THEME

Bank Finance to the SME Sector– Issues And Perspectives

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Small and Medium Enterprises (SMEs) play a very significant role in the economy in terms of balanced and sustainable growth, employment generation, development of entrepreneurial skills and contribution to export earnings. However, despite their importance to the economy, most SMEs are not able to stand up to the challenges of globalisation, mainly because of difficulties in the area of financing. With the opening up of the Indian economy, it has become necessary to consider measures for smoothening the flow of credit to this sector. The article provides a cross-country perspective in this regard and highlights the Indian scenario with reference to SME lending.

There are a number of issues in lending to the SME sector, which banks generally face. The key issues among them are outlined below:

(a) Information Asymmetry: Accurate information about the borrower is a critical input for decision-making by banks in the lending process. Where information asymmetry (a situation where business owners or managers know more about the prospects for, and risks facing their business than their lenders) exists, lenders may respond by increasing lending margins to levels in excess of that which the inherent risks would require. However, the sheer ticket size of SME lending makes it inviable for banks to invest in development of information systems about SME borrowers. In such situations, banks may also curtail the extent of lending even when SMEs are willing to pay a fair risk-adjusted cost of capital. The implication of raising interest rates and/or curtailing lending is that banks will not be able to finance as many projects as otherwise would have been the case.

(b) Granularity: This refers to a situation where the risk grading system at banks does not have the requisite capability to discriminate between good and bad risks. The consequence is tightening of credit terms, or an increase in prices, or both. From the borrower's perspective, this leads to an outcome where the bank is over-pricing good risks and under-pricing bad risks. The fact that most banks in India have not developed adequate expertise in SME lending risk assessment exercises leads to the problem of granularity when it comes to SME lending.

(c) Pecking Order Theory: Pecking order theory flows from the above two issues, which makes SME lending highly difficult for banks. Under this hypothesis, SMEs, which face a cost of lending that is above the true risk-adjusted cost, will have incentives to seek out alternative sources of funding. Evidence suggests that in such situations SMEs prefer to utilise retained earnings instead of raising loans from banks.

(d) Moral Hazard: Even when loans are made to SMEs, it may so happen that the owners of these SMEs take higher risks than they otherwise would without lending support from the banks. One reason for this situation is that the owner of the firm benefits fully from any additional returns but does not suffer disproportionately if the firm is liquidated. This is referred to as the moral hazard problem, which can be viewed as creating a situation of over-investment. The moral hazard problem may, thus, result in SME lending turning bad in a short period of time, a situation that all banks would like to avoid.

(e) Switching Costs: SMEs may find it harder to switch banks, when countered with any issue. It is a known fact that the smaller the business, the more significant the switching costs are likely to be and, therefore, it is less likely that the benefits of switching outweigh the costs involved. This situation results in SME lending becoming a sellers market, which may not be attractive to SME borrowers.

Steps for Smooth SME Lending

In order to ensure that the

above issues do not stand between SMEs and Bank Finance, the following steps could be taken as remedial measures:

Collateral: Existence of collateral that can be offered to banks by SMEs could be one effective way of mitigating risk. Banks could, therefore, look at collateral when pursuing the question of SME lending. It can also be stated that a borrower's willingness to accept a collateralised loan contract offering lower interest (relative to unsecured loans) will be inversely related to its default risk. However, not all SMEs would be able to offer collateral to banks. Hence, Reserve Bank of India (RBI) allows banks, with a good track record and financial position on SSI units, to dispense with collateral requirements for loans up to Rs. 25 lakhs.

(a) Relationships: The length of the relationship between a bank and its SME customers is also an important factor in reducing information asymmetry, as an established relationship helps to create economies of scale in information production. A relationship between a SME and a bank of considerable duration allows the bank to build up a good picture of the SME, the industry within which it operates and the calibre of the people running the business. The closer the relationship, the better are the signals received by the bank regarding managerial attributes and business prospects.

(b) Quality of Information: SMEs are required to provide accurate and qualitative information to the banks for them to undertake a reliable risk assessment. Accurate risk assessments obviously rely upon good information regarding the SME and its prospects. Hence, it is suggested that banks should make efforts to encourage SMEs to improve the quality of information provided.

(c) Customer Consideration: The SME market is somewhat different to the corporate market in that corporate customers generally have a wide range of financing options to choose from and are not as dependent on bank financing as is the case with SMEs. The extent to which SMEs can take necessary steps, with the aid of public initiatives, to easily switch to another bank is another factor that can influence the level of competitive pressure on banks in the case of SME lending.

