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Lending to Micro Small and Medium Enterprises: An Analysis of Bank Approaches and Risk Perceptions

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Abstract:

The Banking Sector has played an important role in the modern economy by providing credit to the weaker segments. One such segment is Micro, Small and Medium Enterprises (MSMEs). It has been found in the literature that MSME sector is facing a major hurdle in access to finance. Credit flow to the sector is not found to be adequate although the sector contributes 45 per cent to total industrial production and 40 per cent to the exports of the country.

The Perceived risk towards MSMEs pose greater challenge for banks in providing finance, resulting in different types of approaches adopted by banks towards MSME Lending like Income gearing, Capital gearing approach etc.

This research is an attempt to identify 1. Approaches used by Banks to finance MSME sector thereby finding out whether these approaches differ across banks, Type of units and Loan Types.

2. To identify and evaluate important criteria in different Lending approaches.

Keywords: Credit to MSMEs, Perceived Risk, Lending Approaches to MSMEs

1. Introduction

Finance is a crucial ingredient for economic growth. The modes of financing industrial development have been changing over the years (Levine, 1997). Financial systems tap savings and then channelize the funds to a wide spectrum of industrial activities.

The Indian financial system is bank-oriented, and despite the growth in other avenues of raising resources by the industry, there is a lack of adequate and timely provision of credit to the Industry (EPW Research Foundation 2009). In order to stimulate the economy and support the growth of Banking Sector in India, Reserve Bank of India (RBI) has proactively adopted several policy measures from time to time. But it has been found out that MSME sector is facing a major hurdle in access to finance.

Micro, Small and Medium Enterprises (MSME) sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades. MSMEs not only play crucial role in providing large employment opportunities at comparatively lower capital cost than large industries but also help in industrialization of rural & backward areas.

The Indian MSMEs contribute 8% to the Country's GDP thereby creating 100 million jobs through the 46 million units from the rural and the urban areas across the Country. They also contribute to 90% of the total Industrial output and 45% of the Manufacturing output of India and comes out with 6000+ products across the spectrum. MSMEs are credited in contributing to 36% of the Total Value of exports from the Country and the sector has recorded a constant year on year growth of over 10% thereby making this sector as the backbone of Country's economy.

As per the report of Industrial Finance Corporation on Micro, Small and Medium Enterprises (MSME) in November 2012, despite the growth in other avenues of raising resources by the industry, the lack of adequate and timely access to finance has been the biggest challenge for MSME Sector. The statistics compiled in the Fourth Census of MSME sector September 2009 revealed that only 5.18% of the units (both registered and unregistered) had availed finance through institutional sources, 2.05% had finance from non-institutional sources. The majority of units i.e. 92.77% had no finance or depended on self-finance. This could be because of the perceived risk involved in lending to SMEs.

Therefore it is important to identify the different factors leading to the risk perceptions by Bank Managers while lending to MSME sector, thereby identifying various approaches used in MSME lending across different types of Banking Institutions.

1.1. Objectives

The objective of this research is to identify various approaches used in MSME lending across different types of Banking Institutions in the state of Goa and whether it differs across types of units, types of banks and loan types.

The study will also identify the most important criteria in different leading approaches considered by Bank Managers while lending to MSME sector.

2. Literature Review

2.1. Loan Assessment Principles

Banks are profit-seeking institutions. They operate under the objectives of profit maximization through appropriate risk management strategy (Sinkey, 1998). It is reported that earnings from the lending activities account for more than 80 percent or more of the bank's profits (Wong, 1997). To estimate borrower's creditworthiness banks gather, process and analyze different types of information collected from firms.

Traditionally, the assessment of creditworthiness of a small business borrower was based on the experience and skill of the bankers in applying basic lending principles.

The basic lending assessment techniques or principles of lending used by the banks were as follows-

| THREE C'S | CAMPARI | PARSER | PARST | SAPACTRPS |
|------------|---------------|--------------|------------|------------------|
| Character | Character | Person | Purpose | Standing Ability |
| Capital | Ability | Amount | Amount | Purpose |
| Capability | Margin | Repayment | Repayment | Amount |
| | Purpose | Security | Security | Contribution |
| | Amount | Expediency | | Term |
| | Repayment | Remuneration | | Repayment |
| | Insurance | | | Profitability |
| | | | | Safety |
| | NEDC, 1986; | NEDC, 1986; | NEDC, 1986 | NEDC, 1986. |
| NEDC, 1986 | Berry, Crum & | Deakins & | | |
| | Waring, 1991, | | | |
| | 1993; | | | |
| | Deakins & | | | |
| | Hussain, 1991 | | | |

Table 1

2.2. Important Criteria in Assessment

As identified in the literature, although the banks had certain lending Principles, there were various criteria that were shown to be important.

