

ARE COMMERCIAL BANKS REALLY ABSENT FROM MICRO AND SMALL ENTERPRISE FINANCE?¹

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Abstract

This study reports on the findings of a global survey of commercial banks with respect to their micro enterprise and small business financing activities. A sample of banks representing over sixty countries was examined in detail. Contrary to the general belief it is found that a large number of commercial banks have been involved in micro and small business finance for decades. The major incentive for banks to enter into this field was reported as profitability and market diversification, not social or political pressure as it was commonly believed. It is also found that newer banks tend to participate in micro and small business finance more than the older and often large institutions.

Another important finding of this study is that banks have higher arrears in their small business loans than in their micro enterprise loans. Furthermore, small business loan arrears found to be positively and significantly related to the collateral taken from these businesses. This indicates that reliance on collateral tends to cause poor borrower evaluation and inadequate follow up once the loan has been made. The majority of micro enterprises however, do not have conventional collateral that can be used as a security to make loans.

The level of interest rates charged on small business loans, are also found to be significantly related to banks' arrears. This indicates the sensitivity small businesses to loan interest rates. In addition, the minimum deposit requirement of banks to open a bank account has a negative impact on the overall level of savings collected by these banks.

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1. INTRODUCTION

The view has been widely accepted that commercial banks have been nearly absent in the field of micro enterprise finance (Baydas et al, 1997). This assumption has dominated the perception of academics and practitioners for a long time, who viewed NGOs as the main source of finance for micro enterprises. Therefore, it has been the belief that there is little scope for discussion or much to be learned from the experience of commercial bank lending to micro enterprises.

A number of recent studies, however, indicate that the banking sector plays a more important role than it was believed earlier (World Bank, 1996; Almeyda, 1997). Almeyda (1996) reported that commercial bank participation in micro enterprise finance is significant even when compared to large and advanced NGOs. As banks have much larger loan portfolios than NGO, even a small percentage age of their loan portfolio is bigger than the total loan portfolios of most of the NGOs.

Similarly, a World Bank (1996) study confirms that a small number of banks have achieved significantly higher outreach figures than has NGOs. This World Bank study identified over a thousand micro finance institutions that served at least 1000 clients. In total, 206 institutions responded to the World Bank questionnaire, of which 150 were Non-Government Organizations (NGOs), 28 were Credit Unions, and 25 were banks. The survey indicated that 25 banks were responsible for 70 % of the total outstanding volume of micro finance loans whereas 150 NGOs were responsible for only 4 % of the same.

The above studies, although providing significant information on the role of banks in microfinance, under-represented the number of banks that are involved in micro enterprise finance. The cross-country study represented in this paper, is far from being exhaustive, but it identifies a large number of banks that are making micro and very small business loans in over sixty countries for decades.

The objective of this study is to provide new insights about the micro finance activities of banks that will help policy makers and micro finance practitioners to have a better understanding about lending behavior and the business strategies of banks that attempt to serve this sector of the economy. The paper specifically seeks to investigate and explain the factors determining participation of commercial banks in microfinance, loan characteristics, and the performance of banks in micro and small enterprise finance.

2. PARTICIPATION OF COMMERCIAL BANKS IN MICRO AND SMALL ENTERPRISE FINANCE

Contrary to the common belief that banks are nearly absent from micro and small business sector, this research identified 148 banks worldwide that have been making loans to small and micro enterprises for decades.² Though majority of these banks have a small percentage of their total loan portfolio in micro or small business loans, in dollar terms the amount lent to this sector is very significant. For example, 8 % of the total loan portfolio of National Australia Bank corresponds to a value of US \$2 billion.³ Similarly, 10 % of the total loan portfolio of Bank Rakyat Indonesia corresponds to over \$2 billion.⁴

A detailed questionnaire was sent to over thousand commercial and development banks in 75 countries to identify those banks that were involved in small and micro enterprise finance and to capture information on their lending operations. 220 banks have responded to the questionnaire by sending a completed questionnaire form by fax and mail. Out of the 220 banks, 148 banks reported that they have been making small and micro enterprise loans whereas 72 banks reported that they were not currently serving this sector.

