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Peril or Promise—How the SME Banking Sector Will Perform in 2022 and beyond? Do We See an Overreliance on Recovery?

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Abstract

The study takes a specific look at the microstructure of banking lending to SMEs and the latent trials in maintaining a better balance between the loan demand and supply after the COVID-19 pandemic to upkeep the overall economic goals. The global "war" on the COVID-19 pandemic and related economic waves indeed have led to the worldwide recession. The COVID-19 crisis becomes the most extensive systemic-risk unification the world has ever comprehended in the commercial sense. More actions are needed to avoid falling these economies into life-support despite government initiatives regarding new regulations and stimulus packages. Unfortunately, the smallest business segment struggles and fails to claim essential funding through internal and external sources due to inherent weaknesses and poor business architecture. Historically, the SME funding gap was one of the critical areas of discussion and research. Before the current situation, accessing financial services, crucial for SMEs' growth, severely constrained many economies. However, the problem has further deteriorated. The prolonged low-interest environment, high competition, and compressed interest margins made many banks under-priced SME risk, particularly after the previous financial crisis. Against this backdrop, the predominant SME lenders experience high NPL ratios, adversely affecting the entire banking system's soundness and lending to the real economy.

Keywords

SME, SME-Funding-Gap, NPL, Systemic-Risk, Risk-Response, Crowdfunding

1. Introduction

The world needs SMEs to thrive again after the pandemic. Nearly half of GDP and almost three-fourth of employment opportunities in many regions are derived from the SME sector. Many underdeveloped Asian countries practice advanced economic propositions through this strategic sector, including urban development, resource allocation, wealth distribution, export orientation, and even poverty elimination strategy. However, even before the current situation unfolded, the small enterprise sector was underserved by the mainstream banking system and has been a historical issue. Despite high yield, it becomes challenging for SME players to access banks' funding due to limitations of tangible assets, viable business plans, financial records keeping, and weak corporate governance framework.

On the other hand, as the turbulent 2020-2021 ended, being ready for whatever lies ahead is more important than ever for the banking business, though knowing how to be fully future-proofed is difficult. Unfortunately, although almost all business segments are severally impacted, the global banking industry is still at the front line of economic disruption. Even before the COVID-19 outbreak, the rising economic themes like high volatility, geopolitical issues like trade wars, manipulation, and undue influences on financial markets, had gradually but significantly increased the complexity of judging future market performances and trends and their impact on the banking industry (Acharya, Bo, Black, Hadj, & Paschoa, 2019). As per estimates, most countries could still experience an annual contraction even in 2021 amidst multiple interruptions to value-chains. The economic and social influences of COVID-19 are almost at an unprecedented scale, and the knock-on effects of the virus are seemingly endless. These impacts might bring a whole new dimension to the banking industry, and SME lending architectures are not an exception. These critical issues have further narrowed the banks' funding commitment towards the minor sector, further escalating the traditional SME-funding gap.

Fortunately, most banks are better positioned than in the previous financial crisis in 2008, except that the interest income has been reduced sizably due to low-interest regimes and spreads post. The demand reduces the cost and increases the yield through non-funded income. Reducing inefficient and non-profitable systems and channels and optimizing resources/branches/networks is critical in low-income environments. Leveraging and demanding more digital technology to minimize per-transaction costs has become the crucial benchmark. The leading techniques are agile-banking and fintech support for a nimble, sandbox-lie environment for high volume/accuracy processing. Since we are in a pivotal moment in the banking industry and a simple digital strategy is no one-size-fits-all solution, a series of linkages between the traditional lenders and modern technology providers is essential to build a win-win relationship.

