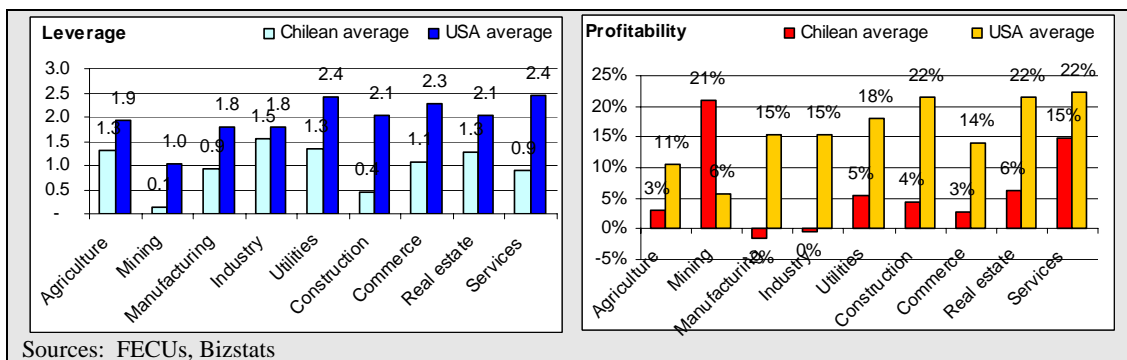


The data reveal that Chilean firms tend to be conservatively managed, but profitability has been depressed for several years because of a lack of cost restructuring. As shown in Figure 3, the balance sheet structure of the average Chilean firm is conservative: the average leverage ratio of the sample firms was 1.3x over 2001-2003, and only 0.4x when only long-term financial liabilities (bank loans and bonds) are included (including the portion falling due within a year). As a result, the average interest coverage ratio was a healthy 227x. Even when the portion of long-term debt maturing within a year is added to interest charges, the ratio remained a healthy 145x. The current ratio of Chilean firms was also high, at 59x. By contrast, the average return on equity (RoE) of Chilean firms was 6 percent, compared to an estimated cost of capital of 10 percent on average over the same period. This is partly due to insufficient cost restructuring in light of the lower sale volumes resulting from the regional crisis (the average cost to income ratio of Chilean firms was 123 percent over the period).³

³ Leverage is defined as the ratio of total liabilities / total shareholders' funds; interest coverage is defined as the ratio of EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) to interest charges; the current ratio is defined as the ratio of current assets to current liabilities; return on equity is defined as the ratio of net

Figure 3: Indicators of the Balance Sheet Strength of Chilean Firms, Average over 2001-2003

Compared to other countries and to rating agency benchmarks, the financial situation of Chilean firms remains sound, although profitability is low. A comparison with US firms by sector (see Figure 4) highlights that leverages are smaller in Chile than in the US in all sectors, while the profitability of Chilean firms is much lower than that of their US peers in all sectors, except in mining (and in the services sector where the difference in profitability is small). Compared to rating agencies' benchmarks, this conclusion remains valid (see Figure 5): on average Chilean firms have a low leverage (equivalent to that of AA / A rated firms), an excellent interest cover (well above AAA firms) but a low profitability (below B firms).

Figure 4: Comparison of Leverage and Profitability by Sector, Chile and the USA, 2003

income to total shareholders' funds; and the cost to income ratio is defined as the ratio of total operating costs (cost of sales, operating and administrative costs) to operating revenues (sales and other operating revenues).

Figure 5: Comparison of Financial Indicators with S&P-Rated Firm Averages (2003)

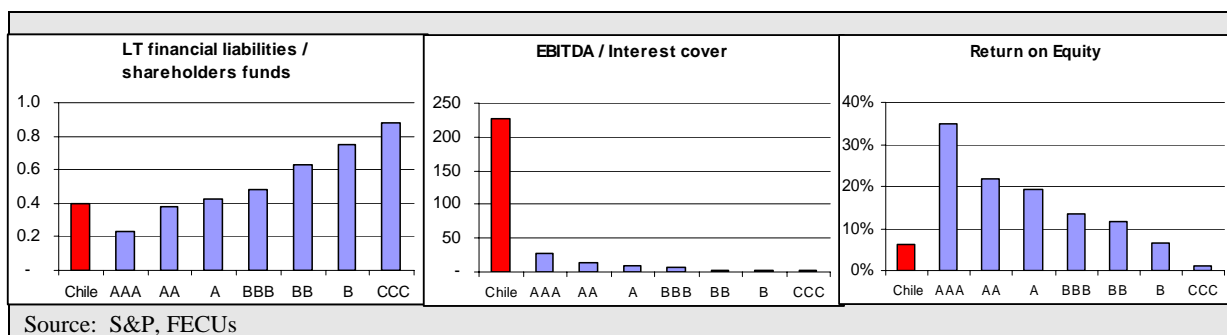
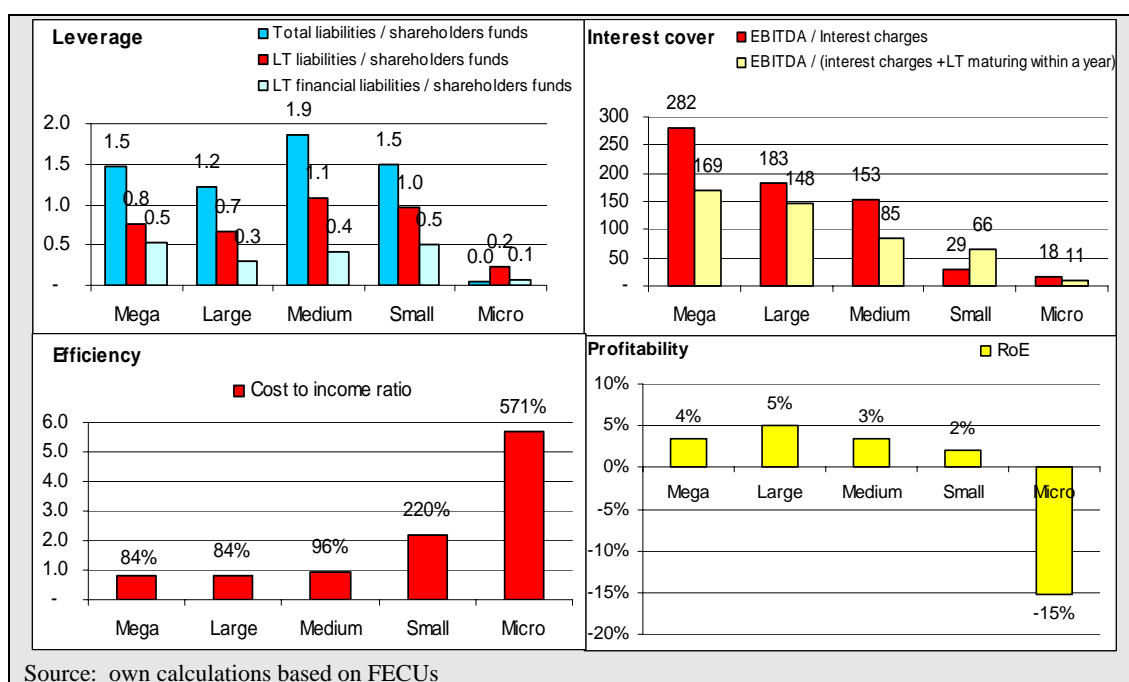


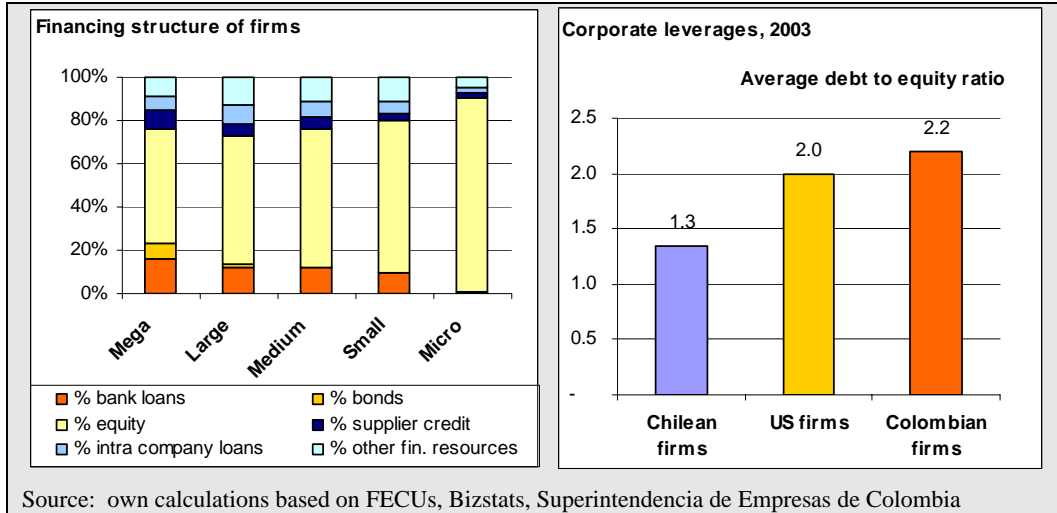
Figure 6: Financial Strength of Chilean Firms by Size, Average over 2001-2003



The low leverage of Chilean firms suggests that their access to debt financing may be constrained, while differences in financing structures across firms suggest these constraints may differ depending on firm sizes. The lower average leverage ratio of Chilean firms than that of their peers in other emerging or industrial countries may result from conservative financial management (see Figure 7). However, it could also signal that firms cannot get as much debt financing as they would want. Leveraging one's balance sheet optimally creates indeed value added for shareholders (via the tax savings resulting from debt financing). Therefore, under-leveraging firm balance sheets as much as in Chile may not be optimal and

could result from constraints in raising appropriate amounts of debt. In addition, the nature of these constraints may differ for firms of different sizes. For instance, Figure 7 suggests that only mega firms can issue bonds, and that micro firms get only tiny bank loans compared to their balance sheet size. To a detailed analysis of these issues the paper now turns.

