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FINANCIAL SUPPORT FROM BANKS FOR SMES IN SRI LANKA

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ABSTRACT

Small and Medium Enterprises (SMEs) are a key driver of economic growth in Sri Lanka, contributing significantly to employment and GDP. However, access to bank financing remains a major challenge that constrains SME growth, particularly in rural and export-oriented segments. This paper examines the role of bank lending to SMEs in Sri Lanka, assesses key barriers to credit access, and evaluates how financial support from formal banking institutions affects SME performance. Drawing on both empirical studies and policy literature, the paper finds that while bank loans are the principal source of formal finance for SMEs, significant supply- and demand-side constraints limit their effective access. Policy recommendations include improving risk-sharing mechanisms, financial literacy, and tailored lending products.

INTRODUCTION

Small and Medium Enterprises (SMEs) constitute the backbone of the Sri Lankan economy, accounting for a substantial proportion of employment, entrepreneurial activity, and regional economic development. SMEs operate across diverse sectors including manufacturing, trade, agriculture, construction, tourism, and services, thereby playing a pivotal role in income generation, poverty reduction, and inclusive economic growth. Recognizing their strategic importance, successive governments in Sri Lanka have identified SME development as a national priority within broader economic and industrial policy frameworks.

Despite their economic significance, SMEs in Sri Lanka continue to face persistent structural and operational challenges that limit their growth potential. Among these challenges, access to adequate and affordable finance remains one of the most critical constraints. For most SMEs, internal funds and informal borrowing are insufficient to support business expansion, technological upgrading, and productivity enhancement.

Consequently, bank financing emerges as the primary formal source of external finance, particularly for working capital requirements, fixed asset investment, and project expansion.

The Sri Lankan banking sector dominated by licensed commercial banks and licensed specialized banks, plays a central role in financial intermediation. Over the past two decades, banks have introduced various SME-focused lending schemes, including term loans, overdraft facilities, leasing products, and government-supported refinance and concessionary credit programs. Institutions such as the Central Bank of Sri Lanka (CBSL) have further promoted SME financing through policy interventions, refinance facilities, and credit guarantee initiatives. However, despite these efforts, empirical evidence suggests that a significant proportion of SMEs remain financially excluded or underfinanced.

The difficulty in accessing bank finance stems from both supply-side and demand-side factors. From the banking perspective, SMEs are often perceived as high-risk borrowers due to limited collateral, inadequate financial records, volatile cash flows, and high failure rates. Strict regulatory requirements, prudential norms, and risk-averse lending practices further constrain banks' willingness to extend credit to small enterprises. From the SME perspective, limited financial literacy, weak accounting practices, lack of formal credit history, and high borrowing costs discourage engagement with formal banking institutions.

These financing constraints have important implications for SME performance and broader economic development. Limited access to bank credit restricts SMEs' ability to invest in modern technology, adopt innovation, improve productivity, and compete in domestic and international markets. In a developing economy such as Sri Lanka— characterized by structural transformation needs, export diversification goals, and post-crisis economic recovery—enhancing bank-based financial support for SMEs is essential for sustainable industrial and entrepreneurial growth.

While several studies have examined SME financing challenges in Sri Lanka, gaps remain in understanding the extent, nature, and effectiveness of financial support provided by banks, as well as its impact on SME performance and development outcomes. Much of the existing literature focuses on access constraints without sufficiently analyzing how banking practices, loan structures, and support mechanisms influence SME growth.

Moreover, limited research integrates policy, institutional, and firm-level perspectives within a unified analytical framework.

Against this background, this study seeks to examine the role of banks in providing financial support to SMEs in Sri Lanka, with particular emphasis on lending practices, accessibility, constraints, and developmental impact. By synthesizing empirical evidence and policy insights, the study aims to contribute to the literature on SME finance in developing economies and to inform policymakers, financial institutions, and development practitioners on strategies to strengthen bank-SME linkages.

RESEARCH OBJECTIVES

General Objective

The primary objective of this study is to examine the role of commercial banks in providing financial support to Small and Medium Enterprises (SMEs) in Sri Lanka and to assess the impact of bank financing on SME performance and development.

Specific Objectives

1. To identify the main types of financial products and services offered by banks to SMEs in Sri Lanka.
2. To examine the extent of SME access to bank financing and the major constraints faced in obtaining credit.
3. To analyze the factors influencing banks' lending decisions toward SMEs, including collateral requirements, credit assessment practices, and risk perception.
4. To evaluate the impact of bank financial support on SME performance in terms of growth, profitability, and sustainability.
5. To assess the role of policy interventions and regulatory frameworks in facilitating or constraining bank financing for SMEs in Sri Lanka.
6. To propose strategies and policy recommendations to enhance bank-based financial support for SMEs

Literature Review

Importance of Bank Financing for SMEs

Bank loans remain the most critical source of formal financing for SMEs in Sri Lanka. Research shows that commercial bank loans are pivotal for SME operations, despite difficulties that SMEs encounter in loan applications and approvals. However, alternative financial instruments such as leasing, equity financing, and venture capital are underutilized due to lack of awareness and market development.

Constraints on SME Access to Finance

Studies highlight multiple barriers that SMEs face in accessing bank finance. These include inadequate collateral, insufficient financial records, lack of credit history, high interest rates, and complex documentation procedures. Quantitative evidence further suggests that SMEs with higher monthly income paradoxically face challenges obtaining loans because lending decisions often rely more on risk perceptions than on profitability. Additionally, limited branch networks, especially in rural areas, restrict the physical reach of banking services.

