Financial Assistance to SMEs: An Analysis of Decision-Making Criteria of Commercial Banks in India

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Abstract:
In India, Small Scale Industries (SSIs) have an important role to play, which is evident from their contribution to GDP, employment generation, regional development, export promotion, etc. But many problems impede their growth, out of which finance is the most pressing one among others. Commercial banks have been found to be the main source of finance for SMEs. But informational opacity and risk in SMEs pose greater challenges for commercial banks in providing finance to them, hence resulting in a conservative approach of commercial banks towards SMEs. This article is an attempt to analyze the decision-making criteria of commercial banks while extending credit to SMEs.

Keywords: SMEs, commercial banks, decision-making criteria

1. Introduction

In the Indian context, the definition of the SME sector is largely framed in terms of cumulative investment in plant and machinery. While most of the countries in the world adopt the level of employment as the criterion for defining the SME sector. According to the official definition adopted in India till recently, the investment limit up to Rs.10 million in plant and machinery is treated as Small Scale Industries (SSI) unit. However, in respect of certain specified items such as hosiery, hand-tools, drugs & pharmaceuticals and stationary items, the above investment limit in plant and machinery has been enhanced up to Rs.50 million.With the recent enactment of Micro, Small and Medium Enterprises and Development (MSMED) Act, 2006, Small and Medium Enterprises (SMEs) sector has emerged which will replace the SSI sector. Like in any other developing countries, in India SMEs play a very significant role in terms of their balanced and sustainable growth, employment generation, development of entrepreneurial skills and contribution to export earnings. They are estimated to employ about 59 million persons in over 26 million units throughout the country. Further, this sector has registered a higher growth rate, that is, 13 per cent than the rest of the industrial sector (8 per cent).

In recognition of the contribution and the vast potential of the SSI sector as well as its inherent strength, provision of adequate credit to this sector has continued to be a big problem. The SMEs look towards banks for their credit needs as commercial banks are the primary source of finance for them (Berger &Udell, 2002; Cole et al., 1996; Ghosh, 2007; Petersen &Rajan, 1994; Ruis et al., 2009). The credit process represents a critical banking function. The banks have to ensure that credit is granted to the customers who are capable as well as willing to repay the loan and interest, and denied to those who are not (Bruns & Fletcher, 2008). As a result, it becomes essential that banks develop methods that reduce risk and uncertainty in managing loans to SMEs. The lending decision is an interaction between the rules and head office instructions and a manager's experience, which explains the variation in decision outcome even with formal guidelines for the credit decision (ibid.). Every commercial bank seeks to make profit and thus, they need to be sure of regaining their monies when they lend them out to SMEs. It is, therefore, very necessary for SMEs to develop an understanding of the decision-making criteria used by bankers to increase the chance of getting their loan request approved by fulfilling the required criteria adequately.

2. Review of Literature

The existing study on "Financial Assistance to SMEs: An Analysis of Decision-Making Criteria of Commercial Banks in India" occasionally, a few research articles are found in research journals and reports in this area. However, in this section, an attempt has been made to review the studies made by researchers in this area. The findings of such research studies are presented in the following paragraphs.

Studies have found commercial banks as the main source of external finance for SMEs (Berger &Udell, 2002; Cole et al., 1996; Ghosh, 2007; Petersen & Rajan, 1994; Ruis et al., 2009). But SMEs generally face difficulty in obtaining loans from them as financial providers have a lack of knowledge about the nature of the SMEs' business on the one hand, and that many entrepreneurs have a lack of knowledge about the lending criteria and procedures of the banks on the other (Tucker & Lean, 2001). Banks generally follow three

types of approaches while providing loans to SMEs. These are character-lending approach, income-based approach and capital-based approach where asset-backed security is required (Bruns& Fletcher, 2008).

Banks are increasingly taking the view that lending decisions should be based on the cash flow, business plan and prospects, thus adopting an income-based approach (Fletcher, 1995). Here, financial performance, profitability of the project, business projections and risk and uncertainty are considered while making loans to SMEs. Financial performance is an important variable which is widely stressed upon while making loans to SMEs. Lending officers' probability of supporting credit increases with higher past financial performance of the borrowing SME (Bebczuk, 2004; Bruns& Fletcher, 2008; Fletcher, 1995). As far as risk and uncertainty and business projections are concerned, risk proclivity has a negative effect (Bruns& Fletcher, 2008; North et al., 2010) and good business projections have a positive effect (Bruns& Fletcher, 2008) on probability of granting credit by banks. Relying upon highly certain plans is a part of uncertainty-avoidance strategy followed by banks (Nguyen et al., 2006).

Cowling and Westhead (1996) put light on other considerations viewed by banks while financing to SMEs, like loan pay-back periods and purpose of loan. They evidenced that banks prefer a quicker pay-back than the uncertainty generated by longer-term loans. It was also found that demand of loan for fixed investment has a positive impact on loan approval, whereas a small firm consistently borrowing for working capital may signal to the bank that it is not in a strong commercial position.

Nguyen et al. (2006) exhibited two types of strategies followed by banks while providing loans to SMEs. One is uncertainty-avoidance strategy relying upon sufficient collateral, highly certain business plans, close monitoring and legally reported documents. On the other hand is the trust-based strategy which covers trustworthiness, collateral, business plans and documents monitoring. It was also evidenced that state-owned banks tended to use uncertainty-avoidance strategy more than private banks which adopted trust-based strategies.

Hence, various studies have covered different aspects of decision-making criteria of banks. In this study, researchers try to extend the literature by examining the decision-making criteria of commercial banks towards SMEs in Indian context.

