



# ENHANCING THE CAPACITY OF BANKS TO SHAPING DEVELOPMENT OF SMEs

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## **Introduction**

Sri Lanka's economy is growing and its environment is favorable for faster development. The time has come for the citizens of Sri Lanka to foster their faith in their own ability and potential for achievement. A surer way of increasing the nation's usable wealth is to empower the people to excel in their pursuit of private interest in the path to profit maximization and accumulation of wealth. People are likely to excel when their innovative efforts are recognized and constraints on resource mobilization are removed. Initially, a system of support with financial grants, infrastructure provision, skills development and advice to manage businesses would greatly enhance the chances of transforming the traditionally closed-minded, inward-looking, and imitative business personalities of our underdeveloped economic system towards a faster modernizing community. In this process, which is a historic one in our way to catching-up with the rest of the world, small and medium-scale enterprises (SMEs) have a definitive role to play. Banks and financial institutions are increasingly under pressure to adjust and develop their functions and capabilities so that the society's innovative strengths are diverted and nourished for the purpose of creating value. This article discusses a few ideas in that direction.

## **Understanding the Potential of SMEs**

The potential contribution of small and medium-scale enterprises (SMEs) development in the economy to the growth of the banking sector is apparently underestimated. The Banking Survey of the SME Market in Sri Lanka (2006-07) of the IFC listed five principal constraints faced by the SME Sector. They were (a) difficulties in obtaining bank finance (b) absence of technical and management skills (c) marketing constraints (d) inadequate infrastructure facilities for production, and (e) outdated technologies. According to the survey, one of the most common constraints to growth cited by businessmen in the SME sector was the requirement of banks for collateral in providing credit facilities. This collateral requirement is one of the most common practices that banks have conveniently carried forward over time. A lack of assets such as land on the part of the entrepreneur, especially the young and educated ones emerging from the low income groups, is a significant reason. Apart from collaterals, banks often find it difficult to assess financial requirements and business viability due to lack of orderly business plans and proper financial records with the applicant. If the banker understands the potential contribution of SMEs to bank's



lending portfolio, then a concerted attempt to evolve solutions to these constraints would emerge from the banks themselves. How would this happen?

Banks need managers and special categories of staff that have a systematic knowledge of the processes of economic development in open markets. A simple depiction of the relationships among the key variables of this process is presented in Fig. 1. The key variables of the development equation that require resource mobilization interventions from government policy makers and planners on the one hand and institutional support from commercial and development bankers are four-fold. They are (i) the productive system driven by technology and product/service designs, (ii) markets driven by factor supply (input suppliers) and consumption demand (customers), (iii) human energy, energized by knowledge and skills that are organized by entrepreneurs, and (iv) economic development needs of society featured by ever increasing opportunities for people to engage productively and improve the society's quality of life as a whole.

It is in the interest of the banks to identify the weak points of these links of development and innovate new solutions. Many traditional product areas such as art and craft, spices, plantation products (coir and coconut products in particular), rice mills, and brass works are good examples of technological stagnation. Technological innovation, new product designs and the provision of infrastructure facilities such as industrial parks are basic requirements that small businesses cannot invest easily. It is the responsibility of the government agencies such as National Enterprise Development Agency of the Ministry of Industries to organize and implement programs for support in these areas. Acting with understanding, banks should look into issues in these areas of SME development proposals and it is for this purpose that banks should develop institutional capacity such as research and analysis, and support programs for technology transfer and support of young inventor business proposals.

**Fig. 1: Role of Banks in SME Development – A process perspective**





Many business failures in the SME sector are due to market failures. Some of the market risks are systematic risks resulting from macro factors such as low-cost imports, inflation, high energy costs about which banks can do very little. However, there are unsystematic risks that are firm-specific, resulting from such reasons as marketing failures, production problems, and poor management which banks normally try to manage by way of diversification of loan portfolios. An approach to capacity development of banks must consider methods of direct intervention to such company specific risks while forming a common front of governmental and banking institutions to provide long-term assistance programs for SMEs to develop their internal capacity to deal with such issues affecting variation of company returns.

The people dimension of the development equation is concerned with energizing human energy with knowledge and skills in the context of entrepreneurial spirit on the one hand, and creating increasing opportunities for people to engage in productive activity in the economy. The resulting expansion of employment and quality of life is in the interest of banks who compete for deposit mobilization and consumption loans in the emerging income segments.