As quoted by D. Agyapong, G. Agyapong and Darfor 2011, criteria considered important by bankers to accept or reject a small business loan proposition include

Collateral, guarantee, maturity and schedule of repayment (Ulrich and Arlow, 1981),

Credit history, initial capital, managerial experience and bank policy (Jones, 1982; Memon, 1984)

Security, financial strength, business ability and honesty (Fertuck, 1982)

Profitability, financial stability and liquidity (Berry, et al. 1993a),

Trading experience, equity stake, gearing and profitability (Deakins and Hussain, 1995; Fletcher, 1995)

Quality of management and risk of default (Rosli, 1995).

Loan Characteristics, Financial Profitability and Collateral Backup, Entrepreneurial Characteristics, Margin Money, Earlier Track Record, Entrepreneurial Skills and Purpose of Loan. (Bhalla & Kaur 2012)

Character, Collateral and Capacity of the borrower (Haron, Ismail, Ganesan and Mustafa 2012)

2.3. Lending Approaches

Considering the various lending criteria's adopted by different banks, there are four Lending approaches identified in the literature. In considering whether to advance loans to applicants, banks can apply one of these approaches or a combination of these four approaches. The four approaches identified in the literature are

Income gearing Approach

Capital gearing Approach

Relationship Lending Approach.

Character Lending Approach.

2.3.1. Income Gearing Approach

When assessing the loan applications, banks tend to look forward to future earnings potential (of the SMEs), as a source of repayment of the loan and interest. This lending assessment technique is known as *income gearing* Berry et al (2003). Berger and Udell (1995) called it *financial statement lending*, where the decision to lend and the loan contract are principally based on the strength of the balance sheet and income statement. This approach they said is best suited for relatively transparent companies with certified audited financial statements.

Various factors identified in the literature that are associated with this approach are-Financial Performance of the company over a period of time; Business Plan; Turnover of the company; Profitability of the company; Future Projections; Liquidity Ratios; Trade Debtors and Creditors.

Capital Gearing Approach-Banks especially in the developing countries tend to take a security-based lending approach. Under this approach, credit decisions are principally based on the quality of the assets pledged. (Berger and Udell 1995, Bruns & Fletcher, 2008). In the banking literature this approach is referred to as capital gearing approach.

Various factors identified in the literature that are associated with this approach are – Availability of collateral; Quality of Collateral; owners Capital in the business/Equity stake.

2.3.2. Character Lending Approach.

In Character lending approach, information on the borrower is gathered that can inform banks about the chances of the borrower failing to repay the loan. In this approach, variables such as age of entrepreneur, gender of entrepreneur, age of enterprise, entrepreneur's trading experience and his earlier track record with the bank are given importance. (Bhalla & Kaur 2012).

Various factors identified in the literature that are associated with this approach are- Age of the owner; Trading Experience; Age of the enterprise; Quality of Management; Location of the unit; Gender; Intended purpose of the loan; Tenure of the loan/Repayment Schedule; Type of business activity; Type of Loan.

2.3.3. Relationship Lending Approach

In Relationship lending approach, bankers focus their decisions in substantial part on proprietary information about the borrowers through a variety of contacts over time.

Mahmood and Rahman (2007); Diamond (1984); Peterson and Rajan (1994) and Berger and Udell (1997) advocated that the relationship banking approach is used to reduce the asymmetries of information when dealing with small businesses.

Various factors identified in the literature that are associated with this approach are- Track record of the bank; Loan activity with the other banks; Length of time doing the business with the bank; Shareholder of the bank.

3. Methodology

The present study has been carried out to identify the approaches used in MSME financing and to identify if these approaches differ across banks, types of MSME units and loan types.

The study also tries to identify the criteria in these lending approaches considered as the most important ones by Bank Managers while providing loans to MSMEs.

