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## **EVALUATING THE ROLE OF COMMERCIAL BANKS IN SUPPORTING SMALL AND MEDIUM-SIZE ENTERPRISES**

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### **ABSTRACT**

This research paper examines the crucial role played by commercial banks in supporting small and medium-size enterprises, which constitute a significant portion of the global economy. Despite their economic importance, small and medium size enterprises often face substantial challenges in accessing adequate financing. This study evaluates the various mechanisms through which commercial banks support small and medium size enterprises, analyses the effectiveness of these mechanisms, identifies existing gaps, and proposes recommendations for improvement. Through a review of relevant literature and analysis of case studies from different economies, this paper contributes to the understanding of banks and small and medium size enterprises' relationships and offers insights for policy development to enhance financial inclusion for small and medium size enterprises.

**Keywords:** Commercial Banks, Small and Medium-size Enterprises, Relationship Banking, Credit Access, Financing Gap.

### **INTRODUCTION**

Small and Medium-size Enterprises are widely recognized as the backbone of the global economy, contributing significantly to employment generation, innovation and economic growth. According to the World Bank, small and medium size enterprises represent about 90% of businesses and more than 50% of employment worldwide. Despite their economic significance, small and medium size enterprises consistently face challenges in accessing adequate financing, which constrains their growth potential and limits their contribution to economic development.

Commercial banks, as primary financial intermediaries, play an important role in bridging the financing gap for small and medium size enterprises. Through various lending mechanisms, advisory services and specialized financial products, banks aim to address the unique financing needs of small and medium size enterprises. However, information asymmetry, high transaction costs and perceived risks often create barriers to effective bank-small and medium size enterprises relationships.

## **OBJECTIVES OF THE STUDY**

The objectives of this research paper are:

1. To evaluate the various mechanisms through which commercial banks support small and medium size enterprises.
2. To analyse the effectiveness of these mechanisms across different economic contexts.
3. To identify existing gaps in bank support for small and medium size enterprises.
4. To propose recommendations for improving bank-small and medium size enterprises relationships.

Understanding the role of commercial banks in supporting small and medium size enterprises is critical for developing effective policies that enhance financial inclusion and promote sustainable economic growth.

## **REVIEW OF LITERATURE**

**Boot (2000)** studied that relationship banking involves building long-term relationships with small and medium size enterprises to reduce information asymmetry. He found that relationship banking facilitates repeated interactions, allowing banks to gather soft information about small and medium size enterprises, which complements hard financial data.

**Beck and Demirgüç-Kunt (2006)**, found that small and medium size enterprises are having greater financing obstacles than large firms and these obstacles have a stronger negative effect on their growth. The OECD estimates that the small and medium size enterprises' financing gap in

emerging markets is approximately \$5.2 trillion, representing 1.4 times of the current level of small and medium size enterprises lending.

**Berger and Udell, (2006)**, highlighted that information asymmetry between banks and small and medium size enterprises significantly contributes to the financing gap. Small and medium size enterprises often lack proper financial documentation, credit history and collateral, making it difficult for banks to assess their creditworthiness. Additionally, the high transaction costs associated with small-scale lending make small and medium size enterprises financing less profitable for banks as compared to lending to larger companies.

**Studies by De la Torre et al. (2010)** demonstrated that commercial banks offer various traditional lending products to small and medium size enterprises, such as; term loans, working capital loans, asset-based lending and overdraft facilities. These products form the foundation for small and medium size enterprises' financing but their effectiveness is often limited by collateral requirements and stringent creditworthiness assessment.

**Beck et al. (2010)** studied that governments often intervene to enhance small and medium size enterprises access to bank financing through credit guarantee schemes, interest rate subsidies and regulatory incentives for small and medium size enterprises' lending and targeted refinancing lines. He provided evidence that the credit guarantee schemes can increase the small and medium size enterprises' lending by reducing banks' risk exposure.

**Beck et al. (2011)** showed that many commercial banks have established specialized small and medium size enterprises' banking units with dedicated staff trained to understand small and medium size enterprises' needs. He found that banks with specialized small and medium size enterprises' units tend to have larger small and medium size enterprises' loan portfolios and lower default rates.

