CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

In many developed and developing countries, SMEs form a large part of the private sector. There is sufficient evidence to show that small firms face higher growth constraint and have less access to bank financing as compared to the larger firms.

2.2 Definition of SME

There is no fixed definition of SME. SME definition varies from one country to the other and most common criteria are number of employees, value of assets, amount of sales, and size of capital (Bataa Ganbold, 2008). However, most countries used number of employee to define SME. For example in Mongolia, SME is defined as a business entity with employee of 199 or less and with an annual sales of 1.5 billion togrog (approximately 1.3 million USD) or less respectively. In the US and Canada, SME consists of firms with less than 500 employees. Comparatively, SME Department of the World Bank defined SME as follows:

1) Micro enterprise - up to 10 employees, total assets of up to USD10,000 and total annual sales of up to USD100,000.

2) Small enterprise - up to 50 employees, total assets and total sales of up to USD 3million.

3) Medium enterprise - up to 300 employees, total assets and total sales of up to USD15 million.

2.3 SMEs and growth – Importance of SME

Targets have been the SMEs because they are the engine of growth for the country. SMEs are deemed crucial to the economy by generating employment, diversifying economic activity and contribute significantly to exports and international trade. World Bank (2004) show contribution of SME sector and the informal sector to GDP and employment approximately stable across all income groups of countries at 65% to 70 % and that when the income of the countries increases, there is considerable shift from informal sector to SME sector. Meanwhile, SMEs growth and performance have been dampened due to market imperfections and weakness of financial institutions (Klapper et al. (in press)). Snodgrass and Biggs (1996) have assessed the importance of SMEs in the economic development and industrialization process.

Demirguc-Kunt et al. (2006) pointed that the reasons for firms going for corporation status is because in countries with developed financial infrastructure , efficient legal systems, strong shareholder and creditor rights, low corporate taxed and efficient bank bankruptcy processes; firms face lower obstacles in growth. Further countries with developed financial institutions and favorable business environments will see fewer financing, legal and regulatory obstacles by the corporations. Ayyari et al. (2005) findings show that finance, crime and political instability are the only obstacles directly related to firm growth and finance has the most direct impact.

Importance of SME in socio economic development reported in World Bank (2004) is that SME enhance entrepreneurship, competition, innovation and productivity growth. Further, supporting SME will help countries explore the social benefits from competition and entrepreneurship. Also, SME are more labor intensive and can boast employment. This helps alleviate poverty in developing countries. Finally, financial market and financial institutions failures hinder the progress of SME development and therefore broadening access to financial services is significant.

Based on numerical data from World Bank (2004), indeed there is evidence that SME play a significant role in any economy in terms of GDP and total employment.

2.4 Access to Finance

Bataa Ganbold (2008) defined access to financial services as an absence of price and non-price barriers in the use of financial services. He states that improving access to finance indicates “improving the degree to which financial services are available to all at a fair price". Access to finance basically means the supply of financial services.

In general the issues of access to finance attracts interest to policy makers and researchers for both developed and developing countries due to empirical evidence that showed the increase in access to finance may reduce prevailing poverty in developing countries and financial development may lead to growth to emerging economies. World Bank through Investment Climate Survey found out that one of the main hindrances of promoting development of firms was lack of access to financial services. Lack of access resulted in non-expansion of economic growth and employment generation as well as lacking in poverty reduction, in developing countries.

In theory, when firms do not get external financing upon receipt of a project that can be internally financed if resources were available, then a problem of access exists. This is attributed by the gap between the expected internal rate of return of the project and the rate of return that firms need for financing. These constraints in enforcing financial contracts are known as *principal-agent problems* and *transaction costs*. Principal agent problems consist of adverse selection and moral hazard. The adverse selection problem is due to high risk borrowers are more willing to look for financing. When a financier is willing to give financing to high risk borrowers by increasing the risk premium, the riskiness of interested borrowers also increases. Consequently, the higher interest rates lower the financier reliability of differentiating good borrowers from the bad ones. This approach somehow backfires as “high risk borrowers are adversely selected by higher risk premiums” (Bataa Ganbold, 2008). Thus borrower may window dress bad projects when they can anticipate the good and bad ones while financier cannot extract or verify all this information. Lenders will try to use non-price criteria to screen debtors/projects and subsequently will apportion financing rather than further increasing the risk premium when they are faced with adverse selection.

Meanwhile the moral hazard problem occurs when the borrower has received the financing from the lenders. Borrower may use the resources or financing for other purpose and inconsistent with lender’s interest. Borrower may divert to riskier activities and the banks may not have an effective ways to monitor such activities. Therefore, the banks may try to find ways to monitor such financing and if unable to do so will cease to provide funding.

According to Bataa Ganbold (2008) transaction cost problem arise when the transaction costs involved ‘in the provision of finance exceed the expected risk-adjusted returns**’.** He mentions that this happens when the financial institutions unable to reduce costs by “capturing economies of scale and scope.” This resulted in SME activities or projects being unprofitable due to high cost of doing financing. High transaction cost can also exist due to deficiencies in financial institutions infrastructure that resulted in higher costs of gaining information on the borrower or projects, enforce contracts, monitor contracts and value assets.