Research technique used for data collection is Questionnaire collected from Loan Managers or Bank managers of different Banks.

The questionnaire consisted of three parts, each of them listing down the different criteria associated with a particular lending approach.

Sample selection has been done on the basis of types of banks- Public Sector banks and Cooperative Banks in the state of Goa. The total Sample Size is 25. The sample consisted of 15 Public Sector and 10 Private Sector banks.

4. Analysis and Graphical Interpretation of Results

4.1. Lending Approaches

4.1.1. Bank Lending Approaches in MSME Lending-Types of Units

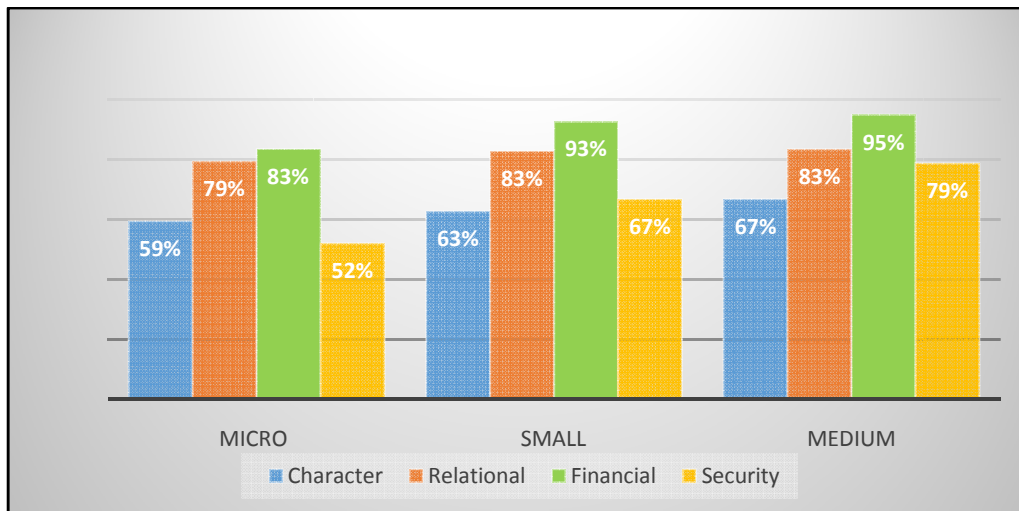


Figure 1: Lending Approaches towards MSME in banks

It is observed that the banks rely their lending decision on Financial Lending approach for MSME followed by Relational Lending approach. However for Micro sector, it is observed that the character lending has been given preference over security or collateral based lending.

