

# SME Lending: A Long Term Commitment towards the Development of Industry

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## ABSTRACT

**Purpose:** The basic purpose is to find out the impacts of SME lending on their development. While conducting the research, a clear objective was established in order to explore the relationship between SME lending and its ultimate impact on the development of SME sector in Bahawalpur, considered as SME Concentrated market of the economy.

**Design/methodology/approach:** The research have been conducted utilizing the actual data with the help of a questionnaire based on the literature studies extensively on SME's lending and the impact on its development to explore the attributes which leads towards the establishment of SME's lending in Bahawalpur region. A new dimension is added by conducting research on SME's lending and the impact on its development in Bahawalpur region, taking sample of 100 respondents from 20 banks and their customers.

**Findings:** Factors abstracted from the market concentration, commercial vs. SME's lending, issues of SME's lending, Term of loan, size of enterprises, self employment in SME sector that they are significantly associated with SME's establishment.

**Research limitations/ implication:** The results found are based on available material being studied. A structured questionnaire has been used to collect data from a sample of 100 SMEs being financed by financial institutions of Bahawalpur region.

**Practical implications:** The financial institutions in Pakistan are needed to take initiative in creating awareness about SME's lending and providing more effective services to their customers. The results can be generalized on over all SME lending practices in Bahawalpur region. The facilities to cottage industry could be made from the effective use of findings in this paper.

**Originality/ value:** This is one of the very first researches on SME's lending and the impact on its development conducted in Bahawalpur region and could be very useful for countries adopting SME'S lending.

**Key words:** SME lending, SME's establishment, Cottage industry, SME Financing, Small Loans.

## **INTRODUCTION:**

This research that has been conducted on SMEs lending provides the comprehensive knowledge and information about how the modes of lending to SMEs are affecting the process of SMEs establishment in a particular area and how these factors can be used as measures of growth. This research is conducted in Bahawalpur region so as to explore SMEs establishment there because this area is highly concentrated with SMEs and facing issues as well.

After considering literature on the subject matter we found several variables that are affecting it like market concentration of financial institutions and SMEs, time of loan, terms of loan, size of enterprise, commercial v/s SME lending and self employment, all of these have enormous effect on it. As this is a quantitative research, response from target respondents is also taken into account to make the research more valid and reliable. Therefore this paper will explore all possible factors that have impact on establishment or that can help towards the growth of SMEs in the area.

## **LITERATURE REVIEW**

After considering the available literature on researches conducted on SME lending, following are the important variables that have effect on the modes and process of lending generally.

### **1. Commercial Vs SME Lending:**

Commercial lending has relative lead to make use of transactions lending technology based on solid information while as SME'S may take in with relative advantage through relationship lending technology based on soft information (Berger & Udell, 2004). Big organizations may perhaps capable towards acquiring benefit of large scales economies during dispensation of solid information, however survival comparatively unfortunate by the side of dispensation of soft information as it is problematical to enumerate and broadcast throughout the communication channels of big organizations (Stein, 2002). Credit official of financial institutions has an immediate access along with the SME is storehouse of soft information that cannot be communicated smoothly to the administration or owners of the financial organization. So that SME'S are capable to take comparative gain in relationship lending, through lesser agency expenses in the organization (Berger and Udell, 2002).

Large institutions are to some extent disadvantaged by relationship lending toward SMEs, because of the diseconomies of organizations and by way of providing transactions loans and complementary widespread services to big company clients (Williamson, 1988). Big financial institutions believe in lending to SME'S which are big, mature and money-wise safe (Ou, Haynes & Berney, 1999). Large institutions; in lesser operating expenditures employ lending technologies, which are expected to be transactions loan. And they have not as much of special, short-term, more coldly, furthermore lengthy space interaction with their SME credit clients (Berger, Stein, Petersen, & Rajan, and Miller. forthcoming). It can be said that SME credit consideration of large financial institutions are stand on accompanying well-built financial ratios than on prior relations with SME'S (Cole, Goldberg, and White 2004, Berger, Miller, Petersen, Rajan, and Stein forthcoming).

