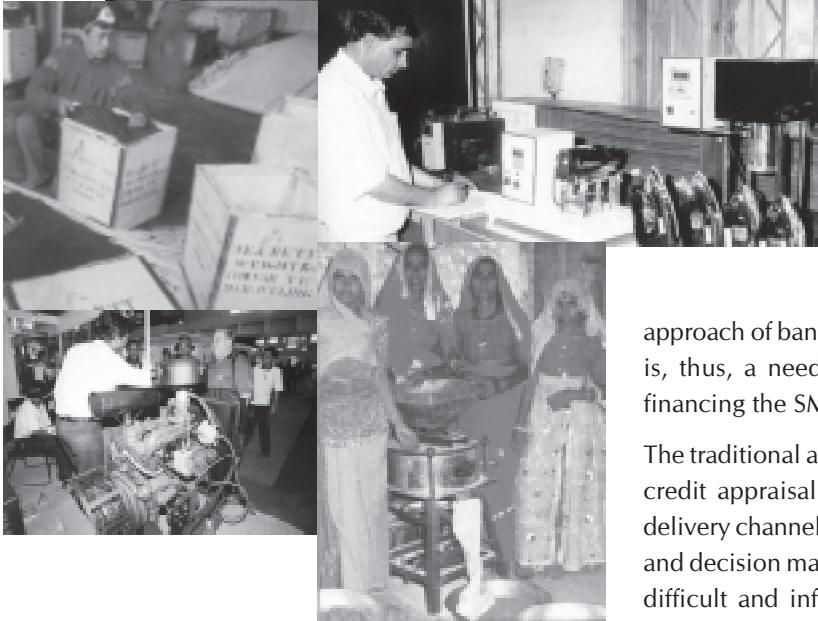




SME Financing – Need for a New Business Model

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approach of banks towards the segment. In this background, there is, thus, a need for formulating of a new business model for financing the SMEs.

The traditional approach to SME financing which is based on rigid credit appraisal systems that revolve around financials, single delivery channel, involvement of various hierarchies in processing and decision making, limited focus on cross selling opportunities, difficult and inflexible system of accessing transaction history, limited and pre-structured credit products, etc. has to be replaced with a new business model for financing SMEs. Before discussing the need of new approach for SME financing, it is necessary to understand the psychology and characteristics of an SME customer.

Psychology of an SME Customer

A study conducted by *McKinsey* revealed following psychological attributes of an SME customer.

- (a) He has low price sensitivity. Low service fees/interest is the least important criterion for him to select a bank for his requirements. Proximity of branch to his office/residence is the most important deciding factor in choosing a bank. Superior service, comfort/relationship with bank staff and bank's reputation are the other criteria which play significant role in choosing the bank.
- (b) SME customer believes in long-term relationship and generally remains loyal to the bank. More than 60% customers continue with the same bank for more than five years.

Several initiatives have been taken from time to time by the Government of India, since initiation of planning process, to address the problems faced by the SME sector. A large number of organizations, boards, corporations and training centres have been set up to provide technological, entrepreneurial, managerial and financial assistance to these units. Likewise, several committees and study groups set up by the Government, the Reserve Bank of India and Small Industries Development Bank of India (SIDBI) have analyzed their problems in depth and suggested various measures to address these issues. These efforts have undoubtedly made significant contributions and provided enabling environment for setting up and nurturing small industrial units. However, high incidence of sickness and subdued credit offtake in this sector indicates that the results have not been as desired. This necessitates a paradigm shift in the

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(c) SME customer provides significant cross sale opportunities to the banks. He likes to maintain CA/OD/CC accounts, purchase bank drafts, utilize other remittance facilities, use cash management services, place fixed deposit, avail forex services, open LC/BG, avail term loan, avail factoring services, etc. from the same branch, provided the services are satisfactory.

(d) Lack of alternative channels of delivery was found to be the major reason of switching over to other bank. Poor treatment by the staff, bad/ poor services and cumbersome loan renewal processes were other reasons, which resulted in switching over to other banks.

