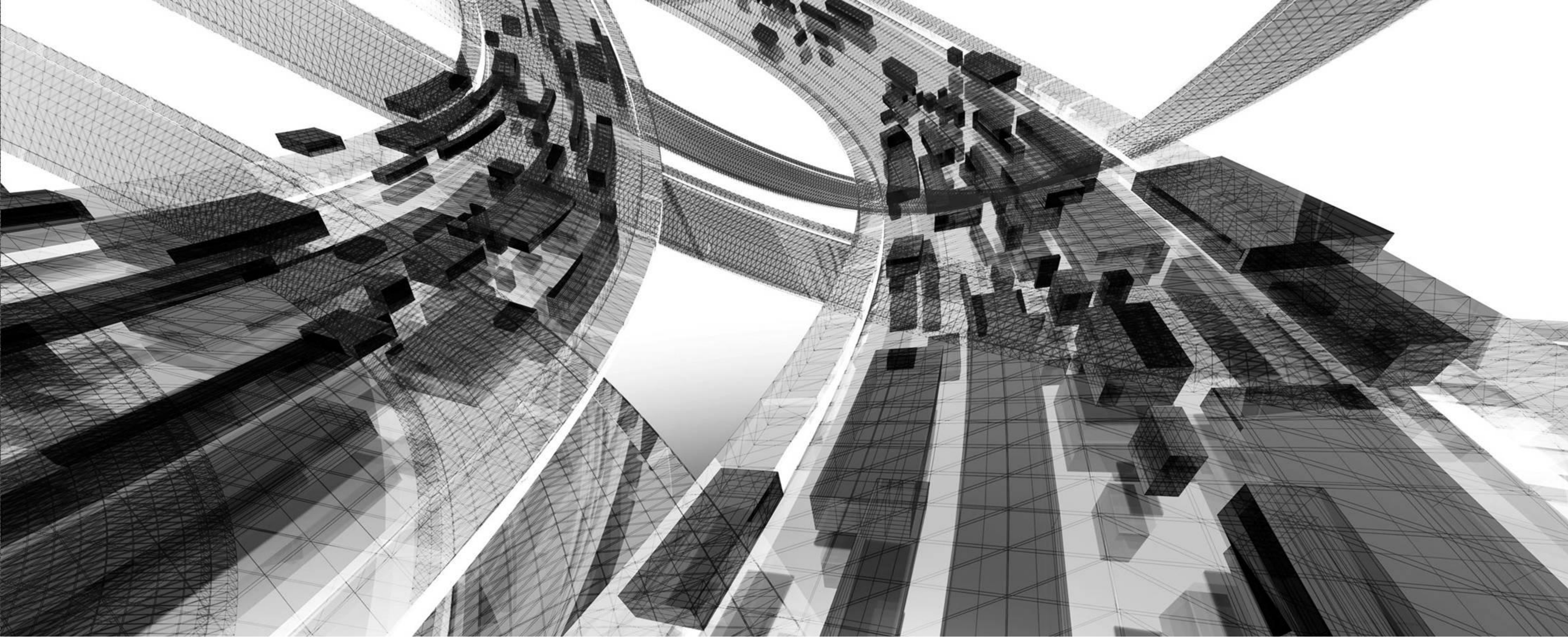


Bank Finance for MSMEs

June 2012

Criticality of MSMEs well understood

Small and Medium Enterprises (SMEs) are critical to the nation's economy

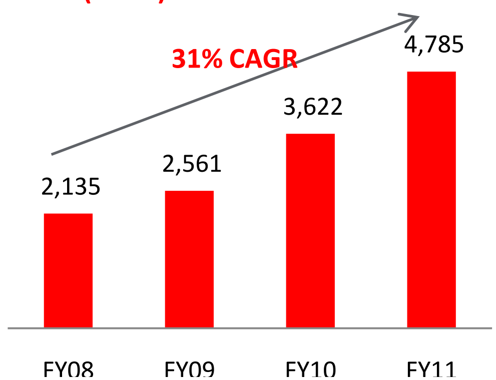
Contribution of SMEs

40%	50%	45%	2nd largest
of India's domestic production	of total exports	of industrial employment	employers of manpower after agriculture

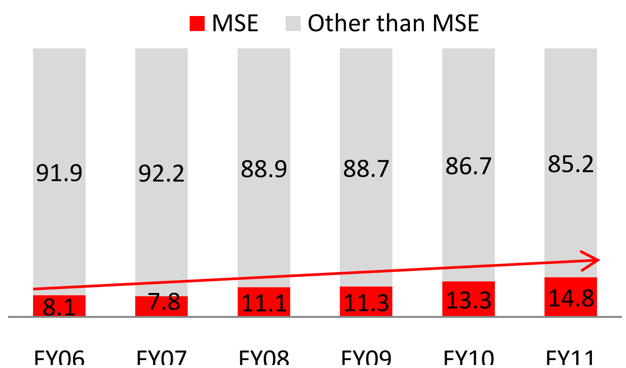
SMEs in India operate mostly in the unorganised sector and are the source of livelihood for millions of people

Growth in Financing has been strong, but still inadequate

Outstanding Credit to MSE sector
All SCBs (INR b)



Credit to MSEs by PSBs[1]
As % of ANBC



- Despite increase in sector credit, MSMEs feel that lenders are not doing enough and are catering more to the needs of the large corporates. This gap in perception needs to be bridged
- Absence of adequate and timely banking finance, limited capital and knowledge amongst SMEs

1) Increase in 2008 is due to change in definition of MSEs following MSMED Act

Major Obstacles in SME Development

Major obstacles in the path of business development for SMEs

Financing	• Lack of access to finance and timely credit as well as escalating cost cited as primary reasons for under-utilisation of the manufacturing capabilities of SMEs
Infrastructure	• Infrastructural facilities in India have not reached to the desired level. This restricts private initiatives in this sector. Creation of better infrastructural facilities for SMEs must receive greater priority
Taxes And Regulations	• Multiplicity of regulating agencies lead to harassment and inspections with greater impact on operations of SMEs than on larger units
Marketing	• With growing access to modern means of communication, particularly revolution in the information technology, the sheltered market for the SMEs product is no longer so
Technology	• Difficult for SMEs to access cutting-edge technology due to the high initial costs, thus leaving them behind in the race for competitiveness. A major impediment in SME development is their inability to access timely and adequate finance

Issues Faced by Banks in Lending

Information Asymmetry	• Information symmetry leads to banks increasing lending rates disproportionate to risk profile. • Small ticket sizes makes development of SME information systems unviable for banks • Banks may also curtail lending even when SMEs are willing to pay a fair risk adjusted cost of capital
Granularity	• Situation where risk grading system at banks does not have the requisite capability to discriminate between good and bad risks leading to tightening of credit terms/higher rates • Most banks in India have not developed adequate expertise in SME lending risk assessment .
Pecking Order Theory	• SMEs, which face a cost of lending that is above the true risk-adjusted cost, will have incentives to seek out alternative sources of funding. • In such situations, SMEs prefer to utilise retained earnings instead of raising loans from banks.
Moral Hazard	• When loans are made to SMEs, it may so happen that the owners of these SMEs take higher risks than they otherwise would without lending support from the banks • SME owner benefits fully from any additional returns but does not suffer disproportionately if the firm is liquidated
Switching Costs	• SMEs may find it harder to switch banks, when countered with any issue. • Results in SME lending becoming a seller's market, which may not be attractive to SME borrowers

Thank You