Modern banks, like modern businesses, must create their future markets. In the above perspective of SME development, Banks' desire and capacity to involve directly in strengthening relationships between technology, production and markets would lead to new business creation and reduction of banking risks. Similarly, their desire and capacity to promote entrepreneurship and skills development would be a surer way to increase the income streams in society which directly support the foundations of banks.

Business development through technology development/transfer and entrepreneur and skill development could become a new strategic function of banks. For example, one may consider the opportunities available in the tourism and hospitality industry which shows a high potential for growth. Consider in particular the potential in the following areas of SME investment: Adventure sports centers; camping sites; eco-lodges; guest houses; boutique hotels and villas; tourist shops; and wellness centers.

SMEs are a key source of entrepreneurship and innovation in any economy. The Chamber of Young Lankan Entrepreneurs (COYLE) is the association for new entrepreneurs in Sri Lanka. This relatively less flamboyant organization has attracted over 125 members with turnover of Rs. 100 million or higher over a decade of its operations. The leading members of these enterprises have come up on their own with little assistance from banks when such help was needed. In this country, there is another group of potential entrepreneurs who have not seen the doors of banks and they are known as young inventors. For the past decade or so, the Institute of Engineers, Sri Lanka with the support of the Ministry of Education, had been identifying inventors from our schools system. Annual conventions and exhibitions in Colombo introduce these inventions, often very promising processes and products, which need the attention of businesses and banks for commercialization. These are a few references for those who wish to develop institutional capacity and direct resources for meaningful SME start ups.



## **SMEs in Sri Lanka and Addressing their Challenges**

In Sri Lanka, SMEs constitute 80-90% of the total number of business establishments and 20% of industrial value added. They accounted for 70% of employment generated in the business sector in 2005. It is estimated that around 16,000 manufacturing enterprises operate in urban areas and over 600,000 in rural areas (the rural enterprises employ over 1,500,000). It is noteworthy to see that over 40% of these enterprises are engaged in production. However, if a standard definition of small and medium-scale enterprises such as the following is used strictly, these numbers are likely to vary:

- (i) Small Enterprise: Asset value - LKR 10 million to 100 million
- (ii) Medium Enterprise: Asset value - LKR 100 million to 400 million

SMEs in Sri Lanka operate either as individual enterprises or in groups/clusters. Some of them operate in industrial estates set up mostly by the Government. Altogether, there are around 60 industrial estates run by Board of Investment, Ministry of Industries, Industrial Development Board, Urban Development Authority and private sector. A large number of naturally-formed SME clusters of different sectors exist in Sri Lanka, and they are connected with natural resource bases of our regions. A few examples are: (a) Brass industries in Kandy area, Beliatta, and Jaffna; (b) Black smith, silver smith villages in Webada, Kothmale and Puwakdandawa, (c) Coir clusters in the Coconut Triangle, and (d) Rice milling clusters in Ampara, Polonnaruwa, Anuradhapura and Tissamaharama.

The average size of SMEs in Sri Lanka is rather small. The cross sectoral study of 318 SMEs by IFC (2006) reported an average asset size of LKR 21.1 million. The construction and commercial transport sectors reported relatively higher assets. The average sales turnover in 2005 across the nine SME sectors it studied was LRS 43.6 million, with rubber companies having an average over LKR 72.0 million. Sectors such as printing and deep sea fishing had lower average sales, less than LKR 25.0 million.

Structural patterns of SMEs in Sri Lanka seem to change rather slowly. For example, the IFC study found that almost 70 percent of the companies had been in operation for over 10 years, and over two-thirds of the promoters or businesspersons were in the age band of 40-60 years. Less than 5% were below 30 years of age, found largely in the emerging sector of construction. Almost 50% of the SMEs had 20 employees or less while 14% of the sample companies had over 100 employees. The mean annual turnover of companies across sectors grew at 14% in 2005.

Sri Lanka's SMEs make fairly decent profits, according to the above study. The average gross margin across sectors in 2005 was 39%, with construction companies showing higher margins (45%). Bankers would be more interested to know that the average ROI for the sample was 21%, with nearly 40% of the companies having ROIs in the range of 11-20%. Among the sectors, above average (30% plus) ROIs were reported by firms in deep sea fishing, gems and jewelry. The sectors with intensive capital investment had reported lower ROIs, showing, inter alia, low levels of productivity, innovation, change and competitiveness.



