THEME

Alternative Modes Of Finance For The SME Sector In India - Some Issues And Suggestions

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In this article, an attempt has been made to examine the inadequacies of finance to the SSI/SME sector from traditional sources and assess the feasibility of alternative sources. Generally, the quantum of the finance so released is neither adequate nor timely, nor commensurate with the performance of the sector and its contribution to GDP growth. There should no longer be any doubt that SSIs should be treated as a separate sector. Indeed, the compatible expression, in consonance with the global trend, is SMEs.

As on record, over the last three decades, SSIs have emerged as one of the most vibrant sectors of the economy, accounting for about 95 per cent of the industrial units in the country; 39.52 per cent of the value addition in manufacturing; 34.03 per cent of national export; and 6.81 per cent of the GDP. That apart, employment generation per Rs. 1 lakh investment is 4 persons; export as percentage of fixed investment is to the tune of 49 per cent; and export as percentage of production is 27.57 per cent. The growth rate of the sector is 7.57 per cent, as against 6.09 per cent in the industrial sector during 2003-04 (April-Dec.), and all in all, the SSI sector is producing more than 7,500 items.

Since 1991, the sector is operating in the open economy and, as such, is working under the constraints of stiff competition from large industries as well as multinational companies. It is evident from the export figures that the SSI sector is competent to excel over others, if more and more attention is given to technology upgradation, availability of adequate and timely finance and suitable mechanisms for marketing.

Finance/credit is the most critical component in any business process. Any industrial sector cannot work to its full capacity without adequate flow of funds. The SSI/SME sector is working with low capacity utilisation, which, however, has now improved from 33.34 per cent to around 52 per cent. Still there remains a vast scope for enhancing the capacity utilisation of SSIs, which will ultimately help in economic growth and employment generation.

A survey conducted by the All India Management Association has identified 'lack of finance' as one of the most crucial hurdles in the growth of SSIs, more so in the Eastern Region. The survey revealed that 60 per cent of the units fail due to lack of demand for products, 36 per cent due to marketing failure and 46 per cent due to lack of adequate finance. Significantly, as per a survey of ICSI, more than 60 per cent of the SSI units are sick and being pushed to closure due to non-availability of timely and adequate finance, whereas some Associations even feel that as many as 80 per cent of SSI units are afflicted with financial problems.

Banks and financial institutions (FIs) have been traditional sources of finance for the SSI sector and they still play a dominant role in this regard. However, now the SSI sector, for the purposes of lending, is coming under 'priority sector lending' and the banks are to lend 40 per cent of their loanable funds to the priority sector, which is inclusive of the SSI sector. That being the fact, there is a stiff decline in the credit flow:

- March – 2002: SSI Credit is 12.5 per cent of net bank credit
- March – 2003: SSI Credit is 11.1 per cent of net bank credit
- The flow is down from 17.33 per cent in March 1999 and again the cost of credit to the SSI sector is 14 per cent against 8.9 per cent for large-scale industries, which includes an insistence on collateral security.

In order to meet the

credit flow requirements of the SME sector, the Centre has from time to time appointed high-powered committees, namely:

1. Nayak Committee to examine institutional credit to the SSI Sector (1990-92)
2. Expert Committee on Small Scale Enterprises (Abid Hossain Committee, 1997)
3. High Level Committee on Credit to SSIs (S.L. Kapoor Committee, 1998)
4. Study Group for Development of Small Scale Enterprises, Chaired by Dr. S.P. Gupta, Member, Planning Commission, 2001
5. Devi Dayal Committee Report of Sub-Group II on Financial and Fiscal Measures for SSEs, 1999.

Similarly, Reserve Bank of India (RBI) too has appointed several committees for Credit dispensation over the years. These are:

1. Study Group to frame guidelines for follow up of Bank credit (TANDON Committee, 1974)
2. Working Group to review cash credit (Chore Committee, 1979)
3. Committee on Financial System (Narsimhan Committee – I, 1997)
4. Committee on Banking Sector Reforms (Narasimhan Committee-II, 1998)
5. Working Group for harmonising the role of DFI and Banks (Khan Working Group, 1998)
6. SIDBI Report on Small Scale Industries Sector, 2000
7. Committee on New Financial Package for SSI Sector, 2003 (appointed by Ministry of SSI & ARI).

