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Banking on SME Growth:
Concepts, Challenges, and Policy Options to Improve Access to Finance in Sri Lanka

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Executive Summary

In Sri Lanka's transition to a middle-income economy, the growth of the small and medium enterprise (SME) sector in Sri Lanka has been identified as vital to provide more employment, bridge regional growth disparities, and ensure that post-war growth is inclusive. Globally, SMEs continue to make significant contributions to national economies around the world and have gained special attention due to their relative size and dispersion within the global economy. Given their wide geographical spread within a country as well as their wide sectoral coverage, SMEs are often a key source of inclusive economic growth. If given the right environment to thrive, the SME sector will not only create employment and promote industrial development, but also nurture entrepreneurial talent.

Although SMEs have been recognized as an integral component of Sri Lanka's economic and social fabric, they are faced with a myriad of constraints that impede their ability to grow. Even though the sector has received much attention from successive governments as well as international development agencies over recent decades, the sector is still faced with these challenges that need to be addressed in a comprehensive manner. Among them is the critical issue of the difficulty in accessing finance. The ability of SMEs to develop, grow, sustain and strengthen themselves is heavily determined by their capacity to access and manage finance. Unfortunately, SMEs in Sri Lanka consistently cite the lack of access to finance as a serious bottleneck. In accessing finance, SMEs are faced with challenges on many fronts - lack of collateral by SMEs and unwillingness of banks to lend without it; financial sector 'unfriendliness' towards SMEs; mismatch in funding opportunities vs. SME needs; misunderstanding between banks and SMEs on each others' priorities and constraints; lack of information on financing availabilities; and lack of mechanisms to mitigate risks.

A unique contribution of this paper is that it puts forward a new way of looking at the access to finance challenge for SMEs. This 'Twin-Pillar Approach to Access to Finance' argues that improving access to finance for SMEs is a case of improving 'availability' on the one hand and improving 'bankability' on the other. 'Availability' refers to ensuring that funds are available for SMEs to borrow - enhancing overall private sector credit, expanding lending volumes to SMEs, and providing more and more funding lines and special credit schemes for SMEs. These are often influenced by the overall monetary policy of a country, liquidity levels in the market, level of borrowing by the state and credit availability to the private sector, and the number and nature of SME loan schemes with lower interest or concessionary terms. This first pillar is not the main focus of this present paper. It largely focuses on the second pillar - 'bankability'. This stems from the understanding that a flush of SME credit alone is not enough. 'Bankability' is about improving banks' approach to SME lending as well as improving SMEs' ability to approach banks. Things that improve the climate for SMEs to borrow and addresses the following questions are important - Are banks genuinely oriented towards the unique banking needs of SMEs? Are there specialized branches dealing with SMEs? Are there mechanisms to bridge the information and risk asymmetry between SMEs and banks, like credit guarantees and credit scoring? Are there schemes to improve SMEs' financial management and ability to develop bankable business plans?

This paper dissects these issues to better understand the drivers of the access to finance challenge, from both a conceptual as well as practical perspective. Some of the key policy options put forward are the adoption of SME-friendly banking practices, introduction of SME credit rating and Credit Guarantee Fund, and improving financial literacy and internal management of SMEs. The paper cautions against over-zealous policy intervention and argues that the focus of the government must be to put in place suitable incentives as well as regulatory frameworks that encourage greater SME lending.

The paper draws on the latest insights from recent IPS surveys to provide evidence for Sri Lanka, and puts forward pragmatic policy options, considering strategies adopted in East Asian economies. Through this, the paper aims to inform the ongoing National SME Policy process of the government as well as future SME interventions to be undertaken by government agencies, financial institutions, chambers of commerce, and international development agencies.

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ශ්‍රී ලංකාව මධ්‍යම ආදායම් ලබන රටක් බවට පරිවර්තනය වීමේ දී කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර අංශය වැඩි සේවා නියුක්තියක් සැලසීමට, කලාපීය වෙනස්කම් පියවීමට හා පශ්චාත් යුද කාලීන වර්ධනය සියල්ලන් ඇතුළත් කර ගන්නා බව සහතික කිරීමට අත්‍යවශ්‍යයැයි හඳුනා ගෙන ඇත. ගෝලීය වශයෙන් කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර එක් එක් රටවල ජාතික ආර්ථිකයන්ට කැපී පෙනෙන දායකත්වයක් ලබා දෙන අතර ඒවායේ සාපේක්ෂ ප්‍රමාණය සහ ගෝලීය ආර්ථිකයේ විසිරීම නිසා විශේෂ අවධානයට ලක්වේ. ඒවා භූගෝලීය වශයෙන් රට පුරා පැතිර තිබීම මෙන්ම අංශීය වශයෙන් ඇති පුළුල් ආවරණය නිසා කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර සියල්ලන් ඇතුළත් කර ගන්නා වර්ධනයේ මූලික මූලාශ්‍රයක් ද වේ. ඒවාට වැඩීමට සුදුසු පරිසරයක් පවතින්නේනම් කුඩා හා මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර අංශය රැකියා නිර්මාණය හා කාර්මික සංවර්ධනය ප්‍රවර්ධනය කිරීමට අමතරව ව්‍යවසායකත්ව කුසලතා පෝෂණය කරනු ඇත.

කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර ශ්‍රී ලංකාවේ ආර්ථික සහ සමාජ ක්ෂේත්‍රයේ අන්තර්ග්‍රහිත අංගයක් ලෙස පිළිගෙන ඇති නමුත් ඒවායේ වර්ධනයට ඇති හැකියාව සීමා කෙරෙන බාධක ගණනාවක් පවතී. මෙතෙක් පැවති සෑම රජයකම සහ අන්තර්ජාතික සංවර්ධන ආයතනවල අවධානයට ලක් වුවද මෙම අංශය තවමත් පුළුල් ලෙස අවධානය යොමු කළ යුතු අභියෝග ගණනාවකට මුහුණ දී සිටී. ඒ අතර තීරණාත්මක වන්නේ මූල්‍ය පහසුකම් ලබා ගැනීමේ දුෂ්කරතාවයයි. කුඩා සහ මධ්‍යම ව්‍යාපාර වර්ධනයවීම, පුළුල්වීම, චිරස්ථායීවීම සහ ශක්තිමත්වීම මූලික වශයෙන් තීරණය වන්නේ ඒවාට මූල්‍ය පහසුකම් ලබා ගැනීමට සහ කළමනාකරණයට ඇති හැකියාව මතය. අවාසනාවකට මෙන් ශ්‍රී ලංකාවේ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර නිරන්තරයෙන්ම දක්වන බාධකයක් වන්නේ මූල්‍ය පහසුකම් ලබා ගැනීමට ඇති ගැටලුය. මූල්‍ය පහසුකම් ලබා ගැනීමේ දී කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාරවලට පෙරමුණු ගණනාවක අභියෝගයන්ට මුහුණ දීමට සිදුව ඇත. කුඩා සහ මධ්‍යම ව්‍යාපාවලට ඇප වශයෙන් ඉදිරිපත් කළ හැකි දේ නොවීම හා එවැන්නක් නැතිව ණය නිකුත් කිරීමට බැංකුවල අකමැත්ත, මෙම ව්‍යාපාර කෙරේ මූල්‍ය අංශයේ මිත්‍රශීලී බවක් නොමැතිවීම, මෙම ව්‍යාපාරවල අවශ්‍යතා සහ අරමුදල් ලබා දීමේ අවස්ථා අතර පවතින නොගැලපීම, ප්‍රමුඛතා සහ සීමාවන් පිළිබඳව බැංකු සහ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර අතර පවතින අනවබෝධය, මූල්‍ය පහසුකම් පවතින අංශ පිළිබඳ තොරතුරු නොමැතිවීම සහ අවදානම සමනය කිරීමේ යාන්ත්‍රණ නොමැතිවීම යනාදියයි.

මෙම පත්‍රිකාවේ සුවිශේෂ දායකත්වය වන්නේ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර වලට මූල්‍ය අභියෝගයට පිවිසීම කෙරේ නව ආකාරයකින් බැලීමයි. කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර වලට මූල්‍ය සඳහා පිවිසීම වැඩි දියුණු කිරීම යනු එක අතකින් මුදල් පහසුකම් 'පැවතීම' වන අතර අනෙක් අතට බැංකු සමග කටයුතු කිරීමේ හැකියාව (Bankability) වැඩි දියුණු කිරීමයැයි 'මූල්‍ය සඳහා පිවිසීමේ ද්විත්ව කුළුණු' තර්ක කරයි. 'පැවතීම' යන්නෙන් අදහස් වන්නේ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාරවලට ණය ලබා ගැනීම සඳහා අරමුදල් පවතින බව සහතික කිරීම, සමස්ත පෞද්ගලික ණය ප්‍රමාණය වැඩි දියුණු කිරීම, එම ව්‍යාපාර සඳහා දෙන ණය පරිමාව පුළුල් කිරීම, කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර වලට ලබා දෙන අරමුදල් වර්ග සහ විශේෂ ණය යෝජනා ක්‍රම වැඩි වැඩියෙන් ලබා දීමයි. රටක සමස්ත මූල්‍ය ප්‍රතිපත්තිය, වෙළඳ පොළ පවතින ද්‍රවශීලතා මට්ටම, රජයේ ණය ලබා ගැනීමේ මට්ටම සහ පෞද්ගලික අංශයට ලබා ගත හැකි ණය ප්‍රමාණය සහ අඩු පොලී හෝ සහන ක්‍රම යටතේ ඇති කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර සඳහා පවතින ණය ක්‍රම සංඛ්‍යාව සහ ස්වභාවය මේ කෙරේ බොහෝවිට බලපායි. මෙම පත්‍රිකාවේ ප්‍රධාන අවධානය යොමු වන්නේ පළමු කුළුණ දෙස නොවේ. වැඩිම අවධානය යොමු වන්නේ දෙවන කුළුණ වන බැංකු සමග කටයුතු කිරීමේ හැකියාව යන්නටය. එය පැන නගින්නේ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාරවලට ලබා දෙන ණය විශාල වශයෙන් වැඩි කිරීම පමණක් ප්‍රමාණවත් නොවන්නේය යන්නෙනි. බැංකු සමග කටයුතු කිරීමේ හැකියාව යන්නෙන් අදහස් වන්නේ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාරවලට ණය ලබා දීමේදී බැංකුවල පිවිසීම මෙන්ම එම ව්‍යාපාරවලට බැංකු සමග කටයුතු කිරීමේ හැකියාව වැඩි දියුණු කිරීමයි. කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාරවලට ණය ලබා ගැනීමට ඇති වාතාවරණය සහ පහත සඳහන් ප්‍රශ්නවලට විසඳුම් ලබා ගැනීම වැඩි දියුණු කෙරෙන තත්වයන් වැදගත්ය. බැංකු අවංකවම කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාරවල සුවිශේෂී බැංකු අවශ්‍යතා කෙරේ යොමුව ඇත්ද? එවැනි ව්‍යාපාර සමග කටයුතු කිරීමට විශේෂිත වූ අංශ පවතින්නේද? ණය සහතික කිරීම සහ ණය සාර්ථකත්ව අනුපාත (Credit Scoring) වැනි කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර සහ බැංකු අතර තොරතුරු හා අවදානම් අසමමිතිකය පියවීමේ යාන්ත්‍රණයන් පවතින්නේද? එවැනි ව්‍යාපාරවල මූල්‍ය කළමනාකරණය සහ බැංකුවලට ගැලපෙන ව්‍යාපාර සැලසුම් සකස් කිරීමේ හැකියාව වැඩි දියුණු කිරීමේ ක්‍රම පවතින්නේද?

මෙම පත්‍රිකාව සංකල්පීය මෙන්ම ප්‍රායෝගී දැක්මකින් මූල්‍ය අභියෝගයට පිවිසීමේ මාර්ග වඩාත් හොඳින් අවබෝධ කර ගැනීමට ඉහත සඳහන් කරුණු විශ්ලේෂණය කරයි. ඉදිරිපත් කර ඇති මූලික ප්‍රතිපත්ති විකල්පවලින් සමහරක් වන්නේ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර වලට හිතකර බැංකු භාවිතා යොදා ගැනීම, එම සඳහා ව්‍යාපාර ණය අනුපාත සහ ණය සහතික කිරීමේ අරමුදලක් හඳුන්වාදීම සහ එම ව්‍යාපාරයන්හි මූල්‍ය සාක්ෂරතාවය සහ අභ්‍යන්තර කළමනාකරණය වැඩි දියුණු කිරීමයි. පමණ ඉක්මවා කෙරෙන ප්‍රතිපත්ති මැදිහත්වීම් ගැන ප්‍රවේශම්විය යුතු බව පෙන්වා දෙන මෙම පත්‍රිකාව රජයේ අවධානය යොමු විය යුත්තේ කුඩා සහ මධ්‍යම ප්‍රමාණයේ ණය දීම වඩාත් වැඩි කෙරෙන සුදුසු දිරිගැන්වීම් මෙන්ම නියාමන රාමු සකස් කිරීම බව පෙන්වා දී ඇත.

මෑතක ප්‍රතිපත්ති අධ්‍යයන ආයතනය සිදු කළ සමීක්ෂණ වල ශ්‍රී ලංකාවට ආදර්ශයක් වන නවතම සියුම් කරුණු උකහා දක්වන මෙම පත්‍රිකාව නැගෙනහිර ආසියානු රටවල් යොදා ගත් ක්‍රමෝපායන් සැලකිල්ලට ගනිමින් ප්‍රායෝගික ප්‍රතිපත්ති විකල්ප ඉදිරිපත් කරයි. දැනට සකස් වෙමින් පවතින රජයේ ජාතික කුඩා සහ මධ්‍යම ප්‍රමාණයේ ව්‍යාපාර ක්‍රියාවලිය මෙන්ම රජයේ ආයතන, මූල්‍ය ආයතන, වානිජ මණ්ඩල සහ අන්තර්ජාතික සංවර්ධන ආයතන සිදු කිරීමට අදහස් කරන අනාගත කුඩා සහ මධ්‍යම ව්‍යාපාර මැදිහත්වීම් ගැන දැනුවත් කිරීමටද මෙම පත්‍රිකාවෙන් අරමුණු කරයි.

