

Crisil Young Thought Leader Series – 2004

SME Sector: Strategies for Improving Credit Flow

Mukesh Tiwari (pgp19086@iiml.ac.in)
IIM Lucknow

Phone No. 09831429279
Address: IIM Lucknow, Prabandh Nagar
Off Sitapur Road Lucknow - 226013

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WTO membership is supposed to bring enormous benefits to India. In short term however, there would be many dislocations in various sectors, which might cause an increase in unemployment. To counteract such an effect the government shall take steps to promote SMEs, which has the potential to generate jobs and spur the economic activity in the country. However, a major restraint in the development of SME Sector is their access to debt and equity financing.

Executive Summary

SME lending in India has been a neglected target market since the independence. Though, government tried to propagate SME lending using regulations and incentives, however, somehow beneficial impact was never visible and SME lending always remained a poor cousin to other activities of lending institutions.

The paper initially identifies the current constraints existent for the SME lending. It is recognized that Government should take initiative to operationalise SFCs in big Scale, and professionally run rather than bureaucratically.

Subsequent sections focus on how SFCs or financial institutions need to first evolve a strategic focus on the sector by understanding the client & his needs. The SFC needs to reengineer the SME lending value chain with the intention to develop a long standing relationship with the SME clientele set. The modifications needs to be executed across the critical areas via marketing execution, product development , streamlining of operations through internet integrated delivery channels & application of advanced risk modeling techniques. As the relationship evolves over time, the firm is able to indulge in relationship lending due to reduction of information asymmetry which lowers supervisory costs & increases account profitability for the firm. Through retrained & empathetic staff dealing with SME clients, the interaction level deepens. Finally

the SFC by donning the role of a Financial Consultant transforms from a lending institution into a one stop solution for all the financial needs of the SME client.

At the end the concept of Fund Financing is also suggested as an approach.

The focus in the dissertation has not been made on traditional sources of Financing as SIDBI, is coming out with processes to replicate and innovate the present schemes to suit SME needs.

Introduction

SMEs constitute a large source of industrial employment in India. The actual performance of SMEs, however, varies depending on the relative economic efficiency, the macro-economic policy environment and the specific promotion policies pursued for their benefit.

Historically, India followed a development strategy in which private investment was controlled through a host of regulations involving investment sanctioning, credit disbursement, import licensing, foreign exchange allocation, etc. While these regulatory barriers thwarted private investment in general, the impact fell unevenly on SMEs. This was because of the relative inability of the SMEs to cope with the regulations compared to their large-scale counterparts. Thus, the policy regime was largely biased against the SMEs although, paradoxically, promoting SME development was a stated objective of successive governments.

SME lending market constraints

The SME lending market currently uses a corporate lending approach as financial institutions have difficulties in servicing the wide-reaching SME sector.

The limitations of such a lending approach include:

- High ***processing and monitoring costs*** of loans to SMEs resulting from-
Complicated loan disbursement procedures
- ***Project Preparation and Evaluation:*** The SMEs often lacks the ability to formulate a proper project proposal
- ***Loan review and servicing process are not consistent or scalable***

- **Credit Assessment:** The key issue is to improve their credit assessment capabilities with regard to SMEs so that they can distinguish adequately between good and bad credit. Small-scale must not be equated with high risk. The cost of credit assessment of SMEs can be reduced by a focused recognition of clusters
- **Assets pledged are not reliable in recovering loans from SMEs:** The collateral is intended to help mitigate some of the risks of making loans to SMEs, their value deteriorates the most in an economic downturn when SMEs encounter financial problems.

Restructuring Of SFCs

The strength of SFCs will lie in their ability to capture market niches sidestepped by financial institutions and banks.

SFCs should be reconstrued, working in together with SIDBI, so as to jointly promote the SMEs. It is to be recognized that, Government has to take steps as SMEs are considered high risk project. SFC could act as an arm of the Government in providing funds. The major impediment would be to do away with the Bureaucratic structure and evolve a professionally managed Corporation.

Understanding the Customer

The fundamentals of SME lending usually originate with understanding the customer & his needs & then realigning the systems & processes to create a new identity in the competitive landscape by following sequential steps elucidated below:

- Use dataset developed from erstwhile lending process.
- Identify the relevance of SME sectors.
- Compare –
 - The percentage of the financial system lending going to
 - Future Scope of SMEs as identified by the government in various policy documents.
 - Present competitive capabilities of SMEs
- Classify firms into clusters using tools like
 - Multivariate analysis.
 - Econometric Data to investigate impact of lending with respect to factors like firm size, balance sheet fundamentals etc.
- Identify market opportunities by –
 - Developing a competitive matrix of SMEs.
 - Computing the divergence in their lending requirements for optimal growth vis-à-vis their current debt portfolio.