4.1.2. Bank Lending approaches in MSME lending -Type of Loans

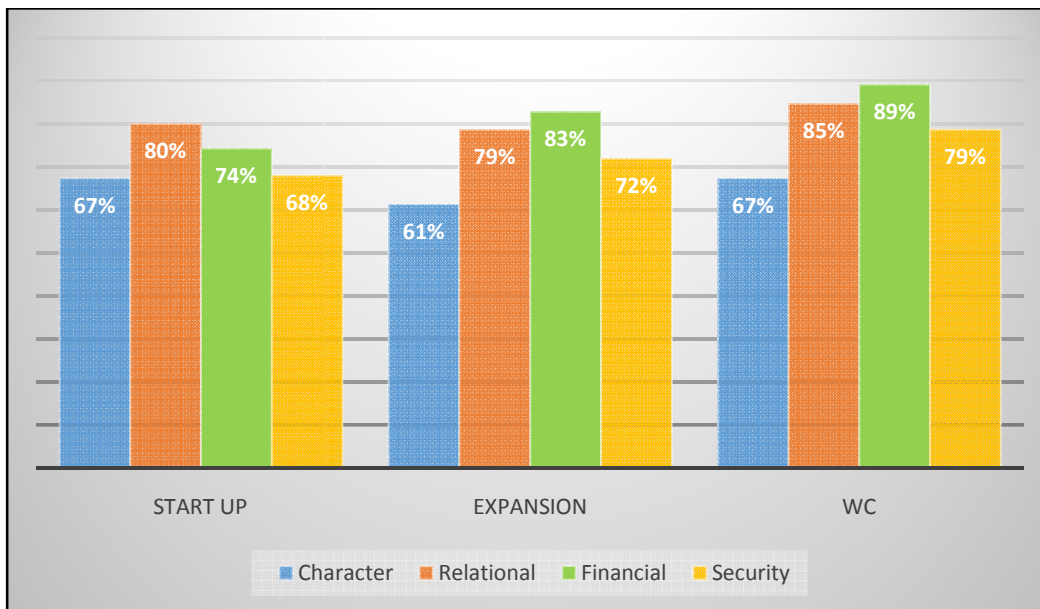


Figure 2: Bank Lending Approaches across type of loans

It is observed that the loans for expansion and the working capital loans show similar trend. for these loans banks adopt Financial followed by Relational type of approach. Whereas for startup loans, emphasis is given on Relationship of the client with the bank thereby following Relationship lending approach.

4.1.3. Bank Lending approaches in MSME lending -Type of Banks

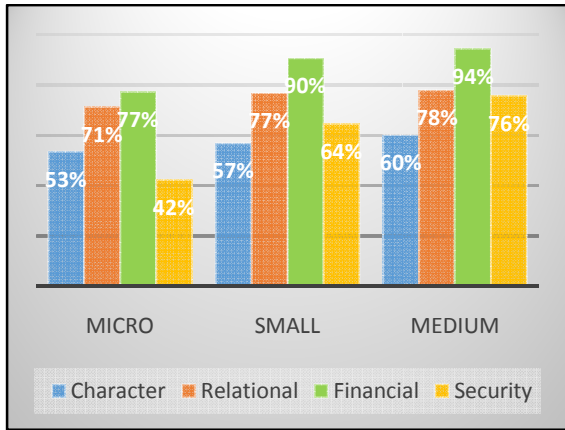


Figure 3: Lending Approaches-Public Sector Banks

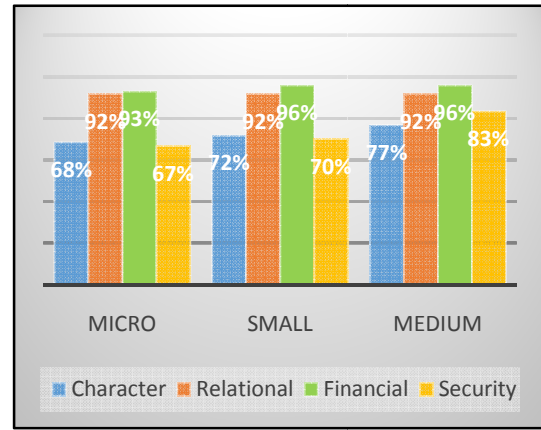


Figure 4: Lending Approaches-Cooperative Sector Banks

Lending to Micro Sector has seen to be more conservative in Cooperative sector banks as compared to Public sector banks. It is observed that the security is asked in 62% of the samples as compared to 42% of the times in Public sector banks. It is also observed that the financial approach is dominant in Public sector lending where as in cooperative sector, along with financial approach, relational lending approach is considered to be equally important.

