# Development Discussion Papers

**Commercial Bank Behaviour in Micro and Small Enterprise Finance**

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Development Discussion Paper No. 741
February 2000



Harvard Institute for International Development

HARVARD UNIVERSITY

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## Abstract

This study reports on the findings of a global survey of commercial banks with respect to their micro and small enterprise financing activities. A sample of banks representing seventy-eight countries was examined in detail. It is found that there are a large number of commercial banks that have been making micro and small loans for decades. The results also indicate that banks have higher arrears in small business loans in comparison to micro enterprise loans. These arrears are found to be significantly related to the level of interest rates charged on small business loans, which indicates a sensitivity of small businesses to loan interest rates. It is also found that the reliance on collateral to back small business loans is positively related to the level of banks' arrears. Furthermore, 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.

**Keywords:** micro finance, micro enterprise, small business finance, commercial banks, collateral, loan arrears, small savers, loan terms

**JEL Codes:** G21, O16

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I am grateful to Richard Patten, Glenn Jenkins and Jay Rosengard for their comments on an earlier draft. Any errors that remain are my responsibility.

# Commercial Bank Behaviour in Micro and Small Enterprise Finance

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## I. 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, 1996: 17-27*]. 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 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 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 Organisations (NGOs), 28 were Credit Unions, and 25 were banks. The survey indicated that 25 banks were responsible for 70 percent of the total outstanding

volume of micro finance loans whereas 150 NGOs were responsible for only 4 percent of the same.

The above studies, although providing important information, under-represented the number of banks that are involved in micro enterprise finance. The cross-country study presented in this paper, although far from being exhaustive identifies a large number of banks that are making micro and very small business loans in over fifty countries. The survey results 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 behaviour and the business strategies of banks that attempt to serve this sector of the economy.

## II. METHODOLOGY

In late 1997, a detailed questionnaire was sent to commercial and development banks in 78 countries. The questionnaire was designed to identify the banks that were involved in small and micro enterprise finance and to capture information on their 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 generalised. On the other hand, the findings of this study make it possible to analyse 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 with the reporting bank, there is still a possibility that the respondents may over emphasise the positive characteristics of their organisation 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; and 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.

**Definitions**

In this study micro enterprise loans are defined as loans that are equal to or less than 10,000 US dollars; and small loans are defined as loans that are between 10,000 and 100,000 US dollars. Table 1 represents the classification of 148 banks according to their loan sizes.

**Table 1: Classification of Banks According to Their Loan Sizes**

| **Loan Range in US $** | | **Number of Banks in Each Range** |
|---|---|---|
| Micro Loans | ( less than or equal to 10,000) | 60 |
| Small Loans | ( 11,000 – 100,000 ) | 49 |
| Both Micro and Small | ( 0- 100,000 ) | 39 |
| | Total | 148 |

According to our loan classification, out of 148 banks, 60 banks are making micro loans; 49 banks are making small loans and 39 banks are making both micro and small loans. According to the ownership structure, 98 of these banks are privately owned and 50 banks are state owned.

## III. INCENTIVES AND DISINCENTIVES FOR MICRO AND SMALL BUSINESS FINANCE: THE BANKERS' PERSPECTIVE

In late 1980s and early 1990s thousands of non-governmental organisations (NGOs) and specialised finance institutions around the world initiated micro enterprise finance programs [*Morduch, 1999*]. Most of these programs are financially supported by the international donor agencies or governments to improve the lives of the poor. Therefore, for NGOs micro enterprise finance appears to be socially motivated. Achieving social objectives however, is not a sufficient reason for profit oriented commercial banks to enter in this market. The aim of this research is to better understand what encourages or discourages banks from making loans to micro and small enterprises, and to identify the factors that contribute banks' success or failure in this area.

In our survey, 148 out of 220 banks indicated that they were 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?' 49 per cent of banks indicated that 'the profitability of micro and small loans' and 44 per cent 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 2].

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 behaviour appears to be the increasing competition in lending to large and medium sized enterprises. It has been well researched and documented that, the financial liberalisation 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: 171-183; Pehlivan and Kirkpatrick,1993: 186-201*]. 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.

