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Financing challenges and effects of concessionary loans on firms' performance in MSMEs in Sri Lanka

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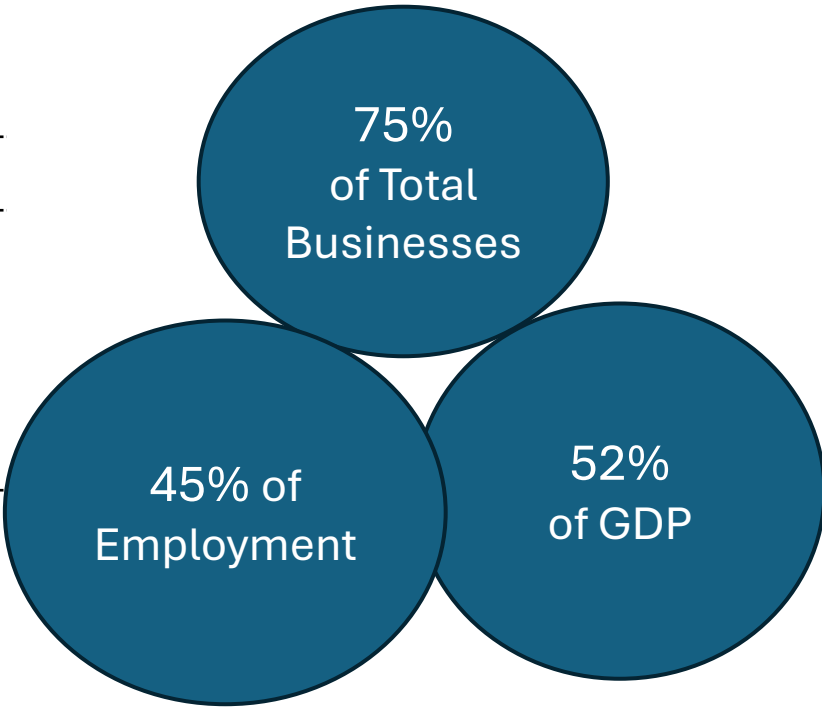
Sri Lanka defines SMEs as

Table 1: National Definition of MSMEs in Sri Lanka

Sector	Criterion	Medium	Small	Micro
Manufacturing	Annual turnover	Rs. 351 mn – Rs. 1 bn	Rs. 20 mn - 350 mn	Less than Rs. 20 mn
	No. of employees	51-200	10-50	Less than 10
Services	Annual turnover	Rs. 351 mn – Rs. 1 bn	Rs. 20 mn - 350 mn	Less than Rs. 20 mn
	No. of employees	51-200	5-50	Less than 5

Source: Ministry of Industries Sri Lanka, 2024

SMEs contribute to



Source: Ministry of Industries and Commerce Sri Lanka, 2015

Many SMEs lack formal access to finance which inhibits their growth

- Access to finance remains one of the most widely cited determinants of SME growth (**Erdogan, 2023; Ongbali et al., 2024; Thompson Agyapong et al., 2018; Wang, 2016**).
- This limited access has been empirically determined (**Laveren et al., 2023; Lim et al., 2021; Moscalu et al., 2019; Schmukler et al., 2017**), and it is further exemplified in developing nations (**Berthaud et al., 2010; Pietrovito & Pozzolo, 2019**)
- To bridge these gaps, governments and development agencies have introduced targeted financial interventions, such as,
 1. credit guarantees
 2. subsidised interest rates
 3. publicly funded loan schemes
- Such measures have been found to improve the growth of participating SMEs (**Dore et al., 2024; Kenza & Kamal, 2024; Riding & Haines, 2001; Rupasingha & Wang, 2017**).

Despite targeted intervention, SMEs particularly in the rural sector faced challenges,

- In many developing economies, financial infrastructure is concentrated in urban settings, leading to an urban/rural divide in credit access.
- As a result, rural SMEs often face
 1. Higher transaction costs
 2. Longer travel distances, and
 3. Limited availability of formal financial services
- This deepens existing barriers to finance faced by SMEs, especially in the rural context (Andersson et al., 2023; Ladzani & Netswera, 2009; Adams & Nehman, 1979).
- Therefore, there is an economic foundation for exploring the challenges SMEs face in accessing financing schemes, and to explore the moderating role of location in SME growth under financing.