Because of the nature and scale of this study it is not possible to draw a representative sample where the survey findings can be fully generalizable. On the other hand, the findings of this study make it possible to analyze the common experiences of a large number of banks that can provide us useful insights into commercial banks' involvement in this sector. It is also important to note that the findings of this study are based on self-reported data. Although the data has been screened and doubtful data has been checked

² The list of surveyed banks can be obtained upon request.

³ This includes loans up to US\$75,000.

with the reporting bank, there is still a possibility that the respondents may over emphasize the positive characteristics of their organization and under estimate their weaknesses. This is however less likely to be the case in this study mainly for two reasons. First, the questionnaire was sent from a research institution rather than from a donor agency that would create incentives to manipulate data to establish good relationship with the donor agency.⁵ Second, the respondents were financially independent banks who did not rely on donor funds. In fact, most of the respondents indicated their interest in the result of this research study rather than expecting future financial benefits.

In this study micro enterprise loans are defined as loans that are between zero and 10,000 US dollars; and small loans are defined as loans that are between 10,000 and 100,000 US dollars.⁶ These ranges correspond to those commonly found in other micro finance programs where the maximum loan size rarely goes above 10,000 US dollars.

Table 1 represents the classification of 148 banks according to their loan sizes. According to our loan classification, out of 148 banks, sixty banks are making micro loans; forty-nine banks are making small loans and thirty-nine banks are making both micro and small loans.

Table 1: Classification of Banks According to Their Loan Sizes

<u>Loan Range in US \$</u>	<u>Number of Banks in Each Range</u>
Micro Loans (less than 10,000)	60
Small Loans (10,000 – 100,000)	49
Both Micro and Small (0- 100,000)	<u>39</u>
Total	148

⁴ This includes loans up to US\$ 10,000.

⁵ The survey was sent from Harvard Institute for International Development (HIID), Harvard University where this research was completed by the author.

⁶ These loan ranges were determined in a pilot survey where banks asked to define their loan ranges. The majority of banks defined their micro loans as less than 10,000 US dollars, and small loans between 10,000-100,000 US dollars

According to the ownership structure, ninety-eight (66% of the sample) of these banks are privately owned and fifty (34% of the sample) of these banks are state owned. Whether the ownership structure made a difference in banks participation in micro and small enterprise finance, in terms of sectoral coverage and diversity is analyzed with a statistical test.

To test the statistical significance of the differences in the sectoral diversity of the loan portfolio between state and private banks, we made a sectoral break down of the loan portfolios for each bank. We then measured the number of sectors each bank had lent to and used the Chi-squared test to find if these two sets of observations are significantly different from each other (Table 2). We found that sectoral diversity of the loans between private and state owned banks is not significantly different from each other.⁷

These findings indicate that regardless to their ownership structure, the surveyed banks allocated their small and micro enterprise loans across all economic sectors. This result is quite encouraging as it may indicate that the governments are moving away from selective credit policies and adopting a market oriented approach in micro and small enterprise finance.

Table 2: Frequency of Lending to Sectors by Private and State Owned Banks

<u>Number of Sectors Served</u>	<u>Number of Banks</u>	
	<u>Private</u>	<u>State</u>
1	1	3
2	6	4
3	11	7
4	20	11
5	20	8
6	39	15
Total	97	48

Chi2 critical value: 12.59

Chi2 statistic: 11.07

1. The degrees of freedom is 5

⁷ The Chi-squared statistic of 11.07 is less than the critical value, 12.59.

We also see that the majority of banks favored to businesses in trade, manufacturing and service sectors, rather than consumption or housing sectors. As we know from the micro finance best practices, majority of micro and very small businesses do not possess traditional collateral, therefore, loans received by these businesses are mostly made on the basis of their cash flows rather than the securities they have. Profitable businesses operating in trade, manufacturing and service sectors are likely to generate sufficient cash flows to borrow from banks, however borrowing for consumption or housing purpose apparently is difficult given that these activities do not usually generate cash flows .