All these committees have voiced their concerns over the SME sector suffering due to the non-release of adequate and timely finance and have made recommendations for easy access to credit and its flow to the SSI/SME sector. The RBI has issued several guidelines to Banks and FIs for credit dispensation to the SME sector. In the given situation, apparently these committees seem to have produced only large volumes of paper, which may be dubbed as good research work, but there has been no improvement in credit dispensation to the SSI/SME sector. This is primarily, because the RBI guidelines have got no mandatory force and the banks/FIs are not mandated to act in terms of guidelines. Bankers go by risk perception while lending and take pre-emptive steps to prevent the occurrence of Non-Performing Assets (NPA). As such, neither RBI nor the banks compel their officers to lend according to the prescribed guidelines. The officers, while lending, use their discretion on the basis of risk perception to avoid acting in breach of 'Bank Officers' Conduct Regulations.'

Here, it would be apt to quote from the address of Hon'ble Prime Minister Dr. Manmohan Singh at the 5th SSI Convention and Presentation of National Awards to Small Scale Industries on 30th August 2004 in New Delhi when he said: "I do recognise the importance of the SSI sector not only for its contribution to our GDP but also for its stellar performance in exports and generating employment. Employment is the key thrust area of our Government. And thus the key to our success in employment lies in the success of manufacturing by the SSI sector… While initiatives like the Credit Guarantee Trust was launched in recent years to help small enterprises with new credit schemes and higher limits of loan eligibility, and a Credit-linked Capital Subsidy Scheme, the availability of credit still remains a problem… Banks today are flush with funds and yet small enterprises continue to complain about lack of funds." The Hon'ble Prime Minister had further observed that the SSI sector would be freed from the 'Inspector Raj' and given "improved access to credit" as part of the National Common Minimum Programme. The Prime Minister in that speech had even advised bankers that they must also pay heed to the developmental dimensions of lending to the small enterprises. The advice has not been heeded much by bankers but there is indeed a silver lining in the dark clouds as certain banks have issued a charter to help out the SSI sector.

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In this backdrop, one conclusion that can be drawn is that the SME sector continues to be aggrieved and continues to complain about lack of funds even when the banks are flush with funds. This dichotomy and attitude of ambivalence should be discontinued, but this is a *fait accompli* and therefore, the SSI fraternity should devise their own system for alternative finance.

(CRISIL) has launched

SME rating services to facilitate banks to undertake better pricing decisions while extending credit to SMEs. The Government has given a fresh thrust on the extent of credit outlay to the SME segment to the tune of Rs. 1,35,200 crore by 2009-10 and RBI has prepared guidelines classifying all entities. However, RBI has also stipulated that entities with excess of SSI limit and up to Rs. 10 crore should be classified as Medium-Size Enterprises and has bracketed SSI financing in the priority sector. Definition of SSI and Tiny Industries, however, will continue. Such a rating has perhaps been prescribed as a pre-requisite for getting loan under the availability to pre-empt risk perception and resultant NPA.

We no doubt welcome free-flow of funds to the SSI sector but instead of this sort of approach, an innovative approach was expected because of the recent policy declaration of the Government on 'Public-Private Partnership'.

Alternative Finance

While speaking about alternative modes of finance, we will touch upon "Factoring Services," which are within the framework of the banking system that should be slightly re-oriented since the risk perception and/or the risk involvement of banks and financial institutions is minimal. When we talk of "Factoring Services", it is not an innovative concept although it may sound so. In the year 1988, a Study Group was appointed under Mr. P.S. Kalyansundaram, Former Managing Director of State Bank of India along with Senior Officers of Commercial Banks, Financial Institutions, Government of India and RBI, and academics with expertise in the area to examine "the feasibility and mechanics" of starting factoring organisations. Primarily speaking, factoring as a concept, is to meet the need for hassle-free post-sale finance to industries, particularly under the SSI sector that pass off as SMEs. Factoring, as a concept, has gained ground in the Indian system in the early 90s and under the recommendation of the Study Group. The Centre initiated a Venture Capital Fund for Software/IT Industries but the same is not strictly in consonance with the terms of recommendations of the Study Group. In whatever form it may be, the very nature of the "Factoring Services" business does not pose any threat to the functioning of commercial banks. For, they only complement banks in post-sale dispensations. Under the fold of "Factoring Services," Factoring organisations not only provide SMEs with finance, but also offer other services such as:

(i) Sales Ledger Administration
(ii) Debt collection
(iii) Credit insurance.