SMILE III loan scheme

- The Small & Micro Industries Leader & Entrepreneur Promotion Project III (SMILE III) was funded by a loan from the **Japan Bank for International Corporations (JBIC)**, with a total of **9.6 billion Japanese Yen**.
- **Objective:** To promote economic growth through providing capital to SMEs, developing managerial, accounting & technical skills of SMEs & strengthening institution capacities of intermediary financial institutions.
- The SMILE III Revolving Fund Loan Scheme was implemented in **2012** under the Ministry of Industry & Commerce with the participation of the ten selected financial institutions.
- The study analyses a **unique nationwide dataset** covering SMEs in diverse economic sectors and geographical backgrounds to evaluate the impact of the Small & Micro Industries Leader & Entrepreneur Promotion Project III (SMILE III) loan scheme.

Research Problem

- Isolated studies can be found on increasing the performance of rural SMEs owing to enhanced credit access **(See: Manzoor et al., 2021)**.
- However, the literature surrounding the moderation effects of location on SME performance is mixed.
- **Kärnä and Stephan (2022)** found that urban-based MSMEs are more likely to benefit from concessionary loans compared to rural-based SMEs, while **Khafagy et al. (2024)** found the contrary, where rural-based SMEs benefit more.

Little to no research explores this issue amongst developing economies, despite the significant contribution of SMEs to such economies in their journey towards economic development.

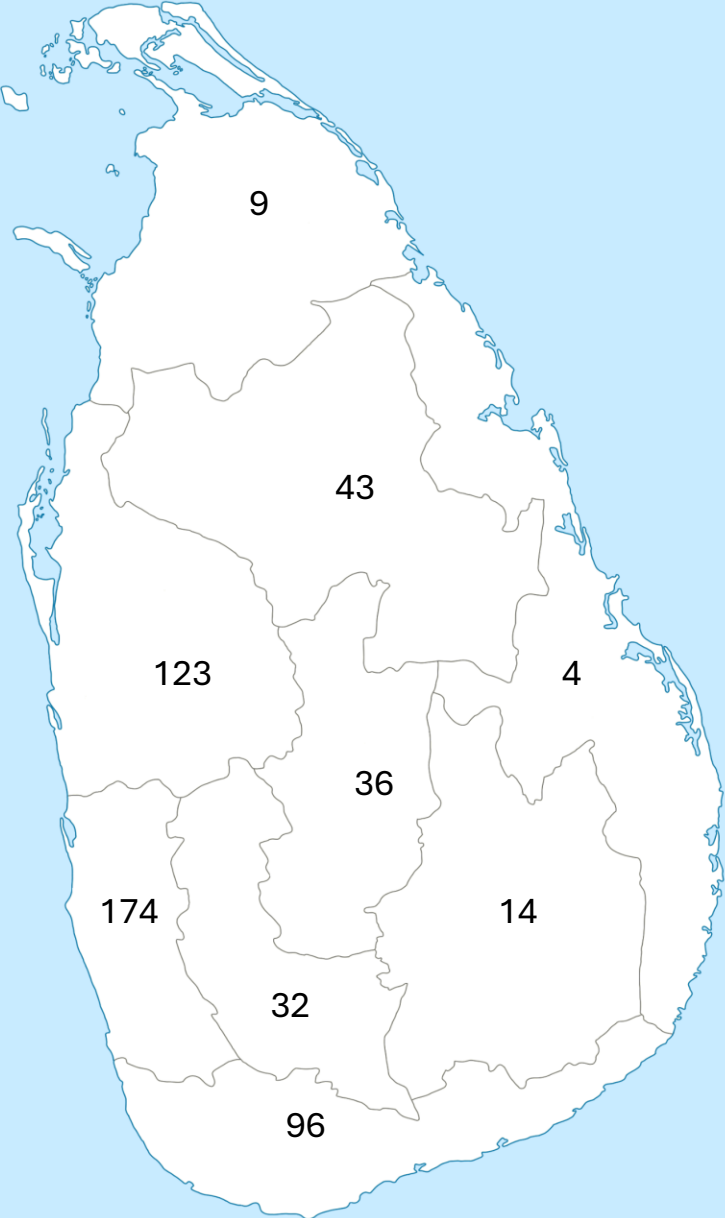
Research objective

- Explore the moderation effect of firm location on credit access and SME performance in Sri Lanka.
- Identify challenges faced by MSMEs in Sri Lanka in accessing targeted external financing.