Table 3: Sectors Served by Private vs. State Banks

<u>Sector</u>	Private Banks		State Owned Banks	
	# of Banks	%	# of Banks	%
Trade	92	95	40	83%
Agriculture	70	72	34	71%
Consumption	69	71	23	48%
Manufacture	86	89	44	92%
Housing	60	62	24	50%
Services	83	86	41	85%

1. Sectorial distribution of credit is based on data from 97 private and 48 state owned banks.
2. Most of these banks make loans to more than one sector therefore the total %age lent exceeds 100% of loans made.

3. FACTORS DETERMINING COMMERCIAL LENDING TO MICRO AND SMALL ENTERPRISES

3.1. Incentives and Disincentives for Lending

In late 1980s and early 1990s thousands of non-governmental organizations (NGOs) and specialized finance institutions initiated micro enterprise finance programs to create low income people access to credit (Morduch,1999). Most of these programs are financially supported by the international donor agencies and governments to increase employment and eliminate poverty in the third world. For most of the NGOs micro enterprise finance is socially motivated. Social objectives however, are not appropriate or sufficient for profit oriented commercial banks to enter in this market. Therefore, this research aims

investigates economic factors that encourage or discourage banks from making micro and small enterprise loans.

In our survey, 148 out of 220 banks indicated that they are currently making loans to micro and small enterprises. When they were asked “what were the main reasons for the bank to start making loans to this sector?” 48% of banks indicated that “the profitability of micro and small loans” and 4% of banks indicated that “the changing market conditions and increasing competition in lending to large/medium enterprises” were the most important two reasons for entering in small and micro enterprise finance (Table 4).

Table 4: Why Banks Make Micro and Small Enterprise Loans

	<u>Frequency of Response^{1/}</u>	<u>% of total</u>
a) Profitability of micro and small loans	72	49%
b) Changing market conditions and increasing competition in lending to large/medium enterprises	64	44%
c) Poverty alleviation / social objectives	29	20%
d) Regulations imposed by the government ^{2/}	25	17%

^{1/} Some banks indicated more than one factor that affected their decision therefore the total number of reasons for making small loans exceeds the number of banks in the sample.

^{2/}These regulations require banks to allocate certain percentage of their loan portfolio to micro and small business.

The survey results show that increasing awareness of the profitability of small and micro enterprise loans was indeed the most important factor in attracting banks into this sector. The second most important factor in changing banks lending behavior appears to be the increasing competition in lending to large and medium sized enterprises. It has been well researched and documented that, the financial liberalization policies in the 1980s and 1990s, allowing foreign bank operations in domestic markets and freeing interest rates have indeed increased competition in the banking sectors of many developing countries around the world (Pehlivan, 1996; Pehlivan and Kirkpatrick, 1993). Many of the domestic banks lost their large clients to the international foreign banks hence; they began to look for new creditworthy clients from small and medium sized enterprises.

“Government regulations” (17%) or, social objectives such as “poverty alleviation” (20%) were not nearly as important in attracting these banks into small and micro enterprise finance. These findings indicate that, banks, as regulated and commercially sustainable institutions, are more likely to respond to profitability and market conditions than to indirect objectives of poverty alleviation or other socially oriented objectives.

When the 72 non-lending respondent banks were asked about the major disincentives for not making loans to small and micro enterprises, 49% of these banks indicated that “the higher administrative cost of making these loans” was the major constraint, 32% of them indicated the “lack of network and personnel to serve this sector”, and 29% of them indicated that “interest rate controls” were the major reasons that discouraged them from entering in this market (Table 5).

Riskiness of this sector however was not sighted as a significant discouraging factor for the same banks. Only 17% of the non-lending respondent banks believed that this sector was risky. This finding contradicts with an earlier study by Baydas et al (1997) where the authors argue that micro enterprises are viewed as too risky by banks which in turn negatively affect banks participation to this sector. The finding of Baydas et al, (1997) however is questionable because their research is based on limited interviews with seventeen banks. Furthermore these seventeen banks that were interviewed in Baydas et al (1997) were already making successful micro enterprise loans which contradict with the argument that micro enterprise finance is viewed as too risky and hence it is unattractive for banks.

