



## FINANCIAL INCLUSION: A REVIEW ON SMALL & MEDIUM ENTERPRISES (SMES) ACCESS TO CREDIT

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### Abstract

Financial inclusion refers to the ability of individuals/organizations to access financial products and services in order to meet their financial needs including saving, transacting, receiving credit and insurance.

Small and Medium Enterprises (SMEs) which unarguably play an important role in any emerging economy have limitations in access to finance which is important for the growth of SMEs. However, as widely accepted, SMEs have struggled with a number of growth barriers – one of the most commonly cited is the inability to successfully access to formal credits.

This paper explores the challenges faced by SMEs in obtaining funding from formal financial institutions and the actions taken by Governments worldwide to facilitate SMEs access to credit. A special attention was made to Sri Lanka as an emerging market in accessing the contribution to economic development explaining the practices. Further, it is envisaged by this paper to make suggestions based on the review, on remedial measures to improve SMEs access to funding from the formal financial institutions in Sri Lanka.

The outcomes of the study show that small and medium enterprises do face considerable challenges when accessing credit from formal financial institutions. The investigation also determines that financial institutions consider the SME sector as an unreliable/risky industry thereby offering them credit facilities at a premium in contrast to discounted rates offered to the larger corporations thus driving up the costs of SMEs.

Further, a case is made for the intervention of the state in a regulatory capacity as well as an independent umpire in the lending market, thereby improving the credit ratings of the SMEs allowing them access to formal lending institutions.

The paper concludes that there are barriers for SMEs in accessing financing from formal financial institutions which had led to their stunted growth which in turn impacts the economy at large. Remedial action is necessary and should address the information asymmetry problem and the related stigma of SMEs being unreliable borrowers as well as improve the regulatory framework to include non-traditional approaches to granting credit facilities to SMEs.

**Keywords:** Financial Inclusion, Debt Financing, Government Intervention, Small and Medium Enterprises, Sri Lanka

## **1. Introduction**

Financial inclusion refers to as the accessibility to finance and financial services by the society at large, in a fair, transparent and equitable manner at an affordable cost (Solo, 2008).

Fuller & Mellor, (2008) define financial inclusion as the desire to develop welfare-oriented, consistent, reasonably priced and accessible financial services for all sections of an economy.

Further, it could be considered as a market-driven solution aimed at alleviation of poverty (Du, Bian, & Gan, 2017; Fatoki & Smit, 2011; Stiglitz & Weiss, 2011). Financial inclusion also provides savings and borrowing opportunities to marginalized groups, thus, micro-credit schemes are viewed as an integral part of financial inclusion (Conroy, 2008).

SMEs are regarded as the lifeblood of every country's economy. Most corporate majors today were the humble SMEs of yesteryear. SMEs are critical to the smooth functioning of an economy by filling the gaps that large corporates cannot fill, as well as support the large corporates by way of sub-contractors, and even customers be it primary, secondary or tertiary industries. Despite the SMEs considerable contributions to economies at large, SMEs in developing economies face difficulties in obtaining funds from financial institutions.

A survey carried out by the International Finance Corporation (IFC) in 2013, revealed that out of the approximately 100 million SMEs in the developing countries, around 60% have been identified as unserved or underserved. Further, an extended survey has identified the demand for finance from SMEs estimated at USD 8.9 trillion, in compared to the credit supply of USD 3.7 trillion, creating a gap of USD 5.2 trillion (International Finance Corporation, 2017).

In Asian region, SME's add up to more than 96% of all enterprises and contribute to the two third of the private sector jobs in the continent. Accordingly, the role of SMEs in the success of Asian Economies is significant (Asian Development Bank, 2019; Yoshino & Taghizadeh-hesary, 2017).

Being such contributor to the economy, SMEs in the Asian region face major challenges in obtaining affordable finance mainly due to the non-availability of proper information/records required by the financial providers (Department of Development Finance, 2018; Du et al., 2017; Koththagoda & Dissanayake, 2017).

