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# Institutional Finance for the Development of Small and Medium Scale Enterprises – Globe Scan

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**Introduction**

Small and medium enterprises (SMEs) play a major role in economic development in every country, including in African countries. Studies indicate that in both advanced economies and developing countries SMEs contribute on average 60 percent of total formal employment in the manufacturing sector (Ayyagari et al, 2007). For African economies, the contribution of the SME sector to job opportunities is even more important. Taking into account the contribution of the informal sector, SMEs account for about three-quarters of total employment in manufacturing (Ayyagari et al, 2007).

A crucial element in the development of the SME sector is access to finance, particularly to bank. financing, given the relative importance of the banking sector in serving this segment. Firm-level data collected by the World Bank show that access to finance is perceived as one of the main obstacles to doing bus iness (World Bank, various years). A number of studies have shown that financing is a greater obstacle for SMEs than it is for large firms, particularly in the developing world, and that access to finance adversely affect the growth of the SME sector more than that of large companies (Schiffer and Weder, 2001; Beck et al, 2005; Beck et al, 2006). It is, therefore, 'unsurprising that the international development community has listed SME access to finance as an important policy priority.2

In spite of the importance of the topic, relatively little research exists on whether, why and how banks finance SMEs around the world. This is compounded by the fact that comprehensive data on SME finance is still to be more consistently collected and monitored over time.3 Nonetheless, existing studies show that, contrary to the conventional perception that financial institutions are not interested in dealing with SMEs, banks consider the SME segment strategically important. Yet institutional constraints remain and the market is far from saturated.

Beck et al (2008; 2010) provide the first attempt to understand SME financing from the supply side. Based on a survey of 91 banks in 45 countries, the authors provide a characterization of bank financing to SMEs and find that banks perceive the SME segment to be highly profitable and serve it through a number of lending technologies and organizational setups. The authors observe few differences in the extent SMEs are reached out by banks based on their ownership structure (i.e. public, private or foreign-owned). However, they find significant differences across banks based in developed and developing economies, and conclude that the enabling environment is more important than the size of the firm or bank ownership in shaping bank financing to SMEs.

De la Torre et al (2010) investigate banks' approaches to SMEs in terms of business models and risk management systems. Based on surveys for 48 banks and one leasing company in 12 countries, the authors find that all banks in the sample are interested in serving the SME segment. To do so, almost all have separate organizational units and offer a wide range of products, applying different transactional technologies such as credit scoring or risk-rating systems. The authors conclude that the conventional wisdom according to which large banks are not attracted by SMEs and that this business is dominated by small banks and based on relationship lending does not hold in practice.

In a similar study, Rocha et al (2011) investigate the status of bank financing to SMEs in the Middle East and North Africa (MENA) based on a survey of 139 banks in 16 countries. The authors find that in spite of a positive perception of the attractiveness of the segment, the SME sector in the region remains largely underserved. Direct government interventions through public banks, credit guarantee schemes and other forms of subsidized financing play a major role in SME lending, partly compensating for the low level of private sector involvement, which in turn reflects the MENA's weak financial infrastructure.

Finally, Stephanou and Rodriguez (2008) analyze both trend and structure of the SME financing market in Colombia. They find that banks in the country regard the SME segment as an attractive business opportunity though their level of sophistication in terms of business models and risk management tools remains modest. The authors conclude that the market is characterized by a Tiumber of institutional and policy constraints, which inhibits further growth of SME lending.

Ongoing efforts to study SME financing from a supply-side perspective are particularly relevant for Sub-Saharan Africa. According to enterprise-level data collected by the World Bank (various years), SMEs in Sub-Saharan Africa are more financially constrained than in any other developing region. Only 20 percent of SMEs in Sub-Saharan Africa have a line of credit from a financial institution compared, for example, with 44 percent in Latin America and Caribbean, and only 9 percent of their investments are funded by banks versus 23 percent in Eastern Europe and Central Asia. These findings alone provide the rationale for investigating the structure of the SME lending market in the region, with the aim to understand the main drivers and obstacles to SME financing as well as banks' operational approaches.

