BANK INVOLVEMENT WITH SMES IN ZIMBABWE

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Abstract - The 2012 World Bank Survey in Zimbabwe revealed that 5.7 million people are working in the Small and Medium-sized Enterprise (SME) sector. The SME sector is the country's economic fulcrum. SMEs find it difficult to access finance. Conventional wisdom argues that banks are the source of SME external funding. A survey of 8 banks on SME funding, was carried out to assess the banks involvement with SMEs. From the survey, banks are keen to move into the SME lending market but are sceptical on how to do it. Most banks concur that SME lending market is profitable.

Keywords - Bank Involvement, SME External Funding, SME Lending, SME Sector.

I. INTRODUCTION

According to the World Bank/Finscope MSME Survey in Zimbabwe, 2012, the MSME sector absorbs 5.7 million people. Of the MSMEs surveyed, 14% used banking facilities of which 3% operate bank accounts in the name of the business. The Ministry of Finance in the 2013 National Budget Statement, pronounced that the sector employs 60% of the national workforce and contributes 50% of Gross Domestic Product (GDP). These statistics illustrate the huge contribution of SMEs to employment creation and GDP. Regardless of this, the Reserve Bank of Zimbabwe observed that in 2012 only $164.4 million was extended to SMEs of total loans of $2.8 billion, only 5% of total loans. This showsthat SMEs do not have adequate access to external funding; therefore this affects their development and growth. On the other hand,MSMEs do not use available banking facilities because their total incomes are too small to justify use of such facilities and their income inflows are generally irregular. Furthermore, 9% stated that the failure to use the facilities was due lack of financial knowledge and literacy.

Zimbabwe, as an emerging economy, strives for economic development to reduce poverty, improve the standard of living of the majority poor; therefore sees SMEs as the solution. They are regarded as efficient and prolific job creators, the seeds of private sector and the fuel of national economic engines (Abor and Quartey, 2010). Governments throughout the world focus on SMEs to promote economic growth (Finlayson, 2003). Owing to their simple structure, SMEs can respond quickly to economic conditions and meet customers' needs, growing sometimes into large powerful corporations or failing shortly after inception (Altman and Sabato, 2005). Developing countries often experience high levels of poverty and income inequality. FinMark (2003) suggests that the best way to address these socio-economic ills is to improve SME development and growth.

Low access to finance has led to stunted development of SMEs in Zimbabwe. Most SMEs depend on grey markets and internal financing, which is inadequate to survive and grow, for it is increasingly difficult to keep costs within the constraints of self-financing, hence the need for external financing (Fatoki and Smit, 2011). SMEs have two primary sources of external finance: equity and debt. Owing to the rigorous requirements for equity, SMEs depend on bank loans for investment objectives. Access to debt finance is limited, especially in Zimbabwe (Demirguc-Kunt et al, 2006).

On the other hand, competition in financial markets from both supplyand demand sides have prompted some financial practitioners, academics and researchers to explore ways to profitably lend to SMEs by objective evaluation of their creditworthiness. Altman and Sabato (2005) demonstrated (using SME data from US, Italy and Australia) that banks benefit, in terms of lower capital requirement when considering SMEs as retail customers. Basel II drastically transformed the way banks do business with SMEs. By adopting Basel II financial institutions improve credit risk measurement of SMEs for objective credit evaluation for the benefit of the economy in general. This reduces the severity of the historical poor relationship between these two. Success in developed countries (Altman and Sabato, 2005; Saurina and Trucharte, 2004; Schwaiger, 2002) indicates that SMEs in emerging economies can also access finance from commercial banks if the latter adopt Basel II's Internal Ratings-Based (IRB) approach to measuring credit risk.

Emerging economies are following developed economies to improve relationships between banks and SMEs for eventual economic growth and development. Defaults among bigger companies are often caused by systematic risk factors, while defaults by smaller businesses are driven by idiosyncratic risk factors (Roszbach et al, 2005). SMEs cannot meet corporate capital requirements under the existing Basel I Capital Accord. This meansbanks should use a blended approach that considers some SMEs as retail and some as corporate customers. According to

Altman and Sabato (2005) banks need to use Advanced Internal Ratings-Based (A-IRB) to manage SMEs on a pooled basis.

II. DATA

Eightbanks in Zimbabwe completed a questionnaire through respective bank managers and credit managers. During data collection some on-site interviews were carried out to validate information on the questionnaire. SMEs across the country provided a second source of data. This was to extract complementary information from the demand side perspective on bank-SME relation. This provided corroborating and complementary evidence on the current relation between banks and SMEs. A detailed measurement instrument was used to extract ongoing transformations from the perspective of the demand (SME) side. Thirdly some data and findings from the World Bank/Fin-scope MSME (2012) Survey were used to gauge the banks involvement in SME financing. The World Bank captured different perspectives of the demand side of bank products and services. The World Bank Survey supplemented both the bank and SME surveys.

