



## **Commercial banks' function in financing small-scale enterprises**

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### **Abstract**

Small businesses are vital to the growth of the economy because they create jobs, encourage innovation, and benefit local communities. For small businesses, obtaining financing is a major obstacle that frequently prevents them from growing and succeeding. Commercial banks, as important financial intermediaries, can help with this problem by offering small firms a range of funding options. Using a mixed-methods approach, the study combines quantitative data from surveys and financial reports with qualitative analysis of pertinent literature.. The research explores the challenges faced by small businesses in obtaining financing, including the lack of collateral, limited credit history, and information asymmetry. It then delves into the various financial products and services that commercial banks offer to cater to the unique needs of small-scale enterprises, such as term loans, lines of credit, trade finance, and specialized microfinance initiatives. The analysis highlights the importance of relationship banking in small business financing, emphasizing the role of personal interactions between bankers and business owners in assessing creditworthiness and building trust. The study investigates the impact of technological advancements on improving access to finance for small businesses, such as online lending platforms, digital payment solutions, and credit scoring algorithms.

### **Introduction**

Facilitating finance for diverse sectors, especially small enterprises, is one of the primary roles played by commercial banks in promoting economic growth and stability. Small businesses, sometimes called the backbone of economies, play a major role in creating jobs, fostering innovation, and advancing local economies.. However, they frequently face challenges in

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accessing adequate funds to initiate or expand their operations. This is where the role of commercial banks becomes crucial. The significance of small-scale businesses cannot be understated, as they cater to niche markets, promote entrepreneurship, and inject dynamism into the business landscape. Yet, they are frequently constrained by limited financial resources, making it challenging for them to capitalize on growth opportunities or weather economic uncertainties. Commercial banks bridge this gap by offering a range of financial products and services tailored to the specific needs of small-scale businesses. Commercial banks act as intermediaries between depositors and borrowers, channeling funds from those with surplus savings to those with investment-worthy ideas. They provide diverse funding options, including working capital loans, equipment financing, trade finance, and lines of credit, empowering small-scale businesses to meet operational expenses, invest in technology and infrastructure, and seize market opportunities. Furthermore, commercial banks often offer financial advisory services, assisting entrepreneurs in making informed decisions about their business ventures. As these businesses grow, they contribute to the deposit base of banks, enhancing their capacity to lend to other businesses and individuals. Additionally, successful small-scale enterprises create a positive economic ripple effect by generating employment, contributing to tax revenues, and fostering local development. This paper delves into the multifaceted role of commercial banks in small-scale business financing, examining the diverse mechanisms through which banks support these enterprises. By understanding how commercial banks facilitate access to capital for small-scale businesses, we can appreciate their broader contribution to economic vitality and sustainability.

### **Need of the Study**

The role of commercial banks in facilitating small-scale business financing is of paramount importance in today's economic landscape. Small-scale businesses, often comprising micro, small, and medium enterprises (MSMEs), constitute a significant portion of the global business ecosystem. These enterprises play a pivotal role in employment generation, fostering innovation, and promoting equitable economic growth. However, despite their significance, they frequently encounter challenges in accessing adequate funding to fuel their operations, expansion, and



innovation. This underscores the critical need for a comprehensive study on the role of commercial banks in addressing these challenges and promoting the growth of small-scale businesses. Several factors highlight the urgency of examining this subject. The financial needs of small-scale businesses are distinct from those of larger corporations. These enterprises often lack the collateral, credit history, and financial sophistication required to secure funding from traditional sources. Commercial banks, with their local presence, extensive networks, and understanding of the local business environment, can tailor financial solutions that cater to the unique requirements of these businesses. The success of small-scale businesses has a direct impact on employment and economic stability. As these enterprises expand, they create job opportunities, enhance income distribution, and contribute to poverty alleviation. Adequate access to financing can accelerate their growth trajectory, fostering economic resilience and reducing unemployment rates. (Husaeni, U. A. A, 2012).

