

Strategy for Profitable Growth through MSME Lending by Indian Banks



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Rising capital requirements and NPAs are impediments to large lending by Indian banks and thereby their profitability. Indian banks, therefore, need to design strategy for their profitable growth through MSME lending. For successful lending to MSME, sector specific approach is required by banks. Different approach is required for manufacturing enterprise and service enterprise. Banks need to innovate and modify the financial products which are best suitable to them, and also design risk management strategy for MSME lending.

Key words: MSME, Financial products, Risk management for MSME lending.

1. Introduction

Banking as business is undergoing many changes in the recent time across the globe as well as in India. From deposit mobilisation and lending institution, banks became financial supermarkets, catering to all financial needs of the clients. Under such universal banking approach, though many new financial services are added the traditional banking of mobilising deposits and lending has not become insignificant. The very existence of banking is based on deposits and lending. Along with mandatory priority sector lending Indian banks depend upon lending to large corporate and thereby earning interest income for their revenue and profit. Lending to a large business and corporate is a profitable business for banks. The contribution by treasury income and fee based income is growing but the major portion of the total income comes from interest earning.

Table IV.7 Trends in Income of Scheduled Commercial Banks

Item	(Amount in Rs. billion)	
	2011-12	2012-13
1. Income	7,416	8,614
a) Interest Income	6,553	7,636
b) Other Income	863	978

Source RBI Report on Trends and Progress of Banking in India 2012-13

The strategy followed by Indian banks, therefore, is to cater to the large corporate clients. These borrowers do more fund based borrowing for their working capital as well as term loan requirements from banks. However, in recent past in India due to variety of macroeconomic factors, earning by banks from this traditional source is reducing. Hence, it is affecting profitable growth of banks.

The year 2012-13 has shown noticeable slowdown in the growth of credit to all productive sectors, like agriculture, industry and services sector. The slowdown was the highest for agriculture and allied sector. The slowdown is also noticed in the industrial sector as well as infrastructure sector. Since these sectors require large funds to be deployed the growth potential of interest income is higher. Even credit to NBFCs, which account for about one-fifth of the total credit to the services sector, has also shown slowdown. Following table gives entire picture of this situation.

Under such scenario tapping Micro Small and Medium Enterprises (MSMEs) for lending is a profitable proposition for banks to grow. It has large potential of business for the Indian banks. In India, according to one estimate, MSME sector accounts for about 45 percent manufacturing output and around 40 percent of the total export of our country. It accounts for 50 percent of private employment and 22 percent of India's GDP. MSME sector in recent past has shown higher growth compared to overall industrial sector.

As per the research study undertaken by International Finance Corporation in 2012 on Indian MSME financing, there is a demand supply gap of Rs. 3.57 trillion among 11.3 million enterprises, which formal financial institutions can viably finance. Many of these MSME units have received formal finance but it is inadequate. Nearly 40 to 70 percent of their financial requirements they have from formal financial sector. This study shows a good potential for Indian banks to tap this sector for lending to drive their growth.

Table IV.19 Sectoral Deployment of Gross Bank Credit

(Amount in Rs. ` billion)					
Sr No.	Sector	Outstanding as on		Percentage Variation	
		March 2012	March 2013	2011-12	2012-13
1	Agriculture and Allied Activities	5,484	5,899	14.1	7.6
2	Industry, of which	19,374	22,302	20.7	15.1
	2.1 Infrastructure	6,300	7,297	20.8	15.8
	2.2 Micro and Small Industries	2,363	2,843	12.4	20.3
3	Services, of which	10,166	11,486	14.5	13.0
	3.1 Trade	2,245	2,760	21.3	22.9
	3.2 Commercial Real Estate	1,126	1,261	15.7	12.0
	3.3 Tourism, Hotels & Restaurants	323	354	16.7	9.9
	3.4 Computer Software	143	169	3.0	18.4
	3.5 Non-Banking Financial Companies (NBFCs)	2,278	2,570	24.0	12.8
4	Personal Loans, of which	7,873	9,009	13.4	14.4
	4.1 Credit Card Outstanding	204	249	12.9	21.9
	4.2 Education	498	550	16.6	10.4
	4.3 Housing (Including Priority Sector Housing)	4,013	4,600	12.6	14.6
	4.4 Advances against Fixed Deposits (Including FCNR(B), NRNR Deposits etc.)	569	611	15.4	7.3
5	Non-food Credit (1 to 4)	42,897	48,696	17.0	13.5
6	Gross Bank Credit	43,714	49,642	17.1	13.6

Note: Percentage variation could be slightly different as absolute numbers have been rounded off to `billion.
Source: Sectoral and Industrial Deployment of Bank Credit Return (Monthly).