In our survey, only 7% of 72 non-lending respondent banks indicated that they were not interested in micro enterprises and this was mainly due to the nature of their operations.⁸ Our findings indicate that it is financial and organizational barriers rather than social or cultural problems that are the relevant factors which prevent banks from making loans to micro and small enterprises (Table 5). High administrative costs (40%), lack of network and trained personnel (32%) to serve this market and interest rate regulations (29%) are

⁸ These banks are large international banks or banks that are specialized in foreign trade or mortgage finance.

important financial and organizational factors that indeed can prevent banks from making successful micro and small enterprise loans that are commercially sustainable.

Table 5: Why Banks do not Make Small and Micro Enterprise Loans

	Frequency of <u>Response*</u>	<u>% of total</u>
a) Higher administrative costs	29	40%
b) Lack of network and personnel to serve this market	23	32%
c) Interest rate controls	21	29%
d) Risky borrowers	12	17%
e) Not interested in micro enterprises	5	7%
f) Other	18	5%

* Some banks indicated more than one factor that affected their decision therefore the total number of reasons for making small loans exceeds the number of banks in the sample.

3.2. Bank's Age and Their Portfolio Share in Micro and Small Enterprise Loans

Out of 148 banks, 119 banks provided us detail information about their loan portfolio. These 119 banks show a great diversity in terms of country, years of operation (i.e. age of banks), loan size and loan portfolio share in small and micro enterprise loans. The age of these banks ranged between 1 to 175 years; the loan size ranged between 1,000 to 100,000; and their portfolio share in small and micro enterprise loans ranged between 1% up to 100% of their total loan portfolio.

When these banks are classified according to the number of years since they were established, it is found that the newly established banks, on average, have a larger share of loan portfolio dedicated to small and micro enterprise loans than the older banks (Table 6). For example, the newest six private banks that were established within the last five years had 56% of their loan portfolio, on average, in micro and small business loans. This loan portfolio share dramatically went down to 12% for banks that are older than 60 years. Table 6 presents similar results for the state owned banks, where the newest banks on average have the largest portfolio share in micro and small business loans.

These results may indicate an increased awareness by newer banks of the profitability of small and micro enterprise loans. Indeed, in recent years, a number of new private banks were established mainly to serve this sector. For example, Banco de la Pequeña Empresa, a privately owned commercial bank in Dominican Republic was established in 1997 to serve the small business sector. Similarly Banestado Microempresas S.A. a subsidiary of Banco del Estado de Chile was established in 1996 to make only micro enterprise loans.⁹

Table 6: Banks' Age and Their Loan Portfolio Delegated to Micro and Small Enterprises

A) PRIVATE BANKS

<u>Age of Banks (years)</u>	<u>Sample Size</u>	<u>Percentage of Portfolio Dedicated To Micro/Small Enterprise Loans</u>	
		(Mean)	(Median)
1-5	6	56	58
6-15	20	26	18
16-30	16	14	6
31-60	16	18	19
60>	22	12	9
Sub Total	80		

B) STATE OWNED BANKS

<u>Age of Banks (in years)</u>	<u>Sample Size</u>	<u>%age of Portfolio Dedicated To Micro/Small Enterprise Loans</u>	
		(Mean)	(Median)
1-5	5	38	30
6-15	10	18	8
16-30	11	9	7
31-60	7	21	10
60>	7	19	12
Sub Total	39		
TOTAL	119		

It is also true that, the newly established small commercial banks have a limited scope to enter into the highly competitive market of large enterprise finance. This is due to the fact that the large and well-established banks are in a stronger position than the smaller banks to negotiate the interest rates, and loan terms and conditions with large sophisticated

⁹ This information obtained from the survey.

corporate clients. Therefore, new and smaller banks find it easier to do business with smaller, local businesses.