நிறைவேற்றுச் சுருக்கம்

நடுத்தர வருமானப் பொருளாதாரம் என்ற நிலைக்கு இலங்கை மாற்றமடையும் போக்கில், அதிக தொழில் வாய்ப்புக்களை வழங்குதல், பிராந்திய வருமான சமநிலையற்ற தன்மையினை சீர் செய்தல் மற்றும் யுத்தத்தின் பின்னரான வளர்ச்சியை உறுதிப்படுத்தல் போன்றவற்றினை அடையாளம் கண்டுகொள்ளல் மிக முக்கியமானது என்பதனை இலங்கையின் சிறிய மற்றும் நடுத்தர கால தொழில் முயற்சிகளின் வளர்ச்சியில் அடையாளம் காணப்பட்டுள்ளதுடன் உள்ளடக்கப்பட்டும் உள்ளன. பூகோள ரீதியாக, உலகம் பூராகவும் உள்ள தேசிய பொருளாதாரத்திற்கான முக்கிய பங்களிப்புக்களை தொடர்ச்சியாக சிறிய மற்றும் நடுத்தர அளவான தொழில் முயற்சிகள் வழங்கி வருவதுடன், பூகோள பொருளாதாரத்தில் அவற்றின் ஒப்பீட்டு ரீதியான பருமன் மற்றும் வருமான சமநிலைத் தன்மையின் காரணமாக விசேட அவதானத்தினை ஈர்த்துள்ளது. நாட்டில் தங்களுடைய பரந்த பூகோள ரீதியான மற்றும் பரந்த அளவிலான தங்களுடைய துறைசார் முக்கியத்துவத்தை வழங்கி, பொருளாதார வளர்ச்சியில் முழுமையாகவும் மிகப் பிரதானமானதுமான முல வளமாகவும் அடிக்கடி சிறிய மற்றும் நடுத்தார தொழில் முயற்சிகள் செயற்பட்டு வருகின்றன. சிறிய மற்றும் நடுத்தர தொழில் முயற்சியாளர்களுக்கும் அத் துறைக்கும் சரியாக சூழலை உருவாக்கிக் கொடுத்தால், அதன் ஊடாக அவர்கள் தொழில் வாய்ப்புக்களை வருவாக்குவது மற்றுமல்லாது கைத்தொழில் அபிவிருத்தியையும் மேம்படுத்துவதுடன் மாறாக இயற்கையான தொழில் முயற்சியாளர்கள் திறன்களையும் வெளிக்கொனர்வதற்கு முயற்சி செய்வர்.

அதே வேளை சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகள் இலங்கையின் பொருளாதாரத்தில் மிக முக்கியமானதும் ஒன்றிப் பிணைந்தததுமானதொரு அங்கமாக அங்கிகரிக்கப்பட்டுள்ளதுடன் சமுகத்துடண் ஒன்றிணைந்த வலையமைப்பாகவும் உள்ளது. அது மட்டுமல்லாது, தங்களுடைய திறன்களை வளர்சியடையச் செய்வதற்கு உள்ளாரந்த பல தடைகளுக்கு முகங்கொடுத்து வருகின்றனர். இருந்த போதும், அண்மைய தசாப்தங்களில் தொடர்ச்சியான அரசாங்கங்கள் மற்றுமல்லாது சர்வதேச அபிவிருத்தி முகவரகங்களின் ஊடாக போதியளவான அவதானத்தை இத்துறை பெற்றிருக்கின்றது, இத்துறை தற்பொழுதும் இவ்வாறான சவால்களுக்கு முகங்கொடுத்து வருவதுடன் இவ்வாறான சவால்கள் பரந்த அளவில் கலந்துரையாடப்பட்டு தீர்க்கப்பட வேண்டிய விடயங்களாகும். அவ்வாறான சவால்களில், நிதி வசதிகளை அடைந்து கொள்வதில் மிக முக்கியமான பிரச்சினைகளாக உள்ளன. சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் அபிவிருத்தி, வளர்ச்சி, நிலைத்த தன்மை மற்றும் வலுவான்மையினை நிலைநிறுத்துவதற்கு அவர்களுடைய நிதி வசதிகளுக்கான பிரவேசம் மற்றும் முகாமைக்கான இயலுமை வெகுவாக உணரப்பட்டுள்ளது. துரதிஷ்டவசமாக இலயங்கையில் சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகள் நிதி வசதிகளை அடைந்து கொள்வதற்கான தடைகளை தொடர்ச்சியாக வெளிப்படுத்தி வருகின்றன.

நிதி வசதிகளை அடைந்து கொள்ளும் பொருட்டு, சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகள்

பல்வேறு பட்ட கோணங்களில் சவால்களுக்கு முகங்கொடுத்து வருவதுடன், அவ்வாறு தீர்த்து வைக்கப்பட வேண்டிய சிக்கல்களாவன : சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகள் மற்றும் வங்கிகளுக்கிடையிலுமான சாதகமான முனைப்பின்மை, சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகள்

மற்றும் நிதித் துறைக்குமிடையேயான தொடர்பற்ற நிதியளிப்பு வாய்ப்புக்கள், சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுக்கும் வங்கிகளுக்குமிடையிலான புரிந்துணர்வின்மை, நிதியளிப்புக்களின் கிடைப்பனவு தொடர்பில் இருவருக்கிடையிலான முன்னுரிமை மற்றும் தடைகள் தொடர்பிலான புரிந்துணர்வின்மை மற்றும் இவ்வாறான தடைகளை நிவர்த்தி செய்வதற்கு தடைகளாக உள்ளன.

சிறிய மற்றும் நடுத்தர தொழில்முயற்சிகள் முகங்கொடுக்கின்ற நிதி வசதிகளுக்கான பிரவேசம் தொடர்பாக புதிய உபாய வழிகளை நோக்கிய முன்வைப்பினை இந்த ஆவணத்தின் ஊடாக மிக முக்கியமான பங்களிப்பை செய்துள்ளது. சிறிய மற்றும் நடுத்தர தொழில்முயற்சிகளின் நிதி வசதிகளுக்கான பிரவேசம் என்ற விடயானது "நிதி வசதிகளுக்கான கிடைப்பனவு" என்று ஒரு புறமும் "வங்கியியல் செயற்பாடுகளை மேம்படுத்தல்" என்பது மறு புறமுமாக என்ற வகையில் இவ் விடயம் இரு வேறு பரிமாணங்களில் விவாதிக்கப்பட வேண்டிய முக்கிய விடயங்களாகும்.

"கிடைப்பனவு" என்பதன் மூலம் குறிப்பிடுவதாவது சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுக்கான நிதி கிடைப்பனவுகளை பெற்றுக் கொள்ளக் கூடிய இயலுமையை உறுதிப்படுத்திக் கொள்ளல் - தனியார் துறையின் மொத்த கடன் பங்கினை மேம்படுத்தல், சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுக்கான கடன் வழங்கும் அளவினை விரிவு படுத்தல், மற்றும் சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுக்கு மென் மேலும் அதிகமான கடன் திட்டங்களையும் விசேட நிதியளிப்பு மார்க்கங்களையும் வழங்குதல். நாட்டின் மொத்த நிதிக் கொள்கைகள், சந்தை திரவத்தன்மை மட்டம், அரச கடன் பெறல் மட்டம் மற்றும் தனியார் துறைக்கு கிடைப்பனவில் உள்ள கடன் மற்றும் குறைந்த வட்டி வீதத்தில் அல்லது சலுகை அடிப்படையில் சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுக்கான கடன் திட்டங்களின் தன்மை மற்றும் எண்ணிக்கை போன்றன அடிக்கடி செல்வாக்குச் செலுத்துகின்றன. இந்த சமர்ப்பிப்புப் பத்திரத்தின் பிரதான நோக்கம் இந்த முதல் விடயமன்று.

"வங்கித் தொழில் கிடைப்பனவுத் தன்மை" என்ற இரண்டாவது விடயம் தொடர்பாக பரந்த அளவில் கவனம் செலுத்துகின்றது. சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் உண்மையான புரிந்துணர்வு மட்டும் போதுமானதன்று. சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுக்கான வங்கியின் அணுகல் திறனை மேம்படுத்துவதற்கான செயற்பாடாக "வங்கித்தொழில் கிடைப்பனவுத் தன்மை" காணப்படுவதுடன் வங்கி நோக்கிய சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் அணுகு முறையினையும் மேம்படுத்துகின்றது. சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகள் கடன் பெறும் சூழ்நிலையினை மேம்படுத்துவதாக இவ்விடயங்கள் இருப்பதுடன் பின்வரும் வினாக்கள் மிக முக்கியமானது என்றும் குறிப்பிடுகின்றது -- சிறிய மற்றும் நடுத்தர தொழில் முயற்சி பிரத்தியேக வங்கித் தொழில் தேவைகளை நோக்கி வங்கிகள் உண்மையாக முனைப்புடன் இருக்கின்றதா?

சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுடன் செயற்படுவதற்கு விசேட வங்கிக் கிளைகள் உள்ளதா? கடன் உத்தரவாதங்கள் மற்றும் கடன் புள்ளியடல் போன்றவாறாக சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுக்கும் வங்கிக்கும் இடையில் தகவல் மற்றும் இடர் சமநிலைப்படுத்தல் பிணைப்புக்கான முறைமையொன்று இங்கு காணப்படுகின்றதா? சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் நிதி முகாமைத்துவம் மற்றும் இயலுமையை மேம்படுத்துவதற்கான திட்டங்கள் மற்றும் வங்கித் தொழில் வியாபார திட்டமிடல்களை அபிவிருத்தி செய்வதற்கான இயலுமை தொடர்பான திட்டங்கள் உள்ளதா?

எண்ணக்கருத்தியல் ரீதியாக மற்றும் செயற்பாட்டு நோக்கில் இருந்து பார்க்கின் போது, நிதிச் சவால்களை அடைந்து கொள்வதற்கான பல்லினத்தன்மையினை சிறந்த முறையில் புரிந்து கொள்ளக் கூடிய விதத்தில் இந்தப் பிரச்சினையினை இந்த ஆவணமானது பிரித்து தெளிவுபடுத்துகின்றது. சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளுடனான சினேக பூர்வமான வங்கித்தொழில் செயற்பாடுகளை பின்பற்றல், சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் கடன் தரப்படுத்தல் மற்றும் கடன் உத்தரவாத நிதிகளின் அறிமுகம், மற்றும் சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் நிதியியல் அறிவு மற்றும் உள்ளக முகாமை அறிவு போன்ற விடயங்களில் தேர்வுகளை செயற்படுத்துவதல் சில முக்கிய விடயங்களாக காணப்படுகின்றன. அபரிதமிதமான கெள்கை இடையூறுகள் தொடர்பாக எச்சரிக்கையை இவ் ஆவணம் தெரிவிப்பதோடு சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் கடன் பெறல் ஆற்றலை பாரிய அளவில் ஊக்கப்படுத்தும் வகையிலான ஒழுங்கு முறைப்படுத்தல் வேலைச் சட்டகம் மற்றும் பொருத்தமான ஊக்கக் கொடுப்பனவுகளை அரசாங்கமானது அறிமுகம் செய்து முன்னெடுத்தல் வேண்டுமெனவும் இவ் ஆவணம் விவாதிக்கின்றது.

இலங்கைக்கான சான்றுகளை வழங்குவதற்கான கொள்கைகள் கற்கை நிறுவனத்தின் அண்மைய ஆய்வுகளிலிருந்தான புதிய ஆய்வு முடிவுகளின் பால் கவனத்தைச் செலுத்துமாறு தூண்டுகின்றது மற்றும் கிழக்காசிய பொருளாதாரங்களில் அமுல்படுத்தப்படுகின்ற யதார்த்தமான கொள்கைத் தெரிவுகள், பயன்படுத்துகின்ற உபாயங்கள் பற்றியும் கவனம் செலுத்தும் படி ஊக்கப்படுத்துகின்றது. எனவே, இந்த ஆய்வுக் கற்கைப் பத்திரமானது அரசாங்கத்தின் அமுலில் உள்ள சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகளின் கொள்கை செயன்முறை பற்றி தகவல் அறிவுப்புக்களை வழங்குவதுடன் சிறிய மற்றும் நடுத்தர தொழில் முயற்சிகள் பால் அரச முகவரகங்கள், நிதி நிறுவனங்கள், வர்த்தக சம்மேளனம் மற்றும் சர்வதேச அபிவிருத்தி முகவரகங்களினால் முன்னெடுக்க இருக்கின்ற எதிர்கால திட்டங்கள் தொடர்பாகவும் தகவல் வழங்குவதற்கு இலக்கு வைத்துள்ளது.

1. Introduction

Broad-based inclusive and sustainable growth with the active involvement of the private sector is one of the most important development strategies opted by many developing countries.[1] It is widely acknowledged that industrial growth matters for employment generation, competitiveness and inclusive socio-economic development even in services-oriented emerging economies; international experience suggests that a robust industrial policy is in fact essential to realize the full potential of services-led growth.[2] These dynamics are particularly relevant to public policy when the pattern of intra-country growth points to significant geographical disparities, as is the case in Sri Lanka.

Policy experience in post-war situations around the world suggests that the private sector is one of the most resilient and adaptable institutions for socio-economic reconstruction and revival in the face of systemic shocks.[3] Coming out of a protracted armed conflict, the role of private sector development in post-war development is a key consideration in economic policy.

In this context, cross-country policy research shows that Small and Medium Enterprises (SMEs) play a vital role in generating high and inclusive economic growth, job creation, as well as in reducing inequality and poverty, particularly in developing countries.[4] Development of this sector has been widely acknowledged as a crucial strategy for growth both in developed and in developing economies of the Asian region (UNESCAP, 2012). In their industrial policies, many countries are increasingly placing heavier emphasis on the development of the SME sector.

In Sri Lanka, too, SMEs have been recognized as an important sector of the economy due to their significant contribution to national income, employment, inclusive private sector development, bridging regional growth disparities and poverty reduction. Since independence, successive governments have introduced various support programmes to facilitate the growth and expansion of SMEs in different sub-sectors of the economy. However, as the SME White Paper (2002) argued, there has been no deliberate policy effort to exploit the full development potential of SMEs. Many private sector development policies in the past have continued to focus more heavily on large-scale enterprises (through Board of Investment and other schemes) over smaller ones. The SME sector in Sri Lanka today faces many challenges. Understanding these better and devising smarter, more comprehensive and coherent strategies to overcome them, is now of paramount importance. This is especially true of one of the most critical factors that continue to affect SME development - access to finance.