2. Contemporary Market Situation and Challenges

SME growth is identified as a combination of many factors, including strong banking support, savvy, innovation, continuous planning, plus well-thought-out strategy and tactics. Access to financial services remains severely constrained in many economies, which is a key reason restricting the sector's growth. According to the World Bank, in developing nations, owners and entrepreneurs have reported access to capital to be one of their toughest challenges, one that sometimes outranks electricity shortage and other main concerns (IFC, 2020). Due to multiple reasons, the conventional banking sector has not supported the segment adequately. As an exception, a few advanced societies where systems relish strong bankruptcy law, credit-insurances, ample options on credit-default-swaps (against small segment defaults), and credit guarantee schemes (driven by the government), have supported the small lending propositions favorably. However, despite the relatively high yield than corporate lending (including cross-border exposures), the funding supply is well below the loan demand in many other regions. As per the World Bank, the funding gap is vast in developing nations which is estimated as above US$ 5B on an annual basis, which is 140 percent of the current aggregate funding (Fernanda & Wei, 2015). The level of unmet funding is varied from region to region, while, as per findings, Asia and Pacific accounted for the largest share of the total global finance gap (46%), followed by Latin America and the Caribbean (23%) and Europe and Central Asia (15%). The situation is dire and has historically pulled back the respective country's overall growth and speed of globalization. Close to half of the formal SMEs do not have access to formal credit. The financing gap is even larger when micro and informal enterprises are taken into account (Stein, Ardic, & Hommes, 2013).

As per OEDC's study on the United States, during the initial period of the pandemic, 90% of the SMEs have experienced a negative impact, out of which 51 percent experienced a severe impact, 45 percent felt the disruption in the supply chain, and further 25 percent experienced a liquidity issue with the rapid decline in cash reserves (OECD, 2020). The situation is worst for upcoming Thailand, as nearly 90 percent of extreme revenue losses during the period are expected. In developed Canada, the expected drop is a high 78 percent. Accordingly, as assumed, the significant adverse impacts are obviously in the case of young and less productive small businesses irrespective of jurisdiction compared to more established counterparties. A comprehensive examination by Gavurova, Dvorsky and Belas (2020) highlights three traditional key risk elements: Market, Financial, and Personal, at the top of the list. It has further been found that the financial-risk remains at the top, even though the other two core risks have increased the weightage marginally (Gavurova, Dvorsky, & Belas, 2020). Moreover, SMEs with a strong assets-bases, low leverage, and enough financial slack could pursue more debt financing even now. If business volumes are not improved, the rapid demand for such additional funding could lead to sudden debt rises and long-term solvency challenges. However, the mainstream banks are not highly profound in extending fresh banking lines to the small sector as a result of experiencing some liquidity stress due to the high demand for funding from the more established corporate sector and limited deposit mobilizations. This mismatch has further extended the funding gap to the SME sector. Unfortunately, SMEs have not found strong financing support through internal means and promotors' contributions. According to renowned M/s JP Morgan, half of all small firms hold a cash buffer of less than one month and 25 percent hold fewer than 13 days (Taylor, 2020). Given the pandemic status and demand shocks, small ventures desperate for concessions and lengthy moratorium of loan settlements have augmented the bankers' liquidity issue.

Given the lack of enthusiasm in the traditional banking sources, SMEs look for other non-traditional avenues for funding requirements. Most businesses depend heavily on the Promotor's net worth during the introduction stage, though, based on the commercial viability of the idea, some level of contribution can be expected from Angel Inventors and venture capitalists. Peer-to-peer (P2P) is another popular option. As explained by Gandhi (2008), peer-to-peer (P2P) lending was started with the idea of connecting individual borrowers with individual lenders, but of late, many variations of P2P lending have become popular. The initiative started as a support system by a dominating member in the segment/industry, and subsequently, it has become a popular funding method. The same has been extended as the ecosystem financing among the broader value-chain members. The other most popular form of financing is crowdfunding platforms. Due to various reasons like quick/flexible offerings, comparatively low pricing, approachability, and additional services like consultation/business partnering, most up-to-date crowdfunding regimes have become very attractive.

The rising non-performing loan ratio (NPLs) has become a modern trial in the banking industry. High NPL ratios adversely affect the banking system's soundness and damage its primary ability to lend to the real economy. (Huljak, Martin, Moccero, & Pancaro, 2020). Secondly, as per their findings, non-performing loans feature higher risk weights and higher capital allocations. Banks may thus deleverage to maintain or boost capital adequacy, which might cause a contraction in credit supply. Banks with high bad loan stocks easily divert significant managerial resources away from the core and more profitable activities for time-consuming recovery, remedial, and restructuring negotiations. Accordingly, many banks might end up in the red zone again in 2022, further restricting their appetite towards relatively risky small propositions. The introduction of IFRS-9 also demanded additional capital allocation based on counterparty-credit profiles' deterioration, linked to stating changes/expected credit exposure (ECL). As per the below findings, many predominant SME-banks have performed poorly compared to the country averages (**Figure 1**).

