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INTERVIEW

Financing of SME firms in India
Interview with Ranjana Kumar, Former CMD, Indian Bank; Vigilance Commissioner, Central Vigilance Commission

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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. Ranjana Kumar, a prominent Indian banker who also served, till recently, as the Vigilance Commissioner in the Central Vigilance Commission, speaks on some aspects that are raised 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.
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Context of interview

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 (Ministry of Micro, Small and Medium Enterprises, 2008—2009).

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[1]) 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.

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[1] In this paper, we use SME to refer to the micro, small and medium enterprises, although in the Indian context, MSME (referring to micro, small and medium enterprises) is commonly used.

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 (Economic Survey, 2009—2010). 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. (Bank for International Settlements, 2006, paragraph 273).

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 (Reserve Bank of India, 2009). Information is a key input that goes into the credit decision of banks and one of the challenges for banks is to acquire information about the credit risk of the borrower, as borrowers have more information than the lender about the projects (Myers & Majluf, 1984). This fundamental information problem is a key concern that needs to be addressed in the allocation of loans; the absence of a mechanism to bridge the information asymmetry between the borrower and the lender would lead to a failure to allocate loans efficiently. This information asymmetry becomes more pronounced for loans to the SME sector as this sector is considered more opaque for reasons that would be discussed later in the paper.

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, as Stiglitz and Weiss (1981) have argued, 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.

Carbo, Rodríguez, and Udell (2008) argue that 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. Carbo et al.'s (2008) study of a large number of Spanish SMEs suggests that constrained firms with restricted access to the bank loan market may turn to the trade credit market to exploit their investment opportunities, while unconstrained firms would turn to the bank loan market. Additionally, they analyse the supply side of the trade credit market by testing whether the extension of trade credit is sensitive to bank lending. They find that there is a significant sensitivity of the extension of trade credit to bank lending for unconstrained firms, thereby, suggesting that these financially unconstrained firms may act as'lenders' due to their easier access to a less costly source of funding (bank loans).

Banerjee, Cole, and Duflo (2003), using a 1998 enhancement in investment limit as eligibility criteria for preferential bank loans for SMEs in India, find that firms that newly came under the preferential lending criteria were able to obtain more loans with a consequent beneficial impact on increase in sales, suggesting that that these firms were previously credit constrained.

The other argument is that SME firms have lower profitability and therefore banks are reluctant to lend to them. Bhattacharya, Faiz, and Zohir (2000) 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 capitalisation, insufficient assets, and high mortality rates.

Framework for analysing 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

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