The IFC study revealed that the involvement of banks and financial institutions in meeting term finance needs of SMEs rather low. Approximately 77% of the companies of the survey requiring financing had a requirement for medium-term and long-term financing while about 30% had a requirement for short-term financing. It was noteworthy that there was an evolving requirement of financing R&D and product development. The latter is a good sign for industry which should be an eye opener for bank capacity development efforts.

Financing by banks contributed to only 29% of the total sample requirements and only 53% of the firms requiring financing approached financial institutions that year. Among the reasons given by financial institutions for their rejection of applications were lack of collaterals, personal guarantees, and reliable business plans with business and financial forecasts. The IFC report stated that,

“ The SME sector in Sri Lanka suffers from a lack of access to financing. SME financing in Sri Lanka is considered to be more of the nature of development financing rather than commercial ones by bankers. As the commercial banks are not adequately equipped with the necessary credit structuring and evaluation skills, it leads to high costs and burdensome collateral in order to justify the risk-return trade-off.” (IFC, 2006: 8).

This type of conclusions call for new efforts to look at development of banks’ capacity for strategic and competitive analysis of business, project lending, revision and adoption of application procedures, technical and business evaluation, risk management and effective collaboration with entrepreneurs. The analysis and discussion given in the pages to follow, it is hoped, would assist such efforts in the time to come.

## **Learning from International Experiences**

There is a great deal to learn from effective SME financing practices of Asian countries. Even though this is not the right place to examine their relevance to Sri Lanka in detail, it is pertinent to refer to a few of them so that future efforts in capacity building in Sri Lankan banks would take a serious note of recent developments in other relevant economies.

As illustrated by Fig. 1 above, the policy and planning role of government is a crucial one for resource mobilization around prospective ventures and for enlisting support from other institutions such as banks. In India, one of the effective programs of government has been one for the establishment of business incubators, supporting specially engineering technology-based entrepreneurs. As of 2007, there have been about 40 incubators in India. They fall into one of three types: (a) incubators of leading engineering technology and management institutions (such as IIMs and IITs), (b) incubators in Science and Technology Parks (STEPS), and (c) incubators set up by leading private sector enterprises (e.g.: Nirmalabs).

The incubation idea has received a fillip with National Science and Technology Entrepreneurship Development Board (NSTEDB) deciding to create an incubation fund to facilitate the development of entrepreneurship in knowledge-based, high-growth businesses (Mani, 2009:



7). India has three different types of financial arrangements for financing innovations. They are: (a) research grants, (b) tax incentives, and (c) venture capital. Grants and loans are available through a number of schemes such as (i) finances from the Technology Development Board, (ii) Techno-entrepreneurs Promotion Program, and (iii) the New Millennium India Technology Leadership Initiative. Substantial funds are available from these sources for innovations to transfer from design stage to commercial stage. In Sri Lanka, banks could come forward, especially with the externally negotiated funds available for SMEs to work with government institutions (such as NEDA) and government programs (e.g.: the entrepreneur development program of the Colombo Municipal Council/Ministry of Economic Development).

India's government policies, programs, institutional capabilities, flexibility of certain sectors of financial and banking institutions, and above all their coordinated resolve to stay focused on strategies for the development of Indian capacity has been inspirational and challenging. Since the 1970 when India undertook the 'White Revolution' through its National Dairy Development Board, India's milk production and the village economy attached to it had really revolutionized. Anand Milk Union Ltd., popularly known as AMUL, epitomizes the success of cooperative dairy movement in India. The AMUL model of cooperative farming gave impetus to institutional cooperation, resource mobilization and SME development not only in the milk industry but in an array of related/linked economic ventures at the village level. These developments and the resulting income streams among villagers have surely enhanced the economic base of commercial banks of India.

In Thailand, the venture capital fund for SMEs was set up under the first SME promotional plan (2002-2006) as a source of funds for high potential SMEs. The fund requires a joint venture investment with qualified SMEs, with approximately 25-35% of the registered capital held by the Office of Small and Medium Enterprises Promotion (OSMEP) Fund. The joint venture investment ranges from 1 to 1000 million THB ( US \$ 3,000 to 3 million) with an investment period ranging from 1 to 7 years (Parthanadee & Chaveesuk: 2009:6). After a due diligence investigation by independent financial consultants selected by the OSMEP, the venture capital fund will invest, and mentors/consultants will be provided to support the SME business operations such as marketing, manufacturing, operating and accounting management during the term of venture capital investment to assure good corporate governance and professionalism.

