

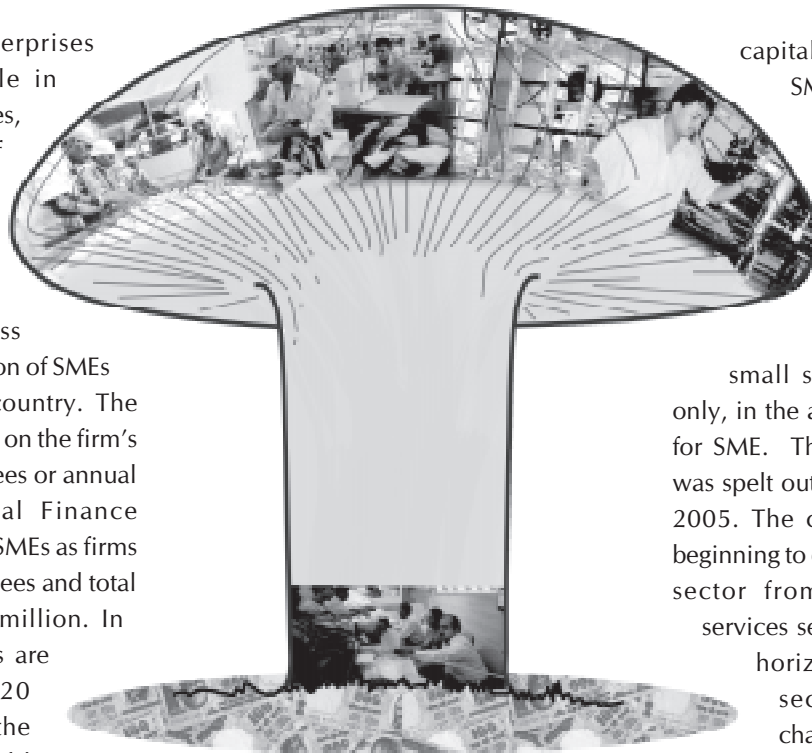
Small and Medium Enterprises Financing – Need for Paradigm Shift

Dr. K.C. Chakrabarty*

Small and Medium Enterprises (SMEs) play a vital role in providing job opportunities, enhancing the quality of human resources, nurturing a culture of entrepreneurship, fostering creativity and opening up new business opportunities. The definition of SMEs varies from country to country. The classification can be based on the firm's assets, number of employees or annual sales. The International Finance Corporation (IFC) defines SMEs as firms with less than 300 employees and total assets less than US\$15 million. In smaller economies, SMEs are defined as less than 20 employees. Whatever the definition, and regardless of the size of the economy, the growth of SMEs throughout the region is crucial to regional growth.

SMEs - The Global Scenario

The abbreviation of SME occurs commonly in the European Union (EU) and in international organizations, such as, the World Bank, the United Nations and the WTO. The term small and medium sized business (SMB) has become standard in a few other countries. EU member states traditionally had their own definition of what constitutes an SME but now they



have started to standardize the concept. Companies with less than 50 employees are categorized as small and those with 50 employees and above and less than 250 employees are categorized as medium. In most economies, small enterprises predominate. In the EU, SMEs comprise approximately 99% of all firms and employ between them about 65 million people.

