THEME

Risk Management in SMEs

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Risk management highlights the fact that the survival of a business entity depends heavily on its capabilities to anticipate and prepare for the change rather than waiting for the change and then react to it. It should be clearly understood that the objective of risk management is not to prevent or prohibit taking risk, but to ensure that the risks are consciously taken with complete knowledge and clear understanding so that it can be measured to help in mitigation. It is more so in the case of SMEs.

Risk is omnipresent and all pervasive in any walk of life. It is more so in the business sectors, particularly in Small and Medium Enterprises (SMEs). The etymology of the word "Risk" may be traced to the Latin word *Rescum*, which means Risk at Sea. In business, risk is always measured against capital and therefore the Capital to Risk-weighted Assets Ratio (CRAR) is much in vogue.

Risk is the potentiality that both expected and unexpected events may have an adverse impact on the capital and earnings. When we use the term "Risk", we all mean financial risk or uncertainty of financial loss. If we consider risk in terms of occurrence frequency, we measure risk on a scale, with certainty of occurrence at one and certainty of non-occurrence at the other end. When the probability of occurrence or non-occurrence is equal, risk is the greatest.

Risk can be broadly defined as any issue that can impact the objectives of a business entity, be it financial service or commercial. Risk Management is an ongoing process that can help improve operations, prioritise resources, ensure regulatory compliance, achieve performance targets, improve financial stability and ultimately, prevent loss/damage to the entity.

Business, more so in the context of SMEs, is the art of extracting money from other's pocket, sans resorting to violence and unethical means. But profiting in business without taking risk is like trying to live without being born. Risk taking, as all of us know, is failure-prone as otherwise it would have been termed as sure taking. Every enterprise, be it small or medium, has its own objectives and mission. Risk Management plays a key role in protecting its assets and resources and ensuring that risks are reduced to an acceptable level. The essence of risk management is to reduce the risks to a reasonable and manageable level, on an on-going basis.

Risks Specific To SMEs

No doubt any business entity needs robust risk management systems but the SMEs need much more than that as they may not have wherewithal to manage and control risks due to their very size and several limitations. This is not true in the case of large corporate entities where professional personnel take care of many aspects pertaining to risk. All risk taking units must operate within approved procedures, limits and controls. There is no specific definition for SMEs, which normally cover closely held or unlisted companies, partnership firms, proprietor concerns, etc.

There exists fundamental difference between the way they function and the way they will be served in the financial market, as the character and integrity of the promoter/owner are the key and critical credit indicator and hence play a large role. In SME business, the 'gut feeling', which is subjective, is more relied upon than the 'pure analysis' that are more objective-oriented. Hence, both the business and professional relationships are rolled into one. Therefore credit rating or for that matter risk rating may not make a material difference to SME sectors. Certain misconceptions such as SMEs may get low rating, provide unreliable information, may not afford the fees for getting them rated, etc. will have to be dispelled first. However, rating agencies with specialised teams with analytical tools customised to SME sector will go a long way in putting in place proper mechanism in this regard.

The SME sectors are exposed to some specific risks, some of which are discussed below:

(a) Constitution of business entity

The business entities under SME sectors are mostly proprietorship and partnership concerns. Few in the joint

stock companies are private limited or closely held public limited companies. Thus, the very constitution itself may prove to be risky due to lack of professionalism and over-dependence on one or two key persons for running the show. Lenders and other stakeholders in SME sector cannot afford to forget this fact.

(b) Leverage on financial structure

The nature of constitution of the business entity limits the funds mobilisation efforts and leveraging capacity. There is a limit up to which a small and medium business enterprise can raise capital and borrow. This naturally affects their capacity to leverage on the financial structure.

(c) Tough competition and Inadequate margin

By virtue of the fact that most of the entities in SME sector are small players in their field, they may have to encounter tough competition from the bigger players. They face the pressure on their margin as they can't raise their price but have to absorb the high input cost.

(d) Low collection in Account Receivables

As is evidenced in the increasing trend of outstanding receivables in the SSI sectors, there exists collection risk in the receivable portfolio of SME sectors for the reason that SMEs cannot dictate terms to their customers. As SME sector business entity is at the receiving end, this may put strain on the liquidity position of the business entity. However, the track record of SMEs as borrowers reveals that the default rate is low. Very low rates of bad debts may be the result of banks restricting their exposure to this sector.

(e) Incapacity to go for technological advancement

With very little financial resources and poor ability for leveraging the financial structure, the SME sectors may not have the wherewithal to go for highly sophisticated technological advancement which would help them optimise their available resources in the best way.