Figure 7: Financing Structure of Chilean Firms by Size, 2003



2. Firm Access to Capital Market and Bank Financing

Foreign Capital Markets

Access to foreign capital markets is restricted to mega large firms. Firms with access to foreign capital markets (bonds or equity) are concentrated in three sectors - utilities (including the privatized utilities and the road concessions which issued infrastructure bonds), manufacturing and industry. They include exclusively mega large firms and nearly exclusively firms based in Santiago.

Domestic bonds

The high cost of issuing bonds and minimum rating requirements by institutional investors create a minimum size for bond issues higher than in neighboring countries. As Figure 8 shows, the cost of issuing bonds is twice as high in Chile as the cost of issuing equity. In fact, in terms of transaction cost, it is cheaper for Chilean firms to issue debt

abroad than at home. Equity issuance costs in Chile compare favorably to Brazil and Mexico but debt issuance costs are the highest in Chile. The high cost of issuing debt comes from the imposition of a stamp duty on issuances. While other sources of issuance costs are similar across countries, neither Brazil nor Mexico levy this stamp tax. For a US\$100 million issue for instance, the stamp tax adds 25bps to the yield the company pays to raise debt capital. In addition, there is a clear threshold for credit ratings evident in debt outstanding as seen in Figure 9. Nearly all bond issues in Chile are indeed rated A- or above. This is likely due to the importance of pension funds as bond investors (they hold the largest amount of corporate debt), and result directly from the minimum rating requirements imposed on their investments. Insurance companies have grown their holdings of corporate debt dramatically in the last few years, but remain small players compared to pension funds. In any case, their rating requirements are quite similar. Due to these cost, rating and liquidity considerations, the minimum size for a bond issue in Chile is estimated by market practitioners at US\$45 million for a domestic bond issue, and at US\$200 million for an international debt issue. Costs do not appear to create a minimum size for equity issuances. In Mexico, the minimum size for a domestic bond issue is estimated at US\$18 million by local banks although there has been many smaller issues. In Brazil, 18 percent of all issues between 2001 and 2003 were below US\$50 million.

Figure 8: The Cost of Issuing Debt and Equity in Chile, Brazil and Mexico (2004)

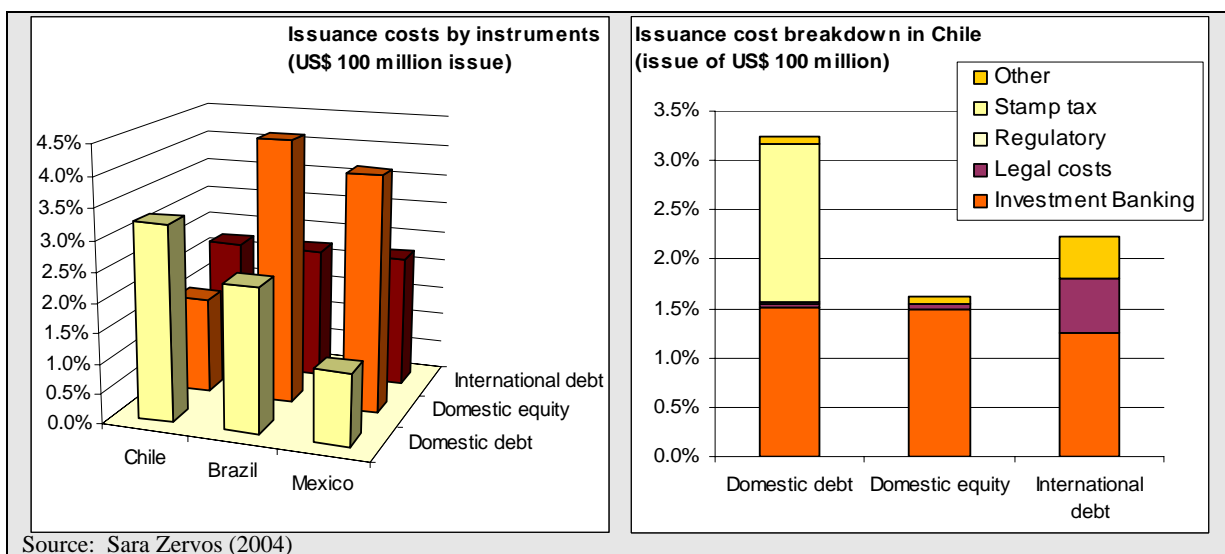
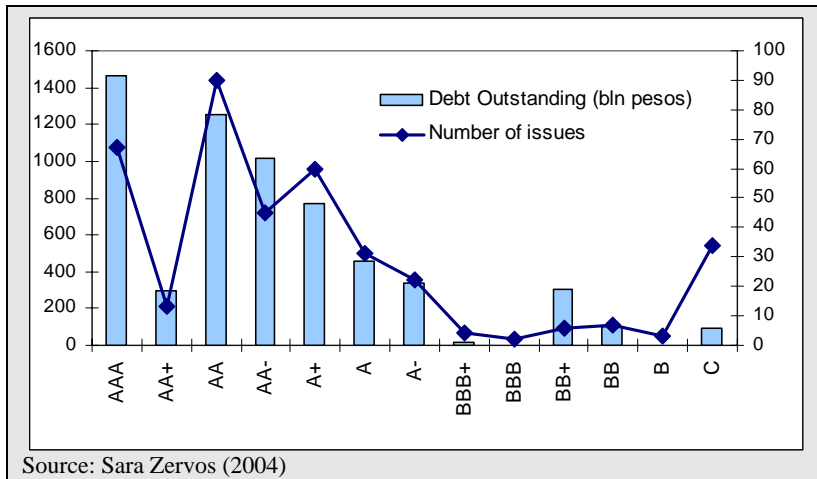
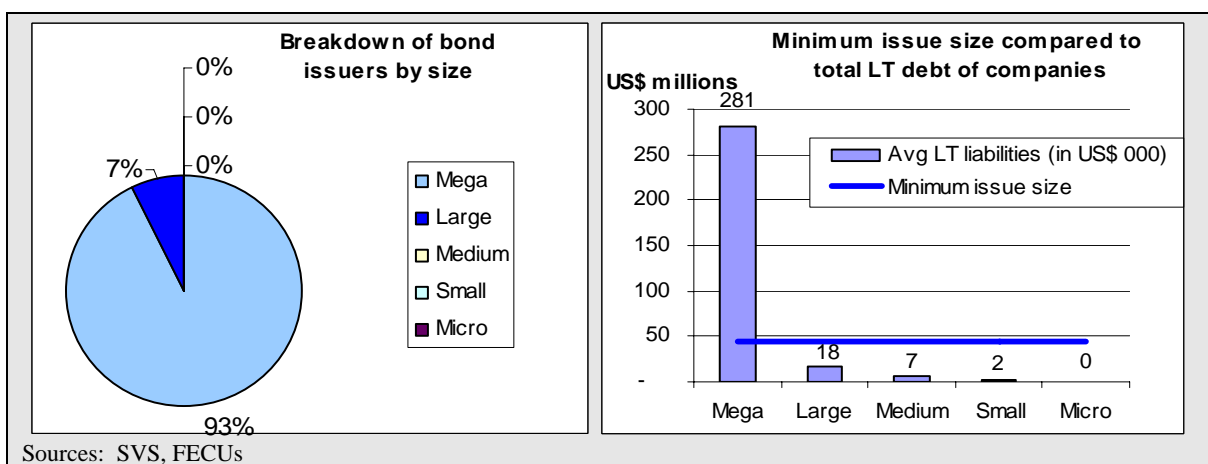


Figure 9: Corporate Bonds Outstanding by Credit Ratings (9/2003)

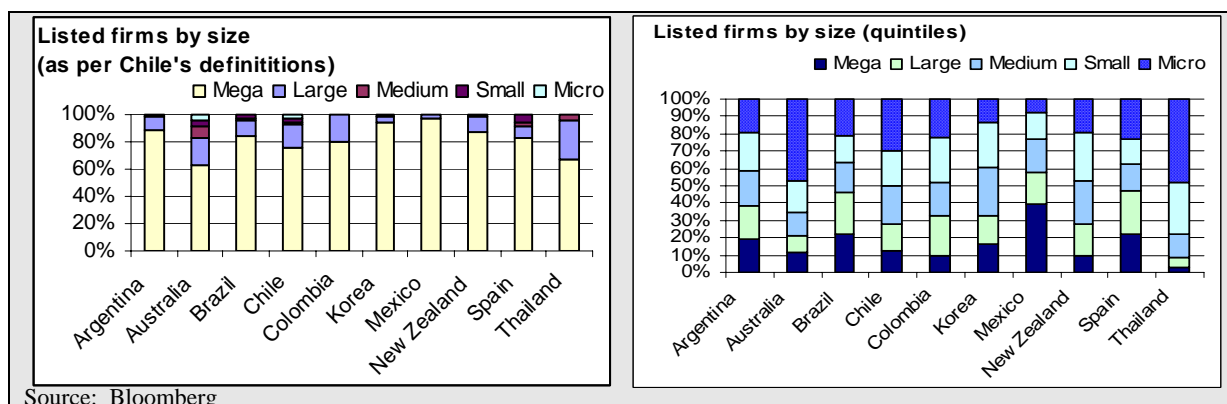
Due to the minimum size requirement, bond issues have been restricted to mega large (and some large) firms. 93 percent of all bond issues still outstanding were made by mega large firms, and the remaining 7 percent by large firms. This seems to result directly from the high minimum issue size, since the latter is well above the financial capacity of all firms except the mega large ones. Figure 10 shows indeed that a US\$45 million bond issue would more than double the total amount of long-term liabilities on the balance sheet of large firms, and multiply by more than 6 that of medium firms.