The bank survey targeted both banks that lend to SMEs and banks that have no or little relation with SMEs. The study population represents the Zimbabwean financial market and covers a large part of the bankpopulation. Some banks are not at liberty to divulge information for research purposes. The number of banks in Zimbabwe at the time of the survey was fourteen. All banks were assured that the information provided would be reported in aggregation without exposing individual bank's strategy and position. Six banks did not participate in the survey on the grounds of security and confidentiality of bank data. The questionnaire queried the following: institutional assessment; government policy on SME finance; training of personnel in SME lending; competitive environment for SME Lending; Government programs and actions affecting SME lending; bank policies and procedures to finance; SMEs and reduce associated costs; credit risk management processes and bad loan recovery strategies.

There was no sampling frame of SMEs due to heterogeneity in the definition of the SME. In Zimbabwe SMEs organised themselves into an association called the Small and Medium Enterprises Association of Zimbabwe (SMEAZ), whose membership is voluntary and provided a worthy study population. The sampling frame of the association is not regularly up-dated; therefore, internet-basedpurposive sample was used to reach members, through the association website.

There are notable differences between the Bank survey and SME survey. The bank survey captured the main features of the banking system in Zimbabwe in its entirety. It covered all about SME banking, covering crucial aspects of ownership and size (foreign, domestic, public, small and large) and also on institutional and policy hurdles. The SME survey focussed on the SME as unit of analysis on the demand side of bank products and services. Questions in the respective questionnaires overlap thereby allowing analysis of Bank-SME relationship from both viewpoints. This overlap helped validate responses from both sides and corroborate evidential information from different sources. In summary, the SME measurement instrument queried:general characteristics of the main owner and the enterprise (demographic part); general information on the type and situation of the enterprise; financing of the enterprise and future, growth and obstacles of SMEs.

III. RESULTS AND DISCUSSIONS

The government's role as the facilitator of bank involvement with SMEs seemed to be encouraging banks to pursue SMEs financing. The government established a ministry responsible for SMEs to facilitate SME financing. On the question of whether the government SME policy improved financing, 38% of banks say it improved a lot whilst around 13% say it got worse. Government's positive SME policy helped contain divergence in the way banks look at SMEs due to the heterogeneity in the SME definition. There is no universal definition of SME, which may compromise bank involvement. Normally banks use turnover to define SME but with diverging thresholds, thereby making it difficult to compare one bank involvement into SME financing with another bank. To synchronise the relation between banks and SMEs, the ministry responsible for SMEs and Cooperatives has come up with homogenous SME definition adoptable by banks interested in doing business with the sector. This helps to compare between bank lending practices. This is consistent with the work of Beck et al. (2008, 2010), and De la Torre et al.(2008) who downplayed heterogeneity of SME definition by considering whatever classification a surveyed bank adopted.

38% of banks affirm that government involvement into SME lending improved a lot, government must still improve before an enabling environment for Bank-SME relation is achieved. Interviewed banks cited the non-existence of a credit reference bureau with adequate database that would help banks make informed decisions as an impediment to finance SMEs. Some banks suggest that the government must play a significant role to improve the judicial process in Zimbabwe, especially to enforce lender's rights when security lodged has to be liquidated. Government must make loans to SMEs cheaper by subsidising banks involved in SME lending. The establishment of a ministry responsible for SMEs is applauded although not adequately capitalised.

Banks in Zimbabwe seem to be driven into SME business by various factors. From the bank survey,

the major factor behind bank involvement withthe sector is to pursue profit. Profits in the SME market are attractive. The current downturn of the Zimbabwean economy, which has seen large firms downsize operations. The implication is that banks, the traditional funders of large firms, experience lower profit margins. Spreading to the non-traditional SME market is the logical thing to hedge profit margins. On the other hand retail competition has increased as there is an influx of other players, departmental stores among others. Lending to government decreased due to stringent fiscal policies and the ability of government to source funding from international capital markets. By re-positioning into SME lending market, banks are developing better technologies to assess this type of clientele, minimising the cost of lending which would eventually reduce interest rates to affordable levels for SMEs. There are also other factors; besides perceived profitability, which drove banks to engage with SMEs (see Figure 1)