(f) High employee turnover

As growth prospects are very limited in SME sector, it is prone to high degree of employee turnover and this may involve lot of wastage of manpower and additional cost in the form of training and knowledge updation, affecting continuity besides lowering the productivity. Qualified and experienced personnel may not stay long as they may gain some experience and change employment.

Majority of SME loans are backed by residential property and standard home loan margins apply. Where SMEs are backed by other forms of collateral the margins do not appear to be excessively above those available for large business. It may be noted that the two biggest problems faced by the SMEs are relating to Regulatory issues and unskilled employees, which collectively constitute nearly 45 to 50 per cent of the problems encountered by them. Access to finance is at the bottom end of the problem list.

(g) Micro Finance

Micro Finance can be defined as providing credit, thrift and financial related services and products of very small amount so as to improve the standard of living. In Indian context, loans up to Rs. 25,000/- are covered under Micro Finance. Number of small enterprises could be covered under these social-oriented entrepreneurial ac-

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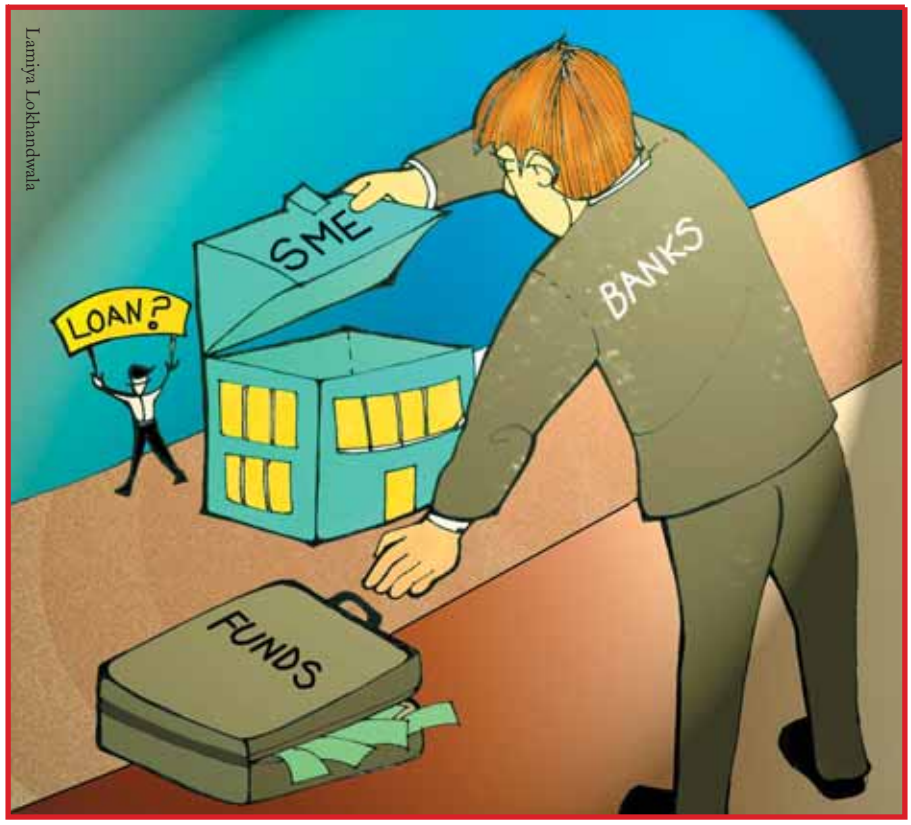

Laniya Lokhandwala

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tivities. There can be no doubt that lenders spread their risk when they lend to this particular sector. It is under the premise that poor are bankable and micro enterprise finance through repayment incentive structure, streamlined administration and market based pricing adopting profit center approach is sustainable. This approach leads to profound changes in a cumulative causation triggered by credit to rural mass, as well as SMEs.

(h) Collateral Security

The existence of collateral means that banks do not have to rely as much as they otherwise would on detailed investigation and analysis of borrower's business. It serves as insurance to lenders and for the borrowers. It is a reflection of credit-worthiness to lenders. Extending the logic further, where the promoter of SME is willing to offer the family home as security against the amount borrowed, it serves as a catalyst to avoid default. That is to say the incentive to avoid the risk of default is likely to be stronger where the family home is used to obtain business finance.

Collateral is more important in the following circumstances.

a. The business is small, as larger firms generally have other attributes such as credit rating, cash flows, track record, etc. that reduce the need for collateral.
b. The business entity has come into existence recently and the lenders have no track record to call upon for analysis.
c. The borrower is yet to establish strong relationship with the bank as reputation, character and first-hand opinion is very important in lending decision.

