BANK FINANCE FOR SMALL AND MEDIUM-SIZED ENTERPRISES IN SRI LANKA: ISSUES AND POLICY REFORMS

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Abstract:

Access to bank finance is necessary to create an economic environment that enables Small and Medium-sized enterprises (SMEs) to grow and prosper. The SMEs in Sri Lanka, however, face significant constraints to access bank finance. The purpose of this paper is to investigate the access to bank finance and related issues in the SME sector of Sri Lanka. The paper is exploratory in nature and reviews the bank financing situation for SMEs in Sri Lanka, as well as provides an overview of constraints faced by the banks (supply-side) and SMEs (demand-side). The paper also highlights some good practices in SME lending from international experience and outlines some recommendations to help overcome the constraints faced by the banks and SMEs. The recommendations discussed in this paper may be of importance to policymakers, not only in Sri Lanka, but in many other developing countries in a similar stage of economic growth.

Key words: *Small and medium-sized enterprises, Bank lending, Financial constraints, Sri Lanka*

1. Introduction

Small and Medium-sized Enterprises (SMEs) continue to be central to the economic development of Sri Lanka. According to a newspaper article in the 'Daily News', government estimates indicate that around 80 per cent of the businesses in Sri Lanka are considered to be SMEs (Joseph, 2014). Additionally, SMEs contribute 50 per cent to the Gross Domestic Production of the country and employ 26 percent of the labour force and have a value addition of 17 percent (Institute of Policy Studies & Oxfam International, 2014). However, most financial providers consider that financing SMEs is a risky business that generates high transaction costs and/or low returns on investment, and therefore hesitate to grant loans to potential clients in this sector. In fact, the World Bank's 2011 Investment Climate Assessment Survey in Sri Lanka, reveals that around 35 percent of Sri Lankan small firms can access a loan or a line of credit and around 14 percent of those who applied were denied financing. Therefore,

developing solutions to this major concern should be a priority for public policymakers. This paper examines the current situation of SME financing in Sri Lanka.

The article proceeds as follows. In the next section, a theoretical framework that underpins the prevalence of credit market imperfections is discussed. Then a brief description of historical background of SME financing in Sri Lanka is presented. Thereafter, a discussion on the constraints faced by banks and SME operators are provided. Finally, the article concludes with some recommendations on how to overcome these constraints.

2. Literature review

Finance theorists highlight that the credit market imperfections exists due to adverse selection, moral hazard and contract enforcement problems. Banks need information in order to decide whether to offer loans, what kind of loans to provide to which customers, and at what rate. However, in practice, there are problems in gaining information from SMEs due to reasons such as lack of records maintained by the owner-managers of SMEs and high transactions cost of gathering these information. Because of this information asymmetry, banks are unable to differentiate between the high-risk and low-risk borrowers and face two problems, namely; adverse selection (hidden information) and moral hazard (hidden action).

Adverse selection can occur prior to contracting because lenders have to decide whether, and on what terms, to lend. As discussed by Stiglitz and Weiss (1981), borrowers have 'inside information' about the nature of the project they want to be financed and may reap substantial rewards from 'talking up' their projects. Moreover, while the lender gains if the loan is repaid with interest, it is not a beneficiary of any upside gain in the firm's performance; it is, however, a victim of any downside losses in the case of default. Lenders therefore face difficulties in discriminating between good and bad credit risks and simply increasing the price of credit to all potential borrowers can lead to adverse selection; rather than driving potential non-payers out of the market, there may be systematic reasons why some of the highest risk firms are willing to pay high interest rates (Pollard, 2003).

The other information asymmetry problem; namely, the moral hazard, arises when lenders are unable to discern borrowers' actions that would affect the distribution of returns from an investment. This means that after a lender has extended finance to a firm it is exposed to moral hazard, the risk that the firm will not perform in a manner sufficient to meet the contract. For example, once a loan has been secured, a borrower could use the proceeds of the loan for a higher risk purpose or a non-income generating activity.

