A Study on the Bank Financing of SMEs in India

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ABSTRACT

The financing of small and medium-size enterprises (SMEs) has been a subject of great interest both to policy-makers and researchers because of the significance of SMEs in private sectors. In developed and developing countries, on average, SMEs account for close to 60% of manufacturing employment. More importantly, a number of studies using firm-level survey data have shown that SMEs not only perceive access to finance and the cost of credit to be greater obstacles than large firms, but these factors constrain SMEs more than large firms.

Banks are the main source of external finance for SMEs. Furthermore small banks are more engaged in relationship lending whereas the large banks have a comparative advantage at financing SMEs through arms-length lending technologies (e.g., asset-based lending, factoring, leasing, fixed-asset lending, credit scoring, etc.) instead of relationship lending. Early studies on SMEs financing shows that bank credit is the major source of external finance for the SMEs. Both small and large banks play a vital role in financing SMEs.

The study finds that the following are the main factors which act as the driver for the financing decisions. They are: profit earning of SME, legal formation of the firm, stages of development of the firm, no of default firm made in previous loans, availability of collateral, payment history of firm, preparation of financial statements, feasibility of the proposed project and experience of management in business. The influence of these factors decides the risk associated with the SME lending.

Keywords: SMEs, Bank Financing, Factoring,

Introduction:

Growth of the corporate sector is important in the process of economic development. The issue of finance has been identified as an immediate reason why business in developing countries fails to start or to progress. It is imperative for firms in developing countries to be able to finance their activities and grow over time if they are to play an increasing and predominant role in providing employment as well as income in terms of profits, dividends and wages to households. A part from big industries Small and Medium Enterprises (SME’S henceforth) also contribute to the expansion in the size of the directly productive sector in the economy; generating of tax revenue for the government; and poverty reduction through fiscal transfers and income from employment and firm ownership.

In India, small-scale industry is conventionally defined in terms of the size of the investment. Globally, the sector has more flexibility and is known as the Small and Medium Enterprises or SME sector. Certain parameters tend to their characterization: the entities are likely to be listed in the stock market, ownership of the business is limited to few individuals, usually a family group, and they are micro-to medium-sized businesses that have a purpose larger than self-employment. The sector has a significant contribution to manufactured exports, and critical work. Financing of SME in the country is largely seen as a part of the regulated lending through a network of state-created institutions. While it is an achievement on the part of the banking sector and shows the credit absorption capacity, there is a definite and visible gap in its support to the sector.

Reviews of Literature:

Mercieca, S. and Simon, W. (2006), in the paper titled “Bank market structure, competition, and SME financing relationship in European” tried to find out how concentration and competition in the
European banking sector do affects lending relationship between SMEs and their banks? By using Herfindahl Hirschman Index (HHI), Multinomial logit regressions, sensitivity Tests. This paper says about Competition has a positive effect on the number of lending relationships, weak evidence that concentration reduce the number of banking relationship and weak persistent evidence that they tend to offset each other. Further study is possible in Concentration and competition describes characteristics of banking systems.

Aghion, P. and Scarpetta, S. (2007), the paper titled “Credit Constraints as a Barrier to the Entry and Post-Entry Growth of Firms” discussed on the credit constraints as a potential barrier to the entry and post entry growth of firms. Study is based on the Correlation analysis and finds the following results. Higher financial development enhances new firm entry in sectors that depend more heavily upon external finance. The entry of smallest size firms benefits the most from higher financial development, whereas the entry of largest firms is negatively correlated with credit. Financial development enhances post-entry growth of firms in sectors that depend more upon external finance.

Martínez, M. and Schmukler, S. (2010), in the study titled “Bank involvement with SMEs: Beyond relationship” viewed that large and foreign banks are generally not interested in serving SMEs, at the same time small and niche banks have an advantage because they can overcome SME opaqueness through relationship lending. Study use the non statistical method Banks’ business model and risk management systems. It shows light on the intensification of bank involvement with SMEs in various emerging markets is neither led by small or niche banks nor highly dependent on relationship lending. Moreover, it has not been derailed by the 2007–2009 crisis. Rather, all types of banks are catering to SMEs and large, multiple-service banks have a comparative advantage in offering a wide range of products and services on a large scale, through the use of new technologies, business models, and risk management systems. It leads for further observation because this Study conducted in four countries Argentina, Chile, Colombia, and Serbia. But Banks generally define SMEs in terms of average annual sales, with thresholds that vary by country according to the size of the economies and structure of the corporate sector.

Objectives of the study

The present study has been undertaken with the following objectives:

- To identify the different financing options available for financing SMEs.
- To identify the factors which act as the drivers for financing decisions of the bank, while financing SMEs.
- To analyze the impact of the identified factors on the financing decisions by bank.