The remedies proposed by extant literature are: the implementation of credit information infrastructures for SMEs to overcome the problem in providing information, utilization of credit rating techniques for SMEs, the development of a sustainable credit guarantee scheme, the development of specialized banks for SME financing, and the implementing community-based financing and tech-based lending platforms. (Athukorala, Hal Hill, 2017; Ou, 2006; Yoshino & Taghizadeh-hesary, 2017)

Du et al. (2017) have acknowledged that government intervention enables the SMEs to secure more bank loans and that the SMEs are more likely to access bank loans in regions with higher level of government intervention than median government intervention. Further, government intervention in establishing funding institutions to provide accessible and low-cost financial assistance to SMEs is of utmost importance to a developing country. (Gamage, 2003)

This study is carried out in Sri Lankan context as they have shown a significant contribution to the economic contribution to the economic development over the last decades. However, it seems that with approximately 30% of firms having sufficient access to finance, the gap of the funding demand and supply is significant compared to other countries in the Asian region (Asian Development Bank, 2019).

Thus, this study contributes to the literature by examining the challenges that hinders the development of SMEs in Sri Lankan context and the contributions made to the economy with the available sources of financing. More importantly, this analyses the existing government intervention programmes within the Asian region to seek the level of involvement of government in reducing the problem of SMEs access to formal credit.

The paper is structured into three sections. The first section gives a general outline of SMEs focusing in Sri Lankan context and elaborates the importance of SMEs to an economy. Second section discusses the difficulties faced by SMEs in obtaining financial support from the financial sector and the final section is focused on the role of government intervention in broadening SME's access to finance.

### ***1.1 SMEs in Sri Lankan Context***

SMEs have been identified as the main strategic sector for promoting growth and social and economic development of Sri Lanka (Asian Development Bank, 2019; Athukorala, Hal Hill, 2017).

Different terms have been used in different documents to identify SMEs and some of the terms commonly used interchangeably are, Small and Medium Industries/Enterprises, Micro Enterprises, Rural Enterprises, Small and Medium activities, Cottage Industry, etc. (Conroy, 2008; Department of Development Finance, 2018; Gamage, 2003; Ketley, Lightfoot, Jakubec, & Little, 2012; Vijayakumar, 2014).

The World Bank has defined the enterprise size in Sri Lanka based on the number of employees: those with fewer than 49 employees are small; those with 50-99 employees are medium-sized; and those with more than 100 employees are large (The World Bank Group, 2015).

The number of employees as the criterion for size appears comparatively reasonable because it differentiates between enterprises regardless the line of business, and the amount of capital invested which are subject to frequent revisions due to inflation.

However, in Sri Lankan perspectives, the SME policy framework defines SMEs based on the **number of employees** and **annual turnover** which is acceptable across all the agencies (The Ministry of Industry and Commerce, 2016).

The table 1 shows the definitions of the categories of SMEs in Sri Lankan context.

**Table 1: The definitions of the categories of SMEs in Sri Lankan context.**

Size/Sector	Criteria	Medium	Small	Micro
Manufacturing	Annual Turnover	Rs.Mn. 251 - 750	Rs.Mn. 16 - 250	Rs.Mn. 15 or less than Rs.Mn. 15
	Number of Employees	51-300	11-50.	10 or Less than 10
Service Sector	Annual Turnover	Rs.Mn. 251 - 750	Rs.Mn. 16 - 250	Rs.Mn. 15 or less than Rs.Mn. 15
	Number of Employees	51-200	11-50.	10 or Less than 10

*Source: The Ministry of Industry and Commerce, Sri Lanka*

In Sri Lanka, in 1983, 98% of the total enterprises was consisting of SMEs with only 2% of large enterprises. But the contribution to the employment generation was 48.6% from SMEs, whereas the large enterprises accounted for 51.4% of the employment generation. As of 2008, 93% of the enterprises was comprising of SMEs which accounted for 29.6% of employment generation of the country (Ernst and Young, 2019; Vijayakumar, 2014).

Accordingly, it is evident that even though successive governments since independence have made development of SMEs the cornerstone of poverty reduction policies, the impact upon the SMEs have clearly not been realized. Thus, this study contributes to the literature by examining the challenges that hinders the development of SMEs in Sri Lankan context and the contribution made to the economy with the available sources of financing. More importantly, this analyses the existing government intervention programmes within the Asian region.

