RESEARCH PAPER | Economics | Volume : 2 | Issue : 3 | December 2012 | ISSN - 2249-555X

Role of Development Banks in Promoting Small Scale Industries - Some Major Issues

KEYWORDS

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Introduction
All the banks interviewed have considerable exposure to the SME market, according to each bank's definition. Of the 16 banks interviewed, only twelve were able to provide the percentage flumes of SME loans when compared to the total loan book, whilst ten were also able to vide figures related to deposits. The reasons for the lack of a 100 percent disclosure on the taf the interviewed banks were varied. One prominent reason was that some of the banks -presented system limitations as their IT systems were not configured to identify an SME transaction (in particular deposits) from any other transaction. Moreover, almost all the central banks in the region do not specifically require banks to report on SME transactions.

The average aggregate exposure to SMEs measured by the ratio of SME loans to total lending to the private sector was 37 percent. Kenyan banks had the highest average loan exposure to SMEs (50 percent), followed by Uganda (42 percent), Tanzania (37 percent) and Zambia (18 percent). The highest reported loan exposure to SMEs was 87 percent (one Ugandan bank), whilst the minimum exposure was about 8 percent (one Zambian bank). The average deposit ratio from SMEs for the sample countries was 36 percent. Once again, Kenyan banks displayed the highest deposit ratio from SMEs at 49 percent with Zambia at the lowest end with 14 percent.

Banks had a much more difficult time quantifying the income contribution of SMEs. Only 44 percent of the banks were able to approximate the contribution of interest income on SME loans to total income. The same share of banks was able to quantify the contribution of total income from SMEs to total income. Only 25 percent of banks were able to quantify the contribution of fee income from SMEs to total income. The reasons for this were largely due to IT system limitations.

Overall, interest income on SME loans averaged 47 percent of total interest income in the aggregate sample of responding banks. Two banks reported each in Kenya, Tanzania and Uganda on interest income contribution of SMEs with Uganda reporting the highest contribution (62 percent), followed by Kenya (42 percent) and Tanzania (30 percent). In Zambia only one bank disclosed the figure, which was relatively high (60 percent) in view of the fact that the bank has its roots in the microfinance industry. Two banks in Kenya only reported on the fee income contribution of SMEs, which averaged 33 percent. The banks in other countries were not able to report on this variable. Three banks in Zambia and two in Kenya reported on the total contribution of SMEs to total income, with Zambia averaging 41 percent, largely because of the effect of the SME roots of the largest contributing bank. In Kenya two banks reported an average of 30 percent as the contribution of SME income to total income. However, given the difficulties most banks faced in quantifying these variables, the income contribution ratios can at best be considered as estimates.

Explaining the stylized figures
This section illustrates the factors driving banks' involvement with SMEs in East Africa. First, we present the main drivers behind banks' involvement and, second, the obstacles to SME lending as perceived by the banks. Then, we analyse the SME lending market in terms of structure and trends, and, finally, we present the banks' assessment of the role of government and prudential regulation in fostering SMEs' access to bank lending.

Drivers of bank involvement with SMEs
When the interviewed banks were asked to indicate the main drivers behind their participation in the SME market, the results were varied, although the perceived profitability of the segment was -consistently listed as the major driver. Sixty-three percent of the banks interviewed expect high profits from working with SMEs, which would more than compensate the relatively high costs associated with dealing with this segment. Intense competition for the corporate business was mentioned by 33 percent of the banks whilst "reverse factoring" was mentioned by 20 percent of the banks.

Fifty percent of Kenyan banks reported that they were motivated to participate in the SME market in view of its profitability. They also reported that the need to seek out SME relationships from existing large corporate clients (reverse factoring) was also an important factor (50 percent of banks). This is probably because of the existence of a well-developed corporate sector in Kenya based on value chains, when compared to the other countries in the region. A quarter of Kenyan banks also reported that intense competition for retail clients drove them to the SME sector.

In Tanzania, the perceived profitability within the SME sector and the need to avoid intense competition from other banks within the corporate banking market were both reported by 75 percent of the banks as the two main motives to participate in the SME market, whilst the need to reduce exposure to the corporate sector was mentioned by 25 percent of the banks.

Three Ugandan banks mentioned that profitability was the main driver for them to participate in the SME market. "Other" reasons included (i) generally positive perception of the long term opportunities within the SME market; (ii) follow the lead of other banks and (iii) involvement with SMEs because it was a specific area of specialization for certain banks. Only one Ugandan bank mentioned the need to pursue SME relationships through links with existing corporate clients as a significant driver.

In Zambia, 75 percent of banks also reported that the profitability of the sector was the main driver to participate in the SME market. Intense competition for the corporate market was mentioned by 50 percent of the banks, with the need to reduce exposure to both corporate and the retail markets featuring for 25 percent for the banks.