Figure 10: Bond Issues and Minimum Size Requirements compared to the Financial Capacity of Firms by Size

Domestic Public Equity

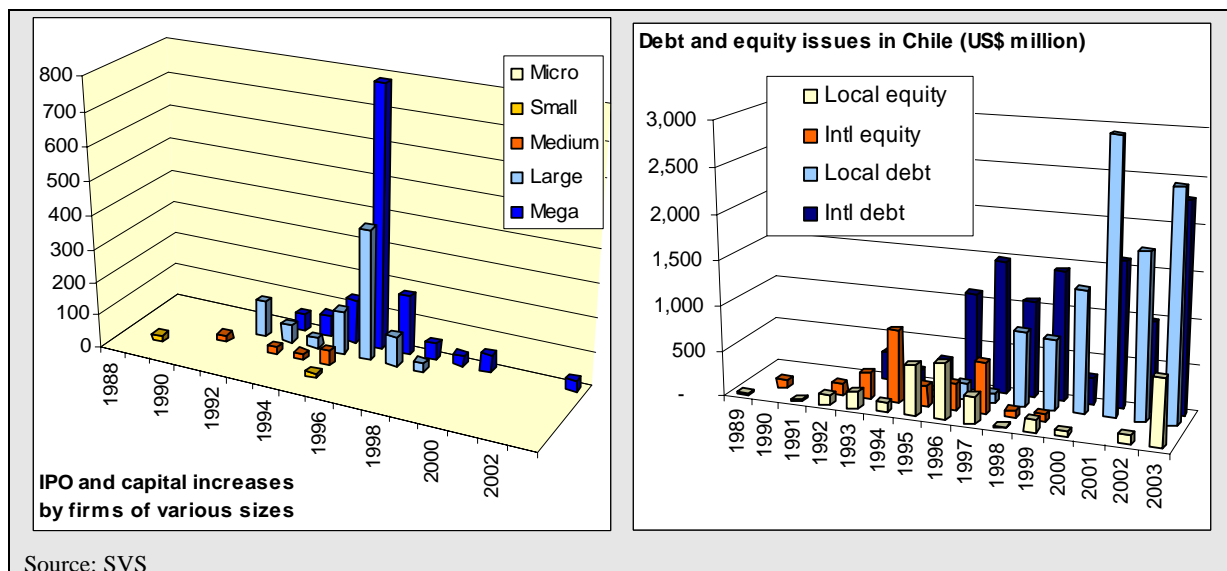
Public equity issues in Chile have spanned across companies of various sizes; but most issues by smaller firms date from the early 1990s. As Figure 11 shows, about 7 percent of listed firms in Chile are medium, small or micro in terms of sales volume. This is in sharp contrast with the breakdown of bond issuers described above. In addition, the share of medium, small and micro listed firms is higher than in other middle income countries (but smaller than in industrial countries such as Australia and New Zealand). However, there has not been any issue by a medium, small or micro firm since 1998 and most of the small issues date from before 1995 (see Figure 12). Also, equity amounts raised have become significantly smaller than bond issues (despite the lower cost).

Figure 11: Breakdown of Listed Firms by Size, Chile and Other Countries (2004)



Source: Bloomberg

Figure 12: Evolution of Equity and Bond Issues in Chile



Source: SVS

The depressed profitability of many Chilean firms may currently prevent them from accessing the equity market as they used to. As illustrated in Figure 4 and Figure 5 above, the profitability of Chilean firms has been low for several consecutive years. It is currently below the estimated cost of capital in Chile of 10.6 percent. As a result, investing in Chilean equity is currently not interesting for an investor with alternative investment opportunities compared to the risk taken.

In addition, Chilean pension funds' decision to restrict their equity investments to a minority of potentially interesting firms may work as a deterrent for new firms to issue securities. Without the participation of Chilean pension funds (the AFPs)⁴, no issue can pretend to find enough buyers to be successful. All issues are in fact tailored to the needs and preferences of the AFPs, which held about US\$5 billion in corporate shares at the end of 2003. However, the AFPs do not seem hungry for more equity investments than they already have. In fact, out of a list of 205 stocks in which they are allowed to invest, they have only invested in 82 (40 percent) and their individual selection of equities are very similar. This is because pension funds are so large relative to the size and liquidity of domestic securities markets that AFP managers face increasing difficulties in selecting assets in which to invest without creating price bubbles or becoming locked in their investments. They thus "pick" a few liquid securities issued by the most reputable issuers, fully use their allowance to invest abroad, and invest their residual funds in bank CDs. In addition, pension funds' indirect share investments via mutual funds are rather miniscule. As a result, there are many profitable liquid stocks in which the AFPs have not invested. Using a financial performance index which captures most key financial indicators⁵, it appears that on average, the performance of

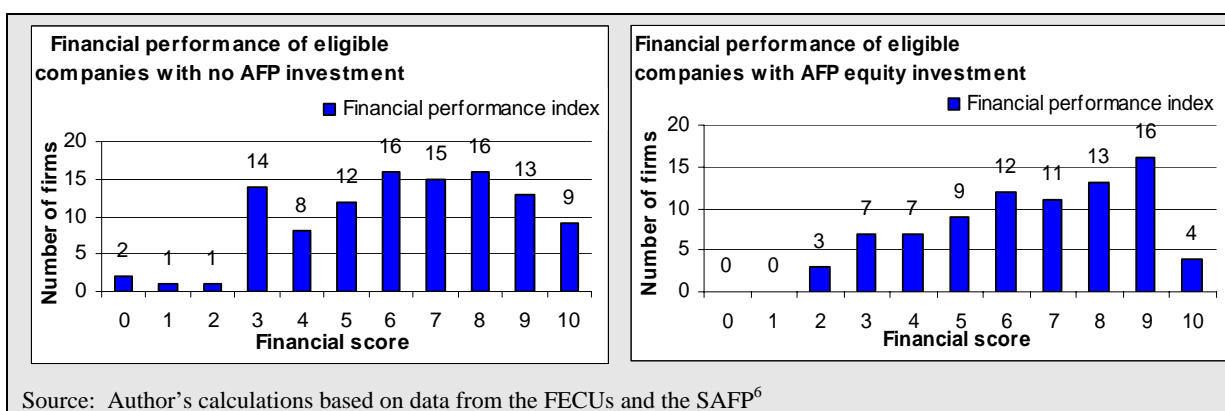
⁴ Administradora de Fondos de Pensiones

⁵ The financial performance index has been defined using 10 indicators of financial soundness (three measures of leverage, two of interest coverage, one of current exposure, two of efficiency and two of profitability). Each company has been given a score of 0 or 1 for each indicator, depending on whether it had a healthy or non healthy indicator. Healthy indicators have been defined as followed:

- Total liabilities / equity < 1.7
- Total LT liabilities / equity < 1.5
- Total LT financial liabilities / equity < 1.1
- EBITDA / interest charges > 2.5
- EBITDA / (interest charges + current portion of LT debt) > 2.0
- Current assets / current liabilities > 1.5
- (Operating + administrative costs) / Operating revenues < 85%

the firms in which AFPs have invested is a little higher (lower leverage, higher coverage ratio, and higher profitability) than that of firms that are eligible for AFP investments but in which they have not invested. However, the dispersion of financial performance is large for both groups of firms (with AFP investments or not). In fact, all groups of firms contain badly performing firms and performing firms in similar proportions. The group of eligible firms in which AFPs have acquired equity contains 17 firms with a score below 5 (i.e. scoring poorly on more than half of the 10 indicators used). By contrast, there are 33 eligible firms in which AFPs have not invested which have a liquid stock and a score of 7 or higher. The existence of such a plethora of performing stocks left aside by institutional investors and the fact that there is little pension fund money going to new market entrants is likely to create a disincentive for firms thinking about issuing securities.

