KNOWLEDGE SHARING PROGRAM

2011 Modularization of Korea's Development Experience

Small and Medium Enterprises Policy Funds Financing System

2012

SMBA Small & Medium Business Administration

SBC 중소기업진흥공단 Small & medium Business Corporation

2011 Modularization of Korea's Development Experience:

Small and Medium Enterprises Policy Funds Financing System

2011 Modularization of Korea's Development Experience

Small and Medium Enterprises Policy Funds Financing System

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Preface

The study of Korea's economic and social transformation offers a unique opportunity to better understand the factors that drive development. Within one generation, Korea had transformed itself from a poor agrarian society to a modern industrial nation, a feat never seen before. What makes Korea's experience so unique is that its rapid economic development was relatively broad-based, meaning that the fruits of Korea's rapid growth were shared by many. The challenge of course is unlocking the secrets behind Korea's rapid and broad-based development, which can offer invaluable insights and lessons and knowledge that can be shared with the rest of the international community.

Recognizing this, the Korean Ministry of Strategy and Finance (MOSF) and the Korea Development Institute (KDI) launched the Knowledge Sharing Program (KSP) in 2004 to share Korea's development experience and to assist its developing country partners. The body of work presented in this volume is part of a greater initiative launched in 2007 to systemically research and document Korea's development experience and to deliver standardized content as case studies. The goal of this undertaking is to offer a deeper and wider understanding of Korea's development experience with the hope that Korea's past can offer lessons for developing countries in search of sustainable and broad-based development. This is a continuation of a multi-year undertaking to study and document Korea's development experience, and it builds on the 20 case studies completed in 2010. Here, we present 40 new studies that explore various development-oriented themes such as industrialization, energy, human capital development, government administration, Information and Communication Technology (ICT), agricultural development, land development and environment.

In presenting these new studies, I would like to take this opportunity to express my gratitude to all those involved in this great undertaking. It was through their hard work and commitment that made this possible. Foremost, I would like to thank the Ministry of Strategy and Finance for their encouragement and full support of this project. I especially would like to thank the KSP Executive Committee, composed of related ministries/departments, and the various Korean research institutes, for their involvement and the invaluable role they played in bringing this project together. I would also like to thank all the former public officials and senior practitioners for lending their time and keen insights and expertise in preparation of the case studies.

Indeed, the successful completion of the case studies was made possible by the dedication of the researchers from the public sector and academia involved in conducting the studies, which I believe will go a long way in advancing knowledge on not only Korea's own development but also development in general. Lastly, I would like to express my gratitude to Professor Joon-Kyung Kim for his stewardship of this enterprise, and to his team including Professor Jin Park at the KDI School of Public Policy and Management, for their hard work and dedication in successfully managing and completing this project.

As always, the views and opinions expressed by the authors in the body of work presented here do not necessary represent those of KDI School of Public Policy and Management.

May 2012

Oh-Seok Hyun

President

KDI School of Public Policy and Management

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Summary

Thanks to the launch of four 5-year economic development plans, the Korea economy has achieved dramatic growth through industrialization. By the end of the 1970s, there was a nationwide consensus for the promotion of small and medium enterprises to achieve sustainable growth and development, built on an upgraded industrial structure. As a result, the Small and Medium Enterprises Promotion Act was enacted. Per the Act, the Small &medium Business Corporation (SBC) was founded in January 1979 to implement assistance policies for small&medium enterprises. SBC was founded as a special corporation and implements an extensive range of programs, such as the policy funds financing project, consulting, training, overseas marketing, and support for small and medium enterprises penetrating overseas markets.

When the SBC was first established, most SMEs found financing through the banking industry. However, there were many that could not obtain financing, due to the lack of collaterals or performance-based evaluations. Even those that could find financing struggled with high interest rates. The SBC thus initiated the policy funds financing program to select and provide concentrated assistance to companies with growth potential, but in businesses in which private financial institutions were reluctant to grant loans. The goal of the SBC was to help such firms become blue-chip companies.

To finance SME policy programs, the government created the Small and Medium Business Promotion Fund in December 1978, which comprised of government funding, the Public Capital Management Fund, bonds, lottery proceeds, borrowings, etc. Since 1994, financing comes mainly from SBC Promotion Bonds, and any differences between financing rate (bond issue rate) and interest rate (loan rate)are subsidized by the government.

The SBC considered government policies and demands of SMEs when selecting key areas for policy funds. In its early days, the SBC focused its assistance on modernization and collaboration, shifting to changes of business and restructuring around the 1990s and on structural improvements as part of the 100-day Plan for New Economy in 1993. When the Asian financial crisis hit, the SBC reorganized its financing to include assistance for venture start-ups, commercialization of research and development, export, and management stability programs. The major framework of these programs has been maintained but their names, sizes, recipients, conditions, etc. have been constantly changing.

Agency loans via financial institutions was the main type of financing until the early 1990s, when there were growing problems accompanied by such loans, like high rates of reversing loan grants, caused by insufficient collateral or complicated procedures. The SBC adopted direct loans in 1993, which were directly executed by SBC, while maintaining agency loans. It was in 1998, during the Asian financial crisis, that direct loans were expanded. The SBC revamped its organization, human resources and system to effectively carry out direct loan programs. The SBC continued to expand direct loans through three transition periods from 1993 through 2010, providing assistance that amounted to KRW 11,229.3 billion to some 40,600 businesses, to help SMEs that had difficulties accessing assistance from the private finance industry.

The size of SBC's policy funds has fluctuated over the years, based on the demands of the government responding to the economy. Considering demand as required by various economic cycles, KRW 3.1-3.6 trillion have been provided annually for the last five years-new policy funds of KRW 3.2 trillion on average. The policy funds are provided mainly to manufacturers and knowledge-service providers, above all to start-ups in their early stage, small enterprises with less than 50 employees, companies located outside the Seoul metropolitan area and long-term facilities investors that are highly consistent with the policy objectives. These policy funds are competitive in terms of loan rate, duration and other conditions, as they were designed to support industries or companies that meet the requirements of government policies.

More than anything, it is vital for policy funds financing to have a proper company evaluation system in order to identify and select the outstanding SMEs with excellent technology, business and growth potential. Well aware of such necessity, the SBC built and continually improved the technology evaluation system since the beginning its financing system, so that it could take the management viability of SMEs into account and evaluate their values. The SBC also recognized the importance of credit risk management since the expansion into the direct loan sector in 1998, and has exerted enterprise-wide efforts to enhance relevant systems, work processes, company evaluation systems, organization, human resources, expertise and information systems.

The following are details on the financing process. First, the applications/registrations are submitted to one of the 24 SBC headquarters/local offices located throughout Korea. They are assessed by two management and technology evaluators, based on their field investigation to determine financing. The evaluation is categorized into a quantitative evaluation (financial evaluation), based on financial statements, the company's market outlook, technology level, management capability and future financial outlook (business evaluation on technology). The financial rating is currently used for rating adjustment only, and companies are selected based on the business evaluation on technology for financing programs.

The role of policy funds has been distinguished from private financing, and has improved in a mutually beneficial manner without undermining the private financial market. Acting as an example to private industry, the funds have benefited SMEs with low credit ratings and weak collaterals. Their role was especially outstanding during the Asian financial crisis in 1997 and the global financial crisis in 2008. They provided immediate support for liquidity, serving as a social safety net in the face of a sluggish economy.

The analysis of policy funds performance indicated that they contributed to the national economy in all macro- and micro-economic aspects. Particularly, their decision to expand direct (credit) loans and assistance played an important part in overcoming the liquidity crisis for SMEs. In other words, the policy funds helped foster companies with growth potential by ensuring the availability of money in a failed market, thereby encouraging SMEs to create jobs and lead to many other achievements. Behind such performance was trial and error, and it is also true that there is a debate on the identity of the funds for the somewhat ambiguous distinction with the private market.

The SBC seeks to utilize its unique experiences to propose useful policies on the introduction and operation of the policy funds financing system for developing countries. This is so that funds may become firmly entrenched in providing effective assistance programs, which help minimize trial and error when developing countries adopt new systems and boost SME development.

The first proposal is on policy funds financing. The first and foremost element to consider before introducing any system is to secure financing sources. It is necessary to have relevant legal grounds and systemize the ways to secure a stable source of finance. Considering that it is difficult to secure financing solely from the government in the developing countries, there are several options: using the government contribution for initial capital and borrowing the rest from the government or private institutions, utilizing low interest rates from overseas, or issuing bonds to secure financing and receiving interest subsidies from the government.

Next are suggestions on the operation of policy funds. Since funds cannot be provided to all SMEs that require such support, it will be useful to determine the scope that best fits each country to effectively utilize limited resources. It is worth noting that favorable loan rates and duration, compared to private institutions, may lead to imaginary demand and a greater financial burden on the government. The SBC diversified its assistance programs by expanding direct loans and hybrid finance assistance for investments and loans. As such, developing countries are also encouraged to meet SME financing demands by introducing diversified financing systems.

The last proposal is in regard to the selection of companies and risk management. When the SBC selects companies, business and technology evaluations are the key criteria for making a decision. This system is critical in to distinguish itself from private organizations, and to manage the policy funds financing system for SMEs. However, the risk is bound to increase if companies are solely selected from the technology and business evaluations, without considering credit and financial health. Although this is what distinguishes the SBC from private lenders, any substantial accumulation of losses can even determine its fate, as it would any lending institution. Therefore, developing countries need to set an appropriate risk management goal for the financing system that can efficiently respond to risks by establishing a relevant system and enhancing the expertise of employees. On top of the financing, developing countries can also conduct a management diagnosis on SMEs to provide any necessary customized programs (e.g., marketing, training, technology support or R&D) that meet the needs of companies, which will eventually result in better results for assistance programs and risk prevention/management.

Chapter 1

Establishment and Development of SBC

Establishment and Development of SBC

1. Korean Economy of the Time

1.1 National Economy of Korea

In the 1960s, Korea launched two 5-year plans in phases to boost its economy. With the plans' success, Korea successfully drove absolute poverty out and built the foundation for economic independence by creating the manufacturing and export platform. The administration that came to power in 1961 embraced much of the previous economic policy platform with little change in SME policies, succeeding to SME policies such as maintaining the SME department of the Ministry of Commerce and Industry, the committee on the SME policies and comprehensive policies to foster SMEs. It also established the Small and Medium Industry Bank (SMIB) and introduced a loan guarantee system. The keyword of the Korean economy in the 1960s was "export," an attempt to overcome the weak domestic market based on the labor-intensive industries, where it had comparative advantages. In pursuit of export-driven economic growth, the government implemented an intensive policy-funding system for SME exporters, enacted the Small and Medium Enterprises Promotion Act, and promoted the SME department of the Ministry of Commerce and Industry to the Small Business Service.

By the 1970s, the strategies were modified, with a focus on the heavy and chemical industries, which were reinforced even more through the third and fourth 5-year plans (1972-1976 and 1977-1981, respectively). The policies advanced the industrial structures and achieved economy of scale via growing exports. Thanks to the real growth of more than 10% per annum in 1972-78, the Korean economy rose to the level of advanced developing countries by the end of the 1970s.

However, the pursuit of sustainable dramatic growth accompanied the issue of imbalance. This imbalance accumulated and threatened economic stability. It has become one of the tasks that urgently needs to be resolved since the late 1970s.

The obsession with the quantitative growth made relative poverty and distribution of income even more acute. Blinded by the obsession to achieve goals, Korea lacked efforts to offset or reduce the negative effects of the policies, leading to new problems such as a distorted market. Currency inflation brought by the shortage of investment capital sparked the rise of the prices in real estate and others. While the wholesale prices in particular went up 12% on average per annum during 1962-71, it surged by up to 18% from 1972 to 1979. This chipped away at the fair distribution of wealth and efficiency of corporate activities. By the end of the 1970s, unclear forecast surrounding the world economy, a heavier inflation burden due to rising oil prices, higher wage, belt-tightening measures and more exacerbated these problems.

1.2 Management Climate of SMEs

Out of all the mining and manufacturing industries in Korea in the 1960-1970s, the percentage of SMEs was 98.5% in terms of the number of companies, 62.4% in terms of the number of employees and 49.7% in terms of the added value as of 1963-a very high portion in the national economy. Looking at the growth, it can be seen that SMEs were responsible for 52.4% of growth in exports on average each year from 1964-1972, and contributed substantially to the economy. The role of SMEs in the 1960s and 1970s was indispensable to the growth of the economy.

Table 1-1 | Number of Companies in Mining and Manufacturing (1963-1975)

(Unit: No. of Companies, %)

Category	1963	1966	1969	1971	1972	1973	1974	1975
All	19,550	24,264	26,688	24,963	25,248	24,881	24,215	24,229
SME	19,253 (98.5)	23,845 (98.3)	25,977 (97.3)	24,138 (96.7)	24,356 (96.5)	24,139 (97.0)	23,387 (96.6)	23,304 (96.2)
Large Co.	297 (1.5)	419 (1.7)	711 (2.7)	825 (3.3)	892 (3.5)	742 (3.0)	828 (3.4)	925 (3.8)

Table 1-2 | Number of Workers in Mining and Manufacturing (1963-1975)

(Unit: No. of Workers, %)

Category	1963	1966	1969	1971	1972	1973	1974	1975
All	462,068	631,179	901,865	923,237	1,045,201	1,227,566	1,369,677	1,503,220
SME	288,157 (62.4)	368,413 (58.4)	458,157 (50.8)	418,170 (45.3)	466,700 (44.7)	568,787 (46.3)	611,033 (44.6)	680,050 (45.2)
Large Co.	173,911 (37.6)	262,766 (41.6)	443,708 (49.2)	505,067 (54.7)	578,501 (55.3)	658,779 (53.7)	758,644 (55.4)	823,170 (54.8)

Table 1-3 | Added Value of Mining and Manufacturing (1963-1975)

(Unit: KRW million, %)

Category	1963	1966	1969	1971	1972	1973	1974	1975
All	69,888	174,893	453,882	733,104	942,426	1,436,151	1,951,950	2,945,758
SME	34,754 (49.7)	72,460 (41.4)	133,315 (29.4)	202,566 (27.6)	260,476 (27.6)	487,224 (33.9)	607,571 (31.1)	923,386 (31.3)
Large Co.	35,134 (50.3)	102,433 (58.6)	320,567 (70.6)	530,538 (72.4)	681,950 (72.4)	948,927 (66.1)	1,344,379 (68.9)	2,022,372 (68.7)

Source: Page 3, New Developments for Small and Medium Business Policies. Ministry of Commerce and Industry, The Statistical Report on Mining and Manufacturing Industries (SMEs since 1973 refer to the companies with less than 300 employees)

The policy to stimulate the export of light industrial products in the 1960s provided a favorable environment for the development of the SMEs, which were mostly labor-intensive. It was during these times that the legal and institutional foundation was established for the promotion of SMEs.

Government policies for SMEs originated during the August 1956 presidential inauguration. It was announced that one of the government's basic policies would be focused on the growth of SMEs. As part of the government's initiatives, the "Guidelines on the Promotion of Small and Medium Enterprises" was created. The guidelines were the first policies for SMEs, illustrating the enactment of the Small and Medium Enterprise Cooperatives Act, financing worth KRW 2 billion for SMEs, introduction of voluntary tax filing, reduction/exemption of direct taxes, expanded sales channels for SMEs and more.

On March 7, 1960, the 3-year economic development plan was announced. One of its basic tenets included the self-sufficiency of daily necessities and increased employment opportunities. On December 15 of the same year, the Comprehensive Economic Forum's report was selected, in which the sub-committee for the reform of the industrial structures proposed various measures to spur the growth of SMEs. The sub-committee for the employment and living also suggested a plan to create more jobs and develop SMEs. Based on these efforts, the Comprehensive Plan on the Promotion of Small and Medium Business was issued in 1961, focusing on the establishment of a small and medium business cooperative, improvement of the health of SMEs, support of critical industries and reduced tax burden.

However, these policies were rather fragmented, dispersed and limited. Specifically, the first 5-year plan in 1962 sought to develop SMEs and manual industry through trade associations, and gradually support subcontracting agents alongside the development of large corporations. Under the circumstances, SMEs could not go beyond being subcontractors for large corporations.

The 1970s witnessed the rise of the heavy and chemical industry in Korea. Due to the bottleneck capital and demand for scale of economy, much of the resources were funneled into large corporations, posing further challenges to SMEs. Few, if any, SMEs had sufficient capital to invest in large facilities.

The government wanted to enhance expertise and systematic partnership of SMEs to promote the machine industry. Starting with agricultural machineries in May 1971, the government designated expert companies in metal processing machines in October 1972. After the declaration in 1973 to expand the heavy and chemical industries, there was a clear need for alliances to achieve industry success. On November 1, 1974, the Finance Minister Meeting voted for the enactment of the Act on the Promotion of Alliance between Small and Medium Enterprises. In January 1975, the alliance for the automotive parts companies was designated for the purposes of localization and quality improvement. In March, textile machineries were targeted for the purpose of healthy promotion and growth of exports. On December 31, 1975, the Act on the Promotion of Alliance between Small and Medium Enterprises was implemented.

