

# Credit Risk Aspects and Mitigation Strategies in SMEs Lending

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## Abstract

In most developing countries, financial institutions apply credit risk management as safeguard assets of the credit portfolio, deposit and improve loan recovery. In this regard, this research outlines the importance of risk management within financial institutions and focuses on credit risk. This paper is based on literature review to identify all relevant risks associated with credit transactions. As a result, it focuses on credit mitigation paths to provide strategies to minimize or eliminate these credit risks.

**Keywords:** Credit Risk, Mitigation Strategies, Loans, Financial Institutions, SMEs.

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## 1. Introduction

In recent past years, developing countries have started paying attention to SMEs as key drivers of the national economy and they play a crucial role in furthering prosperity and innovation. They are a source of employment and innovation but unfortunately, they are challenges affecting the growth and expansion of SMEs in developing countries. Despite the high liquidity of banking institutions in recent years, they may not be able to access local banking services and face highly unfavorable lending conditions. However, access to finance remains the greatest economic challenge for SMEs all over the world and need cooperation from all the parties involved in the business process.

For this purpose, access to finance is necessary to create a business environment that enables SMEs to grow and prosper. In developing countries, particularly in Cameroon, SMEs face significant barriers that impact their access to finance. Increasing the access to finance for SMEs can improve the economic condition by fostering innovation and Gross Domestic Product (GPD) growth. SMEs worldwide listed financing constraints as the second most severe obstacle, while large companies placed it only fourth<sup>1</sup>.

In general, financial constraints are higher in developing countries, but SMEs are particularly constrained by weaknesses in the financial system such as high administrative costs, high collateral requirements and lack of experience of financial intermediaries. Increasing the access to finance for SMEs can improve economic conditions in developing countries by fostering innovation, macro-economic resilience, and GDP growth (Dalberg report, 2011).

The effect of access to finance varies depending on business size and environment. In SMEs investment is often riskier. Consequently, access to low risk collateral is naturally lower than for large and well-established companies. About access to finance, World Bank Enterprise (2010) states that Micro-enterprises in Sub-Saharan Africa have some access to finance through microfinance, personal loans, and moneylenders. These sources of credits are more limited for SMEs.

In Cameroon, barriers to financing particularly affect SMEs more than large enterprises. Not only SMEs reports higher financial barriers, but they are also more affected by these barriers. This might be due partly to a lack of other financing sources, and partly because it hinders SMEs from taking advantage of economies of scale. However, the banks aim to maximize their profit, so they seek simultaneously the highest possible return on assets or loans, with high-quality investment, and reduce the lending risk that might be achieved by dealing with borrowers who can pay a high-interest rate and are unlikely to default. These factors make it difficult for SMEs quest to borrow from banks (Al-Anagre et al., 2005).

This research is important to fulfill the research gap in credit lending and credit mitigation strategy areas which present the main factors adopted by the credit decision-maker in Banks for evaluating and managing risks in SMEs.

The purpose of this paper is to understand the current trend of credit lending decision making for SMEs and identify the risks specific involved in the attribution of credit to SMEs. This paper proposes also possible mitigation strategies to eliminate credit risks.

This research was guided by the following questions: Which are the different risks involved in the credit lending process for SMEs? What risk mitigation strategies are used to managing the credit risks and improve the SMEs' lending process in Banks?

## 2. Credit Risk Management

Risk management is the process of identifying risks and planning actions to manage the risks. The identified risks

<sup>1</sup> World Bank Group, Enterprise Surveys Database, 2010

are assessed; prioritized and only significant risks are managed. According to Barton, Shenkir and Walker (2002), risk management decision-making is a process of selecting the best possible alternatives or ranking alternatives for a specific risk management objective. The ultimate goal of risk management is to create, protect and enhance shareholder value by managing the uncertainties that influence the achievement of business objectives.