### ***1.2. Importance of SMEs towards economic development***

Access to finance permits SMEs to initiate productive investments and contribute more to economic development and poverty alleviation in any economy (Beck & Demirgüç-Kunt, 2008)

In addition, in the absence of external finance, SMEs will most probably not be able to survive in an international market, to expand the businesses and strike relationships with the large firms. (Osano & Languitane, 2015)

Further, there are many studies that supports the concept of SMEs as the driving force of a nation's economic development (Beck & Demirgüç-Kunt, 2008).

Apparently, even in rapidly developing economies as Nigeria, Banks are somewhat reluctant to provide credit to micro, small and medium enterprises (MSME) with MSME loans accounting for approximately 5 percent of the Deposit Money Bank (DMB) lending portfolio, which is uncanny considering the competitiveness of the banking sector and credit extension to MSME being a plausible avenue for expansion (Ketley et al., 2012).

The statistics indicates that SMEs account for 99 percent of total enterprises, 80 percent of employment, 50 percent of the government taxation and 80 percent of new product development in China at the end of year 2017 (Du et al., 2017).

In Sri Lanka, the gap of supply and demand for credit is narrowed in the financial market, there is an immense opportunity for the SME sector to create employment opportunities, mainly because majority of the SMEs are labor intensive (The Ministry of Finance, 2018).

## 2. Methodology

This research follows a deductive approach in which arguments are supported by empirical evidences. The researcher reviewed journal articles, industry publications in order to obtain an understanding on the access to credit by Small and Medium Enterprises. Accordingly, literature review was used as the main research tool to provide a better knowledge on financial inclusion, access to credit, the importance of SMEs to an economy and the role of government in improving access to credit to SMEs.

The paper is organized as a concept paper whilst arguments were empirically supported. Finally, the author discusses and conclude the paper by suggesting future research directions in line with the formed discussion.

## 3. Literature Review

### *3.1 Challenges Faced by The SMEs in Accessing Formal Credit Facilities*

Access to finance, has always been regarded as the most serious barrier to business expansion and or business start-up by SMEs. (Mori, 2014)

The research evidences show that the challenges faced by the SMEs are very much similar despite the fact that evidences are collected from different parts of the world from the economies in different development levels (Aghion, Fally, & Scarpetta, 2007; Chandrasiri & Bamunuarachchi, 2016; Fatoki & Smit, 2011; Ketley et al., 2012).

The limited availability of financial and other data in SMEs, which is necessary for credit risk assessment impacts banks' lending decisions in a negative way, either by driving interest rates high or by limiting financing SMEs (Yoshino & Taghizadeh-hesary, 2017).

Only 30 percent of Sri Lankan firms do have the sufficient access to bank loans and other formal sector financing, evidencing the key barrier of limited access to finance faced by the entrepreneurs in Sri Lanka. These restrictions are greater for businesses located in rural areas (Asian Development Bank, 2019).

Furthermore, recent researches have provided remarks on the barriers faced by the SMEs in accessing formal financial providers in comparison to the established, large enterprises irrespective of the economic condition of the country (Du et al., 2017; Maiti, 2018; Yoshino & Taghizadeh-hesary, 2017).

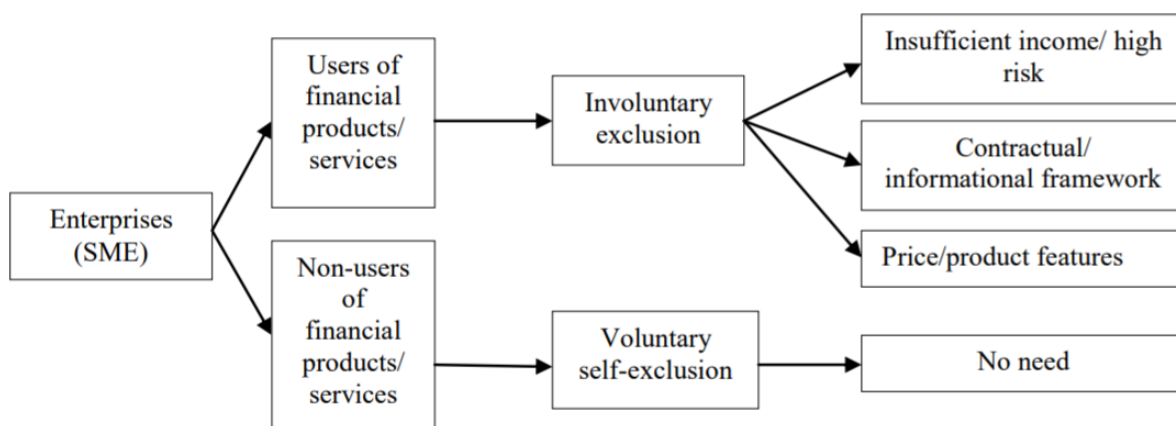
Accordingly, it is evident that lessening SMEs' financing limitations can generate a sustainable and healthy development of any country's economy. The World Bank (2003) has identified several factors that create restrictions to SMEs in accessing formal credit facilities. These limitations include the high risk involved with SMEs as regarded by banks, availability of current and historical information required by lending institutions and the absence of the required analytical skills of the lenders.