Figure 13: Performance of Firms With and Without AFP Investments



The closed family owned structure of many firms may also be at the root of decisions not to go public. Many Chilean firms have a closed family-based structure, and many others belong to family-owned conglomerates. In fact, from a universe of about 6,500 large and mega large firms, only about 250 are listed. In addition, many listed firms have only a fraction of shares in the hands of the public (the free float of about 30 percent of all listed stocks is lower than 10 percent, and for nearly half of all listed stocks, the free float is lower than 30 percent). As a result, while there are 156 firms non eligible for AFP investments

- Net margin > 5%
- RoE > 8%
- RoA > 1.5%

⁶ Superintendencia de AFPs

with a financial performance score above 6 (and 88 above 8), only three of these have a liquid stock⁷. This confirms that a significant number of firms that are not eligible for AFP investments have a healthy financial structure and profitable operations (in fact 25 firms score 10 out of 10 and another 32 score 9 out of 10) but prefer to maintain their listed stocks within controlled hands. Such preferences also work as deterrents to the development of private equity as the next section will show.

Firms' access to the equity market could also be enhanced through the vigorous implementation of recent improvements in the legal framework for corporate governance. A 2003 assessment conducted by the World Bank found Chile to score well in its observance of the OECD Principles for Corporate Governance. The so-called OPAs (*Ofertas Públicas de Adquisiciones*) law, enacted in 2000, introduced fundamental improvements, including tender offer rules, class action procedures, and other minority shareholder protections (especially in case of changes in corporate control); disclosure and board review of related party transactions; increased board authority; and equal treatment of foreign shareholders. Following an extended transition period, the law is taking effect in 2004. The draft Capital Markets II Reform law proposes additional improvements to the corporate governance framework, in line with the recommendations of the mentioned assessment. As the new legislation is implemented, efforts could be directed at enhancing disclosure of the true beneficial owners of companies, ensuring that internal safeguards are in place to prevent insider transactions, and increasing the pool of potential directors that are qualified. This could be complemented with clear legal guidance on board and directors' responsibilities, as well as education of judges to ensure appropriate and consistent enforcement.

Finally, the inadequate financial statements of closed firms are an obstacle to their issuing securities. The financial statements of closed firms are indeed often very different from those required from public companies, and from those expected by institutional investors. Investment bankers reckon that bringing their accounts to acceptable standards for a public issue (over several historical years) would excessively increase the cost of them issuing securities.

⁷ More than 10 percent of capital listed.

Private Equity

Private equity emerged in Chile in the early 1990s, but the industry's development was hampered by three problems. First, it lived through one cycle only, and a bad one: most investments were indeed made from 1995 to 1997, just before the Asian crisis hit. Since then, the country went into recession, and recently the regional crisis started. As a result, in total, asset prices fell by about 40% between 1997 and 2001 and many of the investments made prior to 1997 are still held in portfolios. This left a very poor track record for this nascent industry. Second, the legal and regulatory environment was unfavorable, in particular the rights of minority shareholders were insufficient and there were strict limits on investments by mutual funds. Third, there was excessive political noise around losses by pension funds, in particular following the IsaCruz scandal in 1995. All of this created a strong disincentive for AFPs to invest in "risky investments".

Today, the overall environment has improved significantly. First, education on the industry has improved among authorities, investors and managers. Second, authorities have realized the potential role of private equity in economic development and have established a more favorable legal framework. In addition, the training and quality of fund managers has improved and CORFO has been developing several interesting financial instruments to fund the industry (such as guaranteed credit lines, etc).

There remain three major issues however, the main one being that the potentially large investor base has so far mostly ignored private equity (PE) and venture capital (VC) investments. First, dominant AFPs channel very little to private equity funds (an estimated US\$200 million). This results from their investment limits and from their discomfort in investing in PE or VC following the IsaCruz scandal. In fact, many AFPs still have a large stock of illiquid VC share investments that need to be recycled but would require recognizing investment losses. Therefore, they now prefer later stage investments in medium to large companies with lower risk. In addition, AFPs do not like to invest directly into small firms as monitoring small investments is costly and difficult, while simultaneously, they do not like to invest in mutual funds of which they find the commissions excessive. Second, foreign private equity funds find it quite unattractive to invest in Chile compared to neighboring

countries because they pay a 35% tax on remittances, and 18% VAT on their funds. Finally, large conglomerates rarely incubate or sponsor start-ups and small firms. They tend to invest in larger firms and prefer majority stakes.

Another key obstacle to the industry's development is the reliance on strategic sales for exit. As a result of the lack of appetite from institutional investors in Chile for small riskier listings, two third of exits are made by strategic sales (mostly abroad or to large Chilean conglomerates) and only one third -the largest investments- managed to go public. As exit is crucial to private equity, this is not healthy for the industry. Nevertheless, the legal framework for mergers and acquisitions is seen as adequate, although the tax treatment of capital gains discriminates strategic sales (only initial public offerings –IPOs- on the Bolsa Emergente are exempt from capital gains).

The lack of demand for private equity and venture capital from Chilean entrepreneurs and the limited number of firms with high growth prospects are also obstacles to a faster industry development. Most start-up projects are said to be poorly prepared due to a lack of managerial skills among young entrepreneurs. In addition, there is a lack of interest for entrepreneurship among new graduates. The latter may result from the stigma created by the risk of bankruptcy, and the impossibility to get other sources of financing, such as bank loans, for new businesses. Finally, the creation of incubators is quite recent. There also seem to be a limited number of firms with a sufficient growth potential (those in consolidating industries such as suppliers to large supermarkets / department stores which need to increase their negotiating power by horizontal consolidation, firms investing in Brazil / Argentina and firms taking advantage of the free trade agreement such as in agriculture, fishing and mining).

As a result, there are only a few funds operating, and most existing investments are later stage private equity. Start-up venture capital is nearly inexistent in Chile. No business angel group has been formed yet. There is only a handful of venture capital funds, most with some foreign capital. They only invested in two companies in 2003 and all investments made since 2000 reach less than US\$50 million (investments varying from US\$500,000 to US\$2-3 million per company). However, some funds have a potentially large investment

capacity (no formal limit). Regarding initial stage private equity, there are also only a few funds, all local. For later stage private equity, the offer is wider, with several mutual funds managing small later stage private equity funds and one foreign capital fund operating from Santiago (CVC Citibank). Other foreign funds have a regional focus and are rather based in Buenos Aires or Brazil for tax reasons. These foreign funds have a large potential investment capacity (no formal limit) and have already invested about US\$400 million. Later stage private equity funds tend to invest mostly in medium to large companies (market value >US\$50 million), with investments varying from about US\$4 million to US\$50 million per firm. Their total investments are estimated to exceed US\$500 million, but most are old investments made prior to 1997.

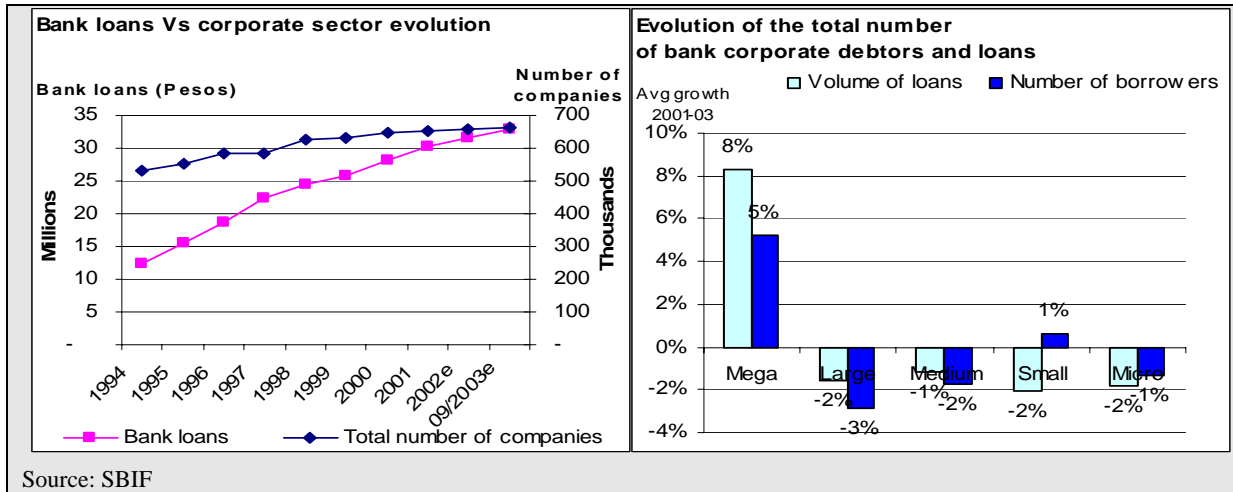
Although there are only a limited number of players, there is no real shortage of funds yet. As explained above, the demand for private equity and venture capital is currently limited by the small number of attractive investment opportunities and the lack of interest in creating one's own business. By contrast, on the supply side, some existing funds have an unlimited investment capacity. Therefore, all really interesting and well-prepared projects do find funding in today's market. However, if the deal flow picks up, it cannot be excluded that the industry would not face funding problems.