On June 3, 1976, the Enforcement Decree on the Act on the Promotion of Alliance between Small and Medium Enterprises was promulgated as Presidential Decree No. 8114, detailing the establishment of the alliance review council, benefits of alliance and modernization of SMEs.

These policies were designed to narrow the gap between SMEs and large corporations caused by previous expansionism policies. The government's efforts not withstanding, the only way for SMEs to survive toward the end of the 1970s was to support large corporations. The laws on the SMEs of the time-Credit Guarantee Fund Act (1974) and Act on the Promotion of Alliance between Small and Medium Enterprises (1975)-were ultimately implemented to resolve collateral issues and help ailing heavy and chemical parts manufacturers amidst the oil shock. They were by no means effective solutions for struggling SMEs. Furthermore, SME assistance was virtually non-existent compared to the all-out financial support given to large corporations, such as resource infusion from home and abroad, infrastructure development for strategic sectors, foreign capitals and national investment funds.

SMEs accounted for a substantial percentage of industrial output and laid the foundation for the national economy. And yet, the production gap between them and large corporations widened in the process of rapid industrialization. Small scales of business, shortages of funding, outdated management and technology, lack of assistance and many more serious problems emerged. The rise of issues in regard to location, pollution and lack of human resources began to threaten its very existence.

2. Foundation of Small and medium Business Corporation

2.1 Background

The four 5-year economic development plans surely ushered in impressive growth and expedited the national goal of industrialization. When the development of SMEs was sluggish however, the fast pace of growth by large corporations resulted in excessive facilities, and destabilized prices due to the reduced light industry and chronic trade imbalance.

By the end of the1970s, there was a national consensus that the country urgently needed to promote SMEs, which were relatively behind in terms of growth and development, in order to resolve the structural vulnerabilities and imbalance in Korea. Thus the government began to explore ways to pursue a long-term promotion of SMEs more proactively, to upgrade the industrial structure and stimulate sustainable growth. To do so, it organized and dispatched a small and medium business investigation team to Japan, where the promotion of SMEs was successfully carried out. The government believed that the delegation should be dispatched to Japan rather than the United States or Europe, as Japan shared the same Asian culture, implemented efficient SME policies, and enjoyed an unprecedented economic boom backed by SMEs. In addition, the president pursued the Japanese economic development model as the ultimate goal of the Korean economy.

[Reference] Small and Medium Business Investigation Team in Japan

■ Composition and Period

- Comprised of 14 experts from the government financial institutions, research institutions, Korea Federation of Small and Medium Business, etc. (Team leader: Assistant Minister for Business, Ministry of Commerce and Industry)

- For 15 days (March 13-27, 1978)

■ Major Activities

- Visits to Japanese SMEs, large corporations, government institutions (Ministry of International Trade and Industry, Ministry of Finance, Small&Medium Enterprise Agency), execution agencies (Japan Small and Medium Enterprise Corporation, National Federation of Small Business Associations), financial institutions dedicated to SMEs, Japan Finance Corporation for Small and Medium Enterprise, Economics Institute for Tokyo City and other relevant institutions.

- Conducted extensive researches on Japan's SME assistance policies, programs, function and role of the supporting institutions, overall status and conditions of SMEs, structure of subcontracting, etc.

■ Outcome

- Prepared the 80 page report entitled "Restructuring Small and Medium Business Policies," and reported it to the President of Republic of Korea at the Trade Promotion Meeting on April 27 of the same year.

- Proposed the foundation of Small&medium Business Corporation and establishment of the special law to promote SMEs.

Based on their visit to Japan, the team prepared the 80 page report entitled "Restructuring Small and Medium Business Policies," and reported it to the President of Korea at the Trade Promotion Meeting on April 27 of the same year.

This report highlighted that SMEs in Japan held crucial roles in the Japanese economy, considering the number of SMEs, as well as the jobs and value they created. The team said that SMEs were the driving engine of the economic development in Japan. They served as the basis for balancing power between sectors, and provided stability for the lives of citizens. In addition, they helped stimulate the economy, which could otherwise be be rigid and large corporation-oriented. The SMEs were good rivals to compete against for a healthy economy.

At the time when Korea lacked such awareness of SMEs, the visits and ensuing report by the team reminded the nation of the crucial role that SMEs played in the society and economy. The in-depth analysis of the role helped the government change its mindset about existing issues and ways to promote SMEs.

In September of the same year, another team was organized to visit Japan. Comprised of the working-level officers from the relevant institutions, the team closely studied the institutions of Japan, in order to establish a new direction for SME policies in Korea. It was the step toward customizing the policy directions, based on the situations faced by SMEs in Japan.

Above all, the report presented with detailed explanations on the necessity of special laws and the Small&medium Business Corporation. This was how Korea's SME policies in the late 1970s were revised and reinforced.

2.2 Establishment and Change of Small and Medium Enterprises Promotion Act

The Small and Medium Enterprises Promotion Act came into being in March 1978, when the team was dispatched to Japan to study the SME policies. The government initiated efforts to draft the Small and Medium Enterprises Promotion Act based on the report of the team, and it was drafted by the Small Business Service under the leadership of the Assistant Minister for Business, Ministry of Commerce and Industry. The draft was revised/supplemented by relevant government institutions, and reviewed by the Ministry of Government Legislation. It was then brought before the 75th Vice Minister Meeting and the 68th Cabinet Meeting for review. Finally, it was approved by the President on October 11, 1978. On October 12, the government submitted a draft to the regular session of the 100th National Assembly, as the Small and Medium Enterprises Promotion Act. It was passed by the plenary session of the National Assembly on November 14. On December 5, 1978, it was promulgated as the Statute No. 3126.

The Act contained seven chapters, 44 articles and supplementary provisions. Its enactment provided for the legal basis for government policies designed at promoting SMEs in Korea.

The Act presented programs that the government needed to launch for SMEs, and stipulated on the foundation of the Small &Medium Business Corporation, in addition to the creation of the Small and Medium Business Promotion Fund, for the successful execution of programs.

While the Framework Act on the Small&Medium Business (the "Framework Act") was a charter on SME policies in nature, the Promotion Act was the law with the power to execute the Framework Act. In other words, the Framework Act listed the basic policies for the promotion of SMEs, and made sure that the implementation of these policies was regulated by relevant laws.

Out of the policies from the Framework Act, the Promotion Act specified core policies required to aggressively support SMEs, such as facility modernization, alliance, SME start-up assistance, promotion of changes of business and training.

The Promotion Act especially elucidated details on promotion plans and funds, serving as the compass that helped to set the future direction for SBC programs. Chapter 2 of the Act designated priorities, which included modernization an dalliance programs, and obligated the government to establish and announce relevant plans. Chapter 3 was about the setting up the Small and Medium Business Promotion Fund with contributions from the government or third party organizations, loans, profit or income to finance the promotion of SMEs. It also defined the scope of use for the funds, and specifically appointed the SBC for the operation and management of funds. Chapter 4 prescribed the purpose of the SBC, which is to efficiently implement programs for SMEs, as well as the articles of incorporation, appointment of personnel, fund and program management, and other details.

In December 1994, the three acts were integrated to improve SME-related laws: the Small and Medium Enterprises Promotion Act (enacted in 1978), the Act on Special Measures for the Promotion of Managerial Stability and Structural Adjustment for Small and Medium Enterprises (enacted in 1989), and the Facilitation of Purchase of Small and Medium Enterprise-Manufactured Products Act (enacted in 1981).The result was the Promotion of Small and Medium Enterprises and Encouragement of Purchase of their Products Act, the third Chapter (Expansion of Sales Channel and Facilitation of Purchase of Small and Medium Enterprise Products) of which was taken out as the Act on Facilitation of Purchase of Small and Medium Enterprise-Manufactured Products and Support for Development of their Markets (enacted in May 2009). Its name was changed and remains effective currently as the Small and Medium Enterprises Promotion Act.

2.3 Establishment Process

The legal ground for the foundation of the SBC was provided by the announcement and enforcement of the Small and Medium Enterprises Promotion Act on December 5, 1978. Pursuant to Article 16 and Article 2 of the Supplementary Provisions in the Promotion Act, the government created a SBC foundation committee by appointing committee members. Chaired by the Vice Minister for Commerce and Industry, the committee had its members appointed from the Economic Planning Board, Vice Minister for Finance and heads of economic institutions.

The SBC foundation committee held its first meeting at the Office of the Vice Minister for Commerce and Industry on December 22, 1978. The members listened to the progress report and reviewed the articles of incorporation, contributions and capital market. Then the committee hosted a general meeting where the founding members adopted the prospectus and finalized the articles of incorporation. On December 26, 1978, the prospectus, articles of incorporation and meeting minutes were submitted to the Ministry of Commerce and Industry for the approval of the foundation of SBC.

In the meantime, the foundation committee rented the Ssanglim Building in Ssanglim-dong, Jung-gu, Seoul on December 29, 1978 and financed a total of KRW 200 million from the Small and Medium Industry Bankto pay for rent and related expenses.

On December 30,1978, the government appointed Mun Gisang, the Assistant Minister for Business at the Ministry of Commerce and Industry at the time, as the first chairman, who commenced the foundation of SBC. The foundation of SBC was officially approved on January 4, 1979 (Ministry of Commerce and Industry Approval No. 252) and its registration was completed on the same day. The committee successfully fulfilled its purposes, and its members were relieved of their duties on the same day. Thus, SBC was founded officially on January 30, 1979 with a mission to serve its role as the organization that implements government policies to advance the fundamentals of SMEs in Korea.

2.4 Significance of the Foundation

The foundation of the SBC holds significance as it emerged as the organization that was in charge of providing an extensive range of assistance policies at a time when the government redirected and bolstered its SME policies in the late 1970s.

After exporting an impressive amount of $10 billion in1977, Korea looked to promote all industries and expand its exports further. As a result the following policy tasks were acknowledged as urgent priorities: an alliance of experts for the promotion of SMEs, and an enhanced international standing via facility modernization, cooperatives, streamlined management, technology innovation, etc. The founding of the SBC was in response to the need for an organization that could support the implementation of SME policies and resolve urgent economic tasks.

Furthermore, Korea’s SME policies placed priority on financing. There was potential for mistakes and failures, due to the sporadic and fragmented nature of the policies that were provided by multiple organizations, such as the government agencies, financial institutions and SME cooperatives. As the policies became more diverse and extensive, it was imperative for an institution with a certain degree of independence to commit its efforts to Korea’s policies. It was against this background that the SBC was founded, designated to lead a new way for SMEs.

3. Organization and Main Functions of the SBC

3.1 Organizational Structure

The SBC organization has evolved to quickly respond to various changes in the management environment and effectively achieve its goals. The specific details are stipulated in the Small and Medium Enterprises Promotion Act, articles of incorporation and organization regulations. To better meet the requirements of its expanded functions and roles, the SBC continued to reform its organization. SBC's organization was first recognized on February 5, 1979, with three offices, 24 departments and seven sections, totaling 195 employees. The roles and functions grew even more diverse and its standing increased in Korea, since the nation increasingly became aware that SMEs form the foundation of its economy. The SBC continued to grow and now has five offices, 13 departments, 24 Regional Headquarters, three regional training institutes and over overseas technology cooperation center, totaling 761 employees, as of 2011.

3.1.1 The Operating Committee

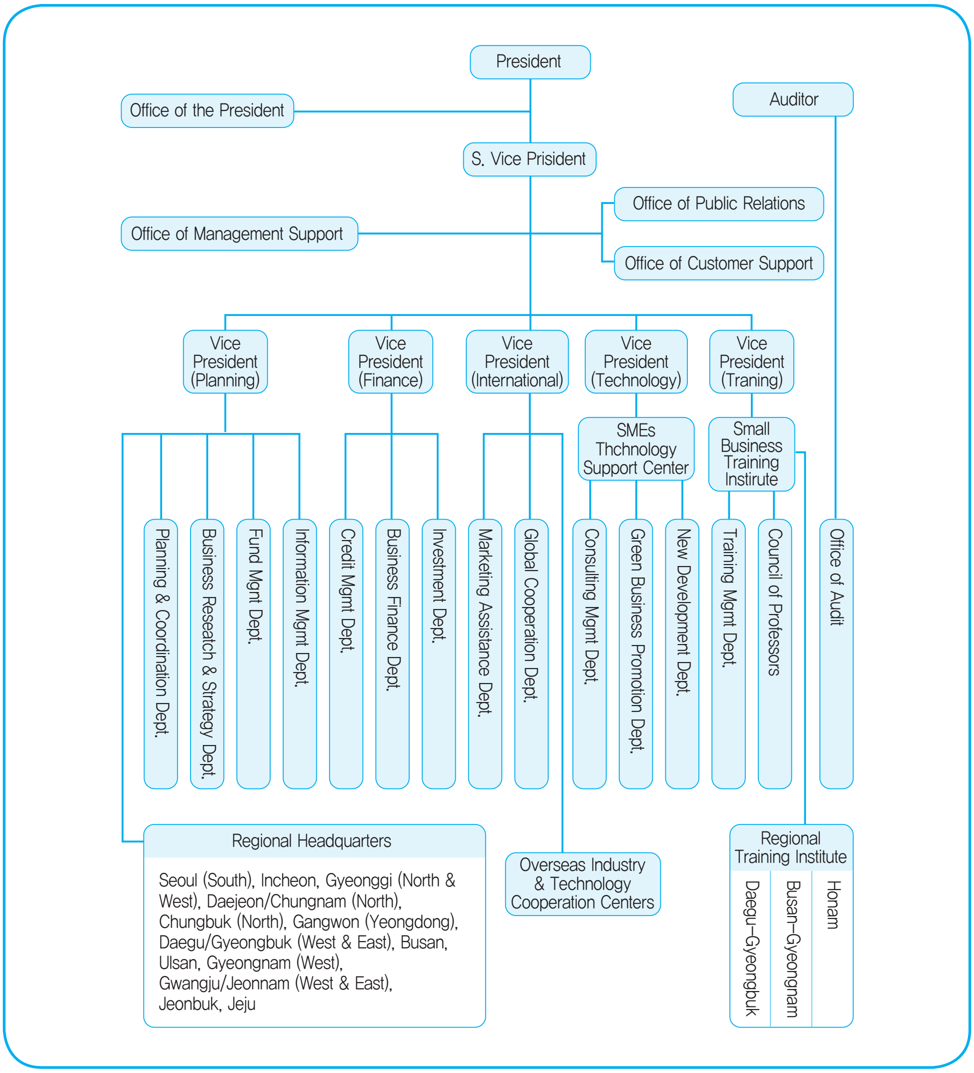
The SBC has an Operating Committee, pursuant to Article 71 of the Small and Medium Enterprises Promotion Act. The Committee is comprised of a chairman (President of the SBC) and 20 members. The members consist of: 1) a Level 3 civil servant from the Ministry of Strategy and Finance, the Ministry of Knowledge Economy and the Small&Medium Business Administration, or a general civil servant from the Senior Civil Service, each appointed by the head of their organizations; and 2) a person appointed by the President of the SBC from a pool of the permanent Vice Chairman of Korea Federation of Small and Medium Business, and a person with profound knowledge and experience with SMEs. The office is held for two years and may be held for two consecutive terms. In the beginning, the Committee was designed to define the scope of work and basic guidelines for the SBC. Moreover, it revised the articles of incorporation, set up business plans, allocated budget and settlements, borrowed long-term funds and necessary resources, acquired SME stocks or bonds, and reviewed any necessary agenda from the resolutions of the board that required the Committee's review.

To enhance efficiency, the Committee's authority to review was changed to include the review of the budget, settlement and agenda from the board that determined by the chairman to require the Committee's review in September 1983, when the articles of incorporation was revised. The Committee has regular and provisional meetings held twice each year. To pass any resolution, a majority of the current members are required to be present, and upon the agreement by the majority of the members in attendance.

3.1.2 Board

The board was formed in order to pass the important agenda of the SBC, pursuant to articles of incorporation in January 1979. It consists of 15 members, including the President and Senior Vice President. The President chairs the board. The auditor cannot vote but may be present to voice his or her opinion. The board is summoned by the chairman or a third of the members present, and the resolution is passed by a majority of the members present. The first chairman was appointed on December 30, 1978. The first board was held on January 22, 1979 to discuss the draft on the organization regulations, which forms the basis of SBC's work. On June 5, 1979, the 12th board passed the draft on the regulation of board operation and paved the way for its operation.

Figure 1-1 | Organization Chart of SBC (as of 2011)



3.1.3 Executives

Pursuant to the Small and Medium Enterprises Promotion Act and the articles of incorporation, the SBC has executives, including president, vice presidents, senior vice presidents and an auditor. Vice presidents are divided into permanent and non-permanent positions. The president can sign a performance agreement with permanent vice presidents and evaluate their performance. If the performance is inadequate, vice presidents can be dismissed. The President is appointed or dismissed from multiple candidates selected by the executive recommendation committee, and is appointed by the President of Korea, based on the recommendation of the head of the Small&Medium Business Administration. Permanent vice presidents are appointed or dismissed by the president. Non-permanent Vice Presidents are appointed or dismissed by the head of the Small&Medium Business Administration from the multiple candidates recommended by the executive recommendation committee.