Thus, the study has highlighted the importance of quick, convenient and multi-channel, knowledgeable, proactive and personalized service and need of simplified and reliable processes in banks.

Special Characteristics of the SME Customer

The third census of SSI (2002) has also revealed certain unique characteristics of SSI customers which may help banks in developing their business model and structuring credit products. Some of these characteristics, relevant in developing new business model, are:

(a) about 95.8% of SSI units are of proprietary type ownership which means less professionalism and less transparency in financials.

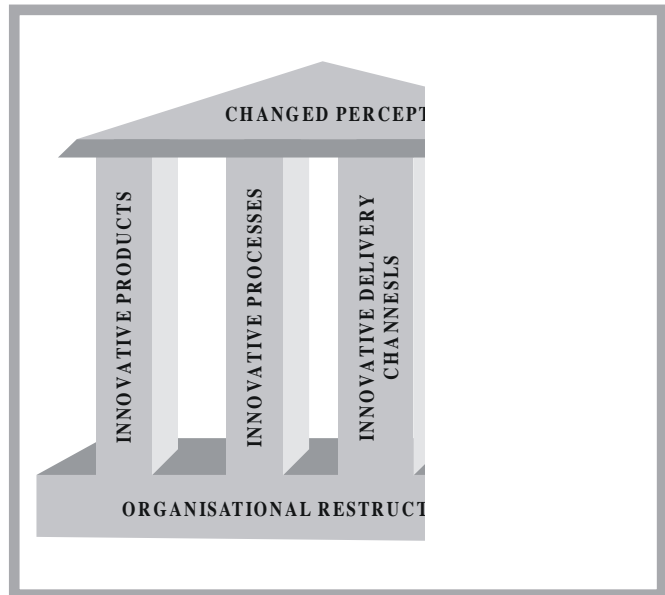
(b) about 97% of the units had a fixed investment upto Rs.2.00 lakh. Out of total 105.21 lakh units, 60.75 lakh (i.e. 57.74 %) were Small Scale Service & Business Enterprises (SSSBE) with investment in plant and machinery less than Rs.10 lakh. Out of remaining 44.46 lakh units, 99.5 % were tiny units, with investment in plant and machinery upto Rs.25.00 lakh.

(c) about 96 % of the units had the original investment in plant and machinery upto Rs.1.00 lakh. It provides opportunities to banks to finance for technological up-gradation or expansion.

(d) among working units, share of small industrial units has come down from 96 % during second census to 66 % during third census. This is on account of substantial increase in number of units engaged in services (from 3.24 % to 34 %). Approach for credit assessment of these units, engaged in small service sector, has to be based on potential/ competence of the proprietor rather concentrating on financials of the unit.

The New Business Model

An innovative SME financing model has to be built up in view of the challenges facing the SMEs, banks' reservations in financing SMEs and unique characteristic of SME customers. A new model for SME financing, which employs multiprong approach to enhance SME financing, has been diagrammatically depicted below.



Organizational restructuring is considered as a foundation block of the model as it addresses the grass root level problems in banks. Innovations in products, delivery channels, processes and handholding are the four pillars or building blocks of this model. Success of all these blocks requires protective ceiling of changed (positive) perception of bankers towards financing SMEs. It is also expected that once the strong foundation is laid and these four pillars or building blocks are strengthened, the changed perception towards SME financing would automatically emerge as a protective cover.

(A) Organisational Restructuring

Majority of banks, particularly the public sector banks, follow a traditional vertical, hierarchical, formal and 'line and staff' type of organizational structure which is considered inappropriate in the rapidly changing external environment. Increasing number of modern banks all over the world is moving towards an 'organic' organizational structure which is horizontal, decentralised, informal and functional.