Furthermore large quantity of physical assets can be presented by big organizations for supplementary collateral as bank call for, which lead to a comparative increase in commercial lending. While SME'S are not able to provide collaterals like big organizations due to its scarce resource and neglected by banks for lending. Collateral be able to job the same as indication and communicate information of organization's scheme excellence (Bebzuck, 2003). Role of SME'S is important for economic growth and employment creation but finance gap is main hurdle in their establishment which is comparatively not faced by big organizations. SMEs' chiefly rely on bank source for getting finance. The main hindrance to get bank financing is solid information abnormality among borrower and lender, and this abnormality became more serious For SMEs, due to their small volume, short record, incomprehensible bookkeeping etc, as all the internal funds, collaterals firm size, contractual clauses are factors affecting firm's ability to borrow loan from banks (zhao, wu & chen, 2006).

## **2. Market concentration of SMEs:**

Market concentration of small and medium size enterprises has a great impact on lending provided to small and medium enterprises. Concentrated markets may have positive or negative effect on policies made by financial institutions regarding provision of loan to SMEs. With respect to these policies the access to credit may reduce, using lending technology either relationship lending or transaction lending. Institution may use the scenario of market concentration in their favor for increasing their profitability rate by charging high interest rates on loans being provided to organizations (Berger and Udell, 2003). In a concentrated market financial institutions want to reduce risk and supervisory burden, for this purpose they formulate quite stiff policies for allowing credit to SMEs or they adopt less aggressive policies to attract creditworthy customers as they have enormous number of options for allowing credit. Institutions attain market power in concentrated markets; they use to provide subsidized interest rate in short term period and then receive competitive rate after that particular period institutions (Sharpe 1990, Petersen and Rajan, 1995).

As there are a large number of enterprises operating in that particular area, financial institutions always adopt those ways that helps in reducing the default rate. They formulate and execute those policies through which they get refined documentation for enterprise to be allowed financing. Higher concentrated markets lead to increase interest rates provided by institutions and has effect on modes of lending. Recent studies have shown the effect of banking market

concentration and other factors like regulatory restrictions on competition on SME performance. Some have found these effects as unfavorable and some as favorable (Jayaratne et al, 1998).

While some have a point of view that results may differ due to modes of lending and economic conditions. Market concentration is associated with SME lending regarding terms and policies made by financial institutions (Berger and Udell, 2004).

### **3. Size of enterprises (SMEs)**

From the reliable theory and its analysis we know that the major factor which affect SMEs' ability to borrow from bank is the size of firm. For small enterprises various capital structures are observed. If small size firm starts rapid growth then the result will be financial gap because these firms have no excess to the capital market. Relationship with other parties and capital providers is the main problem of small enterprises. Small enterprises argue that the irregular information and ways to deal with problems bonding and monitoring are not possible or very expensive. So that to lessen the problem lender relies on collateral. Size of business has negative relation with total debt ratio (Gupta, 1969). Small enterprises rely on their savings and bank loans than large enterprises. In case of small enterprises there is inconsistency in growth and profits. With increase in size profitability also increases (storey et al, 1987). Collateral become less important and long-term debt are available if flotation had been achieve (Chittenden, hall and Hutchinson, 1996).

Large amount of new firms are included in micro-firms. For medium size firm there is an important relationship between long term debt and growth, they rely more in borrowing. When the size of firm is large enough then financial institutes are ready to lend to them on their growth potential basis. Basically, collateral is not related to total debt strongly but there is positive relation between long-term debt and collateral or strongly negative relation between short-term debt and collateral. According to various studies, Small enterprises face more financial hurdles as compare to those large size businesses. Small enterprises have less access to credit because small firms have ambiguous financial information. Mostly entrepreneur is proprietor and manage SME himself and financial information is not reported on daily basis. Small firms have not as much of assets to propose as collateral. The banks utilize collateral as one of the tool, in order to reduce the estimated risk and ethical vulnerability linked with lending. The collateral ensures the borrowers commitment to the loan repayments and also provide guarantee to the bank in case of fail to pay. Higher cost of financing is faced by the small and growing firms and they are essential to suggest collateral (Berger and Udell, 1995).

