Presentation on:

“The role of commercial banks in providing funding for small enterprises"

The Department of Trade & Industry (the dti) SME Summit
11 – 12 October 2011
Bloemfontein, Free State
Role of Banks in Economic Development

- To provide the necessary lending to viable initiatives aimed at growth and expansion of the respective sectors.

- The promotion of capital formation
  - Accepts deposits from business and individual and make them available for productive purposes. Not only stores wealth but provide financial resources for economic development

- Investment in new and existing enterprises
  - Banks provide loans to entrepreneurs to invest in new enterprises and adopt new methods of production. A timely provision of credit where it may have taken a longer period for the businessman to accumulate the initial capital injection

- Balanced development of different regions
  - Transferring surplus from developed regions to less developed regions – FSC’s Targeted Investments

- Influencing economic activity by increasing amounts of money in circulation through credit creation and adjustments in interest rates.
Why the focus on SME lending....

- SMEs are the backbone of many successful developed and emerging economies (Japan, China, Germany, Korea, et al.)

- South Africa too has touted SMEs as the engine for inclusive economic growth and development - SNA, NGP

- SMEs contribute 34% of GDP
- About 60% employment
Why the focus on SME lending

Total Population, Millions, 2010

- 50.0
  - Unemployed
    - 4.4
  - Not economically active*
    - 14.7
  - Employed
    - 13.0
      - Employed by informal SME's
        - 1.6m
      - Employed by formal SME's
        - 7.7m
      - Employed by large firms
        - 1.3m
      - Employed by Government
        - 2.7m
      - Total Employed
        - 13.3m
  - Rest of population
    - 17.9

- Labour force 17.4 m
- Working age population (15-65) 32.1 m

Informal MSMEs comprise 90% of total MSMEs but have less than 20% of MSME contribution to national employment.

Source: Labour Force Survey, 3rd Quarter 2010; FinScope South Africa Small Business Survey 2010. Note: * Discouraged workers of 2.033m and those not available to work of 12.669m; ** The split between formal/informal SME jobs is obtained by using the same proportion of total formal to informal jobs in the economy, excluding government.
What does existing data say about banks’ lending to SME's?

- Banks constituted 95% of all exposure to SME’s in 2009
- FSC achievement on black SME financing from 2004 to 2008 was R11.4bn by the banks. Target was R5bn for the sector (Banks for 2009 to 2010 at R2.2bn)
- Collaboration with government departments in the various levels – National, provincial and local
- Non-financial support e.g., a network of Enterprise Development Centres, BDSPs
- Small and Medium Enterprise Fund, in partnership with govt. of R267 million, aimed at budding entrepreneurs unable to put up security
- Invoice Clearing solution to address cash flow issues for SME suppliers. Banks have dedicated units to provide various financing options and other support
What does existing data say about banks’ lending to SME’s?

- Exposure and impairments - context

Exposure to SMEs

Credit impairments (all)

Source: SARB returns (BA120, DI200, BA200)
Banking Association SME Initiatives

- **KHULA Cooperation agreement**
  - To address inter-alia non-financial support issues and BDSP with SEDA, SME Credit Bureau and Financial Literacy, SME Forum that will include DFIs to address the advocacy gap

- **Financial Sector Charter and BBBEE**

- **Financial Sector Program (FSP) – USAID**

- **SME Financial Literacy – BANKSETA and Others**

- **Risk Capital Facility (RCF) – EU fund admin. by the IDC**

- **Stakeholder engagement – Government Departments and Agencies, multilateral organisations.**

- **Research and Knowledge Management**

- **“Downscaling” and Financial inclusion – Microfinance, Cooperatives, Stokvels & Cooperative Banks**
Commercial Banks

- “profit-seeking and risk averse”
- Need to satisfy themselves of the SMEs ability and capability to repay the loan sought.

Definition of SMEs (impacts on how banks approach the entity)

- Varies from bank to bank; Could be based on assets, no. of employees, and or annual turnover
- Generic Codes definitions of EME and QSE

Banks’ view of SMEs

- Considered high risk due to insufficient assets, low capitalisation, lack of collateral and vulnerability to market conditions
Role of commercial banks in providing funding for small enterprises.....

- Role ranges from creation or participation in SME finance investment funds to the creation of special units for financing SMEs within the banks.

- Services provided take various forms, including:
  - Short-term loans – compatible with business and income patterns
  - Repeated loans – full repayment of one loan brings access to another
  - Overdraft facilities
  - Factoring and invoice discounting – asset finance; equity finance
  - Non-financial support services
Private banking sector role in SME Financing

Drivers

- A feeder for future business
- Important to develop healthy pipeline of MEs
- Evidence of re-organisation to support this migration
- A profitable and resilient business in its own right...... but mostly transaction and deposit-led model, not credit
- Public programmes matter only to a very limited degree

Obstacles

- Macroeconomic factors
  - Most significant constraint cited
  - Reflective of character of boom & nature of SME market
- Bank-specific factors
  - Capacity to assess credit risk of SME’s
- SME-specific factors
  - Significant information gaps (e.g. financial statements) & lack of SME credit bureau
  - Lack of basic business and financial skills
- Regulatory and policy constraints
  - Concern of judicial processes required to recover a debt & R7,000 limit on small claims court
  - Companies Act: concern over ‘business rescue provisions

