

## Banking the SME Sector: Beyond Financing

### Summary

- Nurturing SMEs and supporting their development is central to the Kuwaiti government's strategy of increasing the role of the private sector in generating economic growth, fostering innovation and creating large-scale employment opportunities.
- SME access to credit remains low in the GCC region and suffers from one of the highest rejection rates for SME loan applications (70 percent in 2018, according to the IMF), with SMEs in Kuwait receiving only 4.7% of total gross loans in 2019. Other hindrances impeding SME growth and development include inadequate access to finance and structural and operational obstacles.
- Kuwait banks face challenges in profitably serving the SME segment as potential loan rates are capped, and inadequate financial records make it difficult to price risk. Furthermore, unclear business objectives, unrealistic valuations by entrepreneurs, and a lack of sufficient assets (for use as collateral) create daunting challenges for banks.
- To overcome these hurdles — and aside from providing credit — banks could offer non-financial support, including advisory and support services in collaboration with other agencies, to foster the development of SMEs. They can incentivise SMEs to improve their operational efficiency by offering cheaper credit when key performance indicators are met. Banks can also assist SMEs in obtaining credit ratings that can enhance an SME's ability to apply for future loans.
- In addition, banks can organize workshops and conferences to facilitate interactions between SME entrepreneurs and decision-makers, like regulators and industry leaders, which will help foster entrepreneurship. Through such services and initiatives, banks can ensure a win-win proposition of developing the SME ecosystem while profitably supporting them.

### SME Ecosystem in Kuwait

Small and Medium Enterprises (SMEs) are vital to the economic development of a country as they foster innovation, entrepreneurship, and create large-scale employment opportunities. As Kuwait transitions to a non-oil based economy, the private sector is expected to play a key role in future economic growth and in generating employment. Globally, SMEs are a key part of the private sector and the wider economy with SMEs responsible for more than 45% of global GDP. In Kuwait, the SME contribution to GDP is lower (around 12% as of 2017), likely due to the outsized role of the Kuwait public sector in a heavily hydrocarbon-based economy. As Kuwait embarks on an ambitious plan to reduce the dependency on hydrocarbons over the next few decades, the government has also been making efforts to build the non-hydrocarbon economy. Nurturing and supporting SMEs to enhance the role of the private sector in the economy and creating jobs for its burgeoning workforce are a key part of the strategy.

### SME Funding in Kuwait and Challenges Faced by Banks

Access to credit has remained a key challenge for SMEs looking to grow and expand. The SME loan application rejection rate by banks is as high as 70 percent in the region, compared to less than 20 percent for OECD countries. Cognizant of this,

in 2013 Kuwait established the Kuwait National Fund (KNF), a specialized institution to fund, promote and develop SMEs, with a capital of KD 2 billion. From 2016 to the end of 2019, the KNF funded around 1,035 SMEs at a cumulative cost of KD 177 million, according to the Public Authority for Industry (PAI).

As of 2019, bank loans to SMEs stood at 4.7% of total gross loans. In 2018, the share of SME loans was even lower at 2.8%. The sudden spurt could be attributed to CBK's move to reduce risk weights for SMEs from 100% to 75%.

### Challenges facing the banking sector in relation to serving SMEs include:

1. **Interest rate ceiling:** Interest rates of short-term loans (less than 12 months duration) are capped at 2.5% above the discount rate, and long-term loans are capped at 4% above the discount rate. As a result, banks tend to not extend credit at a rate that is not commensurate with the risk undertaken by the bank.
2. **Difficulty in pricing risk for SME loans:** Many SMEs are run as 'sole proprietorships' and lack the detailed financial reports provided by larger firms. Many SMEs might not follow traditional accounting standards and are not rated by credit rating agencies, nor do they have credit scores, making it very difficult for banks to determine risk rate accurately.

<sup>1</sup> World Bank

<sup>2</sup> Central Statistics Bureau, Marmore Research

- 3. Lack of assets available as collateral:** The lack of collateral and inadequate financial records often mean that SMEs cannot access long-term financing instruments like term loans. Banks are forced to extend short-term unsecured loans to SMEs on an ad hoc basis at higher rates.
- 4. Lack of business objectives and unrealistic valuations by entrepreneurs:** A great majority of SMEs can present business goals and objectives that are unclear, with the entrepreneurs' valuations of their businesses also being generally unrealistic. Hence, the size of the loan demanded is often excessive compared to the actual capital required to run the business.

Issues within the SME ecosystem in Kuwait can explain the challenges listed above. According to data from the Central Statistics Bureau, a significant percentage of SME businesses are in low margin industries like wholesale and retail trading (39%), real estate and hospitality (27%), and construction (9.9%). SMEs in these sectors are vulnerable to economic shocks like recessions.

## Existing Challenges Exacerbated by the COVID-19 Pandemic

Government-mandated lockdowns and curfews have led to many SMEs closing for much of March, April, and May 2020 in Kuwait. This resulted in a significant revenue drop for many businesses, making it more difficult to pay stakeholders like employees, suppliers and banks. The government has tried to mitigate this impact by instituting measures like suspending collection of KNF loans, postponing social security contributions and expediting outstanding payments due to SMEs from the government. The CBK has also reduced the risk weights for SMEs loans from 75% to 25% to incentivise SME lending.