Such services could be rendered either by the commercial banks or non-banking financial institutions. But unfortunately, non-banking financial institutions are indulging more in Car Finance and Housing Finance instead of doing their professed functions, including that of "Factoring Services". This is also not an exception in the case of both public and private sector financial institutions. Flushed funds are thus siphoned off to finance consumer durables and housing but not to the SME sector. Thus, there needs to be an attitudinal change or rather a change of mindset among bankers. In this article, we are not treating all the Public Sector Banks at par. A case in exception is Canara Bank, which has successfully floated a subsidiary entitled CANBANK Factors Ltd.. In fact, Canara Bank has also set up another subsidiary for exporting of readymade garments. Its establishment at Bangalore is a luminating point. It is now imperative to popularise the scheme as it is useful and beneficial—both to its clients as well as Financial Institutions.

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Since "Factoring Services" are not limited to financial institutions (either public or private) and/or non-banking finance companies, exclusive Factoring organisations, therefore, may be organised by the patrons of the SME sector. The Government should, in fact, encourage the system to grow. The benefits that could be extended by Factoring organisations could be as under:

(i) Helping SMEs in saving time and cost through quicker and improved cash flow
(ii) Treating Factored Debt as an off-balance sheet item
(iii) Flexible terms and quicker sanctions
(iv) Improved and easy returns on funds deployed
(v) Matching the seasonal need of finance to the needs of SMEs
(vi) Developing a network of better quality customers and ready availability of information.

While availing "Factor-

ing Services," SMEs are required to produce copy of the invoice with the notice of assignment in favour of the customer, duly acknowledging the receipt of materials by the customer either on the invoice itself or by means of separate delivery challans. And last but not least, the Power of Attorney from the buyer customers to the Factors should agree to make payment directly to facilitate collection of debt, as a safeguard measure for the Factors.

Factoring of Balance Sheet

Factoring involves risk in the areas of finance and credit nature. Here, in this case, selling goods or providing services to trading customers, 'customer' on open account basis whereby the factor purchases the client's bad debts (accounts receivable) either with or without recourse to the client. Under 'with recourse factoring' where credit cover is provided and here, when the customer fails to pay, recourse is taken to get back the money paid whereas under 'without recourse' when credit cover is provided and in the event of failure of the customer to pay, the factor is to bear the bad debt risk.

"Factoring Services" , being sponsored by Financial Institutions, are to follow the prudential norms of banking and treated as risk adjusted, weighted assets, and off balance sheet items. By 'risk adjusted', we mean weighted aggregate of funded and non-funded items. Degrees of credit risk expressed as percentage weighting are assigned to balance sheet assets and conversion factors to off balance sheet items. The value of each asset or item shall be multiplied by relevant weights to produce risk-adjusted values of assets and off balance sheet items. Credit will be taken into account for reckoning of minimum capital ratio.

The credit risk exposure attached to off balance sheet items has to be first calculated by multiplying the face amount of each of the balance sheet items of credit conversion factors. Detailed guidelines for calculating this, including the format, have been provided by the RBI. Off balance sheet activities/items are not booked in the balance sheets and are of contingent nature, and hence carry definite element of risk though they generate fee income for the banks. Banks are presently exposed to off balance sheet items, which are new and newer products/schemes.

Now coming to the clients' part of the issue and the 'Procedure' for accounting the debts of the company, which are assigned in favour of the factor. These can be removed from the current assets but the margin retained by the factor needs to be shown under 'other current assets'. However, the repayment amount received from the factor has to be shown as 'contingent liabilities' as the factor retains the right of recourse to the 'client' in case of non-payment by the customer. This will facilitate improvement of the over all working capital base of the company and thereby increase the current ratio.

