

New Ways of Financing Small and Medium Enterprises

Vijay Chandok*

Over the last decade, the Indian industry has transitioned from largely protected and license oriented business functioning to a globally competitive business environment. With the easing of trade barriers, Small and Medium Enterprises (SMEs) have started to leverage opportunities in exports and simultaneously upgrade their domestic product supply range and quality. The SMEs, in the changing world, had to face price competition from low cost neighbours, manage technology changes and adapt to a market driven by buyers than sellers. Despite these challenges, the Indian entrepreneurs have shown credible resilience and have started to make in-roads into the domain once boasted as forte of developed countries such as, IT, telecom, pharmaceuticals, gems & jewellery, retail trade and commodities. Many more industries are already knocking the door to join this league. India, a country of more than a billion people is blessed with competitive advantages like easy availability of intellectual expertise, efficient labour and an abundance of natural resources. This advantage is being increasingly recognized by more than 10 million business entities both in the organized and unorganized market and now looking at banks, who can understand their changing business needs and can act as an adviser and partner in their growth expectations,.

World over, SMEs have been recognized as the silent drivers of a nation's economy. Their enterprise is laudable and their ability to generate pools of growth and employment, invaluable. The SME story in India is no different. With over 40% of industrial output through 95% industrial units, SMEs form the backbone of the Indian economy. Within the SMEs, the services sector is a vital component. The services sector mainly comprises of IT / ITES, entertainment, telecom, hospitality, fitness and wellness, financial intermediary and consulting firms. This sector has seen a rapid and consistent growth, validated by the fact that in the last six years the services sector has contributed almost 60% of our GDP growth!

Shifting SME Financing Paradigm

If we look at the SME financing environment in the past, we did find that traditionally the SMEs are being served by public sector banks with a branch based model and following a one-size-fits-all strategy for credit assessment. Lending to SMEs offered significant challenges due to the lack of transparent credit information and access to credit history, limited sectoral data, high cost



of servicing due to low ticket sizes and low capitalization of entities. The cost of acquisition of an SME client too is relatively high and cost of credit processing and delivery is higher compared to large corporates. The existing legal framework is not favorably disposed towards enforcement of security. Also, there are limited options for sell-down of SME loans. In such a context, funding an SME business would have biased towards high cost of credit and restrictive scalability. ICICI Bank created a focused SME strategic business unit (SME-SBU) to cater to the emerging needs of the sector.

The bank formulated a 4-C strategy for SME financing based on following key business elements: (i) customer focus, (ii) contain risk, (iii) managing cost and efficiency optimization, and (iv) cross sell.

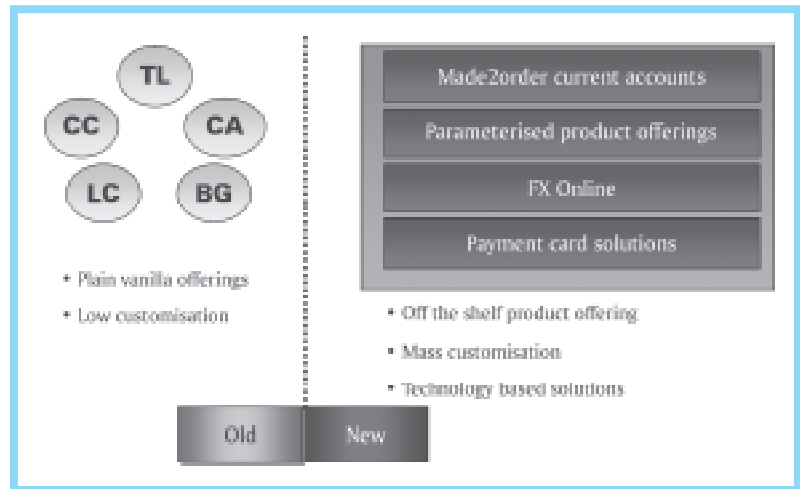
*Head – Small Enterprises Group, ICICI Bank Ltd., Mumbai.

SME-SBU was formed as a part of the consumer banking unit. This was due to the synergies offered in terms of:

- ❖ Evaluation of customers
- ❖ Credit delivery to widely dispersed clientele
- ❖ Large portfolio of small ticket loans
- ❖ Leverage the distribution capability

As we know, banks have traditionally lent against the security of fixed assets. SMEs, in general and the service sector SMEs which form a significant emerging growth driver of the economy in particular, do not have high investment in fixed assets. This has resulted in the SMEs being under-financed or inadequately financed. Lending to SMEs requires a slightly different approach vis-à-vis the traditional approach to financing adopted by the banks. It is only recently that some private sector banks including ICICI Bank have come up with alternate methodologies to finance SMEs in this sector. These banks have taken slightly different approach to meet financial requirements of this sector through innovative product and services like receivable financing, factoring, cash flow based lending and collateralized lending. Using a sector specific approach (cluster approach) would help banks to get a better understanding of the sector and develop credit proxies to evaluate their business. Unlike the conventional financial based lending model, the cluster approach captures a 360 degree view of the SME, bringing out the strengths in terms

Innovative Products for SMEs



of its manufacturing capabilities, marketing strengths, position vis-à-vis competitors and other strengths. This gives a true understanding of the SME's potential and the bank is in a better position to take credit views beyond just financial parameters.

To create a scalable business model, the banks are developing a wide range of basic and sophisticated products suite backed with integrated IT application and data mining capabilities, which cover areas such as, working capital, term loans, risk management, wealth management, bank assurance. The banks also need to invest significantly in automation of risk monitoring processes and events based triggers. These initiatives would help the banks to deliver services to a large

set of customers with consistency in response and with greater cost efficiencies. The banks have to constantly evaluate and innovate SME centric products to meet the fast changing business requirement of SME customers. The new age SMEs are the fastest to innovate and have consistently been translating competitive advantage to national and in many cases global benchmarks of excellence. SMEs would continue to be the growth engine for most economies of the world in the times to come. As far as India is concerned, the SMEs would evolve and grow while driving the economy towards a double digit growth.

Traditional approach to SME financing