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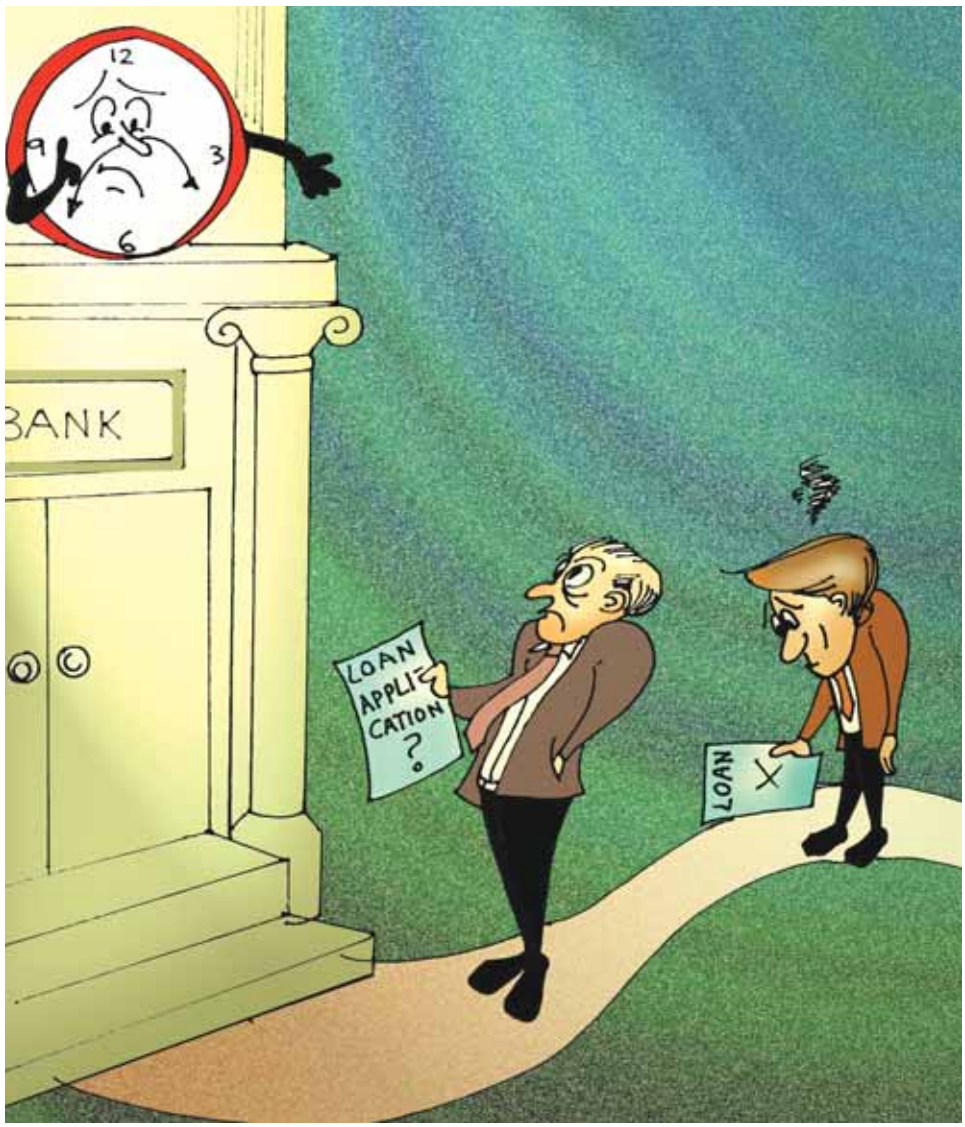
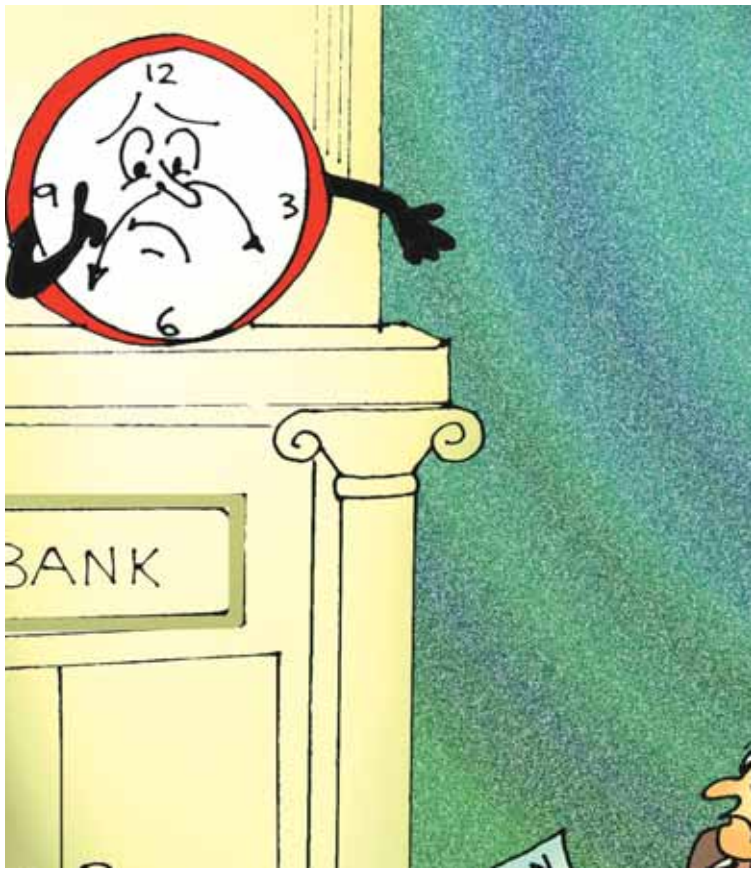
Role of Government and Banking Regulator in SME Lending