3. Risk Response and Behavioral Intention

The credit risk governance and the identification of main risk elements are essential for the lender to respond to the challenges and to maintain long-term lending appetite/support to the small segment. The modern bankers, accordingly, evaluate the (economic) viability of current risk appetite statements (RAS) and risk tolerance frameworks (RTF) closely through several established

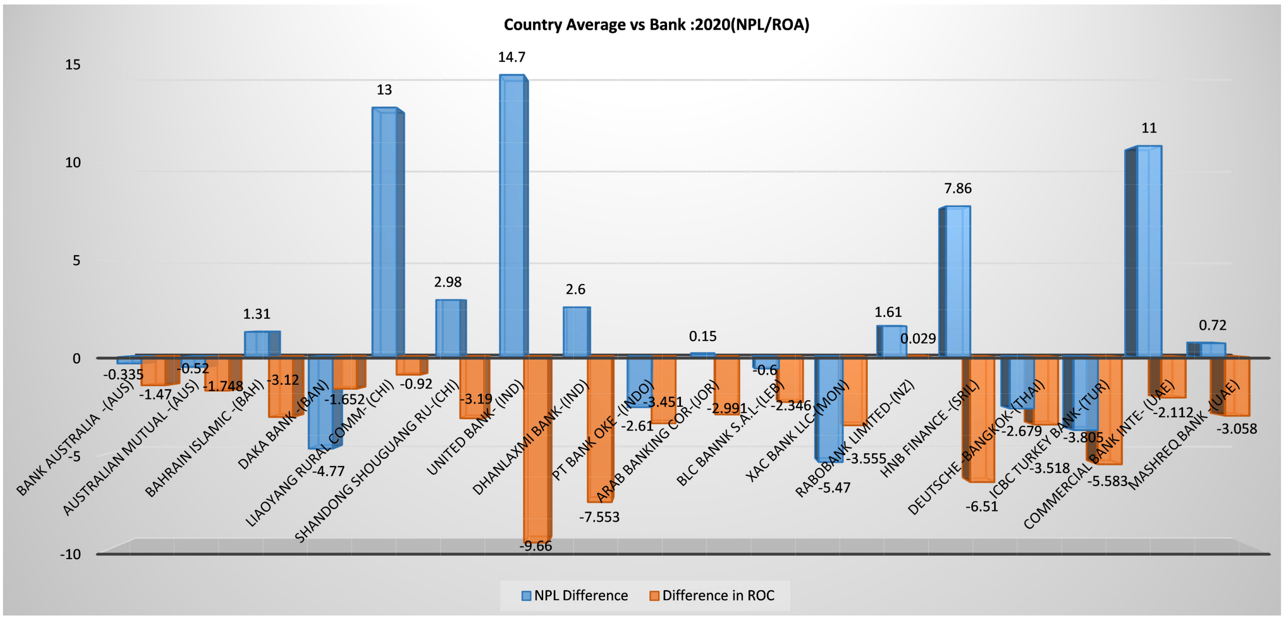

Figure 1. Country average vs bank: 2020 (NPL/ROC). Source: multiple banking and central bank databases and websites.

techniques. Given the challenges and economic slowdown associated, regular review and possible re-adjustment of the small-sized portfolio through advanced techniques has become indispensable. A business impact analysis (BIA) is a process and tool to align business priorities and define responses to critical issues. BIA input shall be used for RAS modifications accordingly. The proper portfolio analysis would also help allocate the authorities' stimulus to target economic support systems (TESS), low-interest rates regimes, and capital rule relaxations more economically and distribute the privilege to the most needed sectors. Governments trust the banking system to distribute subsidies and extended support to the valuable small-business sector as a critical strategic motive.