Methodology

- A quantitative study based on a secondary cross-sectional dataset for the SMILE III loan scheme from the Ministry of Industries, Sri Lanka.
- The sample consists of 531 MSMEs (262 urban and 269 rural).
- Challenges faced by MSMEs in securing financing were identified based on the survey results.
- The moderating role of the location on firm performance under the SMILE III loan scheme was evaluated using a Probit analysis.
- The dependent variable was SME performance assessed under 17 different indicators, and the explanatory variables were
 1. Gender of the industrialist
 2. Education level
 3. Location of the establishment
 4. Natural logarithm (ln) of the loan amount
 5. Interest rate
 6. The proportion of loan used
 7. An interaction term for loan and location

Methodology



- Separate probit models were estimated for **seventeen performance indicators**.

Table 2: Performance indicators and explanatory variables

1. Improved value creation	10. Increased turnover
2. Introduction of modern technology	11. Increased savings
3. Increased volume	12. Improved product quality
4. Reduced costs	13. Increased involvement in local culture
5. Increased profits	14. Expanded community involvement
6. Market expansion	15. Expanded social responsibility
7. Expanded production process	16. Improved work environment
8. Improved management practices	17. Improved productivity of employees
9. Expanded technology usage	

- Plots of predicted probabilities were used to understand the interaction effect (Mize, 2019).
- The moderating effect is analysed by taking the difference of Marginal Effects (MEs) between the two locations (urban and rural) over the values of Loan.
- Further, the Average Marginal Effect (AME) is used to summarise the presence of a moderating effect

Challenges Faced by MSMEs in Sri Lanka in Accessing External Financing

1. Excessive collateral requirements

- 97% of respondents were required to provide collateral in order to obtain loans.
- The average value of the collateral is approximately 6.25 times the loan amount.
- 67% of the respondents were also required to purchase insurance as an added assurance for loan repayment

2. Time delays in processing the loan

- On average, it takes 50 days to process a loan application.
- Notably, more than 20% of loans required over 85 days for processing,
- Only around 50% of the loans were processed within 45 days.

3. High transaction costs

- For over 50% of respondents, transaction costs amounted to more than 13% of the total loan value, with extreme cases reporting costs exceeding 20%.

4. Moral Hazard

- Over 15% of respondents admitted to not utilising the allocated funds for their intended purposes.

Table 3: Average Marginal Effects from Probit Models

Performance Indicator		Improved Value Creation	Introduction of Modern Technology	Increased Volume	Increased Revenue	Reduced Costs	Increased Profits	Market Expansion	Expanded Production Process	Improved Management Practices
AME Second Difference	Difference of AME between Urban and Rural Establishments	-0.0518*	-0.0632*	0.0023	-0.0464	0.0102	0.0388	-0.0588**	-0.0192	-0.0433

Performance Indicator		Increased Turnover	Increased Savings	Improved Product Quality	Increased Involvement in Local Culture	Expanded Community Involvement	Expanded Social Responsibility	Improved Work Environment	Improved Productivity of Employees	Expanded Technology Usage
AME Second Difference	Difference of AME between Urban and Rural Establishments	-0.0351*	-0.0126	-0.0757**	-0.0919**	-0.0495	-0.0706*	-0.043	-0.0830**	-0.0580*

The AME second difference (between urban and rural locations) of ln(Loan) for the urban establishments is lower and statistically significant for **nine** performance indicators.