Mushinski (1999) argues that credit market imperfections in developing countries derive not only from moral hazard and adverse selection problems but also from costly monitoring and contract enforcement. From the lenders' perspective, contract enforcement is important because in case of borrowers' default, the lenders often have the right to seize collateral. However, in practice, the enforcement of this

right depends on the judiciary efficiency of the country. For example, drawing data from 129 countries, Djankov *et al.,* (2007) conclude that the weak legal system is an impediment to the functioning of credit markets in many developing countries. Similarly, using loans to borrowers in 48 countries, Bae and Goyal (2009) conclude that banks respond to poor enforceability of contracts by reducing loan amounts, shortening loan maturities, and increasing loan spreads.

Although these arguments are not specifically drawn at SMEs, these problems are more associated with SMEs than with large companies.

3. SME Financing Situation in Sri Lanka

The establishment of People's Bank and the nationalisation of Bank of Ceylon in 1961 were landmarks in providing institutional credit to SMEs in Sri Lanka (Williams,1999). Bank of Ceylon branches and its sub offices at Agrarian Services Centres provided credit facilities under special programmes to SMEs. Some domestic private banks have also introduced special facilities to these industries with the expansion of their branch network. Sri Lanka's first development bank, DFCC Bank, was established in 1955 to encourage greater equity financing. However, definite and concerted efforts to provide formal credit for small enterprises began in the late 1970s' with the commencement of an industrial policy which promoted labour intensive small scale enterprises (Williams, 1999). A credit line called the 'Small Scale Industries (SSI) credit scheme' commenced in 1978. This credit line was operated through the Bank of Ceylon and People's Bank in collaboration with the Industrial Development Board (IDB). In 1979, a new credit line, called SMI Loan Scheme commenced operations.

This credit line was funded by the World Bank and the Asian Development Bank, and the National Development Bank (NDB) acted as apex institution for this credit scheme. It was operated through the branch network of five leading local commercial banks, and two other local commercial banks along with Regional Rural Development Banks (RRDBs) became the participating credit institutions for the SMI III & SMI IV credit schemes. Industrial Development Board (IDB) provided the technical assistance for this credit facility and it was made available exclusively to small and medium industries (SMIs).

The main objective of the SMI loan scheme was to provide finance on a concessionary interest rate to SMIs. Since the end of SMI IV in 1996, there have been other credit lines introduced to the country, which provided loans for SMEs such as the SMILE credit scheme, SMAP credit scheme, E-Friends credit scheme, SPREAP credit scheme, SMERDP credit scheme, KfW credit scheme, Sahanya credit scheme, Susahana credit scheme and Saubhagya credit scheme.

While the Central Bank of Sri Lanka collects and reports data on total assets, deposits and credit advanced by banks, neither the government nor other parties have comprehensive and comparable data from all financial institutions describing their current lending activity for SMEs by the size, type and location of borrowers. As per the knowledge of the researcher, the only recent and reliable data related to lending to

SMEs come from the recent survey conducted by the World Bank in 2010 as part of the preparatory work for the Small and Medium Enterprise Development Facility (SMEDeF) Project. Although the data is available only for the top seven banks covering SME lending in Sri Lanka, these seven banks represent approximately 75 per cent of the banking assets to SMEs. The share of SME loan portfolio of the top seven banks in Sri Lanka is shown in Table 1.

Table 1: Share of SME portfolio of the top seven banks covering SME lending-2009

Bank	Total portfolio (in million $*)	SME portfolio (in million $*)	Percentage (%)
Bank of Ceylon	1,865.75	58.83	3.15
People's Bank	2,584.83	40.39	1.56
NDB Bank	485.53	30.73	6.33
DFCC Bank	339.79	140.48	41.34
Hatton National Bank	1,545.28	763.86	49.4
Commercial Bank of Ceylon	1,554.06	468.85	30.17
Wayamba Development Bank	66.73	7.02	10.53
TOTAL	8,441.97	1,510.16	

  (*Converted from LKR May 21, 2010)
Source: World Bank, SME Banking Assessment – Sri Lanka, 2010

As can be seen from Table 1, approximately 17.9 per cent of the total portfolio of the top seven banks covering SME lending is related to SME financing (both short-term and long-term facilities).
Another interesting point from the above data is that three local commercial banks, i.e. Hatton National Bank, DFCC Bank and Commercial Bank were actively engaged in SME financing and had the largest SME portfolios, whereas the lowest SME portfolios were held by the two large state-owned commercial banks, Bank of Ceylon and People's Bank.