Most SMEs are forced to take the downsizing route to adjust to the challenging economic conditions. Banks must also relax some credit-risk-policy sanctions to disburse quick funding to required businesses. This easing should also include adequate support steady demand for loan (repayment) modifications and restructuring possibilities. Given the downsizing strategy, most mortgage lenders see a spike in refinance applications after Fed's rate cuts. Again, the situation has emphasized the traditional financial concept of "cash is the king" for business operators. Value-chain financing or Ecosystem financing, various discoursing methods of receivables with or without recourse, point of sale (POS) based lending are a few examples. Accordingly, the bank can counsel these counterparties on new business financing methods and cost reduction strategies (variable and fixed).

The traditional lenders might encounter additional administrative risks as per the current environment. The people risks would continue to rise, and the risk hiring landscape will evolve, emphasizing diversity, environment, social and corporate governance (ESG), and technology. Excessive dependability on technological enhancement and more frequent cyber-attacks would place banks on the frontline of cross-border warfare, with geopolitical risks embedded in cyber threats. Supply-side operational risks (including cyber and fraud) will be waved into market risk models, digital assets tokenization, and blockchain ledgers will become the basis of corporate supply chain financing tools in advanced countries (Ro, 2021). Managing these emerging risk need strong internal controls and a risk culture within the organization. Banks prioritize internal actions like the (re) workforce assessment, scaling, and repositioning them based on the new norms. Some clients still rely heavily on relationship models based on personal touch and paper fillings. Given many environmental restrictions, the banks are developing a scalable capacity to meet the demand for new funding, possibly requiring setting up advanced parameters to select the correct obligors.

4. Discussion, Conclusion, and Future Research

As we look ahead to 2022 and beyond, most small businesses have started the journey towards transition into new/low norms and are looking for restructuring and cost-structuring plans, given high (commodity) volatility, demand shocks, and currency fluctuations remain acute. The environment also has become unfamiliar to the bankers, and therefore, credit risk monitoring has to be done with limited viability. The economy's unique features demand more frequent and advanced real-time data from risk analysis and credit decision-making. Therefore, banking is being rapidly modernized, and the traditional banks that continue business as usual will be left behind. Most alternative lenders use modern Fintech technologies for crowdfunding and marketplace platforms to enhance their approach to the investors and the fund seekers. Secondly, unlike traditional small sector banks, these platforms rely heavily on technology and alternative data sources to assess the counterparties' creditworthiness, which might be more accurate. The thinking is to align these advancements to the traditional (banking) credit assessment process. However, these alternative sources' direct competition has taken a back seat, especially during the current pandemic, predominantly due to limited funding opportunities. Most clients are high-risk aversions, and their appetite has diminished substantially with the rising risk levels, and flee to more secure investment options. Unlike the mainstream banking sector, these segments have not received financial stimulus and other supporting programmers from the authority. Accordingly, shrinking alternatives, especially for the small sector, will emphasize their dependability on the traditional banking sector for survival and growth. However, the banks should still look for options to build synergies with the platform and advanced service providers to progress and improve reach.

Clustering or a large wave of non-performing exposures would have to be handled differently. The crisis-induced shocks to financial performances would differ based on sector and region. Banks equipped with essential peer groups & advanced impact analysis and progressing with a robust market intelligence system will enjoy a competitive edge. The portfolios must be reviewed and recalibrated more frequently, including stress testing based on crisis-specific scenarios and public data. The modifications to the risk appetite statement are also made to guide the business units and the entire organization. Still, the borrower's (individual) resilience would vary, not forgetting the objective, which is to create winners under problematic situations, a priority. Apart from the low leverage, the operating flexibility/adaptability and innovation could decide the winners in the small niche. The lenders need to understand the subsector dynamics, which are performed differently based on the market's distinctive demand patterns/nature, supply/value chain factors, and market organizations. Anyhow, the crisis has generally created profound exogenous shocks, and both loan supply and demand have been suppressed. Hence, the decision to carefully allocate the economic capital to meet the ultimate corporate objectives. Contradictory to the SME loan demand, corporate leverage has risen to an unprecedented level due to excessive funding demand.

