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ORIGINAL ARTICLE

PROBLEMS AND PROSPECTS IN BANK SME FINANCING IN INDIA

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Abstract:

Financial services are vital in developing a vibrant SME sector. However access to financial services to this sector remains severely constrained. Lack of access to financing is consistently cited by SME's as one of the barrier to growth. Commercial banks are the oldest institutions having a wide network of branches, commanding utmost public confidence and having lion's share in the total banking operations. Often commercial banks consider SME financing as risky and costly to serve because of insufficient assets, low capitalization, vulnerability to market, and lack of accounting records. The study attempts to understand the commercial banks lending to priority sector and non priority sector lending and to identify problems and prospects of SME lending. Overcoming the challenges can results in excellent opportunities to commercial banks by proving a wide market to serve and make SME lending a profitable banking operation. Moreover SME has multiple banking needs. This in turn can provide excellent opportunities in the other banking operations. Commercial banks should be proud of serving an important sector of the economy, which is the key engine growth of the Indian economy.

KEYWORDS-

Commercial banks, SME, Credit Gap, NPA & Priority sector.

INTRODUCTION

Small and medium sectors are crucial to the economic and social development of Indian economy. They play a major role in creating jobs and generating income for low income people. SME foster economic growth. Financial services are vital in developing a vibrant SME sector. However access to financial services to this sector remains severely constrained. Lack of access to financing is consistently cited by SME's as one of the barrier to growth. SME financing in India is largely part of regulated lending by a network of state created institutions. Commercial banks are the oldest institutions having a wide network of branches, commanding utmost public confidence and having lion's share in the total banking operations.

Up to late sixties, they were mainly engaged in financing organized trade, commerce and industry, but since then, they are actively participating in financing agriculture, small business and small borrowers also. Banks lending is special important for industrial sector. The lending and deposit taking activities of the banks are complementary & go to build up banking relationship which increases the availability of fund to the industrial sector, which in turn enable them to partially avoid taking more expensive credit. Moreover, a significant difference in the collateral requirements exists between banks and other financial institutions. All such differences effectively segment the market for business lending and make banks loans highly un-substitutable. Indian banks have freedom to decide about the flow of credit to the different segments. However, the regulators have prescribed exposure limits for the sectors, keeping in view the importance of meeting the credit needs of various sectors, so that an individual or a group does not corner a major chunk of the funds. The issue concerned in case of commercial banks as to concentration of credit to groups and spatial distribution of credit, the regional and sectoral disparity in disbursal of credit.

OBJECTIVES

To understand the criteria followed by commercial banks in lending to different sectors
To know the policy guidelines in lending to SME sector
To analyze the problems faced by Commercial banks in financing SME sector through literature review.
To identify the prospect for SME lending by commercial banks

METHODOLOGY

The study is based on the secondary source of data. Data were collected from RBI website and Ministry of MSME website and represented in the forms of graphs and charts. Books, articles from news papers and journals were also source of data.

COMMERCIAL BANKS LENDING CRITERIA

Bank deals with funds of large depositors and they are required to return the money to the depositors as and when it is demanded for. Banks are also responsible to ensure return in the form of interest to the depositors. Therefore it becomes necessary for banks to monitor the loans and see that they do not turn bad. Consequently they have to follow the principles of credit management to avoid the danger of non recovery.

The bank's lending is based on the following criteria which is in turn based on the principles of sound lending,

The safety of the funds advanced by them along with the interest on the money lent. The banker will see that the business for which the loan is being granted is sound and borrower is capable of carrying it out successfully.
The money should return to bank as per repayment schedule. Banks shall ensure that the money lent is not locked up for a long time.
Banks are essentially commercial organization profit earning is the motto. Therefore fair return on investment is essential.
The purpose for which loan is being taken is an important consideration for banker while advancing loan.
A prudent banker always tries to select the borrower very carefully and take tangible assets as security to safeguard his interest.
The banker will not consider for sanction unless there are alternative sources of repayment available.
The commercial bank tries to ensure that the borrower possesses the requisite character, capacity and capital.
Thus commercial banks looks for safety, liquidity, profitability and security of funds and lending policies are guided by its loan policy or credit policy.

In contrast with the above commercial banks are directed to lend to the weaker section of the society which are deprived of obtaining funds from financial institutions. As a part of social control measures right from 1968 and nationalization of commercial banks it is mandatory for commercial banks to lend to neglected sectors of the economy under priority sector lending. Thus lending to SME's is a priority sector lending and commercial banks are expected to the follow the guidelines of Government and RBI in lending to SME sector.

Commercial banks provide short term and medium term loans to MSME's. The purpose of short term lending is to meet working capital requirement to procure raw material, to hold stock and to pay wages salaries, fuel power and water. Medium terms loans are provided for acquisition of land, machinery and to meet pre operative expenses.