### **4. Terms of loan**

The Small and Medium Enterprises (SMEs) play an important role in the economic development of the Pakistan. For the encouragement of SMEs the State Bank of Pakistan issued special Regulation for the flow of their credit. For their development, the banks are helping the SMEs for the preparation of lending programs. The banks are also conducting research for the determination of their sub-sector. According to the encouragement of SBP the banks are providing credit to SMEs on the basis of their future cash flows. For the better understanding of SMEs, the banks are providing loan's application in their regional languages.

In terms of providing loan to SMEs there are some certain regulations. First of all the banks identify the key drivers of the business of their borrowers. The banks provide loan on the basis of assets conversion cycle and the future cash inflows. There are also some personal guaranties for the purpose of lending to SMEs. Usually owner of the SMEs provides the guaranty. In some conditions if there are limited numbers of companies then the directors provide the guaranty (Hussain, 2011). In order to provide the cash flow basis lending the banks has the authority of clean exposure; if banks provide the Rs 3 Million to SMEs the exposure should not be more than 2 Million. And also for the security of the interest the banks are free for their margin requirements on providing facilities to SMEs. The single SMEs can get the loan of Rs 75 million from a bank. Total facilities those are available for SMEs shall not be more then Rs 150 million including all the leased assets. And when it does not include the lease assets then this amount is restricted to Rs 100 million. For the purpose of record the banks also get the financial statement of the SMEs where the exposure of bank exceeds Rs 10 million. And also the banks ensure that the loan which they are providing having a proper utilization of the loan (Hussain, 2011).

### **5. Self Employment in SME sector:**

It is the important feature of SME sector that it has abilities to generate job opportunities. The supply of labor force continues to a rapid increase in Pakistan; due to this factor unemployment is increasing likewise. According to the figures published in economic survey 2004-05, during 2001-02 to 2003-04 labor force in Pakistan has increased from 42.39 to 45.23 million. When millions of unemployed workers are there in market, there is a crucial need to promote small scaled economic activities where labor is required. Besides this, the size of modern sector is expected to remain small in the coming years because capital available for business is quite limited. In these circumstances, economic activities limited to small scale can serve as a ray of hope. Small scale businesses are fortunately accepted in our society and are growing gradually. Small and medium enterprises have a vital role in creating job opportunities, they promote innovation, encouraging an environment of competition and increasing economic wealth. SMEs are contributing extensively in economic growth but are neglected in researches. These small firms have proved that they have extensive impact on employment growth as compared to large sized established businesses. Empirical studies have declared that small fractioned businesses have ability to generate considerable wealth and create opportunities of job. The scheme of self employment requires that loans must provide to unemployed people and to small size businesses which are working at present and looking for extension in business. This scheme is an inflated and compassionate account launched in 1992 with the support of the Small Business Finance Corporation SBFC. As compared to the requirements in previous scheme, the requirements of security in the new self employment scheme are moderate. SBFC tackled with a default rate of about 50 percent on its expended loans when former version was operating during 1992-96 (Hussain A, 1999).