Further, it has been identified that the nature of Micro Small and Medium sized Enterprises often creates impediments in giving proper financial information to the financial institutions for estimating credit risk with in turn affects the formal credit lines (Aghion et al., 2007; Fuller & Mellor, 2008; Nijam, 2014; Roman, 2011).

In general, the financial inclusion or the access to financial products/services is meant to be a situation where there are no barriers to use financial products, irrespective of whether the barriers are related with pricing or not (Beck & Demirgüç-Kunt, 2008).

Thus, broadening this access to finance means increasing the availability of financial products/financial services for everyone and at a fair price.

The Figure 1 exhibits the types of financial exclusion in relation to SMEs.



**Figure 1 : The difference between the access to finance and the use of financial products/services**

Source: (Beck & Demirgüç-Kunt, 2008)



SME's are not capable of accessing debt and equity markets as a source of direct finance and therefore heavily relies on banks and financial institutions (Beck & Demirgüç-Kunt, 2008).

Fatoki & Smith (2011), categorized the availability of business information, security/collateral provided, networking and the capabilities of the management under the internal variables whereas the legal framework macro-economic factors, ethical and social perspectives are being categorized under external variables that affects the access to credit.

Information asymmetry between lending banks and borrowing firms have been regarded as the main reason that lead to a credit rationing problem (Stiglitz & Weiss, 2011).

Informational opacity problem of not having audited financial statements is another problem SME's must face and overcome. Coupled with methods used by banks to limit/screen the borrowers such as comparatively higher rates, necessities of past/historical records or strict collateral requirements has created a difficult environment for SME's to prove their credit worthiness (Uchida, Hirofumi, Udell, Gregory F., Yamori, 2012). It is common belief that banks are somewhat reluctant to server SME's partly due to deficiencies in the served collateral (Brewer & Genay, 2014).

The intuition is straightforward: commercial banks have the great difficulty in identifying the creditworthy borrowers, hence, to mitigate the default risk, banks will use a variety of screening devices such as high interests or strict collateral requirements.

Researchers suggests that access to credit in imperfect capital markets depends on the menu of assets that can be credibly offered as collateral by borrowers (Aghion et al., 2007; Hart & Prakash, 1997; Stiglitz & Weiss, 2011).

Regardless of the actions taken by the government to widen the availability of development finance to SMEs, majority of the SMEs still struggle to accomplish their financial/investment needs. (Department of Development Finance, 2018)

### ***3.2 Need of Government Intervention for the Development of SMEs***

The traditional institutional economists believes that the government intervention weakens entrepreneurship (Hart & Prakash, 1997), however, it is counter argued that the government financial assistance has a special role to play in reducing SMEs financial constraints by assisting them to generate additional capital through the formal finance sector.

Further it is argued that the government interventions to directly broaden the access to finance, however, are costly and contain the risk of missing the targeted groups (Claessens, 2006).

In other context, as evident in case of China, the intervention of the government has helped to increase profits of SMEs, by promoting the firms access to credit. Further, especially when the economic institutions in a country are not strong, the government intervention to design & implement programmes to improve firms access to finance is inevitable (Fu, 2017).

Furthermore, China's local governments have constructed strategic alliances with financial mediators (e.g., banks) and firms in making investment choices. The strategic alliance assures the promotional effect of government intervention on firms' access to finance (Norden, Roosenboom, & Wang, 2012).