The auditor is appointed or dismissed bythe President of Korea, based on the recommendation of the Minister for Strategy and Finance, from multiple candidates recommended by the executive recommendation committee and reviewed or passed by the Committee on the Operation of Public Institutions. The term of the president is three years, and the terms for auditors and vice presidents is two years. The president represents the SBC and supervises the business of the SBC. The senior vice president assists the president and serves as the acting president, if the president cannot fulfill his duties. Permanent vice presidents are assigned to oversee different sections of the SBC. If both the president and senior vice president cannot fulfill their duties, the responsible persons, as designated by the president, will do so. The auditor reviews the business and accounting of the SBC, as per the auditing standards set forth by the Minister for Strategy and Finance, and the recommendations are submitted to the board. Vice presidents review the agenda brought to the board and participate in voting.

3.1.4 Overseas Office

From the beginning, the SBC was aware that it is necessary to introduce outstanding technology from overseas, in order to help SMEs in Korea to escape their technological vulnerabilities. The SBC's eyes were on the US, Japan and Europe, which owned many of the most advanced technologies in the world. The SBC decided to choose Europe for its overseas offices since it was difficult for Korean companies to access the region due to geographical and cultural reasons, despite the wealth of original technologies. On September 14, 1979, the SBC founded the European office in Eschborn near Frankfurt in what was then West Germany. On June 10, 1981, an office was opened in Tokyo, Japan and another office in Chicago, USA on March 15, 1983-two years apart from one another. After Korea and China began diplomatic ties in 1992, China emerged as the opportunity for further investments. The SME investment in China was opened in Beijing, China on May 21, 1993.

The main responsibilities of the overseas offices include: recommendation of overseas experts for training; arrangement of joint investment and technology cooperation; support for overseas market penetration of SMEs; arrangement of technical training and visits; and introduction of the latest information on the advanced management techniques and technologies. The overseas offices also played a vital role when Korean SMEs visited these countries. However, the interim report meeting on national tasks on April 24, 2008 decided to integrate domestic export-support activities by the SBC andits overseas marketing channels through KOTRA, closing four overseas SBC offices and opening 17 export incubators under KOTRA.

3.1.5 Regional Headquarters in Korea

As the SBC became more active, it was flooded with the requests for the installation of SBC regional offices, from SMEs located outside Seoul and its surrounding metropolitan areas.Local governments also requested the central government for regional offices. In response, the SBC opened offices in Busan-Gyeongnam and Gwangju in February 1985, followed by Daegu and Daejeon in 1987, Jeonbuk and Chungbuk in March 1988 and Changwon in February 1989(separated from Busan-Gyeongnam and opened as Gyeongnam in March 1991). In July 1990, the Gangwon office was opened in Chuncheon, Gangwon, and the Gangneung office in January 1992 to oversee Gangwon and Yeongdong.

In 1993, when local governments grew increasingly autonomous, many assistance programs managed by central headquarters were transferred to the regional offices. New offices were also built in Ulsan and Jeju. In 1994, Seoul-Incheon and Gyeonggi offices were opened. Furthermore, the Jeju office was promoted as Jeju Headquarters-responsible for a total of 12 regional headquarters across Korea. During reorganization in December 1995, the offices were renamed as headquarters. In September 1996, Euijeongbu was installed to oversee northern Gyeonggi Province, yet another foundation to achieve balanced regional development.

In 2006, six regional headquarters were opened: West Gyeonggi (Siheung), West Gyeongbuk (Gumi), East Gyeongbuk (Pohang), West Jeonnam (Mokpo), East Jeonnam (Suncheon) and North Chungnam (Cheonan). South Seoul (Seocho), West Gyeongnam (Jinju) and North Chungbuk (Chungju) were opened in 2007, 2009 and 2011, respectively-a total of nine regional headquarters. The total number of the regional headquarters grew from 15 to 24. To enhance risk management and ensure site-centered businesses, the regional headquarters were divided into four sections, each supervised by four executives, thereby ensuring responsible management.

3.1.6 Training Institutes

From its foundation, the SBC planned training institutes, believing that SMEs needed well-trained talents in management and technology, as well as systematic training. However, there were budget problems. It was difficult to use the given budget to secure land, construct buildings, purchase equipment for experiments and practice, provide overseas training to teaching staff or develop textbooks. After a lengthy deliberation period, the ABD Fund-a long-term, low-interest loan provided to educational institutions-was used. Finally, in October 1982, the SBC opened the SME Training Institute in Ansan, Gyeonggi.

Nevertheless, a single institute could not meet the ever increasing demands for training, especially for those who wanted to learn in other regions. To resolve this issue, the SBC opened three more training centers: Honam Institute (Buk-gu, Gwangju) in September 2001; Daegu-Gyeongbuk Institute (Gyeongsan, Gyeongbuk) in November 2003; Busan-Gyeongnam Institute (Jinhae, Gyeongnam) in October 2004. The local training institutionsprovide local SMEs with training services and programs, specifically tailored to meet the needs of each region, thereby contributing to each regional economy.

3.2 Main Business

Pursuant to the Small and Medium Enterprises Promotion Act, the SBC was founded to contribute to the national economy by efficiently implementing programs that help SMEs grow. The SBC functions in various ways to respond to the government's SME policies and the demands of SMEs. The main business includes: policy funds financing, consulting, training, export marketing, global cooperation, SME start-up, operation/management of various funds such as promotion funds, and programs commissioned by the head of the Small&Medium Business Administration. These functions have evolved flexibly in response to the changes in government policy during the process of implementation, or to the changes in domestic and international environments surrounding SMEs.

As of 2011, the SBC has been reorganized into four core areas: financing, training, diagnosis/technical support, and export/global cooperation. This is to focus on the "areas that are critical and the SBC is good at." For enhanced effectiveness, the SBC has also shifted from an organization divided by functions, to one working based on "areas of expertise".

3.2.1 Policy Fund Financing

SBC provides long-term policy funds at low interest rates to boost start-ups, expedite commercialization of technology, facilities improvements, etc. By business, there are: Venture Business Start-up for firms less than seven years old; Commercialization of R&D Results that helps technology-based SMEs; Promotion of the New Growth Industry that invests in the facilities required to achieve higher productivity, added value and enhanced competition; Management Stabilization that provides operating funds required for production and sales, and for the resolution of temporary management issues; Business Conversion; Trade Adjustment Assistance; Small Business Assistance and much more.

3.2.2 Training

The SBC provides training programs that meet the needs of SMEs. SBC provides Executive, Technology, Quality Management, and Administrative Management Training and other working-level programs, both online and at remote locations. SBC continually develops new courses to meet the needs of SMEs. It also selects those who are looking to start a business, to offer systematic training as provided at the SBC venture school in order to foster young and innovative CEOs.

3.2.3 Diagnosis and Technical Support

The SBC offers a program in which the health of SMEs is analyzed and evaluated. The area expert visits sites, analyzing their businesses for strengths and weaknesses, diagnosing any problems, presenting resolutions and providing support in line with the relevant policies, all to sharpen the competitive edge of these companies.

While providing the technical consulting services, the SBC is developing a program to attract experts from overseas to Korea. In this program, these experts are assisted with wages, living expenses and travel costs.

3.2.4 Export and Global Cooperation

The SBC operates export assistance programs to promote SMEs' competitiveness in the global market. To help SMEs penetrate and settle into the global market, thereby strengthening their export competencies, the SBC has dispatched trade delegations, hosted overseas exhibitions and buyer seminars and partnered with global private networks.

Other programs include international technology cooperation (support for the identification and introduction of the latest technology from advanced countries, in addition to joint development), overseas penetration/localization support (based on the network between partner institutions in main target Asian countries-China, Vietnam, etc.-and SBC overseas offices and Export Incubators), and international cooperation between companies.

Table 1-4 | SBC Scope of Work

Four Areas	Policy Fund Business	Commissioned
Policy Fund Financing	■ Start-up ■ Commercialization of R&D Results ■ New growth industry ■ Management stabilization ■ Business Conversion ■ Small business support	
Diagnosis and Technical Support	■ New product development support ■ Invitation of overseas experts	■ Green consulting ■ Support for the promotion of green management
Training	■ Improvement training (technology, management, quality, etc.) ■ Customized training (job recommendation, global cooperation, etc.) ■ In-site training ■ E-learning ■ School for young, innovative CEOs of start-ups	
Export and Global Cooperation	■ Online export support ■ Domestic sourcing of global buyers ■ Export Incubators (Korea-SBC; overseas-KOTRA) ■ Overseas industrial cooperation support ■ APEC SME Innovation Center	■ Global branding support ■ Overseas private network ■ SME overseas internship ■ Overseas market penetration, export consulting meetings, etc. (commissioned by local governments, etc.)

4. Procurement and Management of SBC Promotion Fund

4.1 History of SBC Promotion Fund

In December 1978, the government set up the Small and Medium Business Promotion Fund, under the management of the SBC to finance SME policy programs.

The SBC Promotion Fund is a public fund created in accordance with Article 63 of the Small and Medium Enterprises Promotion Act, for the purpose of promoting SME start-ups, balanced industrial development, industrial foundation, management platform and advanced industrial structures.

Since then, the SBC Promotion Fund has been integrated with other relevant funds, and renamed many times according to the changes in SME-related laws. In January 2009, it was officially named the "Small and Medium Enterprise Establishment and Promotion Fund" ("SBC Promotion Fund") and remains effective to date.

The current SBC Promotion Fund includes: Small and Medium Business Promotion Fund; Small and Medium Business Start-up Fund; Regional Small and Medium Business Promotion Fund; Industrial Foundation Fund; and Agricultural&Industrial Promotion Fund.

[Reference] Change of Name

- Small and Medium Business Promotion Fund ('78-'95)→Small and Medium Business Establishment and Promotion Fund ('96-'01)→Small and Medium Business Promotion and Industrial Foundation Fund ('02-'08)→Small and Medium Business Establishment and Promotion Fund ('09-today)

4.2 Creation of SBC Promotion Fund

The SBC Promotion Fund is comprised of government contributions, bonds, Public Capital Management Fund, lottery proceeds, borrowings, and more. For the first time, the government contributed KRW 20 billion in 1979, and a total of KRW 191 billion from the general account until 1986. From 1987, however, the government contribution was restricted in use to institution management and other recipients, according to government guidelines to reduce financial burden. The amount dropped to KRW 3 billion a year and loans were shifted from the fund management special account to the financing special account. Bond issues, a main financing channel for the fund, began in 1994. Starting with the issue of private bonds amounting to KRW 140 billion of the Public Capital Management Fund in1994, some 88.4% of the accumulated fund, totaling KRW 17.0475 trillion as of the end of 2010, was set up by the SBC Promotion Bonds.

When the size of the government's financing expenditure and the amount of principal repayments are determined, the repaid principal is first used. The rest is covered by issuing the SBC Promotion Bonds. Any differences between financing rates (bond issue rate) and interest rates (loan rate) are subsidized by the government. The issue is limited up to 20 times the accumulated fund (capital + capital surplus + earned surplus + capital adjustment).

Table 1-5 | SBC Promotion Fund Financing in 2010

(Unit: KRW 100 million)

Category	Amount	%	Remarks
■ **Contribution and operating income**	17,048	10.0	General account: 18,591 Public institutions: 3,411 Private: 340
- Contribution	22,342	13.1	
- Operating income, etc.	△5,294	△3.1	
■ **Borrowings**	153,427	90.0	
- Public Capital Management Fund	1,865	1.1	
- Bond	150,789	88.4	Domestic: 146,233 Overseas: 4,556
- Foreign currency	773	0.5	Foreign currency: 773
Total	170,475	100.0	

The procedure is as follows: the Public Capital Management Fund, a private bond (set up to integrate/manage the fund, deposits and surplus funds to use them for the public, such as investing/financing, or acquiring government or public bonds) is raised by directly taking the SBC Bonds between transaction parties, based on agreements without going through the bond market. Public bonds are then issued via public offerings for fund managers in the domestic and overseas markets; these bonds go through bidding and are issued by selecting securities companies as the underwriter.

Table 1-6 | Types of Bond Issuance

Category	Private	Public
Issued	Based on the agreement between the parties in transaction * SBC Promotion Bonds directly acquired by the Public Capital Management Fund	In the domestic and overseas bond market via public offering * Securities companies selected as the underwriter
Maturity	3 year term; repay installments over 5 years (at the end of the quarter) (6 month repayment terms for bonds issued since '05)	2-10 years (debt-equity swap or government financing at maturity)
Issue rate	Interest rate of the Public Capital Management Fund (average rate of 5 year treasury bond)	Market rate at the time of issue
Fee	None	0.2% of the issue price

4.3 Operating System of SBC Promotion Fund

Pursuant to relevant laws, the fund is reviewed by the board and the Operating Committee at the stage of establishing, revising and settling fund management plans each fiscal year, which then goes through the review and resolution of the government and the National Assembly.

The fund management plans are reviewed by the board and the Operating Committee, coordinated and discussed in advance by the government (Small&Medium Business Administration, the Ministry of Strategy and Finance and the Ministry of Knowledge Economy), and finalized after review and resolution by the National Assembly. To modify the plans, the SBC may have leeway within the scope designated by the government, depending on the details and scopes of such a change, but if it is anything of significance, it is reviewed and passed by the National Assembly (changing more than 2/10 of the expenditure on major items), or coordinated by the Ministry of Strategy and Finance or Small&Medium Business Administration.

The settlements of the fund are also reviewed and passed by the board or the Operating Committee, and submitted to the government (Small&Medium Business Administration). The government then submits the settlements, reviewed by the Board of Audit and Inspection of Korea, to the National Assembly. It is then finalized after the review and resolution by the National Assembly.

Figure 1-2 | Process of the Establishment of SBC Promotion Fund Management Plan

Step	Description
Establish the mid to long term finance operation plan (draft)	■ Coordinated by the supervising Small&Medium Business Administrationand submitted to the Ministry of Strategy and Finance (end of every January)
Establish the fund management plan for the next year (draft)	■ Establish the fund management plan for the next yearafter discussing with the Small&Medium Business Administrationand the Ministry of Strategy and Finance ■ Submit to the government after approval by the board and the Operating Committee (end of June) * Includes the size of the fund for the next year, government assistance (contribution, etc.), bonds issued, repayment of borrowing, etc.
Finalize the fund management plan (draft) by the gov't	■ Review by the Ministry of Strategy and Finance and come up with the government plan (draft) ■ Send to the National Assembly after approval at the Cabinet meeting and by the President of the Republic of Korea (every October 2)
Finalize the fund management plan (draft) by the National Assembly	■ The fund management plan (draft) reviewed, coordinated and finalized by the National Assembly (every December 2)
Report the fund management plan	■ Finalize by the National Assembly and report the fund management plan to the Small&Medium Business Administration

Chapter 2

History and Management of Policy Fund Financing System

1. History
2. Major Financing System by Period
3. Policy Fund Financing System
4. Implementation of Direct Loans
5. Management of Corporate Evaluation System

History and Management of Policy Fund Financing System

There are considerable concerns over imbalance between supply and demand in SME financing, due largely to information asymmetry, and financing costs related to asymmetry. Accordingly, many overseas governments interfere with the market by providing policy funds for SMEs, in order to handle the imbalance issue, enhance their financial industry and secure growth potentials. Major economies like Japan, Germany and Canada have dynamically developed SME policy funding systems that are adaptive to their unique economic, financial, political, social and cultural environments.

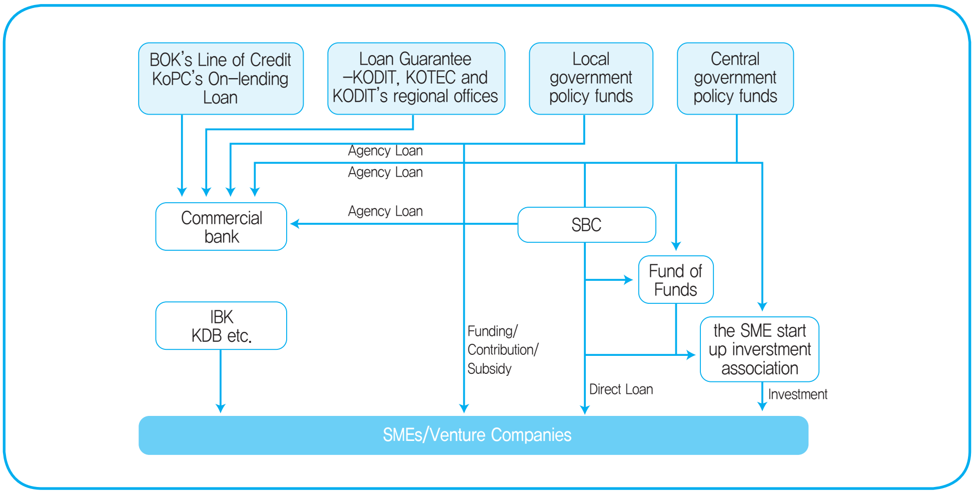
The Korean system has also evolved into diverse forms, in accordance with the degree of government involvement and the use of private funds to achieve policy goals. The system addresses market failure, including policy funds, loan guarantee, lines of credit and loans.