Variables of the study

Dependent variable
The dependent variable in the study is Bank financing
Independent variable
Independent variables used in the study are profit earning of SME, legal formation of the firm, stages of development of the firm, no of default firm made in previous loans, availability of collateral, payment history of firm, risk associated, preparation of financial statements, feasibility of the proposed project and experience of management in business.

Hypotheses

H1: Profit earning of a firm does not influence the decision taken on SME financing by bank.
H2: Bank does not give importance for legal formation of a SME.
H3: Stage of development of a firm does not influence the bank decision on SME financing.
H4: SME financing is not highly risk associated and it does not affect financing decision by bank.
H5: No. of defaults in a SME lending does not influence finance decision of bank.
H6: SME does not provide enough collateral for bank lending and this affect bank lending.
H7: – Payment history of SME firm does not influence a bank decision on SME financing.
H8: Bank does not consider authenticity of financial statements of a firm.
H9: SMEs does not have to make project with good financial feasibility, as it influences bank decision.
H10: Experience of management in business does not influence bank financing decisions.

Sampling procedure

Set of 40 are taken as the sample for this study. The stratified sampling method was followed, as the total sample will be heterogeneous in product, process and marketing particulars.

Data Analysis:

<table>
<thead>
<tr>
<th>Hyp 1</th>
<th>Hyp 2</th>
<th>Hyp 3</th>
<th>Hyp 4</th>
<th>Hyp 5</th>
<th>Hyp 6</th>
<th>Hyp 7</th>
<th>Hyp 8</th>
<th>Hyp 9</th>
<th>Hyp 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>t α α=0.05</td>
<td>1.729</td>
<td>1.729</td>
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</tr>
<tr>
<td>t (calc.)</td>
<td>0.034</td>
<td>1.204</td>
<td>1.510</td>
<td>1.501</td>
<td>0.720</td>
<td>0.761</td>
<td>1.795</td>
<td>1.139</td>
<td>1.021</td>
</tr>
<tr>
<td>Decision</td>
<td>Reject</td>
<td>Reject</td>
<td>Reject</td>
<td>Reject</td>
<td>Reject</td>
<td>Reject</td>
<td>Accept</td>
<td>Reject</td>
<td>Reject</td>
</tr>
</tbody>
</table>

H0 : µ=<4
H1 : µ>4
N = 40

From the table 1 for all the cases except hypothesis 7, the as the t calculated is less than t α, all the alternative hypotheses are accepted. It shows that all these independent variables has high influence SME financing decision of banks.

Findings of the Study

After undertaking the study, the following findings were made about the Drivers of the Bank financing for SMEs.

- Bank respondents have a mixed preference for SME financing.
- Bank considers following factors about an SME while financing it.
  a) Profit earning of SME.
  b) Legal formation of the firm.
  c) Stages of development of the firm.
  d) No of default firm made in previous loans.
  e) Availability of collateral.
  f) Payment history of firm.
  g) Preparation of financial statements.
  h) Feasibility of the proposed project.
  i) Experience of management in business
- Among these factors, it is found that bank give least important for the financial feasibility of the project.
- There are mainly 5 categories for formation of the company.
  a) Sole proprietorship
  b) Partnership firm.
  c) Parent group.
  d) Ltd. Company
  e) Family Business
Among these categories bank prefer partnership firms and Ltd. Company. Bank prefer to finance firms in a growth stage, either slow growth or fast growth stages. Respondents say that financing SMEs are highly risk associated.

Conclusion:

India has a vibrant SME sector that plays an important role in sustaining economic growth, increasing trade, generating employment and creating new entrepreneurship in India. SMEs mainly approach banks for their external financing. But there are many obstacles in financing a firm for the banks. Government of India encourage entrepreneurship by providing various kinds of benefits. As a result many of unemployed people start SMEs. Their main motive is to overcome the unemployment situations and to analyse their ability to run a company. In this case these people start the business without proper experience in it and they do not provide 100% participation in the business. As a result it reduces the probability of the success.

This is the main obstacle each bank face in SME lending

Based on the study conducted, we find some factors which act as the driver for the financing decisions. They are:
- Profit earning of SME.
- Legal formation of the firm.
- Stages of development of the firm.
- No of default firm made in previous loans.
- Availability of collateral.
- Payment history of firm.
- Preparation of financial statements.
- Feasibility of the proposed project.
- Experience of management in business.

The influence of these factors decides the risk associated with the SME lending. Bank respondents take these as the drivers while choosing a SME for financing.

References:


41. Torre, Martinez, M and Schmukler, S. (February 2010). "Bank involvement with SMEs: Beyond relationship lending". USA.