Although the importance of growing the SME sector is now back in the country's economic policy discourse, much of the recent policies and initiatives for SME development have been mostly centred on successive rounds of concessionary credit schemes. Yet, there appears to be limited understanding of the underlying dynamics driving the access to finance problem faced by SMEs, and very little published literature in Sri Lanka on the subject. This paper attempts to fill this void. It explores the drivers of the problem, including conceptual elements surrounding financing of small businesses. It reviews innovative strategies adopted by other economies to address the problem - particularly those in emerging Asia. It highlights the scale and nature of the problem specifically in the Sri Lankan context, using results from a recent survey by IPS, key interviews with the banking sector, as well as secondary information. It also puts forward possible mechanisms and policy options to tackle the challenge in Sri Lanka. Through all this, the paper aims to expand the knowledge on the specific area of access to finance

1 ESCAP (2011), 'Enabling Environment for the Successful Integration of Small and Medium-sized Enterprises in Global Value Chains', United Nations: Bangkok.

2 Sulaman, H. and S. Hassan (2010), "Services-led Industrial Policy for Inclusive Growth and Competitiveness", *Competitiveness Review*, Vol. 20, No.2.

3 MacSweeny, N. (2008), "Private Sector Development in Post-conflict Countries: A Review of Current Literature and Practice", The Donor Committee for Enterprise Development, available at http://www.enterprise-development.org/page/current-work.

4 See for instance: Ardic, P., N. Mylenko, and V. Saltane (2011), "Small and Medium Enterprises: A Cross-Country Analysis with a New Data Set", Policy Research Working Paper No.5538, World Bank, Washington D.C.; and, Ayyagari, M., A. Demirguc-Kunt, and V. Maksimovic (2011), "Small vs. Young Firms across the World: Contribution to Employment, Job Creation, and Growth", Policy Research Working Paper No.5631, World Bank, Washington D.C.

challenges for SMEs and inform the design and implementation of ongoing and future interventions in this area by the government, private sector and international agencies.

The rest of the paper is organized as follows. Section 2 reviews the literature on the importance of SMEs from a global and local viewpoint. Section 3 sets out the rationale for overall policy support to SMEs. Section 4 tackles the scale and nature of the access to finance challenge, starting with setting out some conceptual issues and then going on to review international evidence, and more crucially the Sri Lankan evidence on the access to finance problem. Section 5 explores the supply and demand dynamics driving the access to finance challenge. Section 6 discusses a comprehensive set of policy options to improve SME access to finance, including exploring specific mechanisms and models. Section 7 concludes.

2. Importance of SMEs - Global Context

The strategic importance of SMEs in overall economic development has been widely recognized in the past and has been even more evident in recent decades, both in developed and in developing nations (UNESCAP, 2012). The aftermath of the global financial crisis of 2008-2009 witnessed a renewed interest in SMEs as an engine of inclusive growth in countries around the world.

The growing debate on the advantages of small firms over larger ones in developing countries has also drawn much attention towards the SME sector. Fischer (1995) highlights that the advantages of small enterprises over large scale enterprises in developing countries are threefold: 1) small enterprises are labour-intensive and use relatively simpler techniques of production that correspond to the abundance of labour and the scarcity of physical and human capital that prevail in most developing countries; 2) small enterprises demonstrate a higher degree of efficiency in using capital and in mobilizing savings, entrepreneurial talent, and other resources that otherwise would remain idle; and 3) a large share of small enterprises is also expected to exercise a positive influence on the distribution of income both in functional and in regional terms.[5] Ahmed (2011) states that being a small firm as opposed to a large one is said to have the advantages of being, much more capable than large firms of overcoming economic turmoil and much more capable than large firms in achieving faster growth due to the ability to make faster decisions.[6]

Various studies highlight the economic importance of the SME sector in national economies. A review conducted by India's Ministry of Science and Technology revealed that 99.7 per cent of all enterprises in the world are SMEs while large enterprises only account for 0.3 per cent.[7] IFC (2010) indicates that formal SMEs contribute up to 33 per cent of

The aftermath of the global financial crisis of 2008-2009 witnessed a renewed interest in SMEs as an engine of inclusive growth in countries around the world.

[5] Fischer, B. (1995), "The Basic Problem in Financing Small Businesses". In: Brugger, E. A. Rajapathirana. S., (Eds.), *New Perspectives on Financing Small Business in Developing Countries*, San Fransisco: ICS Press.

[6] Ahmed, F. (2011), "Why Small and Medium Enterprises are More Profitable than Big Ones", *ICE Business Times*.

[7] Ministry of Science and Technology (2011), *Small and Medium Enterprises (SMEs) in India*, New Delhi, Department of Scientific and Industrial Research of India.

GDP in developing economies.[8] On employment creation, it notes that SMEs contribute up to 45 per cent of employment and adds that, "in the context of the international development agenda, and given the critical importance of job creation in the recovery cycle following the recent financial crisis, promoting SME development appears to be an important priority".[9] Estimates on employment creation in Hall (2002) are much higher, indicating that SMEs, on average, provide between 60-70 per cent of all jobs, especially within the Asia-Pacific context.[10] The Asian Association of Management Organizations (AAMO) reports that, in the Asia-Pacific region, SMEs typically account for nearly 50 per cent of all value addition within the economy, directly and indirectly.[11]

Box 1: SME Definition: A Tricky Issue

Definitions of what constitutes an SME vary quite widely from country to country and even within single countries. Often it depends also on the business sector concerned - e.g., agriculture, natural resources, manufacturing, services and retailing (ESCAP, 2009). There is no universal determinant of or criterion for an SME. Much depends on the character of the respective host country, and the profile of its own particular corporate sector, from which a relative measure of an SME is then typically made, sometimes on a rather arbitrary basis. The form of ownership profile, type of legal entity or general provenance of the company is typically deemed irrelevant when creating the definition. While an SME is often imagined as a locally-owned and privately-held business, there is no reason why it cannot be a state-owned or foreign-invested enterprise. Some countries will distinguish between a micro-enterprise and a small enterprise, while others - by not setting a limit for SME size - effectively include micro-enterprises within their SME umbrella definition. The above notwithstanding, most SME definitions pertain to businesses that are formal in nature and have been registered in some manner, and exclude small-scale, informal family enterprises (ESCAP, 2009b). According to a World Bank study, more than 60 definitions of SMEs are used in 75 countries (Indian Institute of Foreign Trade, 2011). Some countries have used the number of employees as the sole criteria for determining whether a business is an SME or not. Other countries use this same criterion, plus an additional one based on either the value of the firm's assets or the size of revenue in local currency. In cases where a currency value is cited (either for assets or revenues) any marked inflation can pose a problem for the SME definition over time. Some countries recognize this issue and occasionally update their criteria for SMEs, but most do not (ESCAP, 2009a). The three main parameters that have been generally applied to define SMEs are: (a) the number of employees; (b) turnover of business; and (c) capital investment.

[8] IFC (2010), "Scaling-up SME Access to Financial Services in the Developing World", October, G20 Seoul Summit 2010.

[9] *Ibid.*

[10] Hall, C. (2002), "Profile of SMEs and SME Issues in East Asia", in C. Harvie and B.C. Lee (Eds.), *The Role of Small and Medium Enterprises in National Economies in East Asia.* Cheltenham, United Kingdom, Edward Elgar.

[11] Asian Association of Management Organizations (AAMO) (2007), “SMEs in the Asian Region - Harnessing the Growth Potential”. New Delhi, AAMO.

3. Rationale for Policy Support to SMEs

It is clear that it is not possible to discuss economic policy without recognizing the role which SMEs play in the rest of the economy and society as a whole. Yet, it is appropriate to examine the arguments often put forward in favour of government policy support for SMEs. A widely noted reason is that there are market failures that are peculiar to SMEs because of their comparative weaknesses in the market and their relative high cost of compliance with government regulations (Bannock and Peacock, 1989). This argument is that SMEs do merit support not to give them an undue advantage over other types of enterprise, but simply to offset the disadvantage which they experience by their small size and to offset perverse effects of other government policies. This is an important proposition because it goes to the heart of the current discourse in private sector development that cites the importance of "creating a conducive enterprise environment". In this framework, then, addressing failures like access to finance, among others, should become the focus of policy support.

The overall objectives of government policies to support SME development are: (a) create jobs and generate income; (b) improve SME performance and competitiveness; and (c) increase their participation in and contribution to the national economy. There are a number of obstacles that need to be overcome to achieve these objectives. The following constraints for SME development identified by AAMO (2007) are useful to recall here:

1. Poor business environment (e.g., bureaucracy, taxation and unfavourable property rights enforcement)
2. Poor infrastructure (e.g., transportation facilities, power plants, industrial estates and telecommunications)
3. Inadequate access to finance (e.g., obtaining loans, securing collateral and third-party guarantees and a lack of alternative sources)
4. Low technological capacities (e.g., rapid technological advancement in markets, locating sources of appropriate technology and acquiring technology to develop attractive products
5. Too few applications of ICT (e.g., business communi-cations, marketing intelligence and customer development)
6. Intensified competition in domestic, regional and global markets (e.g., trade and investment liberalization, less protectionism, freer movement of goods and capital, lower import duties, cuts in subsidies and cost pressures).

The focus of this present paper is exclusively on factor number 3 above, as the authors believe that this issue is at the heart of the strength and competitiveness of SMEs. Addressing the access to finance problem more robustly, would have positive knock-on effects on the other factors as well.

The overall objectives of government policies to support SME development are: (a) create jobs and generate income; (b) improve SME performance and competitiveness; and (c) increase their partici-pation in and contribution to the national economy.

4. The Scale and Nature of the Access to Finance Challenge

4.1 Financing the SME Sector - A Conceptual Overview

Financial inclusion is a prerequisite for growth of the country and its commercial sector.[12] For SMEs in particular, financial inclusion through better access to finance is important. The ability of SMEs to grow and improve competitiveness greatly depends on their potential to invest in development of the business, restructuring, innovation, improvements, and diversification over time (UNESCAP, 2012). All of these investments need short- and long-term capital. Therefore, access to finance is a central issue in SME development. Improving access to finance means enhancing the degree to which financial services become available to all, through ways that are easier to access, appropriate, and affordable.

First, the study takes a conceptual overview of the various stages of SME financing and the typical types and sources of SME financing,

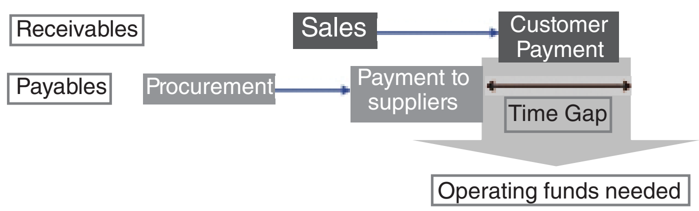
4.1.1 Stages of Financing

The financing needs of an SME may vary throughout each stage of its life cycle - start-up, growth, maturity, decline, transition and exit.[13] SMEs may obtain equity capital and debt financing from various sources at each of these stages (Sridhar, 2008).

In the first stage (start-up), SMEs could face a high probability of failure if they cannot raise sufficient capital, even though the scale of their needs may not be that large. In this stage, a firm may have limited sales revenues and also profits may only be on paper and cash in hand may be strained, leading to inability to pay wages, bills and other operating costs, This mismatch of cash flow timing continues throughout the life cycle of an SME (see Figure 2). Survival in this stage could depend on a firm's ability to raise additional working capital from the banking system. Apart from personal loans from family and friends, during the start-up stage SMEs may get funds from seed capital, venture capital, government and/or institutional sources.

In the second period (growth), SMEs pass the break-even point and start making money at which point they need additional financing including significant working capital loans (short-term) as well as investment loans (longer-term) to expand production and staffing. The availability of other funds could also increase at this stage with local, national and international financial sources. Venture capital funds may also become an important resource for expansion. Entrepreneurs typically experience difficulty raising funds at this critical stage. Commercial banks do not lend easily to those who still have no, or limited, credit record, and venture capital is not readily available for small-scale investment in new businesses, particularly in developing countries and non-IT enterprises. In the third period (transition), it is necessary for SMEs that are losing money to undertake measures to improve profitability, either by improving efficiency and productivity (cutting costs, streamlining operations, etc) and increasing sales through enhanced competitiveness. While long-term financing or working capital generation is necessary for continuous enterprise growth and development, immediate short-term financing, perhaps through

Figure 1
Mismatch of Cash Flow Timing



Source: ESCAP, 2012.

[12] IFC (2013), 'Promoting Financial Inclusion', International Finance Corporation: Colombo.
[13] This is a generalization for the sake of demonstration. Real life cycles may differ between individual firms and between sectors/industries.

commercial debt financing, is often critical for SMEs during cash-drain periods.

So it is now clear that SMEs require access to finance of various types at various stages of their life cycle, and obtaining timely and sufficient loans is a key part of this.

4.1.2 Types and Sources of Financing

SMEs obtain financing via a number of different financial instruments. While this paper largely focuses only on a sub-set of these, particularly formal debt financing through loans from the banking system, it is useful to take a brief overall look at these instruments, in the interest of completeness.