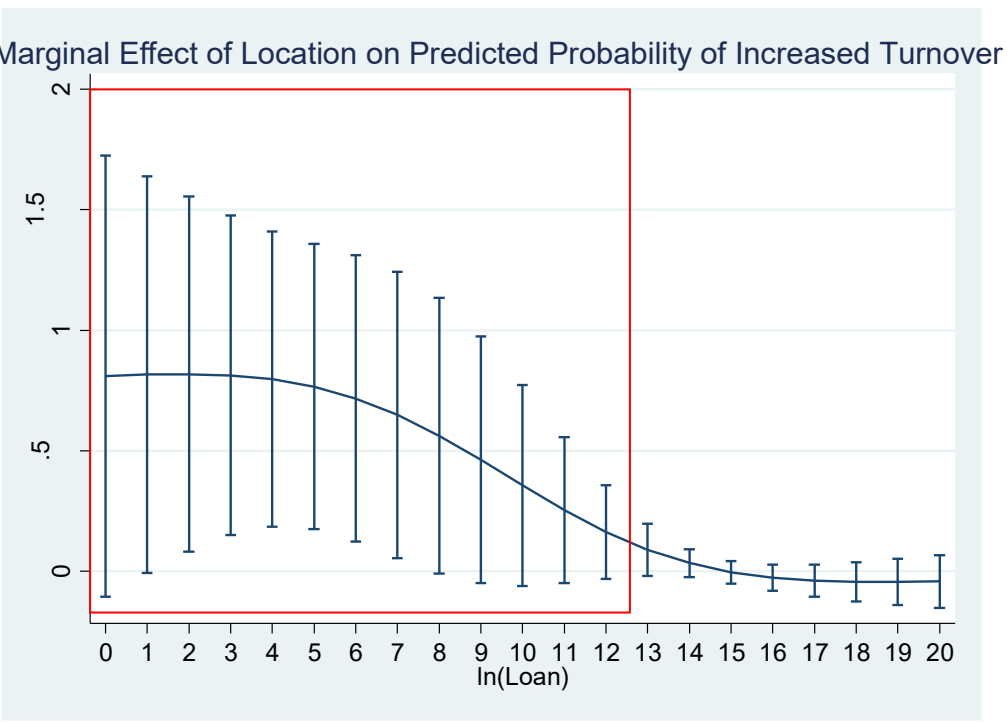
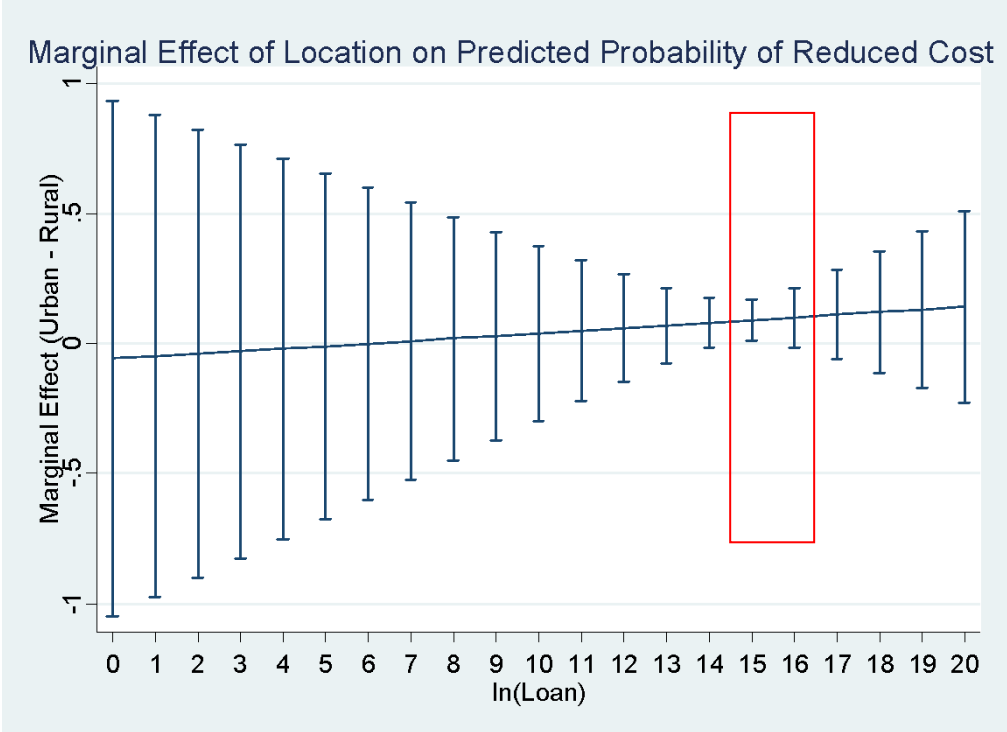
This indicates that rural establishments record improved performance due to loans than urban establishments.