**Table 2: Reasons Why Banks Make Micro and Small Enterprise Loans**

| | Frequency of Response* | % of total |
|---|---|---|
| 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) Regulations imposed by the government | 25 | 17% |
| d) Poverty alleviation / social objectives | 29 | 20% |

Note: 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.
Source: Survey data.

'Government regulations' (17 per cent) or, social objectives such as 'poverty alleviation' (20 per cent) 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.

On the other hand, when banks were asked about the major disincentives for not making loans to small and micro enterprises, 72 banks which did not make small and micro enterprise loans indicated that 'the higher administrative cost of making these loans' (40 per cent), 'lack of network and personnel to serve this sector' (32 per cent) and 'interest rate controls' (29 per cent) were the major reasons that discouraged them from entering in this market [Table 3].

Riskiness of this sector however was not sighted as a significant discouraging factor for these banks. Only 17 per cent of 72 banks believed that this sector was risky. This finding contradicts with an earlier study by Baydas et al [1997] where it is argued that micro enterprises are viewed as too risky by banks. The findings of Baydas, et al [1997] are based on limited interviews with 17 banks. Furthermore these 17 banks have already been making successful micro enterprise loans which contradicts with their own argument that micro enterprise finance is too risky.

Contrary to a widespread belief that banks are not interested in micro enterprises, only 7 per cent of 72 banks indicated that they were not interested in micro enterprises and this was mainly due to the nature of their operations.[1]

**Table 3: Disincentives for Making Micro and Small Enterprise Loans**

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

Note: 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.
Source: Survey data.

[1] These banks are large international banks, or banks that are specialized in foreign trade or mortgage finance.

The above findings indicate that it is financial and organisational barriers rather than social or cultural problems that are the relevant factors which prevent banks from making loans to micro and small enterprises. High administrative costs, lack of network and trained personnel to serve this market, and interest rate regulations are important financial and organisational factors that indeed can prevent banks from making successful micro and small enterprise loans that are commercially sustainable.

## IV. BANKS' LENDING BEHAVIOUR AND LOAN CHARACTERISTICS

Contrary to the common belief that banks are nearly absent from micro and small business sector, this research identified 148 banks world-wide that have been making loans to small and micro enterprises for many years. This section aims to analyse the common characteristics of these banks and their lending behaviour over the years. The following sub-sections cover some of the important topics such as: the size of banks' loan portfolios delegated to micro finance; the loan terms; arrears; degree of sectoral diversity of bank loans, and collection of deposits.

### Banks Age and Their Portfolio Share in Micro/Small Business Loans

Out of 148 banks, 119 banks answered to the question on loan portfolio analysis [Table 4]. 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% 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 delegated to small and micro enterprise loans than the older banks (Table 4). For example, the newest six private banks that were established within the last five years had fifty six per cent of their loan portfolio, on average, in micro and small businesses' loans. This loan portfolio share dramatically went down to twelve percent for banks that are older than 60 years. Table 4 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.

**Table 4: Banks Age and Their Loan Portfolio Delegated to Micro and Small Enterprises**

**A) PRIVATE BANKS**

| | | Percentage of Portfolio Dedicated to Micro/Small Enterprise Loans | |
|---|---|---|---|
| Age of Banks(years) | Sample Size | (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**

| | | Percentage of Portfolio Dedicated to Micro/Small Enterprise Loans | |
|---|---|---|---|
| Age of Banks (in years) | Sample Size | (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 | | |

Source: Survey Data.

These results may indicate an increased awareness by newer banks in the profitability of small and micro enterprise loans. Indeed, in recent years, a number of new private banks were established mainly to serve small businesses and micro enterprises. For example, Banco de la Pequene Empressa, 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 micro enterprise loans.[2]

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 corporate clients.

Another important finding of this research is the evidence that private commercial banks have not been absent from micro and small business finance. It is found that a large number of private commercial banks have been lending to small and micro enterprises for decades.[3] Most of these banks are old European banks with large branch networks. Though most 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, eight per cent loan portfolio of the National Australia Bank corresponds to US $2 billion.[4]

[2] This information obtained from the survey.
[3] Some of these banks are: Banco de Chile; Banco Borges & Irmao SA; Banco BHIF; The Co-operative Bank Plc, Banco Fonsecas & Burnay, SA; National Australia Bank; Banco Bilbao Vizcaya SA; Banca Carige SPA, Sociabank, Cariplo SPA..
[4] This includes loans up to US$75,000. According to our definition, this includes both micro and small business loans.