Short- and long-term loans, especially from commercial banks, are the predominant form of financing for SMEs. Short-term loans are the most common form of bank loans for start-ups and small businesses, as commercial lenders are generally less willing to take large risks with new companies. They have a maturity of one year or less, although many are repaid within a shorter timeframe (Peavler, 2012). They are usually taken out for a specific expenditure, for example, to purchase a piece of equipment or to pay a particular debt. In this context, a fixed amount of money is borrowed for a set time with a fixed interest rate (Business Owner's Toolkit, 2012a). In general, the sources of short-term financing for SMEs include a line of credit, promissory notes, other short-term banking instruments (e.g. , overdrafts) and loans from other financial companies. Short-term financing is easier to arrange, has lower costs and is more flexible than long-term financing. However, short-term financing is more vulnerable to interest rate swings, requires more frequent refinancing and requires earlier repayment. SMEs tend to rely on short-term loans to meet sudden financial needs or to gain additional working capital, especially if they face a temporary cash crisis or an unexpected delay in receipts from a debtor. Long-term commercial loans usually refer to those with tenure beyond one year. This type of loans, also called 'project loans', enable businesses to invest and expand their business with less financial uncertainty, and increases working capital while reducing the amount of instalments. Longer-term commercial loans are used for a variety of purposes, such as purchases of equipment and plant facilities, business expansion and acquiring specialty raw materials for a new project. Lenders require significant collateral because the risk increases with the term length. It is more difficult for SMEs to obtain long-term loans due to the lack of adequate assets to use as collateral and the insufficient supply of such long-term loans, particularly in developing countries (IFC, 2009). The obvious consequence of difficulties in accessing long-term loans is that SMEs are unable to plan on a long-term basis, thereby constraining growth plans and long-term investment decisions (Obamuyi, 2007).

Informal sources of finance also play an important role for SMEs. Informal financing refers to all transactions, loans and deposits occurring outside the regulation of a central monetary authority (Atieno, 2001). Although rarely seen in the Sri Lankan SME sector, equity financing is also an option for SMEs. In equity financing, investors provide a capital infusion in exchange for an ownership share in the business. It includes a wide range of financing sources such as business

Table 1
Types and Sources of SME Financing

Category	Type of Instrument
Informal financing	Personal savings Borrowing from family or friends Borrowing from moneylenders Trade credit
Internal financing	Retained profit Internal savings Working capital Sales of assets
Debt financing	Short-/long-term loans Line of credit Promissory notes Credit cards Overdraft Corporate bonds
Equity financing	Seed capital Angel finance Venture capital IPOs
Asset-based financing	Factoring Invoice discounting Inventory financing
Leasing	Capital leasing (hire-purchasing) Operating leasing
Government grants and subsidies	Grants Interest subsidies Credit guarantee schemes Loan insurance schemes Loan schemes

Source: Authors.

angels, venture capital and initial public offerings (IPOs). Asset-based financing is also used by SMEs whereby funds are obtained by pledging part of the firm's assets as collateral or as the primary source of repayment (Berger and Udell, 2005). The most common types of asset-based financing are factoring, invoice discounting and inventory financing (Business Owners Toolkit, 2012a). Additionally, SMEs often use leasing as a way to financing new equipment like machinery or motor vehicles.

A summary of the various SME financing sources discussed above are provided in Table 1 above.

The present financing structure of SMEs in Sri Lanka consists mainly of the development financing institutions (DFIs) and licensed commercial banks. DFIs such as DFCC Bank and NDB Bank often offer medium- to longer-term, project-based funding for SMEs, and are often the Partner Financial Institution (PFI) for numerous concessionary loan schemes refinanced by aid donors.

Several commercial banks also function as PFIs in implementing donor-funded as well as government-funded SME credit schemes, in addition to providing their own schemes aimed at SMEs. In addition, equity market, debenture market and venture capital act as supplements in SME financing, but have very limited reach. Recent venture and angel finance initiatives like the Lankan Angel Network have begin to gain ground, but are largely limited to the Western Province.

4.2 Access to Finance Gap - Exploring the International Evidence

Against this backdrop, SMEs consistently cite lack of access to finance as a severe handicap (UNESCAP, 2009a). While the gap in financing SMEs is significant both in developed and developing countries, some differences do exist. A survey of SME financing by the OECD (2006) indicated large financing gaps in both OECD and non-OECD countries, but the situation was more acute in non-OECD countries. Further, there were significant differences between OECD and non-OECD countries on the matter of debt financing. While only 30 per cent of the firms in the OECD countires felt a gap existed in debt financing, 70 per cent of non-OECD countries felt this. This suggests underlying weaknesses in the banking sector - the main provider of debt financing - in dealing with small firms in non-OECD countries. Park, Lim and Koo (2008) confirm this, and further explore the disadvantages in SME financing due to the lending policies of commercial banks, the most important source for SMEs' external financing. A survey conducted by Beck, Demirgüç-Kunt and Peria (2008) confirm this by showing that in developing countries, commercial banks require more collateral for small business loans and charge higher interest rates than those in developed countries, regardless of firm size. Their findings imply that the transaction cost in the commercial banks of developing countries is high, adding further challenges for SME financing in such countries.

According to a 2009 Asian Development Bank survey of SMEs in 13 countries, obtaining capital is the top constraint for firm formation and growth (ADB, 2009). There are a multitude of reasons for this, and these reasons in the Sri Lankan context are explored later in section 6. But Sri Lanka is not an outlier in its access to finance problems. As ESCAP (2012) observes, "although most of the governments in the Asia-Pacific region have formulated well-structured policies and placed well-developed institutional financing agencies on the ground to meet the needs of SMEs, there is a gap in the actual implementation of these policies. Bank management may not appreciate the dire need that SMEs have for cash. Banks may be willing to help but their SME clients get lost in the shuffle as bank management caters to larger, wealthier customers. Unfortunately, the SME-banker relationship may then become adversarial, further defeating the best intentions of policy makers. Part of the intransigence often lies with the owner of the SME, who may not be able to communicate effectively with the banker or present their needs in a way that would give incentives for the bank to cooperate".

Historically, SMEs around the world have frequently had difficulties in accessing finance. The recent global financial crisis, however, intensified this challenge. According to an Economist Intelligence Unit (EIU) survey report on access to finance among SMEs,[14] 45 per cent of respondents from the Asia-Pacific region say that the availability of finance has deteriorated in the aftermath of the crisis. According to the IMF, lending to the sector has fallen much more sharply than it has to larger companies.[15] The stresses and pains of SMEs owing to the lack of finance seem to have augmented

[14] Economist Intelligence Unit, ACCA and CPA Australia (2009), *Access to Finance for the Small and Medium Sized Enterprise Sector Evidence and Conclusions.*
[15] International Monetary Fund (IMF) (2012), *World Economic Outlook.*

with the tightening of financial regulations in the aftermath of the global financial crisis.

A recent IFC study revealed the severity of the financing issue faced by SMEs, particularly in emerging markets. Approximately 45-55 per cent of formal SMEs in emerging markets were found to be *unserved* (i.e., they need credit but do not have access to it) while 21-24 per cent were found to be *underserved* (i.e., they have access to some credit but still identify financing as a constraint).[16] The survey also concludes that only 17 per cent and 32 per cent of small firms in low and middle income countries, respectively, had access to a loan/line of credit from financial institutions, while the corresponding figure for high income countries was 50 per cent.[17] Further, the results of the World Bank Enterprise Surveys indicate that SMEs in developing countries are more likely than SMEs in developed countries to report access to finance as a major obstacle for their development.[18] According to the Enterprise Surveys, 30 per cent of all countries and nearly 35 per cent of countries in South Asia identified access to finance as a major constraint.

ADB (2009) reiterates that the growth potential of SMEs tends to be more vulnerable to financing constraints than large firms. They estimate that financing obstacles result in an average decline in growth of 10 per cent for smaller firms vis-à-vis 6 per cent for larger firms.

4.3 Access to Finance Gap - Exploring the Sri Lankan Evidence

The access to finance issue certainly is not a new one in the SME development discourse in Sri Lanka. It has been identified in previous policy documents as well. For instance, the 'National Strategy for Small and Medium Enterprise Sector Development in Sri Lanka White Paper' (2002) identifies problems related to finance as the foremost impediment to SME growth in the country.[19] The report further states that the lack of SME access to finance results in a vicious circle linking financing problems with the performance and progress of SMEs, as the lack of finance in turn results in undesirable outcomes such as the use of outdated technology, absence of quality control, and weakening profitability.[20]

Several studies by international agencies have reported headline figures on the access to finance problem. The World Bank Enterprise Survey for Sri Lanka (2011) reported that among 610 firms surveyed, access to finance was the second-most cited 'business environment constraint' (30 per cent of firms).[21] Meanwhile, an IFC micro-study of 2010 reported, "a significant proportion (40 per cent) of firms interviewed mentioned that insufficient access to finance had been a main obstacle either when starting or expanding their business".[22]

Adding to this body of knowledge is a recent survey of SMEs in Sri Lanka conducted by the Institute of Policy Studies with the National Chamber of Commerce of Sri Lanka.[23] The survey was conducted in early 2013 via a semi-structured questionnaire. The sample was randomly selected using

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[16] International Finance Corporation (IFC) (2010), *Scaling-up SME Access to Financial Services in the Developing World*.

[17] *Ibid.*

[18] World Bank (2013), Enterprise Surveys.

[19] Task for Small & Medium Enterprise Sector Development Program (2002), *National Strategy for Small and Medium Enterprise Sector Development in Sri Lanka, White Paper*.

[20] *Ibid.*

[21] Survey only covered manufacturing enterprises.

[22] IFC (2010), 'Assessing Private Sector Contributions to Job Creation: IFC Open Source Study', IFC: Colombo.

[23] The sample was randomly selected using NCCSL database of members classified by NCCSL as SMEs. Any selection bias is unlikely owing to the strongly heterogeneous nature of the enterprises surveyed. All are formally registered businesses.

NCCSL's database of SME members.[24] The common feature of the sample was that they were all members of the Chamber and formally registered businesses. Although all respondents come from this same enterprise cohort, any selection bias is unlikely owing to the strongly heterogeneous nature of the enterprises surveyed. The authors looked closely at the nature of the business that each respondent was engaged in to ensure that the results aren't skewed towards any one business type (i.e., wood work, food processing, etc). This was deemed not to be the case.

The survey received 101 responses, covering all provinces in Sri Lanka (see Table 2). At the outset, the focus in the sampling was on enterprises outside the Western Province, taking the argument that SME development in other regions is particularly difficult. As such, 96 per cent of respondents were from regions outside the Western Province.

The aim of the survey was to identify the key issues faced by SMEs in Sri Lanka. According to the findings of this survey, 91 per cent of respondents considered access to finance as one of the 'top five constraints' on their businesses, while half of all respondents considered it as their 'most significant constraint' (see Figure 2).

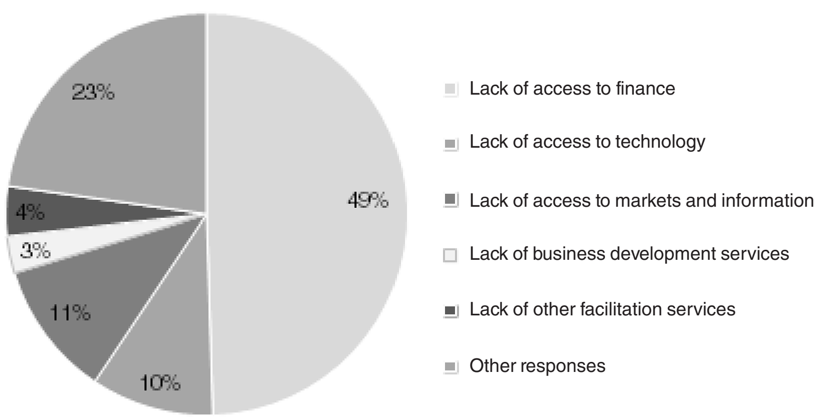
Table 2
Distribution of Respondents by Province

Province	No.
Eastern	9
Central	24
North Western	24
Uva	11
Southern	10
North Central	12
Sabaragamuwa	4
Western	4
Northern	3

Source: IPS-NCCSL Survey.

The most significant reason for inadequate access to finance experienced by most of the survey respondents was attributed to the inability of financing development/ expansion plans. Of the respondents who reported they had inadequate access to finance, 69 per cent said they had more difficulty in accessing finance for development/expansion, while those who stated it was more difficult to access working capital were relatively fewer (around 31 per cent).

Figure 2
Most Significant Constraints on Businesses as Perceived by SMEs



Source: Survey results.

According to the survey results, financial restrictions also contributed to the tightening of other constraints on the working of the business. Of the individuals that participated in the survey, more than one-third of those whose employees had not received any training, credited insufficient finances as the main reason for it.

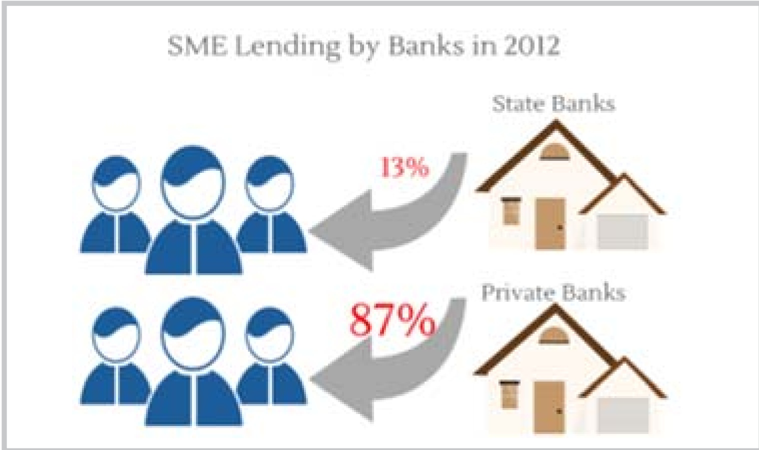
The majority of respondents (60 per cent) noted that formal channels were their main source of financing (37 per cent) of which government banks were the preferred option. Informal sources were acknowledged by nearly 40 per cent of all respondents as part of their financing options, with the majority coming from friends/ relatives and local moneylenders (Figure 3). This is not unusual. While commercial banking plays a key role in formal SME financing, informal financing often dominate the financial sources of SMEs because of the very nature of their structure and networks (sole-proprietorships, locally-based, etc). A report by RAM Consultancy Services (2005) on SMEs in the ASEAN region revealed that 75 - 90 per cent of SMEs rely on informal financing and internal financing. Hussain, Millman and Matlay (2006) report that, in China, 15 per cent of financing needs of SMEs come from borrowing from friends, relatives and other individuals while approximately 20 per cent comes from bank loans.

For SMEs examined in our survey, the most common reasons for using such

[24] The size of the database was 400 members. However the authors acknowledge that this does not capture the entire SME population in these Provinces. Such information is not available from government census and statistics data owing to SME definition and classification issues.