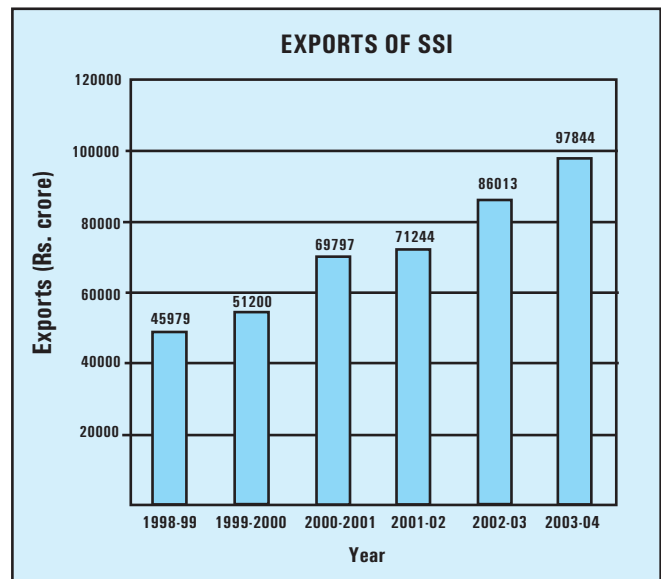
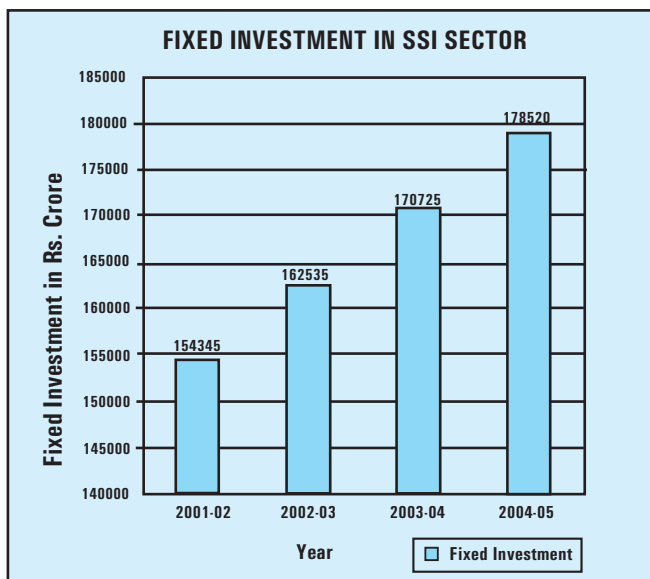
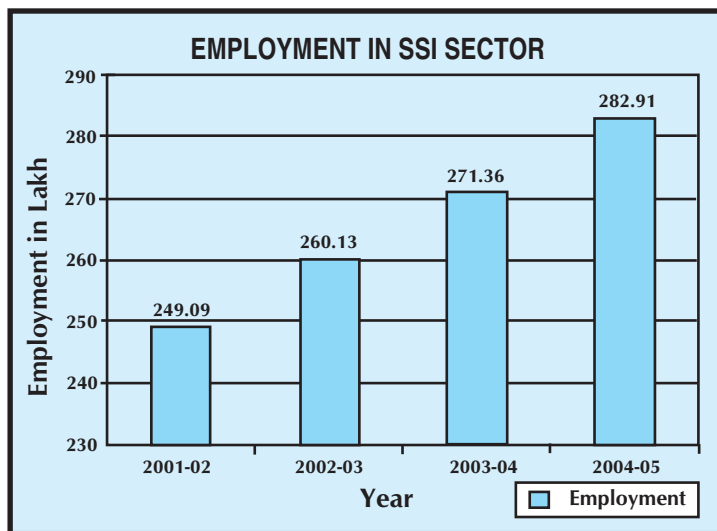
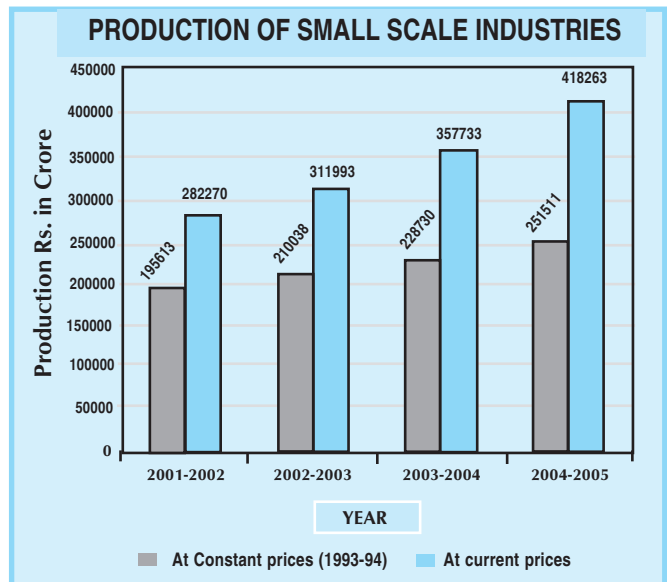
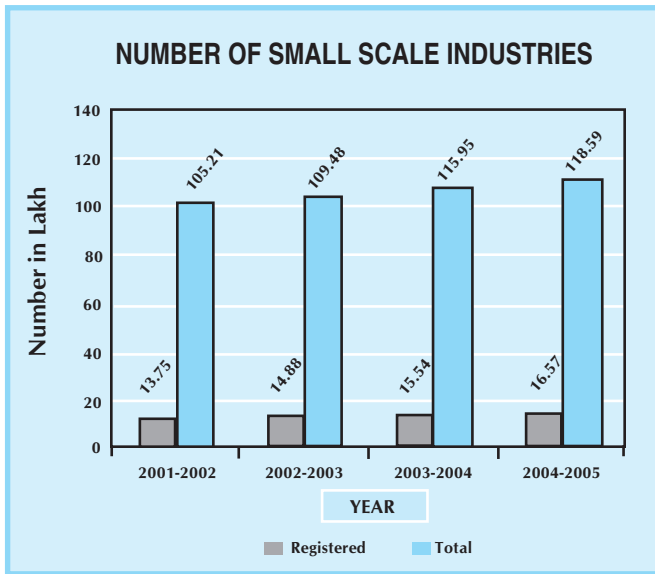
SMEs – The Indian Perspective