Frequently, risk managers have to make a high-stake decision based practically on unlimited information but limited time to analyze and organize the information. Instability and Uncertainty of the business environment also contribute to the complexity of risk management decision-making.

Risk assessment allows managers to classify risks according to their priority and their feasibility. In general, it is based to which extent the likelihood of a risk event's occurrence and it would impact on achievement objectives (Magro and Kellow, 2004). It means that risks that have a higher probability of occurrence must have the priority in terms of attention to developing a response plan. For that reason, credit risks can be considered as one of the most important risks because it is associated with every trade in the banking sector.

The goal of credit risk management is to maintain the efficiency of the business activities and the continuity of business operations. According to Spuchl'áková et al., (2015), credit risk management is monitoring system intent for continuity of the business and considered as one of the important tasks Banks handled.

### **3. Risk and Credit Risks**

The risk is defined as exposure to the chance of injury or loss, a hazard or dangerous chance. The exposure implies the fact that there will be no risk if the company is not exposed to a possibility of loss. According to Mitchell (1995), risk is defined in terms of the probability of loss and the significance of that loss to the enterprise. Generally speaking, risk comprises the probability of a negative event occurring multiplied by how harmful that event would be.

In the field of economics and finance, risk can be defined as a set of random factors that could have a negative impact on a person or organization. The risk is a condition in which, there is a possibility of an adverse deviation from the desired outcome that is expected or hoped. For a risk to be qualified as a financial risk, it must be involved three elements, which are an individual or an organization that is exposed to loss; the asset or income whose loss or destruction shall be the origin of a financial loss and, finally, a peril that can cause a loss. According to this definition, the risk is associated with loss and to a negative impact. This simply means; where there is no loss there is no risk, no matter the risk factors in that environment.

In the banking sector, credit risk is identified as the most important risk and can be defined as the economic loss incurred as a result of the default of a borrower or counterparty. Default does not necessarily mean the legal bankruptcy of the other party, but simply the failure to fulfill its contractual obligations in a timely manner, due to incapacity or unwillingness. The loss results from the financial distress or insolvency of customers. A credit risk assessment had become a particularly challenging issue for banks. It is serving as the stimulus to evaluate the credit admission or possibility of business failure, in order to make aggravate initial movement.

### **4. Some barriers of credit risks specific to SMEs lending**

Financial institutions are faced with many correlated risks, multi-level risks, deriving from macro-economy such as inflation, unemployment, stock market crashes, and so on. The risks have been multiplying after the deregulation period, which brings new products, services and unregulated entities, bearing unknown risks and financial institutions that have developed in other business models than intermediation.

In this section we will first look at a lack of financial information history and, It will demonstrate that the access to loans gap is a complex problem driven by several factors.

#### *4.1 Lack of financial information history*

According to IFC (2010), financial institutions generally grant loans to clients according to their capacity to have verifiable financial information. In doing so, they limited the credit risk associated with lost revenues and assets due to delayed payment or non-payment of loans.

Zeneli and Zaho (2014) affirmed that restrains for funding SMEs came from the lack of true financial information presented by the bank, so banks could not able to evaluate the SME performance. Also, Fatoki (2014) stipulated that banks required audited financial statements before SME lending, to access their credit-worthiness and decrease the risk of default.

Credit risk is an important concern when lending loans for SMEs because they cannot provide the same level of information as to their counterpart the bigger businesses. For that reason (De la Torre, Pería and Schumkler 2008), claimed that, the opacity that characterises the SMEs give difficulty for them to access their capacity and willingness to repay their credit an asymmetry of information that constrains the banks' willingness to allocate loans to them.

Youssef (2014) reported that SMEs are not interesting in targeted customers for banks because there is a lack of verifiable financial information records that reflect the enterprise capacity to pay their debts. We can say that

banks are seeking trustworthiness of financial statement as they confirm that the business will provide enough earnings to repay their loans.