Notes: *Significant at 10%, **Significant at 5%, ***Significant at 1%

Marginal effects of location on different performance indicators

For reduced cost and increased turnover:

ME is higher among urban establishments compared to rural establishments

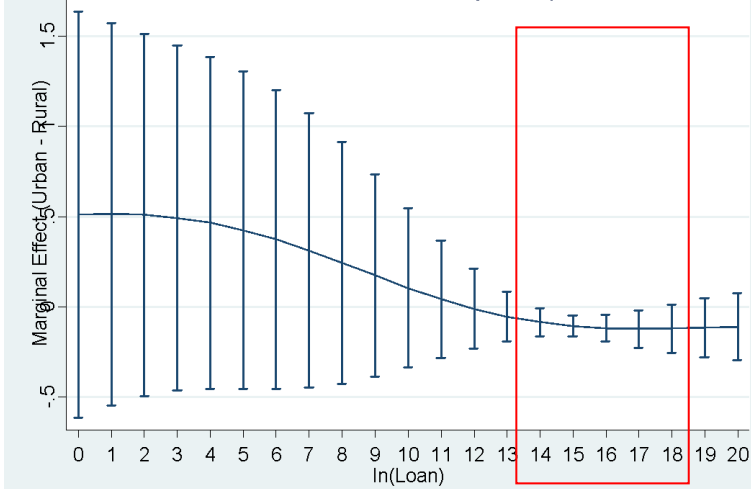


Results

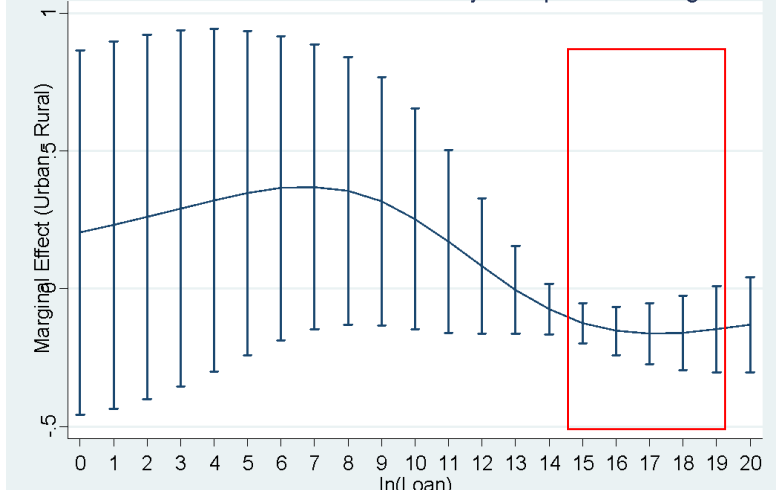
Panels for Expanded Production Process, Improved Management Practices, Increased Savings, and Expanded Technical Usage:

MEs are higher among rural establishments than their urban counterparts.

