Volume : 4 | Issue : 5 | May 2015 ISSN - 2250-1991

Research Paper Finance

Financing of SME Firms in India

Ms. Jahnavi K. Dubal

Assistant Professor, Shree Swaminarayan Institute of Management & IT, Porbandar

ABSTRACT

A major bottleneck to the growth of the vital Indian small and medium enterprises (SME) sector is its lack of adequate access to finance. This paper examines the major issues in the financing of SMEs in the Indian context, such as the information asymmetry facing banks and the efficacy of measures such as credit scoring for SMEs; whether transaction lending would be adequate to address the information issues or would lending have to be based on a relationship with the SME, using both 'hard' and 'soft' information; and whether the size and origin of the bank affect the availability of credit to SMEs. Some aspects are elevated in the paper, such as the importance of the credit appraisal and risk assessment processes in today's banking landscape and the role that banks can play in developing the SME sector in India.

KEYWORDS SMEs, credit rationing, Transactions lending,Basel capital norms

1. Introduction

In recent years, while the Indian economy has been growing at over 6%, the production from micro, small and medium enterprises has been growing at over 11% between 2002–2003 and 2007–2008.

In India, banks are the dominant channel for providing funds to industry. However their importance in funding smaller firms is even more pronounced since most small and medium enterprises (SMEs) are not able to access the capital markets for funds. In recent years, governments and policy makers have been giving considerable attention to facilitate the development of the SME sector, as a strong and vibrant SME sector provides a good foundation for entrepreneurship and innovation in the economy.

2. The SME sector in India

The census of micro, small and medium enterprises (MSME) in 2006–2007 reveals that there are about 26 million MSMEs in India providing employment to 80 million people. The MSME sector contributes 8% of India's GDP, generating 45% of manufactured output and 40% of exports. The Government of India enacted the Micro, Small and Medium Enterprises Development Act 2006 to provide a policy framework for the development of the MSMEs. The Micro, Small and Medium Enterprises Development Act 2006 groups MSME firms into manufacturing enterprises and service enterprises.

A manufacturing firm with investment in plant and machinery not exceeding Rs. 25 lakhs (2.5 million) is considered a micro enterprise. Firms with investment in plant and machinery between Rs 25 lakhs and Rs 5 crores (50 million) are considered a small enterprise, and medium enterprises are those where the investment is in the range of Rs. 5 crores to Rs 10 crores (100 million). In the service group, for investment in equipment of less than Rs 10 lakhs (1 million), the firm would be in the micro category, if it is between Rs 10 lakhs to Rs 2 crores (20 million), then it would fall in the small enterprise category; if investment in equipment is in the range of Rs 2 crores to Rs 5 crores, then it would fall in the medium enterprise category. In order to get a sense of international comparison, the Basel Committee on Banking Supervision defines an SME as a legal entity, sole proprietorship or partnership where the reported sales for the consolidated group of which the firm is a part is less than €50 million.

3. Financing SMEs in India: directed lending and credit rationing

One of the major bottlenecks to the growth of SMEs in India is access to finance. Banks are the dominant channel for funding SMEs and in this paper, we survey some of the major issues in the financing of SMEs in the Indian context. While banks in India are not provided with a specific target for lending to SMEs, the bank loans given to the micro and small enterprises is part of the priority sector lending. Indian banks are required to achieve a target of 40% of adjusted net bank credit to the priority sector, while foreign banks have a target of 32% exposure to the priority sector.

Bankers consider two aspects of the loan in their credit decision—the interest rate on the loan and the credit risk of the loan. However, the interest rate itself affects the risk of the loan due to two factors. First, is adverse selection; that is, only more risky projects would come forth for loans at higher interest rates; and second, moral hazard, as borrowers who have been granted the loan at a higher interest rate would undertake a more risky project in order to earn higher expected returns. As a result, at higher interest rates, the expected return from a loan would start decreasing after a point due to higher defaults. Thus, in the presence of information asymmetry in the market for loans and costly monitoring, banks would not use interest rates alone to equate demand and supply, but would ration credit.

The issue of bank competition and credit availability may matter most to SMEs for two reasons. First, SMEs are more vulnerable to information problems. Second, SMEs are much more bank-dependent than large enterprises. Study of a large number of Spanish SMEs find that there is a significant sensitivity of the extension of trade credit to bank lending for unconstrained firms.

The other argument is that SME firms have lower profitability and therefore banks are reluctant to lend to them. It been identified that banks are averse to lend to SMEs as they do not consider them as attractive and profitable undertakings. SMEs are also regarded as high-risk borrowers because of their low capitalization, insufficient assets, and high mortality rates.