#### *4.2 Lack of internal control and Informality of SMEs Systems*

One of the most important barriers of credit risks specific to SMEs lending is the lack or weakness of internal control structures and the informality systems of SMEs. These can further limit SMEs' access to loans and reinforce the lending risks.

According to the experts of OECD, SMEs are most likely informal, especially in developing countries such as Cameroon. Informality makes difficult for SMEs to grant loans from financial institutions. We can define informality as a lack of formal compliance with regulations, laws, codes and standards, as well as, the lack of formal control structures. The main drivers of informality are the high costs imposed through social security and taxes. It can create short-term higher profits and more flexibility, but it has long-term consequences such as limited access to loans.

SMEs, especially give less importance for strong formal internal control mechanisms, partially because of their size defined (Mutambanengwe, 2013). Procedures and policies are limited and the risks are concentrated on the owner who takes several roles in SMEs, resulting in a situation where the ownership and management are concentrated in one and the same individual or a smaller group of people. Hence the risk mix-up of funds may be greater in SMEs than in larger companies with the lines between professional and private being less clearly defined.

#### *4.3 High interest rates and costs*

Various challenges faced by SMEs is result generally in very high-interest rates for SMEs lending, creating a situation that making credit less affordable for SMEs. Financial institutions are considered SMEs like high-risk companies with a very high failure rate.

In developing countries, the costs of lending to SMEs are high, as loan sizes are small, and the transaction costs per loan are relatively constant. This reduces considerably for regular banks to lend to SMEs.

#### *4.4 Nepotism*

SMEs lending, similarly to microfinance, often involves small structures. The relationship between the borrowers and lenders has often been used as a way for banks to select their clients in the absence of verifiable financial information. This proximity is not a problem but, in the absence of effective internal controls, it can lead to nepotism in lending and the establishment of favorable Relationships (Souleymanou, 2018). And also, Acclassato, Aga and Eggoh (2009) argue that the repeated and long-term interactions between agents can make the credit officer favour certain SMEs. Nepotism, by the way is defined by the ability of the manager of favoring relatives or friends by giving them a job or preferential treatment.

#### *4.5 Conflict of Interest between Borrowers and Lenders*

The conflicts of interest can also pose problems in the granting loans process. In the absence of adequate supervision and internal control and prevention mechanisms put in place by the financial institution, the credit agent can approve credit procedures or validate conditions that are favourable for the benefit of certain SMEs.

### **5. Mitigation strategies**

They are established techniques and procedures that are used to reduce and prevent the occurrence of credit risk associated with lending exposures.

Mitigation strategies and solutions to prevent risks in SMEs lending need to take into account the specific needs and capacities of SMEs to ensure effective due diligence and encourage the establishment of integrity structure while understanding the constraints faced by these structures.

They are techniques and procedures that are used by SMEs to reduced and prevent the occurrence or the possibility of occurrence of credit risk associated with the loan exposures. The procedure includes credit risk measurement, policies and practices applied in management systems in reduction of the credit exposure.

#### *5.1 Mitigation strategies at the level of the Bank*

##### *5.1.1 Internal control mechanisms*

Internal control mechanisms are essential for all financial institutions to ensure identification and assessment of beneficial ownership and to prevent them from inadvertently facilitating money laundering and credit risks. Financial institutions should be very attentive to the ethical structures in place in SMEs with which they operate. A commercial intelligence company puts forward three features of any "know your customer" policy that is relevant for SMEs banking (World Compliance 2013):

- Customer Identification: this procedure is performed by the banks at every stage of the relationship with the client;

- Customer Acceptance: it is a policy for banks to background checks are conducted on a potential client to ensure that they are using their real name and are not involved in illegal activities;
- Risk Management Strategy: which allowed financial institutions to establish internal audits and compliance functions to ensure adherence with “know your customer” requirements?

#### 5.1.2 Adapting the products and services to the SMEs market

According to Mutambanengwe (2013), the most significant shortcoming with existing financial products is that they use models designed for large companies applying them practically unchanged to SMEs.