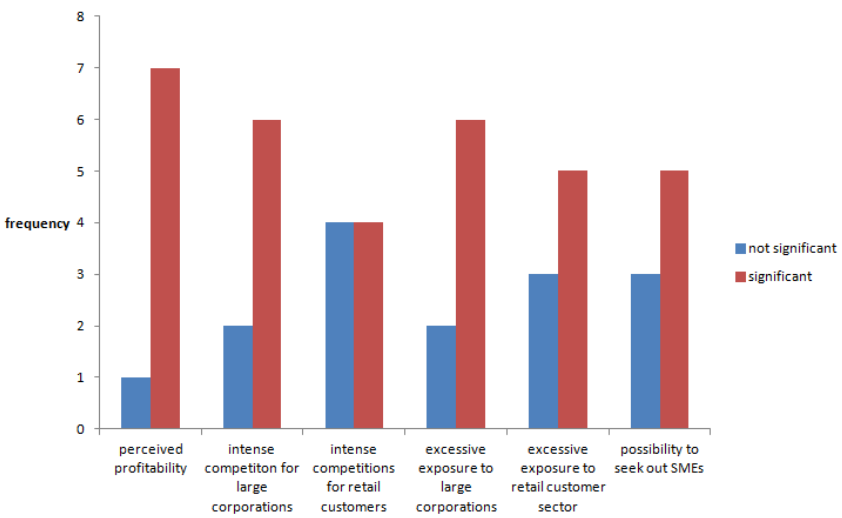


Figure 1: Drivers of Bank Involvement with SME.

Impediments from involvement with SMEs: SME-specific factors (which include poor quality of financial statements, poor debtor information systems, inability of SMEs to manage risk and informality) are the most deterrent factors to bank-SME engagement. Legal and contractual environment is also an obstacle to bank involvement with SMEs. Interviewed banks called on the judicial service sector to regularise bank-SME engagement for the benefit of both parties. On SME-specific factors, some banks suggest that they must nurture SMEs to adopt good business principles such that they can reach them with arms-length technologies, like credit scoring which require 'hard' information. Interviewed banks applauded the Small and Medium Enterprise Association of Zimbabwe (SMEAZ) for constantly holding of seminars on how to do business professionally. Such practice would go a long way to alleviate the effect of SME-specific factors on bank involvement with SMEs.

Macroeconomic factors could have been as the major hindrance to SME lending, which may be due to poor bank-SME relation. Figure 2 shows how banks in Zimbabwe rate the major obstacles to banks involvement with SME lending.

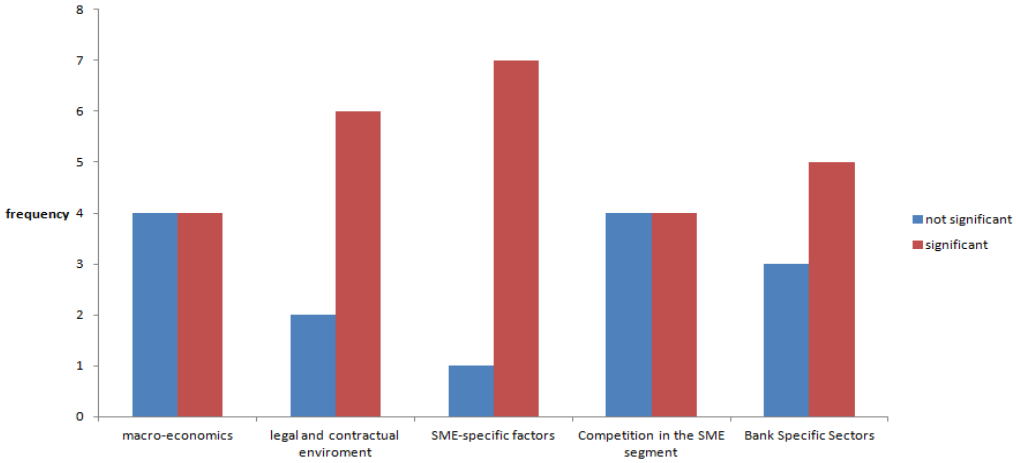


Figure 2: Obstacles to exposure bank-SME engagement.

Evidence from the survey is that the SME lending market is large with significant prospects. Therefore, banks adopt bullish strategies given the prospective outlook of this market. About 63% of banks said that the SME lending market is big and prospects are good, although some banks were pessimistic about prospects of the market, although they acknowledge the vastness of the market. About 88% of the banks said the market is competitive, but not saturated (Tables 1 and 2). The evidence from the survey corroborates the World Bank/ Finscope 2012 MSME Survey in respect to the dominance of the Zimbabwean lending market by SMEs where about 5.7 million people are involved. This is a direct consequence of closures of large firms.

Table 1: Size and Prospects for SME market

Variable	Category	Frequency	Proportion (%)
What is your view on the size and prospects for SME market in general	The SME market is small and prospects are good	2	25.0
	The SME market is big and prospects are bleak	1	12.5
	The SME market is big and prospects are good	5	62.5

Table 2: Competitive nature of the SME lending Market

Variable	Category	Frequency	Proportion (%)
How competitive is the market for SME lending	The market is not competitive and entry costs are low	1	12.5
	The market is competitive but not saturated	7	87.5

The study looked at aspects to do with business models banks in Zimbabwe adopt in this market; types of products they are offering; risk management (collateral requirements for SMEs, monitoring and credit analysis). In order to deal with SME market, the organisational setup was arranged to suit the new environment. About 38% of banks mentioned that they separate dedicated units to deal exclusively with bank-SME relations and other banks anticipate doing the same in the near future. This shows that SME lending is different from traditional lending; retail and corporate. The major reason to adopt separate dedicated units is to offer SMEs a wide variety of tailored products and services. Banks, which had not yet adopted the new organisational setup, offered standardised products to their SME clientele.