4. PERFORMANCE OF COMMERCIAL BANKS IN MICRO AND SMALL ENTERPRISE FINANCE

4.1 The Level of Arrears

In this study, the performance of banks in micro and small enterprise finance is evaluated on the basis of their arrears. The level of arrears, i.e. the amount of non-performing loans determines the loan portfolio quality, profitability and hence the long-term viability of credit institutions. According to Stearns (1996) loan default for micro/small business loans is an institutional problem where it is the lender not the borrower who causes or prevents a high level of arrears. This is because the loan repayment rate is largely determined by the lender's image and credit methodology. If the lender is viewed as a charitable organization it is difficult to establish an on-time payment behavior for the borrowers. This is particularly true for micro finance NGOs and development banks that mix social and financial objectives. Furthermore, the credit methodology, such as loan approval, loan pricing, loan monitoring and collections that are not suitable for micro and small business finance can encourage delinquency (Churchill, 1999).

This research focuses on commercial banks rather than microfinance NGOs, therefore findings related to poor loan collection performance will be largely related to banks credit methodology rather than their public image. Out of 148 banks, 103 banks provided us information on their loan arrears. The rate of arrears ranged from 0.10 % to 52 % for micro enterprise loans, and from 0.11 % to 80 % for small enterprise loans (Table 7). These rates of arrears are quite high for commercial banks. Nevertheless, the medians of the rates of arrears indicate that 50 % of banks making micro enterprise loans have less than 5 % of their micro loans in arrears.

When we examine the performance of banks with respect to small business loans, it appears that these banks not only have a higher average (13.9%) but also have a much higher median (10.8%) indicating a less satisfactory overall performance for banks in small business finance (Table 7). This difference between the rates of arrears may simply

be the result of different credit methodologies used by banks to make micro and small loans. In the following section an econometric analysis is used to determine the factors that are associated with banks' high arrears with respect to their micro and small business loans.

Table 7: Banks' Arrears in Small and Micro Enterprise Finance

	Sample Size	Min (%)	Max (%)	Average (%)	
				Mean ²	Median
Micro	57	0.10	52	11.4	5.0
Small	46	0.11	80	13.9	10.8
Total	103			13.4	6.0

1. Arrears are defined as total loans past due for one month/total loan portfolio.

4.2. Determinants of Banks' Arrears in Micro and Small Enterprise Loans:

Determinants of banks' arrears in micro/small enterprise loans are estimated by using the cross sectional data obtained from 103 banks that provided the required data. The functional relationship between the proportion of the loan portfolio in arrears and the explanatory factors are written as follows:

$$A / LP = a_0 + a_1 LT + a_2 IR - a_4 D_1 - a_5 D_2$$

Where:

- A = amount of loans in arrears (one month past due)
- LP = total size of loan portfolio
- LT = average loan term for micro/small loans
- IR = average nominal interest rate charged on micro/small loans
- D1 = dummy variable (1, if privately owned; 0 if state owned)
- D2 = dummy variable (1, if collateral is required; 0 if not)

The dependent variable consists of banks' arrears in micro/small enterprise loans expressed as a ratio of the banks loan portfolio to this sector. The justification for the inclusion of the explanatory variables is as follows:

Loan term: In micro/small business finance, the loan term or the loan repayment schedule can affect the ability of the borrower to pay his/her loan back (Patten and Rosengard, 1991). The shorter loan terms or frequent payments of installments can make it easier for the borrower to pay his/her loan back, whereas the longer loan terms and infrequent payments of loan installments can make it difficult for micro/small business owners to pay their loan on time. Therefore, the longer the loan term, or the less frequent are the loan installments it is more likely for banks to have higher arrears which indicates a positive relationship between the length of the loan term and the level of arrears for a bank.

Average interest rate on micro/small loans: In the micro finance literature, it has been widely accepted that micro and small enterprises are capable of borrowing at commercial, or market interest rates (Sterns, 1991; Robinson, 1995; CGAP, 1996). It is also argued that, if micro or small enterprise loans are subsidized by governments, i.e. interest rate is kept below the market rates, loan default or corruption may be encouraged and this may results in higher arrears in banks' loan portfolios (Webster, 1991). These arguments suggest a negative relationship between loan rates and banks' arrears.