Although the above data represented a significant coverage of the SME financing portfolio of all banks in Sri Lanka in 2009, it should be noted that the absence of such information for all banks in the country on a regular basis makes it impossible to know with confidence the coverage that banks are providing for SMEs.

4. Shortcomings and constraints in SME financing

This section covers the constraints in SME financing in Sri Lanka. The constraints are covered from two perspectives, namely banking sector constraints and SME operators' constraints.

4.1 Banking sector constraints: Supply-side

Bankers consider it risky to lend to SMEs. This risk comes from many angles including single person risk, problem of uncertainty surrounding SME activities, risk of default, insufficient assets, low capitalisation, high failure rate etc. For example, the SME banking sector assessment for Sri Lanka conducted by the World Bank found that non-performing loan ratios on Banks' SME loan portfolio ranged from 2.7 percent to 11.5 per cent (World Bank, 2010).

The banks find it costly to make and service loans to SME clients. For instance, collection and review of financial and non-financial information to assess loan applications for SME clients is a difficult task and involves significant amount of staff labour. As a result, SME lending erodes the lender's margin. Moreover, most administrative costs of lending (e.g. the costs of collecting information about the borrower) are independent of the size of the loan and inevitably make small loans more expensive than large loans.

Lack of information on the borrower is another barrier faced by the banks in lending to SME clients. This may be due to the lack of reliable financial information, no credit history of the borrower, etc. Unlike listed companies, SMEs do not have to comply with financial reporting requirements of the regulators and at times even some of the established SMEs with sound financial performance are unable to provide information required by the banks due to their underreporting or withholding profit figures to avoid tax. Even the SMEs with accounting records may have two or three sets of accounts for different audiences. As a result of this information asymmetry, it is difficult for banks to assess the credit worthiness of potential loan applicants. However, this problem is mitigated to a certain extent as Sri Lanka has a Credit Information Bureau (CRIB) which issues credit reports on individuals and firms to financial institutions. Membership of the CRIB is mandatory for licensed commercial banks, the licensed specialised banks, leasing companies and finance companies.

SMEs are an extremely heterogeneous group of businesses and it is challenging for banks to establish lending operations to this sector. According to Weidig (2011), the SME sector is a heterogeneous group compared to micro enterprises and corporate businesses, and requires a more sophisticated approach to customer service and risk assessments.

Most of the banks lack the technical capacity or willingness to service this heterogeneous sector. Another capacity-related problem faced by banks is the difficulty of doing the follow-up loan procedures due to poor banking practices of SME owners. The legal system of Sri Lanka can be stated as not-debtor friendly. The strength of legal rights index measured by the International Finance Corporation (IFC) is an important indicator to support this claim. To construct the strength of legal rights index, eight aspects related to legal rights and two aspects related to bankruptcy law are considered. Sri Lanka is assigned an overall score of 5 out of 10 for the strength of legal rights index (IFC, Doing Business Indicators, 2013). For example, there are inefficiencies in the land registry and there is not a centralised system for registration of

chattels. Most of the time the courts are too weak to repossess any collateral that is offered. Moreover, banks face a serious handicap as the judicial process takes a long time to resolve the default cases filed in the courts.

The longer-term credit lines to banks to lend to the SME sector are required as the banks are faced with the problem of managing their fund mismatch. Indeed, the majority of deposits in the financial sector tend to be short-term and are hardly appropriate for funding long-term lending on a large scale because of maturity mismatches. This problem aggravates as credit lines from foreign donor agencies to Development Financing Institutions have decreased in the recent past and leading development financing institutions in the country, such as National Development Bank and DFCC bank, have obtained the commercial banking license as a measure to aggressively target local funding sources.

4.2 SME Operators' constraints: Demand-side

The credit culture in the Sri Lankan banking industry shows that banks predicate their decisions not so much on cash flows but on collateral. Therefore, being able to offer a clear title to land can be critical in qualifying for a loan.

The banking survey of the SME market in Sri Lanka 2006/2007 undertaken by the South Asia Enterprise Development Facility identified insufficient or undervalued collateral as one of the reasons for not borrowing from a bank.