Venture Capital Finance

This is another alternative. The term 'Venture' is generally understood and/or defined as equity investment in a new company, which has grown out of the nursery stage, and now requires finance in order to develop high-risk projects related to some innovation or new technological development. In short, it is a combination of capital and management expertise. The main objective of Venture Capital Financing is to exploit new/virgin areas for investment. We should not miss out a mention of services rendered by National Small Industries Corporation (NSIC). This age-old institution, which was exclusively set up for SSIs could not come up to expectations and the SSI fraternity is generally not happy with its functioning.

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Character: It may be mentioned that all new projects and/or virgin areas in business pursuits cannot attract Venture Capital Financing. For, such financing is done only for concepts involving new inventions, improved technology with a capability of commercial exploitation, or in the case of applications having viability. To attract Venture Capital, the project should not remain in the conceptual stage but cross pre-production stage since nobody would like to take a risk on conceptual framework until its configuration.

Therefore, Venture Capital Finance may be available to the entrepreneur at the early stage as seed capital; for financing Research and Development; as start-up capital at the take off stage; or in the form of collaboration.

Venture Capital has been very popular in China, Hong

Kong, Japan, Korea, Singapore and Taiwan. In India, however, the concept of Venture Capital found articulation on the floor of Parliament when the then Finance Minister was presenting fiscal policies on 20th December 1985. The Abid Hossain Committee recommended introduction of Venture Capital. Besides the Abid Hossain Committee, the Study Group appointed by the Planning Commission recommended introduction of Venture Capital for SSIs by setting up special Venture Capital type funds of Rs.500 crore to be named as Laghu Udyog Nirman Nidhi for equity support. Followed by such recommendations, SIDBI has introduced Venture Capital Funds for Software and IT Industries. Venture Capital Finance has made a powerful impact not only in the South Asian countries but also in the USA and UK. However, in India, we are still at the stage of infancy mainly because of non-involvement of the resource personality and partly because of low awareness among the SSI fraternity as to the existence of such schemes and their inability, if not their inertia, to tap the available potential.

The sources are many and varied. The IITians and NRIs are very enthusiastic about Venture Finance, but what is needed is the involvement of IITs. And this is the exclusive job of the SSI/SME associations. That apart, such associations should tap pensioners and retired intellectuals to be involved in such projects. The Venture Capitalist may be a technical collaborator. They may also be fund providers. Thus it is a mixed bag and a mixed deal of technology and capital. With this end in view, a Memorandum of Understanding needs to be signed.

Capital Market

Another alternative source is the capital market. Following ongoing reforms, the capital market has brought many advantages for large companies. However, the small and medium industries, more particularly the small industries, cannot tap the debt market for raising capital/funds because of their inherent characteristic differentials from that of large companies. That is why there is a need to open the system further to facilitate SSI entry into the debt market. There is a need for a Working Group on Developing the Capital Market for the SSI sector. The launching of the 'Over the Counter Exchange of India (OCEI)' was a step towards this end. However, OCEI has not been able to live up to expectations. In addition, because of various limitations, the SSI sector has not been able to avail of the available, viable means for tapping capital and debt markets in various forms. Neither has the SSI sector been able to provide a safe exit route for equity providers to the sector. Viewing this, the Study Group observed: 'even the modern SSIs prefer to remain as partnership firms for various reasons. Corporatisation will help the sector to become more market oriented, financially disciplined, and transparent and also make them eligible to tap funds from the capital markets. Efforts should be made to build up the equity and financial strength of the SSI sector on the lines of the tax incentives being extended to the corporate sector.' The Study Group recommended that: "The required encouragement should be provided to SSI units for transforming them into limited companies through suitable enactment, policies and procedures. The Government should design suitable policy packages, including legal enactments, for encouraging SSIs to convert themselves into limited companies." Therefore, tapping the capital market should not be a problem for medium-sized industries, which are corporate in character but the SSIs have to transform themselves into limited companies, leaving all prejudice, to identify themselves as a partner of business in the trading market.