Evolving a Strategic Focus on the SME Sector

The basic ingredients for success in carrying the model to the market & strategically positioning oneself as the key lender offering a multitude of products to SMEs lies in the following four major components as identified below.

- **Clear strategic focus on SMEs** by primarily committing the organization to be the one & only “One Stop Solution” in the SME field. The entire

organization needs to deploy its resources towards understanding the following with regard to SMEs-

- Unique features
- Needs – both financial & advisory.
- Various operational & Financial practices

➤ **Management of Credit Risk via innovative methods** –The financial institution needs to adapt usage of surrogate indicators of credit risk whenever the borrower’s accounting records prove tedious or the information needed to evaluate a project too costly to acquire. The organization also needs to have the following:

- Loans to SMEs in various industries, including larger accounts and short-term credit.
- Reduction of Risk by continued lending to service the financial needs of SME clients that have matured and grown and could easily avail themselves of the credit facilities of bigger commercial banks.
- Countering the inherent weaknesses of the SME sector by requiring guarantees and collateral to cover its credit exposure

➤ **Maintaining a long-term orientation and developmental perspective.**

The organization needs to views its relationship with clients as a long-term partnership and focus on elements that-

- Provide non-financial services such as:
 - Management counseling

- Bringing clients together with prospective markets and suitable business partners.
- Assist in the reconstruction of the client's records, preparation of project feasibility studies, and
- Evaluation of investment options.

Although this approach invariably entails additional costs for the SFCs, the familiarity with prospective projects and borrowers themselves is advantageous over time, because it reduces the cost of monitoring and supervision in the long run.

Restructuring the Value Chain

The basic process of restructuring the value chain of lending to the SMEs evolves with an appreciation of the value chain as illustrated below.

1. Marketing
2. Origination & Application
3. Credit
4. Operations
5. Service
6. Risk Management
7. Cross Sell

The reengineering begins with:

- **Segmenting the customer:** As customer needs & perceptions regarding services product offerings are diverse across segments for delivering the

right product at the most competitive price, the institution can segment the customers to identify the –

- Identify reachable segments.
- Design products & services tailored to meet the needs of the most profitable segment.
- Develop communication to effectively reach segments via-
 - Relevant advertising
 - Usage of Promotional Vehicles
- Select effective channel strategies.

The segmentation can be done on the following principles of

- Behavioral: How Customers access the SFC.
- Contribution Tiering: Classifying SMEs by virtue of their contribution to total profitability.
- Life Style Segmentation: Segmenting SMEs on the basis of their positions in various stages of lifecycle growth & factors like line of credit & growth potential etc.

The marketing execution post segmentation needs to address the following issues:

Marketing Execution via -

- Centralized SME marketing strategy combined with local branch programs/execution.
- Consumer-model marketing approaches
 - Focus on SME owner

- Avoid commercial product approach
- Targeted marketing
 - Few, simple products
 - Clear value messages
 - Convenience
 - Enhance cash flow management
- Position brand as SME-friendly
 - “We help your business grow”
 - Distinct SME positioning within branches.
 - SME kiosks in branch lobby
 - Commercial-only teller window

Product Development focus on –

- Simplified commercial products
- Low-doc applications
- Single-signature loans
- Standardized product features/not tailored commercial loans
- Limited number of products

Origination & application via

- Creation of target lists, prioritization and distribution centrally by marketing group based on segmentation strategy.
- A Central telemarketing telesales group can be the key to origination
 - Sets appointments for relationship manager after qualifying targets.

- Relationship manager calls on clients
- Retrieves company information for SME prospects and customers
- Focus on larger SME clients; credit thresholds
- Limited negotiations
- Enabled with mobile technology for real-time customer information and communication with credit area
- **Risk Management through Credit Modeling:** The basic features of simplifying the loan process while preventing risk of delinquency is via a two pronged process –
 - Centralized credit function supporting branch, relationship manager, and remote/direct channels with Loan operations centralized with credit facility.
 - Credit scoring auto-decision implemented for smaller SME loans through usage of:
 - Technology platform used for automating document verification
 - Standardized documents across product types
 - Electronic connectivity with third parties (filing collateral liens, local government filing, and credit bureaus)
 - Use of automated risk-based pricing models
 - Exception-only credit reviews and limited restructuring efforts

