ACCESS TO CREDIT: CONSTRAINTS FOR SMES

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ABSTRACT

Small medium enterprises (SMEs) are very important to the economy of Pakistan. Their failure rate at about 75% is one of the highest in the world. Lack of finance is one of the primary reasons for the failure of SMEs in Pakistan. Access to finance, was identified by the SMEs, as the single most important impediment to growth. The prime objective of the paper is to investigate the determinants of credit approval for new SMEs. This research will help in evaluating the facts that what barriers come in SMEs financing. Moreover this research will also help the government to know that what it must have to do in order to increase the credit availability to SME's.

Keywords : *Credit, Finance, Small Medium Enterprises.*

Introduction:

Small and medium enterprises (SMEs) are increasingly playing a significant role in the economies of many countries. Therefore, governments throughout the world focus on the development of the SME sector to promote economic growth. Pakistan suffers from high unemployment with an official estimate of approximately 24% of the economically active population unemployed. SMEs are therefore expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development. SMEs are also an important source of innovation in the development of new products, services and technologies. According to the recent census of establishments conducted by the Federal bureau of statistics (FBS) the contribution of SMEs to the economy is that there are about 2.9 million economic establishments in Pakistan. Out of these small and medium size enterprises constitute about 90% of all private enterprises employing approximately 78% of nonagricultural labor force. SMEs contributed over 24% to GDP, 22% in export earnings besides sharing 31% in manufacturing value addition. Economic indicators clearly reveal the importance and potential of the SME sector in the national economy. SMEs are of great socio-economic significance. However, their long-term growth and competitiveness has been compromised by the chronic and often acute constraints in their access to finance. Access to finance was identified by the SMEs, as the single most important impediment to growth. This problem increases in magnitude with reduction in size and experience of the firm. This realization led to explore into the constraints in accessing the credit by small medium enterprises.

Research Objectives:

- To measure the financing problems of SMEs.
- To provide Support to financial institutes in designing and launching industry based program-lending schemes.
- Awareness and promotion of options for formal financing and good accounting practices amongst SMEs.
- To enable authorities to coordinate activities for SME development.
- Suggest solutions to solve these problems.

Literature Review:

The argument of this study is that there are many variables in the business environment that create constraints in the accessibility of debt from commercial banks and trade creditors to SMEs in Pakistan. According to Coco (2000) there are some external and internal factors in capital structure of organization that impact the financing and external progress in business. Bollingtoft, Ulhoi, Madsen and Neergaard (2003) explain that these factors are both borrower-specific (internal factors) and system specific. Demirguc-Kunt, Maksimovic, Beck and Laeven (2006) suggested that equity and debt are most significant and basic source for the SMEs for external financing. Usually External equity in the form of capital plan or the stock exchange is not accessible for SMEs (Akarro, 2009). Research by Pretorius and Shaw (2004) document the significance of dependence of SMEs on bank debt for their growth. SMEs faced frequent challenging situation to access the debt. According to Gertler and Gilchrist (1994) SMEs struggle to face failures in generating finance from banks. This phenomenon is called as capital rationing (Cole, 1998).

Conceptual Background:

Frelinghaus, Mostert and Firer, (2005) defines collaterals as assets that are guaranteed by a borrower to a lender as security for the payment of debt. Lyles, Saxton and Watson (2004) discuss that those firms heaving strong investment in perceptible assets will have stronger and higher financial influence as their debt is secured with such assets. According to Coco (2000) collaterals can solve problems derived from irregularities in evaluation of projects, uncertainty about the quality of projects and the riskiness of borrowers, and problems related to the cost of monitoring or supervising borrowers' behavior. Collateral requirements also reduce moral hazard problems. Collateral requirements can reduce moral hazard problems by adding a potential cost to borrowers if they do not make their best effort. The borrower may be willing to divert funds towards private use or extract the whole surplus from the project. When collateral requirements are in place this perverse incentive is diminished, since that sort of action would increase the chance of losing the assets pledged as collateral Daniel, Masli., Rahman and Selvarajah (2006). Therefore, it is proposed that the unavailability of significant collateral impact on access to debt finance to SMEs as banks and financing institutes are more interested in secured loaning.