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The Study Group has also recommended introduction of the Limited Partnership Act for the SSI sector and an easy exit route. Perhaps, the SME Bill 2005, which has already been placed in Parliament, whenever enacted, will help the SSI sector to tap the capital market. However, at the present moment, modern medium industries that are complying with the norms of the capital market, may easily tap the available opportunities, but this requires exercise for enrolment. "The Patil Committee has already made recommendations for necessary action by the Government, Securities and Exchange Board of India (SEBI), RBI and SIDBI, which need to be accorded due consideration".

The success of SMEs frequently depends upon their ability to work in co-operation with similar enterprises. In order to survive the intense competitiveness of a global marketplace, it is essential that the SMEs work together through institutions, which are able to ad-

dress both local and export markets and to provide the strength to meet the challenges of multinational competitors – often even in their home markets. This requires setting up of SMEs Co-operative Credit Societies, cluster-wise, and district-wise. For, this is the only way for salvation of SMEs from financial institutions.

According to the snap poll conducted by CII in SMEs across the country, as far as non-traditional sources of finance substituting traditional sources like banking are concerned, 58 per cent felt that newer forms would dominate. Of course, 25 per cent didn't agree and 10 per cent didn't comment. According to a survey by ILO, banks are biased in financing SMEs. Further, according to a survey carried out by FICCI, it was disclosed that there is need for increased capital requirements for smaller banks under Basel II norms (to come into effect in 2007). Since banks are more averse towards credit dispensation, there is likelihood that Small and Medium Enterprises (SMEs) and the farm and rural sectors will be left out of the loop and face a credit squeeze. Therefore, there is a need for SSIs/SMEs to develop their own alternative sources of finance in a collective manner. Such a move will:

1. Ensure timely credit delivery with flexibility in enhancing of limits
2. Lead to lesser compliance of rules
3. Result in a lesser incidence of sickness due to non-availability of finance from traditional sources
4. Provide opportunities for asset creation under a supervisory body
5. Have binding responsibility as a share holder/promoter
6. Have minimal occurrence of NPA and easy exit routes to set up new ventures.

Of course, in the Indian context, after some revelations, Co-operative Credit Societies fall into disrepute. But, this is equally true of developing countries. But under our contemplation, such credit societies for the SME sector have to be formed clusterwise by the units, who are the shareholders, and from the very beginning it should be under the control and supervision of a regulatory body like the RBI. The Government, while releasing any subsidy/grant to SME/SSI units, either for opening test centres or obtaining ISO certification or any facilities under the scheme of SIDO, should release and/or channelise such funds through this system, which will also ensure proper end use of funds. The system will also develop a separate wing for "Factoring Services" with a big departure from the concept of factoring as discussed above for rendering marketing assistance to the units. The idea is that instead of working on the bills and receivables, it will take over the products and make 50 per cent of the payments outright and arrange for marketing. The main difficulty of SSI units is retaining manufactured products and blocking capital. This is primarily because they require space for retaining and almost all SSI units have no retention capacity for finished goods by blocking capital. The system will receive commission for playing a role in the trading business. The units are to part with commission/service charge for effecting sales of products by the system, which is for the administrative cost of the system.

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The SMEs Co-operative Credit and Marketing Society will address the total service needs of the members. This requires lending capacity of the Society. It has been observed in the ILO Workshop that the present capacity of many apex organisations in the region (Asia) was not adequate to meet the challenges of the new environment, notwithstanding the important role, which they have played so far. Their organisational structure, staffing pattern management system, activities and operations have been designed to suit state-sponsored and state-controlled co-operative systems. Since co-operative apex organisations are now mandated to function as representatives of promoters of autonomous, member based and member-controlled Co-operatives, they have to be restructured and reoriented and have to devise methods for raising sufficient funds to make them independent of government subsidies.

The present Government is allowing NGOs to work independently and also involving NGOs in the implementation work of Government Schemes/Projects. As such, it is expected that the Government will support such a move without any hindrance. Therefore, the time is ripe to go in for non-traditional, alternative modes of finance. ❐