4. Framework for analyzing SME financing

Berger and Udell (2006) have proposed a conceptual framework for the analysis of SME credit availability issues. They argue that in the context of loans to SMEs, two factors affect the availability of loans and the nature of the credit facility. First is the lending technology which refers to the combination of primary information source, screening and underwriting policies and procedures, loan contract structure and monitoring mechanisms which are used in the lending business. Second is the lending infrastructure which includes the information environment including the quality of accounting information, the legal, judicial and bankruptcy environments, the social environment, the tax environment and the regulatory environment in which financial institutions operate in a given country. The government policies influence the lending technology used in different countries, through the lending infrastructure.

4.1. Transactions lending and relationship lending
Petersen and Rajan (2002) find that small firms, though informationally opaque, have been borrowing from institutions further away, and they attribute this to the development of firms such as Dun and Bradsteets, which specialize in rating small businesses. The possible reason is that credit scoring helps to reduce the information asymmetry, particularly with respect to small firms and hence geographic proximity of the borrower and lender is not crucial to loan decisions. Other studies also find that credit scoring tends to enhance SME access to debt capital (Berger et al., 2005a, Frame et al., 2001 and Frame and Woosley, 2004).

The Small Industries Development Bank of India (SIDBI) in association with ten banks and Dun and Bradstreet has set up the SME Rating Agency of India Ltd (SMERA) as an exclusive rating agency for MSMEs.

4.2. Bank size and lending to SMEs
A major policy concern in recent times is the impact of the growth in size of banks on availability of credit to the SME sector. A number of studies have analyzed the relationship between bank size and the credit flow to firms of different sizes.

Berger et al. (2005b) find that large institutions have comparative advantages in transactions lending to more transparent SMEs, while small institutions have comparative advantages in relationship lending to informationally opaque SMEs, based on soft information. Competitive banking markets can weaken relationship building by depriving banks of the incentive to invest in soft information. Therefore, less competitive markets may be associated with more credit availability (Petersen &Rajan, 2002).

4.3. The lending infrastructure in India
The legal environment is also an important factor that impacts the willingness of banks to lend to small firms. Haselmann and Wachtel (2007) find in their study of 20 transition economies that foreign banks are more inclined to lend to small and medium enterprises if creditor protection is strong. In order to strengthen the framework for tackling loan defaults and contract enforcement, India enacted the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act in 2002.

The availability of credit scores for SMEs in India should also help to enhance the quality and reliability of financial information enabling more lending to the sector.

In India, while the domestic banks are given a priority sector lending target (which includes lending to the micro, small and medium enterprises) of 40% of adjusted net bank credit (ANBC), foreign banks have been set a target of only 32% of ANBC. It has been argued that both domestic and foreign banks should have the same target towards lending to the priority sector in order to provide a level playing field for all banks and to get all banks actively involved in the faster development of the priority sector.

4.4. Basel capital norms and its impact on funds for SMEs
Capital standards require banks to keep a minimum capital against their assets in order to protect the interests of the depositors and to ensure that there is adequate capital to absorb potential losses. Under Basel II capital standard, the risk weights for different classes of assets depend on the risk of the assets. Basel II capital standards allow banks to categorize the SME lending as 'retail portfolio' which would require a lower risk weight of 75% compared to 100% risk weight for a BBB rated loan (Bank for International Settlements, 2006).

The evidence so far is mixed as far as the impact of Basel II capital standards on bank loans to the SME sector is concerned. While the lower risk weight for retail portfolios should reduce the bank's cost of lending to the SME sector, the actual credit losses from the SME sector may not be significantly different from lending to the larger firms.

5. Conclusion
The SME sector in India, which includes the micro, small and medium enterprises, constitutes an important part of the economy. However, a major concern for the SMEs is the availability of an adequate amount of finances. The government has recognized the key role that the SME segment plays in creating new enterprises and in providing employment to a large segment of the population and has adopted several public policy measures to enhance flow of credit to the sector.One of the prominent measures used to ensure adequate flow of funds to the SME sector is through regulation requiring banks to provide at least 40% of loans to targeted areas which include the micro, small and medium enterprises.

The challenge for banks is to bridge the information asymmetry so as to take the appropriate lending decision so that the good firms are not financially constrained, and at the same time, cut down on exposures to bad credit risks.Measures such as credit scoring for SMEs should improve the quality of financial information and enable greater funding for the sector. The SARFAESI Act and the strengthening of legal provisions to take possession of assets used as security has improved the legal environment for lending in India, thus lowering the cost of lending and enforcement of contracts.

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