The conventional branch centric approach consumes a lot of time and results in delay. A two tier (horizontal) structure with functional segregation consisting of technical field

officers at grass root level and a 'Centralized Processing Center' either at the controlling office or state capital level to process the application and convey sanction within stipulated time period may lead to quick, objective, knowledge based, unbiased and transparent decision making. Some of the leading banks have tried this model successfully. For proposals that involve larger credit limits, the system of sending it to next higher sanctioning authority at ZO/CO can be replaced with an approach of 'Credit Sanction Committee', which may be constituted at 'Processing Centers'. A pool of technical, financial and industry experts may be created at processing centers or at large SSI/IFB/SME branches which may act as processing centers. Non-SSI/IFB/SME branches may submit their proposals either to processing center or to these specialized branches. Adequate sanctioning powers should be delegated based on the expertise of the officials in the relevant field and not on hierarchy in the organisation. As 95.8% of SME customers are proprietorship type of customers, it is essential to closely focus on non-financial parameters during appraisal (i.e. ability of person behind the show). Banks may set up/identify or categorise branches as SSI/IFB/SME branches wherever a SSI cluster is identified. It would help them in optimal utilization of expert staff.

Organisational restructuring may be complemented with improvements in methods and modes of organisational communication. With the advent of information technology, though transaction processing has been automated, loan processing still continues to be an intensive paper work. Banks may develop standardized application forms and online-software for appraisal, analysis, processing and communication of sanction of loan proposals. Any additional information/clarification may be sought and replied through extensive use of corporate e-mail facility. These organizational changes would substantially reduce the response time and ultimately eliminate one of the major hurdles in increasing SME financing. It would also lead to lower incidence of sickness or loan impairment.

(B) Innovative Products

Product innovations in banks have set the rule of the game – "Innovate or perish". The same rule applies to SME segment. At present, there is a vast gap between requirements of the SME customer and availability of suitable/matching products and services in the banking sector. The conventional plain vanilla offerings such as term loan/cash credit with low customisation may be replaced with whole range of customized current account, customized credit limits, insurance, remittance, retail payment solutions, cash

management services, forex services, consultancy, etc. to enable the banks to turn into one stop financial super market. Involvement of industry associations, industry experts, targeted customers and application of cluster-based approach may help banks in innovating products suiting the various requirements of the SME customer.

The issue of high cost of acquiring, serving and monitoring SME customers can be resolved by offering products which reduce frequent visit of SME customers to the branch, provide flexibility to the borrowers as well as to the bankers and fulfill other financial needs of the customer. Most SME customers have to make several small payments through cash, banker's cheques or drafts. Banks may capitalize on emerging electronic payment and settlement systems such as ECS, EFT, RTGS, etc., to offer customized and cost effective retail payment/remittance solutions or cash management services to the SME customers. It may require addition of value added features in CC/OD/CA/SB accounts, integration of CC/OD account with current/saving account, any branch banking for all types of loan accounts, ATM facility even for CC/OD/CA, automatic utility bill payment/ supplier's bill payment facilities, online forex facilities, etc.

New credit products may be developed to take care of the diverse, unexpected and short-term requirements of the SME customers in a hassle free manner and in a short time. Banks may provide a range of products such as, dealer finance (bill discounting or overdraft facilities), vendor finance, equipment finance, receivable finance, commercial paper, factoring, venture capital, securitisation, non project specific short term loans, leasing and hire-purchase services, deferred payment guarantee in addition to conventional cash credit and term loan facilities.

To expand the SME segment, cross selling is an innovative way. Cross selling provides an opportunity to reduce customer acquisition, marketing and servicing costs and substantially increases spread of the bank and enhances customer loyalty. Banks should offer comprehensive solutions to all financial needs of the SME customers. A wide range of non-credit financial services such as, bank-assurance, credit cards, custodial services, demat accounts, remittance services, merchant banking, factoring, venture capital financing, incubation services, forex services, online equity trading, online access to commodity exchanges, online funds transfer, personal loans, deposits, mutual funds, provision of government transactions as tax collection may be provided under one roof.