3. Objectives of the Study
The present study has been planned with the following research objectives:
  i. To explore the factors affecting decision making criteria of Commercial banks to extend finance to SMEs.
  ii. To analyze decision-making criteria of commercial banks while extending credit to SMEs.
  iii. Last but not the least, to forward a few recommendations

4. Research Methodology
Research methodology is an important aspect of any research or investigation. It enables the investigator to look at the problem in a systematic, meaningful and orderly way. In the present study, research methodology comprises data source, sample design, survey instrument, statistical tools and techniques, sampling, period of study used. These elements of research methodology have been discussed in briefly given below.

4.1. Data Source
This study is mainly based on the primary data. Secondary data is only used for the development of the research framework. A structured questionnaire is used as the main tool for data collection.

4.2. Sampling Design
A sample of 71 respondents, who were either bank managers or senior loan officers, was taken from the branches of various public and private sector banks (including specialized SME branches) in Odisha.

4.3. Survey Instrument
A structured questionnaire was used to collect the data from the sample respondents. A five-point scale was used to elicit responses to the questionnaire indicating their level of agreement (1= Strongly Agree to 5= Strongly Disagree). The questionnaire is pretested and revised through reverse translation process for minor change in wordings.
Statistical tools and techniques used:
SPSS (Statistical Package for Social Sciences) version 20.0 is used to compute and analyze the data. The statistical tests used in the analysis of data included exploratory factor analysis

5. Analysis and Discussion of Results

5.1. Sampling Adequacy
In order to establish the strength of factor analysis, the sampling adequacy is checked using Kaiser-Meyer-Oklin (KMO) test and the results are presented in the Table-1 given as below.

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		0.631
Bartlett's Test of Sphericity	Approx. Chi-Square	255.129
	df	78
	Sig.	0.000

Table 1: KMO and Bartlett's Test

From the Table -1, it is seen that KMO value is acceptable, as its value is found to be 0.631 which is indicative of a data set considered to be desirable for factor analysis . The overall significance of the correlation matrix is checked using Barlett's test of spericity and it is found that the chi-square value is 255.129and the p-value as computed is 0.000 which supports the validity of the factor analysis.
For further investigation, four factors having Eigen value greater than one are extracted. The Eigen Value of the four factors along with their cumulative percentage of variance are shown in table-2.

Component	Eigen Value	% Variance Explained	Cumulative Percentage of Variance Explained
1	2.239	17.224	17.224
2	1.973	15.178	32.402
3	1.947	14.980	47.382
4	1.920	14.768	62.150

Table 2: Total Variance Explained

The result of the factor analysis using principal component method shows that 62.15% of the total variance is explained by classifying these 13 variables into 4 components or factors. The percentage of the total variance which is used as an index to determine how well the factor solution accounts for what the variables together represent.
The first factor F1 is the most important factor which explains 17.22% of variance before rotation. The second factor F2 is the second major factor which explains about 15.18 % of the variance of the variables. The third factor F3 explains about 14.980% of the variation. Likewise the fourth factor F4 explains about 14.77% of the variation.
Table -3 gives the factor loading of the variables under each of the four extracted factors. In order to interpret the results, a cut-off point of 0.5 is decided for each variable to group them into factors by forming a rotated component matrix.

	F_1	F_2	F_3	F_4
Financial statements are not properly audited	0.846			
Quality of information supplied is not satisfactory	0.772			
Limited financial information is available	0.597			
Small enterprises are unable to give guarantees of trusted parties		0.752		
Small enterprises lack collateral/security to offer		0.740		
Small enterprises have limited and dispersed rural markets		0.659		
Entrepreneurs are unable to make certain business plans			0.671	
Entrepreneurs lack experience as they are young and at early stage			0.603	
Entrepreneurs lack managerial capabilities			0.598	
Small enterprises are generally located in rural areas			0.581	
Small enterprises prefer longer payback period				0.847
Small enterprises' capital contribution is less, they rely more on bank loans				0.654
There is always risk of NPAs				0.607

Table 3: Rotated Component Matrix
Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.

The first factor F1 having three significant factor loadings can be named as "Information asymmetry" as it includes, 'Financial statements are not properly audited','Quality of information supplied is not satisfactory' and 'Limited financial information is available'. The second factor F2 having three significant factor loadings can be named as "Collateral Backup" as it includes, 'Small enterprises are unable to give guarantees of trusted parties', 'Small enterprises lack collateral/security to offer' and 'Small enterprises have limited and dispersed rural markets'. The third factor F3 having four significant factor loadings stands for "Lack of Technical Skill" as it includes 'unability to make certain business plans', 'lack of experience', 'lack of managerial capabilities'. The fourth factor F4 having three significant factor loadings stands for "Financially Deficit" as it includes 'Small enterprises prefer longer payback period', Small enterprises' capital contribution is less, they rely more on bank loans and 'risk of NPAs'.

6. Findings & Conclusion
Present research work has been carried out to study the overall attitude of commercial banks towards SMEs and identify the factors considered important while extending credit to SMEs. The findings of the study show that the first extracted factor namely Information asymmetry is the most important factor considered by the Banks in decision making for SMEs as it accounts for 17.22 % of the total variance. Likewise Collateral Backup is the second major factor influencing the decision making process of banks as it accounts for 15.18 % of the total variance. Next to it, Lack of Technical Skill is the third major factor affecting the decision making process of banks. Followed by these Financially Deficit is considered by banks when deciding financial assistance to SMEs.

Limitations and Scope of Further Research
This research has some limitations. The sample size is very small and thus the result cannot be generalized. The study is done in Odisha. It is possible to extend the study by including more states and a comparative picture may be drawn. Similar study can also be done in other service areas of banks (both private and public).

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