Source RBI Report on Trends and Progress of Banking in India 2012-13

2. Understanding MSME

The definition of MSME is modified in India by 'The MSME Act 2006.' Under the said Act the sector is broadly classified into two parts, manufacturing and service. The unit is identified on the basis of investment made as shown in the following table.

	Manufacturing Unit	Service Unit
A micro enterprise	Investment in plant and machinery does not exceed Rs. 25 Lacs	Investment in equipments does not exceed Rs. 10 Lacs
A small enterprise	Investment in plant and machinery is more than Rs. 25 Lacs but does not exceed Rs. 5 Crores	Investment in equipments is more than Rs. 10 Lacs but does not exceed Rs. 2 Crores
A medium enterprise	Investment in plant and machinery is more than Rs. 5 Crores but does not exceed Rs. 10 Crores	Investment in equipments is more than Rs. 2 Crores but does not exceed Rs. 5 Crores

3. Methodology

This is a pilot study to be followed by in depth research on the subject. Hence it is mainly based on secondary source of the data. However, unstructured interviews of the bankers involved in lending decision are taken. This gives better insight about the thinking of the lenders with respect to financing MSME as a strategy for growth. Also interviews of the SME borrowers

and potential borrowers are taken to get first hand data about their expectation from the banks. Based on these data, following research questions are raised which are expected to be answered from the study.

4. Research Questions

1. What are the constraints and challenges banks in India are facing while lending to MSME sector?
2. Which of these challenges can be successfully faced by banks?
3. Which of these challenges need policy intervention by authority if they are to be faced?
4. What strategy Indian banks need with respect to lending to MSMEs?
5. How MSME sector be taken as a driving force for growth by Indian banks under present environment?

5. Challenges while Lending to MSMEs

The strategy of growth driven by lending to MSME is not easy. Lending to this sector pose several challenges. Indian banks need to develop capabilities to face these challenges. The major challenge is the non availability of credit information about the prospective borrowers. Most of the MSME units are proprietary concern, hence unorganised. Data available with respect to credit history of the borrower for taking lending decision is limited and unauthentic. Under the situation lending is a challenge.

MSME are found in all manufacturing as well as service sectors. For better lending decision data with respect to these sectors like their present position, growth potentials etc are not readily available. Hence it will affect quality lending. Another challenge is since the requirements of funds by MSME are less compared to large borrowers, the cost of lending and servicing these clients is higher. As the borrower in this sector expects borrowing at competitive rates, the higher cost of servicing is difficult to shift on the borrower.

Rising NPA is also a major concern for Indian banks under their MSME portfolio. Due to industrial and economic slowdown since last couple of years, many MSME are not able to service their debt in time. Shortage of infrastructure especially power is a major reason affecting debt servicing by MSMEs. Indian banks are already facing a big challenge on NPA front. Hence, even if quality lending decision were taken, due to macro economic factors and infrastructure bottlenecks, the account turns out to be nonperforming.

Other constraints faced by Indian banks while financing MSMEs are as follows.

- Inefficiency in business operations due to limited entrepreneurship.
- Inadequate access to infrastructure by MSME, affecting business performance.
- Inadequate market linkage hence, affecting business revenues.
- Inadequate access to technical assistance by entrepreneur.
- Limited rehabilitation support in case of industrial sickness.
- Inadequate access to finance especially in the beginning.

6. Strategy for Effective MSME Lending

Indian banks need to adopt the strategy for their growth through MSME sector under the present economic environment. Banks need to adopt sectoral approach to enhance lending to this sector. Under the condition of economic slowdown all sectors are not equally affected. Hence, banks need to identify those MSME units operating in a sector where there is growth potential. This will enable the banks to increase their lending and thereby the growth.

Banks need to focus on following three areas for designing their strategy for growth, keeping MSME in the centre. The three tire approach to be adopted by banks is having following three focus area.

1. Innovative and customised banking products for MSMEs.
2. Quality lending by better credit appraisal.
3. Credit risk management.