Modification of Delivery Channel

Usage of alternate delivery channels like the Internet is also highly recommended as it gives the following advantages –

- Reduces cost of Transaction.
- Offers ease of managing vast amount of data without need to approach a credit bureau.
- Risks can be managed by obtaining on-going business information from SME borrowers
- Lending to SMEs is the most effective way to move SMEs online
- Web based system allows quick deployment
- Web scoring engine, and risk management system and operating process are easy to understand and do not require experienced SME lending professionals

Reducing Information Asymmetry through Relationship Lending

The theory of financial intermediation suggests that financial institutions need to specialize in information production and loan contract design to resolve credit rationing problems of SMEs, where asymmetric information is most severe .The more information firms obtain about borrowers, the less they have to improve borrower incentives by setting loan contract terms (interest rates, collateral requirements). Since information gathering is costly, any institution will expand their search for information until the expected marginal benefit of search equals

zero. If the remaining information asymmetry induces a risk premium, firms with less signaling opportunities will have to pay higher loan rates. This can be resolved via relationship lending which resolves moral hazard and adverse selection problems under asymmetric information via the following roadmap –

- Typically, small firms provide less information to outside financiers than large firms.
 - With growing age, the information asymmetry decreases, and firms may build up reputation by a good credit history.
 - Learning in repeated transactions reduces cost of gathering information about a borrower.
 - Information memory creates economies of scale in information

The duration is expected to affect the financial institution's stock of private information. A long-term relationship with the borrowers may enable a firm to conduct compensatory pricing. If it is the borrower's sole long-term financier, it obtains an information monopoly and hence a competitive advantage vis-à-vis outside competitors. An information monopoly is often related to the status of a house bank, which "... is regarded as the premier lender of a firm, with more intense, and more timely information production.

Evolution into Financial Consultant for SME

The final aspect is the retraining of staff to act as a financial consultant to the SME client by not only offering financial products but also setting the SME on the path of growth by ensuring the following -

- Partnering with local associations of business owners and helping them expand and function more effectively.
- Sharing knowledge among SMEs and SME service providers through in-person “business roundtables” and Internet-based exchanges.
- Organizing and disseminating business information that can help SMEs identify new markets; understand and comply with local laws and regulations; and learn about new products, production methods, and technology.
- Evaluation of business ideas and concepts on an objective and confidential basis.
- Development of business plans and, where appropriate, engaging expert technical advisers to carry out feasibility and market studies to evaluate fully the viability of business proposals.

SME FUNDS: Equity Financing

The opening up of economy in 2005 because of WTO agreement, there would be many dislocations, which would call for generating employment and this could act as a best option. Not only that, there is a high growth potential in the sector (*Annexure I*). It could also help Government in accumulating more of Foreign Reserves (*Annexure II*)

