Arabian Journal of Business and Management Review
ISSN: 2223-5833

Research Article Open Access

Bank Finance Challenges Faced by UAE SME Sector

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Abstract

While SME Sector plays an important role in the UAE Economy, it has its own unique challenges, especially funding by banks. Banks in United Arab Emirates have an important responsibility to fund SME Sector which is the real backbone of the economy, in such a manner that there can be a mutual win-win scenario. However, recently the banks are reluctant to lend to SME citing several skip cases. Some banks have even shut down SME departments. On the other hand, when we speak to SME segment, we get the sense of fear and panic amongst them in case of a possible default. It may be noted that such a situation usually arise due to circumstances beyond the control of business people. Though vast majority of business in UAE are SMEs, the Bank lending to them is just 3.85% of the total Bank exposure. SME sector complains about the difficulties involved with dealing with banks while banks have their grievances about SME clients. In the current market, the situation has aggravated with banks further tightening the credit lines that has started impacting even the genuine businessmen, triggering a chain reaction. This article tries to analyze the reasons for the challenges faced by the SME and Banks and explore possible solutions.

Keywords: Bank; Finance; Challenges; UAE; SME sector

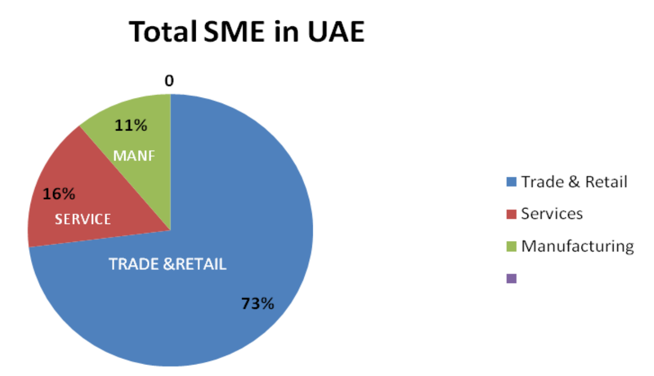
Introduction

SME sector is very critical for the economy of UAE. The country has a bustling SME sector in diversified areas related to trade and services. Around 90% of the registered businesses in UAE are SMEs. However, Bank lending to this very critical sector is abysmally low. Despite having a strong banking sector in the UAE, SME Banking penetration remains minimal [1]. According a World Bank and Union of Arab Banks study, out of the total Bank lending, the lending to SME sector in UAE is just 3.85%.

SME sector: critical for the UAE economy

SMEs represent more than 90 per cent of UAE businesses and they play an essential role in building a competitive private sector. They also contribute significantly to employment and account for more than 86% of the private sector employment while around 60% of the UAE GDP is also derived from SME segment. Hence, the importance of SME sector in the UAE cannot be underestimated [2,3].

The SME Sector in UAE is concentrated mainly on the non-manufacturing sector due to the prominent status as a regional trading and re-exporting hub. Around three fourth of the total SME business in the UAE is engaged in the trade & retail industry [4]. The sector wise classification of the Dubai UAE sector is shown below in Figure 1:



Source: UAE Khalifa Fund White paper on SME sector

Figure 1: Sector wise classification of the Dubai UAE sector.

Challenges stated by SME Sector regarding SME Financing from UAE Banks

Mark Twain once remarked that "A man who carries a cat by the tail learns something he can learn in no other way", which holds true for SME Financing. Many successful SME entrepreneurs, who attempted to get bank funding says that this is one of the most time consuming, uncertain and frustrating activity in their business career. Despite the glossy advertisements by banks offering SME finance in the media, the business reality is stated to be different [5]. One has to be in their shoes to understand the troubles of SMEs face while approaching Banks for funding. Many such SME owners narrate the story of umpteen documentations, delays, non-committal answers, etc. from bankers regarding SME finance, even after providing proof of confirmed orders and similar lending comforts to banks. The experience of the authors and our interaction with the SME owners, Bankers and experts in this field shows that following are some of the challenges faced by SME sector while sourcing finance from Banks in the UAE.

Usually the SME approach the banks for finance based on a business opportunity. For example, they have been recently awarded an order by a large Company for the supply of a product (say Fruit Jam). Similar is the case of a large order for the supply of equipment to a Contractor who has recently won a large Contract from the Govt. [6]. However, many SME owners state that the bankers do not share the sense of urgency and take their own time.