## Bank Support Vital to Supporting SME Development

Postponing SME loan payments will help SMEs in the short term, but will only kick the can further down the road. Longer-lasting assistance needs to be provided for SMEs and banks can play a role in this process. For one, banks can help SMEs on some of their long-standing issues that have slowed their development. Challenges such as lack of financial records and talent management can be alleviated by the extension of non-financial support, including advisory services. Banks could assist in developing business plans and increase the operational efficiency of SMEs by setting key performance indicators (KPIs), and can incentivize SMEs by offering cheaper credit for those that achieve the KPIs. Banks can bring about awareness of credit ratings by helping SMEs initiate a rating action by credit rating agencies, lowering the cost of credit. These advisory services can improve SMEs' chances of achieving growth and profitability in the long run. In addition, profitable SMEs that have demonstrated growth can be advised on the process and benefits of listing in stock exchanges.

Banks can also use innovative debt financing vehicles to fund SMEs. SME loan portfolios of different tenures and sizes can be bundled together to diversify default risk, and the portfolio can then be sold to investors. Structured finance products like these can be explored for financing SMEs in Kuwait.

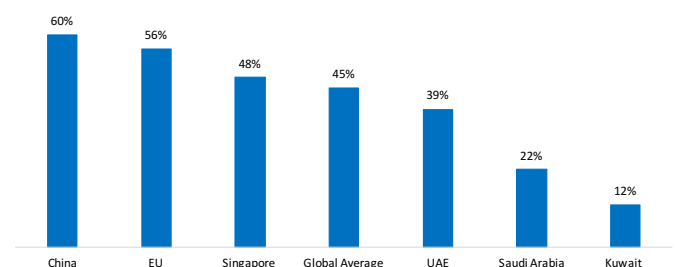
In addition, banks can also organise public forums with SME proprietors to bring about awareness on the rights of SME owners and the opportunities available to them. Public forums can be used to facilitate dialogue between SME owners and government agencies, lawmakers, and other decision-makers who can take into consideration the needs and requirements of SME owners and formulate policies accordingly.

Finally, banks can foster a spirit of entrepreneurship in the country by organising competitions in colleges and universities, even funding winning ideas if they are feasible. Conferences in which current and aspiring entrepreneurs are exposed to industry leaders can also be organised or sponsored. Not only are initiatives like these a great public relations exercise for banks, but they can also bring about much-needed change in the interim.

## Conclusion

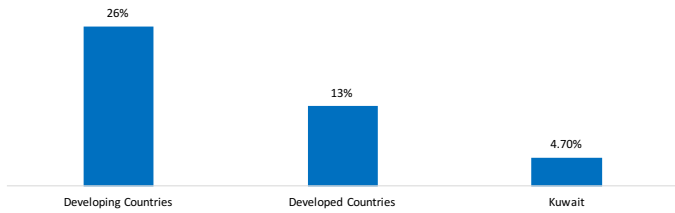
It is imperative that SMEs are given adequate support to enable them to contribute to the local and global economy and create jobs. While the government has provided support through programs like the KNF, banks can also play an important role in SME development. Banks can extend assistance in a number of ways (apart from financial support) to alleviate the operational and structural challenges facing SMEs. Banks can offer advisory and support services that can improve the operational efficiency of SMEs, and can also organize workshops and conferences with industry leaders to provide corporate exposure to SME entrepreneurs. Banks can also come up with innovative debt vehicles to finance SMEs. With the increasing number of fintech companies funded by venture capitalists and private equity funds in the region, banks need to combine bold measures and a fresh approach to serve the SME segment profitably.

## SME contribution to GDP



Source: Government authorities, World Bank, Statista, National Transformation Program (Saudi), Marmore.

## Share of SME loans in overall Loan Book



Source: World Bank, Statista, Central Statistical Bureau.

## Criteria for Micro, Small and Medium Enterprises

World Bank criteria for MSMEs

Firm Size	Number of Employees	Assets	Turnover
Micro	< 10	< USD 100,000	< USD 100,000
Small	< 50	< USD 3 million	< USD 3 million
Medium	< 300	< USD 15 million	< USD 15 million

Source: World Bank; Note: Enterprise must meet at least two of three characteristics to be classified.

## Kuwait National Fund Criteria for SMEs

Firm Size	Number of Employees	Assets	Turnover
Small	Less than 50	< KD 250,000	< KD 750,000
Medium	51 - 150	< KD 500,000	< KD 1,500,000

Source: Kuwait National Fund (KNF)

## The Kuwait SME loan book by sector and the economy

Sectors	Percentage of SME loan book	Percentage of SME businesses
Whole sale and retail trade	41.4%	38.6%
Real estate & renting	38.7%	27.3%
Manufacturing	9.3%	20.7%
Construction	5.8%	9.9%
Others	4.9%	3.5%

Source: Central Bank of Kuwait; Central Statistics Bureau.