Thus commercial banks provide both direct and indirect financial assistance to MSME's. Commercial banks are also part of execution of various guarantee and capital subsidy schemes.

Direct finance to SSI shall include all loans given to SSI unite which are engaged in manufacturing, processing or preservation of goods and whose investment in plant & machinery excluding land & building does not exceed the amount specified. Indirect finance to SSI shall include finance to any person providing inputs to or marketing the outputs of producers of this sector.

SME LENDING GUIDELINES

As per extant policy, certain targets have been prescribed for banks for lending to the Micro and Small enterprise (MSE) sector. The targets for domestic banks and foreign banks are slightly different keeping in mind the limited presence of the foreign banks. The domestic commercial banks are expected to enlarge credit to priority sector and ensure that priority sector advances (which include the micro and small enterprises sector) constitute 40 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.

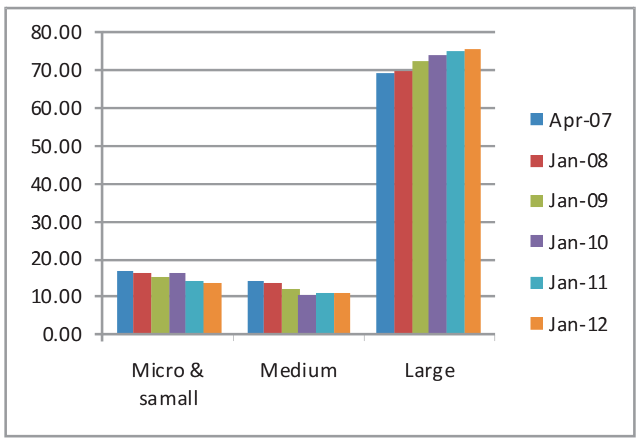
A Prime Minister's Task Force was set up in 2009 by Government of India (Chairmanship T.K.A. Nair, Principal Secretary) to look into the various issues pertaining to MSMEs. In terms of the recommendations of the Task Force banks have been advised to achieve a 20 per cent year-on-year growth in credit to micro and small enterprises and a 10 per cent annual growth in the number of micro enterprise accounts In order to ensure that sufficient credit is available to micro enterprises within the MSE sector, banks should ensure that:

(a) 40 per cent of the total advances to MSE sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs. 5 lakh and micro (service) enterprises having investment in equipment up to Rs. 2 lakh ;
(b) 20 per cent of the total advances to MSE sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs. 5 lakh and up to Rs. 25 lakh, and micro (service) enterprises with investment in equipment above Rs. 2 lakh and up to Rs. 10 lakh. Thus, 60 per cent of MSE advances should go to the micro enterprises.
(c) While banks are advised to achieve the 60% target as above, the allocation of 60% of the MSE advances to the micro enterprises is to be achieved in stages viz. 50% in the year 2010-11, 55% in the year 2011-12 and 60% in the year 2012-13 For Foreign banks the targets are the same except that Foreign banks are expected to enlarge credit to priority sector and ensure that priority sector advances (which includes the MSE sector) constitute 32 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher. Within the overall target of 32 per cent to be achieved by foreign banks, the advances to MSE sector should not be less than 10 per cent of the adjusted net bank credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.

Public sector banks have been advised to open at least one specialized branch in each district. The banks have been permitted to categorize their MSME general banking branches having 60% or more of their advances to MSME sector, as specialized MSME branches for providing better service to this sector as a whole. As per the policy package announced by the Government of India for stepping up credit to MSME sector, the public sector banks will ensure specialized MSME branches in identified clusters/centre with preponderance of small enterprises to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop requisite expertise. Though their core competence will be utilized for extending finance and other services to MSME sector, they will have operational flexibility to extend finance other services to other borrowers.

FLOW OF BANK CREDIT TO INDUSTRIAL SECTOR

	Micro & small	Medium	Large
Apr-07	16.69	14.19	69.12
Jan-08	16.56	13.67	69.77
Jan-09	15.40	12.11	72.49
Jan-10	16.05	10.14	73.81
Jan-11	14.11	10.75	75.14
Jan-12	13.31	10.89	75.80



Source: www.rbi.org

The percentage of credit flow to micro, small, medium and large enterprises to total industrial credit shows that large industries are getting more credit, followed by micro and small. Medium industries are getting credit almost on par with micro and small scale industries by commercial banks. The percentage of credit is too high in case of large industries when compared to small and medium scale enterprises.

The above data indicating flow of credit highlights the fact the commercial banks in India are keen in serving large enterprises than small and medium scale enterprises. This may be due to the difficulties faced by them in extending credit to this sector. Since the conceptualization of priority sector lending commercial banks are not able to meet and beat the he target set by policy makers.