While obtaining SME Funding from banks is tough, even those who have got successful funding suffers from lack of proper monitoring. In an ideal world, the Relationship Manager and the department head has

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Received May 13, 2016; **Accepted** June 06, 2016; **Published** June 14, 2016

Citation: Baby A, Joseph CAC (2016) Bank Finance Challenges Faced by UAE SME Sector. Arabian J Bus Manag Review S1: 005.

to keep a tab how the funds taken by the SME is being used. The banks shall follow a policy of 'follow the money' strategy while financing to ensure its proper end utilization and repayment capacity. However, many bankers do not follow this and do not wake up till the warning signs emerge. The SME owners may divert the funds for other purposes – such as financing other long term ventures, helping fiends, etc. The best way to ensure that SME owners do not get tempted to channel the bank funds for other purposes is to ensure strict monitoring. Unfortunately, often such prudent steps are lacking from banks.

Whilst most SME owners understand the importance of financial management, they often pay inadequate attention to it. Many business owners try to manage the finance directly, which will be successful when the organization is small with just couple of employees. However, as the organization grows and the size increases, the owners develop a false confidence that they can manage the finances – from bank borrowings, to collections and settlement of creditors. This also results in challenges from SME banking perspective as Banks cannot be confident that the Finance Function of SME is in safe hands. An organization's financial management plays a critical role in the financial success of a business. Therefore, an organization should consider financial management a key component of the management of the organization and employ finance specialists to carry out the responsibilities of this vital function. Financial management includes the tactical and strategic goals related to the financial resources of the business. Some of the specific roles included in financial management systems include accounting, bookkeeping, accounts payable and receivable, investment opportunities and risks [7].

Other challenges by SME sector is the tendency to use their facility with banks to help friends and other businesses though 'Accommodation Arrangement' using banking lines. Similar is the case of launching other business without adequate planning or feasibility study. This often results in the classic mistake of funding long term requirements with short term finance, which is a assured path to cash crunch and illiquidity. Such practices have to be discouraged by educating the SME owners about the high risks and existential threat to their businesses. The banks have to establish a mechanism to understand the end utilization of the proceeds from bank facilities.

Challenges stated by Banks regarding the SME Lending in the UAE

It is well known that the key to financing any enterprise lies in the ability of the financier to evaluate and manage credit risks. A high quality credit risk skill of a lender will essentially involve geography and business specific information about SME enterprises in their operational area as well as the ability to evaluate, control, monitor and manage this risk. However, many bankers face several constraints in this respect [8].

Absence of proper legal and regulatory framework is a challenge faced by banks while dealing with default cases. The absence of a proper bankruptcy law makes the job of Banks tougher. The main method followed by banks is to file criminal cases against the defaulting customers, as the last resort. However, as has seen in the recent high number f skip cases, such a harsh step send panic waves in the business sector, which ultimately harm banks and the SME businesses. The absence of a detailed Credit bureau for SMEs, which has adequate information about the borrower and the credit history, complicates the scenario. Al Ithihad Credit bureau, launched recently is an effort to overcome this challenge.

Delay in reporting of loan exposures in Central Bank Risk Bureau is often cited as a risk by bankers. The Central Bank Risk Bureau, a platform for reporting the loan exposures of the Banks, is not updated real time. Banks are given 60 days' time to report loan exposures. Loan exposures below 0.25 million AED need not be reported in the platform. At times, Banks take more than two months to do the reporting due to the volumes involved. This delay opens a window for fraudulent activities for the unscrupulous borrowers. A customer can submit the financial statements to as many Banks as he needs at the same time. Since the loans are processed within a timeframe of 2-3 weeks, the borrower can take loans from many Banks using the same Balance sheet before it gets reported in the Central Bank Credit Bureau after a period of sixty days. If the exposure taken per Bank is less than 0.25 M, it goes unreported.

Management Risks are an inherent risk in the SME sector in UAE as majority of the SME companies operating in UAE are owned by expatriates. The Government of UAE doesn't grant permanent residency to the expats, instead gives it for very short duration. Therefore the Banks which lend to unscrupulous businessmen can be taken for a ride they decide to leave the business and the country. Thus Banks prefer to lend only to those businessmen who have an established track record, leaving the large chunk unbanked. Also most of the SMEs are not professionally managed and is driven by a single person or a family. Corporate governance practices are very minimal in the SME sector when compared to the corporate sector. This puts the Banks at risk and inhibits them from taking major exposure to the sector [9].