Proposition 1: The unavailability of collaterals yield hitches in SMEs access to credit.

Further Pretorius and Shaw (2004) point out that absence of keeping the business financial information and resources effect the payment and credit. Financial information and business information are usually contained in the business strategy of the SMEs. Financial organizations and undertaking capitalists to stand a chance of obtaining financial support. Shane and Cable (2002) find that creditors, banks and other lenders use financial information provided by firms to analyze their present performance and predict future performance. The researchers find that annual financial statements and audit reports are required by formal lenders in order to grant loan. The banks and other creditors prefer, demand and use financial information to access the performance and the repayment ability of SMEs but unfortunately most SMEs do not keep that records which effect their access to the credit. It is therefore proposed that poor record keeping by SMEs serve as basis of hindrance in their access to credit.

Proposition 2: The lack of keeping the business records and information serves as basis of hindrance in SMEs access to credit.

Moreover Gree and Thurnik (2003) argue that networking is most vital for SMEs. It can be used to overcome information irregularity in creditor/debtor relationships. Social and professional aspects are sometime not related with each other and the responsibilities between related parties, and information transfer through social relationships. Coleman and Cohn, (2000) find that established relationship between a trade creditor and SME owner have any advantage to process for loaning. In addition to this networks and relationships increase a firm's acceptability, which in turn positively effects the firm's access to external financing. Networking also benefit a firm to learn appropriate behavior needed to process for loans. Largely, networking is a substitutes for the lack of effective market institutions and can be an effective way for SMEs to access external financing, including bank loans. Networking could be expected to provide to the trade creditors information on legitimacy, which in turn should give the SMEs advantages in accessing trade credit (Petersen & Rajan, 1994). It is therefore proposed that in efficient networking provide hindrance to SMEs in the access of credit.

Proposition 3: The inefficient networking aid the obstacles in the SMEs access to credit.

Elsas and Krahnog (1998) examine that the location dose mater for accessing the credit for SMEs. Geographical intimacy is helping for both buyer and supplier to serve their purpose. It enables new firms to more easily identify and exploit growth opportunities in the market. Harluff, and Koiting (1989) suggest that the geographical area where the firm is located has implications for its access to markets and resources. Firms located in big cities may therefore have higher chance of success for financing than those located in rural areas. Petersen and Rajan (2002) found that larger firms were more likely to obtain trade credit. Therefore it is proposed that remote areas firms may find it more difficult to obtain credit.

Proposition 4: Operating in remote areas minimize the scope of SMEs for credit.

According to Cassar (2004) the longer a firm exists and the bigger it is, the more it signals that it can weather tough economic conditions. Furthermore, by staying in business, a firm can signal that it does not adopt opportunistic behavior. According to Kraus and Litzenberger (1973) younger firms rely less on bank financing and more on informal financing. This view is also supported by Frame, Srinivasan and Woosley (2001) which find that it is often difficult and expensive for young SMEs to access bank financing, due in large part to information asymmetry between the banks and firms. Kitindi, Magembe and Sethibe (2007) argue that young firms are more failure prone than older ones. Therefore, it is proposed that, there is a relationship between the age of the firm and access to debt finance from commercial banks.

Proposition 5: Younger (in age) SMEs face difficulties in access to credit.

However Bernenke, Gertler and Gilchrist (1996) state that the size of a firm has an important influence on the debt ratios as firms with more real assets tends to have greater access to long-term debt. Williamson (1994) finds that larger firms have a tendency to be more diversified and fail less often, Therefore the size can be a converse proxy for the likelihood of bankruptcy. Sutton (1997) study trade credit as a source of enterprise finance and found that the usage of trade credit increases with firm size. Cassar (2004) argues that it may be relatively more costly for smaller firms to resolve information asymmetries with debt providers. Consequently, smaller organizations may be offered less debt capital. In addition, transaction costs are typically a function of scale and may be higher for smaller firms. Therefore, it is proposed that small size of the SMEs is problem in the way of their access to credit.