Beck (2008) analyzed more than 70 developing countries and concluded that governments have roles of building proper institutions, setup the regulatory framework and undertake market-friendly policies in order to reduce financing obstacles for SMEs. Financial intermediaries are willing to support investments that involve government intervention because in case of difficulties they are assured of being bailed out by the local government (Fu, 2017). Further, the Chinese Government has intervened in the State-owned banks' credit policies in order to enable the SMEs to secure more bank loans (Du et al., 2017).

As directed lending is not an avenue that financial institutions generally tend to follow it may entail unforeseen risks and costs, which is normally the case when you venture into fields unknown. As such it would be prudent to consider the potential benefits

with the possible cost and impact of adopting a mechanism of direct lending as the first step (Ketley et al., 2012).

The Ministry of Industry and Commerce with the support of Ernst and Young carried out an assessment of the institutional and regulatory framework relating to the SME sector in Sri Lanka and suggested to formulate effective government policies to create linkages and to facilitate market for goods and services of SMEs.(Ernst and Young, 2019)

### ***3.3 Government Intervention in Sri Lankan context***

The Sri Lankan history of government intervention in order to facilitate the SMEs including farmers dates back to 1911 to the establishment of the Co-operative Credit Societies Ordinance. Subsequently, in later stages the government's credit policy was broadened, especially after 1977, under the open economic policy (Athukorala, Hal Hill, 2017).

Studies have discovered that these micro credit societies and programmes implemented by the government belong to different models. For example, the Farmer Bank Pilot Project Credit Scheme and Samurdhi Bank Finance Scheme are based on SHG models (Self Help Group) and operating as individual banking units linked with the centralized administration system (Gamage, 2003).

'Bhagya' and 'Isura' credit schemes have been implemented under model "intermediaries' involvement" where commercial banks and development banks being involved as facilitators (Chandrasiri & Bamunuarachchi, 2016).

The "Enterprise Sri Lanka" Programme, which was launched in the year 2017 has twenty two (22) schemes designed with an aim to support the SME sector in the country by providing financial and nonfinancial facilities at a concessionary rate with Government intervention (The Ministry of Finance, 2018). Further, in addition to Enterprise Sri Lanka, more than sixty (60) loan schemes are being implemented by the state and private commercial and specialized banks at the prevailing market interest rate by utilizing their own funds. (Department of Development Finance, 2018)

Altogether, during the year 2018, an approximate of Rs. 827,896 million has been granted by both state and private banks through all above schemes to fulfill the financial needs of the SMEs in Sri Lanka (The Ministry of Finance, 2018)

### ***3.4 Examples for Government Intervention Programmes***

#### **1. Mexico – Nafin Model**

A model has been developed by a government owned development bank named 'Nafin', in which many small suppliers are provided the opportunity to use their receivables from large creditworthy buyers, including foreign multinationals, to receive working capital financing.

The programme is designed to effectively transfer the creditworthiness of large firms to small firms and thereby allowing the small firms to access formal finance/credit at a cheaper price (Klapper, 2005).

#### **2. The U.S. – The CRA Model**

Community Reinvestment Act (CRA), endorsed in 1977 and revised in the year 1995, was implemented with the aim of helping the communities in which banks operate, including low- to moderate income neighborhoods, achieve their credit requirements.

Under this, each bank is rated once in every three years on its performance in making loans to low- and middle-income people, permitting the public to apply pressure to banks for noncompliance with the act.

Ratings were based on lending, services, and investment, with lending carrying the most weight. The success/failure of the programme is debatable with neither side having strong evidences. However, the number of small business loans (loans under \$100,000) increased from about USD 5 million in 1995 to USD 14 million in 2004 (Ou, 2006).

The CRA model is unique and has not been followed by any other country, which suggest that its applicability is limited due to the broader, political and economic context.

### 3. India - Directed Lending Model

In the year 2000, a target of 40% of net bank credit has been stipulated for lending to the priority sector by domestic commercial banks as part of India's priority sector lending requirements. Within this, a sub-target of 18% has been specified for lending to agriculture.

While the definition of priority sector has been widened over the years the program is troubled with targeting problems, with banks not being able to identify suitable lending partners within the designated sectors. Even though the priority sector lending for banks continues, microfinance is now being mainly recognized as a substitute to and an effective tool for promoting rural finance (Beck & Demirgüç-Kunt, 2008).