Land is the most commonly offered collateral for SME loans in Sri Lanka. However, lack of proper title for the land prevents SMEs from offering them as collateral at the time of applying for loans. Most private land records take the form of deed registrations that record transactions. Each time a piece of land is used as collateral, a lengthy search for all deeds recorded during the last 30 years must be undertaken to provide title to land. Records are often poor, and this results in frequent disputes (World Bank, 2005).

SMEs are characterised by limited formality and are sensitive to loan delivery time and complex procedures. SMEs are usually small, family-owned businesses, run or managed by one or two people taking full responsibility for all aspects of the business. These individuals typically know their business well, but lack the skills to produce written business and financial plans and are discouraged by the extensive documentation requirements of banks. These complex bank procedures used for SME lending are time consuming and costly. Most of the time, the SME operators give up the loan application process half way through because the owner/manager must spend time away from business to complete these procedures to obtain the loan and to meet the lending officer.

Another main constraint to firms accessing finance is the cost of finance. The SME Banking Assessment done by the World Bank (2010) states that the average rate of interest for term loans charged by Sri Lankan banks was between 12-16 per cent, while working capital loans have been granted at 13-19 per cent. On the other hand, costs such as legal fees, valuation charges, stamp duty, etc. make bank lending

expensive for SMEs. Lakshman *et al.,* (1994) also stated high interest rates to be a serious problem affecting SMEs' performance, competitiveness and growth. On the other hand, when enterprises require financing, they usually need it immediately because their management rarely plans operations far in advance. It is also common that these enterprises have limited or no formal credit history, lack formal financial statements, and possess few immovable assets.

SMEs are also constrained by the lack of branch network, especially in the rural areas. Most of the banks are confined to Colombo (the capital city) and suburbs. There are complaints from the entrepreneurs located outside Colombo that most Colombo headquartered financial institutions are not sufficiently knowledgeable about the other districts and are not in the position to judge credit risks sufficiently, resulting in limited financial facilities being made available to them. The Task Force for SME Sector Development Programme (2002) also highlighted this point and mentioned the lack of regional spread of loans as another financial constraint faced by entrepreneurs operating outside the districts in the Western province where the capital city of the country is located.

Some of the entrepreneurs are of the view that the existing Loan Recoveries Act in Sri Lanka is one sided and it is in favour of the banks (Task Force for SME Sector Development Programme – Sri Lanka, 2002).

Furthermore, they are of the opinion that some banks did not have the capacity and/or attitude to support sick enterprises, their approach to problem loans is a bit rigid and most of the banks applied the provisions of the Loan Recoveries Act (immediately without negotiating other workable solutions such as loan restructuring with the entrepreneurs).

5. Suggestions for improvement

As a remedy for high administration costs in processing SME loans, the banks can use credit scoring systems. With credit scoring, data on an applicant are passed through an analytical model, and this model generates a score that indicates the level of credit risk associated with the loan applicant. This technique can be effectively deployed as an early pre-screening tool to establish which applications to investigate more thoroughly and which to reject before having to investigate in depth. This would enable banks to avoid insolvency due to bad loans, and to sustain profitability from proper lending practices. It would also reduce the cost and time associated with loan applications, as only a smaller pool of borrowers would need a more rigorous individualised review. Sri Lanka can start with simpler 'judgmental' scoring models, based on qualitative parameters, and later switch to more complex and powerful 'statistical' scoring models. These scoring systems could be used for rating individual borrowers and could be used for management reporting, pricing, limit setting and loan loss provisioning apart from loan approval. According to Asch (2000), effective use of credit scoring model can reduce the number of loan applications that need manual review by 50 per cent to 80 per cent.

As mentioned in this paper, some SME operators are of the view that the loan documentation is a complex process. Therefore, policymakers should simplify loan documentation and procedures for SMEs. For example, Sri Lankan banks could follow the approach used by the Planters Development Bank in the Philippines and design or customise the loan documentation to suit the needs of SMEs (Aldaba, 2012). Similarly, Bank Rakyat Indonesia has developed a unique approach to SMEs and relaxed the administrative procedures and collateral requirements to facilitate lending programs to this sector (Murthy, 2007). Sri Lankan banks can refer to these good practices to provide better service to SME customers.