Bank Loans

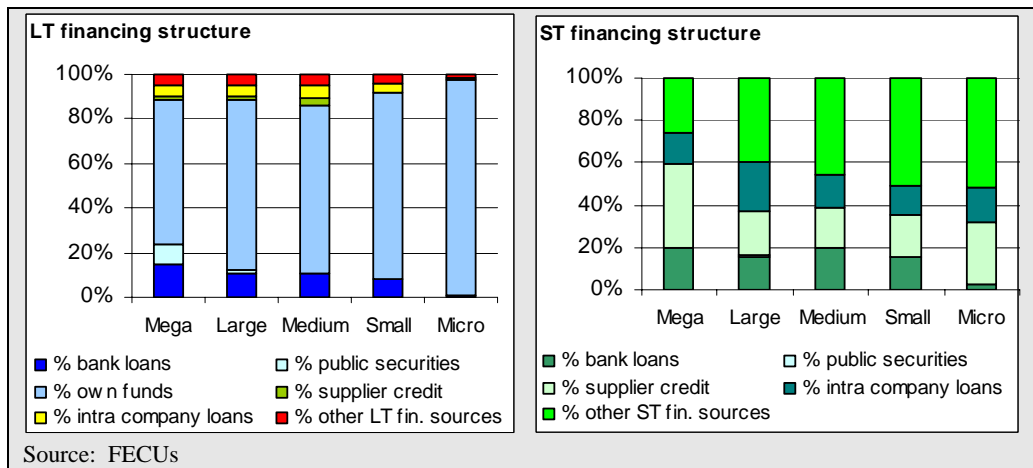
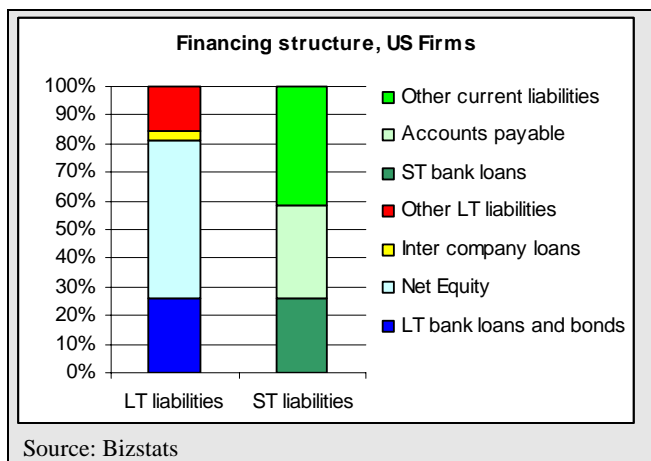
Although in number SMEs and micro firms dominate banks' clientele, the fast growth in bank loans observed over the last decade has benefited nearly exclusively mega large companies. Since 1994, bank loans have increased by a total of 157% in real terms; during the same period, the number of companies has increased by only 25%. Over the last three years, bank loans have risen by 6% in total in real terms, compared to only 2% for the number of companies, but the number of debtors has fallen by 4%. This suggests that a smaller number of debtors benefit from a larger portfolio of loans. In addition, the expansion of bank credit has benefited mega large companies exclusively (+8%), while lending to all other segments has decreased by 1 or 2 percent. The number of debtors shows a similar pattern, with just a small increase among small firms (+1 percent). Nevertheless, in numbers, micro firms continue to dominate banks' clientele (70 percent), followed by small firms (22

percent) and medium firms (5 percent), while large and mega large firms account for only 3 percent together of bank clients.

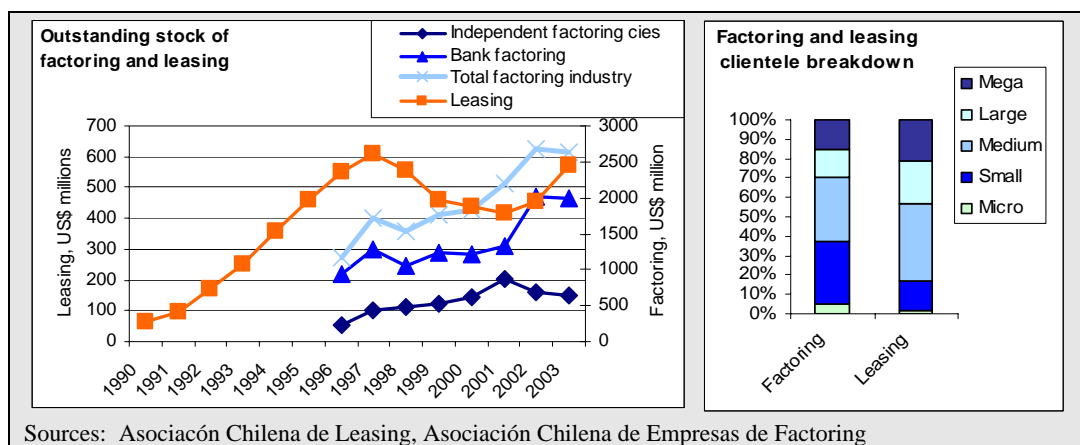
Figure 14: Evolution of Bank Loans and Clientele by Size of Borrowing Firms (1994-2003)



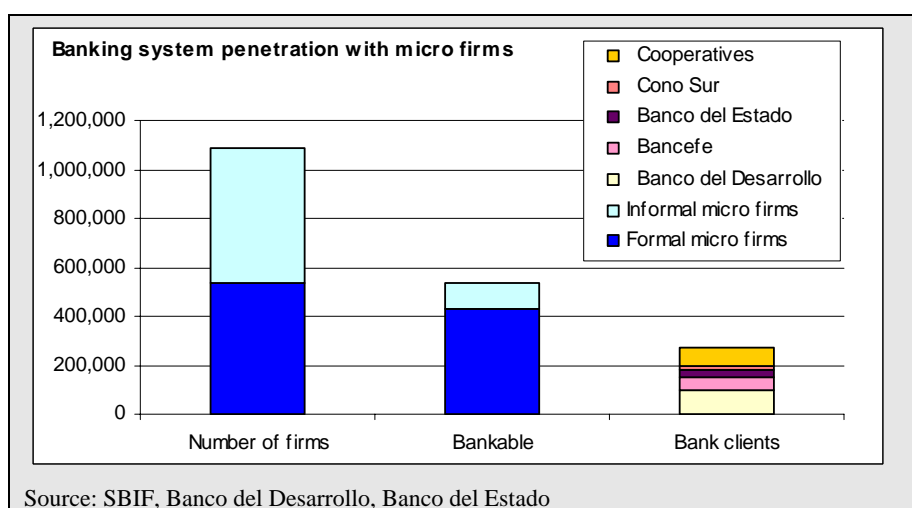
In addition, the financial structure of companies of different sizes suggests that bank financing goes in the largest proportions to the largest firms. The proportion of bank loans in companies' long-term financial structure decreases directly with their size, from 15% for mega large companies to only 1% for micro companies; the deepest drop occur at the level of micro firms. As a result, smaller firms rely nearly exclusively on own resources for their long-term financing needs (97% for micro firms, compared to 65% for larger firms). For short-term financing needs, small and medium firms seem to get access to the same proportion of bank loans than larger firms (about 15 to 20%), but micro firms not (4%). Micro firms also seem to have less access to supplier credit than larger firms (31% compared to 40% for mega firms). Micro firms seem to rely on intra-company loans (19%), probably from the large conglomerates some of them belong to, and on other short-term financing sources (46% in total) such as factoring. Compared to US firms, only mega large Chilean firms seem to have access to a somewhat similar (although slightly lower) proportion of debt financing (bank loans and bonds).

Figure 15: Financing Structure of Chilean Firms by Size (2003)**Figure 16: Average Financing Structure of US Firms (2004)**

However, Chilean banks are growing rapidly their business lines dedicated to SMEs (factoring and leasing), although these still account for a small share of total lending volumes. Factoring and leasing are the only lines of lending products dedicated mostly to medium and small enterprises (65 percent for factoring and 55 percent for leasing). Factoring and leasing account for only 5 percent of the total loan market however.

Figure 17: Evolution of Leasing and Factoring (1990-2003)

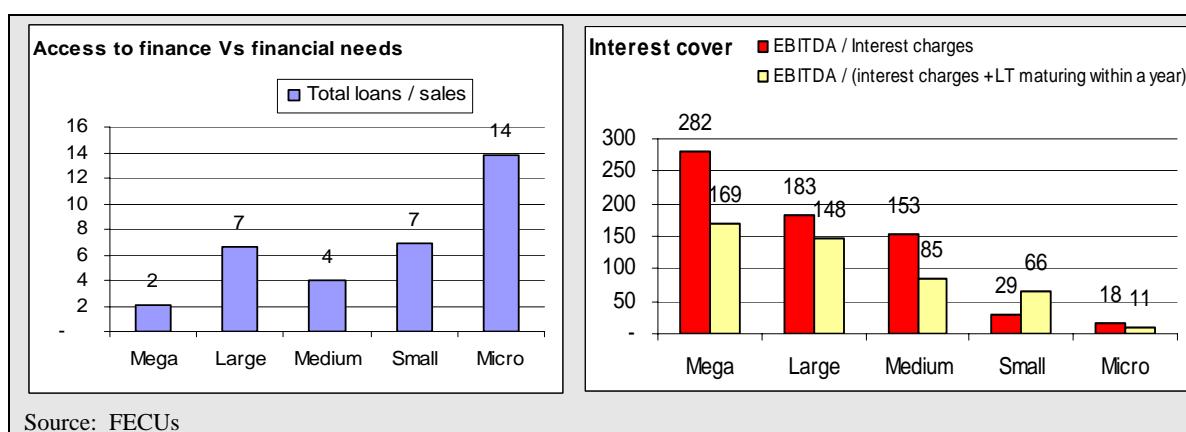
As regard micro firms, bank penetration is relatively high. If one assumes that 80 percent of Chile's 535,000 formal micro firms are bankable and 20 percent of its 550,000 informal micro firms, then there are about 538,000 bankable micro firms in Chile.⁸ This compares with about 270,000 micro firm clients of banks. Since micro firms usually have access to only one bank, it can be assumed that 270,000 micro firms are indeed bankarized, which represent 50 percent of bankable micro firms. This number is quite high compared to other countries in the region, although it is difficult to conduct precise comparisons for lack of data in other countries.