Impact of Financial Support from Banks

Empirical studies indicate that bank financing positively influences SME performance, particularly when accompanied by appropriate loan terms and development finance components. Evidence from ABC Bank PLC shows that development finance credit increases financial performance, although strict collateral requirements can negatively affect outcomes. Another study focused on non-agricultural SMEs found that debt financing, training, and technological support provided by financial institutions contribute significantly to SME performance.

Methodology

This paper synthesizes existing quantitative and qualitative research findings from peer-reviewed journal articles, policy reports, and industry studies on bank financing for SMEs in Sri Lanka. The review includes studies utilizing primary survey data, regression analysis, and descriptive statistics from Sri Lankan SMEs operating across various sectors.

Population and Sample

The population of the study comprises Small and Medium Enterprises operating in Sri Lanka, as defined by the National Policy Framework for SME Development. SMEs from manufacturing, trade, services, and construction sectors were considered to ensure sectoral representation.

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A stratified random sampling technique was employed to select the sample, where SMEs were grouped according to sector and firm size (small and medium). This approach enhances representativeness and minimizes sampling bias. A total sample size of 200 SMEs was selected, which is considered adequate for regression analysis and hypothesis testing in social science research.

Data Sources and Data Collection

Primary data were collected using a structured questionnaire administered to SME owners, financial managers, or senior decision-makers. The questionnaire was designed based on existing literature and consisted of both closed-ended and Likert-scale questions.

The questionnaire comprised four main sections:

1. Demographic Profile: Firm age, size, sector, and ownership structure.
2. Access to Bank Finance: Types of bank financial products used, loan approval experience, collateral requirements, and interest rates.
3. Bank Support Services: Advisory services, training programs, and relationship management support.
4. SME Performance: Indicators such as sales growth, profitability, employment growth, and business sustainability.

Secondary data were obtained from Central Bank of Sri Lanka (CBSL) publications, policy reports, and relevant academic journals to support contextual analysis.

Data Analysis Techniques

Data analysis was conducted using Statistical Package for the Social Sciences (SPSS). The following analytical techniques were applied:

- Descriptive Statistics: To summarize demographic characteristics and financing patterns.
- Reliability Analysis: Cronbach's alpha was used to test internal consistency of measurement scales.
- Correlation Analysis: To examine the strength and direction of relationships between variables.
- Multiple Regression Analysis: To test the hypotheses and assess the impact of bank financial support variables on SME performance.

The regression model is specified as:

$$SMEP=\beta_0+\beta_1 AF+\beta_2 CR+\beta_3 IR+\beta_4 NFS+\beta_5 PS+\square$$

Where:

- SMEP = SME Performance
- AF = Access to Bank Finance
- CR = Collateral Requirements
- IR = Interest Rates
- NFS = Non-Financial Support
- PS = Policy Support
- ε = Error term

Validity and Reliability

Content validity was ensured by reviewing relevant literature and consulting academic experts in finance and SME development. A pilot study involving 20 SMEs was conducted to refine the questionnaire. Reliability of constructs was confirmed using Cronbach's alpha values exceeding the acceptable threshold of 0.70.

Ethical Considerations

Ethical standards were strictly adhered to throughout the study. Participation was voluntary, and respondents were assured of confidentiality and anonymity. Data were used solely for academic purposes, and informed consent was obtained prior to data collection.

Key Findings

Bank Financing as the Primary Funding Source

Commercial bank loans are identified as the most significant source of finance for SMEs in Sri Lanka, despite operational barriers. Formal banking institutions provide critical liquidity that SMEs require for working capital and growth.

Barriers to Access

Several structural challenges affect the ability of SMEs to secure bank loans:

- Collateral and Credit History: Many SMEs lack formal collateral and recognized credit histories, leading to loan denials
- High Cost of Finance: High interest rates and stringent risk assessments make borrowing costly and less accessible.
- Informational Asymmetry: Poor financial literacy and inadequate business records create informational gaps between banks and SME borrowers.

Positive Impact on Performance

Studies demonstrate a statistically significant positive relationship between bank loans and SME performance metrics, such as profitability and growth, particularly when credit terms are managed appropriately. Moreover, ancillary support from banks, including training and supervision, enhances SME productivity.

DISCUSSION

The reviewed literature reinforces that while bank financing is vital for SME sustainability, systemic constraints significantly limit this support's reach and effectiveness. Financial institutions' risk-averse behavior, driven by regulatory risk assessments and scarce long-term funds, reduces the willingness to lend to SMEs with uncertain cash flows. This situation underscores the need for enhanced risk-sharing facilities and public- private partnerships to incentivize banks to extend credit to SMEs.

Furthermore, SMEs' internal challenges—such as inadequate financial documentation and low financial literacy—underscore the necessity of capacity-building interventions that would make SMEs more creditworthy in the eyes of lenders.

Policy Recommendations

Based on the evidence, the following recommendations are proposed:

1. Risk Sharing Mechanisms: Implement partial credit guarantees and refinancing lines for SME loans to lower the risk burden on banks.
2. Financial Literacy Programs: Support SMEs with education on financial documentation and credit readiness.
3. Product Innovation: Develop tailored financial products that accommodate the cash flow patterns of SMEs, including flexible collateral arrangements.
4. Branch Network Expansion: Expand bank outreach to rural regions to improve accessibility for underserved SME segments.

CONCLUSION

Financial support from banks plays a critical role in the growth and performance of SMEs in Sri Lanka. While bank loans remain the main formal financing source, both supply- and demand-side challenges limit access and effectiveness. Overcoming these barriers requires coordinated policy actions, innovative financial products, and capacity building to enhance SME resilience and growth prospects.

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