The SBC is responsible to supply policy funds for SEMs that are likely to be affected by market failure, such as newly-established firms and those trying to commercialize new technologies, to embark on a long-term investment or to convert their businesses. Whereas commercial banks target large or blue-chip corporations, and usually give loans for short terms (with the maturity of one year) to companies that can afford collateral, so that they can generate profits while avoiding bad debts in the first place. State-sponsored credit guarantee agencies, like the Korea Credit Guarantee Fund (KODIT) and the Korea Technology Finance Corporation (KOTEC), assume the role of a social safety net by providing credit guarantees for SMEs with little collateral or supplying liquidity in times of economic crisis. The Bank of Korea (BOK) operates a line of credit program to expand fund supplies available for SMEs, and the Korea Finance Corporation (KoFC) provides loans for projects, to which commercial banks are reluctant to lend, such as SOC construction or resource development, new-growth businesses, or large facility investments of large and promising SMEs.

The aforementioned state-sponsored agencies have pursued SME policy funding practices to differentiate themselves from the private sector. In the course of managing policy funds for over a generation since 1979, the SBC has continued its efforts to identify and select promising SMEs, providing market-friendly and market-complementary support.

The following SME policy funding system, which has been developed through trial and error, and SBC's unwavering efforts, to differentiate itself and secure its identity, is expected to be of substantial help for developing countries that are considering the introduction of their own policy funding systems.

Figure 2-1 | SME Policy Fund Support System



1. History

Before the SBC was founded, SMEs secured most of its finances from private financial institutions. For most of the SMEs however, it was very challenging to obtain finance, as their financial performance was low and their asset was not enough to provide as collateral. What is commonly known as compensatory balances imposed additional financial burdens, as well as high interests. The reason why the SBC initiated its financing program was that it was considered a top priority as an organization to assist SMEs.

In accordance with the 1978 enactment of the Small and Medium Enterprises Promotion Act, the Korean government set up the SBC Fund in January 1979, and had the SBC provide financing to SMEs that pursue modernization and alliance. Ever since, the SBC has developed and provided extensive financing programs to meet the needs and demands of SMEs.

From its foundation to the end of the industrial modernization program in 1987, the SBC operated SME modernization, alliance, and agricultural-industrial complex assistance projects. Its policy funds were utilized to support SMEs that were at a comparative disadvantage to large corporations, with consideration for a balanced industrial development.

Around 1990, the SBC launched a restructuring program based on the Act on Special Measures for the Promotion of Managerial Stability and Structural Adjustment for Small and Medium Enterprises, and added new projects for restructuring.

In 1993, the SBC began to focus on strengthening SMEs by investing KRW 1 trillion in the SME structure improvement program. In 1998,when Korea was hit by the Asian financial crisis, the SBC implemented projects like SME Venture Start-ups, Commercialization of R&D Results, Financial Assistance for Export-leading Businesses, and Management Stabilization, to assume the responsibility of making direct loans. In 2006, the SBC resumed its business conversion program, which was repealed after years of operation. The major framework of these programs has been maintained, despite minor changes in their names, sizes, recipients, conditions, etc.

The annual policy funds amounted to KRW 17.7 billion in 1979, and began to grow in 1993. During the first Structural Improvement period, it rose to more than KRW 1 trillion per annum. The policy funds increased to KRW 2.4 trillion in 1999 after the Asian financial crisis, and later reached KRW 3 trillion. When SMEs began to have trouble obtaining finance due to the global financial crisis in 2008, the amount was boosted to KRW 5.9 trillion in 2009. A series of pre-emptive measures normalized the financing. Then the amount was reduced to the pre-crisis level of KRW 3.3 trillion in 2010, and KRW 3.4 trillion in 2011.

When the financing system was still in its infancy, funds were executed in the form of agency loans via financial institutions. It was from 1993 that the SBC added direct loans. In the wake of the Asian financial crisis, direct loans were expanded in 1998. From 2008, the SBC introduced a hybrid financing scheme that was a cross between an investment and a loan, adding a variety of loan-oriented financing schemes. SMEs were thus able to benefit from an extensive range of financing.

The loan balance to SMEs by financial institutions was KRW 2.7 trillion in 1979, and rose to KRW 441 trillion at of the end of 2010. The loan balance for SBC policy funds has also increased steadily since its founding. The SME loan balance, as opposed to that of the banking sector, rose from 0.7% in 1979, to 3.6% in 2010.As discussed thus far, the SBC has taken the lead for the last three decades in nurturing blue-chip SMEs by providing long-term facility investment funds, technology commercialization funds, emergency stabilization funds and other support for start-ups, technology businesses, venture firms, small enterprises and other companies shunned by commercial banks.

Table 2-1 | Changes in Role and Function in Line with the SME policy trends

Phase	SME Policies	Role and Function of the Fund
Industrial modernization ('80-'87)	· Balanced development of SMEs and large corporations - Came up with SME promotion policies on balanced economic development based on the need to resolve imbalance due to rapid growth · Enacted the Small and Medium Enterprises Promotion Act	· Created the Small and Medium Enterprises Promotion Fund ('79) - Established the comprehensive measures to provide financial support to SMEs · Focused on SME modernization programs · Provided support based on the organic network of financing, training, guide and global cooperation programs
Restructuring ('88-'92)	· Provided restructuring assistance to help enhance the ability to respond to the external changes - Focused on improving the global competitiveness · Act on Special Measures for the Promotion of Managerial Stability and Structural Adjustment for Small and Medium Enterprises - Changed to SME Restructuring Fund	· Focused on the SME restructuring - Focused on technology development programs to sharpen global competitive edge for SMEs - Added more programs: technology development, information, large corporation business transfer, business conversion, and overseas transfer of idle facilities
Developing the 5-year plans for new economy ('93-'97)	· Established the foundation to enhance independence with the emergence of WTO · Small&Medium Business Administration founded ('96) · Promotion of Small and Medium Enterprises and Encouragement of Purchase of their Products Act - Small and Medium Business Promotion Fund → Small and Medium Business Establishment and Promotion Fund - Integrated/removed: Small and Medium Business Start-up Fund, Fund for New Companies at Agricultural&Industrial Complexes, Regional Small and Medium Business Promotion Fund	· Launched the Structural Improvement program worth KRW 1 trillion per annum in accordance with the 5-year plan for new economy · Dramatic quantitative expansion of policy funds (KRW 2 trillion for support) · Expansion of SME restructuring programs - Added automation, information, and Commercialization of R&D Results · Regional Small and Medium Business Promotion Fund transferred to local governments

Phase	SME Policies	Role and Function of the Fund
Overcoming Asian financial crisis ('98-'02)	· Overcame the Asian financial crisis by fostering venture companies · Founded Presidential Commission on Small and Medium Business ('98) · Enacted Act on Special Measures for the Promotion of Venture Companies · Integrated Industrial Foundation Fund and Small and Medium Business Establishment and Promotion Fund → Small and Medium Business Promotion and Industrial Foundation Fund	· Initiated direct loan amidst the financial crisis · Added the management stabilization program for SMEs · Facilitated SME restructuring and continued structural improvements · Focused on supporting venture companies - Designated the local base and supported venture companies in local areas · Expanded channels and promoted exports - Supported SMEs penetrating overseas market via Export Incubators (100 companies at 5 Incubators in Chicago, LA, etc. by the end of '03) - Provided information on exports, consulting for companies entering global market
Fostering innovative companies ('03-'07)	· Focus on innovative SMEs - Established the Comprehensive Measures for Competitiveness of Small and Medium Business ('04) - Measures to restructure SME policy funds ('05) - Became aware of SMEs as the entity driving innovation in corresponding regions · Promoted shared growth via alliance between SMEs and large corporations · Reinforced the SME restructuring support - Enacted the Special Act on the Promotion of Business Conversion in Small and Medium Enterprises ('06) - Enacted the Act on Trade Adjustment Assistance for Manufacturing, Etc. ('06)	· Expanded direct loan to foster innovative SMEs - Restructured policy funds in accordance with policy goals and stages of growth - Introduced BSC system to manage performance ('06)-Introduced the customized assistance to meet the demands based on comprehensive diagnosis · Strengthened the assistance for SME in global market - Expanded Export Incubators to 15 in 10 countries by the end of '06 · New program-assistance for the alliance between SMEs and large corporations · Established the system of regular restructuring - Installed Business Conversion Center and Trade Adjustment Support Center within SBC - Pursued the restructuring fund and trade adjustment fund ('07)

Phase	SME Policies	Role and Function of the Fund
Overcoming economic crisis and creating new growth engines ('08-today)	· Supported SME flexibility to overcome the financial crisis - Expanded financial assistance, extended due date for repayment · Secured growth potential of SMEs - Prepared for the future by fostering new growth engine, such as green industry - Create jobs by revitalizing start-ups	· More policy funds to overcome the financial crisis - Improved the customer-oriented assistance system and simplified procedures · Restructured the business&technology evaluation model - Preferential treatment to companies that create jobs and are in the green technology sector · Restructured the SME policy funds and integrated the execution channel - Policy funds: 23→8; execution channel: 11→1(SBC) · Provided domestic assistance for export due to the integration of overseas marketing channel · More customized assistance to meet the demands based on comprehensive diagnosis

2. Major Financing System by Period

2.1 Industrial Modernization (1980-1987)

In the early days, the goal of policy funds was to select priority industries that would create the greatest ripple effect with limited government resources. Then the funds were executed to modernize SMEs in selected sectors. The priority industry designation system aimed at encouraging enhancement of the Korean industry structure by serving as a reference for would-be entrepreneurs or existing companies to set investment directions, and actually made a substantial contribution to the development of industries by 1989.

The Industrial Modernization program, which was launched right after the SBC's foundation, was designed to identify SMEs with growth potential to provide financial support needed to modernize facilities, streamline management and enhance technology. It was also designed to provide assistance in regard to information, guidelines and training. The eligible applicants were SMEs in the designated industries that establish and submit a modernization action plan voluntarily, based on the government's own modernization plan. Then the SBC would determine the recipients by considering the feasibility of the submitted action plans, and predicting their impact. This program provided KRW 207.5 billion to

2,117 companies until 1989.In 1990, it was integrated with the process improvement program and was renamed as the Automation and Facility Modernization Program. Until 1993, this program provided KRW 347.1 billion to 2,180 companies, thereby contributing significantly to the development of fundamental industries that helped advance industrial structures and boost alliance.

The Alliance program is a flagship program of the SBC, the oldest of all the policy funds. To meet the changing needs of the time and its people, the SBC has continued to make changes to recipients, methodology and types of programs. It is for SMEs that work in alliance, that jointly install production and pollution prevention facilities, warehouse, exhibition stores, etc., or pioneer domestic and overseas channels to sell products, develop products, buy raw materials, and more. Part of the effort to enhance competitiveness both at home and abroad, this program can be divided into Collective, Joint and Alliance.

Launched in 1979, the Alliance program was initially about having cooperatives or companies finance their business activities collectively. However, it changed to giving separate ownership to participating companies, financing implemented by individual companies. Since late 1994, the number of participating companies was reduced from five to three, to encourage more SMEs to participate. The program was also improved to include support for the distribution industry. By the end of 2010, 1,025 companies had been approved by the Alliance program, and KRW 3,534.6 billion was provided to help small businesses to secure their own workplaces and improve working environments. In particular, the support for joint plants, sewage facilities and warehouses significantly contributed to cost reduction, improved productivity and boosted competitiveness.

[Reference] Types of the Alliance Program

- Collective: having collective work site and facilities in a certain area
  - Example: collective manufacturing plant, research laboratory, trade mediation
- Joint: jointly installing costly production, R&D and pollution prevention facilities, or warehouse that a single company cannot build
  - Example: shared manufacturing facilities, exhibition stores, warehouse, sewerage treatment, test labs
- Alliance: jointly pursuing technology, product and trademark development, or sales activities and purchase of raw materials
  - Example: joint trademark development, joint purchase of raw materials, joint production and distribution of contents

2.2 Restructuring and 5-year Plan for New Economy (1988-1997)

The Olympics in Korea in 1988 was a huge success, but the economy deteriorated as a result. SMEs also witnessed their management and competitiveness decline amidst rising prices, wages and exchange rates, as well as an energy crisis that hit around this time. The government felt it necessary to pursue aggressive restructuring to achieve automation and an information-based system and to encourage high value added industries. As a result, the government enacted the Act on Special Measures for the Promotion of Managerial Stability and Structural Adjustment for Small and Medium Enterprises in March 1989. The SBC found it reasonable to try business conversion or diversification by participating in new businesses, in order to create new demands so that SMEs would continuously operate businesses and grow sustainably under ever-increasing uncertainties. As such, it embarked on programs for business conversion and the overseas transfer of idle facilities.

The Business Conversion program was divided into industry conversion and industry diversification. Under this program, KRW 102.2 billion was provided for 482 SMEs from 1989 to 1993, so that they could create new demands through business conversion activities. When an SME submitted a business conversion application, the SBC comprehensively examined the company status, industry, contribution to the national economy and financial status, to determine the feasibility of the business conversion plan.

The SBC also implemented the Overseas Transfer of Idle Facilities program to provide necessary financial support and information for SMEs, when they invest overseas with their idle facilities to operate manufacturing business plans. This program encouraged SMEs to further utilize their idle facilities after business conversion, and to penetrate into overseas markets.

The Structural Improvement program was included in the comprehensive economic stimulus plans, part of the 100-day Plan for New Economy announced in May 1992 by the new administration and implemented in 1993.The year 1993 witnessed a serious economic recession, and called for new economic policies that met the needs of the democratic and open-market era. Accordingly, the improvement program was an attempt to integrate automation, information and commercialization of R&D Results programs to maximize the effect of financial assistance.

The Structural Improvement program was largely characterized by its method of implementation. Unlike other programs, it had, in its Small&Medium Business Structural Improvement Committee, ministers, the Governor of the Bank of Korea, the SBC president, president of the Small and Medium Industry Bank, chairman of Credit Guarantee Fund, et. al, as members. There were also selection sub-committee, a coordination team, advisory team and a corporate diagnosis team. Such organization was a way to ensure consistency in providing assistance. After 1994, the main framework was maintained. The Ministry of Commerce and Industry was in charge of developing the Structural Improvement action plans, procuring financing, coordinating between government agencies and providing relevant institutional measures. The SBC was responsible for executing the program.

As it turned out, the performance of the 100-day Plan for New Economy was acceptable, the government decided to invest KRW 1 trillion per annum and increased the investment to KRW 2 trillion in 1997. During the five years ('93-'97) of the first Structural Improvement plan, 13,935 companies were assisted with KRW 4,696.7 billion, thereby fostering SMEs with future potential by advancing the production platform based on automation, etc.

[Reference] The 100-day Plan for New Economy

- Background: low economic growth (5%) in '92; extremely slow economy, with some 10,000 SMEs going bankrupt

→ The era of democracy and open economy required the new economic policies

- Main Points: revitalizing the economy, easing administrative regulations on the economy, sharing the pain, etc.
- Effect: economic recovery, increased production, export and value of SMEs, enhanced quality, etc.

2.3 Overcoming the Economic Crisis and Challenges (1998-2007)

As the result of the first Structural Improvement plan implemented until1997, there was a widespread awareness that the plan was effective and critical for greater competitiveness of SMEs. In response, the new administration selected the Structural Improvement plan as one of the National Project 100,to be implemented until 2002. Thus the SBC pursued the second Structural Improvement plan, providing KRW 10 trillion to some 25,000 SMEs for facility assistance for five years from 1998. The second plan was designed to nurture creative and promising SMEs that could contribute to Korea to become one of the knowledge and information powerhouses of the 21st century. The focus was on fostering small- and medium-sized manufacturers and information/knowledge businesses to create spillover effects, and expanding program coverage so that different industries and businesses could create synergy effects.

The plan was continually improved after 2003, and remains in effect to date. In January 2007, the plan was renamed as the Management Innovation Fund to better promote the objectives and utilization of the policy, after integrating the Structural Improvement Fund, Knowledge Service Promotion Fund and Alliance Fund. After 2009, it was integrated as the New Growth Foundation Fund. While the first plan emphasized the improvement of physical production foundations such as automation, the second plan had its ultimate goal in enhancing corporate health by supporting advanced production facilities, technology development, sales channels, and management system. The second plan furnished SMEs with KRW 12.5514 trillion (26,070 cases approved) from 1998 to 2010. It encouraged SMEs to improve their management and sharpen their competitive edge. The plan particularly contributed to the growth of the innovation-driven SMEs.

The Asian financial crisis of 1997 devastated SMEs. Even promising SMEs and venture firms failed to endure temporary financial difficulties, and ended up going out of business. The ailing economy and massive business restructuring led to a plunge in demands for facility funds and a surge in demands for working capital. Accordingly, the SBC launched the Management Stabilization program to provide operating capital for SMEs, per Article 39 of the Facilitation of Purchase of Small and Medium Enterprise-Manufactured Products Act. The programs was developed for two objectives: to lay the foundation for stable management by proactively support manufacturing, sales and R&D activities of promising SMEs, and to help SMEs respond resiliently to external shocks like restructuring or natural disasters.