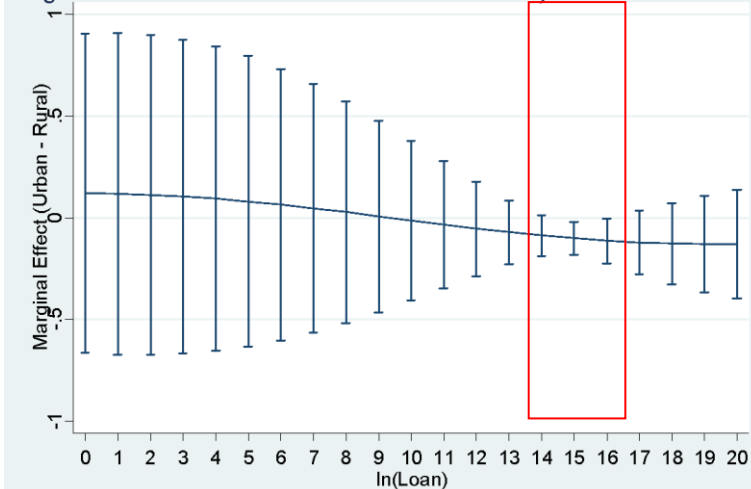
Marginal Effect of Location on Predicted Probability of Expanded Production Process



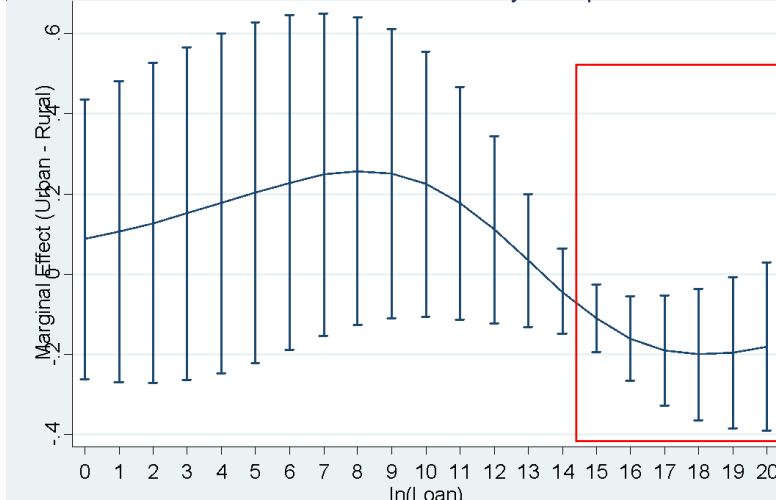
Marginal Effect of Location on Predicted Probability of Improved Management Practices