Figure 18: Bank Penetration with Micro Firms

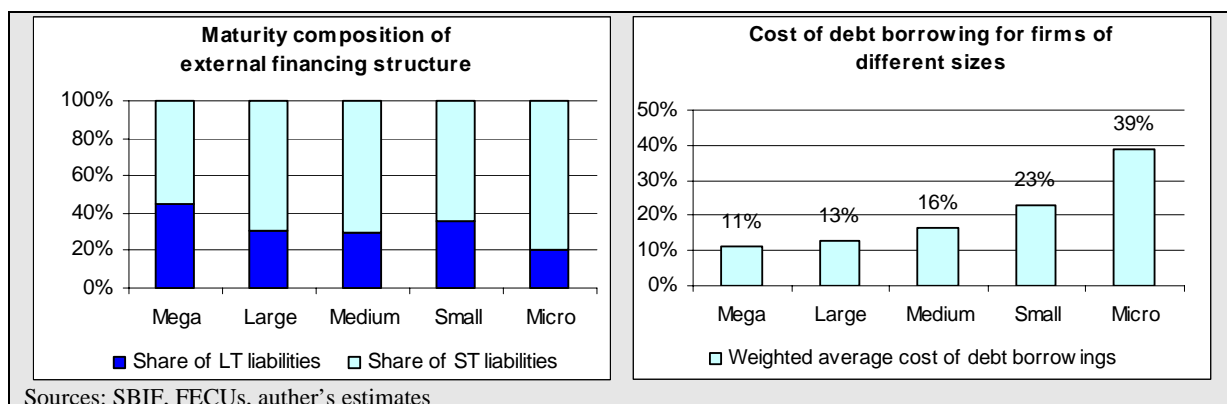
⁸ Being bankable meaning here having a sufficient profitability or sufficient profitability prospects to pretend accessing bank loans if they were awarded on a cash-flow basis.

In addition, compared to their current volume of business, micro enterprises have the highest financial liabilities. The total liabilities (long and short term, all sources together except own funds) of micro firms amount to 14x their sales on average, compare to less than 7x for all other sizes of enterprises. In addition, the average debt coverage ratio of micro firms is lower than for any other firm (despite their lower leverage), because of their low profitability. Therefore the data suggest that those micro firms which have access to bank loans get sufficient financing compared to their business size and profitability.

Figure 19: Liabilities by Size of Firms Compared to Measures of their Size



However, many micro firms have access to consumer loans rather than commercial loans; this shortens maturities and increases the cost of funding for them. Micro firms are the only ones to rely indeed on consumer loans for a large part of their financing needs (38 percent), compared to 5 percent for small firms and zero for all other sizes of firms. This reflects the well-functioning of credit bureaus in Chile (which makes scoring-based lending feasible) and the low quality of the financial statements of small firms (which makes cash-flow based lending difficult). It means that the average maturity of the loans micro firms get from banks is shorter and their cost higher. The author's estimates of the average external funding cost of firms of different sizes show wide differences across them, from 11 percent for mega large firms to 39 percent for micro firms.

Figure 20: Average Maturities and Cost of External Financing by Size of Firms

A major obstacle to increased access to commercial loans by micro firms is the over-reliance of financial institutions on real estate as collateral. Although Chilean legislation provides for several security mechanisms, mortgages (*hipotecas*) over immovable assets is the security preferred by financial institutions. These are governed by the Civil Code, and are typically authorized by a notary and registered at the Registry of Mortgages and Liens of the Real Estate Register of the community where the property of the collateralized immovable asset is registered. Not all Real Estate Registries are interconnected and some use the traditional “book’s method”. However, users of the system are generally satisfied with its reliability⁹. In addition, most costs associated with the creation and registration of mortgages are considered reasonable¹⁰.

Financial institutions also accept pledges on movables, but at a higher interest rate than with real estate collaterals because various difficulties with the related formalities increase the risk of such securities for banks. Pledges (*prendas*) on movable assets (inventories, receivables, machinery, etc.) are considered less secure guaranties¹¹, so that

⁹ In recent years, and particularly since 1995, in Santiago the registration system has been modernized to a certain extent, incorporating computer technology to the recording process, leading to enhanced efficiency and transparency. Nonetheless, inquiry mechanisms are still quite antiquated and cumbersome. In fact, there are no computerized mortgage inquiry mechanisms (only certificates). However, an automation project is now under study and expected to improve service.

¹⁰ The fees charged by the registrars are fixed by the Ministry of Justice. At present, these fees have a ceiling of CH\$259,000 for acts or contracts in excess of CH\$128,000,000. In the case of indeterminate acts or contracts, fees equal 2 or 3 per thousand of the fiscal appraisal value of the asset in question and, for want of such a value, they are set at CH\$2,585.

¹¹ Several interviewed lenders mentioned pledges as “second class guaranties”.

borrowers must pay higher interest rates than those applied to credit secured with mortgages. This is a matter of special concern to small and micro enterprises because most of these businesses lack immovable assets, and therefore are not able to obtain low-cost mortgaged credit. The Civil Code and the Commercial Code provide for pledges with transfer of the possession of the encumbered asset to the creditor. In practice, only shares and negotiable or credit instruments are collateralized as possessory pledges. Non-possessory pledges, meaning the assets remain in the possession of the borrower, are more widely used as contemplated by numerous special statutes¹². As legislation on pledges is fragmented, formalities to create these securities vary widely according to the applicable law. Means of publicizing securities over movable assets is also problematic as not all pledge laws provide for registration of this class of security. Moreover, where registration is required not all pledges are filed at the same registry. The mentioned circumstances –fragmented legislation, different formalities and publicizing methodologies, and, lack of single registry for pledges– bring about uncertainty to pledges and lower the value of movable assets as collateral¹³.

Guaranties other than right *in rem* securities are also used, but in most cases to reinforce the latter. Personal guaranties such as bonds (*fianza simple*), joint-and-several guaranties (*fianza y codeuda solidaria*) and guarantee by endorsement (*aval*), and other security legal methods like leasing contracts (*arrendamiento financiero*), are also usual in financial transactions. Guaranty trusts (*fideicomiso de garantía*)¹⁴ are not utilized in the current market practice. However, these do not tend to increase the borrowing capacity of the borrowers, but rather to complement other guarantees already provided.

¹² Namely: (i) pledge without conveyance (Law No. 18.112); (ii) industrial pledge (Law No. 5.687); (iii) farming pledge (Law No. 4.097); (iv) pledge on bearer securities in favor of banks (Law No. 4.287); (v) pledge on commercial paper and credit instruments (Law No. 18.092); (vi) pledge in bonded warehouses or warrants (Law No. 18.690); (vii) pledge on chattels sold on credit (Law No. 4.702); and, (viii) pledge on creditor monies or assets delivered to be administrated by the manager in charge of a long term debt securities issue and pledge on publicly offered securities, coins, silver and gold bullion or other bearer securities or credit instruments, intended to secure obligations of stock brokers among themselves or with stock exchanges or their clients or any of these with the former, for securities brokerage operations or supplementary activities authorized by law (Law No. 18.045).

¹³ Bank regulations establish that financial institutions using movable assets as collateral should consider only 50% of the appraised value of the asset as truly covering or securing the loan.

¹⁴ *Fideicomisos* are not regulated by Chilean legislation.