Unlike the other countries, where SMEs are defined on employee strength,

capital held, etc., in India, SMEs are defined based on their investment in plant and machinery (upto Rs.10 crore). Though we commonly use the word SME, it was primarily referring to small scale industries (SSIs) only, in the absence of a definition for SME. The definition for SMEs was spelt out during second half of 2005. The concept of SMEs is a beginning to expand the ambit of SSI sector from manufacturing to services sector. The widening of horizon will facilitate the sector to face the challenges of globalisation and liberalisation.

Apart from credit enhancement, the policy also focuses on cluster development, separate rating systems, data build up, information dissemination, etc. The following analysis is based on our SSI sector, as historical SME data is not available. SSIs in India constitute 95% of the units, 40% of value addition and 80% of employment of the total manufacturing sector and 35 % total exports of India. A graphical representation (see page 11) explains the contribution and growth of SSIs in our country.

*Chairman and Managing Director, Indian Bank, Chennai



Understanding the importance of the sector, the Government of India has come out with an exclusive policy package on SMEs which indicates that the growth of credit to the sector should be at least 20% every year so that it doubles in 5 years and at least 5-6 new accounts should be financed by each semi urban and urban branches per annum.

SMEs – Ways to Grow Strong

Flexibility, low start-up and operating cost have enabled SMEs to spring up, to reposition and adjust themselves quickly in response to market and economic changes. SMEs have not only survived the impact of big enterprises and the law of economies of scale but have carved out niches for themselves, which enabled them to coexist with big enterprises, notwithstanding supporting them as well. The intellectual and entrepreneurial capability of people, high quality manpower and cheaper cost of production have made our country a prospective global hub in manufacturing activity. SMEs, despite being a major contributor to the economic growth of the country, face many constraints, viz. technological constraints (old / obsolete technology, inability to adopt and obtain new technology, low R & D), marketing constraints (dependence on one or two buyers only, lack of effective marketing efforts, inability to identify suitable product and its acceptability and sustainability in the market in preference to branded products, delayed realisation of receivables, etc.), human resources constraints (inability to create a second line of management, total concentration only with promoter, etc.) and financial constraints (low capital base, delayed payment by buyers, low margins, improper or even in some cases non-maintenance of records, delayed submission of audited financials to banks, etc.).

SMEs have been depending for a quite long time on government support, such as reservation of products, incentives, concessions, subsidies, government policy for collection of dues, labour policies, etc. and now a time has come where they have to erupt and metamorphasise into a professionally managed sector to overcome various challenges. The SMEs mostly make a small beginning as micro or small enterprises and cater to a local market only. While the large industries / enterprises take care of the demand in the global market, the SMEs cater to the local markets and demands. In view of their strong local presence, the SMEs' growth and success are very much essential for the development of the country's economy. In course of time, the SMEs graduate into large scale industries / corporates. Hence, SMEs are a great opportunity for banks to finance. While the SMEs face competition from the corporate majors, in terms of quality, technology and pricing, there are several examples of SMEs successfully charting their future and growing into big corporates, more so in service sector.

In order to be globally competitive, inclusion of services sector in the ambit of SME has become essential. In this regard, Government of India has enacted the Micro, Small and Medium Enterprises Development Act (MSMED Act) which will come into force with effect from October 2, 2006. The Act defines micro, small and medium enterprises in both manufacturing and services sector. The Act is expected to give further impetus to this growing sector.