**Stein et al. (2013)** analysed that the commercial banks also offer various non-financial services to small and medium size enterprises, which includes business advisory services, financial literacy training, networking opportunities and market information. These services help in strengthening the bank and small and medium size enterprises' relationships and improve their performance.

## **METHODOLOGY**

This research employs a mixed-methods approach combining:

1. **Systematic Literature Review:** Under this, analysis is made of academic papers, policy documents and industry reports published between 2000 and 2017 on commercial bank support for small and medium size enterprises.
2. **Case Studies:** Under these case studies, in-depth examination of bank-small and medium size enterprises relationships is done in selected countries representing different economic contexts:
  - (i) United States (developed economy)
  - (ii) Germany (developed economy with strong small and medium size enterprises sector)
  - (iii) Kenya (emerging economy)
  - (iv) Bangladesh (developing economy)
3. **Secondary Data Analysis:** In this data analysis, study of small and medium size enterprises' financing, data from the World Bank Enterprises' surveys, OECD scoreboard on financing of small and medium size enterprises, entrepreneurs and national central bank statistics is conducted.
4. **Comparative Analysis:** To make comparison of bank support mechanisms across different economic contexts to identify best practices and areas for improvement are analysed.

## **FINDINGS OF THE STUDY**

### **1. Evolution of Commercial Bank Support for SME**

Commercial bank support for small and medium size enterprises has evolved through three distinct phases over the past two decades:

- (i) The traditional pre-2008 phase featured strict collateral requirements and limited offerings.
- (ii) Following the financial crisis (2008-2015), banks developed specialized small and medium size enterprises units amid increased regulatory attention and government support.
- (iii) Since 2015, the digital transformation phase has started technology-integrated lending, alternative credit assessment methods and platform-based financing solutions.

### **2. Effectiveness of Bank Support Mechanisms**

Bank support mechanisms for small and medium size enterprises differ widely in effectiveness across different economies:-

- (i) Traditional lending remained the primary financing source, accounting for 60 to 70% of external financing in developed economies but only 30 to 40% in developing countries, limited by collateral requirements and lengthy approval processes.
- (ii) Relationship banking improved the credit access and terms where implemented effectively, especially in Germany's hausbank system.
- (iii) Technology-based lending has reduced the processing times and expanded access, particularly in the US though it works best when combined with relationship elements.
- (iv) Banks with specialized small and medium size enterprises units demonstrated larger loan portfolios and lower default rates.
- (v) Non-financial support services showed mixed results with customized advisory services and networking opportunities proving most beneficial throughout the studied countries.

### 3. **Gaps in Bank Support for SMEs**

Despite evolving support mechanisms, banks still face significant shortcomings in serving the small and medium size enterprises.

- (i) Banks across all studied countries struggled to effectively serve startups and early-stage small and medium size enterprises, primarily due to their limited track record and high risk profile.
- (ii) Many bank products are adaptations of corporate banking solutions rather than being designed specifically for small and medium size enterprises' requirements.
- (iii) Female-owned small and medium size enterprises faced additional barriers in accessing bank financing, particularly in emerging and developing countries.
- (iv) Service-oriented and knowledge-based small and medium size enterprises with limited physical assets faced greater challenges in securing bank financing as compared to asset-heavy manufacturing small and medium size enterprises.
- (v) Small and Medium size Enterprises in rural areas have significantly lower access to bank financing as compared to their urban counterparts.

- (vi) Banks across all studied economies showed a preference for providing short-term financing rather than long-term financing to small and medium size enterprises, constraining their ability to make capital investments.

### **FACTORS INFLUENCING COMMERCIAL BANK SUPPORT FOR SMEs**

Several key factors influence the effectiveness of commercial bank support for small and medium size enterprises. These are explained as under:-

#### **Regulatory Environment**

Banking regulations impact small and medium size enterprises' lending, with international banking requirements often discouraging it due to higher risk weights, though some jurisdictions have introduced supporting factors.