As SMEs become older, they require dynamic financial needs for research and development activities and to diversify their business operations. Therefore, banks need to create more innovative funding packages, to boost these established small and medium-sized businesses. Additionally, the innovative models like revolving funds can be used to finance credit to SME sector. Moreover, Sri Lankan banks can further promote structured finance methods such as leasing, factoring, supplier finance and warehouse receipts for SME clients. According to Antonio and Cernov (2011, p.167), 'structured finance tools allow financing at different stages of the value chain and it is specially designed to consider the characteristics and needs of the players at a particular stage'.

It is recommended that banks and financial institutions collect and maintain data on SME lending. Banks may collect information on their borrowers such as sales and the number of employees but often they do not keep these data in their computer systems. Maintaining such information on their borrowers would allow banks to monitor SME lending operations. Such data may also be useful for monitoring different segments of the bank's client base and developing credit scoring models.

Organisations like the Chamber of Commerce and other business associations can play a key role in assisting their members to access bank loans from banks. For this reason, it is recommended that banks can cooperate with these organisations to identify credit worthy SME clients and to promote their financial products to SME owner-managers.

Banks are encouraged to advertise the availability of the various loan products to the SME sector, so that the SME owner-managers are aware of all the financial options available to them. This type of communications between the banks and SME owner-managers may help to reduce the problem of access to finance. Bankers should also look beyond financing or lending and aim at efficient and quick customer service for their SME clients. Bankers should hold meetings with their clients on a regular basis in order to understand their needs and grievances and to offer tailor-made products that would help remove the bottlenecks in the growth of SMEs to a greater extent.

Lending to SMEs can be considered more of an art than a science. Therefore, banks should train staff that handle SME clients. The attitudes of bank staff should also be changed and they should be briefed on the importance of the SME sector in national development.

Sri Lankan banks are more oriented towards 'security based' lending as opposed to 'cash flow based' lending. This situation demands some form of government intervention such as credit guarantee schemes. Under the credit guarantee scheme, the government agrees to indemnify the bank up to a certain proportion of its loan to a borrower without collateral.

The objective of such a scheme is to motivate the banks to lend to borrowers to whom it would not otherwise lend in view of the borrower's lack of collateral. Credit guarantee schemes are considered less distortionary and more market friendly. They help reduce the risk to the lender as part of the risk is borne by the issuer of the Credit guarantee. It also diversifies risk by covering loans across different sectors and geographical locations (De Alwis and Basnayake, n.d). However, most SME credit guarantee schemes have terminated by now. Hence, it is recommended that the Central Bank introduce new credit guarantee scheme for SMEs in Sri Lanka and that a dedicated agency such as the Credit Guarantee Cooperation is set up to provide credit guarantee services. Sri Lanka could learn a lesson from the SME credit guarantee fund established by the Taiwan government in 1974 which is operating successfully up to now. Establishing such a credit guarantee fund may help SMEs overcome the difficulties that they face when offering collateral to banks at the time of obtaining loans.

Furthermore, Sri Lankan banks are following the BASEL II standards, so their risk weight for lending is 75 per cent. The risk weight would be much lower, which would encourage the banks to grant more loans to the SME sector.

Another recommendation is to expand the 'Secured transaction registry' of the Credit Information Bureau of Sri Lanka which was introduced recently. Expanding this collateral registry makes it easier for SMEs to obtain financing even without traditional mortgages like land or property. Sri Lanka should also aim at well developed Secured Transactions Act which will enhance financing against movable assets such as inventory and equipment.

For example, in 2004, China embarked upon a reform of its movable collateral framework to encourage financing against valuable movable assets. Following this reform, SMEs can now use movable assets, such as inventory and receivables as a basis for borrowing and the percentage of movable assets based lending in China has gone from 12 per cent to about 20 per cent since the reform (International Finance Corporation, 2010).