An indirect way to reduce credit risks is thus to adapt the bank’s products to SMEs needed and find new ways to screen clients and predict credit risk with the information that SMEs can provide. By using measures, such as credit scoring models, risk-adjusted pricing, and non-lending products tailored to SMEs, banks can develop techniques to mitigate risks and lower costs (IFC 2010). The International Finance Corporation (2010) presents also best practices in SME lending that consist of the importance of creating a specific segment in charge of SMEs and of matching the products and services to the clients.

#### 5.1.3 Training Employees

There is a necessity of training employees of financial institutions on the specificities of SMEs. SME banking suppose higher volumes than corporate banking, and greater levels of service than retail banking; thus the necessary skills often do not correspond to those of a traditional banker (IFC, 2010). While there is a necessity for the introduction of new products and procedures designed to better serve the small business market and to prevent the development of a situation in which small businesses are unable to compete.

### 5.2 Mitigation strategies at the level of the SMEs

#### 5.2.1 Accounting standards

One the most significant challenges for SME when access to finance is the provision of comprehensive and credible financial information for mitigating credit risk. According to Lopez and Hiebl (2015), SMEs use management accounting to a lesser degree or have less-developed management accounting systems compared to large firms. They related also both company size and organizational complexity as a way of explaining why SMEs use less management accounting. Traditional accounting standards might appear stringent especially for small and medium structures. In this context, it may be interesting for SMEs to hire professional accounting staff that can be expected to be important for the professionalization of management accounting systems in SMEs. SMEs should therefore follow the accounting standards developed by the International Accounting Standards Board to meet the capabilities and needs of SMEs.

#### 5.2.2 Staff and Employees Training

Similarly to banks, SMEs employees and staff need to be trained in risk management to better understand credit risks and legal and ethical requirements.

In SMEs risk assessments were perceived as a necessary evil with most employees ignoring them and few actively resisting. The new approach is necessary for SME by changing the nature of existing business process (planning, budgeting, investment management and so on) and making them more risk-based.

Training in the company’s policies and procedures is also an integral part of most codes of conduct. Thus the purpose of training is to improve knowledge, skills and attitudes which in turn increase confidence, motivation, job satisfaction and firm performance.

#### 5.2.3 Implementation of risk management policies

SMEs need to developed and implemented strong risk management credit policies, procedures, and practices which are intended to define clearly the practices of assessment, settlement, and documentation of credit risks. The policies should therefore prescribe how the Bank’s lending loan practices. It should also set out the requirement to evaluate by the bankers.

## 6. Conclusion and Recommendations

This review aimed to provide an overview and a synthesis of the existing literature on credit risk management in SMEs and clarified some aspect of credit lending decision-making for SMEs, thereby identifying the risks specific involved to the attribution of credit to SMEs. Credit mitigation strategy is necessary to create an economic environment that enables SMEs to grow and prosper. The constraints to finance are more prominent in developing countries due to observed gaps in the financial system occasioned by higher interest costs, lack of internal control and information asymmetry amongst others. Increased access to finance for SMEs by reducing credit risk can improve economic conditions in developing countries.

The main contribution of this paper is the synthesis of research on credit risk in lending SMEs, This review should be useful for SME practitioners as they will find techniques and procedures that are used to reduce and prevent the occurrence of credit risk associated with lending exposures, the problems that could arise, and the outcomes of implementing a proper credit risk mitigation.

Financial institutions need to extend more finance to SME and developing the tailored products that would

facilitate credit process for SME and increase the flexibility of loan terms and conditions.

In SMEs risk assessments were perceived as a necessary evil with most employees ignoring them and few actively resisting; this paper recommends SME's employees to integrate risk analysis into their work.

Finally, Government policies may either positively or negatively influence risk management strategies; In this case, the Government might take the necessary actions to facilitate the procedures for obtaining legal documents to carry out the activity in the official manners.

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