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St. Mary's University, Ethiopia

SCHOOL OF ST.MARY'S UNIVERSITY

GRADUATE STUDIES

ASSESSMENT OF BANKS LENDING PRACTICE TO SMALL AND MEDIUM ENTERPRISE (SME) CASE OF SELECTED BANKS OPERATING IN ADDIS ABABA

BY

MEDHANIT ADANE

JANUARY,2022

ADDIS ABABA,ETHIOPIA

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THE THESIS SUBMITTED TO ST.MARY'S UNIVERSITY, SCHOOL OF GRADUATE STUDIES IN PARTIAL FULLFILLMENT OF THE REQUIRMEMT FOR THE MASTER OF BUSSINESS ADMINSTRATION

Research Advisor- Mohammed Seid(Asst. Prof.)

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APPROVED BY BOARD OF EXAMINERS

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Advisor Signature

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External Examiner Signature

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Internal Examiner Signature

Declaration

I, the undersigned, declare that this thesis is my original work, has not been present in any other university and that all sources of materials used for the thesis have been duly acknowledge.

Declared by

Medhanit Adane Signature__________________ Date___________________

Confirmed by Advisor Mohamed Seid (Asst.prof.) Signature__________ Date______

Certification

This is to clarify Medhanit Adane has carried out her research work on the topic entitled “Banks’ Lending to SMEs".

The work is original in nature and is suitable for the submission for reward of Masters in Business Administration.

Advisor: Mohammed Seid (Ast.prof)_________________________

ABSTRACT

The study's major goal was to evaluate bank-lending practice to small and medium-sized businesses in Addis Ababa. In this investigation, a descriptive survey used. The study conducted on randomly selected employees from each of the banks that ranked by NBE as the most profitable and lending institutions in 2019-2020. Structured questionnaires used to acquire primary data from respondents. The descriptive data analysed and presented in the report as tables, bar charts, and graphs using the Statistical Package for Social Sciences (SPSS) Version 20.0. The findings show that financial institutions, particularly banks, have a poor level of involvement with SMEs. The banks did not offer any specific lending packages that tailored to SMEs demand. The elements that influence bank lending discovered and classified as SME, Government, and Bank specific factors. The study indicated that banks are not providing enough loan to meet the needs of SMEs based on its results. On the SMEs' side, a lack of formality and collateral that qualifies them for financing has an impact on banks' lending to SMEs. There is no government intervention to compel banks to lend to small businesses. Finally, the report proposes that the government not impose loan quotas on public and private banks, which known as a "mandated credit extension system." The government should provide practical assistance and advice to banks and financial institutions in order to build an effective mechanism that lowers the cost and risk of lending to small businesses.

Key words: Bank lending, small and medium enterprise,

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ACRONYMS

AFDB	African Development Bank
BOA	Bank of Abyssinia
COOP	Cooperative bank of Oromia
CBE	Commercial Bank of Ethiopia
DBE	Development Bank of Ethiopia
FCI GP.	Finance Competitiveness and Innovation Global Practice
IFC	International Finance Corporation
LTV	Loan to value
LC	Letter of credit
NBE	National Bank of Ethiopia
SME	Small and medium enterprise
SSA	Sub-Saharan Africa
OD	Over Draft
POF	Purchase Order Financing
MSME	Micro, small and medium enterprise
MFI	Micro finance institution
MoTI	Ethiopian Ministry of Trade and Industry

Chapter one
Introduction

1.1 Back ground of the study

The financial sector serves important function for economic growth and development. Ethiopia's financial sector dominated by the banking sector (commercial banks) which currently represents more than 92.6 percent of total assets of the financial sector, excluding the assets of the Development Bank of Ethiopia (DBE) and National Bank of Ethiopia (NBE). Banks generally chartered to support the community with adequate provision of finance in line with the competitively determined interest rate.

In Ethiopia bank's from a macroeconomic perspective, played a pivotal role over the past decade in increasing financial access, raising national saving, and funding major public and private projects. Currently Ethiopian financial sector consists of 18 Banks (17 private, 1 public), and there is one development bank, this contribution progress remains limited in several important respects specially when its seen in the context of comparable countries and from the perspective of local private sector needs. Banking in Ethiopia is a sector with many contrasting forms and features. The sector is dominated by a government-owned entity (with a near two-thirds market share) and yet is also one of the most genuinely' capitalist' segments of the economy, which shows intense competition for customers, high executive compensation, activist shareholders closely tracking dividend pay-outs, and eager foreign suitors waiting for merger and acquisition opportunities. The sector is perhaps one of the economy's most heavily regulated sub-sectors (thanks to close central bank oversight), but then also exhibits many laissez-faire elements (banks are free to charge what they want for loans fees) (Cepheus research &analytics ,2020).

Currently Ethiopian banks remains limited and lagging in several important respects. It provides much stronger support for the public rather than the private sector, almost two third percent of funding gone to the public sector and beyond the comparatively limited credit made available to the private sector. The specific form and features of lending offered have not matches the needs and demands of most private sector business. In particular bank loan tailored to SMEs, or without stringent collateral requirements have all tended to be very limited, thus substantially holding back the potential user base among Ethiopia large pool of SMEs (World Bank report) 2017.

1.2. Statement of the problem

The basic source of finance for an investment is mainly loan taken from financial institutions. In Ethiopia, it is hard to get loan from financial institutions especially from banks because the preconditions are hard to fulfil by customers who are medium, small-scale enterprise and individuals with an idea. Despite of the key role played by Small and medium sized enterprises in economic development, diversification and employment in Ethiopia by perform much worse than large firms across a host of finance indicators, SME are much more likely to be rejected for loans, currently in Ethiopia SMEs considered as missing middle class.

In current Ethiopian financial sector, Banks are dominant in terms of total asset and total deposit, but they are not giving equal provision of finance for SMEs. SMEs and micro enterprises have largest share in the economy next to agriculture. banks are currently not giving much concern about SMEs their largest share of loan is taken by largest companies, So currently in Ethiopia cash is collected from lower income population and given to the higher level population this does not promote fair distribution of resources in the country. Making banks pre conditions flexible based on situation and using other preconditions that reduce the risk of the institution and increase the SME access to finance, will have positive effect on investment and the overall economy (Cepheus research &analytics ,2020).

SMEs represent a missing middle in the financial sector because of lending to SMEs is limited as MFI deposit and loan portfolios comprised mainly by microenterprises (over 90 percent). The same is true for commercial bank portfolios, which are primarily comprised of large enterprises. Deposits and outstanding loans to SMEs typically comprise less than 10 percent of the total portfolios of MFIs or banks. This leaves a considerable missing-middle of SMEs not served by either banks or MFIs and who need access to finance (World Bank, WDI, August 2013).

SME sector is labor intensive; as a result, it can create more employment opportunities. A dynamic SME division recognized as a standout amongst the central driving forces in the advancement of a market economy. They stimulate private ownership and entrepreneurial skills and flexibly can adapt quickly to changing market demand and supply situations, generate employment, help diversify economic activity, and make a significant contribution to exports and trade. Actually, in the developed market economy's SMEs seeks an extensive allotment in output and therefore employment. From the perspective of SME's relativity and commitment to overall economic growth and development of the country, SME’s financing should closely observed, scrutinized and more importantly met with holistic approach by the policy makers of the government and the regulators (FariyaYeasmin, MashroorNayeer, Siddika, HumayunKabir, 2019).

Although some empirical studies have been conduct on SMEs access to finance, credit delivery schemes, causes of default in repayment of loan, opportunity and treat that SMEs face in assessing finance in Ethiopia, there is no clear understanding and further detailed empirical investigations about specifically Banks’ lending practice to SMEs. This investigation will be more helpful for giving information or add knowledge about the current trend of Banks’ in providing loan to SMEs and useful for making amendment to policies related finical provision to SMEs.

1.3 General objective of the study

The general objective of the study is to assess Banks’ lending practice to SMEs in case of Banks operating in Addis Ababa.

1.4 Specific objective of the study

- Evaluate the bank products.
- Evaluate preconditions expected to be full filled by customers.
- Identify share of loan devoted to SMEs from the total loan disbursed by the Banks.
- Identify factors, which are Key constraints to make finance available for SMEs.
- Assessing the impact of existing government policies and potential areas of government involvement on banks in addressing loan to SMEs.

1.5 Research questions

- What are banks business loan products tailored to needs of SMEs?
- Which preconditions hard to be fulfil by SMEs?
- What is the share of loans devoted to SMEs from the total loan disbursed by the Banks?
- Which factors are key constraints for banks to make finance available to SMEs?
- What are the existing government policies and potential government involvement related to banks provision of finance to SMEs?

1.6. Significance of the study

This case is noteworthy because small and medium-sized businesses play a critical role in the economy by diversifying the economy and increasing employment opportunities; however, despite this contribution to the overall economy, these businesses face financing constraints, particularly from banks, which hold the largest share of the financial market. This research adds to the expanding body of knowledge about banks' provision of loans to small businesses. Its goal is to shed light on current trends and practices in Addis Ababa when it comes to bank financing for SMEs. To raise awareness among banks and other government bodies about the current loan disbursement pattern, particularly among SMEs, and to use this information to alter existing policies, resulting in greater bank lending to SMEs.

1.7. Scope of the study

The study focused on selected Addis Ababa-based banks, including Commercial Bank of Ethiopia, Development Bank of Ethiopia, Awash Bank, Bank of Abyssinia, Dashen, and Cooperative Bank of Oromiya, all of which ranked by the National Bank of Ethiopia as the largest banks in the fiscal year 2019-2020. As previously stated, the study evaluates the Bank's lending to SMEs in 2019/2020. Its goal is to provide light on the current patterns and practices of Addis Ababa-based banks' lending to SMEs.

1.8 Limitation of the study

The respondents approached was hesitant to provide information for fear that the information requested used to intimidate them or portray them or their Institution in an unfavorable light. Some responders even refuse to fill out questionnaires when asked. The study addressed the issue by including an introduction letter from the university, assuring participants that the information they provide will be kept private and used solely for academic purposes. Unavailability of executive managers was also one of the challenges faced during the data gathering.

The researcher also faced difficulty in obtaining information from the respondents because some of the information needed is based on sentiments, emotions, attitudes, and perceptions that could not be objectively quantified or validated. Due to the lack of secrecy that envelops Finance institutions, resulted in a lack of reaction. Because the research equipment would not bear their names, the researcher encouraged the respondents to engage without holding back any information they might have.

1.9 Organization of the study

The paper composed of five parts the first part of the paper includes, Introduction which makes the reader familiar with the research main concept. And the second data analysis part contains data related to topic of the study. In the third part deals with methodology used in the research, sources of data, research design used presented. Data analysis is the fourth part of the paper the collected data analysed and presented in the final part of the study recommendation and conclusion of the study.

CHAPTER TWO

Literature Review

In this chapter, important theoretical and empirical concepts related to Banks lending to SMEs, requirement expected to fulfil and factors which are major constraints to SMEs, trends of banks in providing of loan to SMEs are disused.

2.1. Theoretical Literatures

This chapter demonstrate review of existing literature based on facts and theories. Theories which are formulated to explain, predict, and understand phenomena and, in many cases, to challenge and extend existing knowledge within the limits of critical bounding assumptions.

2.2 Banking sector in Ethiopia

The banking sector in Ethiopia contains a big regional giant (with a $20bn-plus asset base) but is also full of tiny players. It is very traditional in its operations (with many old-fashioned, paper pushing branches) and yet shows flashes of 'digital disruption' in certain areas (mobile banking).

With recent reforms raising the prospect of fundamental changes, Ethiopia's banking sector generates much interest from investors and raises as many questions which this research note attempts to address by covering its past, present, and future prospects (Cepheus research &analytics ,2020).