In general access to finance is significant in research due to empirical evidence that higher access may reduce poverty in developing countries, improve financial development, contribute to economic growth and stimulate employment generation

Beck, Demirguc-kunt and Martinez Peria (2007) indicated based on survey of bank regulatory authorities, access to finance can be measured by the following:

1. Geographic branch penetration : number of bank branches per 1,000 km^2
2. Demographic branch penetration : number of bank branches per 100,000 people
3. Geographic ATM penetration : number of bank ATMs per 1,000 km^2
4. Demographic ATM penetration : number of bank ATMs per 100,000 people
5. Loan accounts per capita : number of loans per 1,000 people
6. Loan-income ratio : average size of loans to GDP per capita
7. Deposit accounts per capita : number of deposits per 1,000 people
8. Deposit-income ratio : average size of deposits to GDP per capita

Item (1) to (4) measures the outreach of the financial sector in terms of access to bank's physical outlets while item (5) to (8) measure the use of banking services. Despite not being a precise measurement of access to finance, the indicators above can be suitable proxy indicators of measuring accessibility of financial services.

2.5 Constraints faced by SMEs and access to finance as growth constraints

It is important that we understand the constraints faced by SMEs because any deficiencies might prevent SMEs from growing to their optimal size. Berger and Udell (1998) and Galindo and Schiantarelli (2003) findings show that small firms have less access to external finance and to be more constraints in their growth. Schiffer and Weder (2001) reported that small firms continuously show higher growth obstacles than medium size or large firms. Beck et al (in press) highlighted that size; age and ownership are the determinants of firms' financing obstacles. Findings also show that the higher obstacles faced by smaller firms indeed translates into slower growth. Evidence showed that older, larger and foreign owned firms report lower financing obstacle. It is imperative to note that the obstacles faced by small firms matched for both developed and developing countries. This is because smaller firms face higher transaction costs and higher risk premium since they have less collateral to offer and more opaque.

Institutional development is also important as findings from Beck et al (in press) shows that firms in countries with higher institutional development show lower financing obstacles than firms in countries with less developed institutions. Further, the effect of growth obstacles on firm growth is smaller in countries with better developed financial and legal systems and that small firms will gain most from the financial and institutional development. The findings from Laevan and Woodruff (2003) show a positive association between financial and legal development and firm size. This has significant implication for SME as institutional shortcomings have to be addressed first if there are efforts to promote the growth of SMEs. Importance of the financial institutions cannot be denied as an economic effect to easing SMEs' financial constraints and improve access to formal sources of external finance. However, the availability of credit highly depends on the infrastructure that supports the financial transactions including legal system and the information environment. Again, Beck et al. (2005b) finds that firms in countries with more effective and more adaptable legal systems show lower financing obstacles and the effect of such on growth is lower in countries with better developed legal systems especially for small firms.

Berger and Udell (2006) indicate that besides lending technologies, the banking market structure and regulatory policies influencing the market structure, have significant impact on the availability of SME financing. Clarke et al. (2003) said that the entry of foreign banks result in greater SME credit availability.

2.6 SME Constraints in Accessing Bank Financing

Inadequacies to access financing are the key hindrance to SME growth as consistently addressed in various studies and empirical evidences (Beck, Demirguc-Kunt and Maksimovic, 2004, 2005 and 2006). OECD survey in 2006 also shows that significant problem of access to finance and it is more severe in developing countries. Bataa Ganbold (2008) mentioned that in general theoretical argument on lack of access to finance is that lenders **"**may offer higher rates and credit rationing due to problems of uncertainties like agency and principal problem, asymmetric information, adverse credit selection and institutional problems"**.** This will leave large numbers of potential borrowers specifically more severe to SME than corporate without access to credit.

2.6.1 Financial Sector Policy Distortions

Malhotra et al. (2006) find that banks are discouraged from lending to higher risk borrowers such as SMEs due to the existence of below market interest rates mandated by government. Further, government projects normally enjoy preferential access to bank financing, thus leaving out SMEs in the competition. In addition public sector borrowings like investing in government securities is a safer investment for banks rather than investing in unknown SMEs. Malhotra et al. (2006) further highlighted that the lack of regulations, tax treatment and legislation has restrained lending for creative forms of financing to SME especially for products like leasing, factoring and venture capital. Clearly defining property rights allows borrowers in accessing finance for cheaper and longer term loans as they pledge their properties as collateral.

2.6.2 Lack of know-how on the part of banks

As compared to large companies, Malhotra et al. (2006) highlighted that SMEs only requires small amount of loans but the transaction costs in processing and administrating loans are fixed. Thus processing SME loans becomes inefficient for banks. Banks also lack innovative lending methodologies which include assessing loan processing and analysis that concentrate on borrower cash flow to pay instead of emphasis on collateral (RAM, 2005). Banks also lack decision making and control mechanisms supported by management information systems and information technology to help manage and administer the loan portfolio in order to provide larger loan amounts and longer terms for well performing borrowers (RAM, 2005).