The self employment scheme went Rs. 250 billion up to the initial target of this scheme consequently that was Rs. 7 billion. The array of individual loans varies from Rs. 50,000 to Rs. 500,000; at 15 percent interest rate which is lower than up to 5 percent as compared to the interest rate on loans borrow for commercial purposes. It is a requirement of self employment

scheme, the applicants must be at or above a minimum age of 18 years, but there is no upper age limit. Conversely, qualification or any previous experience of business handling is not the prerequisites to be an applicant of SES. The self employment scheme doesn't offer training to borrowers in the business they are going to start. It is neither concerned with borrowers in provision of technical support, in promoting their business nor to monitor the unit specifically. SMEDA has started monitoring those banks which are distributing the loans. More than the last two decades micro enterprises are highly acceptable in Pakistan and in other countries of South Asia because when the lenders are offered with a package of additional services go along with SME loans; micro enterprise loans have a low default rate and are helpful in increase in income of poor. These additional services include vigilant assessment of micro enterprises, project proposals, communal enlistment, configuration of group, technical training and support and provision of facilities to market their enterprise at community level, to come as a part as participant in development of business. *Aga Khan Rural Support Program*, *SUNGI development foundation*, Pakistan Institute for Environment-Development Action Research, Punjab Rural Support Program and Orangi Pilot Project-research and training institute; are the regions in Pakistan where default rate is up to five percent on loans and affect considerably on the lenders' incomes (Hussain A, 1999).