Ethiopia's commercial banking sector currently consists of 18 banks (17 private, 1public). There is notable change from the single state-owned bank that functioned in 1990 and just 7 banks that were operating as recently as the year 2000.1 Relying on large-scale branch expansions, the rising number of banks have collectively broadened their geographic reach over the past decade, thus improving key access to finance indicators. Public and private banks increased their branch network from 571 ten years ago and 2,208 five years ago to 4,757 branches as of June 2018—substantially improving the population-to-branch ratio over the years, from a situation where each branch served 126,000 people back in 2008 to the current status where each branch is on average serving just 20,000 people (Cepheus research &analytics, 2020).

Commercial banks have increased their total credit to the public and private sector by about 12fold over the past decade, from Birr 67bn to Birr 740bn. The latter figures use a broad coverage of credit that includes financing provided by banks in the form of loans, bonds, or bills. Beyond the comparatively limited credit made available to the private sector, the specific forms and features of lending offered have not matched the needs and demands of most private sector businesses. In particular, bank loans tailored to SMEs, or carrying long-term maturities, or without stringent collateral requirements have all tended to be very limited, thus substantially holding back the potential user base among Ethiopia's large pool of small and medium-sized enterprises (Cepheus research &analytics, 2020).

2.3 Banks' Lending

Banks are financial institutions, which accepts demand and time deposits, makes loans to individuals and organizations, and provides services such as documentary collections, international banking, and trade financing (Essay 2012). Loan is an arrangement of advancing a sum of money on interest for a pre-agreed period sometimes for a particular purpose as well. The main features of loan advanced by a bank are the bank sanctions a sum of amount as loan for (a) prearranged period and (b) at an agreed rate of interest, a separate Loan account is opened in the name of borrower with the amount of loan sanctioned, the loan sanctioned has to be taken in full and not partially as the full amount is transferred to the debit side of the account and starts bearing interest from the date of entry in the debit side, from his loan account the customer is allowed to transfer the amount to his current account, installment repayment of loan is not permitted, But relaxation depends on the bank's discretion (Kumar et al, 2002).

From lending banks, some of the factors that affect the ability of a borrower to repay a loan are very difficult to evaluate but they must be dealt with as realistically as possible in preparing financial projections. This involved looking in to the past record of the borrower as well as engaging in economized forecasting (Reed and Gill, 1985).Furthermore, they suggest that there are the ingredients that determine the lending officer's faith in the debtors' ability and willingness to pay the obligation in accordance with the terms of the loan agreement.

Some writers like Sheker (1982) classified the factors in to 5 C's.

- Capacity of a borrower requires two aspects to be assessed. First, borrower must have legal capacity to borrow, an assessment of the "financial capacity" of a borrower is relevant in ascertaining the repayment ability of a borrower (Sonali, Abeyrante, 2001). W.Reed and

K.Gill (1985) also added that Banks are interested not only in the borrower's ability to repay but also in his or legal capacity to borrow.

- Character of a borrower plays an important role in the credit assessment process. A lending bank will look in to a borrower's past record, its banking operations, integrity and reputation to establish his character (Sonali, Abeyrante, 2001). Reed and Gill (1985) stated that the concept of character definition relates to credit transaction, which means not only willingness to repay debt but also a strong desire to settle all obligations within the terms of the contract.
- Capital or the amount of funds invested by the borrower in a business to support both fixed asset and current assets in other words it described as 'net worth support' (Flesig, 1995). Banks should make sure that every borrower has sufficient equity to enable the creditors to recover their funds through the sales of assets other than the collateral pledged for the loan.
- Collaterals not mandatory in the securing of a loan. Lenders, however, will favor the availability if in the bank's view; there is an element of doubt as to the repayment capacity of a borrower. The amount of collateral taken must reflect that element of doubt (Sonali, 2001).

2.4. Loan Eligibility Criteria

Loan eligibility criteria's are precondition that makes borrowers eligible for loan they divide as general and specific loan eligibility criteria.

2.4.1 General loan eligibility criteria

All customers applying for any types of loan facility must fulfil the following general criteria that all bank needs:

1. All persons engaged in lawful trading activities and creditworthy business and persons who have defined and sustainable source of income are eligible to borrow loans.
2. All applicants who are engaged in business should present renewed trade license for the current fiscal year or investment license and principal registration certificate for new projects.
3. All applicants who are engaged in business must present a Tax Identification Number /TIN/

4. The applicant must never been engaged in tax evasion, or in a breach of exchange and control regulations, or in any other illegal/unlawful dealings, if the information is available/the circulated record is available.
5. The applicant must not have any record of mal-operation of the checking account in the banking system until the rehabilitation period is expired.
6. The applicant shall fulfil at least the required minimum equity contribution for project and asset financing loans.
7. The applicant and/or any of its major shareholders/subsidiaries must not have any nonperforming loans in any bank
8. The applicant has to present all the documents/information demanded by the Bank as per the annexed document checklist herewith.
9. The applicant's business must be financially viable, legally acceptable, technically feasible and environmentally friendly.
10. In addition to these criteria customer has to fulfil the specific eligibility criteria for each loans and advances indicated in the credit product line.

2.4.2 Specific types of business loan and their Eligibility criteria

Are pre conditions that have to fulfil by all investors who are in need of credit, which is differed by the type of loan requested by the customers. Term Loan is a loan granted for working capital, asset financing and/or project finance repaid within a specific period usually with interest. The loan can be repaid in a lump sum on maturity, or in periodic instalments (i.e. weekly, monthly, quarterly, semi-annually, annually or lump sum), depending on the nature of the business and its cash flow.

The Bank extends term loan in forms of

- Short-Term Loan, Loan could be granted up to a maximum of one year
- Medium-Term Loan maturity period longer than one year but not exceeding a maximum period of five years, for projects businesses whose nature justify, or require, such periods of time for implementation and repayment of the loan. The financing of the acquisition

and/or leasing of fixed business assets (leased land, buildings, machinery, equipment, public transport vehicles, trucks and trailers, etc.), the establishment of a new project and the expansion of an existing business. The loans may embody working capital finance

- Long-Term Loan has a maturity period longer than five years but not exceeding a maximum period of ten years excluding grace periods, for projects businesses whose nature justify, or require, such periods of time for implementation and repayment of the loan. The financing of the acquisition and/or leasing of fixed business assets (leased land, buildings, machinery, equipment, public transport vehicles, trucks and trailers, etc.), the establishment of a new project and the expansion of an existing business. The loans may embody working capital finance

2.4.2.1 Line of Credit/Overdraft/facility

Line of Credit/Overdraft is a form of credit facility by which a customer allowed to draw beyond the deposits of its current accounts for the day-to-day operational needs of a viable and ongoing business, for short-term financing needs like seasonal purchases, operating expenses and working capital. Overdraft facility financed for a limited duration normally for one year and can be reviewed.

Eligibility Criteria

- A fresh Overdraft facility extended to an applicant who has established relationship as a depositor or borrower.
- The business must be in operation for at least one year after receiving trade license.
- As the nature of overdraft facility is risky, collaterals like buildings, cash deposits and bank guarantees.
- All customers applying for an overdraft facility shall present financial statement.

2.4.2.2Merchandise Loan

- A Merchandise Loan is a short-term credit facility provided by the Bank against merchandise held as a pledge or collaterals for the loan or documentary evidence to relieve the customer from cash flow problems arising from money tied up in the merchandise.
- Merchandise facility limit only approved for clients with sound financial performance and commendable repayment record.

- The goods kept under dual custody of the Bank and the borrower. The Customer shall insure the goods and the warehouse in his/her/its name and the Bank against fire and lightening, burglary, spontaneous combustion and other relevant risks. The value of the merchandise on which the margin computed, based on cost or market value, whichever is lower.
- Merchandise released upon the request of the borrower after collecting all expenses such as guards' salaries, store-handling expenses etc. and accrued interest to date and principal payment effected to the bank by the borrower.

Eligibility Criteria

1. Merchandise loan facility shall be granted to customer who have been proved highly creditworthy in their relation with Banks.

2. All merchandises held as collateral should have the following characteristics: **I**. must be readily marketable, insurable, and should have stable price. **II**. Perishable items can be held as collateral only if the goods do not expire within six months. Perishable items include medicines, food items, etc.;**III**. Chemical and Fertilizers could be held as collateral.

3. The ownership of the goods should be ascertained through objective evidence prior to accepting as collateral. For imported goods, customs declaration and other import related documents must be presented. For locally purchased merchandise, valid invoices should be presented, and the invoices should be checked against their respective suppliers. In addition, for manufactured goods, internal documents (production reports, for example) have to be presented.
4. The Bank will have all the legal entitlement to the product pledged which unconditionally enables it to sell them in case of adverse situations (default by the borrower).

2.4.2.3. Import Letters of Credit Facility (LC)

A Letter of Credit is a credit instrument issued by the Bank at the request of an importer. Which the Bank commits itself to a payment undertaking an applicant (importer) to pay a seller (exporter) a given amount of money upon presentation of specified documents representing the supply of goods within specific time limits. The documents conforming the terms and conditions agreed by the importer and exporter.

The Bank enters a commitment for the import of goods by a creditworthy importer provided the customer pays a reasonable safety margin in advance, which should be decided on a case-by-case basis by assessing financial strength of the customer, the letter of credit facility account performance, marketability of the import goods and the risks involved.

Eligibility Criteria

1. An Import Letter of Credit Facility is availed only to customers importing eligible goods. A list of goods eligible for import obtained from the National Bank of Ethiopia (NBE) at the time of opening of the Letter of Credit.

2. Any importer applying for Import Letter of Credit facility should come up with renewed import trade License. However, in the case of non-importers who apply for one-time Letter of Credit, an investment certificate and pro forma invoice can be accepted.

2.4.2.4 Pre-Shipment Export Credit

Pre-shipment export credit generally granted to allow the exporter for purchase of raw materials, processing and converting it into finished goods, warehousing, packing and transporting the goods until the time of shipment. An Export Letter of Credit and sales contract serve as evidence of a definite arrangement for realization of the export proceeds and the amount of finance required by the exporter.

If the facility is to be availed against sales contract:

- The applicant's credit risk rating shall be Grade A and above.
- The applicant shall be in the export business at least for six months and shall fulfill most of the criteria stipulated for clean/unsecured loan.
- The applicant shall present valid sales contract/a bona-fide order from a foreign buyer.
- Each advance shall not exceed 90% of the sales contract.
- The facility shall require opening of irrevocable Letter of Credit for each advance made by the Bank.
- The export proceed has to be channelled to the exporter's account only through the Bank.

Eligibility Criteria

1. The applicant shall be in the export business at least for a year.
2. The applicant shall present valid sales contract/a bona-fide order from a foreign buyer.
3. The applicant shall submit export receipt of the previous period.
4. The facility shall require opening of irrevocable Letter of Credit for each advance made by the Bank.

2.4.2.5 Letter of Guarantee Facility

A Letter of Guarantee issued by a bank is a written promise by the Bank to pay a sum of money to the beneficiary (local or foreign) in the event that the obligor fails to honor his/her/its obligations in accordance with the terms and conditions of the guarantee, agreement/contract. It is unconditional obligation of the Bank to pay a sum of money to the beneficiary in the event of non performance by the customer. The beneficiary of the guarantee may be an individual or a business entity located locally or abroad and duration of guarantee the Bank issues shall depend on the contractual agreement entered between the beneficiary and obligor, but never exceeding the specified validity date in the contract (if appropriate). The Bank may avail the facility to customers who have recurrent request. The facility shall be availed for one year and shall be reviewed every year unless the Bank demands it to be reviewed in less than this period by the credit approving team.

The Bank provides Letter of Guarantee Facilities in to two forms

Eligibility Criteria

1 who have experience on the performance which the guarantee applied for,

2. Who can provide certificates of performance and payments of past work or supply performance

3. with proven record in maintaining adequate credit history.