In July 2000, a meeting was held for the heads of exporting SMEs, and the head of SME Export Support Center. The meeting came up with a policy solution for SMEs struggling to obtain trade financing from commercial banks. As a result, KRW 30 billion from the Management Stabilization Fund was utilized to finance exports. A separate budget was set up in 2001 to support small exporters, in addition to companies that had just begun exporting.

The Recovery Assistance program was launched to support SMEs experiencing temporary financial strain due to the Asian financial crisis. Currently, support for SME restructuring is discussed as an issue of market indifference, and regarded as a goal-driven policy program, differentiated from private financing. The Recovery Assistance program was also a highly differentiated project, not only from the financial sector, but also from other policy funds, and continues to expand its assistance coverage. It provided financial support for many companies struggling from external factors despite their excellent technologies and businesses, so that they were able to swiftly restore and normalize their operations. From 2005 to 2010, 994 companies received KRW 256.3 billion in support, a big relief to their financial strain. As of 2011, the program is now renamed the Temporary Management Relief Fund, under the Management Stabilization Program. Eligible applicants include companies that are: in workout; suffering from derivatives hedging foreign exchange risks; suffering a loss of more than KRW 100 million, due to a major accident/incident with a major damage to exports due to the earthquake in Japan; with a loss due to the foot-and-mouth disease, etc.

While looking for measures to facilitate SMEs to commercialize their competitive technology and business, the government reached a consensus that technologies developed by SMEs need to be launched in the market. As a result, it started the Commercialization of R&D Results Program. Excellent technology and business ideas alone are not enough for an SME to enter the market, since technology is not automatically commercialized and the commercializing process can require huge costs.

Since the launch of the Commercialization of R&D Results Program in 2000, it has provided facility funds and working capital to SMEs that participated in R&D projects on patented technology, technology registered as the utility model, technology attested by the government, government recognized institutions and government funded R&D projects, so they can successfully make these technologies available commercially. By 2010, 5,397 companies benefited from KRW 1,111.7 billion in funding. The program seeks to prevent any excellent technologies from being buried, encourage commercialization and foster technology based small and medium companies.

2.4 Overcoming the Global Financial Crisis (2008-Today)

In2009, 11 institutions had financing programs-23 under the supervision of the Ministry of Knowledge Economy-pursuant to the Improvement of Efficiency of SME Support. However, they were integrated into six programs: Venture Business Start-up; Commercialization of R&D Results; Promotion of the New Growth Industry; Business Conversion; Management Stabilization; and Small Business Assistance. The SBC became the single execution channel and shaped the current policy fund system.

In the meantime, the financial crisis originating from the US in late 2008 hit the global markets, and SMEs faced a serious liquidity crisis. This further intensified the demand for policy funds. Until 2008, policy funds were maintained at around KRW 3 trillion. However, the budget surged to KRW 5.9 trillion with an emphasis on working capital, such as Management Stabilization and Small Business Assistance in 2009. Furthermore, early execution of the funds, backed by easing loan requirements and streamlining procedures, also helped SMEs overcome the liquidity crisis.

From2010, the liquidity crisis for SMEs began to dissolve. In response, financing was reduced to the pre-crisis level. The budget was strategically allocated, based on the latest focus on growth potential and future growth engines. The assistance was mainly targeted for the companies in the green, new growth engines, parts, materials and fundamental industries.

Among the six programs, Promotion of the New Growth Industry funds (for companies that are seven years or older) and Management Stabilization funds were scaled down in 2011, as the companies eligible for the two programs stood at higher chances of financing through commercial banks. Instead, the Venture Business Start-up and Commercialization of R&D Results were expanded considerably. The SBC also seeks to offer policy funds to companies that create jobs, help companies that failed to rise again, and aid socially responsible companies, all to help those that are socially vulnerable. Another distinct program is the Ambulance Man, which resembles the hospital emergency system, providing policy funds swiftly for SMEs that are in need of emergency support.

3 Policy Fund Financing System

3.1 Scope

The scope of SBC policy funds has fluctuated in response to demand, based on the economy cycle or the government's requests in different economic circumstances. For the last five years, the new policy funds were between KRW 3.1-3.6 trillion, at an average of KRW 3.2 trillion per annum. During the 2008 global financial crisis, pro-cyclical lending practices of financial institutions further aggravated the credit crunch for SME's. To alleviate the funding and liquidity crisis, the SBC substantially increased policy funds to KRW 5.9 trillion in 2009. When SMEs made it out of liquidity shortage, SBC reduced the funds to the pre-crisis level in 2010. As of late 2010, the loan balance was KRW 15.7 trillion-3.6% of the banks.

Table 2-2 | Scope of SME Loans by Banks and by SBC

(Unit: KRW trillion)

Category		'04	'05	'06	'07	'08	Average	'09	'10
Bank SME		245.2	258.0	303.3	371.7	422.2	320.1	443.5	441.0
Policy Fund	New	3.1	3.6	3.2	3.1	3.2	3.2	5.9	3.3
	Loan balance (b)	11.4	12.3	12.7	12.9	13.2	12.5	16.1	15.7
	% (b/a)	4.6	4.8	4.2	3.5	3.1	3.9	3.6	3.6
Growth rate (%)		4.6	4.0	5.2	5.1	2.3	4.24	0.3	6.2

3.2 Types of Policy Funds

As of 2011, SBC has six policy funds as follows: Venture Business Start-up; Commercialization of R&D Results; Promotion of the New Growth Industry; Management Stabilization; Business Conversion; and Small Business Assistance.

3.2.1 Venture Business Start-up

Introduced in 1998, the Venture Business Start-up Program supports the foundation and operations of firms less than seven years (including the soon-to-be start-ups), with a goal to create jobs and aid SMEs and venture companies with excellent technology and business but little capital. In 2010, the Restart Fund (100% direct loan) was introduced to help failed SMEs obtain a fresh start.

3.2.2 Commercialization of R&D Results

Born in 2000, this program supports facility funds and working capital to "Inno-Biz" companies that participated in R&D projects on patented technology, technology registered as the utility model, technology attested by the government, government recognized institutions, as well as government funded R&D projects, so they can successfully make these technologies available commercially. The goal is to prevent any excellent technology from being buried, encourage commercialization and foster technology based small and medium companies.

3.2.3 Promotion of the New Growth Industry

This program supports the foundation and operations of the firms less than seven years with a goal to create new growth engines by financially assisting SMEs with excellent technology and business and growth potential to enhance productivity, add value and gain a competitive edge.

3.2.4 Management Stabilization

The program intends to provide the working capital required for production and sales activities, and can be categorized into two features: emergency and export. The emergency plan provides cost and expenses for product manufacturing, product development, market penetration, purchase of materials, recovery from disaster and management issues, due to temporary difficulties and normalization of management. The export plan covers export agreement (L/C, D/A, D/P, Local L/C, T/T, M/T, certificate of purchase, O/A,P/O from overseas transactions, etc.), export product manufacturing based on export performance and any other required cost for exports. It is provided only as direct loan (revolving).

3.2.5 Business Conversion

With an objective to support the restructuring of SME's with weak competitiveness and facilitate business conversion and trade adjustment, this program provides facility funds and working capital to SMEs whose business conversion plan is approved and those companies that are approved as a trade adjustment supporting company, pursuant to Article 6 of the Act on Trade Adjustment Assistance Following the Free Trade Agreements.

3.2.6 Small Business Assistance

Set up in 1999, this program assists small business (manufacturing: less than 10 regular employees; wholesale/retail/service: less than five employees) starting a new business and help achieve stability in management, to encourage these companies to create new jobs and contribute to balanced development. Particularly from 2011, the SBC introduced the new Nadeul Store fund to enhance the competitiveness and achieve management innovation (e.g., via modern facilities) of retailers, such as supermarkets and others in the food and beverage industry. This fund provides working capital loans of up to KRW 50 million (KRW 100 million for Nadeul Store). The application is submitted to Small Business Development Center, not the SBC. The loan is available as agency loan only, and is provided at designated banks.

Table 2-3 | Policy Fund Financing for 2011

Program	Amount (KRW 100 million)		Requirement
	2010	2011	
• Venture Business Start-up (Restart)	11,800 (200)	14,000 (200)	• Benchmark rate: Public Capital Management Fund (PCMF) loan rate-0.60p • Period: up to 8 years (facility fund) and 5 years (working capital) • Limit: KRW 3 billion p.a. per company
• Commercialization of R&D Results	1,580	2,580	• Benchmark rate: PCMF loan rate-0.60p • Period: up to 8 years (facility fund) and 5 years (working capital) • Limit: KRW 2 billion p.a. per company
• Promotion of the New Growth Industry (Green new growth) (Convergence)	12,600 (10,200) (1,400)	8,620 (7,000) (1,620)	• Benchmark rate: PCMF loan rate-0.10p • Period: up to 8 years (facility fund) and 5 years (working capital) • Limit: KRW 3 billion p.a. per company
• Management Stabilization (General management stabilization) (Temporary relief) (Disaster-affected SMEs) (Export assistance)	2,700 (1,000) (490) (210) (1,000)	2,400 (1,000) (210) (490) (700)	• Benchmark rate: PCMF loan rate +0.10p • Period: (Emergency) up to 5 years (Export) up to 180 days • Limit: (Emergency) KRW 500 million p.a. per company (Export) KRW 1 billion p.a. per company
• Business Conversion	1,475	1,475	• Benchmark rate: PCMF loan rate-0.60p • Period: up to 8 years (facility fund) and 5 years (working capital) • Limit: KRW 3 billion p.a. per company

Program	Amount (KRW 100 million)		Requirement
	2010	2011	
• Small Business Assistance	3,000	4,450	• Benchmark rate: PCMF loan rate-0.13p • Period: up to 5 years • Limit: KRW 50 million p.a. per company (KRW 10 million for Nadeul Store)
• Liquidation	200	-	Termination of business
Total	33,355	33,525	

3.3 Eligibility

Policy funds executed by the SBC have mainly targeted manufacturers to maximize effect with limited resources. This is because manufacturing is considered to have the substantial inter-industry spillover. Thus the SBC designated and supported priority industries from the manufacturing sector in the beginning. The 2010 performance for financing assistance by industry shows that 83.6% of the assistance was given to manufacturers. Assistance for manufacturing is still strong. Recently, the SBC also expanded support to include knowledge services and cultural contents sectors that have high added value to create new jobs.

In the past, the selection process was a negative method-excluding companies that are inconsistent with the policy purpose, companies in the industries pursuing luxury and pleasure, or companies in the high income industries. In 2001, the SBC adopted a positive method, designating and concentrating assistance to nine strategic industries.

However, funds are unavailable to the companies that did not fulfill their tax obligations, have poor credit or have been socially criticized (e.g., for embezzlement). Other companies that are ineligible are blue chip companies with strong health, such as listed companies, as they can utilize the private financing. Those companies that are barely surviving, such as those with more than 50% decrease in revenue for two consecutive years, are also excluded. The SBC recommends restructuring to such companies.

3.4 Requirements (Rate, Period and Limit)

Because theyare designed to support companies or industries that the government needs to assist as part of its policy goals, funds are provided at a more favorable rate, period and requirements compared to other commercially available instruments.

The interest rate system for SBC policy fund financing has gone through many changes. It maintained a single rate by program until 2001, but cancelled it in 2006. Instead, different rates were applied to companies based on their credit rating (evaluation rating) that reveals their credit risk. From 2008, the SBC abandoned the fixed rate system to prevent market distortion arising from imaginary demand and rates. The floating rate system has been maintained ever since, and different rates are applied as well, consistent with policy objectives. As of 2011, the benchmark rate by program is linked quarterly to the Public Capital Management Fund Loan Rate (average yield for a five year treasury bond of the previous quarter), issued by the Ministry of Strategy and Finance.

The lending period, including the grace period, is in principle up to eight years for facility funding, and up to five years for working capital. However, it may be extended up to 10 years if it is necessary for the business, or if it is a facility fund for the Alliance program, which requires long-term support. For short-term export assistance, the loan period is a year. For a credit loan, it is up to five years for facility funds and up to three years for working capital (five years for Restart and Commercialization of R&D Results) to lower risk. It is longer than borrowing terms from private institutions that favor short-term lending.

The limit for facility funds and working capital is up to KRW 3 billion and KRW 500 million per annum, respectively. Based on the loan balance, funding can be up to KRW 5 billion to the same company (KRW 4.5 billion for companies in Seoul and surrounding metropolitan areas). However, facility funds for innovative companies may be exempt from such limits. The exceptions still cannot exceed KRW 7 billion to prevent any favoritism, and provide more benefits to SMEs that are receiving policy funds for the first time.

3.5 Process and Method

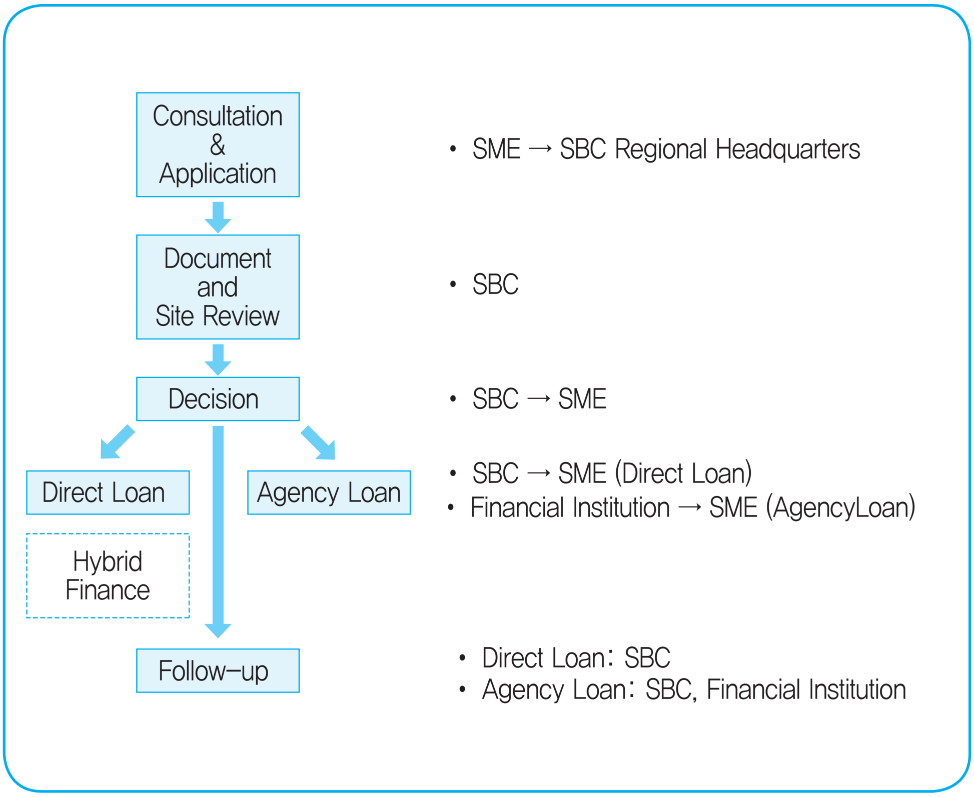
The application for, and the evaluation of, policy fund financing are handled by 24 SBC regional headquarters across Korea. Companies can confirm whether they are eligible and meet the requirements with a self-test system at the SBC website, or through consulting. They can then submit the required documentation to the regional headquarters. Applications are received monthly to prevent early depletion of funds, and to promote equal opportunities throughout the year.

After receiving an application, the SBC examines the application and relevant documents, and conducts a feasibility test through due diligence in order to determine the applicant's loan eligibility. As many are focusing on ex ante risk management for policy funds, the decision process has been reinforced. There are preview by corporate evaluators who assess the amount and type of collateral. Before the fund is approved, it also has to be reviewed by the Loan Review Committee.

For a direct loan, it goes through the above-mentioned process, followed by collateral (for secured loan), conclusion of agreement and verification (for facility funds). Those that apply for agency loans via financial institutions are to satisfy the procedures required by such institutions.

After the loan is executed, it is reviewed whether the loan has been used as planned. For a direct loan, there are various follow-up measures as part of risk management, until the loan is fully repaid.

Figure 2-2 | Policy Fund Financing Procedure



3.6 Introduction of Hybrid Finance

Along with the growing awareness that SMEs make up the foundation of Korea's economy, the government has suggested and implemented a series of policies. However, capital shortage is still a major challenge to SMEs. In particular, promising start-ups often find themselves at the brink of bankruptcy, when they are unable to borrow from financial institutions. Even those funded by private institutions often ended up with deteriorated financial conditions, due to interest payments and an increased debt-to-equity ratio.