#### **Information Infrastructure**

The quality of credit information systems strongly correlates with small and medium size enterprises' access to bank financing. Countries with comprehensive credit bureaus and registries show higher levels of small and medium size enterprises' lending and lower interest rate spreads.

#### **Competition in the Banking Sector**

This research indicates a non-linear relationship between banking sector competition and small and medium size enterprises' financing. Moderate levels of competition appear optimal, with very low competition reducing banks' incentives to reach small and medium size enterprises and very high competition potentially leading to cream-skimming of the most profitable small and medium size enterprises.

#### **Macroeconomic Conditions**

Small and Medium size Enterprises' lending is more sensitive to economic cycles than lending to large companies because the small and medium size enterprises are facing greater credit reductions during downturns.

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## **Bank Ownership Structure**

Small and Medium size Enterprises' lending approaches differ on the basis of bank type; local and community banks depict stronger small and medium size enterprises' focus; large national banks offer standardized products; foreign banks target larger small and medium size enterprises and public banks often have explicit small and medium size enterprises' support mandates.

## **RECOMMENDATIONS**

Based on the above findings and factors, some recommendations are proposed to enhance the commercial bank support for small and medium size enterprises. These are divided into following two parts:-

### **RECOMMENDATIONS FOR COMMERCIAL BANKS**

1. **Develop Small and Medium size Enterprises-Specific Products:** There is great need to design financial products specifically for small and medium size enterprises rather than adapting corporate banking solutions for considering cash flow patterns and growth routes of different small and medium size enterprises' segments.
2. **Strengthen Relationship Banking:** The commercial banks should invest in relationship managers with specialized small and medium size enterprises' knowledge and ensure continuity in relationship management and should also develop systems to capture and utilize soft information.
3. **Adopt Hybrid Lending Models:** The banks should combine traditional relationship banking with technology-based approaches to balance efficiency with personalized service.
4. **Enhance Non-Financial Support:** Commercial banks should develop targeted advisory services for different small and medium size enterprises' segments and growth stages, potentially through partnerships with specialized providers.
5. **Implement Differentiated Risk Assessment:** The banks should develop sector-specific risk assessment and small and medium size enterprises' methodologies by considering the unique characteristics of different industries.



6. **Invest in Staff Training:** The commercial banks must ensure staff training to understand the small and medium size enterprises' dynamics, sector-specific challenges and appropriate financing solutions.

## **RECOMMENDATIONS FOR SMALL AND MEDIUM SIZE ENTERPRISES**

1. **Improve Financial Management:** Small and Medium size Enterprises should strengthen their financial record-keeping and reporting to increase transparency and profitability.
2. **Build Banking Relationships:** Small and Medium size Enterprises should engage proactively with banks beyond loan transactions, including using non-financial services.
3. **Enhance Digital Readiness:** Small and Medium size Enterprises should adopt digital tools that improve operational efficiency and generate data which can support credit assessment.
4. **Utilize Available Support Programs:** Small and Medium size Enterprises should take the advantage of government and bank-sponsored programs designed to enhance small and medium size enterprises' access to finance.

## **CONCLUSION**

Commercial banks play a crucial role in supporting small and medium size enterprises but significant challenges remain there in ensuring adequate access to finance for this big economic sector. The findings of this research paper indicate that while commercial bank support for small and medium size enterprises has evolved considerably but persistent gaps exist, particularly for early-stage businesses, female entrepreneurs and small and medium size enterprises in certain sectors and geographic areas.

Effective bank support for small and medium size enterprises requires a mixed approach that combines appropriate financial products, relationship banking, technological innovation and non-financial services. The optimal approach varies based on economic context, regulatory environment and market structure, suggesting that specialized solutions are needed for effective bank support for small and medium size enterprises.

For enhancing commercial bank support for small and medium size enterprises, there will be requirement of collective efforts from banks and small and medium size enterprises themselves.



By addressing information asymmetries, developing small and medium size enterprises'-specific approaches and creating enabling regulatory environments, stakeholders can work together to narrow the small and medium size enterprises' financing gap and release the full potential of this crucial economic sector.

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