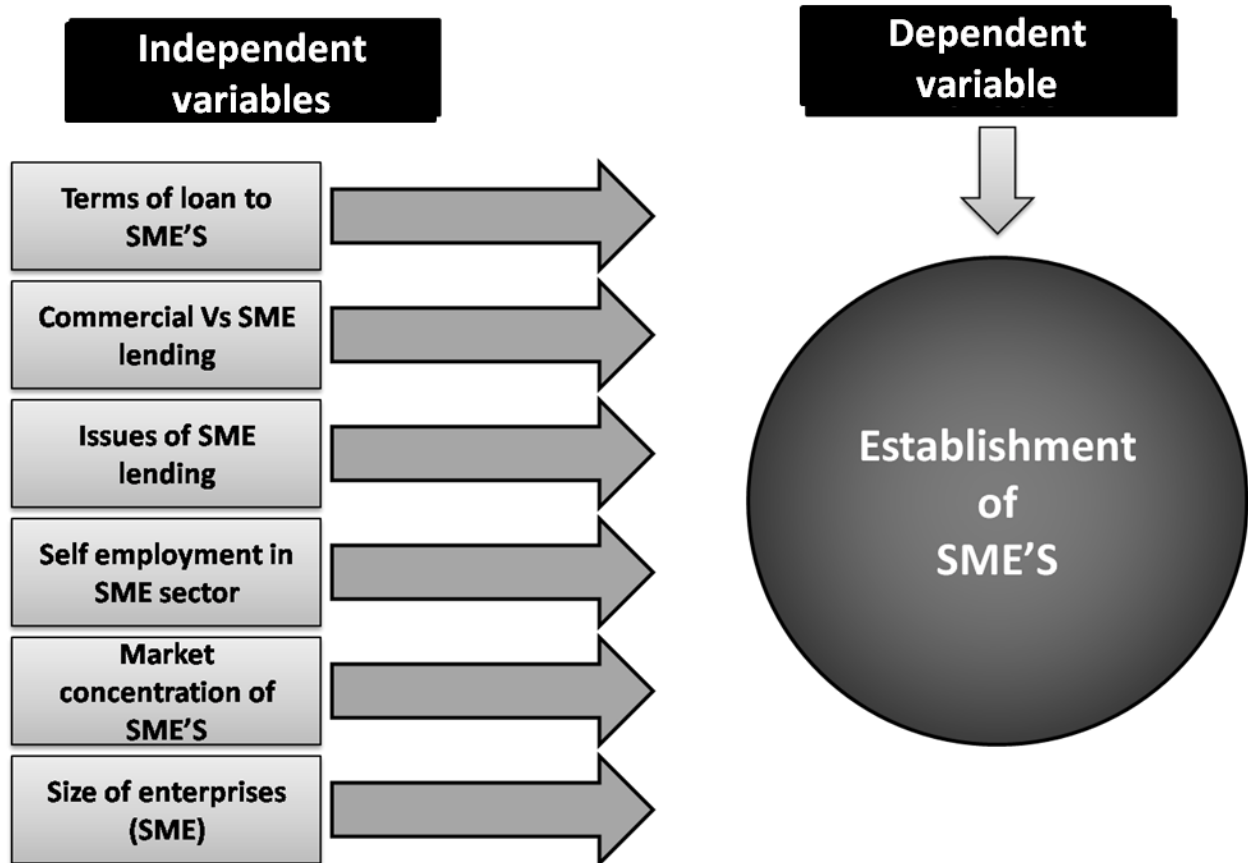
#### **6. Issues of SMEs lending:**

The SME's are providing more employment as compare to the large firms because there is more utilization of labor in SME's. The SME's are also contributing in the other sectors of Pakistan economy as well for example in GDP, employment, industry, import export sector agriculture and to reduce poverty. In the GDP of Pakistan there is 30 percent contribution, in agriculture sector 90 percent of jobs, in manufacturing sectors 25 percent contribution and a large potential of creating employment chance in the other sectors as well. Regarding all these contributions the SMEs are facing so many problems and issues e.g. lack of capital, marketing difficulties, lack of data, poor management and unavailability of proper financing facilities. The major issue that SMEs are facing is the lack of credit which is not only restricted in Pakistan it is also in 54 countries of the world (Business Environment survey). The main factor for unavailability of credit for SMEs is that the banks have risk in providing credit to SMEs. Economies of scale, published financial information are some parameters which made lending more easily to the large organizations. Because most of the banks have their ideas about SMEs that they have not marketing, managerial and technical skills to generate as much cash flows to return the loan on time. To operate more properly the SMEs required suitable environment by the government and the regulatory agencies such as State Bank of Pakistan. But this environment required macro economy's policies should be sound and there is a legal system to provide the property rights. The local and provincial government plays a vital role to allocate the land and to deliver infrastructure facilities on these lands. The SMEDA also play a complicated role in the development of SMEs in his sectors such as managerial training, development and to provide better services. In most of the SMEs they do not have proper trained staff so SMEDA provide training courses in the number of organizations to manage their accounts more properly (Hussain, 2005).



**THEORETICAL UNDERSTANDING OF THE LITERATURE**

Theoretical Framework:



**RESULTS:**

VARIABLE	Mean value	S.D	Chi-square	Hypothesis	Level of Significance
Market interest rate	2.69	0.72	10.332	Accept H1	High
SME establishment	2.18	0.947	3.376	Accept H1	Moderate
Financial institutions	2.17	0.888	9.848	Accept H1	High
Financial Ratios	1.7	0.577	4.532	Accept H1	Moderate
Collateral Ability	1.92	0.825	5.806	Accept H1	Moderate
Fill up the financial gap	2.13	1.07	3.295	Accept H1	Moderate
Facing Issues	2.96	1.325	17.272	Accept H1	Moderate
Generating cash flows	2.43	1.139	6.309	Accept H1	High
Role of Provincial Government	3.32	1.213	9.780	Accept H1	High
Role of future cash flows	3.65	1.086	12.576	Accept H1	High
Personal Guaranties	3.31	13.23	9.390	Accept H1	High
Growth of SMEs	3.18	13.66	5.980	Accept H1	Moderate
Relationship b/w Growth & Debt	3.27	1.1	6.331	Accept H1	High
Restriction of Qualification & Age	2.5	1.142	11.213	Accept H1	High
Low Default Rate	1.86	0.725	11.853	Accept H1	High
Job Opportunities	2.67	0.753	8.812	Accept H1	High

**DATA ANALYSIS**

According to statistical analysis, results from the data taken from target respondents that were bankers and lenders of concerned banks and financial institutions. Responses were measured on interval scale on five responses consist of strongly agree to strongly disagree. The mean value is measured as average responses that were taken from these respondents. Standard deviation is showing the deviation of mean as deviation increases reliability of analysis will decrease.