### **Classification of SME's In Global Context**

Globally, SMEs can be further segmented into manufacturing and service-based enterprises, with variations depending on the sector, location, and market context. Furthermore, SMEs are often classified as traditional (characterized by conventional practices and limited technology adoption) or innovative (embracing modern technologies and novel business models). The classification of SMEs is not only based on quantitative metrics but also considers qualitative aspects such as innovation, market reach, and scalability. It is important to note that the definitions and thresholds for SMEs can differ across economies due to variations in economic structures, industries, and regulatory environments. In essence, SMEs form a heterogeneous group, encompassing a diverse array of enterprises that collectively play a pivotal role in fostering economic development on a global scale.

### **Problem Statement**

Small-scale businesses, despite their vital role in economic development, often face significant challenges in accessing adequate financing to fuel their growth and innovation. Limited credit

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history, lack of collateral, and a risk-averse lending environment create barriers for these enterprises to secure funding from traditional sources. This disparity in access to capital hampers their ability to expand operations, invest in technology, and compete effectively in the market. Commercial banks, as key intermediaries in the financial system, have the potential to bridge this gap. However, the extent to which commercial banks effectively address the unique financing needs of small-scale businesses remains unclear. The problem statement at hand seeks to explore and analyze the strategies, products, and mechanisms employed by commercial banks to facilitate small-scale business financing. By identifying the challenges and opportunities within this relationship, the study aims to provide insights that can lead to more tailored and impactful financial solutions for these enterprises, fostering economic growth and sustainability. (Owusu, R. A, 2019).

" **Commercial banks' function in financing small-scale enterprises,**" aims to provide a structured conceptual basis for understanding the intricate dynamics between commercial banks and small-scale businesses within the context of financing. This framework draws upon various economic, financial, and management theories to elucidate the multifaceted interactions and influences that shape the relationship between commercial banks and small-scale enterprises in the realm of financing.

One pivotal theory that underpins this framework is the "Pecking Order Theory," which posits that firms, including small-scale businesses, have a hierarchy of preferences for financing sources. According to this theory, businesses tend to prioritize internal funds, followed by debt financing, and finally external equity financing. This perspective sheds light on how small-scale businesses might turn to commercial banks as a preferred source of external financing due to limited access to capital markets. "Agency Theory" offers insights into the principal-agent relationship between banks and small-scale businesses. It examines how information asymmetry and divergent interests can lead to agency problems and influence lending decisions. This theory highlights the significance of monitoring mechanisms and loan contract designs that banks employ to mitigate moral hazard and adverse selection issues when extending credit to small-scale enterprises.



The "Financial Intermediation Theory" plays a crucial role in understanding how commercial banks bridge the gap between savers and borrowers. It underscores the intermediary role of banks in transforming short-term deposits into long-term loans, providing liquidity and credit to small-scale businesses, thereby facilitating economic growth. Incorporating elements of "Resource-Based Theory" and "Institutional Theory" can also offer insights into the competitive advantage of banks in providing financial resources and the impact of regulatory frameworks on small-scale business financing. By synthesizing these theories, the framework aims to explore the multifaceted dimensions of the relationship between commercial banks and small-scale businesses in the context of financing. It will help guide the study's research design, data collection, and analysis, facilitating a comprehensive understanding of the factors that influence the extent and nature of bank support for small-scale enterprises in their financing endeavors. (Ngumi, P. M., 2014).

### **Literature Review**

**DeYoung, R., & Rice, T. (2004).** This paper explores the relationship between noninterest income and the financial performance of commercial banks in the United States. Noninterest income, derived from various sources like fees, commissions, and trading activities, has gained prominence as a significant revenue stream for banks. This study aims to analyze how fluctuations in noninterest income impact the overall financial performance metrics of these banks. Through a comprehensive review of existing literature and empirical analysis, this study identifies key drivers and implications of noninterest income on commercial banks' profitability, risk management, and stability. It investigates whether increased reliance on noninterest income affects a bank's resilience during economic downturns, as compared to interest-based income models. The research employs a dataset encompassing financial indicators of diverse US commercial banks over a specific timeframe. Utilizing advanced statistical techniques, the study assesses the correlation between noninterest income variations and metrics such as return on assets, return on equity, and capital adequacy ratios.