Industrial Clusters

One instant solution which has to be thought of is to go in for developing industrial clusters with homogenous manufacturing/ service units. The experience shows that these clusters have less transaction cost, increased production efficiency, enhanced overall competitiveness and provision of infrastructure and logistics at affordable cost to exchequer and the entrepreneur. For developing industrial clusters/ parks, an appropriate industrial policy may be put in place. Further, the cluster / park should be located around the top/big companies which provide scope for setting up of ancillaries and become partners in the financial soundness and ensure marketing support. The cluster may also contain different related industries to make it diversified. This will benefit interaction between two companies in different area of operations to go for a symbiotic relationship and absorbing best placement practices. Apart from setting up manufacturing firms, research institutes, quality testing centres, venture capital firms, incubators and other service providers should also be located in the park for an integrated approach. SMEs in service segment can serve as an outsourcing agent for multi national corporations (MNCs)

Another area of improvement may be promotion of supply chain linkage. For example, in Chinese Taipei, the small and medium enterprise administration has launched a special project aimed at helping SMEs in the auto parts and components industry to build capacity in e-commerce and thereby integrate themselves into the supply chains of MNCs. The objectives are to help 1000 SMEs to electronically connect to their partners in the supply chains and to help 600 SMEs to apply standard electronic frameworks to their supply chain management.

Entrepreneurs may tie up with technological institutions, at individual or association level, for constant upgradation of technology and also upgrade / invest in R & D. Dependence on single buyers is to be reduced and marketing and recovery measures are to be strengthened. Maintenance of proper financial records, balance sheets and final submission of necessary statements to appropriate authorities, especially banks are absolutely necessary.

SMEs - Meeting their Credit Needs

SMEs, being the growth engines of Indian economy, have always been feeling the need for obtaining liberal funding of their operations by financial institutions and banks. Understanding the inherent strengths of the SMEs, the government as well as financial institutions have always been playing a supportive role in their development. Despite the efforts made by financial institutions to close the funding gaps, SMEs continue to experience difficulty in obtaining need based and timely credit on account of firm size, risk knowledge, management systems and flexibility in operations. SME's borrowings requirements, usually, are small and frequent which do not appeal to financial institutions. Most being first generation entrepreneurs, non availability of collaterals is another impediment. Financial institutions/ banks also lack expertise in understanding small and medium knowledge-based businesses. The flexibility, in terms and conditions of financing required by the SMEs, may not be available.

In the past, the delinquency rate of SSIs was high due to their inability to absorb the shocks of industry-downturn or sluggish economy and banks were shy of lending to this sector particularly tiny and small scale service business enterprises (SSSBEs). Non realization of receivables in time and very poor creditors velocity are other

reasons. The main constrain for the SMEs in the credit delivery mechanism, particularly the small borrowers, is the delayed credit, which derails their entire plans due to cost and time overrun. Often the entrepreneurs are not able to project the annual requirements and financials properly. Many a time adhoc credit limits are needed by them. This could be addressed easily by deploying credit scoring model which is a simple statistical tool to determine whether a borrower could be financed or not. The decision could be taken across the table with available information.

To address the problem of lack of collateral security, particularly for small borrowers with limits upto Rs.25.00 lakh, the Credit Guarantee Scheme of CGTSI (Credit Guarantee Fund Trust Scheme) was introduced which is a convenient option for both the borrowers and the bank as both are benefited.

Risk Management – SMEs

Essentially, an entrepreneur is someone who perceives an opportunity and creates an organization to pursue it. Entrepreneurs do take risks but only calculated ones. One of the abilities most successful entrepreneurs share is the ability to evaluate risk. Assuming and managing risk is the core activity of a banker. Risk in banking is a result of many diverse activities executed from many locations and by numerous people.

Credit Scoring Models

It is important that a banker understands his customer properly before financing him. In the absence of financials and other requisite details about the customer it is difficult for a banker to make a lending decision. Credit scoring models solve this problem to the maximum extent. The credit scoring models are