**Loan Terms**

The findings of this research indicate that, the loan terms provided by these commercial banks for small and micro enterprises ranges between three months to six years. On average, the loan term for micro enterprise loans is 2.4 years and for small businesses it is 2.9 years (Table 5). These loan terms are much longer than the loan terms provided by NGOs, which are generally between one to three months [*Almeyda, 1996: 17-27*].

**Table 5: Average Loan Terms for Micro and Small Enterprise Loans**

| | Sample Size | Average(years) | Median(years) |
|---|---|---|---|
| Micro | 57 | 2.4 | 1.75 |
| Small | 46 | 2.9 | 3.00 |

Note: Average loan term is the mean of the average loan term of the surveyed banks.
Source: Survey data.

For small business loans, the median loan term is 3 years which is very close to the average loan term for the sample banks . This indicates that the loan terms of the small business loans are fairly evenly distributed around the mean. For the micro enterprise loans, however, the median loan term is 1.75 years indicating that half of the sample banks has loan terms less than two years although the average loan term is close to two and a half years.

**Arrears**

The amount of non-performing loans, i.e. the level of arrears determines the portfolio quality and the long-term viability of credit institutions. According to Stearns [1996] loan default for micro and small enterprise 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 organisation it is difficult to establish an on-time payment behaviour for the borrowers. This is particularly true for micro finance NGOs who mix social and financial objectives.

In this research, we expected to see that banks would have high repayment rates because they are profit oriented and regulated financial institutions. When we look at the data that has been collected from 148 banks, the rates of arrears range from 0.10 per cent to 52 per cent for micro enterprise loans with an average of 11.4 per cent, and from 0.11 per cent to 80 per cent with an average of 13.9 per cent for small enterprise loans (Table 6). Although these rates appear to be quite high, when we look at the medians of the rates of arrears, we see that 50 per cent of banks making micro enterprise loans, have less than 5 per cent of their micro loans in arrears.

When we examine the performance of banks with small business loans, it appears that these banks not only have a higher average (13.9 per cent) but also have a much higher median (10.8 per cent) indicating a less satisfactory overall performance for banks in small business finance (Table 6). This is an interesting finding that deserves further investigation. In the following section an econometric analysis is made to identify the determinants of banks' arrears in micro and small business loans.

**Table 6: Banks' Arrears in Micro and Small Enterprise Finance**

| | Sample | | | Average(%) | |
|---|---|---|---|---|---|
| | Size | Min(%) | Max(%) | 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 |

Note: Arrears are defined as total loans past due for one month/total loan portfolio.
Source: Survey data.

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

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

$$A / LP = a_0 + a_1 LT + a_2 IR + a_3 IRD - a_4 D_1 - a_5 D_2$$

Where:

| | |
|---|---|
| A | = amount of loans in arrears |
| 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 and 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 and 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 Rosengrad, 1991*]. The shorter loan terms or frequent payments of instalments can make it easier for the borrower to pay his/her loan back, whereas the longer loan terms and infrequent payments of loan instalments 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 instalments 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*]. Furthermore, it is also argued that, if micro or small enterprise loans are subsidised by governments, loan default or corruption may be encouraged which may result 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, the higher nominal interest rate paid on a loan imply a greater cash flow burden on the enterprise hence increasing the likelihood of arrears. 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.

**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 and small enterprise 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 and 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 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 the level of arrears. In particular, high nominal interest rates are not a significant positive determinant of the level of arrears. However, for small business loans, there is a significant positive relationship between interest rates and arrears. This suggest that the higher interest rates represent a relatively larger burden on the net cash flow of the small business in comparison to the micro enterprises.

**Table 7: Parameter Estimates for the Determinants of Banks' Arrears**

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

Note: Numbers in brackets are the t-ratios, * represent statistical significance at the 95% confidence level.

Furthermore, the estimation results 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, 87 per cent of these banks indicated that they would ask collateral for small business loans, whereas only 53 per cent of banks would ask collateral for micro enterprise loans. These findings suggest that banks mostly rely on collateral in the assessment of small business loans and that reliance on collateral often causes banks to adversely select their 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.