Marginal Effect of Location on Predicted Probability of Increased Savings



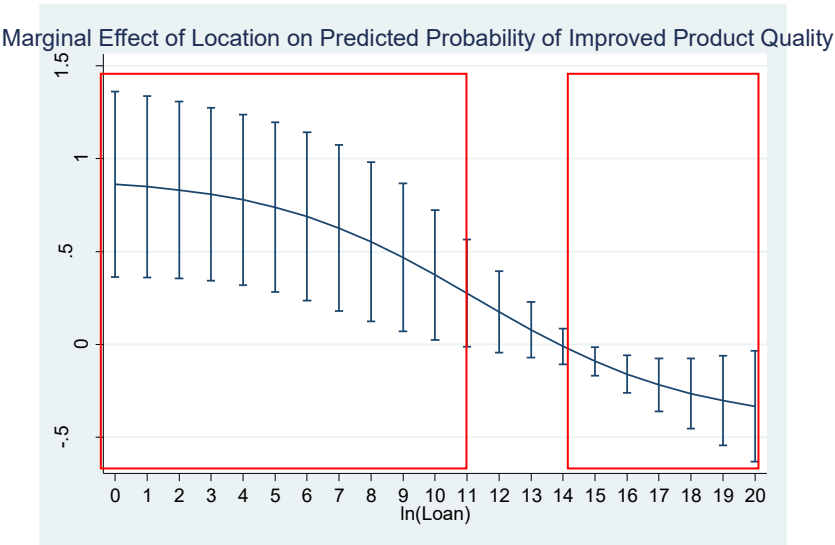
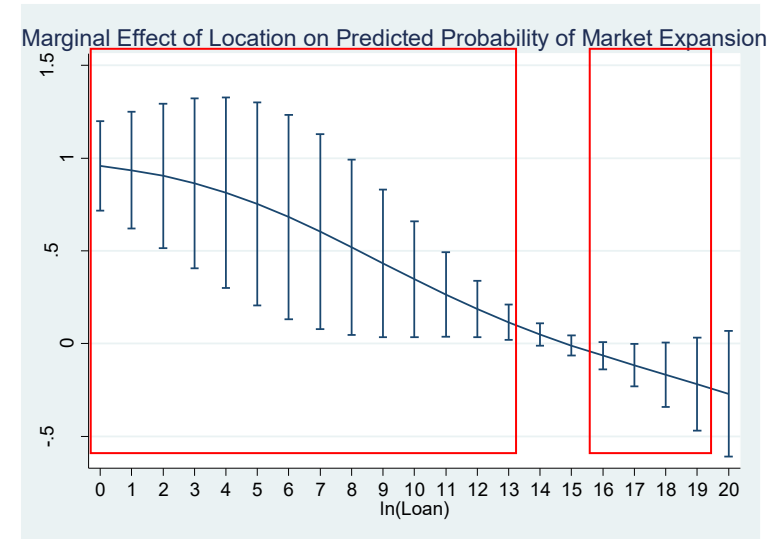
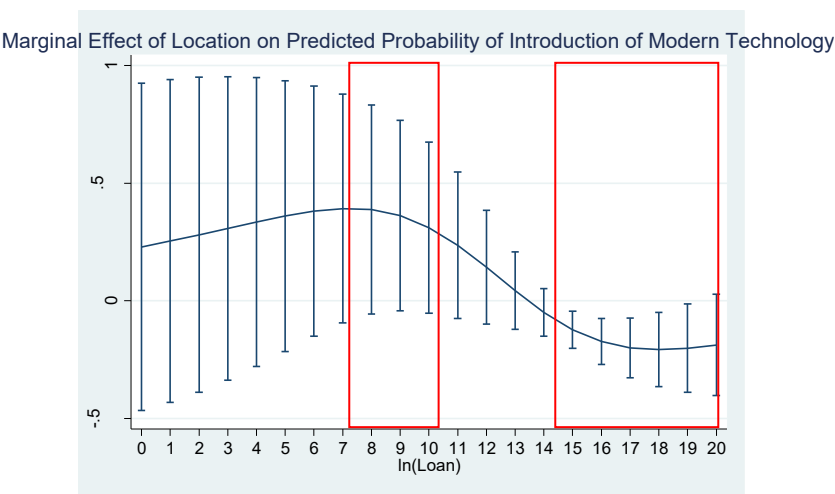
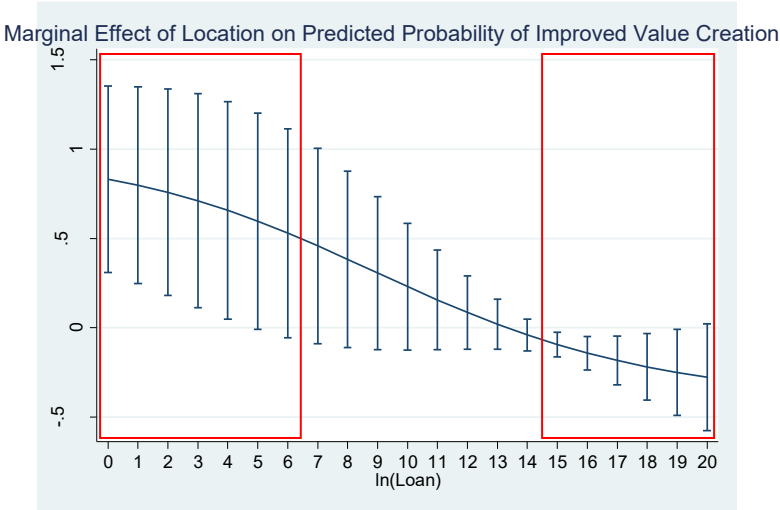
Marginal Effect of Location on Predicted Probability of Expanded Technical Usage



Results

Panels for value creation, Introduction of modern technology, market expansion, improved product quality, Improved Involvement in Local Culture, Expanded Social Responsibility and Improved Productivity of Employees

