

BOX 6  
Bank Credit to Micro, Small and Medium Sized Enterprises

Introduction

It is widely accepted that Micro, Small and Medium sized Enterprises (MSMEs) play a major role in the development of the economy due to their potential to promote inclusive growth by reducing regional inequalities of economic performance, and their capacity to develop into large organisations later on, thereby providing employment to a substantial proportion of the population and contributing to the economic growth of the country over their lifespan. The International Labour Organization (2019) reported that about 90 per cent of all enterprises in many countries consist of MSMEs, accounting for 70 per cent of employment globally. As per the economic census conducted by the Department of Census and Statistics (DCS) in 2013/14 on non-agricultural economic activities,<sup>1</sup> about 99 per cent of non-agricultural establishments in Sri Lanka were found to be MSMEs, while the Ministry of Industry and Commerce (2016) estimated that about 45 per cent of employment in the country is in the MSME sector.

Limited access to finance is cited as a key deterrent to the growth of MSMEs in Sri Lanka. According to the Asian Development Bank (ADB), the major factors contributing to credit constraints of the MSME sector in Sri Lanka are, a) limitations within financial institutions, such as a risk-averse banking culture and heavy reliance on collateral, b) limitations within the market infrastructure, including insufficient mechanisms to overcome information asymmetries, and c) limitations within MSMEs, for example, poor financial literacy, lack of market knowledge and lack of transparency.<sup>2</sup> In this regard, the lack of a regular flow

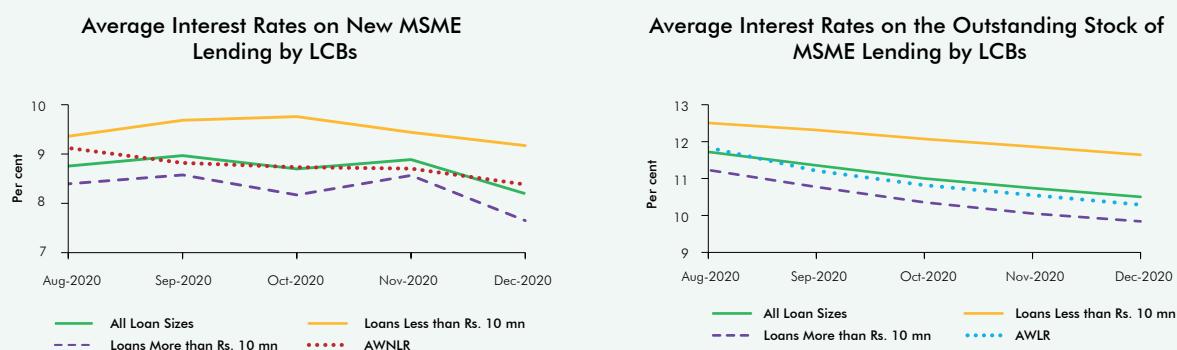
of information to evaluate the amount of credit disbursed as well as interest rates charged on loans for the MSME sector remained a major information gap, hindering effective policymaking. This information gap was strongly felt in the midst of the COVID-19 pandemic, during which MSMEs were severely affected. Given the importance of such information, the Central Bank commenced a monthly survey on credit granted to MSMEs by licensed banks in July 2020. The main objective of the ‘SME Credit Survey’ is to identify the average cost of credit granted to MSMEs<sup>3</sup> by licensed commercial banks (LCBs) and licensed specialised banks (LSBs). For this purpose, the corresponding quantum of loans is also collected to arrive at weighted average interest rates.

Findings of the SME Credit Survey

A preliminary assessment of the survey data indicated that the difference between the average interest rates on MSME lending by LCBs and the average market lending rates to all sectors, as measured in the Average Weighted Lending Rate (AWLR) and the Average Weighted New Lending Rate (AWNLR), was relatively small. However, when the interest rates were evaluated excluding large loans to the MSME sector, presumably for relatively large MSMEs with sufficiently high credit scores and collateral strength, the gap between the interest rates of lending to MSMEs and overall lending rates was large.