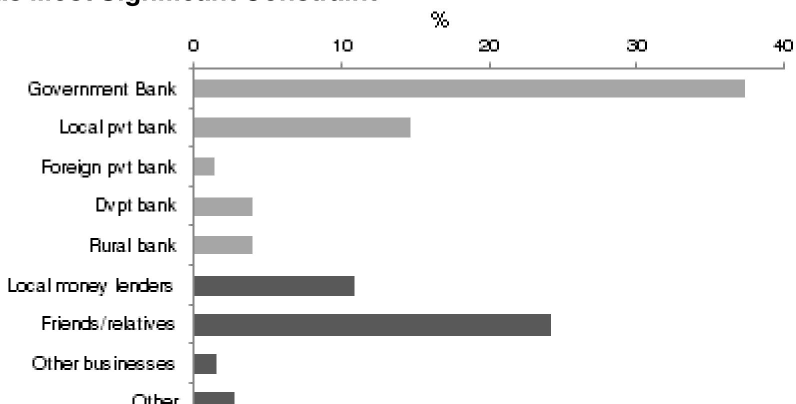
sources were listed as high interest rates and the inability to provide collateral requested by formal banking institutions, with seemingly little relief from development banks. The unwillingness of formal banking institutions to serve SME clients, for a number of reasons, was another significant motive for using alternatives. However, the survey further revealed that 75 per cent of those currently using informal sources declared that they would prefer using formal financing sources instead.

Two subsequent surveys reinforced the notion that banks and financial institutions are not able to suitably cater to SMEs' access to finance needs. An IPS survey focussing on manufacturing-oriented SMEs in the Western Province, noted that while only 44 per cent of enterprises sought access to finance in the last year (2013), the majority of those that did (79 per cent), sought it from commercial banks. Of those that did not seek finance from formal credit channels, the second most-cited reason (19 per cent) for it (the first being that the enterprise had sufficient capital) was that 'application procedures were too complex'. Other reasons included 'need for formal registration' (15 per cent), 'interest rates not favourable' (4.6 per cent), 'collateral requirements were too high' (1.3 per cent), 'did not think it would be approved' (2.6 per cent), and 'size of loan and maturity were insufficient' (2 per cent).



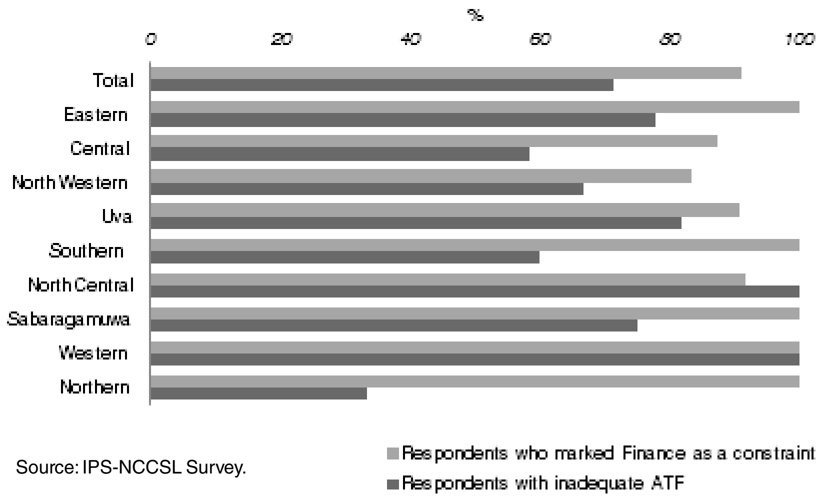
Meanwhile, a further IPS survey focussing on women entrepreneurs in the SME sector revealed very strongly that support received from financial institutions to start and grow their businesses was not satisfactory. According to male and female survey respondents from five districts (Moneragala, Batticaloa, Anuradhapura, Kurunegala and Matale), nearly 60 per cent disagreed or strongly disagreed with the statement that 'support received from financial institutions were good' (Figure 5). Only 20 per cent indicated satisfaction about the services received from financial institutions. Of the 44 per cent of women-owned

Figure 3
Current Sources of Finance for SMEs Reporting Access to Finance as Most Significant Constraint



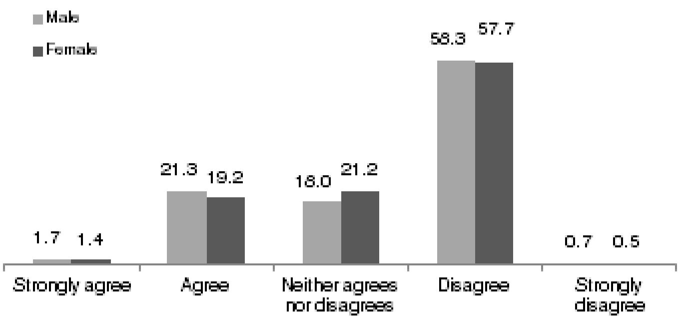
Source: IPS-NCCSL Survey.

Figure 4
Access to Finance by Province



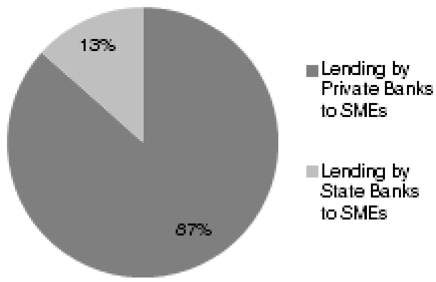
Source: IPS-NCCSL Survey.

Figure 5
Support Received from Financial Institutions that Helped Grow the Business



Source: IPS (2014), 'Female Entrepreneurship and the Role of Business Development Services in Promoting Small and Medium Women Entrepreneurship in Sri Lanka'.

Figure 6
SME Lending by Banks in 2012



Source: Authors' calculations based on Ministry of Finance and Planning (2013), *Annual Report 2012*.[25]

SMEs that had applied for a loan in 2013, development banks were the main source of funding. Furthermore, of the women SME entrepreneurs in this survey who had started their own businesses, only 34 per cent had obtained finance via bank loans or local-level finance companies - the majority (70 per cent) had raised capital from informal sources like friends, relatives, neighbours, spouses, parents, children, siblings, and also through pawning.

Against this backdrop, it would be interesting to look at the recent performance with regard to SME lending in the Sri Lankan financial system. Recent trends in SME banking are certainly encouraging.

In line with Government efforts to promote the SME sector in recent years, the banking sector of Sri Lanka has diverted more attention towards serving this segment. It appears that private sector banks have been the major driver of SME financing in the country. In 2012, for instance, private sector banks accounted for 87 per cent of total SME lending (Figure 6). Further, SMEs in the industrial sector have been the recipient of a relatively larger share of SME loans in 2012, while SMEs in the agriculture sector have received the lowest (Table 3).

Very little published data is available from the individual banks as to their SME lending portfolios. A closer look at company Annual Reports along with key informant interviews revealed

Table 3
SME Loans Provided by Banks in 2012

Bank	Agriculture		Industries		Services		Other	
	No. of Loans	Amount Rs. Mn.	No.of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.
Bank of Ceylon	12	15.0	356	3354.0	231	2395.0	36	346.0
Peoples' Bank	3247	6869.9	1607	10393.7	1795	4135.5	1227	3643.4
Regional Development Bank	385	195.0	590	490.0	170	85.0	280	590.0
Lankaputhra Development Bank	42	101.3	241	1120.6	39	243.2	31	113.5
Sanasa Development Bank	22	152.0	42	581.0	9	139.0	61	625.0
National Development Bank	370	1725.8	1098	3346.7	380	1132.9	2817	5748.3
DFCC Bank	487	1445.4	2953	13053.6	1017	5981.1	-	-
Commercial Bank of Ceylon PLC	18362	8986.7	31186	50939.9	9724	19224.5	18210	16362.9
Sampath Bank	163	894.9	1828	7746.3	215	1074.3	191	1633.4
Hatton National Bank PLC	4364	9323.8	2553	8800.0	4670	13500.0	10397	31000.0
Nations Trust Bank PLC	132	679.2	537	1129.9	2453	3806.1	8876	10929.4
Union Bank of Colombo Ltd.	2526	756.0	3286	4839.0	1382	2326.0	34873	3680.0
Total	30112	31145.1	46277	105794.6	22085	54042.6	76999	74671.9

Source: Ministry of Finance and Planning (2013), *Annual Report* 2012.

[25] Private sector banks include NDB Bank PLC, DFCC Bank, Commercial Bank of Ceylon PLC, Sampath Bank, Hatton National Bank PLC, Nations Trust Bank PLC and Union Bank, while public sector banks include Bank of Ceylon, People's Bank, Regional Development Bank Ltd., Lankaputhra Development Bank Ltd., and Sanasa Development Bank Ltd.

Very little published data is available from the individual banks as to their SME lending portfolios.

some information for a few of the larger banks. As shown in Table 4, the levels of SME lending in the total loan portfolio differs widely from bank to bank. For instance, the NDB Bank, originally set up as a development bank to finance sectors such as SME, demonstrated only a 10-15 per cent SME loan portfolio. Meanwhile, the other development bank, DFCC, demonstrated an over 50 per cent average SME lending ratio over the last four years. Commercial banks like Nations Trust Bank (22 per cent) and Sampath Bank (40 per cent) have been steadily raising their SME lending as well. Yet, what cannot be determined from these numbers is the lending to small enterprises vs. lending to medium-sized enterprises. As there is no regulation to report information in this manner, together with the added complication of a lack of a consistent SME definition, this information cannot be ascertained. It remains questionable if smaller firms readily have access to bank financing or if the funds are concentrated amongst the more 'medium' end of the SME spectrum. Additionally, while the active participation of private commercial banks in SME lending is a promising sign, it is unfortunate that state banks accounted for only 13 per cent of SME loans in 2012 (Figure 6).

The coverage of the formal banking system across the country too has improved, post-war. Among just three banks - NDB Bank, Commercial Bank, and Nations Trust Bank - there was a tripling of the number of branches in conflict-affected Northern and Eastern provinces from 13 in 2009 to 38 in 2011. For these banks, 10-15 per cent of all branches are now in these provinces, which the IFC (2013) calls 'frontier regions'.

Meanwhile, recent budgets have had an SME finance focus; the 2012 Budget in particular contained the most number of SME finance related proposals in recent years. In Budget 2012, the President announced that state banks would be requested to set specialized 'SME Banking Centres' in several provinces. Additionally, all banks were required to set up an Investment Fund Account (IFA) with the Central Bank of Sri Lanka to deposit the savings made from two reductions on taxes on banks - corporate income tax from 35 per cent to 28 per cent and VAT on Financial Services from 20 per cent to 12 per cent. Banks were instructed to lend to SME development out of the funds in the IFA. It was also announced that interest income from SME banking would enjoy a reduced income tax rate of 24 per cent (from the standard 28 per cent). Additionally, 50 per cent government guarantee is given for those banks providing loans to restructure SMEs and improve their performance. Subsequently, in Budget 2013 a rather intrusive move was announced, which ordered that any funds lying undisbursed in the IFA (as at a stipulated date) would have to be transferred to the Treasury.

It remains questionable if smaller firms readily have access to bank financing or if the funds are concentrated amongst the more 'medium' end of the SME spectrum.

Table 4
SME Banking Portfolio of Selected Banks[26]

Bank	2010	2011	2012	2013
NDB Bank	10.5%[(a)]	10.2%[(a)]	11%[(b)]	-
DFCC Bank [(c)]	48%[(d)]	52%[(e)]	61%[(d)]	49%[(f)]
Nations Trust Bank	23%[(g)]	17%[(h)]	22%[(h)]	-
Sampath Bank	-	-	-	40%[(i)]

Notes: (a) Includes SME and refinance loan portfolio; (b) Refers to total SMEs portfolio as a percentage of total portfolio; (c) Refers to data pertaining to financial years 2009/2010, 2010/2011,2011/2012,2012/2013; (d) Refers to SME portfolio as a percentage of total credit portfolio; (e) Refers to SME portfolio as a percentage of total portfolio; (f) Refers to SME portfolio as a percentage of total loans and advances portfolio; (g) Includes the SME banking and leasing portfolio as a percentage of the total loan portfolio; (h) Includes Retail/SME loan portfolio; (i) SME loans as a percentage of its total loan book.

Sources: NDB Bank, Annual Report 2011; NDB Bank, Annual Report 2012; DFCC Bank Annual Reports, various years; Nations Trust Bank, Annual Report, various years; Sri Lanka's Sampath Bank plans Myanmar branch, strong credit growth (Online). Available at: http://www.lankabusinessonline.com/news/sri-lankas-sampath-bank-plans-myanmar-branch,-strong-credit-growth/459288551; Banking on SMEs (Online) http://www.island.lk/index.php?page_cat=article-details&page=article-details&code_title=3450 .

[25] Banks have been selected based on the availability of data.

5. Supply and Demand Dynamics Driving SME Access to Finance Challenge in Sri Lanka

5.1 Unpacking the Problem

As alluded to earlier, the challenges of access to finance broadly includes four sub-sets of problems, namely, availability of funds and other credit instruments, access to loan capital, cost of borrowing and management of finances. The problem of availability of funds is said to owe partly to 'intrinsic weaknesses' within SMEs and partly to the underdeveloped nature of Sri Lanka's financial markets. The lack of venture capital and equity financing options for Sri Lanka are said to compel SMEs to depend mostly on bank loans (aside from informal sources). The problem of poor SME access to funds is said to attribute to factors such as the inability of SMEs to produce collateral with proper titles, the lack of development orientation on the part of both commercial and development banks, and the lack of proper skills among SMEs to make bankable project proposals. The third problem of cost of funds is said to attribute mainly to the high risk credit profile of SMEs which inevitably lead to high interest rates being offered to the segment, while the problem of management of finances is said to attribute to several factors including insufficient equity base, high cost of finance, over-ambitious business acceleration, lack of financial management experience, non-separation of business and private expenditure, over-expenditure on status symbols such as cars, and unexpected policy changes.[27]

Sri Lanka currently has a widespread network of banks covering most of the rural corners of the country. In 2011 alone, 194 new branches were opened across Sri Lanka.[28] Hence the problem of low SME access to credit is due to reasons that go beyond merely not having access to the country's existing banking network. It has become clear that the weak SME access to credit situation in Sri Lanka stems from both demand and supply-side factors. The authors conducted in-depth key informant interviews (KIIs), especially with senior officials of banking and financial institutions in the country, to uncover more insights on this issue. The following sections take a closer look at the findings of this.