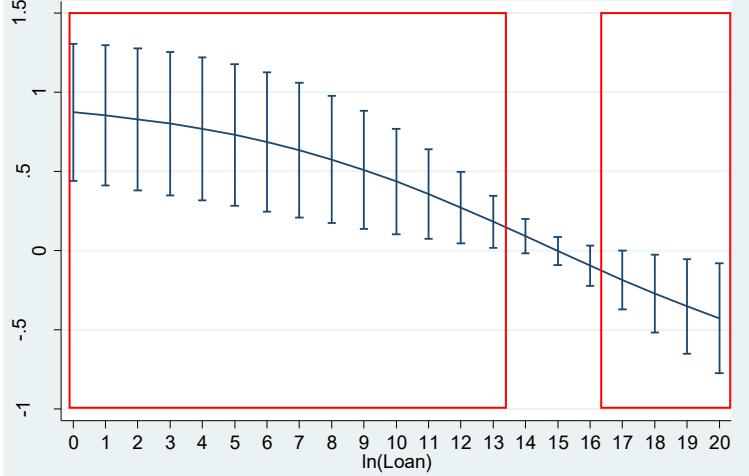
MEs show mixed results.



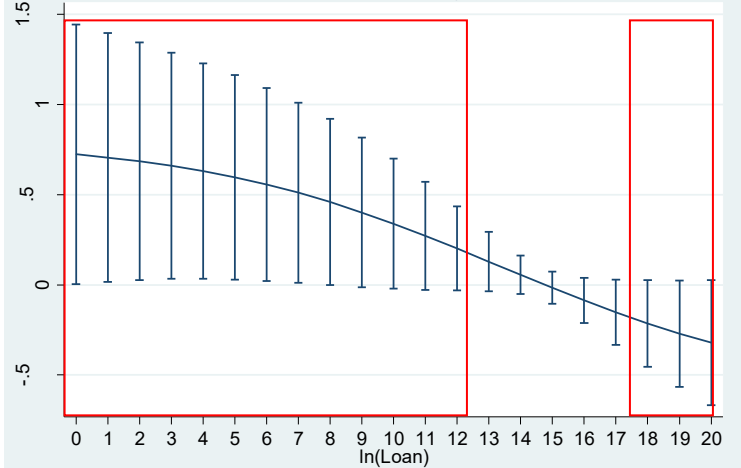
Results

Here Positive MEs (urban > rural) are visible in lower values of ln(Loan), and negative MEs (urban > rural) are observed over higher levels of ln(Loan).

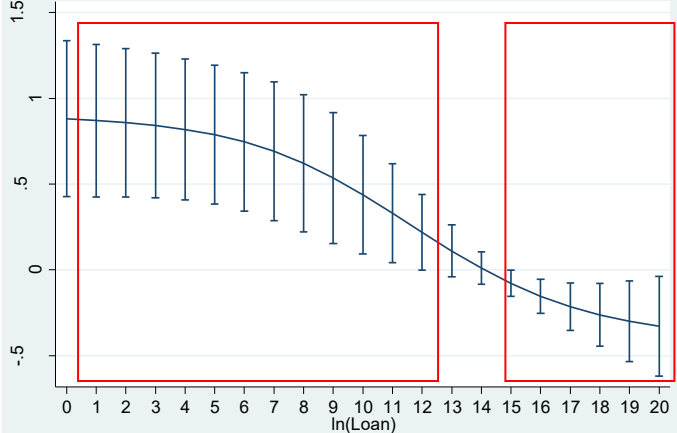
Marginal Effect of Location on Predicted Probability of Improved Involvement in Local Culture



Marginal Effect of Location on Predicted Probability of Expanded Social Responsibility



Marginal Effect of Location on Predicted Probability of Improved Productivity of Employees



Conclusions

- Sri Lankan MSMEs encounter several significant barriers to formal external financing, including,
 - Stringent collateral requirements
 - Lengthy loan processing times
 - High transaction costs.
- In the evaluation of the moderating effect of loans on SME performance, the findings suggest that rural MSMEs benefit more (compared to urban MSMEs) from higher values of concessionary loans.
- Therefore, a greater focus on directing concessionary loans to rural areas is recommended to enhance the effectiveness of such concessionary loan schemes