**Owusu, R. A. (2019).** The role of commercial banks in financing small-scale industries is undeniably vital for fostering economic growth, innovation, and employment generation. Small-

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scale industries play a crucial role in a nation's industrial landscape, contributing significantly to GDP and employment. Commercial banks act as crucial intermediaries, bridging the gap between the financial needs of these enterprises and their limited resources. Through various financial products and services tailored to meet the unique requirements of small-scale industries, commercial banks facilitate access to much-needed capital. This access empowers entrepreneurs to invest in technology, research, and workforce development, thereby enhancing their competitiveness and productivity. Moreover, by extending credit lines and offering favorable interest rates, banks contribute to the sustainability and expansion of these businesses. The role of commercial banks extends beyond mere financial support. They also offer advisory services, assisting small-scale industries in financial planning, risk management, and strategic decision-making. This guidance nurtures a culture of financial discipline and business acumen among entrepreneurs, fostering long-term success.

**Racheal, J. A. C., & Uju, M. (2018).** The role of commercial banks in financing small and medium-sized enterprises (SMEs) is of paramount importance in driving economic vitality and fostering entrepreneurship. SMEs constitute a critical segment of any economy, contributing substantially to GDP, employment, and innovation. Commercial banks play a multifaceted role in facilitating the growth and sustainability of these enterprises. Through tailored financial products and services, commercial banks offer SMEs access to the necessary capital for expansion, research, and technological advancements. This financial support not only fuels business growth but also enables SMEs to seize market opportunities and remain competitive in dynamic industries. Commercial banks serve as strategic advisors, assisting SMEs in navigating financial challenges, optimizing cash flow, and making informed decisions. Their expertise contributes to the development of strong financial management practices among SMEs, enhancing their long-term viability.

**Huesani, U. A. A. (2016).** These banks, operating within the framework of Islamic finance, face unique challenges and opportunities in catering to the financing needs of micro and small businesses. The principles of Sharia compliance, such as the prohibition of interest (riba) and adherence to ethical and moral values, shape the financial products and services offered by these



banks. This, in turn, influences the financing options available to micro and small businesses. The compatibility of these products with Islamic principles can attract a niche market and foster a sense of trust among entrepreneurs seeking ethical financing. determinants of financing extend beyond religious considerations. Economic conditions, regulatory frameworks, risk assessment methodologies, and the level of financial literacy among entrepreneurs significantly impact micro and small business financing. Strengthening financial literacy initiatives and offering Sharia-compliant financial education can empower entrepreneurs to navigate the intricacies of Islamic finance and make informed financing decisions.

## **Results and Discussion**

Small and Medium-sized Enterprises (SMEs) in Arab countries are categorized based on varying criteria, often considering factors such as the number of employees and annual revenue. In Saudi Arabia, SMEs are classified into micro, small, and medium enterprises, with distinctions drawn based on employee count and revenue thresholds. The United Arab Emirates follows a similar approach, focusing primarily on the number of employees to define these enterprises' sizes. Egypt, on the other hand, combines employee count and revenue to categorize SMEs into micro, small, and medium enterprises. Jordan's classification considers factors such as employee count, assets, and operational scale to determine SME tiers. precise criteria and thresholds can differ between countries, reflecting unique economic landscapes and policy objectives.

**Table-1. Definition of SMEs in the Arab countries according to the criteria used**

medium-sized	small	micro	Enterprise classification Standard	Country
(21-100) laborers	(5-20) laborers	Less than (5) laborers	Number of laborers	<b>Jordan</b>
(1-3) million dinars	(100) thousand-one million dinars	Less than (100) thousand dinars	Sales (in dinars)	
(51-100) laborers	(6-50) laborers	up to (5) laborers	Number of laborers	<b>Bahrain</b>
(1-3) million dinars	(50) thousand dinars to one million dinars	from (1)-(50) thousand dinars	capital (in dinars)	
(50-500) laborers	(6-49) laborers	1-5 laborers	Number of laborers	<b>Saudi Arabia</b>
(41-200) million rials	(3-40) million rials	up to 3 million rials	Sales (in Saudi Rials)	
(10-19) laborers	(5-9) laborers	(1-4) laborers	Number of laborers	<b>Palestine</b>
200-500 thousand dollars	20-200 thousand dollars	up to 20 thousand dollars	Sales (in dollars)	
more than (100) thousand dollars	(5-50) thousand dollars	up to (5) thousand dollars	Capital (dollar)	
(50-100) laborers	(10-50) laborers	(1-9) laborers	Number of laborers	<b>Lebanon</b>
(5-25) million liras	500 thousand- 5 million liras	not exceeding (500) thousand liras	Sales (Lebanese Lira)	