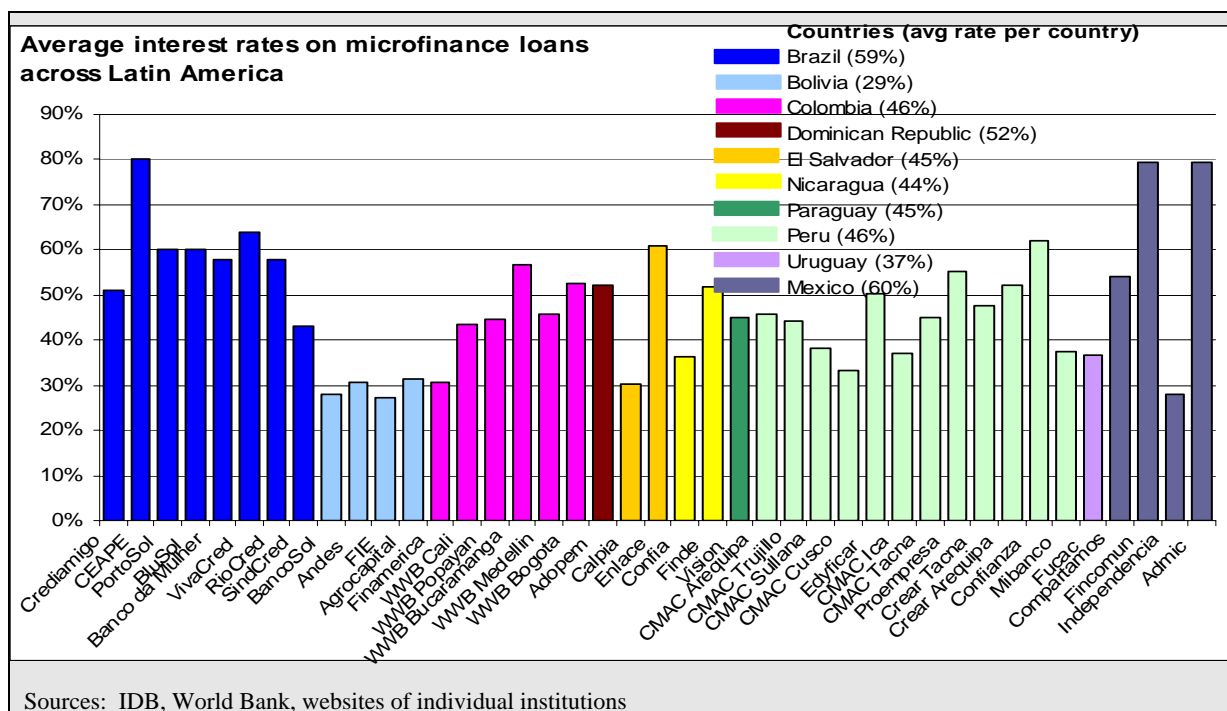
The proposals in the draft Capital Markets II Reform Law are adequate to address these issues; however, changing banks' practices may take time and require additional incentives. The draft addresses the current fragmentation into several codes of the legislation for pledges of movable collateral and the similar fragmentation of the formalities to create security with movables. The draft law would also boost access to finance by creating a single registry for pledges. Despite these substantial legal changes, the experience of other countries shows that changing banks' collateral requirements from real estate to a wider range of assets is difficult and takes time. In case the new law does not seem sufficient to modify banks' practices, the government might want to create incentives for banks to use movable pledges.

Lending to micro, small and medium enterprises is also complicated and made more costly because enforcement proceedings are lengthy and complicated. Apart for some specific classes of assets, enforcement proceedings are a tedious process, where numerous defenses and several appeals may be proposed by the debtor. The execution phase –auction of collateral- is also lengthy and complicated. In total, they can take one to five years, and are generally quite costly. The law provides for extra-judicial out-of-court workout processes, but with some shortcomings so that many firms prefer the legal route. Bankruptcy proceedings are also slow and costly.

Maximum interest rate limits also prevent banks from penetrating higher risk segments, in particular riskier micro firms. Chile's law imposes maximum interest rates ("tasa maxima convencional") on financial transactions. These rates vary according to the nature and amount of the transactions involved. For micro loans, the highest interest rate allowed was 39 percent at the end of 2003. This rate is lower than interest rates generally charged by specialized institutions on micro loans. Figure 21 shows the average nominal interest rates charged annually by a wide number of microfinance institutions across Latin America. It can be seen that in many cases, the average rate is above 39 percent. Since rates tend to be differentiated according to borrowers' own level of risk, the maximum rate which these institutions charge to their riskier borrowers is even higher. Therefore, capping interest rates at 39 percent prevent Chilean banks to offer micro loans to riskier classes of micro

firms. Chile is in fact an outsider in Latin America in this regard as most countries have now completely liberalized interest rates, including Brazil, Argentina, Peru, Bolivia, Mexico, and Ecuador.

Figure 21: A Regional Comparison of Microfinance Interest Rates



The stamp tax levied on almost all financial transactions also penalizes borrowing by micro and small firms. Chile levies a stamp tax of maximum 1.7 percent (“*impuesto de timbre*”) on nearly all financial transactions^{15,16}. This tax penalizes small value loans that are renewed often as the credit history of new small borrowers is being built with the bank. As such it creates a distortion in favor of larger loans, which usually go to large firms.

Finally, the quality and trustworthiness of the financial statements of micro, small and medium firms is a key obstacle for them accessing any type of financing. Credit bureaus function well, so that bankers often prefer relying on scoring systems (and offering consumer

¹⁵ According to the law the stamp tax is levied on the issuance of promissory notes and other similar commercial papers. Notwithstanding, this tax is charged on all financial transactions because in practice banks request all debtors to sign a note, which is an executory instrument (*título ejecutivo*), so as to allow the bank the eventual use of an enforcement proceeding in case of the debtor's default (see Appendix 1).

¹⁶ The stamp tax is progressive and depends on the loan amount and its maturity. It varies from 0.14% per month to a maximum of 1.7% of the credit value.

loans to small entrepreneurs) than having to look at their financial statements. The latter indeed completely lack credibility in the eyes of bankers. They are not homogeneously presented, are not audited by anyone, and exist usually in various versions depending on whom they are designed for.

Conclusion on access

Only mega large firms have access to the whole range of financial instruments available in Chile. In addition, these firms are the only ones with access to foreign funding (capital market or off-shore banks). As a result, all firms of smaller sizes face financing constraints. First, large (but not mega large) firms have nearly no access to the bond market. This results from the comparatively large minimum issue size (US\$45 million) required to attract AFP investments in a bond issue and cover the large issue fees resulting from the imposition of a stamp duty on issuances. In addition, these firms have currently very limited access to public equity because of their depressed profitability. Second, medium and small firms have literally no access to capital market financing. While in the mid-1980s and early nineties, some smaller firms did manage to issue equity, this channel has completely dried out due to their heavily depressed performance. In addition, the under-development of private equity in Chile only allows a fraction of these firms to access private equity. As to access to bank loans, banks are rapidly expanding their leasing and factoring lines of business, nearly exclusively devoted to medium and small firms. However, both industries are still in their infancy in terms of volumes lent. Third, micro firms have only access to very small bank loans, from dedicated institutions. These often take the form of consumer loans as credit bureaus function well in Chile (the poor quality of the financial statements of small firms makes cash-flow based lending more difficult than scoring-based lending). This means that maturities are shorter and the cost of debt higher. The stamp tax to be paid on all new loans further increases the cost of borrowing for micro firms.

There are various obstacles to downsizing access to capital market and further increasing the penetration of banks in smaller segments. The key obstacles to downsizing access to capital markets are: (i) the low appetite of institutional investors for smaller, less liquid or riskier issues (rating below A-), (ii) the under-development of the Chilean private

equity and venture capital industry, (iii) tax distortions, in particular the imposition of the stamp duty on bond issues, and (iv) the low quality of the financial statements of large, medium and smaller firms, especially closed ones. The key obstacles to enabling more small and micro firms to access bank financing are: (i) the legal difficulties in using and executing movable pledges, (ii) the low quality and trustworthiness of the financial statements of smaller firms, (iii) the imposition of the stamp tax on the renewal of small value loans¹⁷, and (iv) the cap on interest rates on small loans (“tasa maxima convencional”).

3. Policy recommendation to Increase Access

Two distinct sets of policy actions may be considered, one to lower the firm size threshold to access capital market financing, and another to further increase the penetration of banks in smaller firm segments. It results indeed from the previous analysis that firms are constrained in accessing adequate financing at two levels. First, capital market financing, in particular bond issuance, is reserved to the mega large blue chips of Chile. The main reasons for this are the minimum size requirement created by the high issue costs, the minimum rating requirement imposed by institutional investors and the inadequacy of closed and small firms’ financial statements. Access to equity is made difficult by Chilean firms’ low profitability, inadequate financial statements, preferences for closed family firm structures and the under-development of private equity. Second, access to bank loans could be enlarged for smaller firms, in particular micro firms which get a large part of their bank loans under the form of consumer loans, and of which the riskiest are still excluded.

Increasing access to capital market financing requires actions to encourage institutional investors to invest more in small value issues and riskier assets. Firm access to capital market financing could be facilitated through incentives for pension funds and other institutional investors to invest more in smaller, less liquid or riskier issues. Banks are playing an increasing role in channeling AFP funds down market, but they do so at relatively high interest margins. Thus, the risk-adjusted cost of access to finance is substantially higher

¹⁷ Although in theory the stamp duty is not applied on the roll over of an existing loan, micro loans are often taxed again upon renewal since the amount or maturity of the loans are often extended, which makes them disqualify for stamp duty exemption.

for firms that do not obtain direct access to AFP funds. It may also be useful to progressively ease pension funds' investment limits in order to promote a greater diversification of their portfolios. Reforms of the AFPs' investment limits could in particular address the minimum rating requirement which excludes so many small riskier firms from the capital markets. In addition to this, "bridging vehicles" could be developed to encourage channeling more pension fund investment towards smaller firms, including funds specialized in higher risk investments, but reducing risks by providing a larger diversification (mixed funds), minimum return guarantees, exit vehicles (vulture funds), etc.