The problem of low SME access to credit is due to reasons that go beyond merely not having access to the country's existing banking network.

5.2 Demand-side Factors: SMEs' Intrinsic Weaknesses

When considering the demand-side factors, the lack of collateral seems to be the most significant constraint on SME access to credit. Financial sector institutions surveyed observed that the high non-performing loans (NPL) ratio of SME customers have prompted them to demand higher collateral when giving out SME loans, in order to cover potential default losses. Banks assert that although they have tried alternatives to collateral-based lending, like cash flow-based and risk-based lending, the NPL ratio was higher for such lending and felt that collateral is necessary in order to exert pressure on SME customers to repay their loans. The banks also expressed a concern that effective credit guarantee schemes, which would ease high default risks of the SME segment, were not available in Sri Lanka, but if introduced would improve the SME credit climate by allowing banks to lend collateral-free.

The lack of transparency and financial discipline among SMEs was considered as the second most significant demand-side factor. SMEs are hesitant to fully comply with preparing financial reports due to the fear of exposure to government regulatory matters like taxes. Tax implications appear to be causing reluctance among SMEs to disclose proper financial accounts to banks. Preparing financial reports based in a standardized manner is also a

[27] *Ibid.*

[28] Central Bank of Sri Lanka (2012), *Economic and Social Statistics of Sri Lanka 2012*.

challenge for many SMEs as they do not have dedicated and large accounting and finance departments. The lack of proper financial data makes it virtually impossible for banks to evaluate the creditworthiness of SMEs and has thus constrained the amount of credit given to the sector.

SMEs often do not have a proper management or organizational structure. The enterprise could be comprised of just a handful of individuals or set up as a 'one-man-show' with no specific skilled professionals for financial management and reporting. This may be an off-putting characteristic for banks.

The lack of access to markets, market information, and effective supply chains are considered as 'intrinsic characteristics' constraining SME growth. This in turn, has an impact on SMEs' access to finance. The interviews revealed that this lack of access to markets, market information and supply chains have prevented SMEs from making better evaluations of critical business criteria such as their respective market size and market trends.

This in turn, has made SME business plans less feasible prompting banks to refrain from lending to SMEs due to inadequate and/or poorly-prepared business plans. The lack of sufficient knowledge of business practices such as the effective financial management, business planning, book-keeping, etc., prevent SMEs from making bankable business proposals. Banks have begun making efforts to address this issue by conducting training programmes and establishing special SME centres to assist SMEs in preparing proposals. However, certain banks expressed concern that SME entrepreneurs were reluctant and unmotivated to gain such skills despite their clear importance. Moreover, the banks also believe that there is a strong need for government attention on this matter, remarking that the banking sector alone cannot help address the challenge sufficiently. The findings of the interviews also reveal that 'intrinsic characteristics' within SMEs such as the lack of proper technology, poor quality products and labour issues not only impose major challenges on SME growth but also make SMEs riskier than other segments for banks to serve. This in turn, makes banks hesitant to lend to SMEs. Necessary measures need to be taken to overcome such weaknesses in order to minimize the risk profile of SMEs and thus make banks keener on serving the sector.

The interviews also highlighted the fact that administrative delays and difficulties in obtaining permits and licences from government institutions enforces problems for SMEs in obtaining credit because the banks are unable to provide credit without proper documentation. Most banks believe that bureaucratic procedures need to be reformed so that a speedier service can be provided for the SME sector when obtaining permits/licences.

Our findings suggest that the lack of proper insurance coverage for the SME segment is yet another critical factor limiting SME credit. Banks feel that the insurance providers of Sri Lanka seem to have given very little emphasis to the SME segment as most SMEs have been unable to obtain proper insurance coverage. The high risk profile of SMEs make banks hesitant to lend to SMEs that do not have proper insurance coverage.

The lack of proper management and leadership plans was found to be yet another demand-side shortcoming constraining SME access to credit. Most SMEs are family run businesses and there seems to be no second line of management for these businesses (especially when the children of the SME owner are reluctant to take up the business). The banks are not in a position to lend to SMEs without a proper line of management, as any mishap to the entrepreneur would mark an end to the business, leaving banks at a loss.

Accounting firms can play a role in addressing this by assisting in financial reporting in the simplest format in order help SMEs to overcome the complexity of financial reporting. The Institute of Chartered Accountants of Sri Lanka is currently setting out a simplified version of accounting system for small enterprises to assist in financial reporting, together with the Small and Medium Practitioners (SMPs) in local areas.

Overall, banks are of the notion that SMEs are substantially riskier than other enterprises and the cost of servicing this segment is higher. Recovering non-performing advances/loans from SMEs is costly and burdensome. SMEs are also seen to be more vulnerable to shocks as they do not possess adequate financial resources to weather difficult periods.

The lack of access to markets, market information, and effective supply chains are considered as 'intrinsic characteristics' constraining SME growth.

5.3 Supply-side Factors: Limitations within the Banking Sector

The KIIs revealed several constraints within the financial sector itself that hinder SME access to credit. Majority of the banks interviewed stated the lack of effective government support and/or incentives given to the banking sector for promoting SME lending as a key factor limiting SME credit. The banks stated that the extremely risky nature of the SME market makes it difficult for banks to serve the segment and that, incentives were needed to make it worthwhile for them to serve such a risky market. This was a surprising observation given the number of concessionary and SME-specific loan schemes available in the market, particularly those refinanced by the Central Bank of Sri Lanka or international development agencies. Banks expressed their disappointment in the current refinance facilities provided by the government as they were found to be ineffective and unprofitable for banks. They also felt that the government needs to take a more proactive role in providing necessary credit lines for SME lending. As the IPS survey revealed, the respondents cited reasons like poor credit history, weak past financial performance and management, and risky/weak market potential to be the main grounds on which loans were turned down by banks. So, clearly, banks do have to battle significant challenges with SMEs' credit worthiness.

The lack of staff that is skilled in SME lending emerged as a critical supply-side constraint. SME lending is a service that calls for a different kind of banking approach. A more analytical, patient, and small business-oriented banking attitude is required for SME lending. SME bankers require more training in handling SME customers than a normal corporate customer since SMEs do not possess the capacity to produce reports on tight deadlines set out by the banks. Moreover, it was highlighted that staff in branches rarely have time to attend to SME customers as they are preoccupied with achieving strict monthly targets. Hence, there seems to be a lack of staff in banks that can and are willing to attend specifically to SME customers and provide a specialized service to them.

Banks are often ultra-cautious when it comes to SME clients, owing to information asymmetry and lack of understanding. Often, a key reason for default among the SME segment is poor credit origination, i.e., credit evaluation that has not correctly ascertained the applicant's background, project potential, and economic conditions.

Box 2: Methods and Criteria for Bank Loan Appraisal

There are two major appraisal methods for loan applications -transaction lending and relationship lending. The main difference between the two methods is that the former is primarily based on quantitative data (e.g., financial statements, bank accounts, credit scores, size of equity, assets and cash flow prediction) while the latter is based on qualitative data (e.g., management skills, leadership, owners' characters, banking relationship, reputation and quality of human resources). In practice, particularly in developing countries in Asia and the Pacific, these two methods are often used by commercial banks in a mixed way to fit in with their unique operating environment. The World Bank's global survey on the banking sector reveals that banks consider specific factors in evaluating commercial loan applications. In general, the following criteria are used: (a) Financial assessment of the business; (b) Firm's credit history with the bank; (c) Characteristics of the firm's owner (age, sex, leadership, managerial skills etc.); (d) Purpose of the loan; (e) Collateral; (f) Firm's credit history from a credit registry; and (g) Size of the loan.

Source: ESCAP, 2012.

Banks are often ultra-cautious when it comes to SME clients, owing to information asymmetry and lack of understanding.

The findings also underscored that financing facilities provided for the SME segment in Sri Lanka seemed to be limited predominantly to loans, leasing and pawning. The lack of diverse and innovative banking products and services aimed at start-ups and small businesses are limited, often non-existent, in Sri Lanka's financial markets. The limited range of SME-focused or SME-friendly financial products offered seems to be a factor constraining SME credit.

The banks also expressed concerns about the policies adopted by the government with regard to financial markets such as imposing credit ceilings and high interest rates as a constraint on SME lending. The banks believe that a favourable financial environment with less interruption is needed so that they will be at a position to follow strategic plans to promote the SME sector. The cost and time taken to deal with policy changes are said to take away time and effort from serving the SME market, as most often than not, banks are found to be preoccupied responding to ad-hoc policy changes rather than following systematic plans.

So, as the preceding sections have amply demonstrated, the access to finance challenge in Sri Lanka is multifaceted, and has both demand and supply features. The paper now turns to some possible policy interventions to tackle this.

6. Policy Options

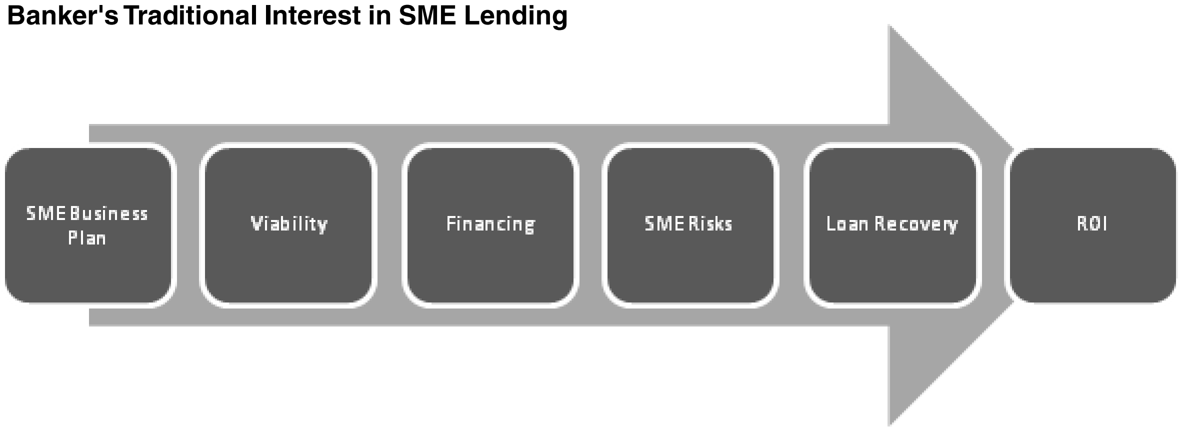
The study now attempts to explore some policy options in tackling this issue. This section first provides two overarching areas, which if addressed can significantly improve the access to finance climate for SMEs - re-orienting the banking system towards SME lending and addressing the information asymmetry that exists. This section then goes on to put forward a few specific mechanisms that could be considered for adoption and also provides case studies of interesting mechanisms adopted by other countries.

6.1 Policy Options - Overarching Measures

6.1.1 Re-orienting Financial Institutions towards SME Lending

Banks' discriminatory behaviour towards SMEs is quite rational. From their point of view, the scarcity of credit in most developing economies (savings-investment gap) means there is less incentive to seek out SMEs when larger and more qualified clients are available. Banks often find that dealing with SMEs incur higher transaction costs because the credit monitoring process requires more capacity at the local branch level, and this is further complicated by the poor financial management and accounting systems of many SMEs that was highlighted earlier. The underdevelopment of risk management skills related to SME lending has contributed to this continued disincentive among banks to lend to SMEs.

Figure 7
Banker's Traditional Interest in SME Lending



Source: Nanayakkara (2011).

Even though there has been a recent shift in the focus of banks (especially in Sri Lanka), from large corporates to a newer, smaller, but yet lucrative, segment of SMEs, the banking procedures and practices carried out by Sri Lankan banks seemed to have not changed accordingly to best suit the new SME focus. Nanayakkara (2011) reckons that the traditional banking functions practised in Sri Lanka involving SME financing do not help in promoting SME lending.[29]

Nanayakkara (2011) goes on to state that SMEs, who are most often than not, unskilled in preparing business plans find themselves unable to complete even the first step of the traditional banking process and often do not succeed beyond the first step of the process (see Figure 7). The high rate of failure of SME applications at the project viability stage is said to owe mainly to the inability of bank staff in accurately assessing the business proposals as they lack entrepreneurial skills to assess the projects.[30] Most loan applicants are start-ups with no prior financial statements, thus SMEs lack the necessary records to prove their financial strength. It remains questionable if SMEs should be evaluated based on the same criteria imposed by traditional banking procedures.

Given the inability of the traditional banking procedure to meet the demands of the SME clientele, the need to streamline Sri Lanka's banking procedure to best suit SME customers is essential.

Banks and other financial institutions need to develop more SME-friendly products, services and processes, develop comprehensive risk management skills and improve information transparency. Increasingly, these institutions would have to move towards offering non-financial assistance to SMEs as well - helping them with capacity-building to enhance their profitability. It is with this in mind that Budget 2012 proposed a special SME bank branch (known more commonly now as 'SME centres') to be set up by each state bank in all districts. This has already commenced with the specialised SME Banking Centres set up by Peoples' Bank. Even though these measures were taken in the right direction, the effectiveness of it is uncertain. Interviews conducted by IPS with leading banks unveiled the difficulties faced by such banks in establishing SME centres. The banks (including state banks) revealed that they are constrained by the lack of financial and human resources to run these SME centres.

Sri Lanka's recent efforts can learn from the examples in Pakistan and Malaysia. The SME Bank of Pakistan offers a range of business development services in the areas of marketing, accounting, product design and business planning. The SME Bank in Malaysia (also known as the Bank Perusahaan Kecil & Sederhana Malaysia Berhad) provides advisory services to SMEs - including entrepreneurship-training programmes to complement loan products.[31]

6.1.2 Improving the Bank-SME Relationship

Despite successive efforts of governments to increase availability of bank loans to SMEs, the lack of understanding between banks and

Banks and other financial institutions need to develop more SME-friendly products, services and processes, develop comprehensive risk management skills and improve information transparency.