On the other hand, high loan rates may cause adverse selection effect. The adverse selection effect is used by Stiglitz and Weiss (1981) to describe a situation that in practice, high interest rates discourage safe borrowers, and at the same time encourage risky borrowers to borrow. Therefore, an increase in loan rates may alter the quality of banks' loan portfolio by attracting riskier projects and hence, may result in higher arrears. Furthermore, higher nominal interest rate paid on a loan implies a greater cash flow burden on the enterprise in the early periods of loan repayment, hence, increasing the likelihood of arrears.¹⁰

Public or Private Ownership: D1 (if privately owned 1, if state owned 0) The dummy variable D1 is included to capture the relationship between bank ownership and the level of arrears in micro and small business loans. It is commonly alleged that the state owned banks which have micro/small business finance programs have relatively higher rates of

arrears than the privately owned banks with similar programs. This is partly due to the image of state banks as lenders for social causes, and partly due to corruption through politically motivated lending. Privately owned banks, however are thought to be more profit oriented which makes them less tolerant to mismanagement, or corruption. Hence we would expect a lower rate of arrears.

Collateral: D2 (if collateral is required 1, if not 0) Dummy variable, D2 is included to capture the impact of the bank's collateral requirements on the level of arrears. We might expect to see a negative relationship between collateral requirement (D2) and arrears as borrowers are more likely to pay their loan back if they have to give up their collateral when they default. On the other hand, if banks rely heavily on the availability of collateral rather than creditworthiness of the borrower to assess their loan applications they might become less vigilant in either loan assessment or later in the collection of loan repayments. The empirical results will indicate which hypothesis has greater validity over the sample of banks examined here.

Findings:

The results of the regression analysis are presented in Table 7. In equation (1) the determinants of banks' arrears are estimated for both micro and small enterprise loans combined. In equation (2) and (3) the same functional relationship is estimated for micro enterprise and small business loans separately.

In equation (1) the coefficients on the 'average interest rates charged on micro/small enterprise loans' (IR) is positive and statistically significant. This supports the hypothesis that the higher the loan interest rate given everything else is held constant, the higher will be the rate of arrears. This finding contradicts with the common argument that the micro and small enterprises are capable of borrowing and paying their loan back with a high rate of interest. It is however important to note that micro and small enterprises may show different characteristics in loan repayment with respect to given interest rates. Therefore

¹⁰ Due to data limitations, other financial costs, such as fees and commissions associated with the loan could not be taken into account in this research.

the same functional relationship is tested separately for micro loans and for small loans and presented in equation (2) and equation (3) respectively.

The estimation result shows that for micro enterprise loans none of the explanatory variables are statistically significant as determinants of loan arrears. For micro enterprise loans, high nominal interest rates are not a significant positive determinant of the level of arrears. In contrast, for small business loans there is a significant positive relationship between interest rates and loan arrears. This finding suggests that an increase in interest rates affects small business and micro enterprises differently. Because micro enterprise loans are of a shorter duration making the principal repayments a larger proportion of total debt service, higher interest rates create a relatively smaller impact on the net cash flow of the micro enterprises as compared to the impact of the cash flow of small businesses. Furthermore, since micro enterprises value the access to credit markets more than the potential gains they might achieve through undertaking risky investments it is likely that an increase in interest rates do not result a strong adverse selection effect for microenterprises.

On the other hand, the significant positive relationship between interest rates and loan arrears of small businesses indicate that the cash flows of small businesses are severely affected by the changes in the level of interest rates charged on their loans. This may be because of the fact that most of the small businesses tend to borrow short term to finance long term investments therefore tend to be over indebted. Hence, even a small change in interest rates may change their debt service burden and cause late payments or loan default.