A capacity building fund for SMEs was initiated in Thailand under the second SME promotional plan (2007-2011) to sponsor financial grants to support consultancy services, low-interest machinery procurement, exports, and intellectual property rights.

Over the past decade, enterprises of the Asian and Pacific Region, especially from the region's developing countries, have made tremendous strides in global markets. Of the world's top 2,000 firms in 2009 ranked by Forbes Global 2000, there came 722 from the region (36%), a substantial increase from 2005 (599 enterprises). This jump which made the region the home to the largest number of the world's top enterprises, signifies the development of global and regional supply or value chains enabling SMEs to connect and flourish.



The business sector itself of the developing nations remain relatively underdeveloped. Among the many reasons are poor entrepreneurship, innovations dominated by the developed countries, market imperfections, institutional weaknesses, human resource inadequacies, and role of governments. From 2001-2006, on average, there were 63 enterprises (SMEs) per 1,000 people in developed countries. In contrast, developing countries had only 28 enterprises per 1,000 in population.

### **Traditional Role of the Banks in SME Lending**

In traditional banking functions involving SME financing, there are at least six activities that bankers are keenly interested in performing (see Fig. 2). Typically, the process begins with a review of *business plan*, if available from the entrepreneur. In the absence of a suitable plan document, the banker would peruse documents and accounts of previous operations to develop an idea. This is weak beginning of communication and negotiation between the parties. What seems to lack at this stage, firstly, is the absence of the conviction on the part of the Bank (bank officials) that a bank's growth and competitive ability depend on the bank's capacity to recognize the true business futures and forging a bond with the right entrepreneur. Instead of moving toward a win-win proposition of business, the traditional banker becomes defensive, investigative and suspicious. This initial position and the attitude that promotes the defensive position is a wrong one. The bank is likely to miss an opportunity rather than taking or creating one.

If the business plan document is sufficient and feasibility of the project or business is clear, then the next logical interest of the banker is to establish its *viability*, at least until the recovery period is over. Many banks do not have staff competencies that are necessary to assess business viability in terms of market performance, technical feasibility and managerial competencies. Competencies in these areas are largely tacit and come from business experience. Since many bank officials do not have real business experience or consultancy experience or even being with business operations on close contact over years, they do not develop tacit knowledge of business and hence they do not read the data as entrepreneurs do. This gap of knowledge and experience lead to bankers' demand for collateral (additional/excessive) as the means of managing risks (unsystematic risks). A large percentage of loan applications fail here and many entrepreneurs become hopeless and blamers of banks. One could see that this a process issue rather than a real one that exists factually.

Loan financing and risk management are the next concerns of the banker. Documentation, release of funds and determination of reporting/information requirements attached to loan utilization are mostly procedural steps. Many bank officials do not recognize the need to involve in the information process because such involvement would be beyond the traditional banker. It is the venture capital provider who will have continued business interest needing involvement. It could take the form of consultancy support, periodic inspections, and even joint-decision making in the conduct of business operations. Working with non-banking institutions and government programs may also come as part of this potential involvement. In analyzing information, traditional bankers would focus on Return on Investment (ROI) and cash flows rather than the stability of sources of revenue, cost management, market competition, and business management.



These traditional activities are not sufficient even the in case of sound business propositions operating under favorable market conditions. To understand this, one must put on the shoes of the entrepreneur.

**Fig. 2: Banker's Traditional Interests in SME Financing**



### Understanding the Role of the Entrepreneur

Entrepreneurs are a unique brand of businesspersons. All businesspersons are not entrepreneurs. Business is about making profit and it could be in many ways, including trading, gambling etc. where value addition may not be necessary. However, entrepreneurs are value creators and they look for unique market opportunities to make profits. They differentiate from others and they receive greatest satisfaction by doing so. In this sense, the sense of true capitalism, Sri Lanka is not blessed with entrepreneurs. There are many, however, and banks should recognize them by understanding their thinking and ways of doing.

Very often, entrepreneurs are poor planners. In essence, they have difficulties with order, and quite often with numbers, to say the least. They, like artists, live with disorder and ambiguity. They are masters of technology of their own choice and derive motivation from creativity, change and experimentation. They like to face risks though they possess more information and intuition to get closer to business situations more than anyone else. What is risky for an outsider who has very little information could be a certain project for a given entrepreneur. Steve Jobs, late leader of Apple is an example of the highest order. Though bankers are not entrepreneurs, they must fully appreciate entrepreneurial thinking, attitudes and roles in business. This is not easy.