To reach SMEs, banks use either headquarters or branches and sometimes both. The headquarters approach was designed to decide which SMEs to target and what products to offer. On the other hand, branches attend to basic needs of the SMEs. There are activities done at both branches and headquarters. From the survey, banks are decentralising major activities by allowing them to be done at both headquarters and branches for instance for the activity: risk management; 12.5% of the banks said this activity is done only at the headquarters, 25% said it is primarily done at headquarters and 62.5% allowed for both. In terms of type of products, banks surveyed offered standardised products (62.5%), equal number of standardised and tailored products (25%) and tailored (12.5%)(see table3). The significance of tailoring rise with the size of the enterprise and banks design such products to a set of SMEs with similar needs.

Table 3: Standardisation of SME products

Variable	Category	Frequency	Proportion (%)
Indicate the most relevant statement regarding the standardisation of your SME products	Standardised	5	62.5
	Standardised/Tailored	2	25.0
	Tailored	1	12.5

Table 4: Collateral requirement for SMEs

Variable	Category	Frequency	Proportion (%)
If collateral requirements are higher for SMEs than for large corporate	SMEs are more unstable	1	12.5
	SMEs are more informal	2	25.0
	SMEs have worse management	2	25.0
	SMEs are harder to evaluate	2	25.0
	SMEs collateral more difficult to seize in case of default	1	12.5

Banks demand more collateral from SME borrowers, because credit risk of SMEs is difficult to evaluate. As a result, SMEs are generally considered riskier due to their inherent informality. To safeguard depositor's money, banks in Zimbabwe require collateral security. SMEs are more vulnerable to both political and economic shocks and that their information is hard to assess for credit risk, the collateral demand is normally huge (see Table 4)
In order to secure loans to SMEs, banks normally use preventative triggers to monitor debt outstanding and repayment frequency. (see Table 5).

Table 5: Monitoring Frequency

Variable	Category	Frequency	Proportion (%)
How often are exposures relative to limits monitored	daily	4	50.0
	weekly	2	25.0
	monthly	2	25.0

IV. SME SURVEY ANALYSIS

The SME (demand side) survey complements the bank side information. The data divulge different but complementary viewpoints of the relation between SMEs and banks.The SME survey findings corroborate many of the findings obtained from bank survey because SME relate with banks consuming an assortment of products and services. Common wisdom asserts that SMEs procure finance via relationship loans due to purported inherent opacity but in practice, they also access financing products and services that are based on objective information of firm and owner.

CONCLUSION AND POLICY RECOMMENDATIONS

Bank survey was done on eight out of fourteen banks in Zimbabwe, although the sample was conveniently selected, the findings offer an overview of banks' attitudes and perception on SMEs in the country. Before the survey, the general view was that banks do not engage with SMEs as the former stereotype the latter risky and unloanable. Common wisdom was that banks are averse to do business with SMEs because of their inherent informality and opacity that they can only access financing through 'relationship loans' wholly dependent on 'soft' information of the enterprise. Therefore, small banks and niche banks were thought to have an advantage to serve such markets, not banks that employ arms-length technologies to assess SME creditworthiness. On the contrary, the bank survey revealed that all types of banks (large or small) are keen to treat SMEs as valuable and important clients. Large and foreign banks view this sector as strategic to pursue profitability when the traditional market dwindles due to economic downturn. Large firms are folding or downsizing, whilst there is competition in the retail market. This results in lower profit margins. SMEs were not the traditional lending market for most banks. Therefore, banks are investing in internal systems to position themselves to serve this potential and unsaturated market. Banks consider SMEs as strategically important, no longer a preserve of small or niche banks. This time SMEs no longer exclusively procure financing products and services through relationship loans, which are processed based on 'soft' information of the enterprise. Large businesses are downsizing and competition in the retail sectors, made banks look for alternatives for their lending business in pursuit of profits. Banks see SMEs attractive and realised that the SME market is large and very competitive, not saturated and the outlook is bright for future growth and prosperity.
In an effort to re-positioning themselves, banks develop new business models, new arms-length technologies and credit risk management systems, since relationship lending is no longer the way to do business. Lending is a fraction of the whole package of what banks offer in a holistic way, in the form of a variety of products and services, which include fee-based products. Large banks also use value chain to reach out individuals linked to SMEs thereby diversifying out their risk.

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