As is apparent, the above factors are only idealistic solutions and may not be practical for SMEs to follow because they are faced with several problems such as weak financial strength, inability to provide adequate collateral and other factors. Hence, the Government and banking su-





pervisors should take a holistic view of the SME Sector while considering SME financing, taking into account the risks faced by banks and the problems faced by SMEs. In this regard, the initiatives taken up by the Government and Banking Regulators across various countries and in India are as follows:

(a) Cross-country perspectives: Increased competition in financial markets in developed countries has led several Governments and Banking Regulators to encourage banks and other financial institutions to launch a number of initiatives to serve the financing needs of SMEs effectively. Some of these initiatives (along with necessary government and regulatory support) include the promotion of venture capital; receivables financing; leasing finance; soft loans, grants, and guarantees for entry into public tenders; setting up of special financing companies with state participation; micro-finance programmes, etc.

For instance, New Zealand has introduced a scheme called 'BIZ Investment Ready', which targets innovative businesses and entrepreneurs seeking funds to expand, diversify or commercialise a new concept. The European Union has devised a scheme to facilitate contacts between SMEs and banks and other financial institutions, by developing a 'code of good practice' for SME lending. The Philippines has instituted a financing programme called SME Force (SME Financing for Organisationally Competent and Excellent Franchise Businesses), which is a franchise development financing facility that will be implemented with the participation of franchiser organisations.

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(b) Indian scenario – Government initiatives: Even in India, the financing of the SME sector has received some attention since independence. Some of the initiatives taken by the Government in this regard are as follows:

❖ Setting up of the Small Industries Development Bank of India (SIDBI), as the apex refinance institution in India for the purpose of channelling of finance to Small Scale Industries (SSIs) and SMEs in an organised manner.

❖ In line with the announcement made in the Interim Budget for 2004-2005, SIDBI has proposed two fund-based initiatives for improving credit flow to the SME sector as follows:

- A contribution of Rs. 100 crore to the Rs. 500 crore corpus of the SME Growth Fund (SGF), which shall make primarily equity/equity related capital investments in accordance with SEBI guidelines, in SMEs operating in various growth sectors such as the life sciences, biotechnology, etc.
- The SME Fund of Rs. 10,000 crore to give an impetus to the flow of funds to the SME sector. This fund has begun operations with effect from April 2004. Under the Fund, assistance is provided to SMEs at affordable rates of interest, and direct finance is extended to SMEs through SIDBI's network of branches. Further, refinance to State Financial Corporations (SFCs) has also been made attractive in terms of low rates of interest.

❖ The Government of India has launched the Credit Linked Capital Subsidy Scheme (CLCSS), which aims at facilitating technology upgradation of SMEs in specified products/sub-sectors.

❖ SIDBI has recently negotiated a line of credit with the World Bank for financing and development of SMEs in India, with a view to upscale the credit flow to the sector and raising resources for the SME Fund.

(c) Indian scenario – RBI initiatives: The RBI, from time to time, has formed several committees and working groups to study the flow of credit to the SME sector in a comprehensive manner, and has issued detailed guidelines in this regard. Recently it has constituted an Internal Group under the Chairmanship of Shri C. S. Murthy to, *inter-alia,* consider the relaxation and liberalisation of credit lending norms that are applicable to the SME sector. The Group has submitted its report on June 6, 2005.

The Internal Group, with reference to financing of SMEs, has recommended:

❖ Constitution of empowered committees at the regional offices of the Reserve Bank to periodically review the progress in SME financing and also to coordinate with other banks/financial institutions and the state governments in removing bottlenecks, if any, to ensure smooth flow of credit to the sector.

● Opening of specialised SME branches in identified clusters/centres with preponderance of SME units to enable entrepreneurs to have easy access to bank credit and to equip bank personnel to develop the requisite expertise.

● Empowerment of the boards of banks to formulate policies relating to restructuring of accounts of SME units subject to certain guidelines.

● Restructuring of accounts of corporate SME borrowers having credit limits aggregating Rs. 10 crore or more under multiple banking arrangements to be covered under the revised CDR mechanism.

The extent to which SMEs can take necessary steps, with the aid of public initiatives, to easily switch to another bank is another factor that can influence the level of competitive pressure on banks in the case of SME lending

Appropriate authorities are currently examining the above recommendations of the Internal Group.

Conclusion

Without adequate bank finance, SMEs cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms. Similarly, banks cannot consider the financing of SMEs as a viable option unless their priorities are addressed by SMEs. In this regard, SMEs should be assisted largely by public initiatives involving participation of the banking industry. In India, however, the various public initiatives for promoting finance to SMEs have not been as successful as envisaged because there has been some overlapping of regional and national initiatives. Efforts to harmonise the standards and practices, therefore, need to be properly coordinated to facilitate SME finance further. ❐