2.4.2.6 Motor Vehicle Loan

Motor Vehicle/Truck Loan is a term loan granted for purchase of motor vehicles including large, medium and small-sized trucks, buses, mini-buses, pickups and automobiles does not include the cost of spare parts or luxury items that are needed to facilitate the borrower's existing business or, simply, as a component of a project provided that the business is capable of serving the loan. The maximum loan amount shall not exceed 70% of the invoice price or engineering estimation, whichever is lower. Equity contribution of the borrower should be evidenced by valid payment receipt or cash deposit at our Bank. The vehicle to be bought should be held as collateral and registered with the legally empowered organ. When motor vehicle loan is part of the project loan and the loan secured by strong and sufficient collateral, the vehicle to be bought may not be held as collateral.

Eligibility Criteria

1 The motor vehicles/ truck to be financed should meet the standard specification of the Ministry of Transport and Communication Transport Authority.

2. Bank financing, or any other type of borrowing, is not acceptable as a source of fund for the borrower's equity contribution. This should be ascertained by evaluating the applicant's financial statements, account performance and credit information.

3. The borrower should commit first the required equity contribution of the vehicle to be bought. The amount of equity contribution shall be determined based on the type of business, the borrower's relevant experience and the additional collateral offered.

2.4.2.7 Loans for Machinery & Equipment

The Bank may extend term loans for purchase of new or used factory or construction machinery and equipment such as dozers, graders, loaders, excavators, rollers, asphalt pavers, crushers, concrete pavers, cranes, concrete mixer mounted on trucks and dump truck for own use or rent. The Bank extends loans for used construction machineries and equipment when facilities of existing projects transferred or in the case of privatized enterprises.

The Bank may extend loans for used construction machineries and equipment for workout of loan maintained in the Bank for maximum loan repayment period for acquisition of new machinery and equipment should not be more than four years for the construction machinery & five years for factory machinery.

For used machinery and equipment, the maximum loan repayment period shall not exceed three years for construction machinery & four years for factory machinery and equipment. However, the year of make/manufacture shall not exceed 20 years for used factory machineries. The machinery to be bought &/or other acceptable collateral should be held as collateral and registered with the appropriate government organ.

Eligibility Criteria

1. The machinery and equipment to be financed should meet the standard specification of the concerned government body, if any.

2. The applicant shall be companies or individuals who are engaged in a viable construction machinery leasing or construction or other businesses at least for one year.

3. The Bank may require additional collateral in addition to the used machinery and equipment. 4. Bank financing, or any other type of borrowing, is not acceptable as a source of fund for the borrower's equity contribution. This should be ascertained by evaluating the applicant's financial statements, account performance and credit information.

5. The borrower should commit first the required equity contribution of the machinery to be bought. The amount of equity contribution shall; however, be determined based on the type of business, the borrower's relevant experience and the additional collateral offered.

6. If the applicant imported the machinery duty-free, he/she/it must submit a document that shows duty free privilege to that, together with his/her/its application.

7. The applicant shall bring letter from Ethiopian Revenue & Customs Authority that clear state the right to pledge the duty free property as collateral.

2.4.2.8 Purchase/Construction of Commercial Building

It is a loan extended to individuals/PLCs/Share Companies/Private Organizations that wants to construct/purchase buildings, which can be used for rental or own use purpose. The duration of the loan shall be determined considering the level of income and amount of loan to be extended but not more than maturity period of 10 years excluding grace period exclusive f grace period. The Bank may grant construction or purchase of building loans to finance a project, which would be profitable and that can generate sufficient cash to make repayment after starting operation.

Eligibility Criteria

1. The maximum financing for the construction of commercial building and /or house loans shall not exceeds 70% of the construction or engineering estimation, whichever is lower. The maximum financing for purchase of commercial building and /or house loans shall not exceeds or purchase of commercial building/house loans shall not exceeds 70% of the acquisition cost or engineering estimation, whichever is lower.

2. Applicants should invest minimum equity contribution from their own source first if the loan is for construction of building.

3. If the loan is for purchase of building, applicants should submit sales agreement & should make a payment of their minimum own contribution of the purchase price or the Bank‘s engineering estimation whichever is lower.

2.4.2.9 Project Financing Loans

The Bank extends loans to customers who have attractive and profitable projects for establishing new projects, expansion or acquiring existing ones, and guaranteed for the period not exceed 10 years excluding grace period. In order to ensure the proper end-use of the funds to be availed by the Bank, some documents (such as pro forma invoices and supply or sales agreement) are required.

Feasibility study that shows the technical and financial viability of the project and other supporting documents should be submitted for processing loans related to project finance. For any project financing, the applicant shall contribute at least 30% of the total project cost. Bank financing, or any other type of borrowing, is not acceptable as a source of fund for the borrower's equity contribution. This shall be ascertained by evaluating the applicant's financial statements, account performance and credit information.

The project financing structure and disbursement modalities shall be made considering the smooth implementation of the project and in a way to ensure commitments of the promoter. In doing so, credit personnel shall properly assess the sources of equity financing and schedule disbursements of the loan on a phase-by-phase basis or at a time along with the equity contributions of the promoter. In any project financing, the Director-CIB and Banking Center/Branch Manager is empowered to release the phase-by-phase loan disbursement as per the terms and conditions of the credit approval. However, if there is a variation from the credit decision, the disbursement request of the customer shall be deliberated by the appropriate Credit Approving Committee.

Eligibility Criteria

1. For any project financing the borrower shall first commit his/her/its equity contribution to the project and it shall be verified before the first disbursement made by the Bank.
2. The project to be financed should be marketable, financially viable and technically feasible.
3. The Maximum Bank finance for such purpose shall not exceed 70% of the total project cost.

The specific preconditions that depends on the type of loan guaranteed. The above listed types of loan are guaranteed almost all of the banks that provides financial service to the market. We can see that all types of loan are not easily full filled by the customers at all level specially SME and person with an idea. This results unfair distribution of resources and affect investment in the economy because SMEs are unable to realize their full potential due to the existence of different factors that inhibit their growth and performance mainly harsh preconditions to access finance.

2.5 Definition of Small and Medium enterprises (SMEs)

The SMEs definition based on the country, universally agreed definition of SME (business entities) some of the commonly used criteria are the number of employees, value of assets, and value of sales and size of capital or turnover. However, the most common basis of defining SMEs is number of employees (Nugent, 2001).World Bank have not published or defined specific definition on the SME. SMEs definition based on the numbers of workers of the organizations or the annual sales of the organizations. As sited in Tom Gibson H. J. van der Vaart 2008 work, the African Development Bank (AfDB) defines SMEs, as an enterprise, which has maximum number of 50 Employees without any requirement Revenues or Turnover. (World Bank, 2015).

Therefore, MoTI classifies SMEs in Ethiopia based on capital investment and on the bases of establishment. This is important because the sector accounts for large share in the economy next to agriculture, so that proper definition and classification is of essence for policymakers in them dealings with SMEs.

Ethiopian Ministry of Trade and Industry (MoTI) defines SMEs as follows:

- Micro enterprises: are small businesses with total capital investment not exceeding Birr, 150000 and excluding these enterprises with high technical consultancy and other High-Technology Establishment.
- Small enterprises: are businesses with a total investment between Birr, 150,000 up to Birr 500,000 and do not include enterprises with advanced technology and high technical Consultancy.
- Medium enterprises: are these business enterprises with a total investment between Birr, 500,000 up to Birr 7.5 million and including those enterprises that have high technical Consultancy and excluding other high-tech establishment.

2.6 Small and Medium Enterprises in Ethiopia

The SME sector in Ethiopia taken as an instrument in bringing about economic transition by effectively using the skill and talent of the people particularly women and youth without demanding high-level training, much capital and sophisticated technology. The development of the sector in Ethiopia is believed to be the major source of employment and income generation for a wider group of the society in general and urban youth in particular (Gebrehiwot, 2006).

In particular, the demand-side analysis shows that MSMEs in Ethiopia perform much worse than large firms across a host of finance indicators. MSMEs are much more likely to be rejected for loans, and less likely to have a loan, line of credit, or overdraft facility. These firms are also more likely to avoid loan applications all together due to high collateral requirements. However, the data reveals that the lack of access to a finance is even more severe for small firms than for microenterprises (FreduNega (PhD) and Edris Hussein (MSc) 2016).

Ethiopian small businesses are lagging behind every other sector. Their growth is sluggish, marketability of their product is limited because of quality, competition, lack of market (deficient in place to market their product), the access that they have for input was limited and expensive in put price and their access as well as use of finance is extremely limited. He also added that only limited number of small business had practice of accessing external loan. In the past twelve months only 41% of the total small business on which the research was conducted had accessed credit and of these businesses 48% indicated the credit has increased and 37% mentioned the debt to asset has decreased (Fetene, 2010).

2.7 Sources of finance for SMEs

Before going into business, an entrepreneur needs to secure sufficient financial resources in order to be able to operate efficiently and sufficiently well to promote success. The money available to a business for spending in the form of cash, liquid securities and credit lines. There are few potential sources of finance available for SMEs, which are formal and informal.

The popular view of informal finance is of powerful moneylenders who exploit the poor through usurious interest and unfair seizure of collateral. In fact, informal finance is both extensive and diverse. The informal sector accounts for most of the financial services provided to the non corporate sector. In addition to family and friends, who provide a large percentage of the loans, informal finance consists of professional moneylenders, pawnbrokers, trades people, and associations of acquaintances (Meghana et al, 2008).

As indicated by Cook and Nixon (2000), some of the types of formal financial institutions include,

- Commercial banks: may be willing to provide an overdraft of some sort and may be willing to lend in the long term where that lending can be secured on major assets such as land and buildings. However, raising medium-term finance to fund operations is often more difficult for SMEs as banks are traditionally rather conservative (William, 2016)

- Cooperatives: institutions with a mutual ownership structure, including credit unions.

- Specialized state financial institutions: specialized financial institutions fully owned by the state or extensions of the government whose main purpose is to lend in support of economic development or to provide savings, payment, and deposit services to the public. This group includes postal banks, government savings banks, small and medium-size enterprise lending facilities, agricultural banks, and development banks

- Microfinance institutions: - financial institutions whose primary business model is to lend to and possibly take deposits from the poor.

- Thus capital markets are a source of direct funding for business, by issuing debt or equity in amounts sufficiently large to attract investors (who prefer liquid issues and are not willing to take too large a share of a single asset) and amortize issuance-related transaction costs (including compliance with complex legal, regulatory, accounting, and disclosure requirements),capital markets do not compensate for deficiencies in the banking sector as they do not have a comparative advantage to deal with opaque and small firms. In effect, capital market financing rests on comparatively high accounting and disclosure requirements, which, by definition, opaque SME lack. These factors normally render unfeasible the direct access to capital market financing for SME (Malhotra et al 2007).

2.8 SMEs Access to Finance

Conferring to Wikipedia Access to finance is the ability of individuals or enterprises to obtain financial services, including credit, deposit, payment, insurance, and other risk management services. SMEs finance is the funding of small and medium-sized enterprises, and represents a major function of the general business finance market – in which capital for different types of firms are supplied, acquired, and coasted or priced. Access to finance for small businesses in the startup and expansion phase of their existence is important, since these firms generate employment, drive innovation, and boost competition in markets (Ellis and Ben, 2017).

SME financing, in fact, is now at the center of the international development agenda and is of considerable interest to policy makers due to their importance for economic development as well as their potential contribution to economic diversification and job creation. However, SME growth potential in developing economies, especially in Africa, is limited as they are significantly more credit constrained compared to larger enterprises (Kuntchev, Ramalho, Rodriguez-Meza, and Yang ,2012) find that over half of SMEs are credit constrained in the Sub-Saharan Africa (SSA) region, which is higher than in any other region.