4.2. Important criteria in Different Lending Approaches

4.2.1. Factors considered in Character Lending

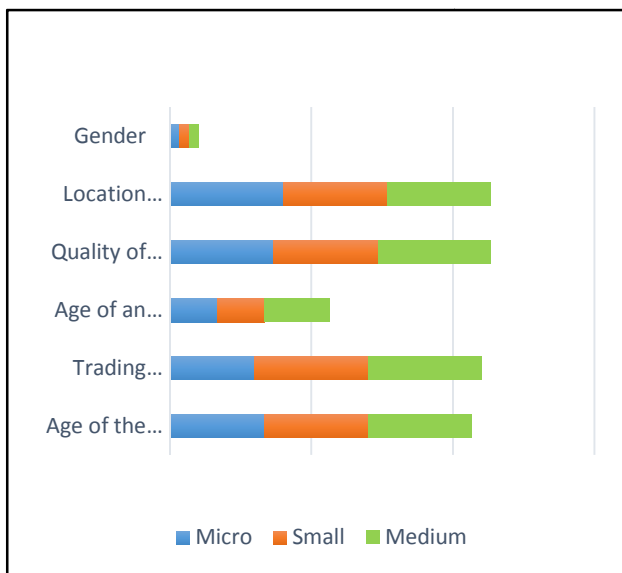


Figure 5: Public Sector Banks

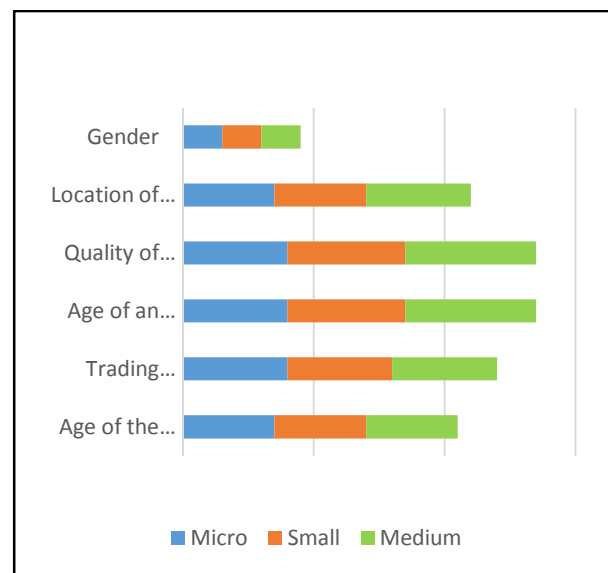


Figure 6: Cooperative Banks

In character lending approach, it is observed that the factor- Quality of Management has been given the most importance in banks. Apart from the above factor, in Public sector banks –Location of the unit whereas in Cooperative banks-Age of an enterprise has been given importance while lending to MSME Units.

4.2.2. Factors considered in Relational Lending

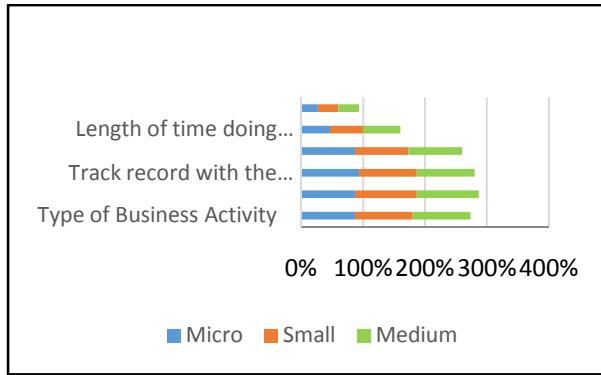


Figure 7: Public Sector Banks

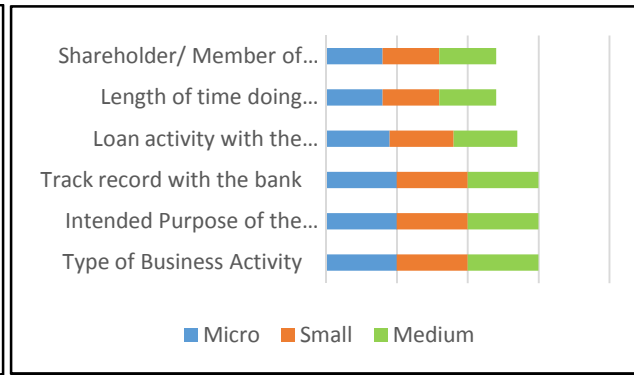


Figure 8: Cooperative Sector Banks

Track Record with the bank and Intended purpose of the loan are the two most important factors considered by both the type of banks in lending to MSME.