Absence of adequate quality financial information for Credit Risk Assessment is yet another challenge for banks. As UAE is a tax free country, filing of annual Balance sheets for SMEs are not mandatory in most of the cases. Many of the Micro SMEs, don't even prepare audited balance sheets. According to the study conducted by the Dubai SME, a Govt. of Dubai initiative, only 50% of the SMEs prepare audited financial statements. So in many of the cases, the Banks are forced to restrict their financial statement analysis to just Bank statement analysis. Now Banks are insisting the SMEs to prepare audited Balance sheets for seeking Bank finance. However majority of the respondents have concerns on the quality of the financial statements including the Income statement and the Balance sheet. Given the absence of taxes, artificial inflation of turnover and profits are a common sight even in audited balance sheets.

SME lending in UAE is largely unsecured lending. Even if it is secured, there is hardly any collateral security apart from the primary security (stocks and receivables). This is because since most firms are in the trading or services sector (89% of total SMEs), they generally don't have any major fixed assets like Land, Building, Machinery unlike the manufacturing sector. This risk is accentuated through loan products like Business loans, which are given as unsecured loans for 'expansion of facilities'. The end use of the funds is not tracked by the Banks. It is probable that these funds could have made way to the Real Estate and stock markets for arbitrage opportunity. The returns in the last few years in Real estate and stock markets were significant when compared to the interest rates on these loans [10].

According to the respondents High chances of Diversion of Bank Finance is a very critical challenge before the Banks. Working Capital finance is often diverted out of the business and goes to other unrelated areas like Real estate, stock markets etc. Since the loan amounts are low when compared to corporate lending and the number of clients are large, banks are not able to always effectively monitor the end use of funds. Another area of diversion of funding is through the associate companies. The Bank finance given to a particular company is often transferred to associate or sister company to manage their cash flow issues. These loans given to associates often take long time to come back and many a times don't come back creating financial problems to the borrower and renders the Bank loan bad.

Banks face the challenge of high cost of lending for SMEs. All the Banks which are in the sector have to setup the complete organizational system and framework for the SME lending. This includes from opening branches, hiring Relationship Managers, Credit Analysts, support and legal teams etc. While the Bank invests so many resources, the lending size is small and the risks are high. This results in higher cost of lending for the Banks after covering the credit risk spread. This in turn creates a vicious cycle, where higher cost of borrowing prevents SMEs from seeking Bank finance [11].

Due to the structure of the economy of UAE, which is anchored in trade and commerce, cyclicality affects the economy. So is the situation with many of the SMEs in the sector. Since the majority of them are in trade related areas, a downturn in the global economy can significantly affect their operations and profitability. Since majority of the SMEs are in these industries, Banks are not able to significantly diversify their portfolio to prevent major cyclical risks. As a result, major cyclical events can significantly affect the loan quality of the Banks.

Conclusion

As evident from the above, there are several reasons why SME Financing face troubles. Poor financial discipline, dishonest businessmen, accommodation to help friends, launching other business without proper planning or feasibility study and that too using short term banks funds are some of the mistakes by SME segment. Probably banks may conduct periodical get together for SME clients to warn about the risks involved in such diversion of funds by SME sector. As far as banks are concerned, inadequate credit risk assessment, lack of follow up once the facilities are granted, unawareness of the end utilization of funds, lack of interest to track 'follow the money principle' tendency by banks to over-lend during good times and panic recalls at the slightest hint of bad times and dishonest bankers are the mistakes often observed with the banks.

It is in overall economy's interest to ensure that more banks funds flow into the vital SME sector. In order to attain this, there shall be a coherent positive initiatives are required by SME sector and the Banks, with Banks taking a lead role in this process. While SME segment has its own challenges, Banks shall devote time, resources and efforts to delve deep into the SME sector and provide support by identifying enterprising, passionate and honest business men and build up relationship and rapport with them and extend need based funding. It is equally important for banks to educate the SME sector about the need for financial discipline and highlight well ahead the unsavory consequences that await businesses that take financial management for granted.

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This article was originally published in a special issue, **Ethical Behavior and Decision Making in Management: A Behavioural Focus** handled by Editor.
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