According to (Wanjohi&Mugure, 2008), Lack of access to credit facilities almost universally indicated as key problem for small and micro enterprises. In most cases, even where credit is available mainly through banks, the entrepreneurs may lack freedom of choice because the banks' lending conditions may force the purchase of heavy, immovable equipment that can serve as collateral for the bank. Credit constraints operate in variety of ways in Kenya where undeveloped capital market forces entrepreneurs to rely on self-financing or borrowing from friends and relatives. Lack of access to long-term credit for micro, small and medium enterprise forces them to rely on high cost short term finance.

2.9 Banks Trend of Lending to SMEs

Banks may be willing to provide an overdraft of some sort and may be willing to lend in the long term where that lending can be secured on major assets such as land and buildings. However, raising medium-term finance to fund operations is often more difficult for SMEs as banks are traditionally rather conservative. Furthermore, banks will often require personal guarantees from the owner-manager of the SME, which means the owner-manager has to risk his personal wealth in order to fund the company. Another important issue to note is that MFIs are more engaged with financing SMEs than banks.

Out of those who had access to finance from formal institutions, more than 68% had their access from MFIs. Only close to 8% had their finance from banks. Since the financing portfolios of the two are different (loans from banks are large in size with a relatively long maturity period than loans from MFIs), it has its own implications especially when firms grow. As firms grow, their debt financing need also grows both in term of the size of the loan and the maturity period of the loan. Moreover, enterprises that are of transformational type who often lead enterprises that often create jobs may not fit well to MFIs financing portfolios. All this demands for a better and wider engagement of banks with SMEs (FreduNega and Edris H. Seid, 2009).

Most commercial banks are so reluctant to provide loan to small businesses because of high risk and supervision cost associated with this type of investments. Sia(2008) identified in Bangladesh that banks are shy to lend to small business activities, as they do not consider them as attractive and profitable under takings. And small businesses are considered as high risk borrowers because of the nature of their operation, low capitalization, and insufficient assets to be used as collateral. Here in Ethiopia access to finance by small business more on suppliers credit, equipment leasing (Gebrehiwot and Wolday, 2006) but the problem is aggravated because nonexistence of international institutions that facilitate the access to finance for example small business Department of International Finance Corporation(IFC), a World Bank group. For example IFC has extended the small and medium scale businesses financing facilities to Bangladesh through South Asia Enterprise Development Facilities (SEDF) along the local states of the country (Siddiquee et al., 2006) IFC provide not only fund for small business but also term loans, leasing industrial hire purchase, for asset acquisition, business expansion, overdraft (OD), revolving credit, Factoring, letter of credit etc.

Due to the sensitive and competitive nature of the banking sector, where obtaining information on lending practices may break business confidentiality, supply side studies especially on bank finance compared to studies into other forms of SMEs finance are relatively rare (Deakins et al., 2008). Since banks are not able to control all actions of borrowers due to imperfect and costly information, they formulate the terms of the loan contracts in such a way as to reduce the risks associated with borrowing. In the absence of sufficient financial information especially in developing countries like Africa where there are no credit bureaus, banks generally rely on high collateral values, which according to bank reduces the risks associated with the problems of adverse selection and moral hazards resulting from imperfect information (Nott, 2003).

2.9.1 BANK OF ABSSINYA Lending Trend

At the end of the Fiscal Year 2019/20, the total outstanding loans and advances of the Bank Reached Birr 37.25 billion (Birr 36.8 billion net off impairment charges), exhibiting an increase by Birr 13.51 billion or 56.9% from that of the preceding year. The growth came as a result of the increase in term loans by Birr 8.0 billion or 47.2%, overdraft by Birr 1.02 billion or 22.9%, and advances by Birr 4.49 billion or 191.9%.

The share of term loans, overdraft and advances from total outstanding loans and advances stood37.25 at 66.98%, 14.68% and 18.34%, respectively. During the review period, all loan balances by economic sectors except Domestic Trade have depicted remarkable increment, a substantial net increase was observed in Export with Birr 7.51 billion (172.2%), followed by Industry Birr 2.79 billion (146.3%),Import Birr 1.92 billion (184.5%), Construction Birr 1.89 billion (86.3%), while lower growth was witnessed in other loans category Birr 0.46 billion (63.2%), in Agriculture Birr 0.4 billion (143.9%), and Transport Birr 0.14 billion (19.9%). Domestic Trade loans, on the other hand, has declined by Birr 1.61 billion (-12.9%) from that of June 2019. The loans and advances percentage distribution by sector exhibited that three sectors took the lion’s share, i.e. export (32%), domestic trade (29%), and industry (13%); whereas construction, import, transport, agriculture and other sectors made up the rest at 11%, 8%, 3%, 2% and 2%, respectively.

2.10 Key roles played by Small and Medium Enterprises

At the international level, the key role played especially by small and medium sized enterprises in economic development and their contribution to economic diversification and employment is widely recognized, and so is the reality that these enterprises face financing constraints around the world, both in developed and developing markets (Ayyagari et al., 2007; Beck et al., 2005).

Therefore, MoTI classifies SMEs in Ethiopia based on capital investment and on the bases of establishment. This is important because the sector accounts for large businesses throughout the country so that proper definition and classification is of essence for policymakers in them dealings with SMEs. Small and Medium sized enterprises have usually been perceived as the dynamic force for sustained economic growth and job creation in developing countries.

They play multifaceted role such as boosting competition, innovation, as well as development of human capital and creation of a financial system.

With increased urban population dynamics of Sub-Saharan Africa (SSA), the importance of SMEs is also growing. In SSA, given the rapid rural-urban migration and deficiency to absorb this migration, SMEs have become important urban economic activities particularly in providing urban employment. In similar fashion, in cities and towns of Ethiopia, SMEs and the informal sector are the predominant income generating activities and thus they have a significant contribution to local economic development and used as the basic means of survival (Gebreegiziabher and Demeke, 2004).

The SME sector in Ethiopia is taken as an instrument in bringing about economic transition by effectively using the skill and talent of the people particularly women and youth without demanding high-level training, much capital and sophisticated technology. The Small and Medium Enterprises informal and Small Manufacturing Enterprise sector (SMEs) contributed value added of Birr 8.3 million in 1996. Based on the 1992/93 data, this figure constitutes about

3.4% of the GDP, 33% of the industrial sector's contribution and 52% of the manufacturing sector's contribution to the GDP of the same year (Gebrehiwot, 2006).

The development of SMEs sector in Ethiopia believed to be the major source of employment and income generation for a wider group of the society in general and urban youth in particular. The five-year Growth and Transformation Plan (GTP) of Ethiopia envisages creating a total of three million micro and small-scale enterprises at the end of the plan period (NBE, 2011). Citing the source from the Federal Micro and Small Enterprise Development Agency (FMESDA), the EEA Research Brief noted that a total of seventy thousand five hundred (70500) new MSEs were established in 2011/12 employing eight hundred six thousand three hundred (806300) people across the country. The performance is below the target set in GTP (EEA, 2015).SMEs are typically owned, operated and managed by proprietors sometimes in the form of sole or joint ownership.

According to a study by (Reuber and Fisher, 2000) of SMEs in developing countries, most of firms under the broad category of SMEs are family owned mainly engaging the services of kindred and other related instances of hired external hands. There are cases of the externally hired hands merely serving apprenticeship roles, which in this case may not be eligible for salaries. (Schmitz,1995) posits that given the low level of capitalization of SMEs most of them tend to operate in sectors utilizing extensive laborious techniques in contrast to largely established firms.

Their primary activities according to (Reuber and Fisher, 2000) are mainly within the areas of primary sector manufacturing, retail and trading. Again, the question of the operational activities of SMEs is largely influence by the location, be it within an urban setting or a rural one for that matter. Retail activities are ideally suited for urban settings where as basic manufacturing can be carried out both in rural and urban areas.

In Ethiopia, despite the enormous importance of the SME sector to the national economy regards to job creation and the alleviation of abject poverty, many of the SMEs are unable to realize their full potential due to the existence of different factors that inhibit their growth and performance. One of the leading factors contributing to the unimpressive growth and performance of the enterprises is limited access to finance (Wolday and Gebrehiwot, 2004). In a similar way, comparing small and large firms the World Bank finds that small firms face more challenges in obtaining formal financing than large firms; they are much more likely to be rejected for loans, and are less likely to have external financing (World Bank, 2015).

2.11 Factors Influencing Banks' lending to SMEs

The factors that influence Bank lending categorized as Bank specific factors, SMEs specific and government related factors. Bank specific factors related to banks which affects Bank lending includes but not limited to Interest rate, collateral, unavailability of products and preconditions, which fulfils the demands of SMEs, loan to value ratio of Banks, Difficulty in Adopting New Lending Technologies discussed below.

- Interest Rate Interest is essentially a charge to the borrower for the use of an asset. Assets borrowed can include cash, consumer goods, vehicles, and property. For loans, the interest rate applied to the principal, which is the amount of the loan. The interest rate is the cost of debt for the borrower and the rate of return for the lender. The money repaid is usually more than the borrowed amount since lenders require compensation for the loss of use of the money during the loan period. The lender could have invested the funds during that period instead of providing a loan, which would have generated income from the asset. The difference between the total repayment sum and the original loan is the interest charged. When the borrower considered low risk by the lender, the borrower will usually charge a lower interest rate. If the borrower considered high risk, the interest rate charged will be higher, which results in a higher cost loan. (Abdi Mohamed Maalim and Dr. Joyce Gikandi, 2009).
- Difficulty in Adopting New Lending Technologies Difficulty in Adopting New Lending Technologies the main information asymmetries that constrain SME access to finance are as follows: High Cost of Obtaining Credit Information on SMEs or markets to allocate resources efficiently, all market participants must have the same relevant information. This is seldom the case, however, in developing countries, and the resulting market failures can create biases against small firms. Under these circumstances, for banks to obtain information on the creditworthiness of potential SME clients is difficult or costly. If, as a result, lenders perceive the risks of lending to SME to be greater than they actually are, they will charge higher interest rates or refrain from lending to them altogether. If lenders

  do charge high interest rates, this increases the risk they exposed to by discouraging low risk, low-return borrowers from seeking loans, ultimately discouraging lenders from lending to SME altogether. At the same time, higher interest rates are associated with mainly high-risk projects, a circumstance referred to as adverse selection (Malhotra et al, 2007).

- Collateral requirements on a loan contract are particularly significant for SMEs rather than the large firms because SMEs are information opaque and collateral can act as a signaling device for borrowers to show their credit quality, which can ease access to financing and strict loan conditions. Similarly, by asking for collateral, a bank can mini- mize its loss exposure in the event of loan default and provide protection from borrower moral hazards. Hence, collateral has important implications for both borrowers and lenders on a loan agreement. However, SMEs possess fewer assets that can be pledged as collateral and, hence, SMEs face credit rationing from banks, 2017. According to this argument, it is clear that banks try to mitigate the lending risks through a capital gearing approach instead of focusing on the future income potential of SMEs. Therefore, collateral has become essential prerequisite to access bank loans (Africa Practice, 2005).
- Limited number of loan products and payment condition another way in which banks react to the market imperfection is by reducing the maturity of their outstanding loans. Shorter loans allow banks to monitor more frequently the firms' performance and, if necessary, vary the terms of the contracts before losses have accumulated (Hernández-cánovas and Koëter-Kant, 2008). Another way in which banks react to the market imperfection is by reducing the maturity of their outstanding loans. Shorter loans allow banks to monitor more frequently the firms' performance and, if necessary, vary the terms of the contracts before losses have accumulated (Hernández-cánovas and Koëter-Kant, 2008.

Government specific factors Government specific factors are factors, which affects bank lending related to Policy and regulatory, legal system, monetary policy. Government regulation and policy cited by most as the very significant factor that drives banks to engage in SMEs.

- Lack of an effective legal system- The lack of an effective legal system to enforce laws impedes the development of a deeper credit market. Some laws exclude movable assets, such as machinery, vehicles, and livestock. As movable assets often account for a greater share of the assets of smaller firms than of larger ones, the impact on access to credit is relatively negative for SME (Bataa, M et.al, 2008).