Often, entrepreneurs are poor listeners and dictators. However, their assets are the superior ability to work with products/services/processes and obsession with quality, markets and customer satisfaction. They often need assistance to manage business operations, work with people, lay systems in place and, of course, capital at hand when needed. Bankers must devote time to train entrepreneurs in business management, banking and finance, and effective communication.

**Fig. 3: SME Entrepreneur's Primary Interests in Business**





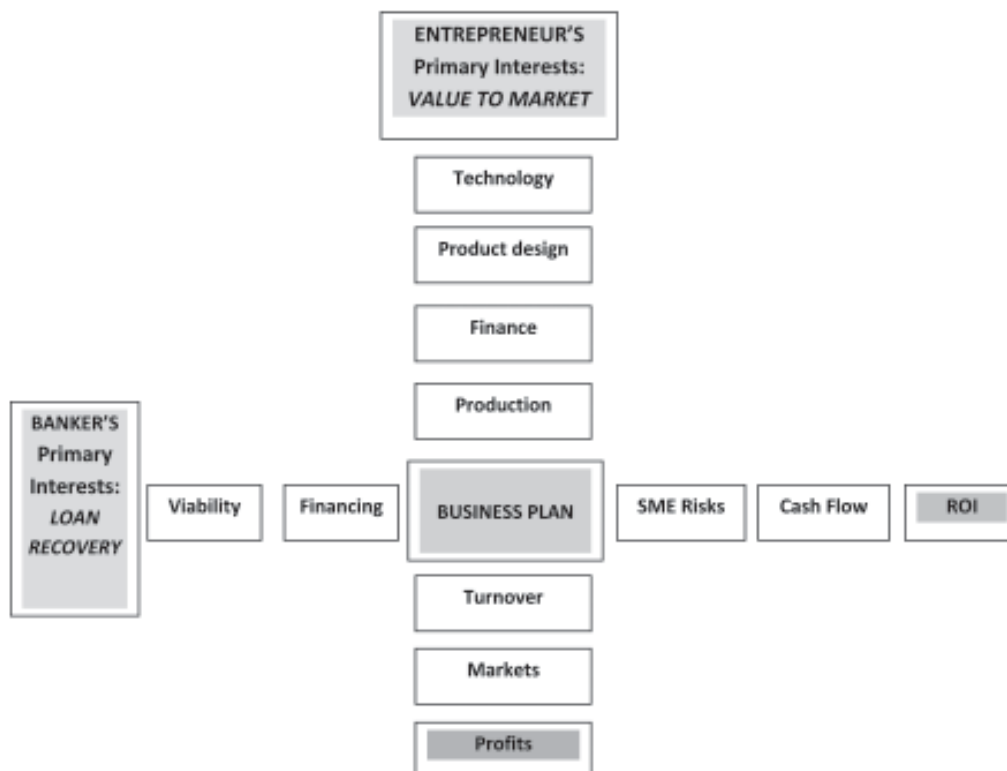


## Enhancing the Capacity of Banks

Entrepreneurs and bankers have shared interests. As seen from Fig. 4, the SME financing has two, largely different but essential, value streams. The entrepreneur's primary interest is producing and supplying value to markets. In this value chain his contributions are in technology, recognition of market needs, value design, production and customer satisfaction and he expects to make a profit. The IFC report 2008 reported five constraints faced by SMEs of which the first and foremost was the difficulties in obtaining bank finance. Resources, infrastructure facilities, technology updating and skills development are the important gaps in this process that need solutions from outside. To what extent can banks be equipped with effective interventions and solutions to address these gaps?

As seen from Fig. 4, the entrepreneurial and banking approaches to SME financing are divergent even though the risks associated with the key concerns of the both parties are mutually significant factors.