Furthermore, lenders' restraining loans or the safety-first approach can easily be counterproductive and lead to severe economic slowdown and stagnation. Thus, the banks should rapidly identify the most affected business sectors and portfolios from the funding perspective to understand how they can be most supportive and provide viable risk responses. Technology-led innovation is essential to bring advanced structural and behavioral changes to the baking sector. Many industrial experts look for a sharp recovery in the medium to long run post-COVID-19 situation. Despite the possible recovery, changes like digital onboarding, contact/virtual customer services, remote security assessment, etc., would have to be continued. They look for multiple databases on the risk management front, especially to verify the owners' integrity, which becomes the cornerstone of SME success and survival. Unconventional methods like social media footprint, social behavior verification, and psychometric analysis can also be helpful.

Most banks use a credit engine that combines a sector-oriented view with data-driven analysis. The shift towards data analysis will unfold during the recovery from the lockdowns. Once the change is completed, banks will retain these data-forward approaches because they support better, more timely, and differentiated credit underwriting and monitoring. In most cases, the drifting of (credit) risk models is mainly due to the limited use of more dominant and directly connected macro elements. The most demanding proposition from these findings is to use the projected macro scenarios to stress the financial performance/cashflows and business projections to assess the business model's sustainability in the future. As an alternative, the high-level ratios like margin, earnings at risk, and cash-flow at risk can be compared with the external debt (financing) and future maturities to gauge the obligor's ability to survive more diligently. Model-lifecycle-efficiency level needs to be shorter, or the time is taken for new adjustments to receive new information. The risk-governance aspect is to be strengthened with the board of directors' support and consistent commitment from the top management. The regulator's role is critical in improving the (credit) risk management, controls, and portfolio management aspects. They can link their supervision mechanism and validation process towards achieving these broader intents. Vibrant awareness is to be promoted within an integral part of the enterprise-strategic assets in risk management to view, select and test a correct risk model. Accordingly, model-risk management should be an obligatory and essential tool to add value to the credit evaluation process on a large scale.

However, given the pandemic status, there is substantial demand globally to temporarily amend or provide further concessions relating to insolvency and bankruptcy act/regimes. For example, in Australia, the debt thresholds for creditors to apply for bankruptcy have increased while the debtors' time to respond to the claims has extended. Banks must evaluate these amendments closely, as they would have corresponding effects. An alternative concept is the possible moratorium of debt settlement, which could sometimes lead to a counterparty pooling liabilities to another period without analyzing the cash-flow deficit. Therefore, these critical decisions would be backed by logical projection and reasonable underlying assumptions the counterparty provided before the request. Given the capabilities and prevailing market share, it is safe to assume that SMEs' recovery rate is slower than large corporates. Some supporting evidence in this regard can be found in the vast China market. However, we remain inspired by the small business's critical potential role. Therefore, banks will have to consider all possible options while committing to consistent and long-term funding supply to essential segments. Accordingly, pure dependability on the potential recovery might not be the best choice.

The lower return environment can be challenging for many SME lenders in the future and is pressurized by rising interest rates, possible default trends (high NPLs), and, thirdly, increased competition for lending share. The key discussion point is to improve the processes of determining creditworthiness, which is the cornerstone in mitigating future NPLs. The counterparty business and financial risk are strongly influenced by the market, ecosystem, value chains, and competitor behaviour; hence, more excessive analysis is critical. Secondly, a robust monitoring mechanism is essential to identify not only the client (defaults) triggers but also the rapid changes in the ecosystem and macro factors which could damage the credit standing. Thirdly, SME banks can look for more synergies within the mainstream banking system and peers like crowdfunding platforms, Credit guarantees, and refinancing schemes for better risk-sharing options. This shall mitigate the risk profile and also enhance the lending capacity. The Authorities will be responsible for developing robust credit-information infrastructures and refinancing schemes, easing the funding process stress. The credit information infrastructure can be multiple and not limited to the reporting system, transactions security, collateral registration, and advanced bankruptcy/insolvency regimes. More remarkably, as a solution to the rising cost structure, the banks have started to use digital banking platforms more seriously. This has led to substantial synergies with FinTech and BigTech segments by leveraging AI, automating the process, improved data and analytical capabilities. By doing most of these things correctly and looking for continuous innovation/new financial solutions, and opportunities, best-established SME lenders can navigate these tricky waters. The transformation and profound/cultural shift can help the small banking sector support long-term sustainability rather than short-term profitability.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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