The scope of Laghu Udyami Credit Card (LUCC) Scheme may be expanded. As most of the SME customers are proprietors, additional sub-limits may be built in the card to take care of their consumption needs. The card may be made more versatile through additional features. It may be enabled to be used as ATM debit, credit and business card.

In addition to normal credit limits, banks may provide small amounts as non-project specific loan. These loans may be provided without insisting on proof of end use as the intention is to take care of petty and emergency needs of the borrower. Some banks have already launched similar products with credit limits fixed higher by 10 to 20 % of the original credit limit. It obviates need of frequent overdrawing in the account and reduces operating cost of the banks.

Other Credit Related Services

More than availability of credit, convenience in access to credit and ease in dealing with the banks and other agencies is of prime concern for the SME borrower. Banks may consider extending the following services to reduce his concern.

(a) Most of the SME borrowers lack knowledge of legal procedures, (search reports, purchase of stamp papers of requisite value, getting necessary approvals), procedure to avail subsidy or to get seed money, etc. for which they depend on chartered accountants or consultants and pay hefty charges. As the bankers have knowledge of these processes, the banks may provide all the services at its doorstep for a nominal fee. This would save the prospective SME borrower from the hassles of completion of formalities. Banks may consider appointing 'Support Service Agents' to carry out these tasks and for liaison with government departments.

(b) The National Small Industries Corporation has recently introduced a credit rating scheme for encouraging SSI units to get themselves credit rated by reputed rating agencies. SIDBI has also developed a Credit Appraisal and Rating Tool (CART) as well as a Risk Assessment Model (RAM) and a comprehensive model for risk assessment of credit proposals of SMEs. Rating services for SME borrowers have paved the way for improvement in quality of credit appraisal and banks may take advantage of these models, adopt risk based pricing and reduce their transaction costs. Banks may assist the SME customer in approaching to rating agencies, educate them in completion of formalities and provide tips to obtain higher rating.

(c) Banks should develop flexible systems and procedures for dealing with SME customers and modify their role to be a facilitator. It may either provide software to these customers to prepare stock and financial statements or help and guide

them in preparation of renewal proposal / statements. In view of enhanced connectivity and usage of advanced technology banks may explore possibilities of a reciprocal arrangement with tech-savvy SME customers. These customers may be provided a secured remote terminal to access his accounts from his workplace. On the other hand, with the help of borrower, bank should also be able to view position of stock, fund flow position and other financial information by logging in to server of the customer. These automated monitoring procedures will obviate need of sending periodical account statements from bank to customers and stock/financial statements from customers to bank.

(C) Innovative Processes

The conventional credit appraisal systems are heavily dependent on financial statements and miss the softer strengths inherent in the business. Secondly, it is not necessary that past financials of the unit (which can be manipulated) reflect future performance of the unit. A rigid credit appraisal approach adopted by the banks has resulted in keeping several units outside the purview of bank lending as evident from the third census of SSI units (2002). The fact that as on March 31, 2002 only 4.55% units had availed loan from institutional resources, indicates that large number of units avail loans from money-lenders, relatives or friends.

A large number of units can be brought under the fold of banking channel provided the credit assessment methods are made simple. Banks may adopt a balanced score card model for credit assessment under which risk weights may be assigned to (i) managerial, technical and commercial competence of the entrepreneur (ii) quality of trade references from suppliers/buyers (need not be in writing) (iii) potential of the industry, unit and person (iv) financials of the unit (v) credit history/dealing experience (vi) rating awarded by the rating agency (vii) credit risk calculated as per model suggested by the SIDBI (viii) level of product, supplier and buyer diversification (ix) opinion of industrial consultants/counselors (x) information availed from credit information companies. Based upon the score of the unit, appropriate and need based limits may be sanctioned. For timely disposal of loan proposals, bank should develop appraisal, financial and technical skills of its officials through training, exposures to trade/industry fairs, participation in seminars, workshops and holding discussions both with successful and unsuccessful entrepreneurs. The appraisal should be a teamwork and the level of competence of the team must be kept high.