Another recent initiative that merits consideration is the SME rating agency. Although a few international rating agencies are operating in Sri Lanka, they all concentrate on rating corporate and listed instruments. At present, there is no agency in Sri Lanka which provides credit ratings for SMEs. It would be advisable that the government authorities in Sri Lanka set up an SME rating agency similar to that in India. The Government of India has introduced an SME Rating Agency (SMERA), focusing on the micro, small and medium enterprise sector. SMERA provides comprehensive ratings for the use of financial institutions in the assessment of credit. The ratings have improved the access to bank financing for at least 20 per cent of

rated clients (International Finance Corporation, 2010). However, some critical issues such as who pays for the ratings to avoid conflicts of interests have to be revisited before implementation.

The lack of hard data on SME financing is a major challenge in evaluating the needs of the sector and in assessing progress. Thus, it is necessary to develop a mechanism to gather data on this important area through a government establishment. Sri Lanka could learn from other countries in the world in developing such a mechanism. For example the National Statistics Office collects this type of data in Japan, Denmark and Greece. In Chile, Lithuania, Taiwan, Nicaragua and Venezuela SME data is collected by the Ministry of Economy. The Ministry of Trade monitors SME lending in Albania, Botswana, Colombia and Zambia. SME lending data is collected to monitor compliance with lending targets set for priority sectors, including SME in some countries in the South Asian region such as India, Pakistan and Afghanistan.

It is proposed that a survey of SME finances should be conducted in Sri Lanka on a regular basis to find reliable independent data on the demand and supply of finance for the SME sector. These types of surveys are quite common in the UK (UK Survey of SME finances 2004, 2008 and 2009) and the USA (Survey of small business finances).

The government may consider introducing an appeals mechanism for SMEs to independently evaluate the appeals made by SMEs with regard to their loan application rejections.

It was also highlighted in this paper that not having accounting records makes the SMEs risky borrowers and makes them less attractive in the eyes of bankers. Hence, the policymakers are encouraged to implement capacity building programmes for entrepreneurs in terms of preparing financial statements and business plans.

Policymakers, small entrepreneurs, donors and those who deal with the development of small enterprises in developing countries can use the network formation approach apart from their traditional supporting approach. For instance, supporting institutions should organise network activities for small businesses. Small business owners should also realise the importance of constructing networks. They should focus their attention and programs not only on providing increasing resources but also on providing more facilities and efforts on '*networking*' (for example, a self-help support network for SMEs, see McRae,1995), because particularly small firms do not expand in isolation and have a lack of resources. Networking is a possible solution because through established network relationships, firms gain not only access to external resources but also gain encouragement and influence.

The government can also implement the 'cluster' approach to SME lending. The 'cluster' is a sectoral and geographical concentration of similar or related complementary manufacturing/ business units that are exposed to similar opportunities and threats (Sobha Rani and Rao, 2008). The government can direct banks to establish specialised SME branches in identified clusters to enable enterprises to have easy access to finance. An international example that can be drawn from the South Asian region is the initiative taken by the Small Industries Development Bank of India

(SIDBI) where they tried to improve the flow of credit to SMEs by using the cluster approach. SIDBI also initiated the establishment of small enterprise financial centres in selected clusters (Murthy, 2007). Similarly, ICICI Bank of India divides SME clients into three groups, namely Corporate-linked businesses, the cluster-banking group and business-banking group. The Cluster-banking group consists of pre-selected and pre-defined industry clusters that represent promising opportunities. This type of segmentation of SME clients into clusters may also help banks to address challenges such as risk management and knowledge development (International Finance Corporation, 2009).

6. Conclusion

This paper examined the current situation of SME financing in Sri Lanka. Thereafter, the paper highlighted some constraints faced by the banks and SMEs. Banking sector constraints discussed in the paper were high risk, high administration costs, lack of information on the borrower and poor legal systems. Among the SME operators' constraints, lack of collateral, complex loan application procedures and high cost of finance have been stated as main issues.

The paper proposed recommendations to overcome these constraints such as developing credit scoring systems in SME lending, simplification of loan documentation, promoting structured finance tools, training bank staff who handle the applications of SME customers, introducing new credit guarantee schemes, setting up a SME rating agency and developing 'cluster-based approach' in SME lending. These recommendations may be of importance to policymakers, not only in Sri Lanka, but in many other developing countries in a similar stage of economic growth.

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