Obstacles to bank involvement with SMEs
Obstacles to SME lending are perceived differently across the countries and perceptions are also influenced by the nature and ownership structure of the bank concerned. SME-specific factors are the most serious obstacle to the development of SME lending. In particular, a large majority of banks in the region (88 percent) consider the lack of adequate information the most important deterrent to their involvement

Volume : 2 | Issue : 3 | December 2012 | ISSN - 2249-555X

with the SME segment. Amongst Kenyan banks, the lack of quality information was the biggest SME-specific hindrance and obstacle to SME lending, cited by 100 percent of the banks. Such is the perceived extent of the problem that some of the banks mentioned that they have allocated internal budgetary resources to assist SMEs through the extension of training services. Family management was also mentioned (50 percent) as a hindrance in Kenya as most SMEs are family-owned. Inability to standardize scoring models also came up from 50 percent of the banks, especially amongst those which have automated their SME lending systems.

Banks in Uganda appear to be facing similar challenges, with the lack of reliable information listed by all banks as the main hindrance to SME lending. However, the issue of collateral is a Significant aspect in Uganda with 50 percent of the banks mentioning the lack of adequate guarantees as an obstacle to SME lending. The Bank of Uganda stipulates that all loans above a certain minimum must be adequately secured, with first-class guarantees or a bond over property as the preferred security type. However, this makes it difficult for Ugandan banks to lend to SMEs in view of the various challenges that this sector faces in terms of coming up with such acceptable security.6 The fact that SMEs are largely family-owned does not appear to be a significant obstacle in Uganda. Scoring shortcomings, informality and high costs to improve information were mentioned by at least one bank in Uganda as perceived obstacles.

All the Tanzania banks also cited the lack of information as the biggest hindrance to SME lending. This, according to most Tanzanian banks, affected the quality of information provided by SMEs, amongst other things, with 75 percent of Tanzanian banks mentioning this aspect as a significant obstacle to their dealings with SMEs. One Tanzanian bank mentioned that they had allocated significant resources to training their SME clients in order to improve both their business skills and quality of information submitted. The issue of the lack of third-party guarantees to address collateral issues was mentioned by one of the banks in Tanzania as a hindrance to doing business with SMEs .

For Zambian banks, only two of the obstacles were relevant: lack of quality information and limitations on the scoring systems were each mentioned by 75 percent of the banks as the main obstacles to SME lending.

Macroeconomic factors were identified as the second most worrisome impediment to the development of the SME financing market, with 75 percent quoting this element. The relative degree of importance of this factor, however, differs from country to country. There are noticeable patterns in the responses provided by the surveyed banks, which to a large extent are influenced by recent economic events. For example, all banks in Zambia mentioned that the biggest macroeconomic obstacle they face is exchange rate and interest rate instability. This is largely due to the fact that the Zambian kwacha has historically been volatile, though it has of late stabilized. Ugandan banks on the other hand all mentioned long term economic instability as an obstacle. At the time of the survey, Uganda was going through a period of accelerating inflation with both interest rates rising and the Ugandan shilling depreciating against major currencies. Only one Ugandan bank specifically mentioned exchange rate and interest rate risk. In Kenya three variables were listed as important deterrent to their involvement with SMEs: (i) long term instability; (ii) exchange rate and/or interest rate risk; and (in) ceiling prices. Factors which might have influenced the selection by Kenya banks include apprehension over the general elections which were pencilled to happen within fifteen months of the survey date and the fact that the Kenya shilling, like the Ugandan shilling, was also depreciating against the US dollar at the time of the survey. The Tanzanian banks were not particularly concerned about the effect of the macroeconomic environment on their ability to lend to SMEs. In their view, the macroeconomic factors that affect their whole banking activities were not specifically affecting "the SME segment in isolation from other lending activities. Only one Tanzanian bank mentioned (i) long term instability; (ii) exchange rate and/or interest rate risk and (iii) ban on exports as obstacles to growing its SME business.

Another factor which appears to have a significant impact on SME financing in the region is business regulation. A large majority of banks in Kenya, Tanzania and Zambia regard this area of regulation as exerting a significant impediment to SME lending. Banks in Uganda, however, did not see business regulatory requirements as a whole as an obstacle to SME financing, with the exception of collateral requirements previously mentioned. The most common complaint was that the business aspects of "know your client" (KYC) process imposed by most of the central banks in the region were too stringent for SMEs. The documentation required in most instances was to a large extent akin to that required for large corporations and therefore considered excessive for SMEs. Most of the countries in the region do not have a separate simplified business company registration process for SMEs, which is any different from the process for larger corporations, with the result that documentation requirements prove to be excessively burdensome for SMEs. Overall, 50 percent of the banks stated that the documentation requirements were a significant obstacle to SME lending.