(i) Bank Lending To SMEs

SMEs are an important part of economic growth in the country and bank lending is the primary source of external finance to them. Therefore, it is essential that banking sector responds not only effectively but also efficiently to the just needs of SMEs.

When the business owners or managers know more about prospects of venture and risks facing their business than lenders, information asymmetry sets in. Where information asymmetry exists, lenders may respond by increasing lending margins to levels in excess of that which the inherent risks would require. Besides, banks

may also curtail the extent of lending and resort to what is known as Credit Rationing, notwithstanding the fact that SMEs would be willing to pay a fair Risk Adjusted Cost of Capital.

Investing in gathering and analysing information will be made only up to the point where the benefits just offset the costs involved. Lenders are now becoming risk intermediary rather than a financial intermediary. Business grows mainly by taking risks. Greater the risk, higher the profit and hence the business unit must strike a tradeoff between the two.

The prime functions of risk management are to identify, measure and more importantly monitor the risk. Risk management activity is a pro-active action in present for securing the future. Managing risk is nothing but managing change, before the risk manages the persons concerned.

As per the RBI guidelines, there are basically three types of risks viz Credit Risk, Market Risk and Operational Risk. While the credit risk is associated with the default of counter party, market risk relates to changes in the earnings as well as capital on account of changes in the market variables and the operational risk is the residual risk which does not directly relate to credit or market risk.

Credit Risk is measured through Probability of Default (PD) and Loss Given Default (LGD). Bank would estimate the PD associated with borrowers in each of the risk rating grades. Historically speaking, the default percentage is quite high in SME sectors than in the large corporate or entity, though in absolute terms, it may relatively be smaller. However, default probabilities do not capture the risk that a bank might experience an economic loss through deterioration in the quality of the loan book rather than outright default.

Credit Risk Rating Framework is essential to overcome the limitations associated with a simplistic and broad-brush approach of classification of exposures into a good or bad category. The rating models must be fully documented and minimum standards must be specified as hurdle points. The models must be duly validated so as to ensure acceptability among the users of the models. The rating scale could consist of 9 strata with the first 5 or 6 representing acceptable credit risk and the rest 4 or 3 grades of unacceptable credit risk associated with an exposure. The whole purpose of risk rating is that the exercise should ultimately reflect the underlying credit risk for a prospective exposure.

When the risk grading system does not show desired ability to discriminate between good and bad risks—implying lack of granularity, the outcome may lead to the relationship between Risk Rate and Pricing losing its predictive capability, thereby causing losses to lender larger

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than the predicted/predictable parameters. This may result in tightening the credit terms or increase in price or both. The situation may lead to overpricing good risk or under pricing bad risk. This may ultimately end up in the bank building up poorer quality loans on its books as better quality borrower may seek alternative lending arrangement elsewhere. Such a situation is known as adverse selection of borrower in banking parlance.

Once loans are sanctioned for business activities, the owners of the business may have incentives to take higher risks than they otherwise would. This is because the owner of the business entity benefits fully from any additional returns when the firm is liquidated. This is known as moral hazard. When a business entity is a proprietorship or partnership concern and the liability of the owner is unlimited, owners may be less prone to moral hazard because the owner may suffer loss in the event of liquidation.

Where information asymmetry and moral hazards are prevalent, business entities are likely to fund themselves primarily from retained earnings and then only through bank debt rather than through public equity. Nevertheless, among the SMEs switching between banks is not a widespread phenomenon.

(j) Reluctance of Lending To SMEs

The reluctance of lending to SMEs may be on account of the following.

(i) Stemming from concerns about risk and in turn, the responsibilities of banks towards its stakeholders such as shareholders, deposit holders and regulators, the banks do not regard it as its role to fund start up ventures, for which venture capitalists are expected to finance. Banks may consider it to be a risky venture.

a. There is a misconception among the banks that a high proportion of small businesses fail within a few years of starting operations and it may be safe to lend to already working and established one than to run the risk of lending to new ventures.

b. It is often seen as difficult for start-ups to satisfy bank requirements, in terms of demonstrating experience in industry, meeting minimum equity stake and having in place contracts for sale to support the business plans.

c. Personnel with specialised skill sets are some times necessary to understand the risks inherent with particular new ventures. The banks, particularly the PSU banks, do not necessarily have such staff strength.

Consequently there is a distinct reluctance by banks to lend to ventures not comprehended completely on technical aspects and the exposed risks not fully understood by the bank employees.

Risk Identification

Identification of risk should occur with the people and experts where the domain knowledge resides. Identification of business process is the foundation for identifying risks as it would provide the framework to help identification of risk in the organisation.