The appraisal system is to be made more realistic and transparent. The applicant and if required, his consultant,

should be briefed on the objective procedures which bank applies to arrive at decisions so as to educate them to understand the requirements of bank and to prepare credit proposals in a scientific manner as suggested by the Federation of Indian Chambers and Industry (FICCI). It would be helpful if the banks inform the SSI units when their performance has fallen below the rating parameters and counsel the units to perform better. Finally the banks have to change their role from dictator to facilitator in credit appraisal.

(D) Innovative Delivery Channels

With growing e-banking business, banks are investing heavily in multi delivery channels to provide a substitute for traditional banking delivery channels with an aim to shift customers from conventional banking to convenience banking. The alternative delivery channels such as, internet banking, tele-banking, mobile banking, ATMs and call centers reduce the operation cost, improve customer service, help in retention of existing customers, keep up with competitors, increase revenue potential and provide a platform for cross selling. These e-banking channels can be used to provide cash management services, electronic payment services and remittance services to SME clients. However, it is necessary for banks to educate SME customers about non-branch options and develop incentives to encourage migration to non-branch channels.

Outsourcing model for marketing and delivery of products and services has also been experimented by some banks and found to be successful. Banks can expand their outreach in a cost effective manner by employing outsource agencies. These services can be used for educating the SME customers and publicity of the products in addition to delivering bank's products and services. Possibility of employing a variant of Directing Selling Agent (DSA) such as 'Support Services Agent' may be explored to assist SME customers for liaison with government departments, completion of formalities for subsidy and mortgage, obtaining legal assistance and financial consultancy. This will help banks in creating an image as facilitator to SME customers and ultimately building the brand.

'Micro-enterprises' are the smallest in size but dominate in number. The third census (2002) revealed that 96% of the SSI units had the original investment in plant and machinery upto Rs.1.00 lakh. Considering the importance of this large chunk of SME segment, which includes small artisans engaged in village and cottage industries, the RBI has advised the banks to ensure that at least 40% of the total credit to SSI should go to this small segment which has less than Rs.5.00 lakh investment in plant and machinery. Micro credit can be a powerful tool for reaching to these small borrowers. The

success of microfinance model has been established in the Indian banking sector on account of high rate of recovery and low operating cost. In India, there are over 26 crore people living below poverty line and the micro credit needs of potential entrepreneurs have been assessed at Rs.50, 000 crore. The existing programme of micro credit, operated by NABARD, SIDBI, banks, NGOs and government agencies has extended Rs.11,398 crore to 2.2 million Self Help Groups (SHGs) by end of 31 March 2006, leaving a vast gap of Rs.38,600 crore between demand and supply of micro credit. The banks may expand their outreach in a cost effective manner by exploring possibilities of adopting 'Business Facilitator Model' or 'Business Correspondent Model' of linking banks with the clients through and external entities as suggested in the 'Report of the Internal Group of RBI to Examine Issues Relating to Rural Credit & Microfinance,' (July 2005). In the Business Facilitator Model, the banks may use Non-Government Organisations (NGOs), industrial co-operatives, IT enabled rural outlets of corporates, postal agents, insurance agents, etc. for supporting the banks by undertaking non-financial services. In the Business Correspondent Model, institutional agents or other external agencies can support the bank in extending financial services. The business correspondent functions as bank's agencies to provide credit, recover the dues and sale other financial products. Registered Non-Banking Financial Companies, Section 25 companies, NGO-Micro Financial Institution set-up under Society/Trust Act, IT enabled rural outlets of corporates and Post Offices may function as business correspondent. Recognising the need for micro credit, SIDBI formulated Micro-Credit Scheme (MCS) in 1994 with the objective to provide financial support to well managed NGOs for on-lending to rural poor. Since inception, it has provided Rs.200 crore equity support to NGOs for meeting capacity building, managerial cost etc. It has also set up a Foundation on Micro Credit (SFMC) in 1998-99. Banks may explore multi channel credit dispensation route through apex NGOs, Micro-Finance Institutions (MFIs) SHG Federations and other Civil Society Organisations subject to regulatory prescriptions. These MFIs, which may include NGOs and community based organizations may be selected on the basis of their credibility, track record, professional expertise, management practices, organisational capabilities and growth potentials.