In micro enterprise loans however, banks appear to rely less on collateral which is consistent with micro finance field experience where collateral plays a small role in loan approval [*Churchill, 1999*].

**Banks' Arrears by Geographical Regions**

Banks' arrears are further analysed in geographical regions to determine the impact of macroeconomic environment on banks' loan recovery. In Table 10, 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 in Table 8 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 per cent). This is followed by African (16.2 per cent) and South Asian (16.0 per cent) banks. The experience of Latin American banks, however, is mixed. On average, the rate of loan arrears is high (15.5 per cent) but the median of the arrears for the same banks is relatively low (5.8 per cent). 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 8: Arrears of Banks by Region in Micro and Small Enterprise Loans**

| Region | Mean(%) | Median (%) |
|---|---|---|
| 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 to be a result of government polices that have wakened the obligation of the borrowers to repay their loans. Among others, these have come in the form of government subsidised loan programs where full repayment was never expected, or by periodic loan forgiveness policies enacted by the governments.

**Degree of Sectoral Diversity in Banks' Loans**

This section investigates how the surveyed banks allocated their small and micro enterprise loans across the economic sectors. The findings shown in Table 9 indicate that majority of the surveyed banks made loans to trade, manufacturing and service sectors regardless to whether they were private or state owned. On the other hand, consumption and housing sectors received the least number of loans by the surveyed banks.

**Table 9: Sectoral Allocation of Credit by Private and State Banks**

| | Private Banks | | State Owned Banks | |
|---|---|---|---|---|
| | # of Banks | % | # of Banks | % |
| Sector | | | | |
| 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% |

Notes: 1. Sectoral distribution of credit is based on data from 97 private and 48 state owned bank.
2.Most of these banks make loans to more than one sector therefore the total percentage lent exceeds 100 per cent of loans made.
Source: Survey data.

It is often argued that the state owned banks have less diversified loan portfolios than the private banks, because, state owned banks are mostly established to serve certain economic sectors. 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 (Table 10) and used the Chi-squared test to find if these two sets of observations are significantly different from each other. We found that sectoral diversity of the loans between private and state owned banks is not significantly different from each other.[5]

**Table 10: Frequency of Lending to Sectors by Private and State Owned Banks**

| | Number of Banks | |
|---|---|---|
| Number of Sectors Served | Private | State |
| 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

Note: The degrees of freedom is 5.
Source: Survey data.

## II. SAVINGS MOBILISATION

The most important economic function of a banking system is financial intermediation between savers and borrowers. Mobilisation of domestic savings, while providing a safe place for savers to accumulate financial assets, also increases the availability of domestic financial resources for investors. In our survey, 136 banks out of a total of 148 banks indicated that they have been collecting savings.

[5] The Chi-squared statistic of 11.07 for the samples observed is less than the critical value, 12.59.

Some small savers however do not always have access to the banking sector as the banks require a minimum amount of deposit to open an account. This study shows that 70 per cent of private banks and 82 per cent 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 11: Minimum Amount of Deposits Required to Open a Bank Account**

| | Private | | State | |
|---|---|---|---|---|
| Minimum amount($) | # of Banks | % | # of Banks | % |
| 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 |

Source: Survey data.

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 12). 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 an deposit account, mobilised only $US92 million deposit per bank. These findings indicate that 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. The question of whether or not these banks are more profitable, as a consequence of these restrictions, is beyond the scope of this research.

**Table12: Banks' Minimum Deposit Requirement and The Amount of Deposits**

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

Source: Survey data.

## V. CONCLUSION

The main conclusions of this paper are that commercial banks world-wide 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 organisational 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 loans and managing their portfolio of small business loans. In the case of small business loans the banks that require collateral have higher than average levels of loan arrears. Hence reliance on collateral tends to cause poor borrower evaluation and inadequate follow up once the loan have been made. It is also found that the level of interest rate charged on the loans is not a factor affecting the

rate of arrears for micro enterprise loans but it is a factor affecting 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 mobilise smaller amounts of savings as compared to the banks that encouraged such savings behaviour. Finally, we found that there are little or no differences in the loan portfolio diversification between the state and privately owned banks across the economic sectors.

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