Table 8: Parameter Estimates for the Determinants of Banks' Arrears

Variables	(1) Micro/Small	(2) Micro	(3) Small
Constant	0.111 (2.143)	0.115 (1.592)	0.030 (0.488)
LT	0.074 (0.777)	0.014 (0.630)	0.004 (0.412)
IR	0.151 (3.136)*	0.133 (1.448)	0.175 (3.858)*
D1	-0.057 (-1.575)	-0.105 (-1.920)	-0.002 (0.035)
D2	0.021 (0.607)	0.002 (0.055)	0.082 (2.041)*

Note: Numbers in brackets are the t-ratios,

* represent statistical significance at the 95% confidence level.

The estimation results also indicate that, the collateral requirement is positively related to the level of arrears in small business loans, whereas there is no relationship between collateral requirement and arrears in micro enterprise loans. It is also interesting to note that 84% of respondent banks require conventional collateral for small business loans whereas only 56% banks require collateral for micro enterprise loans. These findings support the experiences around the world that reliance on collateral often encourages banks to make loans to high risk, or less creditworthy borrowers in the small business sector. In addition, existence of collateral may cause banks to maintain a lower level of vigilance than otherwise for loan monitoring and collection of late payments which may result in higher arrears.

On the other hand, micro enterprise loans are mostly unsecure loans. A typical micro enterprise does not possess conventional collateral such as, land, building or financial assets therefore the loan applicant is evaluated on the basis of its cash flows and personality of the applicant rather than the collateral.

Economic instability, such as high and volatile inflation, currency devaluation may also affect the arrears of financial institutions. In this research, banks' arrears are further analyzed in geographical regions to determine the impact of macroeconomic environment on banks' loan recovery. In Table 9, banks are classified into seven geographical regions: Africa, Asia/Pacific, Western Europe, Former Soviet Union and Eastern Europe (FSU&EE), Latin America, Middle East and South Asia. The mean and median of bank arrears have been calculated and presented for each region.

The regional analysis shows that in the transitional economies of Former Soviet Union and Eastern Europe (FSU&EE), banks have the largest rate of arrears in average (19.9%). This is followed by African (16.2%) and South Asian (16%) banks. The experience of Latin American banks, however, is mixed. On average, the rate of loan arrears is high (15.5%) but the median of the arrears for the same banks is relatively low (5.8%). This indicates that in Latin America, the performance of some banks in managing their arrears is much worse than the majority of banks.

On the other hand, Western European (6.4%) Asia/Pacific (7.1%) and Middle Eastern (8.2%) countries have the lowest rate of arrears in average. This finding indicate that regions such as FSU&EE and Africa, with a history of financial crises and economic instability, are more likely to have high arrears than the regions which have not experienced many major financial or economic crisis.

Table 9: Arrears of Banks by Region in Micro and Small Enterprise Loans

<u>Region</u>	<u>Mean (%)</u>	<u>Median (%)</u>
Africa	16.2	13.7
Asia/ Pacific	7.1	2.9
Western Europe	6.4	2.8
Former Soviet Union & Eastern Europe	19.9	15.0
Latin America	15.5	5.8
Middle East	8.2	5.8
South Asia	16.0	17.0
Total Banks	13.4	6.0

1. Regional arrears are calculated for micro and small enterprise loans together.
2. Regional arrears are the averages of bank arrears in each region.
3. Countries in each region: Africa: Cape Verde, Ethiopia, Ghana, Malawi, Nigeria, Mauritius, Seychelles, South Africa, Sudan Swaziland, Togo, Tunisia, Zambia Zimbabwe; Asia/Pacific: Australia, Cambodia, Fiji, Indonesia, Korea, Philippines, Solomon Islands, Thailand, Tonga; Western Europe: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Malta, Netherlands, Portugal, Spain Switzerland and UK; Former Soviet Union & Eastern Europe: Armenia, Azerbaijan, Albania, Belarus, Czech Republic, Estonia, Kyrgyz Republic, Poland, Romania, Slovakia, Slovenia, Lithuania and Russia; Latin America: Argentina, Bolivia, Chile, Costa Rica, Dominican Republic, Ecuador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Panama, Peru, Uruguay; Middle East: Bahrain, Israel, Jordan, Lebanon, Oman; South Asia: Bangladesh, Bhutan, India, Pakistan.