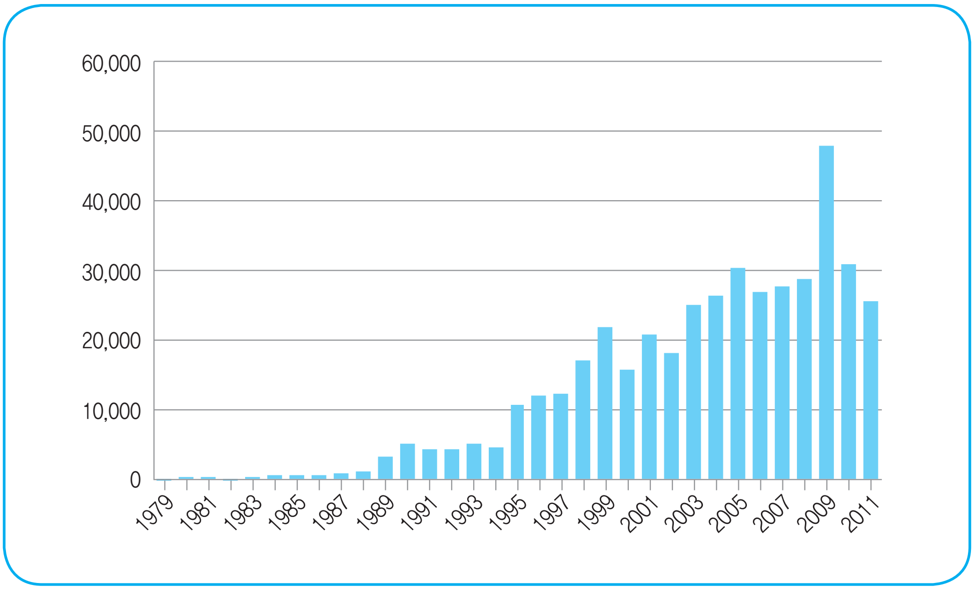
When SMEs relied on indirect financing (loans), the SBC decided to improve the policy fund system to better meet the needs of SMEs by introducing a hybrid financing system in 2008.It was to satisfy the diverse financing needs of SMEs via mezzanine support given to the new growth industries and potentially innovative companies. Moreover, the benefits of growth are shared to reinforce financial health and create a continuing cycle of assistance to SMEs.

The limit of assistance is up to KRW 3 billion for facility funds and KRW 1 billion for working capital. The nominal rate is 1% (4% to maturity), and the period is up to seven years for Venture Business Start-up and five years for other programs. The candidates are initially screened by the regional headquarters and go through a site review by the relevant department (Investment Department) at headquarters, corporate valuation by certified public accountants and coordination on conversion requirements. Then the Review Committee finally selects the recipients. After the SBC acquires convertible bonds, it determines the potential of sharing benefits from growth within seven years of assistance and determines whether to exercise the conversion rights. If not converted into stocks, convertible bonds issued by the SMEs are repaid in installments at a 4% maturity rate.

In 2011, the SBC adopted a new assistance program by which benefits can be shared. This reduces the burden of a fixed interest rate, and collects income-linked interest payments based on the performance of SMEs after the loan, helping those that are not likely to go to IPO to resolve difficulties with finance in the early period of their business. It is only available for companies that are eligible for the Venture Business Start-up Program, or the companies that are less than seven years old and are eligible for the Commercialization of R&D Results Program. The limits on assistance are up to KRW 3 billion for facility funds and KRW 500 million for working capital. The period is up to five years. The interest rate is minus 2% from the general policy fund rates of the company, and an additional 3% of operating income after balance. For those with high operating income, the maximum limit of interest is up to 40% of the principal.

Figure 2-3 | Trend of Policy Fund Execution: 1979 to November 2011

(Unit: KRW 100 million)



4. Implementation of Direct Loans

4.1 Birth of Direct Loans

Since the 1970s, the rapid growth of the Korean economy has also raised SME demand for funds. However, SMEs were small, with relatively poor accounting transparency, low debt servicing rates and high potential for bankruptcy, making it very difficult for them to obtain financing from the private sector. Such challenging access to financing was the greatest problem for SMEs. Against this background, it was agreed that the SBC needs to execute direct loans on top of policy fund financing.

By the early1990s, the SBC's policy funds had been executed only through agency loans from designated banks. The banks often refused to give loans to SMEs with good feasibility test results, citing that they failed to provide sufficient collateral. Consequently, the effective borrowing rates of SBC-approved loans exceeded 30%. According to the survey on 1,725 companies that had policy fund financing, the nominal rate they paid was 9%, but the real rate was around 17%, due to the banks' compensatory balance, commission, collateral expense, issuance of written guarantee, etc.

To tackle these problems, the government revised the Small and Medium Enterprises Promotion Act and provided the legal grounds necessary for the SBC to offer direct loans of policy funds in December 1992. This was in order to simplify loan procedures and provide timely support. In the following year, the basic standard, procedure and follow-ups to prevent vulnerabilities were developed. On May 1, an electronic system, regulations on loans, and follow-up system and requirements regarding collateral were developed. Some KRW 9,474 million was granted to 65 companies via direct loans.

However, there were concerns in relevant government agencies and the SBC about loss, lack of experience in bond management, etc. At the time of implementing the direct loan system, the SBC had 600 employees and only one regional office in each province. It was questioned whether the SBC could implement this system with limited human resources and organization. However, the SBC began to argue for the necessity of direct loans, based on the opinions of SMEs and its experiences with policy fund reviews. The media also encouraged the notion that SMEs needed direct loans to be competitive. The SBC prolonged discussions with the Ministry of Finance, particularly to emphasize the problems of agency loans, as well as the benefits of direct loans. When the Small and Medium Enterprises Promotion Act was revised in 1992, the legal grounds for direct loans were finally created.

Until it began to expand in 1997, a direct loan was limited to the businesses, like alliance projects, start-ups and R&D programs that found it difficult to obtain loans in the private sector due to the nature of their businesses. At that time, most policy funds were provided through agency loans, serving only supplementary roles

[Reference] From the Interview with Cho Bok-Gi,
the Former Senior Vice President of SBC

■ Background of the Introduction of Direct Loan in 1993

- Direct loan was introduced to facilitate financing and reduce burden of cost for SMEs that use our policy funds.

- There was a survey on some 1,700 companies that were assisted with SBC policy funds. The outcome was shocking. On top of the nominal rate, there were other costs, such as compensatory balance, loan commission, collateral and fees. As a result, the companies had to pay the nominal rate of 7% and 4.3% of other additional financial costs.

* Survey on the Use of Policy Funds (Report on the Restructuring and Agricultural and Industrial Policy Fund Loan, 1992)

- Moreover, SMEs have to have the recommendation of SBC, written guarantee of the credit guarantee agency (most banks required this letter along with collateral at the time) and bank loan. They have to go through 3 institutions. The procedure is complicated and there is so much paperwork. In the meantime, there were companies that could invest in their facilities because they could not obtain finance in a timely manner.

- It was reported to the Ministry of Finance, Bank of Korea, Ministry of Industrial Assistance and the National Assembly for discussion. That is how SBC came to implement the direct loan system.

4.2 Launch of Direct Loans

Amidst the Asian financial crisis, the issue of equity debt ratios for the Bank for International Settlements (BIS)and restructuring surfaced. As a result, many banks avoided SMEs. Even those in the black became bankrupt during this time. Credit crunch concerns emerged as a serious issue. On June 17, 1998, the Minister for Economy and Finance proposed the direct loan system for the SME start-up and promotion fund in his report to the President of Korea. On July 15, it was finalized at the 8thEconomic Forum to have the SBC to implement the direct loan system for the Structural Improvement Fund.

In line with the government’s policy, the SBC continued its efforts on the issue, by holding the enterprise-wide seminars in June 1998. On August 25, the Direct Loan Task Force Team was created and prepared thoroughly for the system by modifying the previous system, training employees, etc. for a period of three weeks. In September 1998, an additional KRW 530 billion was set up (SBC Bond worth KRW 130 billion and long-term bonds worth KRW 400 billion) for direct loans, per the Structural Improvement fund.

4.3 Expansion of Direct Loans

SBC's direct loans were a big relief to SMEs under the strain of a credit crunch. SMEs that were used to secured loans from financial institutions welcomed the SBC's credit loans without collateral. According to a poll by Gallup Korea on 600 companies on January 18, 1999, 89.3% of the policy fund users (76.7% of those that failed to receive the policy fund) hoped that SBC's direct loans would be maintained.

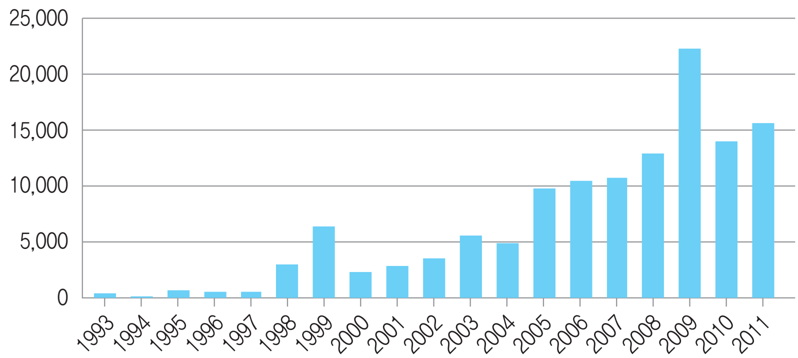
At the discussion on SME financial policy on November 7, 1998, the ruling party at the time and the Financial Policy Department at the Ministry of Economy and Finance also recognized the necessity to expand direct loans. Participants came to the same conclusion at the SME financing efficiency discussion on December 2. The government, SME CEOs and experts from the relevant institutions also argued for the expansion of SBC's direct loans, which eliminated complicated procedures and enhanced credit financing for SMEs. In response, direct loans were expanded to cover the SME Venture Start-up Fund, other than Structural Improvement and Management Stabilization Fund in 1999. By 2000, it covered Commercialization of R&D Results and Export Finance Assistance funds as well.

Government agencies, however, had different opinions about SBC's direct loans. The Industrial Policy Department welcomed the program but the Finance Department was opposed, due to the latter'sconcerns for fund losses. On July 7, 2004, the Korean government announced the Comprehensive Measures for Competitiveness of Small and Medium Business, and one of its main features was that the direct loan system should be expanded for policy funds, which the private sector does not offer, focusing on the start-up, long-term facility, Alliance or Commercialization of R&D Results funds. Thus the SBC began to expand the system even more from 2004 and reorganized the system once again. On June 23, 2005, the government established the second June 23 measures, designed to restructure the SME policy fund system. It became clear that the direct loan system was focused on start-ups and innovative companies. From 2005, KRW 1 trillion-45% of the policy funds under the supervision of the Small&Medium Business Administration and executed by the SBC-was allocated for direct loans.

As such, the direct loan system has undergone three phases for improvement. From 1993 to 2010, the system provided KRW 11.2293 trillion to some 40,600 companies that had been struggling with financing because they could not access the private sector.

Figure 2-4 | Trend of Direct Loans of Policy Fund Execution: 1993 to November 2011

(Unit: KRW 100 million)



4.4 Changes in the Direct Loan System

With the introduction of direct loans for the Structural Improvement Program in 1998, the SBC began to revamp its regulations. In September 2003, the SBC took action to adapt to the financial environment that had changed since the Asian financial crisis. It benchmarked advanced systems of the financial industry and integrated regulations and guidelines that varied by scope of work into two, while aligning the content with workflow for better efficiency.

One of the greatest achievements of introducing direct loans was that the SBC expanded the scope of credit loans without collateral. When the system was expanded in 1998, credit loans were also introduced. At the time, it was limited to working capital, available up to KRW 300 million per company for the period of one year. It was extended to KRW 500 million for three years in 1999, and credit loans became available for facility funds in 2000. In the next year, the limit was increased to KRW 1 billion and the facility fund was excluded to encourage facility investment by companies.

If companies were prevented from repaying the principal as scheduled due to temporary issues with management, they were allowed to postpone three times during a period of up to 18 months. Any mismanaged companies that were likely to be normalized could extend the period of assistance and adjust interest rates as part of a concentrated recovery program. These companies that postponed repayment and that were in the recovery program were assisted to normalize their operations via a comprehensive diagnosis.

Furthermore, the joint guarantee system was enhanced to minimize the strain on SMEs. While this system prevented failed businesses to start again, it also had its benefit of inhibiting the moral hazards of management and helping them focus on business. However, it created innocent victims and needed to be improved. In 1998, it was required that a guarantor with a certain amount of assets, determined based on the assistance amount, had to guarantee the credit loan, along with management. After the change, only the management and owner of the business became a guarantor (for corporations). For private companies, only a spouse or relative who was involved in the management became a guarantor. In September 2009, excellent technology companies whose ratings were Class B (Level 3 out of the 13 ratings) or above became exempted from the requirement of providing joint surety.

With the rise of direct loans, the SBC also changed its loan management organization. Before 1998, the Fund Management office managed direct loans. In September 1998, however, the Loan Management team under Fund Assistance Department (in charge of Structural Improvement) assumed this role. In January 2001, the Loan Management team became an independent department because of efforts to expand loan balances, follow up and enhance the expertise of loan management. The role of collection after borrower default had been performed by the regional headquarters, but it was given to the central headquarters to enhance expertise. The regional headquarters focused more on customer-related responsibilities.

As support for start-ups drew more attention from 2010, more budgets were allocated to them. The expansion of direct loans and credits to start-ups brought the importance of risk management to the forefront. With a great emphasis on proactive risk management, the Risk Management Department took on the corporate valuation business in late 2010.

The risk management system was also improved, and any policy fund financing plan had to go through the Risk Management Committee. Above all, the institutional improvements were made to reinforce proactive risk management and reaching decisions reasonably. Due to its nature, financing is highly likely to lead to corruption and irregularities, and subsequently threaten the very existence of the institution. Therefore, it is essential that evaluators are highly committed to integrity and the system ensures fairness and objectivity.

Because the authority to approve loans was concentrated on the head of the regional headquarters, it was necessary to adopt a balanced decision-making process. The review authority given to the investigator and the heads of the regional headquarters were improved for a better loan approval procedure. Before any approval, the loan was reviewed by the sub-committee, which was formed by the regional headquarters. The loans were then categorized as credit or secured loans, to check the loan approval's transparency. As part of its risk management measures, the HQ Loan Evaluation system was adopted in 2006. This system requires a pre-review process for loans that are more than a certain amount (The amount differs by collateral).

[Reference] Review by Headquarters

- Progress
  - Introduced the review system by the Headquarters (Dec 18, 2006)
  - Reduced the number of the Headquarters reviews (Jan 2009-): to provide more rapid access to assistance during the global financial crisis
  - Normalized the Headquarters reviews (Aug 2009-)
- Loans to be Reviewed
  - (Proactive Review) Direct credit loan more than KRW 500 million (KRW 300 million for the ratings below F4-) and accumulated balance more than KRW 1 billion
  - (Post-review) Companies involved in an accident/incident within a short-term (within 6 months) or the companies that obtained a loan more than a designated amount (credit: KRW 500 million; balance: KRW 2 billion) are in an accident/incident
- Types of Advice
  - Exclusion from assistance, adjustment of amount and credit rating, stronger follow-up measures, etc.
  - * If the head of the Regional Headquarters determine that the companies need assistance but could not follow the advice, the Loan Review Committee at the Headquarters will make a decision.
- Performance (as of late 2010)
  - Review (616 cases): original draft passed (405 cases), major advice such as exclusion from assistance (72 cases), minor advice (139 cases)

The Loan Review Committee at the Headquarters also handles the review of companies that fell short of meeting the eligibility requirements, or companies with their balance limit exceeding for the same person. With similar function, the Loan Review Committee at the regional headquarters was launched in 1993, but was abolished in order to provide more rapid access to assistance and lack of efficiency, amidst the financial crisis in 2008.

Instead, the Loan Review Committee became responsible for more reviews, by which it reinforced before approval. For a faster service, the meeting is held regularly (monthly→weekly).

Companies that failed to satisfy the requirements of the corporate evaluation can apply for another review. The objection (second review) filed by such companies is processed and disclosed on the website, and all companies that failed can apply for a second review. There is the Second Review Committee, comprised of up to nine members-certified public accountants and personnel from the regional Small and Medium Business Administration offices, or SBC-related regional headquarters. The companies are reviewed by the Second

Review Committee, based on a second site review by the Technology Business Evaluation Center at central headquarters in a systematic manner.

4.5 Customer Satisfaction and Transparency

The SBC works toward customer satisfaction by improving transparency and quality of the assistance provided for each process.

Above all, experts in each industry participate in the screening and evaluation process to enhance credibility, and customers may handle the process from screening and evaluation to loan management through a single channel that enhances transparency. Companies can use the self-diagnosis service on the SBC website to find out about eligibility and the types of programs they can qualify for. There is also the Fund Consulting Management System, which records and keeps track of consultation sessions (including reasons for declining applications) on policy funds for responsible consultations. SMEs can use the Home Tax service of the National Tax Service to simplify paperwork (five types) required by the applicants. The SBC also distributes ethics campaign cards to promote anti-corruption and integrity, and operates an illegal brokerage reporting program to prevent illegal transactions and brokers in the application process for funds. Also available is a processing alert system that sends text messages about the process (Received → Evaluating → Evaluation Completed → Result). Customers can check the process information on the SBC website. The Policy Fund Evaluation Index (key performance indicators such as technology, business feasibility and management capability)is disclosed for SMEs that want to check the latest direction of funds and evaluation details. By programs, the loan processing has been reduced from 30 to 20 days to provide more rapid access.