- Unavailability of information providers- Information providers are entities in the market place, which provides information about clients business and credit history. Unavailability of information providers about business entity profiles is third Party Information by Providers in the Market place Lenders' lack of knowledge of their clients and of information on clients' credit profiles and histories reinforce their perception of the high risk involved in lending to SME. One way to overcome the high cost to lenders of directly screening and monitoring clients is through the establishment and use of credit bureaus as third party information providers (Malhotra et al, 2007).

- Policy and regulatory problems -Policy and regulatory problems constitutes the primary obstacles for the growth and expansion of SMEs. An ECA (2001) report attributes the challenges faced by SMEs to the legacy of past structural economic and industrial strategies used by a good number of African countries but most crucially, the inertia of transition is by far the most conspicuous fallout factor. Indeed, the ECA finding is more of a buildup of Spathe (1992), as they both points to a number of hurdles for SME development in Africa.

SME specific factor Are factors that affect Banks' lending related to SMEs business characteristics, which includes inconsistent SME financial statement, High risk of their operation because of lack of managerial and technique skill , lack of collateral, poor financial record.

- Poor financial record As SME are often not required to adopt international accounting standards when preparing their financial statements, large discrepancies arise in the ways firms report their financial positions. For example, many firms in developing countries may have two or three sets of books for different audiences. Auditing such statements can be labor- and time-intensive, which raises the cost of loan processing for SME. In addition, even audited financial statements can be unreliable.
- High Risks of SME Operations SME operations are subject to two major risks Vulnerability and Turnover. SME are riskier borrowers than large firms. This is because SME are more vulnerable to market changes and often have inadequate management capabilities because of their smaller size. Lack of demand and shortages of working capital

were the two most frequently mentioned underlying causes of these business failures. SME activities are extreme volatile with a large number of them starting up while many others are closing down.

- Management Weaknesses despite evidence that lack of access to finance constrains many SME, actual effective (or bankable) demand may itself be constrained by weaknesses in firm management and the dossiers their management can present when applying for credit. Programs to increase financing for SME often begin with training and business development services to strengthen firms' management and productivity (Abdifatah Adan mumin, 2008).

- Lack of adequate collateral Majority of SMEs have been denied loan due to lack of collateral (KiraandZhongzhi, 2012) in their study on the impact of firm characteristics in access of financing by small and medium-sized enterprises in Tanzania findings revealed that collateral has a positive influence on access to finance. Jessop, Diallo, Duursma (2012) according to world bank a lot of SME's are denied loans by financial institutions due to lack of sufficient collateral.

2.12 Empirical Studies

Some related studies conducted by different researchers in different countries. The study focused on analyses of Banks' lending to Small and Medium enterprise. Banks and MFIs engagement in financing SMEs in Ethiopia is limited. The demand side findings and analysis revealed that access to finance is significantly influenced by the age of the firm, firm's previous engagement with banks, experience of the manager and whether firms are managed by the owner (owner-manager) or not. In a similar fashion, SMEs specific factors such as poor financial records of SMEs, lack of adequate collateral, SMEs poor management of risks, and informalities of SMES are the major obstacles underlined by banks and MFIs to their engagement with SMEs (FreduNega and Edris H. Seid, 2019).

According to a research done by Ndungu (2014) on factors effecting credit access among small and medium enterprises in Murang'a County. Findings reveled that there was a positive relationship between collateral and access to finance. In addition, it was suggested that lending institutions should evaluate their lending policies hence encourage SME's to take credit. Karanja, Mwangi, andNyakarimi (2014) in their study Factor influencing access to credit services by women entrepreneurs in Kenya findings revealed that there was a significant relationship between collateral and access to credit services.

Bankers are not interested in providing loan to small business because of the loan immateriality, which increase the transaction cost banks incur and high mortality rate of small businesses (Ogujiuba, Ohuche and Adenuga, 2008).

KiraandZhongzhi (2012) in their study on the Impact of Firm Characteristics in Access of Financing by Small and Medium-sized Enterprises in Tanzania findings revealed that collateral has a positive influence on access to finance. Kihimbo, AyakoandOmoka (2012) asserts that most SME's denied and discriminated by finance institutions, because of high risk and lack of enough resources to provide as collateral.

Monteiro (2013) states that SMEs have limited access to finance because of lack of creditworthiness in the information, which is usually unpublished. According to a study done by MiraandOgollah (2013) in their study on challenges facing accessibility of credit facilities among women owned enterprises in Nairobi central business the study revealed that lack of information accessibility, insufficient skill and knowledge level, lack of collaterals required and socio-cultural roles had a positive relationship on access to finance. MazanaiandFatoki, (2012) asserts that startup SMEs more likely affected by informational asymmetry problems. Beck, BeckDemirgüç-Kunt and Singer (2013) Financial structure, size and access to finance findings revealed that information asymmetry is caused by poor accounting records, lack of audited financial statements and inadequate access to SME information from credit bureaus. Findings also revealed that information asymmetry positively affects access to finance.

According to a study done by Nanyondo, Tauringana, Kamukama, andNkundabanyanga (2014), findings revealed that there was a significant positive relationship between quality of financial statements and access to finance and a significant negative relationship between information asymmetry and access to finance.

The East African Community (EAC) Banks Report (2012) SME's access to credit is affected by managerial incompetence in deciding what information and degree of disclosure. This leads to an increase in information asymmetry between the SMEs and the bank. Opondo (2012) SME's face higher cost of debt because they are considered to be more risky since bank mangers base their lending decisions on the quality of information that is disclosed. DeYoung, Glennon, Nigro and Spong, (2012) argue that informational asymmetries between borrower and lender may limit the types of lenders and the lending but audited financial information is able to reduce information asymmetry.

2.13 Literature Gap

While SMEs access to finance from financial institution have been investigate, banks did not maintain separate record of their lending to SMEs. To address this gap in assessing banks' lending to SMEs data collected using questioners that distributed to professional loan officers by preparing Questions that used to get the share of loan provided to SMEs from the total loan disbursed by the banks.

CHAPTERTHREE

Research design and methodology

The purpose of this chapter is to present the research method used by the study. It presents in detail the Research Design, Population and Sampling Techniques, Method and procedure of Data Collection, and Method of Data analysis and presentation.

3.1. Research Design

The study is a descriptive study that aims to describe the current trend of Addis Ababa banks in providing financing to SMEs.

3.2 Research Approach

The rationale for combining both quantitative and qualitative data to better understand the research problem by combining both numeric values from quantitative research and the detail of qualitative research to neutralize limitations of applying any of a single approach. Both forms of data collected simultaneously and integrates the information in the interpretation of the overall results. This research carried out by investigating Banks' Lending to SMEs that are operating in Addis Ababa, in order to attain the objective of the study and answer the research questions, the researcher adopted both quantitative and qualitative (Mixed) research approach.

3.3 Sampling Technique

The research based on 602 workers from six institutions. Stratified sampling procedure along with simple random sampling followed. The total sample size first distributed to each Banks proportionate to number of employees found in loan departments. Stratified random sampling is the process of segmenting target population into strata and obtaining information from each stratum.

3.4 Sample Size

The study conducted on banks, which ranked as largest lenders by National bank of Ethiopia in 2019/2020 facial year. There is an inverse relationship between bank size and the propensity to lend to small firms (Journal of international money and finance, 2022). In other words, propensity of banks to lend to small business decrease as the size of Banks become larger and vice versa. The

A sample size is a smaller set of the larger population (Cooper &Schindler, 2010). sample should comprise between 10-30% of the population, and a good population sample should be at least 10% and not more than 30% of the entire population Kombo and Tromp (2006), in order for a researcher to get accurate results, a sample size was collected using the formula n= N/ (1+Ne2). The sample size out of each stratum is as follows;

Banks	No Employees
DBE	142
CBE	102
AWASH	85
DASHEN	81
WEGAGEN	64
COOP	56
BOA	72
TOTAL	602

(Source human resource of the banks)

n= sample size   e= error of margin

e= 5%

n= N/ (1+Ne2)

602 /(1+602(0.05)2) = 240

From the total population 240 samples selected and the total sample divided among each stratum as indicated in the nh = (Nh/N)*n

Where: - nh = Sample size for hth stratum

Nh = Population size for hth stratum

N = Size of entire population

n = Size of entire sample

1st stratum – development bank of Ethiopia

nh = (142/602)*240 = 56.6 2nd stratum –

commercial bank of Ethiopia

nh = (102/602)*240 = 40.66 3rd stratum –

Awash bank

nh = (85/602)*240 = 33.88 4th – stratum

Abyssinya

nh = (72/602)*240= 28.7 5th stratum -

Wegagen

nh = (64/602)*240 = 25.51 6th stratum -

COOP

nh = (56/602)*240 = 22.3 7th stratum – Dashen

nh = (81/602)*240 = 32.29 8th

Table 3.2 Sample from Each Banks

Banks	No Employees	Rate	Sample
DBE	142	0.236	57
CBE	102	0.17	41
AWASH	85	0.140	34
DASHEN	81	0.135	32
WEGAGEN	64	0.106	25
COOP	56	0.093	22
BOA	72	0.12	29
TOTAL	602	1	240

3.5 Data type and method of data collection

Data collection is an important component to conduct a research. The common data sources of researches are primary data sources and secondary data sources. Both primary and secondary data used to conduct the research.

3.5.1Primary data

The primary data the researcher uses are the data pertaining to the issues core to the research collected using questionnaire incorporating appropriate questions in respective categories. The questionnaires distributed to loan department staffs of selected banks operating in Addis Ababa. The questioner were distributed to 240 employees of the banks which ranked by National banks as largest banks in 2019/2020 fiscal year. From the total questioner disbursed 194 were collected the remaining uncollected because of different reasons. The questionnaire composed of Three parts the first part Gender and second part includes status of the employee, the third part includes detail questions about type of business loan provided and preconditions that are expected to be fulfill and their effect on Bank lending to SMEs that used to understand specific factor which affect Banks' lending to SMEs.

3.5.2 Secondary data

Secondary data derived from Loan manual of selected banks, annual report of selected banks, published article and NBE directives used to extract data used to answer specific research questions. In addition, the periodic government body's publications and report of development partners are the main source to see the extent to which the small businesses are accessing credit facilities.

3.6 Methods of Data Analysis

The analysis method that used by the researcher descriptive. After all the relevant data collected, data preparation including editing, coding, and data entry made. This step include activities that ensure the accuracy of the data and their conversion form raw from to reduced and classified forms that are more appropriate for analysis. Preparing a descriptive statistical summary was another preliminary step that the researcher conducted to carry out that lead to an understanding of the collected data. The coded data by assigning symbol to responses of the population, to group into limited number of categories; data entry made to Microsoft Office Excel. Statistical instrument like measures of central tendency and measure of variability used. To visualize the data frequency tables, bar graphs and pie charts used. These instruments have used to facilitate interpretation process of the research. Finally, from the premises indicated 25 in the analysis and discussion the research derived finding and conclusion, which in turn helped to recommend the possible action to be taken.

Chapter Four
Data Analysis and Presentation

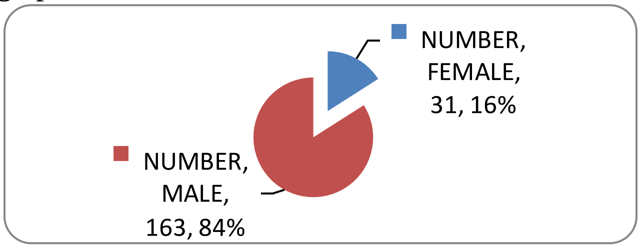
Introduction

This section presents the results and analysis of data collected via questionnaire and secondary document analysis. The data presented in way that shows SMEs, Banks and government side factors that have influence banks' lending to SMEs. In the first subsection, the Demographic condition of samples presented and next part deals with respondents job status in the loan department and the third part includes all issues that answers specific question of the research. In the survey respondents asked about different possible obstacles, which affects their lending. Respondents asked to rate the degree of the obstacles on a scale ranging from no obstacle to very sever obstacle and to higher Demand to no demand. However, the scales were further reduced into two obstacle or no obstacle by categorizing the no obstacle and minor obstacle into no obstacle, and the remaining three, i.e., moderate obstacle, major obstacle and very sever obstacle, into obstacle. The answers to the constraint questions were subjective but they contribute to a better understanding of the nature and degree of constraints SMEs face in Ethiopia.