Fig. 4: The Value Streams of SME Financing



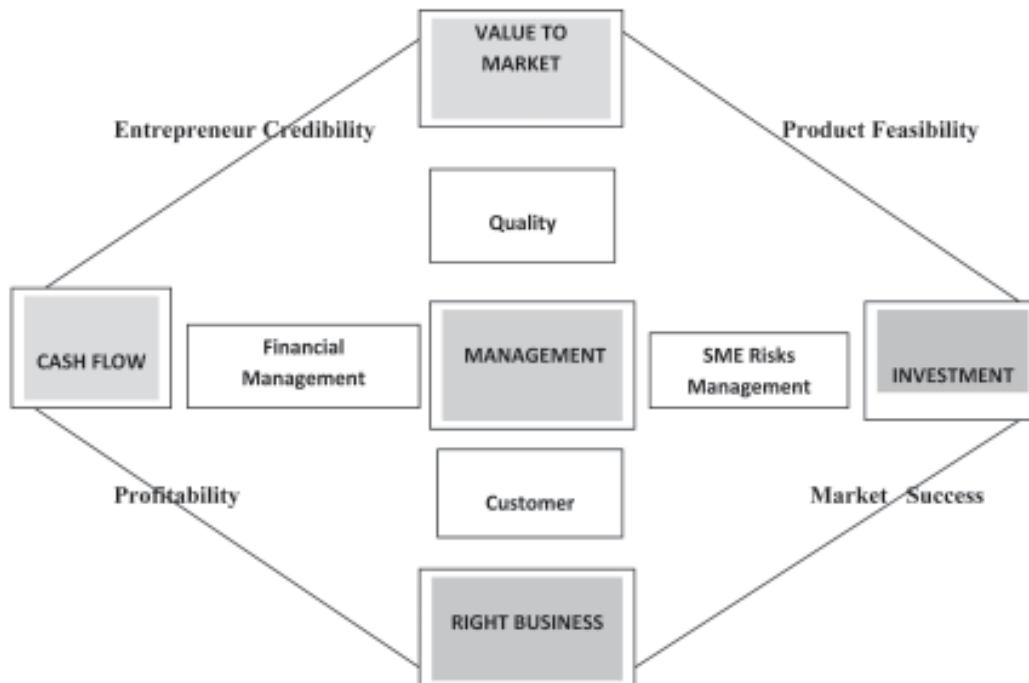


When the interests that are common to both entrepreneurs and bankers are classified, there emerge at least four:

- *Product feasibility*: The first and foremost business factor to start with is product feasibility in terms of technical, managerial, commercial, and financial criteria. Therefore, it is a core value that both parties must share in their endeavours.
- *Entrepreneur credibility*: It is essential that the two parties establish a good understanding on credible business foundations, personality, discipline and trust.
- *Market success*: Unless the venture secures market success in terms of reaching turnover goals, meeting price targets, and serving the customers, stability much needed to the business would not come. This is the hallmark of success which often takes more time than originally planned. Both parties need to exercise enough patience, irrespective of their initial agreements.
- *Profitability*: Profits follow market success.

Traditionally, bankers are more interested in entrepreneur credibility and business profitability while the entrepreneurs are expected to take responsibility for product feasibility and market success. Banks' capacity for dealing with SMEs can better be developed when both banks and entrepreneurs have equal interest in all the four factors.

**Fig. 5: Shared Interests in SME Financing**





## Conclusions

Financing SMEs in Sri Lanka requires banks to prepare more specifically for the purpose. From the findings reported by studies in Sri Lanka and experiences in SME financing in other countries, there are five factors that demand our attention:

- *Centrality of information in risk management:* Risk can be defined as a function of information available in a given situation to mitigate potential losses. When full information is available (the condition of certainty), the probability of occurrence of an event is equal to one, and hence risk is zero. In the absence of any information (the condition of uncertainty), the probability of occurrence of an event is equal to zero, and hence risk is at maximum level. Though zero risk is the ideal, banks would attempt to work with optimum risk levels by having information to understand some and go with a probability of an event.
- *Information, knowledge management and research:* Information is the data organized to give meaning. In banks, we must devise systems to collect data and organize internal bank experiences on shared databases through what you call knowledge management systems. The most valuable knowledge today is generated by organizations through their work and experiences of managers. In order to enhance this, and develop industry profiles, banks must set up branches of research and invest in them for studies of trends, cases of success, and analysis of macro-level data both local and global.
- *A focus on technology and innovation:* Business success depends largely on the innovative and technological capacities of business. Therefore, banks must develop staff competencies in key areas of technology, technology management, and managing innovations for commercialization. This specialized knowledge would enable them to rally entrepreneurs around the banks and enrich banks' customer relations with consultancy practice.
- *Skills of project evaluation:* Low investment in skill training, staff turnover, poor communication and language skills, and changing economic and business environments are some of the reasons affecting poor quality of project evaluation competencies of banks today. These gaps can be filled.
- *Technology and business skills of entrepreneurs:* Today's businesspersons require thorough grounding in business education including core technologies they wish to work with, business planning and management. Banks can deliver these skills as part of their effort to build and maintain business relationships with important clients.



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