[Reference] Text Message on Fund Assistance Processing

- Received
  - Your application is received.
- Evaluation
  - The evaluation on your company is underway.
- Decision
  - Congratulations. Your application has been approved. Please talk to your loan manager.
- Loan Transfer
  - The fund has been transferred. Please check your account.

For companies that are not approved, a letter of decline is sent, which is revised to include the information indicating the reason for the decline, along with advice, procedures about a second review, etc. The loans are provided at the location (place of business) that customers want for their convenience.

5. Management of Corporate Evaluation System

While eligibility and requirements are crucial in policy fund financing, it is no less important to have an evaluation system that helps ensure the selection of outstanding companies with excellent technology, business and growth potential. SMEs may not have sufficient collateral but a good financial statement, making it difficult for them to obtain financing from the private sector. However, companies can benefit from policy funds and become a future growth engine via a system providing a non-financial evaluation. After the introduction of the financing system, the SBC has taken into account the reality that most SMEs face. The SBC continues to transform and advance the corporate evaluation system since direct loans were adopted in 1998. The SBC established the Business Evaluation on Technology System for SMEs.

5.1 Improvement of Corporate Evaluation System

When the financing system was first adopted, candidates were selected based on the business feasibility evaluation, in accordance with the separate selection criteria (Company Score) by program. However, such a scoring system is only based on scores by program, which are not very useful in learning about the credit risk (categorized by credit rating) of the companies. There was also a problem of conducting an efficient follow-up through this procedure. From January 2004, a new rating system was adopted. It analyzes and evaluates both financial and non-financial elements that affect the credit of the companies and rates them by taking comprehensive credit and risks into account. The system enabled the SBC to improve assistance based on credit and conduct an efficient follow-up. The technology evaluation scoring was established for SMEs to supplement the technology side of their evaluations. In the meantime, both technology and marketability (business) were considered, and the technology of the companies was rated into five levels: T1, T2, T3, T4 and T5. Thanks to the system, companies were rated not only by credit but also by a unique standard reflecting their technology level.

Since the introduction of the corporate credit ratings system, the SBC has embraced changes in its business environment, applied advanced techniques and continuously upgraded the ratings model every year to improve the appropriateness of their evaluations. In 2007, the SBC further specified the ratings model from 10 classes to 13, in accordance with corporate size, industry and other factors. In 2009, the model was comprehensively upgraded with its focus on technology and business feasibility, taking into consideration the direction of government's SME funding policy and external voices. In 2010, the model was largely restructured into a more effective, technology/business oriented policy fund evaluation system with powerful feasibility evaluations. The preliminary financial oriented evaluation, based on a proactive filtering model, was replaced by a corporate rating with greater emphasis on technology and business, from the perspective of a credit rating. The evaluation is based on the Business Evaluation on Technology System and the financial rating is only used to adjust the rating. In addition, the Policy Consistency Index was created. It looks at policy consistency with programs, effects of policy funds and other elements to incorporate them into their decision. On the other hand, a new model was developed for cultural contents and bioscience industries, with clear objectives for assistance to reflect their inherent nature.

Table 2-4 | Changes in Corporate Evaluation Model

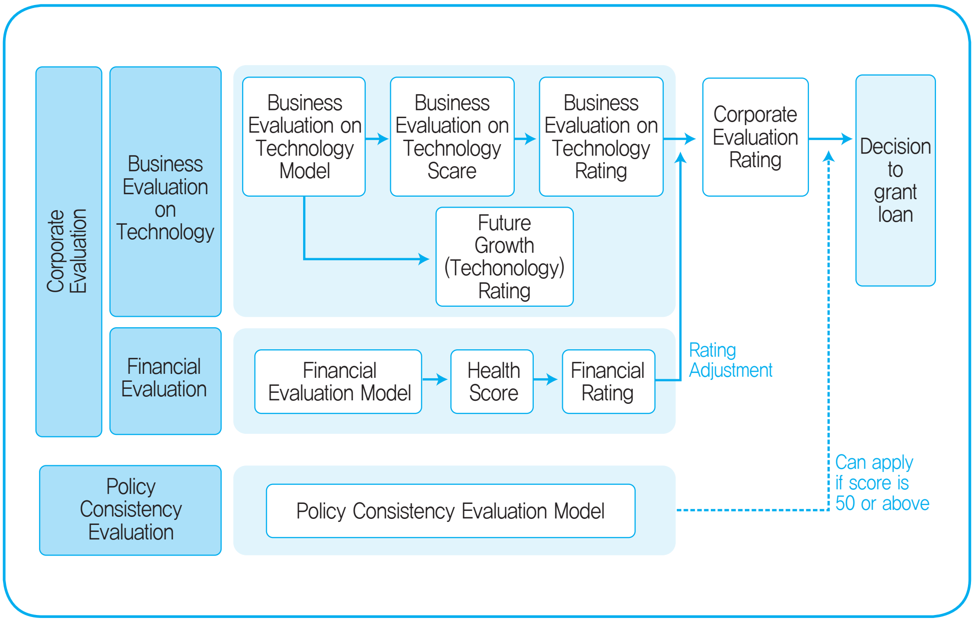
Period	Model	Description
- '03	Scoring	■ Scored based on score chart by program (100/100) * Can apply if the total score by index and by category is 60 or above
'04-'06	Credit rating	■ Developed the corporate credit rating model that comprehensively evaluates credit risk of companies ('04) · (Class) 10, (Evaluation model) 30 * Divided by industry (manufacturing, wholesale, retail, information processing, service, construction), by history (preliminary start-up, less than 3 years, more than 3 years), by asset size (external audit, general), by technology type (general, tall processing, technology development, introduction of technology) ☞ Developed a ratings model by benchmarking advanced techniques such as Moody's ■ Developed and managing various systems that support corporate evaluation * Industrial Analysis System ('05), Monitoring System ('05), Future Credit Prediction System ('06), Peer Group Analysis System ('06)
'07-'09	Subdivided Model	■ Subdivided evaluation models to improve accuracy ('07, '09) · Subdivided class: 10 → 13 · Subdivided model: 30 → 38 * Manufacturing → added the light/heavy industry and small asset (less than KRW 1 billion) Service industry → knowledge service/other services ■ Stronger evaluation supporting system · Developed and managing Financial Account Screening System ('08), Financial Analysis System ('09)
'10-today	Corporate Evaluation Rating	■ Adopted Corporate Evaluation Rating (focusing on competitiveness in technology and business) · Basic rating: technology and business rating · Rating adjusted by: financing rating * Developed the evaluation model for the cultural contents and bioscience industries

5.2 Corporate Evaluation Rating and Loan Grant

Companies that applied for loans are assessed by two management and technology evaluators. They conduct the business feasibility test based on their field investigation to determine the corporate evaluation rating. The evaluation consists of market potential, technology level, management skills and financial forecast (business evaluation on technology), in addition to a quantitative evaluation based on financial statements(financial evaluation), the result of which can change the corporate rating. While the financial rating is automatically computed by the system that processes input data, the technology rating is manually calculated by evaluators based on evaluation criteria.

The latter has become key to corporate evaluation rating since 2010, with the former being used for ratings adjustments.

Figure 2-5 | Corporate Evaluation Rating Process (as of 2011)



The corporate evaluation rating determines the loan grant; companies that are above a certain rating (different by program) are eligible for loans. However, the companies whose policy consistency evaluation rating is less than a certain point (50) are excluded. The evaluators consider appropriateness of the plan, repayment ability, previous loan amount, etc. and reasonably adjust the loan amount. The notification of the decision (both approvals and declines) is given within a designated time (different by program) from the initial application date.

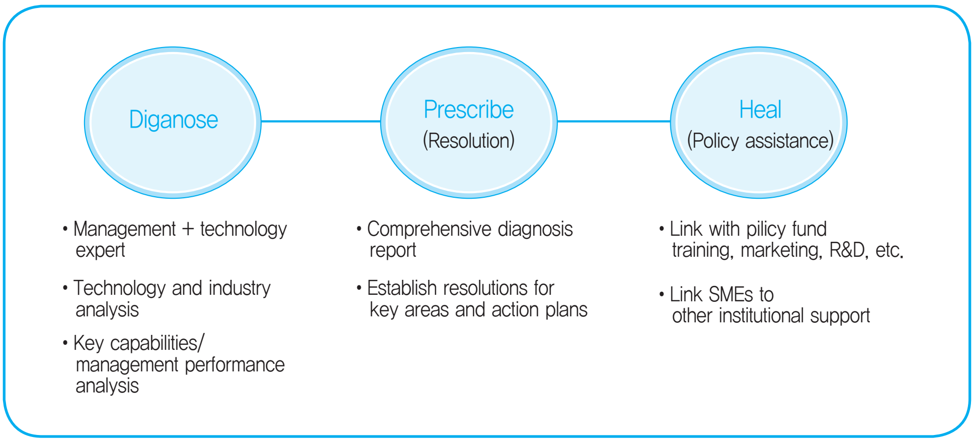
6. Corporate Health Diagnosis and Customized Assistance

One of the SBC's most unique programs compared to those by other institutions is the assistance system, based on a corporate health diagnosis. The diagnosis goes beyond simple fund reviews or loan assistance. The diagnosis goes further to prescribe a solution for issues regarding management or technology, followed by recommendations of various policies to help resolve various issues, such as training, R&D, marketing, information, etc. By doing so, the diagnosis seeks to enhance the global competitiveness of companies.

The seamless flow of the process is facilitated by diagnosis experts. Finding the right policies to enhance, and make up for the strengths and weaknesses of the companies, will eventually contribute to the prevention of risks. The SBC has internally improved its training programs by stage to enhance the diagnosis expertise of its employees, with e-learning programs also available.

In 2011, the SBC integrated and renewed its corporate diagnosis and evaluation systems, and improved the recommendation system in order to provide a more efficient system. The diagnosis and corporate evaluation systems are integrated into one, so that the corporate evaluation rating can be calculated from all types of diagnosis models. The SBC also built a system for performance management of the recommendation system, while enabling advanced searches for such a system and providing lists in an effort to boost the recommendation system.

Figure 2-6 | Procedure of Corporate Health Diagnosis



7. Fund Integrity and Risk Management

The credit risk of SBC's direct loan is borne by the SBC itself. It is, therefore, necessary to adopt a systematic risk management to prevent the loss of funds and financial burden, if the economy should become aggravated, or if borrowers are mismanaged. In particular, the SBC's direct loans have a specific purpose, which is help start-ups, companies that invest in facilities for the long-term, companies that commercialize their R&D results, companies that seeking business conversion and companies that suffered losses from disasters. Moreover, the SBC also expanded credit loans for those in industries that make up for market failures. Against this background, the SBC structurally bears high loan risks.

Since it set out to boost direct loans in 1998, the SBC became aware of the significance of credit risk management and began to take far-reaching efforts across its organization-improving relevant policies, work processes, corporate evaluation systems, human resources and information systems. Thanks to such actions, the SBC continued to maintain a non-financial evaluation system while the business failure rate hit its peak in 2004 and spiraled downwards. By the end of 2010, however, it had risen somewhat due to the eased requirements and increased credit loans-measures taken to overcome the global financial crisis in 2009.

Let us look at the major risk management efforts by each area. First is the advancement of the corporate evaluation system, and expertise of its evaluators and reviewers. The SBC maintains the business evaluation on technology system, not a credit ratings system, while constantly improving the corporate evaluation system to minimize risks by developing the Industrial Analysis System, Credit Rating Monitoring System, Future Credit Prediction System, Financial Account Screening System and more.

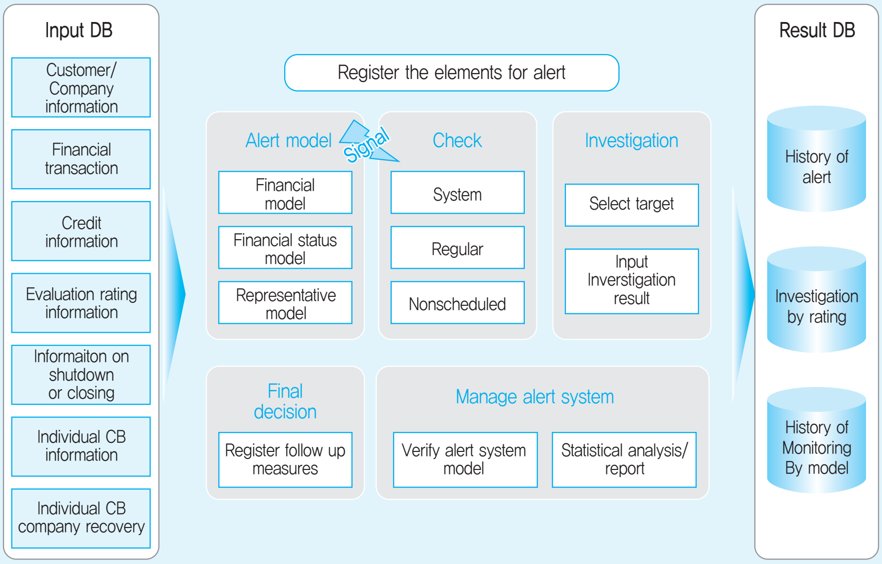
The SBC also continues to enhance the expertise of its employees. All relevant employees are required to complete training programs to provide more professional policy fund financing and consulting services. Since 2004, professionals such as accountants, lawyers and doctorate degree holders have been hired to collaborate with people with field experience.

Second is the improvement of the review process and institutional measures to prevent risks. In fact, the best method of risk management is to prevent it in advance, because not doing so can double the effect the cost amount. To do this, the review process is divided into three (summary, standard, in-depth) by the severity of risk, with consideration for loan method, amount, collateral, etc.

Third is a stronger follow-up system to prevent mismanagement by borrowers. To scientifically and systematically identify the signs of mismanagement, developed in 2006 was an alert model that utilizes information on finance, outstanding payments, size of borrowings, representative CB, and more. Based on this model, the alert system was developed in 2008 to monitor changes in the credit of companies. Since 2006, the SBC encourages companies to use their designated accounts to prevent unusual appropriation of policy funds. Companies that have borrowed more than a certain amount have been required to submit a history of spending the policy funds. For the inevitable bad debt despite such preventive measures, the Credit Management department at the central headquarters works with internal lawyers and expert follow-up teams to recover loans.

[Reference] Alert System

- Background: Identify the signs of mismanagement in companies as soon as possible by monitoring credit changes to respond and manage the situation systematically



- Collect and use internal/external credit information in the companies to check the changes in credit; identify the health and status of loans based on follow-ups and normalization support upon finding the signs of mismanagement, or monitoring analysis
- The rating is categorized as normal, preliminary alert and alert. Preliminary alert and alert are investigated within 20 days.

Fourth is field-oriented organizations and responsible management. The SBC streamlined its headquarters organization and expanded regional headquarters. As a result, the number of local employees has increased from 231 in 2003 to 392 in 2010, strengthening the policy reinforcement necessary. The regional headquarters, which covers more than two local communities, and those experiencing inefficiency due to too many employees were divided, with 11 offices created. The regional headquarters are then divided into four and supervised by four vice presidents to achieve responsible management.

Fifth is the improvement of efficiency for direct loans and the establishment of the information system for risk management. With the expansion of direct loans, the information system for policy fund direct loans added the Industrial Analysis System, Credit Rating Monitoring System, Future Credit Prediction System and Financial Account Screening System in 2004, in order to support policy fund processing tasks. In 2005, the information system was re-built based on the BPM (Business Process Management) solution to enhance productivity.

An integrated electronic guarantee system was established so that the SBC and credit guarantee institutions can provide seamless assistance, and a default and overdue loan management system was also developed to systematically manage risks. To this end, a comprehensive risk management system has been operated to integrate the entire process, from the default and overdue system that provide necessary information for the eligibility screening process and post-management, to a debt collection system that manages bad debt write-offs and losses occurred by overdue payments.

Sixth is policy fund stabilization assistance and allowance for bad debt. Because the applicants for direct loans are not blue chip companies, there need to be measures taken to respond to inevitable circumstances, despite the SBC's internal efforts to manage risks. In this current structure, funds can be financed by issuing SBC bonds up to 20 times the net asset of the funds. Mismanagement can lead to a rising cost of procuring finance, also making it impossible to issue new bonds. In 2006, the SBC began to convince the government and the National Assembly that government aid is needed-1% of the direct loan balance, the allowance for bad debt limit according to the income tax law. As a result, the SBC was able to incorporate a loss share budget of KRW 3 billion for the first time in 2007, which rose to KRW 30 billion in 2011. Furthermore, the SBC is taking preventive measures to prepare for future failures from credit risks of direct loans. It categorizes asset quality in accordance with the Forward Looking Criteria every quarter, and sets up an allowance for bad debt each year.