4.1 Demographics Analysis

This section contains results on demographic analysis, which include; age group of the respondents, their profession and their level of income. It shows the demographic characteristics of the majority of respondents 84% were male only 16% respondents were female.

Figure 4.1Demographic characteristics

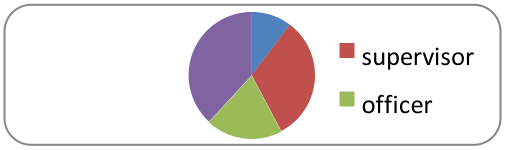


(Source survey questioner)

4.2 Respondents Status

The study was also interested in the position of the respondents and figure 4 below shows the results. Those at the clerk level were the majority represented by 38% followed by supervisor level, which was 32%. Managers had the least respondents at 10.3% as shown below.

Figure 4.2 status



(Source survey questioner)

This section contains descriptive analysis of the study variables. Custom tables containing percentages mean and standard deviations of all the items used to test how respondents agreed to various statements. The descriptive results of every variables shown in the subsections discussed below.

4.3 Discussion of the Banks loan products and preconditions

The study sought to know the extent of SMEs demand for each type loan to which various factors influenced access to finance and its availability for small and medium enterprises in Addis Ababa. The extent to which the factors influenced access to finance and its availability was measured on a five point Likert scale to measure perception of constructs ranging from strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5). The key for interpreting the means recorded is as shown in Table below.

SMEs Demand for Business loan provided by Banks.

Range	**Extent of Influence**.
1.0 – 1.5	No request
1.6 – 2.5.	Lower request
2.6 – 3.5.	Moderate request
3.5 – 4.5.	Higher request
4.6 – 5.0.	Very high request

Table 4.1 SME Demand for each loan products

Loan products	Mean	Std. deviation
Agricultural loan	1.9588	0.73291
Export loan	1.5361	0.58588
Import loan	3.5670	0.96474
Machinery & motor vehicle	4.1701	0.83134
OD	4.1134	0.80640
Project financing	2.8093	0.71238
Commercial building	2.2526	0.43561

(Source survey questioner)

4.3.1Agricultural sector loan

Agricultural loan granted for the purchase of agricultural inputs such as fertilizers, selected seeds, agro-chemicals, rental or purchase of agricultural machinery and equipment; for crop collection, processing, and marketing of agricultural products mainly focused on projects producing exportable products like flowers, fruits, and vegetable and agro-industry developments such as dairy farming, cattle fattening are eligible for this type of loan facility.

In the survey questioner respondents asked to rate the demand of SMEs for agriculture loan that the bank provides. The study found out that request for agriculture loan by SMEs is lower level (M= 1.9588, SD= 0.73291). Banks have unique loan products, which focuses on financing agricultural businesses, primarily small and medium farmers who tend to be located in rural areas but Banks does not meet their goal in addressing to SMEs. The lower demand can be improved by creating awareness to SMEs about the availability of the products to SMEs

4.3.2 Line of Credit/Overdraft

Overdraft is a form of credit facility by which a customer allowed to draw beyond the deposits of its current accounts for the day-to-day operational needs of a viable and ongoing business, for short-term financing needs like seasonal purchases, operating expenses and working capital. The table4.1 indicates there is higher request for over draft (M=4.1134, SD=0.80640),SMEs have highest need of working capital loan to support their ongoing business. This result is support of world bank report (FCI GP), (2019) SMEs mainly needed finance for short-term needs like seasonal purchases, operating expenses and working capital. Having sufficient working capital is an ongoing challenge faced by all business. It is not hard to see why business, including SMEs take working capital loan cover day-to-day costs; it helps to explore new business opportunities. Business opportunities come and go quickly to rising trends, it is important for SMEs to be opportunistic. To do this SMEs need enough funds, which is where working capital loan come in handy. This extra cash on hand allows SMEs to take on new opportunities, which potentially generate higher revenues (World bankreport)

4.3.3 Export Loan

Export loan extended to customers, which have an export permit and engaged in export business. The Survey conducted with employees of the bank's loan department shows that there is lower request for export loan (M=1.5361, SD= 0.58588). SMEs are less likely to request for export loan, because this Export sector requires higher capital and advanced technology to create quality products, which can compete in international market as most of SMEs in Ethiopia lacks. It was established that many firms, especially small firms have significant exporting potential, however, relatively few of them undertaken actual exporting, this is mainly attributed to the firms difficulty in accessing funds for export (yeohand jeong, 1995).

Many SMEs do not engaged in the export sector, hence they have a reduced demand for export financing. These bank products designed to meet the demands of exporters and aid in the growth of the export sector, however they were unable to reach SMEs. Increasing SMEs' understanding of various bank products and making changes to requirements that benefit SMEs.

4.3.4 Import Loan

An import Letter of Credit Facility may be availed to an importer whose funds temporarily tied up in stock or other current assets that are easily convertible to cash, in the event that he/she/it experiences a temporary shortage of working capital. The result of the survey shows there is moderate request by SMEs for import loan (M=3.5670, SD=0.96474).There is a gap in satisfying the existing moderate demand to SMEs. The bank requires proven record of the business in maintaining adequate credit history and SMEs mainly lacks on the other side government sets products that has been given priority when the bank accepts their import request because of the existing lower foreign currency availability in the country.

4.3.5 Motor Vehicle and machinery loans

Banks provide loans to licensed transport operators for the purchase of transport vehicles such as trucks, tankers, and public transportation buses, as well as machineries. The demand for motor vehicles and machinery loans is high (M=4.1701, SD= 0.83134), but the bank requires SMEs to contribute 30% or more in equity, which reduces bank lending to SMEs. To fill this gap, the bank should make the preconditions more flexible for SMEs by using leasing to finance vehicles, machinery, and equipment. Motor vehicle and machinery financing allows businesses to upgrade their operations, resulting in increased productivity, lower transaction costs, increased employment prospects, increased corporate profitability, increased innovation and creativity, and expanded product options.

4.3.6 Project Financing

Loans Bank extends loans to customers who have attractive and profitable projects for establishing new projects, expansion or acquiring existing one. As many SMEs are startup business with new idea or existing they have high need of project financing loan which is more useful for establishment of business major asset or the business major operation is done.

The survey indicates (M=4.1134, SD=0.80640) high demand for project financing loan but there is no bank products and preconditions that specifically arranged for SMEs. For any project financing the borrower shall first commit his/her/its equity contribution to the project and it shall be verified before the first disbursement made by the Bank. The Maximum Bank finance for such purpose shall not exceed 70% of the total project cost. This contribution is hard to be fulfilled by SMEs this makes banks’ lending to SMEs hard.

4.4 The share of loan devoted to small and medium enterprises

The lender borrower relationship starts when loan application made, after that it passes through a complex process before the loan request analyzed and decided. Some of the requests could be accepted and others rejected. In the survey questionnaire, respondents were asked the share of

SMEs from the total loan application during 2019/2020. The table below shows the share of loan applications.

Table 4.2 loan application

	percentage
0% - 5%	16%
6%-10%	79%
11%-15%	5%

(Source survey questioner)

As previously stated, 16 percent of respondents agreed that loan application made by SME is between 0% and 10% of total loan applications in 2019 2020. Moreover, the majority of respondents (almost 79%) agreed that the loan application is in the range of 6 percent _10 percent, while just 5% said the range is between 11 percent _15 percent, no respondent indicating the loan application is greater than 15 percent. We can conclude from the foregoing data that only a small number of SMEs apply for loans, and of those that do, only a small percentage of loan applications get approved. This finding supports Ayaleneh Menberu's assertion that the majority of small businesses studied had no prior experience with banks because of the possibility of rejection high, banks high collateral requirement and using of other external financing like micro financing institutions, family etc. The dominant way of financing small businesses in Addis Ababa was microfinance institutions and other traditional way of financing.

Table 4.3 share of loan gets approval

	Frequency	percent
0% - 5%	79	21%
6%-10%	143	74%
11%-15%	10	5%

(Source survey questioner)

In addition to the decreased number of SMEs applying for loans, 21% of respondents agreed that 0% _5% of loans have been approved, while nearly 74 percent agreed that 6% _10% of loans have been approved, and the remaining 5 percent believed that 11 percent _15 percent of loans have been approved. Despite the great importance of the SME sector to the national economy in terms of job creation and alleviation of abject poverty, many SMEs are unable to use their full potential due to the existence of several constraints that limit their growth and performance. This result supports World Bank report comparing small and large firm's small firms face more challenges in obtaining formal financing than large firms do; they are much more likely to be rejected for loans, and are less likely to have external financing.

4.5 Key factors that constraints Banks' lending to SMEs

Bank specific factors includes factors that specifically emanate from banks related to their lending policy that affect Banks to provide loan to SMEs.

4.5.1.1Collateral

Imposing collateral requirements on a loan contract is a traditional bank practice to eliminate information opacity and to align the interest of borrowers with the interest of banks (Besanko, Thakor 1987; Boot et al. 1991). Beck et al. (2006), using the World Business Environment Survey (WBES), find that collateral requirements are the third of 12 most important financing obstacles for SMEs. Results from the EBRD and World Bank Business Environment and Enterprise Performance survey (BEEPS) in Eastern Europe and Central Asia indicate that collateral is the fourth most important financing obstacle for external loans.

All of the Banks selected as sample accepts same type of collaterals when review the Banks loan manual this collaterals includes

- Machineries and Equipment
- Private residential/commercial buildings/house
- Buses, Automobiles, and construction cars
- Merchandise, Agricultural products
- Government Bond, Treasury bill, share
- Corporate, Personal, Business guarantee Deposit in bank account

(Sources bank loan manual and annual report 2019)

Banks use the above listed collateral to guarantee loans, but in practice, buildings account for nearly 78 percent of the total, followed by motor vehicles. As shown in the table below. Because SMEs lack substantial collateral such as buildings and automobiles. Increasing the share of other types of collateral currently accepted by banks, such as machinery, shares, bonds, and motor vehicles, as well as using new mechanisms such as personal guarantees and business guarantees in addition to tangible assets, would increase bank lending to SMEs by giving them more options and flexibility in terms of collateral.

Table 4.4 share of collateral

Collateral type	Share from total value of collateral
Building	78.2%
Motor vehicles	8.4%
Machinery's&equipment	3.8%
Share&governmentbonds	7.5%
others	2.1%

(Source Annual report of banks 2019/2020)

Small enterprises thought to be untrustworthy, and their assets frequently fail to satisfy lenders. The current trend in Ethiopia's financial industry reveals that land and buildings are the most commonly acknowledged in the formal market (FreduNega and Edris H. Seid, 2016). This is in line with the survey's findings, which show that in 2019_2020, Banks only maintain a restricted number of different types of collateral, indicating that they are not flexible when it comes to the types of collateral that used to guarantee a loan.

As clearly stated in the loan manual of Banks there are situations collateral requirement become flexible. Banks may extend fully unsecured or partially unsecured loans to its prime/corporate customers based on the result of credit risk analysis/appraisal reports. Fully unsecured loan shall mean loans and advances provided without any collateral, whereas partially unsecured loan shall mean loans and advances provided against a certain margin of collateral values.