This paper contributes to the growing literature on SME finance. Its purpose is to shed light on current trends and practices in bank financing of SMEs in four East African countries, i.e. Kenya, Tanzania, Uganda and Zambia.4 The comparison among these countries is interesting because they are neighbours, they are all growing, emerging economies and they have implemented a number of financial reforms in recent years, with their banking systems becoming increasingly integrated. In particular, this paper forms part of a broader African Development Bank regional project on this topic, whose objective is to identify best practices in SME lending as well as constraints that impede growth in the SME finance market so as to draw relevant policy implications.

The approach used for the study was based on a tabulated questionnaire followed by on-site interviews with banks' senior management. The format and the questions of the questionnaire were drawn from previous surveys developed for analysis in different markets (see Beck et al, 2008 and 2010; De la Torre et al 2010) and slightly adapted to cover topics not included in the previous surveys but which may have an impact on SME bank financing in East Africa such as micro-prudential regulation. The interviews and data processing are confidential. This was meant to provide comfort to the banks in sharing their information, with the understanding that data would be presented in aggregate way, without disclosing each bank's position or strategy. The questionnaire included 90 questions divided in three broad analytica! areas, which are described in detail in this paper. The first area deals with banks" involvement in SME lending. The second area focuses on the determinants of banks' involvement with SMEs such as corporate strategy, market structure, government policy and regulation. The third area attempts to understand how banks engage in lending to SMEs, with a special emphasis on the nature of their business models and risk management systems.

To conduct the study, the questionnaire was submitted to 16 banks, four banks in each country. On-site interviews were con-

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ducted by the authors between August and September 2011. The banks interviewed were selected based on the anecdotal consideration that they are among the most active in SME credit markets in their respective countries. In Kenya, we interviewed three foreign banks and one domestic private, accounting for 23 percent of total banking assets as at December 31, 2010. In Tanzania, we interviewed one public bank, two domestic private and one microfmance institution, representing 52 percent of the banking system at end-2010. In Uganda, 'we interviewed three domestic private banks and one foreign, accounting for 36 percent of total banking assets in 2010. In Zambia, we interviewed two foreign and two domestic private banks, accounting for 57 percent of the banking system at the end of 2010. Overall, the interviewed banks represented 37 percent of the regional banking system in terms of total assets at the end of 2010. While the relatively small size of the sample might introduce some bias in our conclusion, we believe this is partly mitigated by the fact that the banks selected are representative of bank financing to SMEs in the region.

All the banks interviewed completed the questionnaire provided, though in several cases not all questions were answered. Overall, this hampers our ability to reach definite conclusions regarding the evolution and the present situation of bank lending to SMEs in the region. The percentages referred to in this paper were calculated based on the sample of total banks interviewed and rounded to the nearest whole number. By definition, each bank accounted for 6.25 percent of the total sampled The percentages are usually calculated for the aggregate sample of Kenya, Tanzania, Uganda and Zambia, and when relevant, these percentages are presented by country. In this case, the percentages are calculated based on the number of banks in each country (four).

We find that the SME segment is a strategic priority for the banks in the region. SMEs are considered a profitable business prospect and provide an important opportunity for cross-selling. Banks consider that the SME lending market is large, not saturated and with a very positive outlook. A number of obstacles are, however, constraining further banks' engagement with the SME segment, including SME-related factors such as the lack of adequate information and collateral as well as their largely family-owned structures. Macroeconomic factors, business regulation, the legal and contractual environment, the lack of a more proactive government attitude towards the segment, some areas of prudential regulation and some bank-specific factors are also perceived to negatively affect the SME lending market in the sample countries. Nonetheless, banks have adapted to their environment and developed mechanisms to cope with it through innovation and differentiation. Most banks have dedicated units serving SMEs, to which they offer largely standardized products though the degree of personalization is growing. And albeit advanced transaction technologies based on scoring and risk-rating systems remain relatively underdeveloped, banks are gradually automating their risk management frameworks to achieve efficiency gains. On the whole, our findings are broadly akin to those of similar studies in other geographical contexts (see De la Torre et al, 2010), suggesting that the strategic interest of East African banks in the SME segment can make an important contribution to closing the 'lSME financing gap" in the region compared to other developing countries. We conclude that this trend should be supported and encouraged through reforms to soften the negative impact of those obstacles which are hindering the further involvement of banks with SMEs.