- ❑ single point indicator for diverse risk factors as also tool for pricing
- ❑ good for entry level decisions. Can effectively decide whether to grant a new facility
- ❑ applied to individuals and small business enterprises
- ❑ for analysing consumers' data, past behavior of individual / promoter, his track record, earnings credit worthiness, etc. about the owner of the firm and combining it with relatively limited data of the firm itself
- ❑ applied to score the borrower as well as score the effectiveness of services rendered by the organization (both sides can be scored)
- ❑ internal assessment as to whether the portfolio is remunerative, services, operational efficiency and better control
- ❑ used for predicting /forecasting response, attrition, retention, recovery, profitability, collections and provisions
- ❑ used for micro (individual) as well as macro (group/segment) purposes
- ❑ being used for credit cards, mortgage and auto credits and recently for small enterprises
- ❑ statistical approaches to predicting the probability that a credit applicant will default or become delinquent
- ❑ cost saving, automated accept or reject

Credit Rating

As per Basel II norms, the banks are required to quantify the risk associated with each borrower and arrive at the risk weights by assigning rating. There are two approaches for designing a credit model. One is the statistical model and the other which captures distribution of firm's asset value over a period of time. The SME policy package announced last year has advised the public sector banks to follow a transparent rating system with cost of credit linked to rating of an enterprise. Further, external rating agencies like, CRISIL, ICRA, etc. have started rating SMEs. SMERA, an exclusive SME rating agency, has been promoted by the SIDBI. The rating of SMEs provides an independent third party credit assessment which the banks can rely and base their decisions on. These assessments capture those traits that make the units successful or unsuccessful and factors the same in the rating process, gives overall assessment of the unit regarding financial and non financial qualitative parameters, enhances comfort level of the bankers and help the SMEs to negotiate better terms with their bankers and their customers.

At the Asia-Pacific Economic Cooperation (APEC) ministerial meeting on SMEs held at Daegu, Korea, in September 2005, an

- ❖ Developing human resources and technology through linkage between industry and educational and research institutions
- ❖ Business venture capital or incubation system – entrepreneurs in the making - to be tied up with centres of learning excellence.
- ❖ Accessing to specialist advice and assistance
- ❖ Enhancing availability of capital to innovative SMEs
- ❖ Networking and clustering for innovative SMEs
- ❖ Establishing appropriate legal and regulatory structures
- ❖ Establishing a market consistent economic environment
- ❖ Developing methodologies for effectively measuring progress in the implementation of innovation programs for SMEs.

Innovation Action Plan (IAP) on SMEs was discussed and drawn till 2020. Certain aspects of the IAP are

Taking into consideration the prevailing market conditions and emerging needs, funding institutions should encourage venture capital financing for the SMEs, evolve tailor made products fitting the cluster needs and harmonize the financial policy framework across economies. These will promote cross-border strategic alliances including SMEs and facilitate transfer of experiences between the regional economies.

Conclusion

The above discussion focused on the present state of affairs of the SMEs and what needs to be done to overcome the problems faced by them. But, there is always a feeling that the reality and the expectations are divorced and the gap is too big to bridge. The success lies in identifying/ understanding the various problems faced by the SME at domestic and international level, on an ongoing basis, and evolving solutions which will augment their growth. Systems and procedures should be made scientific and professional so that subjectivity is eliminated largely. ■

Technology Bureau for Small Enterprises (TBSE)

The Technology Bureau for Small Enterprises (TBSE) provides a platform where small enterprises can tap opportunities at the global level for acquisition of technology or establish business collaboration. Resulting from the joint initiative of the United Nations' Asian and Pacific Centre for Transfer of Technology (APCTT) and Small Industries Development Bank of India (SIDBI), it represents, under one roof, synergy of technology and finance. The important features of TBSE services are :

- ❑ Offers a professionally managed system for technology and collaboration search.
- ❑ Helps in building up confidence between prospective partners.
- ❑ Lends a friendly hand in the intricate task of negotiations and matching of perceptions.

- ❑ Provides a gateway to global technology market through networking.
- ❑ Unique mechanism for arranging technology and finance. The Bureau provides services for Technology Information, Match Making, Finance Syndication, Business Collaboration and Support Services.

Overseas Linkages

In addition to accessing APCTT channels for sourcing technologies and collaborative opportunities, TBSE has, over the years, developed dedicated linkages with overseas agencies/ companies. These are primarily long term cooperation for exchange of technology related information on regular basis. Some of these pacts are with CSTG, HPSTC and JCIEST (all of P.R. China), Concern-UPI (of Russia), SMIDO (of Bangladesh), REDS (of Sri Lanka), GOM Vlaams-Brabant of (Belgium), PGS Consulting, SES (of Germany) and Enterprise Florida (of USA)

(Source: <http://www.techsmall.com>)