The recent decline in the overall market interest rates due to eased monetary conditions was observed in average lending rates to MSMEs as well. As per the

Figure B 6.1  
Average Interest Rates on Loans Granted to MSMEs by LCBs



Source: Central Bank of Sri Lanka

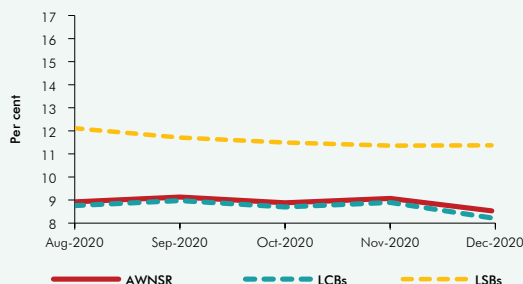
1 See DCS (2015)  
2 See ADB (2017)

3 The manner in which MSMEs are defined varies across nations. In the case of Sri Lanka, different agencies seem to use varying definitions based on their respective objectives (DCS, 2015). For the purpose of the SME Credit Survey, banks are requested to consider establishments with an annual turnover not exceeding Rs. 1 billion and employ less than 300 employees, in order to be consistent with guidelines issued under some recent Directions by the Central Bank.

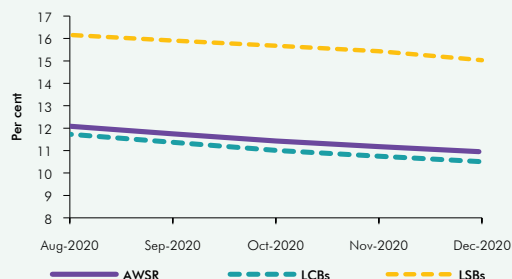


Figure B 6.2  
Average Interest Rates on Loans Granted to MSMEs by LCBs and LSBs

Average Interest Rates on New MSME Lending



Average Interest Rates on the Outstanding Stock of MSME Lending



Source: Central Bank of Sri Lanka

survey, the Average Weighted SME Lending Rate (AWSR), which is the weighted average interest rate of the outstanding stock of credit to MSMEs by all licensed banks, was recorded at 10.95 per cent by end 2020, while the Average Weighted New SME Lending Rate (AWNSR), which is the weighted average interest rate of new lending to MSMEs by all licensed banks, was 8.53 per cent for lending during December 2020. The average lending rates to MSMEs by LSBs, which mostly grant smaller loans in comparison to LCBs, were found to be higher than those of LCBs, making the average MSME rates of all licensed banks higher than the overall market lending rates. Of the outstanding loans granted to MSMEs by end 2020, the share of loans granted by LCBs was 90.2 per cent. Meanwhile, in terms of the number of loans granted, the share of LCBs was 50.2 per cent by end 2020.

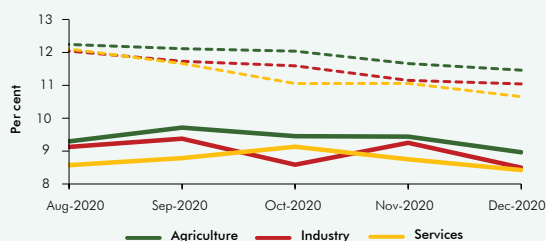
The average interest rates on loans granted by licensed banks to MSMEs in the Agriculture sector were higher than those on loans granted to Industry and Services

sectors. Further, as per the distribution of loans in terms of loan size, average interest rates on large loans remained lower than smaller loans. However, since the initiation of this survey, small size loans also seemed to have attracted relatively low rates, compared to mid-sized loan groups.

The outstanding balance of credit granted to MSMEs was Rs. 743.0 billion as at end 2020,<sup>4</sup> which was 11.1 per cent of total loans disbursed to the private sector by licensed banks.<sup>5</sup> The Industry sector accounted for the largest share of outstanding loans, as well as new loans to MSMEs, both in terms of the amount and the number of loans. The Agriculture sector constituted the smallest share of MSME loans, both in terms of the amount and the number of loans, in the outstanding balance as well as new disbursements.

Most of the new lending granted to the MSME sector during recent months had been of short-term nature, whereas the stock of lending remained mostly balanced,

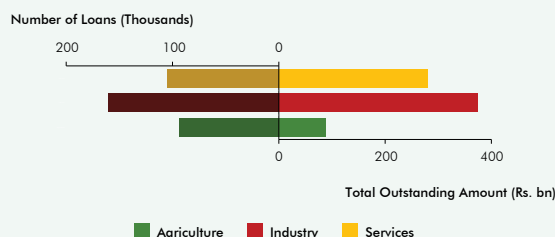
Figure B 6.3  
Average Interest Rates on Loans Granted to MSMEs by Sector



Note: Thick lines represent average interest rates on new loans and dashed lines represent average interest rates on the outstanding stock of loans.