The rest of the paper is organized as follows. Section 2 presents some stylized facts on bank involvement with SMEs in the four countries surveyed. It explains the criteria used to define SMEs and the extent of SME lending. Section 3 focuses on what is behind these stylized facts. It provides a description of the main drivers and obstacles of SME lending, features of the market environment, the role of government and prudential regulation. Section 4 addresses how banks in "the region engage with the SME segment, describing their business models and risk management tools. The sub-section on business models focuses in particular on the general organizational structure and the products offered to SME clients. The one on risk management provides details on the credit risk analytical framework, the monitoring of exposures and the management of nonperforming loans. Section 5 concludes and offers some policy implications.

**Some stylized facts on banks' involvement with SMEs**

In this section we present some stylized facts on SME lending in the region. First, we examine the criteria banks use in classifying SME clients and exposures. Second, we provide an overview of the extent of banks' involvement with the SME segment in Kenya, Tanzania, Uganda and Zambia. In this respect, we also assess the relative contribution of SMEs in terms of banks" income.

**Definition of SME**

The definition of SME differed amongst the banks interviewed. As a general note, some of the banks interviewed especially the smaller banks and those which had a strong microfinance background, tended to have very low thresholds for a business to qualify as an SME. The bigger and more established traditional commercial banks tended to have much higher thresholds. Fifty-six percent of the banks used more than one criterion to define an SME; 38 percent used at least two criteria, whilst 13 percent used four criteria to define an SME.

The most widely used criteria were loan size and company turnover, both of which were employed by 69 percent of the banks. Staff size was an additional SME definition used by two banks in Kenya and one in Tanzania (or 19 percent of the banks in the sample). No bank in Uganda and Zambia used thiscriterion, i.e., staff size, to define an SME. Capital employed was used by one bank in Kenya and one bank in Tanzania, whilst aggregate income to bank was used by one bank in Uganda (see Figure 1).

Most banks which used the turnover as a classification criterion reported very wide variances in the qualifying amounts, with the minimum turnover between zero (two banks in Tanzania and on in Zambia) US$1 million (one bank in Kenya). The banks which reported a very low minimum turnover threshold also reported a relatively low maximum turnover threshold of US$1.8 million (see Table 1). Interestingly, the maximum turnover threshold for the lower reporting banks was not anywhere close to the minimum turnover threshold of the banks with the higher thresholds. In addition to the influences exerted on a bank by its historic background, one of the reasons noted for this wide variance was the actual 'location' of the SME department within a particular bank. Banks which housed their SME departments within the "corporate banking unit" tended to report very high turnover thresholds, whilst those which housed their SME departments within the "retail banking unit'7 tended to report very low thresholds.

**CONCLUSION**

The same trend was also noticeable with banks which use loan size as an SME defining criterion. The lowest loan size is between zero and US$5,000 which was reported by a bank in Tanzania, whilst the maximum SME loan amount is US$10 million (reported by a Zambian bank). The banks with the lowest loan size criteria largely have a microfinance background. Commercial banks, especially international banks, use much higher loan thresholds. The lack of a single definition of SME makes comparison between bank lending practices "somewhat inconsistent. However, it would be very difficult to construct a single definition for the purpose of this study. Therefore, in line with the approach followed in similar studies (Beck et al, 2008 and 2010; De la Torre, et al, 2010) we ignore the heterogeneity of ranges observed in the definition of SMEs and use whatever classification is used by the banks surveyed.