The SSIs which are linked as supplier or service providers to successful large corporate houses/industries are usually successful ventures. There are a number of corporates in India who adopt corporate linked SME cluster models to gain competitive advantage and derive mutual benefits. These corporate may be tapped to provide channel finance to units under SME cluster with tri-partite agreement.

(E) Innovative Hand-holding

As the SMEs cannot compete with large scale companies due to their size, resource crunch, capital scarcity, non-professional management, lack of managerial abilities, etc. they should not be left alone to face various challenges and adversities. Though the potential and new entrepreneurs have technical knowledge, they lack financial, legal and managerial skills. A new unit needs nurturing and hand holding through means other than credit. It needs proper guidance and support not only from the government but also from banks. Over the period, the Government has introduced a large number of schemes to help and assist small entrepreneurs in setting up new ventures. Due to lack of awareness, the new entrepreneurs either remain ignorant or feel confused. The banks can play a proactive supportive role and do the hand holding through various innovative methods for the new entrepreneurs to establish. Some of these hand holding/support practices, which would prove mutually beneficial to the bank and entrepreneur in long run and develop an environment of mutual trust and relationship, are:

- a) Banks may conduct workshops for entrepreneurs to upgrade their financial, technical and managerial skills as also to inform them of various schemes of the Government, SIDBI, RBI and also provide knowledge on legal and tax related matters
- b) Banks may provide help and guidance to new entrepreneurs to obtain subsidy or seed money from the government departments
- c) Banks may help SMEs in completion of formalities to obtain license, permit, pollution control clearance, electricity connection, etc.
- d) The Boston Consulting Group has suggested that banks should provide professional services like legal, accounting, tax, etc. Banks may maintain a panel of consultants, industrial counselors and advocates who may extend assistance to SME entrepreneurs at reasonable charges. Banks may consider providing advisory services to SME customers on fee basis. They may help entrepreneurs in preparation of project reports, financial statements, accounting, loan proposals, obtaining search report, creation of mortgage, etc. If required, banks may appoint 'Service Support Agents' to assist entrepreneurs in services mentioned above.
- e) Banks may publish periodicals/magazines to disseminate information pertaining to various schemes of bank, various ministries, RBI, SIDBI, CBDT, CBEC and other tax related policy matters. It may also provide the same information through its website and e-mails.

f) Banks may create data bank and information bank on industrial activities, markets and movement of prices. Free access may be provided to SME entrepreneurs to utilize this information.

(F) Changed Perception

There is a felt need that banks should change their perception towards SME lending. Bankers have to understand that SME lending is not riskier than any other lending activity. In the long run it is a profit-making proposition. The socio-economic benefits of SME lending outweigh the high cost of serving this sector. Employment generation is not only an economic proposition but also a social commitment. Banks, who are known for their social commitment, can definitely become harbingers of change for sustainable employment generation and placing India in the category of developed nations. Lending to this sector provides vast cross sale opportunities to the banks. Through cluster based credit approach, use of technology in servicing the SME customers and use of multi channel medium of credit/products delivery, the cost of lending to SME sector can be brought down substantially. SME customers are not price sensitive and believe in long-term relationship. Banks can capitalize on this unique characteristic of the SME customer. It is expected that by adopting innovative model of SME financing the perception of bankers towards SME sector would change and they would not feel shy of lending to this sector.

Conclusion

SMEs play a very important role in economic and social development of the country. For banks to become partner in their healthy growth, which would ultimately lead in mutual beneficial relationship, there is an urgent need to adopt a new business model for financing SMEs.

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