2.6.3 Information asymmetries

The main information asymmetries that constraints SME access to finance includes high cost of obtaining credit information on SME, inconsistent SME financial statements and audits and lack of access to third party information by providers in the marketplace (Ganbold, 2008). Due to lack of information on the creditworthiness of potential SMEs, banks perceive SMEs as high risk and thus charge higher interest rates (RAM, 2005). This in turn discourages low risk SME to seek financing and ultimately reduced the interest of banks to lend. Ganbold, 2008 highlighted that SMEs also produce financial statements with large discrepancies and unreliable as they are not require to adopt international accounting standards. It is also reported that Banks also need to rely heavily on third party information especially from credit bureaus in order to get histories and credit profiles of SMEs.

2.6.4 High risk in lending to SMEs

SMEs are considered higher risks to the financial institutions as they are inadequate in terms of management capabilities, shortage of working capital and failure of product demand (Ganbold. 2008). SMEs are vulnerable to market and economic changes as their activities are volatile with huge numbers of SMEs are opening up business while many others are closing down. Ganbold, 2008 also pointed out that weaknesses in firm management and documents submitted when applying for credit resulted in the firm's inability to meet the standards set by the respective banks during loan application.

2.7 Improving Access to Financing for SME

Ganbold, 2008 noted by several international experiences, problems faced by SMEs in accessing loan financing can be improved by working with the financial intermediaries and the governments.

2.7.1 Role of Financial Institutions

World Bank (2007) highlighted that private commercial banks are now expanding and planning to expand their operations aggressively in SME segment as they view SMEs as a strategic sector due to high competition in supplying financial services as financial institutions are moving towards globalization, openness and financial liberalization. Innovatively the lenders now try to find solutions for problems of access to finance SME by looking at the following issues:

- Sharing and lowering risk for the banks on SME loans
- Reduce transaction costs on SME applications
- Improve quality if information from SMEs to the level required by the banks and not burdening the SMEs

According to the paper, new business models, technologies and risk management system are being developed to serve the SME sector and amongst them are;

- Concentrate on fee based income

- Economies of scale by offering wide range of complimentary products and services
- Information gathering via their corporate clients dealing with SMEs
- Delivering financial services through technologies and transparencies via information systems , automatic teller machines (ATM) , internet banking, mobile phones and network connections
- Adopt credit scoring technique to allow reduction in costs and time of making loans while able to process larger volume of small loans more efficiently. At the same time monitoring the risk of portfolio is improved.

2.7.2 Role of Government

It is highlighted by Bataa Ganbold (2008) that some type of government intervention is required to boast financial development and broaden access to financing. However, the types of intervention are rather contrasting views of *interventionist* and *the laissez-faire (free market).* The *interventionist* views highlighted that as private sector fail to expand access, an active government involvement in allocating and mobilizing financial resources is needed to expand access to finance. Meanwhile, the *laissez-faire* views stated that intervention by government directly in the financial system can do more harm than good and should instead focus on mitigate problems of access, reduce agency problems and transaction costs.

Another emerging view called *pro-market activism* favor direct government intervention in limited way of which some government collaboration with the market is warranted. This view acknowledges that institutional efficiency is considered the best in the economy, prior to government collaborations. This *pro-market activism* is more relevant to our study as government intervention is more towards collaboration with financial institutions.

Based on the World Bank (2008) governments can assist the broadening the access to finance for SME by “improving or building sound legal and judiciary infrastructure, build effective information infrastructure and make some rational direct intervention”.

Most literatures highlighted that the best role that the government can provide in improving access to finance is to provide a policy scenario that allows competitive and variety of financial services providers to prosper. Government role is to ensure that financial institutions compete actively to provide services to SME sector profitably and increase the speed of new technologies.

2.7.3 Lending Technologies to SME

Lending technologies have pertinent effects on the access to financing in order to address problems of opaque, creditworthy, transparent SME. Berger and Udell (2006) define lending technology as a combination of primary information source, screening and underwriting of policies or procedures, loan contract structure and monitoring strategies or mechanisms. The choice of lending technology for SMEs depends on the sources of information available for the SMEs added with various adaptability and appropriateness of the combination of information.

Lending technologies are categorized as transactions lending and relationship lending. Transactions lending used by the financial institutions includes financial statement lending, small business credit scoring, asset based lending, factoring, fixed asset lending and leasing. Most transaction technologies focused on opaque borrowers. Meanwhile, relationship lending relies on soft information gathered through direct contact with borrower. Relationship lending focused on observing the SME's performance throughout the banking relationship and past communications with SME's suppliers, customers or neighbouring businesses (Petersen and Rajan, 1994; Berger and Udell, 1995; Degryse and Cayseele, 2000). The soft information remained proprietary to the loan officer.

2.8 Conclusion

Based on the above literature review, access to finance is indeed important for the growth of SMEs. SMEs are subjected to various risks and constraints in relation to Bank financing.