There should be a risk rating model for identification of risk and it is better to evolve an exclusive/separate model for SME sector, duly capturing their peculiarities in the major parameters such as Industry Risk, Business Risk, Financial Risk, Management Risk, Compliance Risk, etc. The rating model used for large corporate or large borrower may not be suitable for rating the risk in a business entity in the SME sector.

The rating model should capture both systemic risk and unsystemic risk. The systemic risk means the risk emanating from general political environment, change in economic policies, fiscal policies of the government and infrastructural changes whereas unsystemic risk arises out of mainly internal factors such as machinery breakdown, labour strike, new competitors, etc.

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Enterprise Wide Risk Management

Enterprise Wide Risk Management is the latest trend and buzzword for an overall approach of the management of risk as a whole in the business. All business entities accumulate resources viz. men, material, money, technology, etc. and invest them in activities which are uncertain and hence fraught with various kinds of risks. As whole is always bigger than sum of its parts, enterprise wide risk management should be attempted instead of adopting silo-approach and handling risk of one issue, in isolation and exclusion of other functions.

EWRM is a process through which a business entity optimises the manner in

which it takes risks. It is not seeking or avoiding risk, but optimising the risk. Hence putting in place an EWRM makes good business sense. Any successful implementation of EWRM framework needs to take into consideration the integration of Enterprise Resource Planning system (ERP) so as to effectively manage the risk across the organisation facilitating the integration of the various roles to manage the same efficiently.

In the light of advancement in information technology, power of computation and sophistication of risk analysis on interest rate, market fluctuations, availability of extensive database as well as information flow, the scope for putting in place an enterprise wide risk management framework has become more a necessity than a luxury for all the business enterprises.

Every business entity, particularly the SMEs, needs to have Business Continuity and Business Contingency Plan (BCBCP). It is a complex exercise involving a number of stages and discrete activities

Basel II and SME Sector

Under the new Capital Accord, popularly known as Basel II, the regulatory capital is more closely associated with risk implying that lending to lower risk borrowers will attract lower capital requirements. Those banks which are likely to employ IRB approach should be better placed to avoid over-pricing good risks and under pricing bad risks. By deduction, it means that there may be some migration of higher risk SME loans to those banks which do not adopt IRB approach and which the banks, by implication, rely on less sophisticated and more standardised measures of risk.

Any enhanced sensitivity of regulatory capital requirements to risk may be doing nothing more than aligning the regulatory environment with current practice. From the perspective of SME sectors, Basel II should be viewed as a positive development, as it promotes alignment of interest rates with true economic cost.

Business Contingency Plan

A study reveals that during the past two decades, nearly 80 per cent of the organisations that lacked business contingency plan and suffered catastrophic loss of property, records, customer loyalty, skilled and trained workforce, cash flow, etc. were gone within a couple of years of the incident, despite many of them having had business interruption coverage insurance policy.

Every business entity, particularly the SMEs, needs to have Business Continuity and Business Contingency Plan (BCBCP). It is a complex exercise involving a number of stages and discrete activities. In this regard, a Local Crises Management Team (LCMT), a core group consisting of senior management personnel shall be constituted to formulate strategies and take decisions in the event of business interruption. Further, a second line Departmental Representative Group (DRG), comprising senior line management from across the business organisation, shall be constituted. Its role, besides assisting the Local Crises Management Team, is to assess the business impact of the interruption on their client base and business areas. In addition, a Contingency Plan Co-ordinator shall be appointed with certain responsibilities and rights so that both the LCMT & DRG meets regularly and initiate the requisite action plan.

The Business Contingency Plan and procedures should be properly documented, covering the critical business process, functions and procedures to be followed and the related database should be duly protected with a back up facility and kept in an offsite storage location. The LCMT shall evolve Resumption Strategy by which the resumption process either at the company's premises or at an alternative location is ensured so that normal business operations are carried out. The Resumption Strategy may include work backlog, critical functions, work prioritisation and formation of communication center.

Conclusion

Functions of risk management should actually be the entity specific, dictated by the size and quality of the balance sheet, complexity of functions, technical/professional manpower and the status of Management Information System in place. Any risk management model is as good as the data input.

In the present scenario, where profits are derived mainly from trading in the market, one can no longer afford to avoid measuring risk and managing its implications thereof. To the extent the SME entity takes risk consciously, anticipates adverse change and hedges accordingly, it becomes a source of competitive advantage as it can offer its products at a better price than its competitors. What can be measured can also be managed. It should be clearly understood that risk mitigation efforts are more important and vital than capital allocation against inadequate risk management system. ❐