### 4. South Africa - Khula Schemes

Khula is the lead parastatal (an organization having some political authority and serving the state indirectly) appointed in the sector of SME lending in South Africa, with an authority to provide financing to the SMEs through banks and other lending institutions as a financier.

The two principal products introduced for SME financing are Khula Credit Indemnity Scheme and Non-Bank Retail Financial Intermediaries (RFIs). The indemnity scheme has been formulated to share risk with commercial banks through a partial credit guarantee (PCG). Credit facility is approved directly by the bank, which can apply to Khula for a guarantee when there is inadequate collateral of coverage up to 90%.

However, it is generally accepted that Khula has not been a success, where the new indemnities being reduced is highlighted as evidence (Fatoki & Smit, 2011).

## 5. Enterprise Sri Lanka (Sri Lanka)

There are 22 tailor-made locally-funded and donor-funded financial and non-financial schemes under the “Enterprise Sri Lanka Programme” with the intention to promote the SME sector which has been identifying as the mainspring of the economic development and support who are engaged in small scale subsistence agriculture to commercial scale agriculture respectively by introducing low-cost funds for automation and adopting the modern agro-technologies.

With the intention of making available low cost funds for the SME sector, which has been identified as the driving force of the economic development, 22 tailor-made locally-funded and donor-funded, loan schemes have been introduced under the umbrella of “Enterprise Sri Lanka”. The main aim is to support who are engaged in small scale subsistence agriculture to commercial scale agriculture respectively by introducing low-cost funds for automation and adopting the modern agro-technologies.

The Government has implemented this programme by introducing refinance and interest subsidy loan schemes to assist the SMEs and has created a path for SMEs and Self Employed persons to access to finance at affordable cost with a range of financial products

(Department of Development Finance, 2018).

However, evidence to the success/failure of the programme is not yet available thus further research works are encouraged to examine the contribution of Enterprise Sri Lanka Programme to financial inclusion of SMEs in Sri Lanka.

## 4. Conclusion

This study focuses on the challenges faced by SMEs in accessing finance from financial institutions.

Access to credit is essential for the growth of SMEs. A laissez-faire approach by the government, with regard to SME financing has surfaced allowing financial institutions to charge a premium, on funding SMEs. Although this proves a win - win situation for financial institutions the same cannot be said for their customer. Higher rates mean higher cost and eventually lead to SME's downfall. This in turn does very little to improve economic activity or reduce poverty which is a valuable by product of SME industry.

In contrast, government provides funding to SMEs by way of direct grants, concessionary loans through government banks and incentive programmes to financial institutions designed to improve SMEs access to finance.

Thus, it is imperative that the market for funds not be left solely in the hands of market forces. But given the general ill effects of state intervention, a more regulatory role is envisaged for the government. Government direct regulations mandating a set proportion of total financing be allocated to SMEs by financial institutions thereby giving inclusion to hitherto sidelined SMEs is one such way that the Government can indirectly promote a conducive environment for SME's.

However, often these types of measures lead to a "Moral Hazard" problem of making SME's dependent on handouts rather than encourage them to be efficient, innovative and competitive and self-sufficient. This situation is further exacerbated by the policies of successive governments to write off non-performing debts of SMEs or terminating long term economic assistance programmes when they are partially completed motivated by the myopic view of ensuring political gains.

SME funding is perennially faced with roadblocks which would also be restraining for emergence of new entrepreneurs. Certain remedies offer a glimmer of hope, which have been discussed in various literature and researches. Such as; promoting public private partnerships, improving rating mechanism to include SME's thereby removing information asymmetry, providing affordable pricing to SME's, streamlining financing procedures to SME providing less stringent access to SME's for affordable funding, to name a few.

It is evident that a paradigm shift in thinking is required to encapsulate SME's into the Banking network. Research suggests that in the present financial environment Banks tend to deter instead of promoting a favorable landscape. Though evidence is limited it can be surmised that the adoption of factors listed above would be beneficial to promote growth in SME sector by providing better access to funding. But further research is warranted to prove the same.

Further, future research could be conducted to examine the effectiveness of government invented programmes in reducing the problem of SMEs accessing to formal credits.



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