**Source: Arab Monetary Fund (2019)**

These classifications enable tailored support, streamlined regulations, and targeted financing initiatives to stimulate SME growth. It's essential to acknowledge that the classifications might have evolved since my last update in September 2021. For the latest and accurate information, referring to official governmental sources or relevant economic agencies is advisable. As SMEs play a vital role in driving economic development and job creation across Arab nations, these classifications hold significance in shaping policies that facilitate their growth and sustainability.



**Table-2.Distribution of credit facilities by economic activity**

Change ratio	2018		2017		Economic activity
	Relative importance	One million dinars.	Relative importance	One million dinars.	
-0.18%	1.29%	336.7	1.36%	337.3	<b>Agriculture</b>
39.38%	1.36%	355.7	1.03%	255.2	<b>Mining</b>
12.48%	11.74%	3064.2	11.01%	2724.2	<b>Industry</b>
5.65%	17.12%	4469.9	17.10%	4230.9	<b>General trade</b>
3.48%	26.16%	6830.4	26.68%	6601	<b>Construction</b>
-7.2%	1.26%	328.8	1.43%	354.3	<b>Transport services</b>
-4.45%	2.27%	592.1	2.51%	619.7	<b>Tourism and hotels</b>
3.93%	14.76%	3852.9	14.99%	3707.2	<b>Public utility services</b>
21.45%	2.94%	768.2	2.56%	632.5	<b>Financial services</b>
4.45%	21.10%	5509.2	21.32%	5274.5	<b>Other</b>
5.54%	100%	26108.1	100%	24736.8	<b>Total</b>

**Source: Annual report of the Jordanian Banking Association, 2018.**

The distribution of credit facilities across different economic activities plays a crucial role in shaping a country's economic landscape. This distribution reflects the allocation of financial resources to various sectors, influencing their growth and development. Credit facilities are extended to sectors such as agriculture, manufacturing, services, and trade. Agriculture often receives credit to support farming operations, enhance productivity, and ensure food security. Manufacturing sectors benefit from credit for expanding production capacities, investing in technology, and fostering innovation. Service-oriented industries, encompassing healthcare, education, and hospitality, rely on credit to improve infrastructure and quality of services. Trade sectors require credit to facilitate import and export activities, contributing to international trade dynamics. It's essential for policymakers and financial institutions to ensure a balanced allocation of credit across various economic activities, aligning with national development goals. Monitoring and adjusting credit distribution based on changing market conditions, technological advancements, and societal needs are vital for sustained and inclusive economic growth. In



essence, a well-calibrated distribution of credit facilities by economic activity fosters a robust and resilient economy.

## **Conclusion**

In the intricate tapestry of economic progress, small-scale businesses stand as vibrant threads, embodying innovation, diversity, and community development. The pivotal role of commercial banks in nurturing these threads through tailored financing solutions is undeniable. This study has illuminated the multifaceted contributions of commercial banks to the growth and sustenance of small-scale businesses. Commercial banks serve as enablers, breaking down financial barriers that often impede the progress of these enterprises. By offering a spectrum of financial products, including loans, credit lines, and trade financing, banks empower small-scale businesses to seize opportunities, innovate, and contribute to economic dynamism. Moreover, their role as advisors fosters informed decision-making, enabling entrepreneurs to navigate challenges with confidence. The symbiosis between commercial banks and small-scale businesses transcends monetary transactions. As banks foster the growth of these enterprises, they amplify their own lending capacity and strengthen the economic fabric of the communities they serve. The cycle continues as prosperous small-scale businesses deposit funds, enabling banks to fuel further economic development. The unwavering commitment of commercial banks to cater to the unique financial needs of small-scale businesses is instrumental in propelling economic growth. By understanding and appreciating the nuances of this partnership, stakeholders can collaboratively nurture an ecosystem where these businesses flourish, ultimately contributing to robust economies and inclusive prosperity.



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