The high arrears in South Asia are likely a result of government policies that have weakened the obligation of the borrowers to repay their loans. Among others, this has come in the form of government subsidized loan programs where full repayment was never expected, or by periodic loan forgiveness policies enacted by the governments.

5.3. Mobilization of Small Savings

In our survey, out of 148 banks that are making small and micro enterprise loans, 136 of them (92 %) indicated that they are also collecting savings. Mobilization of domestic savings not only increases the availability of domestic financial resources for investors but also provide a safe place for savers to accumulate financial assets. However, the small savers do not always have access to the banking sector as banks may require a minimum amount of deposit to open a bank account. This study shows that 70 % of private banks and 82 % of state owned banks require a minimum amount of deposit in order to open an

account (Table 11). For the majority of private and state owned banks the minimum amount of deposit is less than \$100. A smaller number of banks however indicated that they would ask as high as \$500 or more in order to open a bank account.

Table 10: Minimum Amount of Deposits Required Opening a Bank Account

	Private		State	
<u>Minimum amount (\$)</u>	<u># of Banks</u>	<u>%</u>	<u># of Banks</u>	<u>%</u>
No minimum	26	30	7	18
0-100	30	34	25	66
100-500	19	22	3	8
500 >	12	14	2	6
Total	88	100	38	100

The survey findings indicate that, as expected, the largest volumes of deposits are collected by banks that do not have a minimum deposit requirement, or the deposit requirement is very small (Table 11). For example, 32 banks that do not have a minimum deposit requirement collected over US\$6 billion deposits per bank, whereas banks that require over \$500 to open a deposit account, mobilized only \$US92 million deposit per bank. Such restrictions on deposits cause the banks to be less successful in collecting savings.¹¹

Table11: Banks' Minimum Deposit Requirement and the Amount of Deposits

<u>Minimum Amount (\$)</u>	<u># of Banks</u>	<u>Average Deposit per Bank (US\$ M)</u>
No Minimum	32	6,889
0-100	52	4,646
100-500	18	4,569
500>	14	92

¹¹ The question of whether or not these banks are more profitable, as a consequence of these restrictions, is beyond the scope of this research.

5. CONCLUSION

The main conclusions of this paper are that commercial banks worldwide are major sources of both micro enterprise and small business finance. These banks are in this business mainly for commercial reasons and not because of government requirement or policies. When banks do not make such loans it is mainly due to financial and organizational barriers rather than social and cultural problems. It is found that newer banks tend to place more emphasis on micro enterprise and small business lending than do older and often large institutions.

One of the most important findings of this study is that many banks are using inappropriate lending criteria when making small business loans and managing their portfolio. In the case of small business loans we found that the banks that require collateral have higher than average levels of loan arrears. This indicates that reliance on collateral tends to cause poor borrower evaluation and inadequate follow up once the loan has been made. In the case of micro enterprise loans, however, banks tend to focus more on the borrower rather than the collateral. This is because, majority of micro enterprises do not have conventional collateral that can be used as a security to borrow money.

It is also found that the level of interest rate charged on the loans is not a factor determining the rate of arrears for micro enterprise loans but it is a factor in determining the level of arrears for small business loans. Furthermore, there is a distinct regional pattern of commercial bank experience with respect to the level of arrears in micro and small business loans. The Former Soviet Union and Eastern Europe, South Asia and Africa tend to be highest with mixed results in Latin America. The performance of the banks in Asia/Pacific, Western Europe, and the Middle East is much better with respect to loan arrears.

As expected, banks imposing restrictions on savers to open a bank account, such as minimum deposit requirement caused them to mobilize smaller amounts of savings as compared to the banks that encouraged such savings behavior. Finally, we found that by the late 1990s there were little or no differences in the loan portfolio diversification between the state and privately owned banks across the sectors.

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