7. Innovative and Customised Banking Products for MSMEs

Traditional products and services by banks like working capital financing through overdraft and cash credit, bill discounting, export financing, term loans, bank guarantee etc. are important but not sufficient. The modern business has different

requirements. Banks need to constantly interact with potential MSME customers and understand their needs. To cater to the different or specific need product development and introduction of various services are required. For instance many MSME prefer to have services like factoring. As they cannot afford to maintain full fledged collection department, they would prefer such services. A cash management service is another such example. Also expanding the scope of banking services into financial services either directly or through the subsidiaries is to be looked at. For instance financial services like venture capital through venture capital subsidiary, if any. Wealth management services through subsidiary. Many financial services where there is extensive use of IT are also be preferred by MSMEs as many of them cannot afford to make such investment. Customised product by understanding their need will go long way to get remunerative business from MSME sector. When the banks provides such value added services, even the pricing will not be a major concern as the borrower get the products and the services as per their requirements, hence would not mind to pay the bank. By increasing the fund based and fee based services bank can increase their revenue and achieve growth.

8. Quality Lending by Better Credit Appraisal

In zeal to increase lending to MSMEs, bank should not compromise on quality of lending. Indian banks have sufficient experience of credit appraisal but especially with respect to MSME sector different issues are involved. Limited past data is available on credit rating of the borrowers. Banks, therefore, need to follow utmost care while doing credit appraisal to avoid the problem of NPAs at a later stage. Banks are required to look at the financial performance of the borrower in case he is already in the business. For this purpose unit's financial statement and its analysis is critical for lending decision. Financial parameters like profitability, efficiency, solvency etc is to be looked at but more important is, the qualitative assessment of the borrower. Areas where attention by lending banks required are sufficiency of capital and alternative arrangement by promoter in case of need. Promoter's knowledge about the industry in which he is operating is also to be looked into. This is important because many MSMEs are family owned business managed by family member, may not have required technical knowledge of the business. Along with the technical knowledge of the borrower his commercial knowledge i.e. understanding the market and their customer is also to be considered.

For quality lending factors which are external and beyond control of the promoters like industry specific economic conditions, general economic conditions etc. are also needs to be looked at. Continuous scanning of the economic and other environment of different industry will help the bank to gauge the potential threat to their lending.

9. Credit Risk Management

Robust credit risk management is an important part while lending to MSME sector. Many banks follows security based approach for credit risk management. However, rather than security cover, the business potential and repayment capacity from earning is to be looked at. Proper pre sanction appraisal and post sanctioned monitoring of advances are all the more important for MSME sector because; in this sector there is limited scope to get reliable credit information about the borrowers. Banks need to have up to date research data about various industries where they have exposure to know the business potential for various MSME units financed. Banks need to classify the possible credit risk that would arise due to macro economic factors, industry related issues, management problems, financial management weaknesses of the borrowers etc.

Regular review of the MSME portfolio with respect to following areas would help to minimise credit risk.

First and foremost is whether the financed units are operating in line with their business goal? This is necessary to prevent diversion of funds for the purpose other than the one for which funds are borrowed. Secondly, compliance on the part of borrower with respect to various terms and conditions put up by the lending bank. Compliance with respect to regulators, if any, applicable to the unit is also to be looked into. Monitoring of credit and timely action in case of need, forms essential part of credit risk management.

10. Conclusion

Indian banks are facing variety of challenges in the last few years to maintain their profitability and pace of growth. Lending to large corporate and thereby increasing interest income is challenging under present situation. Lower off take of finance along with rising threat of NPAs makes the bank to adopt cautious approach while lending to large scale borrowers. Under uncertain macroeconomic environment different strategy banks are thinking of to neutralise this effect and ensuring revenue. Focus on MSME sector is a suggested strategy under the situation. Due to relatively lower loan size MSME sector is preferred compared to large borrowers. Indian banks can tap the MSME sector for increasing their interest based earnings and growth. MSME sector is one of the important sectors for the economy to grow. Hence, it provides ample opportunity for Indian banks to give fund based facility right from inception of the enterprise to expansion and technological up gradation. Financial exclusion of MSME sector by formal channel is one of the issue bank can address and in the process it can grow. To ride on MSME sector for growth banks need to be customer focused, innovative for the requirements of this sector and should adopt robust risk management techniques.

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