SMEs often holds this back. For instance, banks may not appreciate the SMEs' dire need for quick capital, while SME owners may not understand bank policies and procedures when it comes to SME lending and mitigating risk. While SME development practitioners and policy makers may craft certain programmes and strategies, their efforts may be frustrated when applied in practice. PFIs and other intermediaries may lack either the incentive or the competence to build and sustain bank-SME relations. Banks may often be more interested in focussing on their standard loan products rather than special SME ones. To bridge these gaps, communication and awareness creation are important, for both SMEs and banks on a sustained and ongoing basis. For example, a

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[29] Nanayakkara, G. (2011), "Enhancing the Capacity of Banks to Shaping Development of SMEs". In: Association of Professional Bankers Sri Lanka. 23rd *Anniversary Convention 2011: Banking Foresight- Shaping Integrated Development.*

[30] *Ibid.*

[31] Bank Perusahaan Kecil & Sederhana Malaysia Berhad (2012),"Corporate Info", Kuala Lumpur. Available at www.smebank.com.my/web/guest/home.

research programme has been conducted in Sweden since 1999 to foster better relationships between banks and SMEs through interactions and information exchange between the two groups: (a) banking representatives, SMEs, auditors and tax authorities; and (b) academic representatives[32] (European Commission, 2007). Another example involves the SME Centre for Asia in the Philippines, which provides a training framework for financial institutions dealing with the SME sector, comprising seminars, exhibits and a venue for banks to build linkages with SME entrepreneurs .[33] As part of the National SME Policy's access to finance pillar or a future SME development programme of an aid donor, there can be a comprehensive training and capacity-building module that is implemented. It is recommended that such a module must include the following components: 1) researching and identifying the training needs and existing knowledge materials (locally and globally); 2) Adapting suitable training materials and preparing training modules; 3) pilot testing/field testing of training packages with a sample of selected banks; 4) conducting training-of-trainers programmes and building training capacity within the banks itself; 5) make training material freely available online and/or offer a structured online e-learning course to reduce manpower and financial costs of scaling up training island-wide.

6.1.3 Reducing Information Asymmetry

One of the main underlying drivers of the access to finance challenge for SMEs is the asymmetry of information, which impinges on the banks' ability to discern the creditworthiness of SMEs. On one hand, it is too costly and inefficient for individual lenders (banks) to collect this information while on the other, SMEs usually lack financial administrative skills to provide this information, or may even lack the basic knowledge about what type of information should be prepared. This creates somewhat of a market failure.

Addressing this can be a two-step process that happens simultaneously. Firstly, SMEs need to learn to get better at providing the kind of critical information that banks need when making assessments about creditworthiness. This goes back to the discussion on 'SMEs' intrinsic weaknesses' like transparent bookkeeping, credible accounting, business planning, etc. The help of banks, regional chambers of commerce, as well as national accounting and auditing bodies can help in this. The government, along with national accounting bodies like CA Sri Lanka would need to look at the regulatory climate related to SMEs accounting, and see what bearing does changes to accounting standards adopted nationally and internationally have on SMEs.

Policy intervention is also required to ensure that banks and financial institutions are more transparent and responsible in their lending terms and conditions. At several Private-Public Dialogues (PPDs) hosted by The Asia Foundation that IPS participated in, many SME owners cite the difficulties they have with understanding the "small print" of the loans they obtain.[34] This was especially true of SMEs in the North and East. Due to years of conflict and isolation, many potential borrowers in the North and East struggle with lower levels of financial literacy than borrowers in the rest of the country. Throughout the PPDs, many of the participants were often unable to understand the nuances of interest rate calculations and payment formulas, and accused the banks of imposing "hidden interest rates". Much of this is attributable to the lack of transparency in some banks' lending practices, and is a clear case for simplifying the procedural aspects of SME banking, while safeguarding the interests of the banks.

The second aspect of this is the need to introduce mechanisms like SME credit scoring, which will be dealt with in the next section.

Due to years of conflict and isolation, many potential borrowers in the North and East struggle with lower levels of financial literacy than borrowers in the rest of the country.

[32] European Commission (2007), *Transparency and Dialogue: Final Report*, Enterprise and Industry Publications. EC: Brussels.

[33] SME Centre for Asia (2011), "Programs & Services", Makati City, the Philippines. Available at www.smecenterfor asia.com/programs-services.

[34] Wijesinha, A. (2010), 'Access to Credit: Critical Issue for Conflict-Affected Enterprises', Talking Economics, http://www.ips.lk/ talkingeconomics /2010/10/07/ access-to-credit-critical-issue-for-conflict-affected-enterprises.

6.2 Policy Options - Specific Mechanisms

6.2.1 Credit Guarantee Schemes

A key characteristic of SME lending is the relatively higher level of risk and transactions cost. An IFAC-Banker survey found that lenders do not value information industry trends and clients' business plans nearly as much as they do cash flow statements, collateral and transaction histories.[35] As Storey (1994) observes, SME lending is characterized by asymmetric information; principal-agent issues; higher objective risk; costly monitoring; etc. In order to deal with these challenges, specifically credit risk and information asymmetry, a tool often used is Credit Guarantee Schemes (CGS). This helps to dampen the risks associated with SME lending by sharing it between the government, the lending institution and the borrowing firm.

Rather than successive rounds of concessionary credit lines, CGS are regarded as long-term mechanisms for SME support by cushioning banks from the risks associated with lending to small businesses. These schemes help entrepreneurs to secure both short-term and long-term credits with less collateral or even without collateral. Another policy objective of the schemes is to provide an opportunity for banks to learn more about SMEs - their problems and operations - and to help improve handling of their SME loan portfolios. Through their direct association with SMEs, financial institutions can gradually learn how to lend independently to SMEs.

As uncovered during the KIIs with bankers - and is no doubt a common feature globally - inadequate collateral is a serious issue for lending in the SME sector in Sri Lanka, because banks are traditional and risk averse in their lending, and are strongly collateral-conscious. CGS has the objective of absorbing part of the loss resulting from the default of a bank loan. It reduces the risk of a lender, serves to improve the supply of credit, and facilitates the smooth operation of the loan market. The interviews conducted by IPS with the banking sector of Sri Lanka confirmed the notion that the banking sector is dissatisfied by the credit guarantee schemes (CGSs) that have been introduced in the past. But they unanimously agreed that a profitable CGS has the ability to bolster SME access to finance.

Against this backdrop, it is useful to look at some examples of CGS from the Asian region, particularly Malaysia, Thailand, India, Pakistan and Korea.

In Malaysia, the CGS offered by the Credit Guarantee Corporation (CGC) enables viable SMEs without or with minimal collateral and no track record, to gain access to financing from financial institutions.[36] Further, the SME Credit Bureau established in 2008 by the CGC (and supported by Dun & Bradstreet, UK) enables SMEs to be aware of their own credit standing and identify critical areas for improvement that will enhance their creditworthiness. It also provides banks with trade information and probability of default of a company.

In Thailand, the Small Business Credit Guarantee Corporation (SBCG) is responsible for the Small Industry Credit Guarantee Fund that provides credit guarantees to unsecured parts of a loan. Three guarantee schemes are functional - a normal scheme which guarantees unsecured loans between 10-40 million baht, a risk diversification scheme where financial institutions and SBCG share the risk of loans provided, and a loan guarantee scheme which guarantees up to 10 million baht and payment of up to 10 million baht for a term of 7 years.

In India, the Small Industries Development Bank (SIDBI) has a credit guarantee scheme that provides financial and deferred payment guarantees to its MSME customers. SIDBI, together with India's Ministry of MSMEs has created the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE). This fund encourages lending institutions to emphasize the firm's project viability and extend credit based on primary assets rather than secondary collateral. Thus, CGTMSE covers collateral free loans up to 1 Crore (approx. US$ 200,000) to new and existing SMEs and also provides rehabilitation assistance to the lender, should factors go beyond management's control.

In Pakistan, the SME Credit Guarantee Fund (CGF) incorporated in 1984 as a public-private partnership company operates as a subsidiary of the Small and Medium Enterprises Development Authority of Pakistan. The fund was initially endowed by pooling equity

[35] "ACCA, CGA and CPA Australia (2009), *Access to Finance for the Small and Medium Sized Enterprises Sector, Evidence and Conclusions*.

[36] University of Malaya (2009), "The Development of Corporate Credit Information Database and Credit Guarantee System: Final Draft Report 2009", University of Malaya: Malaysia.

investment of Pakistan Rs. 10 billion by the Government and partner banks on a 1:1 basis. Funds are invested in deposits and securities and returns are used to meet the operational expenses and offset subrogation losses. The upper limit of guarantee exposure may be up to 10 times that of the endowment fund (e.g., Pakistan Rs. 100 billion). The Pakistan CGF operates different schemes - some offer guarantees with as much as 20 per cent required from the SME as collateral to zero per cent from the SME depending on the specific needs of disadvantaged regions and sectors.

Korea has what is widely regarded as one of the most successful CGS in Asia. Korea established the Korea Credit Guarantee Fund (KCGF) (later renamed as Korea Credit - KODIT) in the very early stages of SME development. To capitalize the KCGF, the government enacted the Korea Credit Guarantee Fund Act, mandating that all banks in Korea contribute 0.5 per cent of their outstanding loans to the fund (reduced to 0.225 per cent in later years). SMEs approach KODIT to obtain a guarantee on a potential loan from a commercial bank, after which KODIT analysts conduct an assessment of the application (creditworthiness check, site visit, interview with entrepreneur, etc.), issue a credit rating and offer a certain loan guarantee percentage (could be as much as 90 per cent). The ceiling of the guarantee could be up to US$ 3 million, and in some special cases up to US$ 7 million (in sectors designated by the Financial Services Commission of Korea in line with government policies to promote exports, green growth projects, etc.). KCGF's success is evident in the increase in loans to SMEs, from 35 per cent of total loans prior to 1975 to 77 per cent at present.[37] Meanwhile, to further strengthen SME lending at the 'Bottom of the Pyramid', the government introduced 16 regional Korea Credit Guarantee Foundations (KCGFs) since 1996, followed by the Korean Federation of Credit Guarantee Foundations in 2002 to provide re-guarantee services to the KCGFs. The 16 KCGFs assist in providing finance for promising micro and SMEs as well as consulting services to address technology and managerial skill needs.

There is an urgent need for Sri Lanka to establish a CGS and a national institution for it - an SME Credit Guarantee Fund (SCGF). The institution ought to be separate from the Central Bank of Sri Lanka and function independently. Capital (funding) for it can come in part from the government and in part from private commercial banks. The SCGF ought to have multiple regional branches to cater to SMEs where they are located and in line with the government vision of developing 'lagging regions'. Like in KODIT and other examples, qualified analysts, ideally graduates from a business administration or management background, must staff it. The SCGF can provide between 75 - 90 per cent of loan coverage for an SME seeking a loan facility, which is offered following a credit rating exercise done by it and possibly also using credit information from the Credit Information Bureau that already exists in Sri Lanka.

Moreover, a critical aspect that determines the success of CGS - and particularly evident from the Korean case - is that the system must be supported by an adequate branch outreach and human resource capacity. Without these, the ability to attain a reasonable portfolio scale and the ability to fully assess loan applications is limited. As suggested by Oehring (1995), credit guarantee schemes will only function successfully on the existence of certain factors: (i) if they are part of the national private sector (including banks); (ii) if there are no restrictions regarding the origin of funds used for the scheme; (iii) income from fees and investments cover the cost of running the scheme; (iv) guarantees are granted only to financially sound projects and companies; and (v) the schemes consist of backup programs that provide training, professional advice, and other services.[38] These must be incorporated into any design of a CGS in Sri Lanka.

6.3 SME Credit Scoring and Credit Information

The credit history of SMEs is an important piece of financial information that can help bridge the information asymmetry and default risk problems that often drive the access to finance challenge.

IFC (2010) defines credit scoring as a mathematical technique that uses historic credit data to predict a future outcome, typically the probability of default.[39] Wells Fargo, a leading bank in the United States, pioneered the

[37] Author's interview with KODIT's head of international affairs, December 2013.

[38] Oehring, E. (1995), "Credit Guarantee Schemes for the Small Business Sector". In: Brugger. E. A., Rajapathirana. S. (Eds.) 1995, *New Perspectives on Financing Small Business in Developing Countries*, San Fransisco: ICS Press.

[39] IFC (2010), *Scaling-up SME Access to Financial Services in the Developing World*.

use of credit scoring systems for SMEs in 1992.[40] The automated credit reports and scoring enabled the bank to provide a cost-effective service to its SME clientele. Credit scoring involves the process of granting a score to an individual/ individual business based on parameters such as length of time in business, nature of business, length of time with bank etc. The traditional banking process as depicted in Figure 7, typically involves banks evaluating the creditworthiness of SMEs based on financial data. As discussed in the previous sections of the chapter, asymmetric information due to the lack of proper financial data with regard to SMEs make it impossible to evaluate their creditworthiness based on traditional appraisal methods. Hence the credit scoring method can be used to evaluate the creditworthiness of SMEs and can help in overcoming information asymmetry.

The process of SME credit scoring typically consists of a number of factors: a comprehensive assessment of the overall condition of an SME; a review of the financial condition and several qualitative factors that have bearing on the creditworthiness of an SME (e.g., management skills; and reputation and goodwill); a composite appraisal/condition indicator and size indicator; classification of an SME, based on industry and size, for comparison against peers; characteristics of leadership quality; and tools that enhance the market standing of an SME among trading partners and prospective customers (e.g., technologies, patents, production facilities, knowledge, distribution channels, etc.).

These models are already prevalent in the East and South East Asian region. A study showed that more than 70 per cent of financial institutions surveyed in ASEAN economies have implemented some form of rating or scoring for SME loans. Banks in some ASEAN economies were able to increase loans to the SME sector by 61 per cent by 1995 since the introduction of credit scoring in 1992.[41]

The KIIs conducted with banking sector officials in Sri Lanka underlined the fact that the top management of banks was aware of such innovative tools. Yet, what seemed to be lacking was the confidence to courageously embark on such schemes due to the typical risk-averse nature of Sri Lankan banks. Even though it is unlikely that Sri Lankan banks would rely solely on a credit score to make a lending decision, these models can be deployed as a pre-screening tool to determine which applications to investigate more thoroughly and which applications to reject completely. They could reduce the average time spent on processing applications and the cost of acquisition - two key factors that limit banks from lending to the SME segment.