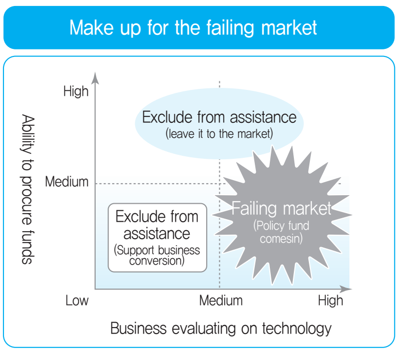
Chapter 3

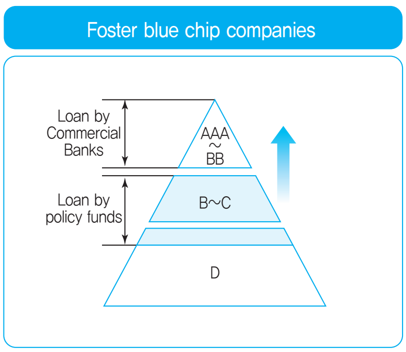
Role and Performance of Policy Fund Financing System

Role and Performance of Policy Fund Financing System

1. Role

Private financial institutions have increased their supply of funds to SMEs, and many advanced financial instruments have been developed so far. The SBC felt it essential for SME policy funds to be distinctively unique from products available in the private sector, while concurrently ensuring that the private sector is not interrupted or distorted by policy funds. The SBC continues to work on improvements to policy funds so they are mutually beneficial with the private sector. The key has been leaving areas normally operated by the market, and using funds to support SMEs with growth potential in failing areas, with the goal of helping them become a blue chip company.





Policy funds have thus grown in areas where the market has failed, and supported venture start-ups and SMEs outside Seoul and other metropolitan areas. Support for the start-ups less than five years old grew from 34.2% in 2006 to 39.2% in 2010. In2012, there will be more assistance: new funds for young entrepreneurs (aged 39 or under) will be set up and start-ups younger than five years (adjusted from the previous seven years) will be eligible for start-up assistance funds.

The percentage of assistance for small businesses with less than 50 employees is constantly rising, from 73.6% in 2006 to 79.2% in 2010. The same can be said for financially struggling SMEs. In 2010, some 65% of the total budget for policy funds was used for SMEs outside Seoul and the surrounding metropolitan areas, and the percentage is expected to be maintained at this level.

Another main role of policy funds is to provide more support for long-term facility investment and expand credit loans for SMEs with weak credit and collateral, as well as to encourage the private sector, which continues to be focused on secured loans. In 2010, 65.5% of policy funds were allocated to long-term facility investments, and 58.1% of SBC's direct loans were granted purely by credit without any collateral.

Korea has faced challenging times twice: the Asian financial crisis in 1997 and the global financial crisis in 2008. During each crisis, policy funds replaced the ineffective private financial sector to urgently improve liquidity, and mitigate the credit crunch for SMEs.

In 2008, the liquidity crisis worsened as the private sector stopped supplying funds; in fact, it took loans back from SMEs. Then, the SBC set up a revised supplementary budget and increased policy funds substantially, while easing requirements to provide quick access to much needed liquidity. This significantly helped SMEs to escape the credit crunch, and policy funds successfully fulfilled its role as the social safety net during an economic crisis.

Table 3-1 | Percentage of Assistance to SMEs in the Market Failed Areas

(Unit: %)

Category	2006	2007	2008	2009	2010
Venture start-up	34.2	34.7	36.6	32.3	39.2
Small business	73.6	74.4	74.2	78.8	79.2
SMEs outside Seoul area	60.1	60.0	60.0	64.1	64.5
Long-term facility investment	63.5	63.6	58.4	40.4	66.5
Credit loan from direct loan	52.6	46.2	56.2	77.5	58.0

2. Performance

The performance of policy funds can be categorized as macro- and micro-performance. The former is based on the Input/Output Analysis, Structural Vector Auto-Regression Analysis, Benefit-Cost Ratio Analysis, etc., by utilizing the aggregated data of policy funds. The latter analyzes the financial performance of SMEs that applied for policy funds from 2000 to 2009 (approximately 75,000 cases), by using their financial data. The analysis uses the difference-indifference estimation to find out about the financial performance of companies that received policy funds, compared those that did not, as well as the survival rate.

Analyses found that SBC's policy funds have made both macro and micro contributions to the Korean economy. Funds are required to further fill loopholes in market failure situations, improve corporate financial soundness, and support innovative and promising technology-based SMEs in strategic industries, so that they can ultimately increase the technology and knowledge assets of SMEs. Funds also should put their priority on the national agendas (like creating jobs, nurturing new industries, and boosting export)and economic stabilization in times of crises.

2.1 Contribution to the Growth of National Economy

The Input/Output Analysis indicates that the effects of induced production among others grew in proportion to the size of the loan. When the size of loan expanded considerably in 2009, the effects of induced production also grew substantially. The effects of induced production per unit of loan from 2000 to 2009 were double the amount of loans, and grew continually.

Table 3-2 | Effects of Induced Production per Unit of Loan

(Unit: KRW billion)

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
2.03	2.03	2.04	2.04	2.03	2.16	2.21	2.25	2.25	2.25

In 2009, policy fund financing led to the added value (nominal) of KRW 3,233.3 billion. The real added value (as of 2009) was KRW 3,128.9 billion, accounting for 0.3% of the GDP (KRW 980.4 trillion). The percentage of nominal added value in 2008 induced by policy fund financing against the added value (KRW 165.473 trillion) of small and medium manufacturers (companies with less than 500 employees, in accordance with the Survey on Mining and Manufacturing by Statistics Korea in 2008) was 1.1%. The effects of induced added value per unit of loan roses steadily but has recently declined. Due to this is the industry-wide fall on added value, not attributable to the SBC's financing policy.

Table 3-3 | Induced Effects of Added Value and Average Added Value per Unit of Loan

Category	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Induced effect per unit of loan	0.74	0.75	0.76	0.77	0.77	0.75	0.75	0.74	0.70	0.70
Added value (Industry wide, %)	43.0	43.0	43.0	44.0	44.0	41.2	40.6	40.1	36.8	36.8

The effects of induced labor (hiring and new jobs)were calculated by applying the labor coefficient (coefficients for hiring and new jobs), which is the labor input against production, to induced production by sector. As a result, the number of hired people induced by policy fund financing was 49,333, and those who found new jobs were 60,203; some 0.3% of the total paid workers (16,454,000) and employees (23,506,000) were hired or found new jobs due to financing provided to SMEs.

Table 3-4 | Effects of Induced Labor per Unit of Loan

(Unit: number of people/KRW billion)

Category	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Hiring	14.5	14.7	15.0	13.5	13.5	12.1	11.9	11.5	10.6	10.6
New Job	19.5	19.6	19.6	16.9	17.0	14.9	14.7	14.2	13.0	13.0

2.2 Economy Control

The Structural Vector Auto-Regression analysis shows that the increase of loan balances affect GDP increases, and that the effects are short-term, not long-term, being at their highest after three quarters following the loan balance increase. It indicates that the increase in the policy fund financing brings the rate of GDP up temporarily, and the GDP itself in the long term, the effect of which is usually revealed in the short-term-meaning that SBC loans control (stabilize) the economic cycle in the short-term. It is thus reasonable to come to a conclusion that in order to control the economy more effectively in the short-term, the SBC needs to monitor the general macro-economy constantly and expand its financing policies when there is a concern for an economic downturn.

2.3 Efficient Fund Management

The Benefit-Cost Ratio analysis on the effectiveness of the fund by business and company history shows that the benefit-cost ratio to the policy fund financing was 17.79 times in 2007, 20.43 times in 2008 and 16.49 times in 2009.

Table 3-5 | Benefit-Cost Ratio and Rate of Return on Policy Fund

Category	2007	2008	2009
Policy performance (B)	3,136.1 bn	3,629.7 bn	4,678.6 bn
Direct loan	837.7 bn	1,044.8 bn	1,784.7 bn
Agency loan	2,183.3 bn	2,512.7 bn	2,015.7 bn

Category			2007	2008	2009
	Rate of return on operating asset investment		33.89%	36.75%	37.12%
		Direct loan	36.28%	36.92%	42.77%
		Agency loan	31.43%	35.66%	23.91%
	Loan balance (D)		9,254.9 bn	9,876.7 bn	12,602.3 bn
		Direct loan	2,309.2 bn	2,829.6 bn	4,172.3 bn
		Agency loan	6,945.7 bn	7,047.1 bn	8,430 bn
Operating cost (C)			176.3 bn	177.7 bn	283.7 bn
Benefit-cost ratio (B/C)			17.79	20.43	16.49
Performance (B-C)			2,959.8 bn	3,452 bn	4,394.9 bn
Rate of return (B-C/D)			32.0%	35.0%	34.9%

2.4 Financial Improvement of the Companies

The analysis of micro-performance of the policy fund shows that companies that received them witnessed considerable financial improvements in terms of Net income to total assets, and revenue growth compared to the companies that did not receive the fund (or declined the fund). The fewer employees the companies have, and the shorter the company history is, the effect was more profound. It was also found that companies that benefited from the SBC's policy funds had higher survival rates. Three years after receiving the policy fund, the survival rate of recipients was 73.3%, 14.7%p higher than that of the companies that did not receive any funds (58.6%).

Table 3-6 | Financial Improvement by SBC Fund

Category		Financial Improvement (against non-applicants)
Venture Business Start-up Fund		■ Net income to total assets: 6.5%p
Promotion of the New Growth Industry Fund		■ Net income to total assets: 1.71%p;net income on shareholder's equity: 4.38%p;ratio of net income to net sales: 3.43%p ■ Debt-equity ratio: △14.9%p (effective a year after the assistance); equity-debt ratio 1.93%p
Management Stabilization Fund	General Management Stabilization Fund	■ Net income to total assets: 7.52%p, net income on shareholder's equity: 5.37%p ■ Revenue growth: 6.64%p; operating income growth: 19.7%p
	Temporary Relief Export Finance	■ Ratio of net income to net sales: 2.01%p (effective a year after the assistance) ■ Revenue growth: 18.57%p

2.5 Improvement of Management Climate

The non-financial improvements, which are difficult to identify with quantitative analysis, were analyzed based on surveys. They show that the contribution of policy funds to survival was 52.3% on average, and the improvements on financial accessibility backed by increased credit ratings and loan limits were 73.6% on average. The average number of people employed was 2.5, and the capacity utilization rate rose by 11.2%.

Table 3-7 | Major Performance Index Survey (by Year)

Category	Total	2006	2007	2008
Contribution to survival	52.3% (1.5)	48.4% (0.3)	51.8% (3.0)	63.6% (15.21)
Improved financial accessibility	73.6% (1.3)	71.1% (2.7)	73.4% (2.7)	90.9% (9.1)
Employment	2.5 persons (0.2)	2.6 persons (0.3)	2.4 persons (0.3)	1.5 persons (0.4)
Improved capacity utilization rate	11.2%p (3.7)	22.2%p (9.4)	9.1% (5.8)	13.8% (3.9)

Chapter 4

Conclusion and Policy Implications

Conclusion and Policy Implications

During its industrialization process, Korea's Small &Medium Business Corporation has taken the lead as an organization that executes policy funds for small and medium enterprises. The SBC has worked toward reaching growth potential by modernizing facilities, promoting restructuring, improving structures, and fostering innovative businesses, in addition to green and new growth engine industries, in accordance with the government's policy objectives. In the financial market, where financial institutions require collateral and a certain degree of financial performance, many SMEs, especially those that are in the areas where the market failed, find it difficult to access financing through the private financial sector, as they have limited resources, weak collateral and/or poor financial performance. The SBC has identified and assisted companies with outstanding business and technology capabilities to help them grow, and has contributed significantly to the rapid economic development in Korea.

Having been responsible for SME policy funds for over three decades, the SBC strived to lead the private sector both quantitatively and qualitatively, by concentrating its focus on start-ups in their infancy, small businesses, commercialization of R&D results in their infancy, long-term facility assistance, etc. Despite arduous efforts to achieve the goals, the SBC has undergone trial and error, and there have been questions about the SBC's role, i.e., that it was no different from the private financial institutions.

Therefore, it is necessary for the developing nations pursuing economic development based on the growth of SMEs to consider a number of elements. When these countries plan to introduce the policy fund financing system, these considerations include: 1) how to secure the source of policy fund financing; 2) how to differentiate and design policy funds according to their objectives, in terms of recipients, requirements types of loans, etc.; 3) how to select the borrowers that meet the objective of policy funds; and 4) how to manage risk so as to minimize the financial burden on the government.

This section will present the suggestions necessary to introduce and manage the policy fund financing system, based on the SBC's experience and performance, in light of the major considerations mentioned above, in the hope of helping developing nations to minimize trial and error.

1. Procurement of the Policy Fund

The first and foremost factor to consider before introducing any policy fund financing system is to secure the source for the funds. First, there need to be legal grounds, on which a stable system can be built.

The SBC established loan funds in accordance with the Small and Medium Enterprises Promotion Act. In itsinitial period, the SBC received contributions from the general account of the government. However, the government switched to a special funding account, in an attempt to alleviate its financial burdens. Since 1994, the funds have been sourced from issuing bonds, and any losses incurred by the differences between borrowing and lending rates have been subsidized by the government.

The amount of the bond issuance is limited up to 20 times the accumulated fund, and it is reviewed by the board and the Operating Committee when establishing, revising and settling the fund management plans each fiscal year. This is then sent for review and resolution by the government and the National Assembly.

Considering that it is difficult to secure financing solely from the government in the developing countries, there are various options to consider: using the government contribution for the initial capital, much like seed money, and borrowing the rest from competent authorities like the SBC that can utilize low interest borrowings from overseas, or issuing bonds to secure financing and receiving interest subsidies from the government, as it is done at the SBC.

In such cases, it is necessary to come up with measures to respond to any losses incurred from assisting SMEs with no or little collateral and poor credit, or in areas where the market has failed, on top of securing resources and government subsidies. This will ensure that the policy fund financing system is maintained steadily.

2. Execution of Policy Funds

Due to many limitations, developing countries may not be able to finance all SMEs that require funding. It is therefore necessary to confine funds to specific groups. The SBC excludes healthy companies that have access to the private financial sector, and provides finance mainly to companies in the green, new growth engine, parts, materials and fundamental industries by considering different factors such as the industrial climate and implications for Korea. Developing countries will also find it effective to designate target group according to their unique situations, to provide the limited resources available to finance SMEs.

SBC's policy funds are provided at lower interest rates-approximately 1-2% lower than those found at commercial funds-for longer periods (five years for working capital and eight years for facility). These preferable loan conditions were designed to provide access to start-ups and small businesses, so that they may enhance competitiveness and grow to become blue chip companies. However, they also have adverse effects of creating imaginary demands, inducing SMEs that are capable of accessing the private sector to use policy funds. The lower the rates are, the greater the financial burden becomes on the government. These are the elements to be considered in designing financing requirements.

When the financing system was first adopted, the SBC was in charge of making a decision on loan eligibility, and the loans were granted through agency loans at commercial banks. However, as many SMEs were not able to take out loans even after being granted permission, the direct loan system was introduced in 1993, allowing the SBC to execute loans without commercial bank affiliation. The system grew each year and as of 2011, more than 50% of the total budget is allocated for direct loans. During the Asian financial crisis and the2008 global crisis when the private financial system failed to fulfill their responsibilities by stopping the supply of fund to SMEs, and even taking loans back from SMEs, the SBC substantially increased its policy funds to help overcome the crises.

To meet the financing needs of SMEs, the SBC has diversified funding schemes, like introducing a hybrid financing scheme (acquiring convertible bonds issued by SMEs, then sharing their future profits) that combines investments and loans in 2008. As such, developing countries are also encouraged to meet their unique financing demands of SMEs, by introducing diversified financing systems.

3. Selection of Recipients and Risk Management

The SBC has the technology and business oriented corporate evaluation system to select its recipients. SMEs that are three years old or less are not subject to evaluation on financial performance. Even for companies older than three years, the financial performance evaluation accounts for 10-20%, so that the financial performance does not critically affect the selection process. In other words, the technology and business evaluations are the key to affecting selection. This is especially helpful for SMEs that are shunned by the private sector, due to their poor financial performance. This is what differentiates the SBC from the private sector, and is crucial to manage the policy fund financing system.

However, selecting borrowers based solely on their technology and business without considering credit and financial performance inevitably pose a greater risk to lenders. When such risks actually result in losses, and the losses grow too big to be made up with government assistance, accumulation of such losses may threaten the very existence of the lending institution. The SBC also sees a high percentage of direct loans, but does not get sufficient subsidies for the losses from the government. While it maximizes the effect of the funds executed according to policy objectives, it also presents a big problem as to how to manage the mounting risks effectively.

Developing countries are encouraged to set a risk management goal when introducing the financing system. A proper risk management system needs to be established, and employees need to be trained to enhance their expertise. This will help them to respond effectively to risk management issues. On top of financing, developing countries can also conduct the management diagnosis on SMEs to provide any necessary customized programs (e.g., marketing, training, technology support or R&D) that meet the needs of the companies, which will eventually result in better effectiveness of financing programs and any risk prevention/management programs.

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