Situations the Bank collateral and other requirements become flexible

- The Customer's credit risk level shall be Grade A or B as per the Bank's Risk Grading. However, for project financing loans, this criterion shall not be applicable.
- The financial position of the customer should show adequate repayment capacity to pay all loan obligations.
- The owner/Manager of the business must have the capability, honesty, integrity and willingness to repay as well as a good track record with the concerned bank;

The borrower must be in business for at least one year after obtaining a trade license (loan manual of the selected Banks).The above listed situations are targeted to full fill the corporate customer's needs, the loan manual of selected banks shows that there is no preconditions that become flexible or make situation favourable for SMEs this is the other major obstacle identified that affects Banks' lending to SMEs.

4.5.1.2 Loan to value (LTV) ratio of the bank

The lower LTV would mean the borrower must present high valued collateral in order to secure a loan. This could largely exclude borrowers without sufficient collateral. The table below shows the ratio of value of loan to value ratio of Banks.

Table 4.5 LTV ratio

Banks	Amount of loan disbursed 2019/2020	Average value of collateral held 2019/2020	Loan to value ratio
CBE	141,415,240,000	212,122,860,000	0.657
COOP	29,333,460,000	154,933,916,000	0.19
DBE	40,248,990,000	64,398,870,000	0.625
DASHEN	29,333,460,000	120,384,870,000	0.24
BOA	37,247,900,000	66,331,447,000	0.56
AWASH	57,274,280,000	96,867,761,000	0.59
WEGAGEN	23,714,140,000	178,256,411,000	0.13

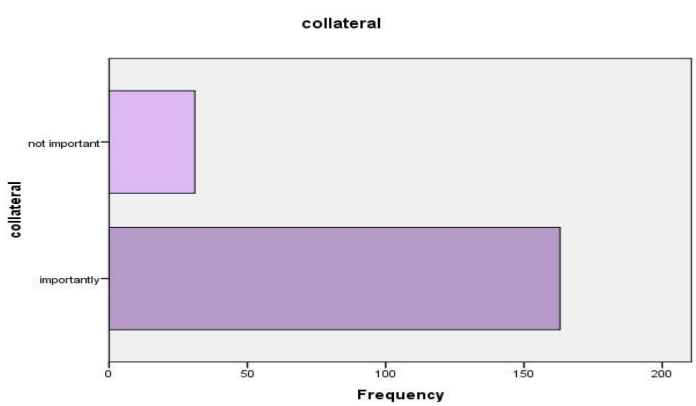
(Source Annual report of banks 2019/2020)

The above table shows that government banks have high LTV value, which indicates lower value of collateral requirement compare to private banks, which have lower LTV.This indicates that the collateral requirement is almost forth times to the loan provided. This is significantly higher than what we get in the literature many financial lenders require the loan to value ratio to be no more than 75%. The current situation exists especially in private Banks don't take SMEs into consideration this results unfair distribution of resources as the result of cash is collected from all levels of the society and providing loan for customers which have higher potential to pledge high value of collateral.

4.5.2 The impact of existing collateral requirement of banks' lending to SMEs

In the survey, questionnaire respondents were asked about the impact of the banks high value of Collateral and few type of collateral accepted in providing finance to SMEs on the scale ranging from very importantly, importantly, not importantly. The answers to the questions were subjective but they contribute to a better understanding of the nature and degree of constraints SMEs face in Ethiopia.

Figure 4.3 Impact collateral requirement



The figure reveals that nearly 84 percent of respondents agreed that lower LTV requirement, limited type of collateral accepted constrains Banks to provide loan to SMEs. Small businesses are perceived as low creditworthy, so banks often require these borrowers to pledge collateral to guarantee their later payment but most of SME establishments do not fully own the buildings and other acceptable high valued collaterals. This result agrees with (FreduNega and Edris H. Seid, 2016) Small enterprises have a LTV, which is almost half of the LTV of medium enterprises.

While medium size firms' e value of collateral is slightly more than double of the value of the loan, for small firms the value of collateral is almost five times the value of loan. Using other type of risk mitigating factors will be better to increase Banks' lending, It was suggested that lending institutions should evaluate their lending policies hence encourage SME's to take credit.

4.5.1.2 Interest rate

The current average interest rate the banks currently charges is higher its almost double compare to the interest rate the bank pays for the deposit it collects currently the bank pays 7% interest on their normal saving accounts. When we compare governmental and private banks average interest rate governmental banks charged lower interest than private banks, there exists minimum of 2% difference but the interest rate charged by banks is still high as shown in the next table.

Table 4.6 Average Interest rate charged by banks

Banks	Average borrowing rate
DBE	14.5%
CBE	14.5%
AWASH	16.2%
DASHEN	16%
WEGAGEN	17%
COOP	17.5%
BOA	16.5%

(Source bank loan manual)

4.5.3 The impact of interest rate on Banks' lending

In the survey questionnaire, respondents asked to rate the impact of interest rate in providing finance for SMEs very importantly, importantly and not importantly the result shown in the table.
Table 4.7 Effect of interest rate on banks' lending

	percentage
Very importantly affect	70.6%
Importantly affect	29.4%

(Source survey questioner)

High interest rates on SME loans de motivate SMEs to apply for loan because the higher interest rate the bank charged slows down business operation and hence reduces profit margin of SMEs, Higher interest rate increases the chance of default in payment and finally lower the returns on capital employed (Karanja, Mwangi, andNyakarimi, 2014). Moderate and low interest helps to improve business performance. In the survey questionnaire respondents were asked to rate the impact of interest rate in providing finance for SMEs very importantly, importantly and not importantly, 70.6% of respondents agree that the higher interest rate charged by the bank very importantly affects lending to SMEs and the remaining 29.4% importantly affect Banks' lending to SMEs.

The higher interest rate the Bank charges first indicates the higher credit risk, because there are conditions that stated in the bank loan manual that the interest rate charged becomes lower and there are situation that customers deal with the bank about the interest rate. If the customers are corporate and with good reputation and the bank benefits from the customer like foreign currency the lending rate become lower to 7% which is equal to the bank accepts its deposit. But the selected banks did not have any situation that the interest rate become flexible for SMEs. The existing NBE directive gives banks the right to set their lending rate this results higher interest in the market. This higher interest charged de motivate SMEs to apply for loan because the higher interest rate the bank charged slows down business operation and hence reduces profit margin of SMEs, Higher interest rate increases the chance of default in payment and finally lower the returns on capital employed. Moderate and low interest helps to improve business performance.

4.5.2 Small and Medium Enterprises Specific Factor

4.5.2.1 Formality of SME

The formality of SMEs includes important factors that affect Banks to provide finance for SMEs that specifically results from informality of SMEs. In the survey conducted respondents were asked to rate the effect of formality of SMEs in providing loan to SMEs 62.9%   very importantly affects bank lending and the remaining also agreed that it importantly have an impact. Formality includes Management Weaknesses and business knowledge, lack of standardize audited financial statement, formal registration and trade license and others the existence of this informality importantly impacts bank lending. Table 4.8 Formality of SMEs

	percentage
Very importantly affect	63%
Importantly affect	37%

(Source survey questioner)

The SME specific factor mainly deals with informality of SMEs the result shows consistent with other findings in the literature. For example, Mills et al. (2006) show a positive correlation between a positive lender-borrower relationship and the approval of a loan. Similarly, firm age has entered with a positive sign and is statistically significant. The older and more established firms are, the better their probability to have access to finance.

Another determinant factor that related to SMEs to have access to finance is their lending history Lending relationships should be most valuable where information about a firm and its potential investment opportunities are most uncertain. This is in conformity with previous findings (see for example, Petersen and Rajan, 1994; Berger and Udell, 1995; Miller, 1995)loan history of firms has entered with a positive sign and is statistically significant implying that SMEs with previous lending history increases their probability of getting credit from banks.

4.5.3 Government related factors

This factors related to the existing government policy that affect banks lending to SMEs. The monetary policy in Ethiopia aim to maintain price and exchange rate stability and support sustainable economic growth through monetary policies

The potential involvement of government in bank lending is through the monetary policy. It is self-evident that monetary policy plays an important role in the performance of an economy. Outstanding credit to the private sector grew at 40.8%, and disbursement during the month grew at about 125%, compared to the same period of last year. Such a rapid growth of credit poses significant risks to price and financial stability, in the context of a rising inflation which reached 26.4%. Consequently, the Board has decided to raise the reserve requirement on Birr and foreign currency deposit liabilities held by commercial banks to 10% (ten percent), from the current level of 5% (five percent), effective on September 1st, 2021. Banks are given a transition period of 3 months to meet the 10% reserve requirement as per Directive No.SBB/80/2021. This results policy lowers Banks lending as banks as the result the share of banks lending to SMEs much lower than the existing lower supply.

Interest rate on banks' individual lending facility. While the purpose of the individual banks' lending facility is to help commercial banks meet unexpected liquidity needs by borrowing from the NBE, some banks are seen repeatedly accessing the facility to finance their aggressive lending.

Hence, the Board has decided to increase the interest rate on facility to 16% (sixteen percent), from its current level of 13% (thirteen percent) to discourage overutilization of the facility for lending purposes. This also lowers the Bank's lending. This strategy is use full if NBEs uses to benefit SMEs by enforcing and follow banks to use the loan specifically to finance SMEs.

Standing central bank credit facility is another instrument used to enhance the financial capacity of commercial banks and to promote financial intermediation and efficiency. The key advantages of such standing credit facility are transparency and predictability of accessing central banks' resources to cover short-term needs.

Open Market Operation (sale and purchase of government bonds or securities) has long been regarded as one of the most important vehicles for the development of money markets. Trading in these instruments liquefies the financial system, as well as the national economy, and boosts financial intermediation between market players. In light of this, the NBE will conduct open market activities (government sale and purchase).

- The NBE allows banks to "freely choose lending rates on loans advances, which shall be fixed in writing by the board of directors of each bank." The government is uninvolved in

> the interest rate charged by the Bank. There is no legally recognized agency in Ethiopia that can register machinery and/or equipment as collateral. As a result, concerns with collateral and insufficient contract enforcement stifle secured lending and limit SMEs' access to capital by putting lenders at risk.

(From the National Bureau of Economic Research's monetary policy framework, 2009).

Existing NBE monetary rules are a good way to regulate bank lending, but they have not been used to give loans to small businesses. There is no law requiring banks to lend to small businesses. The financial regulatory environment in Ethiopia gives the country's financial sector a near-monopoly position. Banks are in the business of giving loans to huge corporations in the hopes of making a profit. The market is open as long as the benefits are great and there are no risks or threats of competition. Banks are not compelled to lend to small businesses by the government's monetary policy.

Chapter Five

Summary of finding, Conclusion and Recommendation

The Bank's lending to SMEs discussed in this article. It included a detailed description of bank loan products, preconditions for guaranteeing loans, and factors affecting banks and SMEs funding. The investigation began by determining the bank's product and the conditions that the bank imposes on borrowers. The investigation then moves on to the products that SMEs demand, as well as the important preconditions that affect SMEs' access to financing from the perspective of banks, as well as potential areas of government participation connected to SMEs' access to finance and SME specific issues.

5.1 Summery of finding

In the survey questioner respondents asked to rate the demand of SMEs for agriculture loan that the bank provides. The result indicates that request for agriculture loan by SMEs is lower (M= 1.9588, SD= 0.73291). Banks have unique loan products, which focuses on financing agricultural businesses, primarily small and medium farmers who tend to be located in rural areas but Banks does not meet their goal in addressing to SMEs.

The (M=4.1134, SD=0.80640), indicates there is higher request implies highest need of working capital loan to support their ongoing business. This demonstrates that while banks have products that fulfill the demands of SMEs, there is a vacuum in the market for addressing this type of loan for them because SMEs typically lack solid collateral and the ability to pay higher interest rates that expected by Banks.

Export loan extended to customers, which have an export permit and engaged in export business.