Market interest rate has a negative relationship with lending, as interest rate increases lending will decrease. On the average most of the respondents showed agree to indifferent response. Whereas critical value of own from chi square 10.332 shows significant association of interest rates and lending. According to the most of the respondents' response, they are quite agreed with that SME concentrated market leads to SME establishment. Also from the critical value of chi square is showing that there is a significant association of SME concentration in a market



and its establishment. As we know that more concentrated a market is, better will be its productivity. Same in the case of financial institutions, in a market increased number of financial institutions facilitate convenient access to credit at acceptable interest rates as shown in the table value of chi square 9.848 which is very much greater than p-value showing a significant relationship. Modes of lending have a significant relationship with SME establishment. As shown in the table, most of the respondents are agreed upon this relationship because more accessible and simplified modes and terms of lending are result in SME development.

Banks always prefer financial ratios over prior relationships, as shown in the table mean value of 1.7 is clarifying that mostly people are agreed upon it. Same is shown from the critical value of chi square. This is because of threat of default on account of SMEs banks always prefer those enterprises that have better financial ratios for making sure the repayment of loan. That's why collateral ability creates hurdle in the way of lending to SMEs as banks prefer large organizations over SMEs because of their collateral ability. According to the results found from the above table respondents are agreed upon this statement. Lending also has a significant relationship with the filling up of financial gap in the economy as because that helps in improving the productivity. As found from the critical value of chi square 3.295 compared with 0.027 p value respondents are strongly agreed upon.

SMEs are facing inappropriate credit facilities and poor management, this problem has a significant relationship with lending but mostly people are indifferent about this statement as shown from the mean value of 2.96. But in real terms SMEs are facing these challenge because of unskilled and untrained workers thus are decreasing the productivity. Since, they are not generating as much cash flows in order to return loan well on time. According to the statistical analysis respondents are also agreed upon this statement that they are not generating as much cash flows as it could be. As far as role of provincial Governments is concerned they are taking remedial steps for the betterment of SMEs since they are not taken into consideration by the respondents. But the value of chi square 9.780 is showing that there is a relationship between role of government and SME lending since they have to take effective steps for their betterment. Personal guarantees for the provision of loan are associated with lending. Respondents are again indifferent on this scenario that either personal guarantee is required for the provision of loan or not. But the chi square value lies in the acceptance region.

Growth of SME has a positive but weak relationship with lending as growth rate increase lending will also increase but in slow pace. On the average most of the respondents showed agree to indifferent response. Whereas, value of chi square 5.980 is showing a moderate association with growth SME and lending. There is a weak relationship between growth of SMEs and along term debts. It means that as the long term debt increase, the SMEs will grow but in remarkably slow pace. At an average, most of the respondents responded as agree, some responded as indifferent and some as disagree as well. Whereas, value of chi square 6.331 is showing a moderate association between growth of SMEs and long term debts.

The role of future cash flows with SME lending has positive but weak association showing that loans are provided to SMEs on the basis of expected cash flows for future in order to avoid risk of loss on account of these enterprises. According to the table there is no any restriction of age and qualification for getting loan and most of the people are quite indifferent about this

scenario or we can say that they don't have enough awareness and knowledge about it. SMEs also have a significant relationship with the provision of job opportunities as shown from the results; the value of chi square is 8.813.

## **CONCLUSION**

After the comprehensive study on the subject matter we have concluded that SMEs play a vital role in the development of economy in providing better employment opportunities and raising the living standards of people as well as to increase the productivity. Accessible and appropriate financing policies for creditors, simplified procedures and proper regulatory bodies regarding taxation also have a magnificent effect on the lending. There must have appropriate financing through any kind of financial institutions in order to fulfill the financial gap and generating opportunities for people. Modes of lending to SMEs have strong relationship with their development in the economy as SMEs are back bone in a developing country.

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