However, it should be kept in mind that several challenges which are unique to developing countries make the execution of credit scoring challenging. The 'Access Finance' Newsletter (World Bank, 2006) identifies four challenges in adopting Small Business Credit Scoring (SBCS) in Developing Countries:[42]

1. Limited availability of timely, accurate and reliable data in credit bureaus and similar data registries
2. Poor record management and MIS systems in financial institutions
3. Significant investment cost to develop SBCS tools
4. Bank's reluctance to share information on SME customers among peers.

A possible jump start developing countries can employ is the 'pooled-data' model, by obtaining detailed SME portfolio data from a number of lenders. This method is a low cost alternative to custom built models. Recent research by the World Bank and the Fair Isaac & Company in several Latin American countries such as Colombia and Mexico, demonstrates the feasibility of such pooled data SBCS solutions.

In terms of structuring a credit rating scheme, Sri Lanka can learn from neighbouring India. India's Performance and Credit Rating Scheme, a program that rates small scale industries was formulated in consultation with the Small Industries Associations, the Indian Banks' Association and various credit rating agencies including Credit Rating and Information Services of India (CRISIL), Investment Information and Credit Rating Agency of India Limited (IICRA India), and Dun and Bradstreet. The rating agencies combine an evaluation of the performance and creditworthiness of the enterprise and include parameters that measure operational, financial, and business and management risks. Even though each enterprise is responsible for paying

[40] *Ibid*.

[41] UNCTAD (2001), *Improving the Competitiveness of SMEs in Developing Countries*: *The Role of Finance to Enhance Enterprise Development*, New York and Geneva, 2001.

[42] World Bank (2006), Access to Finance Newsletter.

the special "small-scale industries fee" set by each credit rating agency, the Ministry of Micro Small and Medium Enterprises subsidizes 75 per cent of the fee charged. Further, the Ministry funds an initiative to create awareness amongst MSMEs about the strength and weaknesses of their existing operations and provides them an opportunity to enhance their organizational strengths. The ratings have improved access to banking finance by at least 20 per cent of rated clients, and collateral requirements have decreased by 10 per cent of rated cases.[43]

Businesses with both the highest operating performance and financial stability are entitled to a reduction of 100 basis points (1 per cent) from the annual interest rate on their borrowing if they participate in the credit rating scheme, while those with strong performance and stability are rewarded with a reduction of 0.5 per cent (Petkar, 2010).

6.4 Business Development Services to Address Access to Finance Challenges

As highlighted in Section 5.2, SMEs' intrinsic weaknesses are a key contributing factor to their access to finance problem. By addressing these weaknesses through provision of advisory services, SMEs could better understand how to approach banks, cater to bank's requirements, and securing financing. By seeking support from business development services (BDS) providers, SMEs can improve the management of their business, bookkeeping and accounting, business planning, etc., and be more attractive to banks.

The lack of availability of BDS providers in Sri Lanka was reported as a top constraint by SMEs. The lack of access to business development services limited business operations in over 40 per cent of SMEs that participated in the survey conducted by the IPS-NCCSL (Figure 8).

As a second-best solution, business/trade associations, chambers of commerce and federations of industries, can help SMEs work with banks to resolve financial and operational concerns that are holding loan approvals back. Meanwhile, banks themselves may want to engage in some BDS activities as well. For instance, the newly established SME Banking Centres of People's Bank attempts to do precisely this.

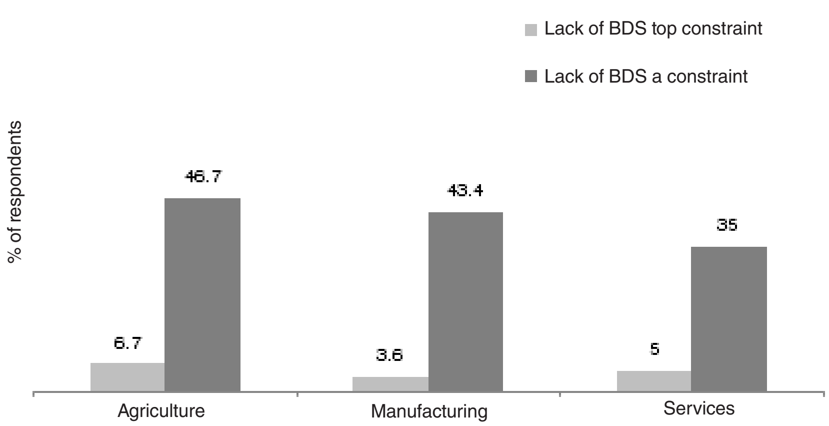
In providing BDS, BDS providers as well as banks and financial institutions should consider the following elements:

(a) improve management and operational systems to enhance transparency and governance

(b) address gaps in bookkeeping/accounting

(c) assist SMEs to develop bankable business expansion plans

Figure 8
Lack of Business Development Services by Economic Sector



Source: IPS-NCCSL Survey.

The lack of access to business development services limited business operations in over 40 per cent of SMEs that participated in the survey.

[43] IFC (2010), *Scaling-up SME Access to Financial Services in the Developing World*.

(d) guide SMEs on financial, taxation and other regulatory compliance matters.

If the government is keen on embarking on programmes to boost BDS provision, a useful model to look at is the EMPRETEC capacity building programme established by UNCTAD. EMPRETEC - the Spanish acronym for emprendedores (entrepreneurs) and tecnología (technology) - addresses the business development requirements of SMEs with the aim of making them globally competitive. The entrepreneurship training workshops conducted under the programme have helped SMEs improve their creditworthiness and attractiveness to potential investors from venture capital funds and financial institutions. Meanwhile, a UNDP programme modelled on similar lines called Enterprise Africa, encourages the large private sector companies, banks and consulting firms, to support BDS provision for SMEs through training and post-training programmes and services. A key feature of this programme is the provision of support and capacity-building services, and assumes responsibility for loan referral and monitoring - thus reducing transaction costs for partner financial institutions and improving SMEs' chances of securing access to finance (UNCTAD, 2001). Additionally, the government can embed BDS provision in current government departments as well. For instance, by installing an SME desk at Provincial Inland Revenue Departments, Central Bank Regional Offices and Industrial Development Board branches, SMEs can gain specialised advice on regulatory and other matters relating to government services.

6.5 Challenges and Risks in Public Interventions to Improve SME Access to Finance

In devising suitable SME financing support strategies, governments must guard against twin risks. The first, being the assumption that successive rounds of concessionary SME credit lines will solve the problem. And secondly, being overly zealous in the government's role in improving the SME access to finance environment.

Governments have a suite of tools that they often use to promote the SME sector - special loan schemes or subsidized credit, tax breaks or reduced tax rates, easier access to land and buildings in industrial parks, special tariffs for electricity, grants for technology upgrading, etc. In this regard, Sri Lanka is no different. Recent years have seen many of these being used, for instance cutting tax rates on SMEs to 10 per cent (Budget 2011), providing interest free loans up to Rs. 250,000 for women entrepreneurs (Budget 2013), and reducing electricity tariffs for SMEs by 25 per cent (Budget 2015). Among the most consistent measures used by governments, however, are those that relate to SME access to finance.

Governments use both direct and indirect interventions to promote SME financing. Direct interventions include grants, subsidized credits, refinance schemes, special loans by state banks, etc. Indirect interventions include setting mandatory SME lending ratios, instituting credit guarantee schemes, setting up new financial infrastructure for SMEs to raise capital (for instance, a special SME board on the stock exchange), and using SME-mandated public institutions to build SME capacity and creditworthiness.

However, direct public interventions are not always a panacea. With concessionary loan schemes and subsidized credit programmes it is not easy to ensure that the financial support reaches the targeted SME group. This is especially difficult when the target group cannot be well defined, like in Sri Lanka's context where no consistent definition for SMEs exists and no database of SMEs is available. Hence, any public interventions could end up being costly, poorly funded, and have sub-par impact. Moreover, government refinanced SME loan schemes administered through private PFIs may not reach lower-level SMEs if the incentives of the PFIs are misaligned. These PFIs would pay more attention on selling their own proprietary loan products than a loan product of a multi-bank programme.

While recognizing the desire of the government to provide concessionary SME lending, it is important to guard against potential distortions it could bring to the financial markets. Government intervention should be carefully designed so as to avoid any disincentive for private sector providers of financial services to serve the SME segment.

Mandatory lending ratios for SMEs -- another tool used by governments -- may be well intentioned, but may not have the desired effect. While it would certainly nudge more banks towards more SME lending, it might also have perverse effects. It may encourage riskier lending by some banks that are less prudential, just to meet the

While recognizing the desire of the government to provide concessionary SME lending, it is important to guard against potential distortions it could bring to the financial markets.

mandatory ratios in the absence of good projects. It may also result in banks choosing somewhat less risky "medium" segment firms and lending large volumes to a few firms in this segment, just to meet the mandatory ratio.

Setting up state-owned and funded specialised SME banks may not necessarily solve the SME finance problem either. For instance, although Sri Lanka set up the specialised 'SME Bank', it was poorly capitalized and poorly managed and was later merged with Lankaputhra Development Bank (LDB). Subsequently, LDB has not been able to make a significant mark on the SME lending landscape. Plagued by delinquent lending of the SME Bank which it merged with, and continued practices of non-prudent politically-motivated lending, has led to very high non-performing loan ratios (from 19 per cent in 2009 to over 45 per cent by end 2013). As warned by IFC (2011b), "the failure of many state banks can be also explained by political interference, excessive risk exposure due to irrational development goals and internal operational inefficiencies". More generally too, many state banks have fared less impressively than private banks when it comes to SME lending. In fact, during the last two years lending by private banks to the SME sector has outpaced that of state banks by around seven times.

The guiding principle of government intervention in SME financing should be ensuring that financial intermediation is efficient and works for SMEs. For this, it must properly identify the market failure. If the market failure is in the form of asymmetric information for instance, the appropriate intervention could be to push through an SME Credit Guarantee Fund and/or SME Credit Scoring schemes. Undoubtedly, a less distortionary public intervention to the SME financing problem would be a well-structured and adequately capitalized credit guarantee fund, similar to the KODIT of Korea. But in the absence of a suitable private-public partnership approach, the mechanism may not attain the necessary scale or effectiveness. The banking system must contribute to capitalize the fund at the start, and continue to make small contributions throughout the lifespan of the fund. The fund must be professionally managed and investments made prudently. Its fund must not be set up as a fully government-owned entity, or as a scheme under the Central Bank (like in the case of previous credit guarantee schemes), but rather as a separate company.

Overall, the role of the government or the nature of public intervention in SME financing should be to create a good enabling environment that incentivizes financial providers to provide financing options that meet SME needs. Meanwhile, the government can facilitate SME promotion agencies, banks, and other stakeholders in the SME space to provide capacity building and training for both financial institutions as well as SMEs to improve the bank-SME relationship to address the issues on both the supply and demand sides as highlighted in Section 5.

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7. Concluding Remarks and Way Forward

A unique contribution of this paper is that it puts forward a new way of looking at the access to finance challenge for SMEs. This 'Twin-Pillar Approach to Access to Finance' argues that improving access to finance for SMEs is a case of improving 'availability' on one hand and improving 'bankability' on the other. 'Availability' refers to ensuring that funds are available for SMEs to borrow - enhancing overall private sector credit, expanding lending volumes to SMEs, and providing more and more funding lines and special credit schemes for SMEs. These are often influenced by the overall monetary policy of a country, liquidity levels in the market, level of borrowing by the state and credit availability to the private sector, and the number and nature of SME loan schemes with lower interest or concessionary terms. This first pillar was not the main focus of this present paper. It largely focussed on the second pillar - 'bankability'. This stems from the understanding that a flush of SME credit alone is not enough. It has to do with things that improve the climate for SMEs to borrow and addresses questions like - are there a good reach of SME branches? Are there specialized branches dealing with SMEs? Are banks genuinely oriented towards the unique banking needs of SMEs? Are there mechanisms to bridge the information and risk asymmetry between SMEs and banks, like credit guarantees and credit scoring? Are there schemes to improve SMEs' financial management and ability to develop bankable business plans? Overall, the second pillar of 'bankability' is about improving banks' approach to SME lending as well as improving SMEs' ability to approach banks.

This paper has attempted to explore the current evidence on the access to finance problem faced by SMEs in Sri Lanka; the questions around what limits access to formal finance (particularly bank lending) for SMEs; and possible solutions to tackle the challenge. The findings of the survey and our interviews suggest that the difficulties in access to credit for SMEs in Sri Lanka owe both to shortcomings within SMEs as well as shortcomings in the financial system and the overall access to finance enabling environment. The former is driven by poor knowledge on financial management, poor financial literacy, lack of transparency in SME management, etc., while the latter is driven by a highly risk-averse banking system, lack of understanding on genuine SME-oriented banking practices, and insufficient mechanisms to improve information asymmetries in SME banking. Even though the steps taken in recent times by both the Government and SME lenders are steps in the right direction, it appears that much more needs to be done.

This paper has not attempted to provide any assessment of the efficacy of ongoing or completed concessionary SME loan schemes offered by the government or by international development agencies in partnership with local banks. Previous IPS publications like Williams (1999) have for instance, evaluated the impact of World Bank credit schemes on small and medium-scale industries in Sri Lanka. This approach in this paper was intentional. The paper focussed on the need to look beyond the typical SME finance 'quick fix', the go-to policy tool, which is the concessionary SME loan scheme. The paper has argued for the need to approach SME access to finance from a much more holistic viewpoint - an approach that calls for improving the overall context that underpins SME lending.

As this paper has discussed, the dynamics driving the problem are multi-faceted, and arise from both the supply and demand sides. Both dimensions must be addressed simultaneously. The Government, together with the financial sector, should create an enabling environment for SME lending in the country through innovative initiatives like a Credit Guarantee Fund and Credit Scoring, for instance. The banking sector needs to boldly adopt more SME-friendly banking approaches. Both of these will go a long way in addressing the lack of trust that is looming large in the minds of both banks and SMEs in Sri Lanka. Meanwhile, support must be lent to SMEs to ease their 'intrinsic weaknesses' that lead to a disadvantaged position in accessing formal finance.

As Sri Lanka aims to achieve rapid growth over a sustained period in an inclusive manner, the contribution of SMEs to the growth process is paramount. By tackling the SME access to finance problem in this holistic manner, much more progress can be made in improving the ability of SMEs to find the finance they need to start, run, and grow their businesses and make a stronger contribution to growth and development in the country.

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