Proposition 6: Organizational size does matter.

Myers (2001) suggests that the industry in which a firm operates does not directly determine its capital structure and borrowing but may do so indirectly via the nature and composition of the firm's assets. Stiglitz and Weiss (1981) suggested that the relationship between industry classification and financial leverage are based on the supposition that industry classification is a proxy for business risk. Reasoning for this may be that organizations in the same industry face the same environmental and economic conditions and therefore, tend to cluster with respect to variance of earnings and sales which will result in the financial institute's trust of credit return. However Opler, Pinkowitz, Stulz and Williamson (1999) conclude that firm specific characteristics are more important than structural characteristics of industry and financial and strategy variables have far greater explanatory power than industry specific effects. Hisrich, and Drnovsek (2002) finds that SMEs in the agricultural sector exhibit the highest capital structure and asset structure or collateral value, while the wholesale and retail trade industry has the lowest debt ratio and asset structure. Therefore, it is proposed that industry matters a lot in access to debt finance.

Proposition 7: Industries in which firms are operating dictate the access of SMEs to credit.

Cassar (2004) argued that financial institutes may perceive incorporation as a good signal which portrays credibility and formality of operations. Myers (2001) coined that the form of business could affect the debt-equity decisions of SMEs. Shareholders of corporations and limited companies have limited liability against losses, whereas general partners and owners of sole proprietorships have unlimited liability. Resultantly corporations and limited liability companies are more likely to finance their projects with equity; Coleman and Cohn (2000) however find evidence suggesting a positive relationship between financing and incorporation on the other hand non incorporation may result in less chances of financing. Therefore, this research proposed that non-incorporation impacts the access to credit by SMEs.

Proposition 8: Non-incorporation of SMEs yield problems in obtaining the loans.

According to Hisrich and Drnovsek (2002) managerial competencies as measured by education, managerial experience, start-up experience and knowledge of the business positively impact on the performance of SMEs. Nilsen (2002) examine the importance of management competence in SMEs success. They found out that, lack of managerial experience, skills and personal qualities are found as the main reasons why SMEs fail get access to credit. In Pakistan, Davis and Haltiwanger (1992) coined that lack of education and training has reduced management capability in SMEs in Pakistan and account for one of the reasons for not getting the finance. Fazzari, Hubbard and Petersen (2000) argued that critical shortage of skilled managers because the bottle necking in advancement processes for loans. Therefore, it is proposed that there is relationship between managerial competency and access to debt finance by SMEs from commercial banks.

Proposition 9: Managerial in-competencies restrict the SMEs access to finance.

Discussions and Conclusion:

The results reveal that managerial competency, business plan, relationships with banks, incorporation, size of the firm and the location of the business are important determinants of access to trade credit by new SMEs. In the light of these outcomes, the study recommends that to get debt funding from trade creditors SMEs owners must ensure that they have high education and related experience which can improve their managerial competency. Educational institutions should introduce and strengthen entrepreneurial education. To improve networking it is important for new SME owners to join trade associations. Good credit history must always be maintained. Agreements such as repayment of credit extended should always be met. In addition, entrepreneurs need to attend seminars and trade fairs to improve their networking. Owners of new SMEs have to take greater responsibility for their own learning. Therefore, they need to create a positive attitude towards entrepreneurship and training . The personal involvement of the entrepreneur in gathering the relevant information and in the writing of the business plan is critical to learn about the industry and to the success of the new venture. Entrepreneurs also need to acquire business and financial management skills if they want to get the required funding from investors. More effective policing regarding availability of finance for SMEs is needed, including better police visibility, area coverage and faster response times. Government agencies can also help to subsidize the incorporation cost of new SMEs to facilitate the speedy access of credit SMEs.

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