Source: Central Bank of Sri Lanka

Figure B 6.4  
Sectoral Distribution of Outstanding Loans to MSMEs by end 2020

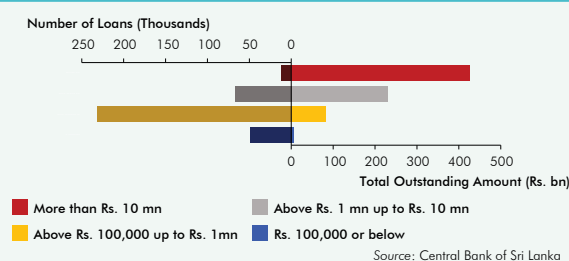


Source: Central Bank of Sri Lanka

4 Only rupee loans granted by licensed banks, excluding non-performing loans, off-balance sheet items, and amounts granted via refinance schemes of the Government and the Central Bank

5 The total stock of credit granted in Sri Lankan rupees to the private sector by LCBs (as measured in the Monetary Survey -  $M_1$ ) and LSBs (as measured in the Financial Survey -  $M_2$ ).

Figure B 6.5  
Size Distribution of Outstanding Loans to MSMEs by end 2020



in terms of the maturity structure.<sup>6</sup> This could mainly be due to the cashflow disruptions faced by the MSMEs amidst the COVID-19 pandemic. The survey findings also revealed varying MSME exposures of banks, reflecting the differences in business models.

### Sri Lanka's MSME Sector Financing Compared to Regional Peers

A cross country comparison of lending to the MSME sector could be challenging due to differences in definitions of MSMEs and the relative importance of the MSME sector in respective economies. However, in a broad sense, compared to regional peers, such as the Republic of Korea, Malaysia and Thailand, whose economic progress in recent years has surpassed that of Sri Lanka, lending to the MSME sector of Sri Lanka by the formal banking sector remains comparatively weak. The share of credit granted to the MSME sector in Sri Lanka remains low,<sup>7</sup> while the spread between average interest rates on loans granted to MSMEs, especially on small sized loans, and average interest rates on loans granted to prime customers remains high. Relatively high interest rate spreads may reflect a multitude of contributing factors, such as the level of financial market development, poor financial literacy of MSMEs, and their approach to banking practices. The importance of promoting the MSME sector could be observed through the success experienced by the Republic of Korea, where the share of manufacturing value added of MSMEs remained over 49 per cent in 2014,<sup>8</sup> despite being home to some of the largest corporations in the world, such as Samsung, LG, and Hyundai.

<sup>6</sup> Loans are classified as short term for loans up to and including one year, medium term for loans from one year up to and including five years, and long term for loans more than five years.

<sup>7</sup> As per the SME Credit Survey, where credit granted only by licensed banks were considered.

<sup>8</sup> See Jones and Lee (2018)

Table B 6.1  
MSME Financing  
in Selected Regional Counterparts

| Country           | Outstanding Loans to MSMEs as a Share of Total Outstanding Business Loans (End 2017, <sup>9</sup> %) | Interest Rate Spread Between Loans to Large Firms and MSMEs (End 2017, <sup>9</sup> bps) |
|-------------------|--|--|
| Republic of Korea | 80.2   | 31   |
| Malaysia          | 50.6   | 217  |
| Thailand          | 50.5   | N/A  |
| Indonesia         | 19.9   | 167  |
| Sri Lanka         | 14.1 <sup>10</sup>   | 246 <sup>11</sup>  |

Sources: OECD (2019), Central Bank of Sri Lanka

### Way Forward

The new survey on bank lending to MSMEs reinforces with data that limited access to low-cost financing remains a major constraint in the MSME sector in Sri Lanka. The recent policy measures, such as the support provided with the spread of the COVID-19 pandemic, the introduction of credit scoring by the Credit Information Bureau of Sri Lanka (CRIB), encouraging MSMEs to access equity capital through the Colombo Stock Exchange (CSE) via initiatives such as the "Empower Board", and the implementation of priority sector lending targets, could help the MSME sector to weather the current economic turmoil, while reaching the growth potential over the medium to long term. Measures such as the introduction of broader credit guarantee schemes or the establishment of a permanent credit guarantee institution could be helpful in improving access to finance for MSMEs, which would address the longstanding issue of the lack of acceptable collateral in the sector.

<sup>9</sup> The OECD (2019) scoreboard contains information for the period 2007-17.

<sup>10</sup> The stock of MSME loans by LCBs measured in the SME Credit Survey, as a share of total credit to Agriculture, Industry and Services sectors, measured in the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, by end 2020.

<sup>11</sup> As a corresponding interest rate for large firms is not available at present, the spread between the weighted average interest rate on new loans to MSMEs by LCBs during December 2020, as measured in the SME Credit Survey, and the monthly Average Weighted Prime Lending Rate (AWPR) for the corresponding month is considered.

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