World Bank also confirms findings
18 Financial Intermediaries (FIs)— banks, DFI’s and private equity funds participated in the online survey

- Successful financing greater among SMEs with higher turnover
- Small SMEs require greater ancillary support
- FI’s working with model that is not totally appropriate for market of largely previously disadvantaged entrepreneurs
- Need for FI’s to develop more risk appropriate evaluation models and products tailored to this market segment
Key Findings of the Survey

- Review of evaluation criteria for SME's necessary
- Inappropriate SME products – lack of diversity
- Complex application process
- Lack of quality business development support (grading and accreditation of BAs)
- SME business skills to be developed
- SME bankability – understanding of FI requirements
- Limited understanding of regulation – company & VAT reg., FICA compliance, NCA...
- Ineffective advocacy for SME sector
- Lack of access to IT infrastructure
- Promote use of loan guarantees
- Facilitate an enabling regulatory and legislative environment for SME's to thrive
- Improve knowledge management systems – SME portal
Proposed interventions

- **Products and Services** – review of guarantee funds, ability to call on collateral, review credit assessment tool/approach, develop SME specialists, designate SME champion, reconstitute credit committees, minimise approval turn-around time, provide mentoring, develop “real” SME products

- **Business Development Support** – establish accreditation and grading of BDS, create panel of BDS experts, set industry-wide BDS standards, professionalise sector, develop generic SME financial literacy course, develop online, open-source and interactive learning, training needs assessment...

- **Policy and Regulation** – identify inhibiting regulations and laws, RIA, promote “one-stop” reporting on SME statistics, lobby to prevent regulation ‘overload’, support the creation of SME Ministry or SME Champion

- **Knowledge Management** – unify existing advocacy groups - BUSA SME policy committee, facilitate setting up of SME forum, design and develop SME portal and data repository, research and knowledge sharing...
Is lack of funding really the issue?

Main Constraints When Starting Up a Business

- Crime and Corruption: 35%
- Fear of Failure: 29%
- Electricity Issues: 15%
- Access to Finance: 7%
- Inadequate Skilled Labour: 6%
- Labour Regulations: 5%

Why Start-up SMEs Fail

- Internal factors: 82%
- External Factors: 18%

Internal factors such as the owner mismanaging the business or not having the knowledge to run it properly.

Source: IFC Presentation (which includes SME Survey – World Wide Worx, IFC Conference Presentation, 2011)
Is Access to Finance an Obstacle for a SME Business?

- No Obstacle
  - 2007: 24.5%
  - 2010: 27.3%
  - Change: +28%

- Major or Severe Obstacle
  - 2007: 75.5%
  - 2010: 72.7%
  - Change: -45%

Clearly access to finance in terms of being an obstacle for a growing business as a situation has worsened in South Africa.

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<th>Issue</th>
<th>Recommendation</th>
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<td>Banks large in scale relative to DFI’s but take cautious approach to SME lending</td>
<td>Improve effectiveness of partial credit guarantee scheme</td>
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<td>• Performance of direct public lending schemes is mixed</td>
<td>• Review cost effectiveness and objectives of schemes</td>
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<td>• Entrepreneurs lack business and financial skills</td>
<td>• Support development of BDS market through public research</td>
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<td>• Lack of credit information on SME’s</td>
<td>• Support development of market credit information for SME’s (e.g. sharing of information &amp; support for credit bureau)</td>
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<td>• Lending to SME’s is costly and risky, and information is lacking</td>
<td>• Subsidize R&amp;D on lending technologies to overcome information gap (e.g. challenge fund)</td>
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<td>• Some regulatory &amp; judicial issues identified (e.g. collateral enforcement &amp; impact of business rescue in Companies Act)</td>
<td>• Review impact of these issues</td>
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Recommendations

Government – addressing structural constraints
- Improve outreach of credit guarantee mechanism(s)
- Promote greater engagement and lending by non-bank financial institutions – cooperatives; debts and equity markets as sources of funding for SMEs
- Improve information access to SMEs
- Conduct studies and publish information on SMEs
- Promote dialogue between FIs, trade associations and SMEs
- Promote entrepreneurship and innovation
- Provide incentives for banks to lend to SMEs
- Promote informal debtor-creditor workout mechanism to settle commercial disputes – litigation takes time and is costly
- Establish a reporting framework for SME-specific statistics
- Dedicated Ministry for SME Development

Banks
- Improve credit evaluation skills of bank officers
- Apply appropriate evaluation techniques – mindset shift
- Proximity of outlets to SMEs, simple loan applications
- Improve turnaround times between application and disbursements
CONCLUSION

■ Private sector committed to this space and larger in scale relative to the public sector
  ■ An engine for future growth and a profitable business in own right
  ■ Encouraging bank innovations to grow sector (e.g. credit scoring and provision of BDSP)

■ Banks remain cautious about lending to the sector
  ■ Experience shows many SME’s fail in early stages. This feeds into risk. One way to address: diversify funding.
  ■ There is a lack of information about potential borrowers and concern about skill of potential entrepreneurs

■ The Association is partnering with KHULA, public sector institutions, multilateral organisations, etc. to address key concerns

■ There is an important role for public policy
  ■ Efforts should harness private sector expertise rather than compete directly with it
  ■ Support the broader credit environment to overcome obstacles to lending
  ■ Have a champion with clout in government to represent SME interest
THANK YOU