4.2.3. Factors considered in Financial Lending

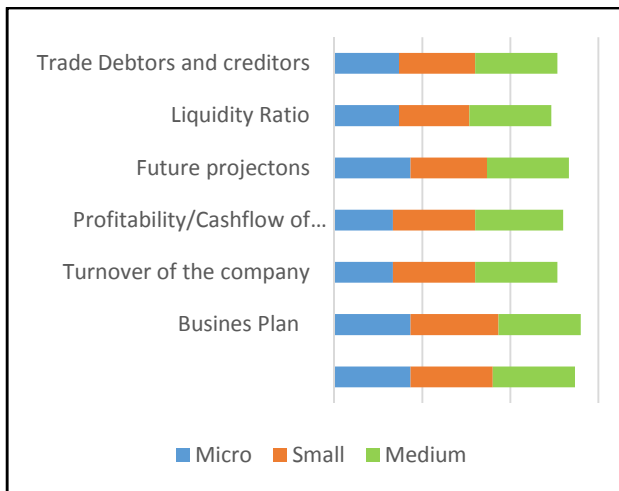


Figure 9: Public Sector Banks

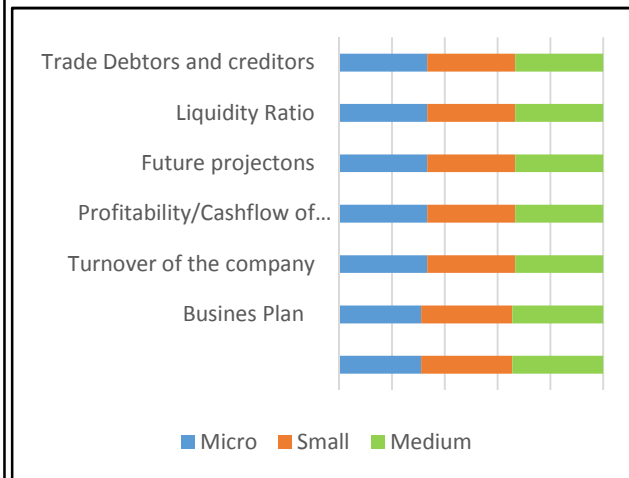


Figure 10: Cooperative Banks

It is observed that in Public sector banks, Business Plan and Financial Performance of the company are the two most important factors among the financial factors mentioned. Where as in cooperative banks all the financial factors seem to be of equal importance.

4.2.4. Factors in Security based lending

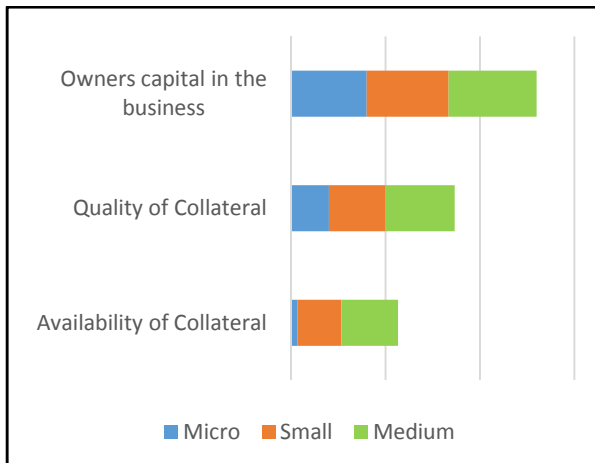


Figure 11: Public Sector Banks

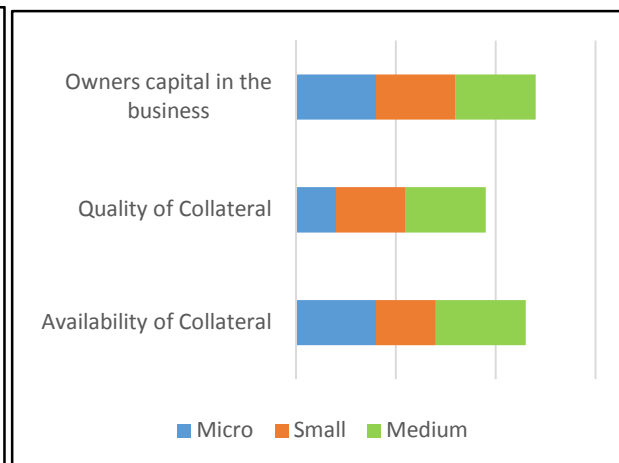


Figure 12: Cooperative Sector Banks

While considering factors in security lending approach in Public Sector banks, Quality of security is considered important whereas in cooperative sector, quantity of security provided is seen to be important. However the owner's capital in the business is considered as the most important factor in Security based lending.

5. Conclusion

The present study has been done with an intention to identify different MSME lending approaches across different banks. The study also tries to identify the important factors considered while lending to MSME sector.

Across Public and private sector banks it is observed that the lending is based on the financial data however the lending based on the relationship has been given equally importance. For micro sector the character based lending has been considered the most important assessment technique after financials.

In character based lending Quality of management has been identified as the most important factor. In relational lending the Track Record with the bank and Intended purpose of the loan are the two most important factors identified and in Financial lending, Business Plan and Financial Performance of the company are the most important factors considered.

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