Tax, accounting and auditing, and corporate governance reforms, as well grass-root actions to foment entrepreneurship, would also help smaller firms access capital market funding. In particular, if a neutral tax reform could be defined that would allow eliminating the stamp tax on bond issues, it would substantially decrease the issuance cost, thereby making bond issues affordable for smaller firms. Reforms aimed at making the financial statements of closed companies and of smaller firms closer to those of open companies would also substantially decrease the costs for them to go public or issue bonds in the market. Also, additional improvements to corporate governance are needed in some areas. Finally, actions that would help the development of the venture capital and private equity industry in Chile include tax incentives (i) on sales of small firms (such as larger or more general exemptions on capital gains) and (ii) to attract foreign funds, as well as actions to foment entrepreneurship (such as seminars with successful entrepreneurs, actions to reduce the stigma of bankruptcy, the development of stock options, tax incentives for new businesses, etc).

In addition to the progress made on the use of movable pledges in the Capital Market Draft Law II and recommendations to improve the financial information of small firms, access to bank loans by smaller firms would benefit most from tax and usury interest rate reforms. Although in theory the stamp duty is not applied on the roll-over of an existing loan, micro loans are often taxed again upon renewal since the amount or maturity of the loans are usually extended, which makes them disqualify for stamp duty exemption. Given the high level of the tax (up to 1.7 percent) and the frequency at which small borrowers tend

to renew their loans (as often as monthly), the tax clearly increases the cost of financing for them and reduces their borrowing capacity. Authorities could estimate the cost of eliminating the stamp tax on the renewal of small value loans or loans to micro firms. In addition, banks could find it profitable to penetrate further the micro firm segment if the cap on interest rates (“tasa maxima convencional”) was either eliminated or at least, increased to international standards for smaller / riskier borrowers.

Appendix one: Enforcement Proceedings for Secured and Unsecured Creditors

Enforcement proceedings are lengthy and complicated (both for unsecured and secured creditors). Effective and efficient procedural rules only apply to foreclose banking claims secured by a mortgage performed with the issuance of a letter of credit¹⁸ and some specific pledges also enjoy abbreviated enforcement proceedings. Aside these special cases, all enforcement proceedings are generally slow and costly. They are governed by the Civil Code. There are two categories of proceedings, depending on whether the obligations are evidenced in executory instruments (*título ejecutivo*). If an execution paper exists, specific rules of execution apply (*juicio ejecutivo*), which in theory are brief and coercive. However, this proceeding is in fact a tedious process, where numerous defenses and several appeals may be proposed by the debtor (one to three years). The execution phase –auction of collateral- is also lengthy and complicated. In the absence of execution papers, creditors must resort to ordinary proceedings, which are even longer (3 to 5 years)¹⁹. These judicial proceedings are generally quite costly. Chilean legislation does not provide alternatives to judicial enforcement. However, there are factual (non regulated by law) collection instances that have generally proven effective. For instance, there are specialized firms that collect unpaid loans for financial institutions.

The insolvency law provides for judicial reorganization proceedings but classification of creditors for voting purposes is not allowed. Formal (in-court) reorganization plans (*convenio judicial preventivo*) may be proposed by the debtor to prevent the commencement of a bankruptcy liquidation process (*quiebra*). After the commencement of the latter, the debtor and its unsecured creditors may still negotiate in-court and approve a plan to lift the bankruptcy adjudication (*convenio simplemente judicial*). All formal (in-court) reorganization plans approved by a legally defined double majority of unsecured creditors (calculated in number of persons and percentage of claims) bind dissenting minorities.

¹⁸ *Ley General de Bancos*, article 91-111 (*Operaciones hipotecarias con letras de crédito*).

¹⁹ Ordinary suits are protracted since they entail a greater number of procedural stages in which both creditors and debtors assert their rights and defenses, since this presupposes the existence of a questioned or disputed right, not conclusively ascertained to exist.

According to the law the plan is negotiated only with unsecured creditors. Secured creditors only vote if they become unsecured by relinquishing their security status. The lack of legal provisions allowing classes of creditors for voting purposes may be underscored as a rigidity of the formal reorganization system. This is especially relevant in a context where most financial corporate credit is secured.

A voluntary out-of-court workout (*convenio extrajudicial*) is also established by the insolvency law and it is quite frequently used in practice although it only binds creditors who signed the restructuring plan. A shortcoming of the current system is that it does not provide for an expeditious way to convert a workout approved by a majority of creditors into a prepackaged restructuring plan binding dissenting minorities. The mentioned feature would explain why some creditors prefer formal (in-court) reorganization plans so as to be sure that all unsecured creditors –including dissenting minorities- are encompassed by the restructuring agreement.

The insolvency law provides for a traditional bankruptcy liquidation proceeding, which in practice is quite inefficient. Bankruptcy proceedings encompass all the assets and liabilities of the debtor (even if not past-due), except for such assets and liabilities expressly excluded by law (e.g., mortgaged or pledged assets). The bankruptcy adjudication has certain immediate and retroactive effects.²⁰ Realization of the bankruptcy estate, in theory, should be promptly completed so as to satisfy creditor claims with the proceeds thereby obtained. In practice, however, liquidations are lengthy processes. Its average duration is 24-36 months. Once privileged and secured claims are paid, unsecured creditors (*acreedores valistas o sin privilegio*) typically receive very low distribution rates. As the law does not

²⁰ Noteworthy among the immediate effects are the following: (i) dispossession of the debtor's property, to be administrated by the receiver (*sindico*); (ii) irrevocable establishment of the rights of the creditors; (iii) suspension of the rights of creditors to individually demand payment from the bankrupt (except in the case of mortgage and pledge creditors, unless they consent to the debtor's continuation of its business activities or to the sale of the bankruptcy estate as a business unit); and (iv) suspension of all pending legal action against the bankrupt (save in exceptional cases). In turn, the retroactive effects of the bankruptcy adjudication relate to certain courses of action that the law allows for the receiver and the creditors to void certain acts, contracts or preferences carried out, entered into or created by the debtor prior to the bankruptcy adjudication, when such acts, contracts or preferences have been carried out, entered into or created in bad faith, or else, in the case of gratuitous acts or contracts, to the benefit of relatives, affiliated companies and certain specific creditors.

provide for the treatment of subordinated claims in insolvency proceedings, the effect of a debtor's bankruptcy on subordination debt agreements is uncertain.²¹

The current legal treatment of setoff and netting of financial contracts in bankruptcy is uncertain. The adjudication of bankruptcy bars any setoff not previously affected by operation of law between the reciprocal obligations of the debtor and his creditors, except in the case of related obligations arising under a single contract or a single negotiation process, and even if they are due in different timeframes (Insolvency Law, article 69).²² This legal provision is not clear as to whether netting and setoff of financial contracts (mainly forwards and swaps) are to be excluded from the general prohibition of setoff after commencement of the insolvency case. Legal interpretation of the mentioned rule is specially dubious or unpredictable when a financial contract has been done under a general framework establishing the conditions ruling all derivatives transactions between the parties ("open contract" or *convenio / contrato marco*).

Courts of general civil and commercial jurisdiction deal with excessive number of commercial enforcement procedures. Even in cities that are large commercial centers, courts are not specialized so as to have competence in commercial law cases. This is affecting the effectiveness of the courts as a significant number of cases are filed every year. A civil and commercial court of first instance in Santiago received approximately 9,000 cases in 2003, which is clearly excessive. At the appeal level, an aggravating factor is that in several jurisdictions courts of appeals are competent also in labor and or criminal cases. Moreover, courts should apply numerous obsolete civil procedural rules to commercial enforcement proceedings and judges are not always selected taking into account the candidate's knowledge of commercial law and related business issues (accounting, business administration, finances). On the positive side, the continuing education of judges and

²¹ According to article 147 of the Insolvency Law, "creditors shall be paid in the form and order of preference established by the laws". Subordination of claims is not regulated by the Chilean legislation.

²² The insolvency law also provides that any setoffs implemented from the date of suspension of payments through the date of bankruptcy adjudication may be rendered void if made with credits acquired against the bankrupt by virtue of an assignment or endorsement, the only requirement being that the assignee must have been aware of the suspension of payments affecting the debtor at the time of the assignment or endorsement.

judicial staff is excellent through mandatory courses provided by the Judicial Academy of Chile.

References

Gobierno de Chile, *La Situación de la Micro y Pequeña Empresa en Chile*, Comité de Fomento de la Micro y Pequeña Empresa, 2003.

IMF, *A Note on the Corporate Sector's Potential Vulnerability*, IMF, 2001.

PriceWaterHouseCoopers, *Doing Business and Investing in Chile*, 2003.

Roman, Enrique, *Acceso al credito bancario de las microempresas chilenas: lecciones de la decada de los noventa*, Serie Financiamiento del Desarrollo, CEPAL, United Nations, Santiago de Chile, Chile, October 2003.

Zervos, Sara; *The Transaction Costs of Primary market Issuance: the Case of Brazil, Chile and Mexico*; March 2004, World Bank.