Obstacles in the legal and contractual environment were also seen as negatively impacting SME lending in the region, though the overall investment climate can be considered an obstacle to private sector development in general and not only to SME financing. Judicial inefficiencies, in particular, were perceived as a very significant obstacle to SME lending, with half of the banks surveyed mentioning them. Three quarters of the banks in Kenya, Tanzania and Zambia mentioned this aspect, whilst only one in Uganda quoted it. Specific aspects of judicial inefficiencies and other legal obstacles which were mentioned included (i) general efficiency of the court systems; (ii) political influence; and (iii) the fact that SMEs can easily get injunctions stopping enforcement of contracts. A quarter of the banks in the region also mentioned the lack of contractual enforcement as an obstacle to their involvement in the SME finance market.

The nature of SME lending was reported as another significant obstacle. In particular, 50 percent of the banks were of the opinion that the difficulty in standardising the risk assessment made the SME lending process problematic. This was particularly noticeable with banks which have to a certain extent automated their internal credit systems. To make them work, 44 percent of the banks mentioned that they would need to adapt their commercial operational models in order to accommodate the peculiar needs of SMEs. Another internal obstacle was the fact that some banks (38 percent of the total) were finding it difficult to lend to SMEs the same products as those extended to corporate and retail clients.

The obstacles given the lowest importance were bank-specific factors. These varied from bank to bank, irrespective of the country of operations. Less than half of the interviewed banks (44 percent) mentioned that the lack of appropriate technology and skilled staff represented an important obstacle in their efforts to serve more SMEs. General staff and operational inefficiency also featured among one-third of the banks. Two Kenyan banks mentioned that they were still new to the segment, and they were finding this to be a significant challenge. One bank in Kenya had resorted to recruiting SME teams from other banks in order to boost its own staff skills base. "A bank in Uganda mentioned that it had to restructure their credit appraisal processes by centralizing it in view of an acute shortage of staff skills at branch level.

SME lending market environment

The SME market in the sample countries is considered large and with very good prospects. This indicates that all banks in the region are very bullish about the outlook for the regional SME market. In particular, almost all banks (93 percent) agreed that the regional SME market was competitive, but

Volume : 2 | Issue : 3 | December 2012 | ISSN - 2249-555X

not yet saturated. In view of this, it is not surprising that most of the banks mentioned that they were aggressively seeking out new SME clients despite the strong demand. Eighty-one percent of the banks mentioned that they are actively involved in some marketing activities to reach out to SMEs.

Almost all the banks in the region (88 percent) said they considered that there have been significant shifts in the bank SME financing market in recent years. This seems to be corroborated by the fact that most of the banks which had SME departments in place had established them during the past five years. The region has over the past ten years liberalised its financial markets leading to extensive structural changes. In all the four countries, several institutions which used to specialize in microfinance applied and obtained a banking licence, leading to a proliferation of new banks with very strong microfinance traditions. This created competition for the "traditional" banks, which seemed to focus largely on the corporate and personal/ consumer banking business, as the new banks sought to move into the relatively unexploited "middle sector".

The motivation for the interviewed banks to get involved in SME financing was to a large extent not driven by the moves of competitors. Almost alt banks (81 percent) reported that they did not become involved in SME financing because of the need to follow other banks. Finally, 63 percent of the banks were of the opinion that it is important to be one of the first movers in financing the sector.

The structure of the SME lending market differs amongst countries, and there is no full agreement within countries. Amongst Kenyan banks, 50 percent were of the opinion that the market was segmented, with certain specific SME market sectors being served by specific financial institutions. One (25 percent) Kenyan bank was of the opinion that the market was dominated by a small number of banks, whilst the other one was of the opinion that the market was atomized. In Uganda, the majority of banks perceived the market as dominated by a small number of banks. Three-quarters of Tanzanian and Zambian banks were of the opinion that their respective SME lending markets were segmented. On the whole, 56 percent of the regional banks interviewed were of the opinion that the regional SME loan market was segmented (4). The main players in the region are large private banks, according to a large majority of the interviewed banks (69 percent). They are followed in importance by niche banks and other financial intermediaries .

Conclusion

The need for the government to play an active role in the development of a vibrant SME loan market in the region differed from country to country. Kenyan banks reported that the lack of adequate government support was hindering the further development of the SME sector and that they would need their government to assist in creating an enabling environment, including the provision of financial support. At the time of the survey, the Kenyan government had a draft bill for the support of the SME sector awaiting enactment.7 One of the Kenyan banks was making extensive use of government-supported facilities, whilst the other banks appeared not to consider accessing government sponsored funding instruments as helpful and depended largely on their own internal loan processes.8 The merits of the credit reference bureau were agreed to by all the banks interviewed although all of them mentioned that it was still new and still needed to accumulate a decent database and was therefore not currently influencing their lending decisions in a significant manner.