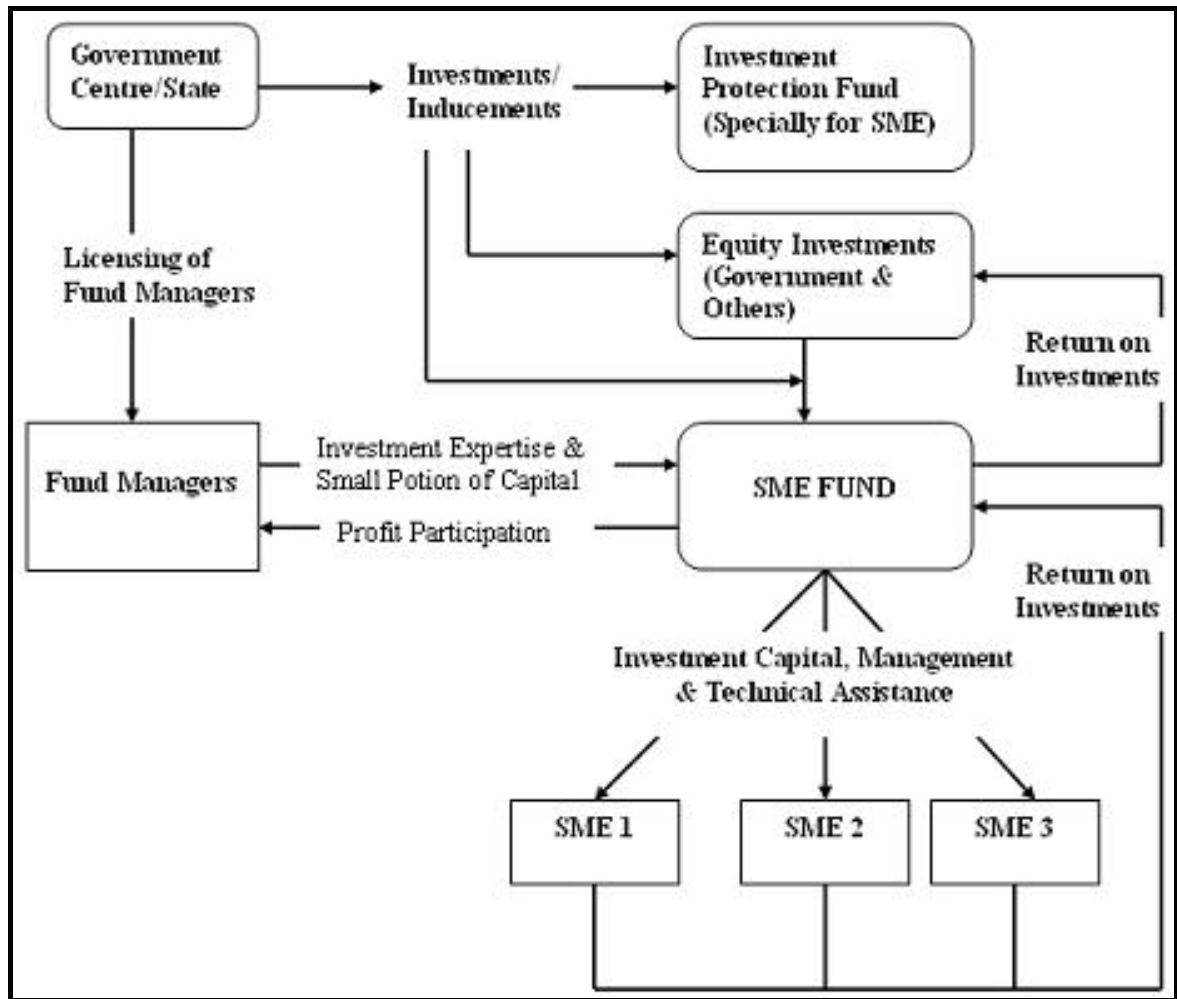


Fig: SME Financing Model

In the above figure, Government and Investors invests for ordinary shares in the fund. The Fund is one with a Non Recourse and Limited Liability Company. The share Capital and the loans are then managed by Fund Managers, which might act as a limited liability company. The Fund Manager will be responsible for identifying potential Investees, Selection of Candidates, Business and strategic planning assistance to them etc.

Leveraged Financing:

The concept maximizes the returns of the shareholders at the cost of Government. In this case the Government might ask the Investors /Venture Capitalist to invest in SMEs/SME Fund, where it will invest a major portion say 50% or 66% but will take a very low share of the profit generated.

For Example let's assume a Portfolio earns a return of 15% IRR, net of all the operating cost. If the government contributes 50% of the investments and requires only 5% return, then the private investors will receive, in addition to 15% IRR, a portion of the Return that the government has not taken. This will improve the returns to 21%, a better risk return match.

Conclusion

There are several alternate source of Financing like Venture-Capital-Funds, Guarantee Corporations which can facilitate the Credit Flow. As also it is important to bring in efficiency in the internal process of SMEs, to Improve Working Capital Efficiency. Before the Flow takes on, several regulatory Framework need to be changed and Government has to take an active role to speed up the process.

Percentage Growth Rates of Small Scale Industries and Industrial Sector in India		
{{(Base : 1993-94) (1994-1995 to 2002-2003)}		
Year	Percentage Growth Rates - SSI Sector	Percentage Growth Rates - Industrial Sector
1994-95	10.1	9.1
1995-96	11.4	13
1996-97	11.3	6.1
1997-98	8.43	6.7
1998-99	7.7	4.1
1999-00	8.16	6.7
2000-01	8.23	5
2001-02	6.08	2.7
2002-03	7.78	5.2*

Source : Handbook of industrial policy and statistics 2002,ministry of commerce and industry Govt. of India

Foreign Exchange Earned by SSI Units		
Year	Exports from SSI	
	In Rs. (Crores)	In USD (Million)
2000-01	69796.5	15278
2001-02	71244	14938.4
2002-03	86012.5	17772.9

Rajya Sabha,
Question No. *144, dated
15.7.2004.