On the other hand financial exclusion is very high in case of bank sme financing. Around 1.56 lakh micro enterprises and .14 lakh small enterprises are availing institutional finance out of 26 million SME's. There is no dearth of credit in the financial system but credit gap exists and banks are unable to fulfill the financial requirement of very important sector of the economy.

PROBLEMS IN BANK SME FINANCING

Various literatures on bank financing to SME sector and priority sector lending has highlighted the following difficulties encountered by the financial institutions and in particular to commercial banks are Insufficient assets, low capitalization, vulnerability to market, lack of accounting records and high transaction cost.

Information asymmetry makes banks to curtail the extent of lending to SME's. As it becomes very difficult to banks to evaluate their repayment capacity and to assess the credit risk associated. Moreover Commercial banks in India do not have requisite capability to discriminate between good and bad risk. They have not yet developed adequate expertise in SME lending risk assessment.

Major concern of the banks is the recovery of the amount lent to this sector. Problem of loan lent to priority sector including SME's becoming Non performing asset is the greatest challenge.

Lending to SME sector looked as a non- profitable banking activity as it lent under the guidance as a part of social control measure.

Commercial banks cannot strategies lending policy to make it as a profitable banking activity, as lending to SME sector is under priority sector lending.

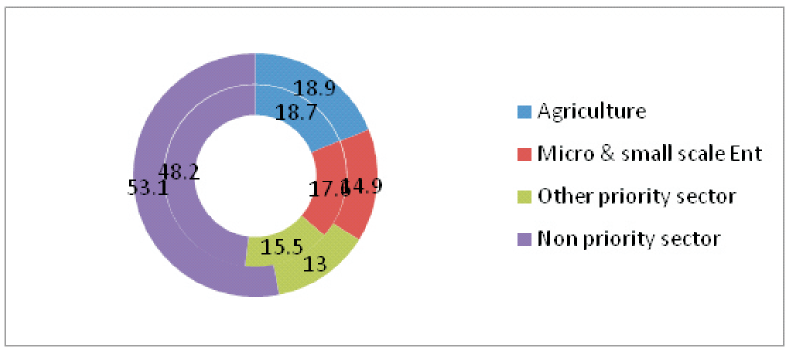
Majority of the SME's are in organized sector. It is very difficult for commercial banks to penetrate this unorganized sector and assume risk of lending, which almost turns to be as NPA.

PROSPECTS FOR BANKS IN SME LENDING

Financial exclusion is very high in case of SME financing. It is approximately 95% of the total SME's are not availing institutional finance including commercial banks. This can be viewed as a great opportunity for commercial banks to penetrate this vast and potential sector for their lending. If number of units served by the commercial banks increase, the transaction cost of serving this sector will automatically be reduced. The problem of high transaction cost of serving SME sector faced by the commercial banks can be reduced by including those units which are out of reach of commercial banks lending.

Another major concern of commercial banks regarding SME financing is that their lending turning out to be bad. The problem of NPA is making banks to not to volunteer to lend SME sector. As per the data published by RBI on NPA from different sectors, the NPA from priority sector and SME's have come down over the years. The percentage of NPA from Non priority sector is little high than the percentage of NPA from priority sector lending.

Percentage composition of NPA's of SCB's as on 31st March 2011&12



Source: Trends and progress in Banking in India report 2011.

High transaction cost and NPA from SME sector has made commercial banks to perceive that lending to SME sector as non profitable lending. One of the reasons attributed for low profits by public sector banks is lending to priority sector lending at lower rates of interest. But the studies in other countries have found that lending to this sector profitable banking activity. Dr. K.C. Chakraborthy , deputy governor of RBI in his special address on priority sector lending has stated that commercial banks should consider priority sector lending as part of their business operations and it should not be viewed as corporate social responsibility.

SME's sector is alleged of not maintaining proper books of accounts, no clear picture about revenue earning capacity, lack of collaterals makes commercial banks to perceive SME lending as a sector with high credit risk. Commercial banks need to develop an efficient credit risk assessment and management system. Loans to SME's are covered by CGTMSE (CREDIT GUARANTEE FUND TRUST FOR MICRO AND SMALL ENTERPRISES). Therefore commercial banks should ensure that loans granted to this sector are covered under this scheme.

Thus, overcoming the above challenges can results in excellent opportunities to commercial banks by proving a wide market to serve and make SME lending a profitable banking operation. Moreover SME has multiple banking needs. This in turn can provide excellent opportunities in the other banking operations. Commercial banks should be proud of serving an important sector of the economy, which is the key engine growth of the Indian economy.

CONCLUSION

To effectively serve SME's commercial banks to change the way they do the business and manage risk. They have to understand the SME market and how it differs from other segments. Developing this capacity to predict the risk without reliable financial information adequate collaterals and by applying mass market approach can make Bank SME financing profitable opportunity.

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