The Survey conducted with employees of the bank’s loan department shows (M=1.5361, SD= 0.58588) implies lower request for export loan (M=1.5361, SD= 0.58588). SMEs are less likely to request for export loan. These bank products designed to meet the demands of exporters and aid in the growth of the export sector, however they were unable to reach SMEs.

The result of the survey shows there is moderate request by SMEs for import loan (M=3.5670, SD=0.96474).There is a gap in satisfying the existing moderate demand to SMEs as the result of bank requires proven record of the business in maintaining adequate credit history and SMEs mainly lacks. On the other side government sets products that has been given priority when the bank accepts their import request because of the existing lower foreign currency availability in the country.

The demand for motor vehicles and machinery loans is high (M=4.1701, SD= 0.83134), but the bank requires SMEs to contribute 30% or more in equity, which results SMEs reduces bank lending to SMEs.

The survey indicates (M=4.1134, SD=0.80640) high demand for project financing loan but there is no preconditions that specifically arranged for supporting SMEs. For any project financing the borrower shall first commit his/her/its equity contribution to the project and it shall be verified before the first disbursement made by the Bank the bank contribution cannot exceed 70 percent of total project cost.

The result of the survey indicates16 percent of respondents agreed that loan application made by SME is between 0% and 10% of total loan applications in 2019 2020. Moreover, the majority of respondents (almost 79%) agreed that the loan application is in the range of 6 percent _10 percent, while just 5% said the range is between 11 percent _15 percent, no respondent indicating the loan application is greater than 15 percent. We can conclude from the foregoing data that only a small number of SMEs apply for loans, and of those that do, only a small percentage of loan applications get approved all of the respondents agreed that the approval range is not exceed 15% of the total loan application.

Banks currently uses building, which comprises 78.2% from the total value of collateral held by banks, Motor vehicles take second share 8.4% of the total value of collateral. Share and government bonds takes 7.5%. Machinery's& equipment takes the list share 3.8% and the reaming 2.1% stated as other type of collateral.

There are situations collateral requirement become flexible. Banks may extend fully unsecured or partially unsecured loans to its prime/corporate customers based on the result of credit risk analysis/appraisal reports.

Government banks have high LTV value, which indicates lower value of collateral requirement compare to private banks, which have lower LTV. This indicates that the collateral requirement is almost forth times to the loan provided. This is significantly higher than what we get in the literature many financial lenders require the loan to value ratio to be no more than 75%.

The average interest rate the banks currently charged higher the minimum average interest rate is charged by government banks, which is minimum to the existing rate 14.5% the highest interest rate charged by private banks 17.5%. The result of the survey indicates 70.6% of respondents agree that the higher interest rate charged by the bank very importantly affects lending to SMEs and the remaining 29.4% importantly affect Banks' lending to SMEs.

The formality of SMEs includes important factors that affect Banks to provide finance for SMEs that specifically results from informality of SMEs. In the survey conducted respondents were asked to rate the effect of formality of SMEs in providing loan to SMEs 62.9% very importantly affects bank lending and the remaining also agreed that it importantly have an impact.

NBE monetary rules are a good way to regulate bank lending, but they have not been used to give loans to small businesses. There is no law requiring banks to lend to small businesses. The financial regulatory environment in Ethiopia gives the country's financial sector a near-monopoly position.

5.2 Conclusion

Despite the SME sector's huge relevance to the national economy in terms of job creation and poverty alleviation, banks paid no attention to them. Many SMEs are unable to reach their full potential because of a variety of circumstances that stifle their growth and success. Limited access to capital is one of the most important factors contributing to the enterprises' lacklustre growth and performance.

SMEs are terrified of requesting for loans from banks, and only a small number of SMEs have done so. This is not due to a lack of financial necessity on the part of SMEs; rather, it is due to banks' insistence of high-value collateral. Aside from the limited quantity of loan applications, only a small percentage of loan applications approved.

There were no specialized loan packages available from banks that included SMEs in their financing. Agricultural and export loans are available to meet the demands of the sector, but SMEs are less likely to request them. Project financing loans, overdrafts, motor vehicle and machinery purchase loans, on the other hand, are in high demand by SMEs, but these types of loans require a high value of collateral to be pledged, as well as a minimum 30% equity contribution; the existence of these preconditions prevents SMEs from obtaining a loan.

Lack of specific loan products unique or preconditions that are flexible for SMEs supplied by banks are among the identified Bank specific factors that primarily affect Bank lending. The lower LTV ratio that banks demand from their lenders is the second main limitation. Currently, banks, particularly private banks, require collateral nearly four times the amount of the loan they guarantee; government banks, on the other hand, have a higher LTV, but this is still significantly higher than what we see in the literature; many financial lenders require a loan to value ratio of no more than 75 percent.

Banks accept limited type of collateral in addition private residential/commercial buildings have largest share followed by motor vehicles, and other types of collateral will have a minor share. This trend by banks will limit SMEs' access.

The average interest rate the banks currently charges is high as the result SMEs are less likely to request loan from banks. Higher interest rate affects loan repayment.

SMEs-specific issues are the outcome of the features of SMEs' businesses, which render them unable to meet even the most basic formal lending standards. Banks have stated that SMEs' weak financial records, as well as a lack of suitable collateral, are important issues that influence bank lending to SMEs.

There is no policy or corresponding government regulation that tries to make it easier for small businesses to obtain financing. The lack of enforcement in the legal environment, as well as judicial inefficiency, has been identified as a major issue affecting bank lending. When financial institutions operate in a legal environment that is well-functioning, they lend to SMEs at a higher rate. If the legal system is unsound, banks, on the other hand, lend more to huge businesses and the government.

The willingness of banks to take collateral determined by the bankers' perceptions of the applicable legislation. Collateral registries are databases of assets' interests or ownership that are open to the public. A well-functioning collateral registry is required for a comprehensive and integrated secured transactions regime to thrive. This institutional and infrastructure mechanism helps to support the legislative framework for security rights in movable assets by making them more visible and establishing priority based on the time of registration.

There is no legally recognized agency in Ethiopia that can register machinery and/or equipment as collateral. As a result, concerns with collateral and insufficient contract enforcement stifle secured lending and limit SMEs' access to capital by putting lenders at risk.

The NBE bill purchase mandate continues to stifle private commercial bank operations, favoring current, well-established clients over newer, riskier SMEs when it comes to loan allocation.

5.3 Recommendation

To help SMEs overcome their financial difficulties, the government should ensure that they have access to financing from banks and other financial organizations. Under a so-called "mandated credit extension system," the monetary policy that oversees banks compel public and private banks to extend loan quotas to SMEs. The government should provide practical assistance and advice to banks and financial institutions in order to develop an effective mechanism for lowering the cost and risk of lending to small businesses. To achieve mutual benefit by utilizing a standing credit facility in which the government provides funds/finance through banks acting as agents, with the sole purpose of financing small and medium-sized enterprises (SMEs), and by establishing a control mechanism through the national bank to prevent funds from being misused.

To address short-term liquidity problems, the government could cut reserve requirements, NBE bill purchase requirements, and the interest rate NBE lends to individual banks. This will boost bank liquidity and result in increased lending potential.

Banks credit policy should include better information provision regarding the various business loan available. This could involve the financing initiatives, unique products which full fills the demand of SMEs, pursuing a more aggressive and continuous marketing communication campaign to inform SMEs of the various financing schemes available in Banks and increase The loan application and also the lending to SMEs.

To enable more SMEs to qualify for access to their money, eligibility rules made a little more liberal. Qualified experts linked with these programs may evaluate applicants' plans, and banks should instead be chosen as managers of loan facilities for a charge, with the government bearing the credit risk. This might speed up the process even more, giving candidates a higher chance of getting into these facilities.

Banks should employ new lending technologies that reduce the highest collateral and interest rate requirements, thereby lowering their lending risk and improving SMEs' access to capital. The following are examples of new lending technologies: Financial statement lending is the extension of credit based on a good financial situation as represented in financial ratios generated from these statements. This sort of lending is beneficial to businesses who do not have adequate assets to put up as collateral with the bank.

Purchase Order Financing (POF) can help growing businesses with limited working capital and poor cash flow that receive orders that are larger or more frequent than their current ability to pay suppliers upfront. In this case, of factoring, the SME's creditworthiness typically enhanced by the link to a larger company placing the order. In this context, as part of the Supply Chain Finance arrangement, POF can be a viable financing vehicle for small businesses involved in supply chains.

It is better to use leasing in the financing of small and medium-sized enterprises who require capital to expand but lack the necessary credit history or collateral to obtain credit from traditional lenders. Leasing is a flexible method of finance that comes with a number of benefits. One of the most significant benefits of leasing is that the leased asset serves as the primary security in the lease agreement. Vehicles, machinery, and equipment financed through leasing by businesses all over the world.

5.4 Suggestions for Further Study

The study recommends further research in the following areas;

- SMEs will be included in future surveys to understand demand side perceptions of bank lending.
- It is preferable to include all Ethiopian banks in order to gain a better understanding of the current lending trend.

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Appendix I Survey Questionnaire for SMEs

St marry university

COLLEGE OF BUSINESS AND ECONOMICS

DEPARTMENT OF BUSSINESS ADMINSTRATION

SURVEY QUESTIONNAIRE

Dear Participants

The name of the researcher is MEDHANIT ADANE, who is currently student in **St MARRY University.** The aim of this project is to **ASSESSMENT OF BANK PROVISION OF FINACE TO SMEs IN case of ADDIS ABABA.** The information collected from this survey questionnaire will be used for finding information about key constraints to get access to loan and their effect. The researcher does believe that the outcome of the research will be helpful in providing short term as well as long term solution for the challenges that these enterprises are facing.

The participation in this survey is totally voluntary. The investigator respectfully requests your kind cooperation in answering the whole question as frankly as possible, regardless of whether or not you have requested financial sources. Your response is anonymously and strict confidentiality will be maintained. Your participation in this survey is greatly appreciated.

For further information, please contact the researcher using the following address:

Tel. (mobile): +251-921728266

E-mail: medeadane@gmail.com

Part I - General Information of the Respondent

About You

1. Gender: Female

Male

2. Status: Manager Supervisory level

Officer level Clerk

Assessment of bank provision of finance for SMEs

3 From the total loan application with in the last one year what is the percentage of SMEs?

0%-10% 11%-20%

21%-30% 31%-40%

41%-50% 51%-60%

61%-70% 71%-80%

81%-90% 91%-100%

4 From the total number of loan provided by the bank share of total loan

0%-10% 11%-20%

21%-30% 31%-40%

41%-50% 51%-60%

61%-70% 71%-80%

81%-90% 91%-100%

3 The SMEs request for the business loan provided by SMEs? Insert ✓

Loan type	Very high request	High request	Moderate request	Lower request	No request
Over draft					
project					
Motor vehicle& machinery					
Commercial building					
Import					
export					
Agricultural					

4 Do you think that banks current loan to value (LTV) ratio and limited no of collateral accepted affect the bank lending to SMEs?

Very importantly ☐ Importantly

Moderately important ☐ Not importantly ☐

5 Do you think banks are flexible in their collateral requirement to create favorable conditions for SMEs?

Strongly disagree ☐ Neutral ☐ Agree ☐ strongly agree ☐

6 Is the current interest rate the bank charges affects banks to provide loan to SMEs?

Very importantly ☐ Importantly

Moderately important ☐ Not importantly ☐

7 Do you think the existing loan policy of the Bank supports SMEs?

Strongly disagree ☐ Neutral ☐ Agree ☐ strongly agree ☐

8 Do you think the formality of SMEs affects bank lending to SMEs?

Very importantly ☐ Importantly

Moderately important ☐ Not importantly ☐

9 Do you think that the current government policy helps SMEs to access finance from Banks?

Very importantly ☐ importantly

Moderately important ☐ not importantly ☐