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Providing Better Access to Finance for SMEs in India

New bank project addresses financing constraints with innovative tools

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The World Bank's Board approved on November 30, 2004 a loan of US$120 million to the Small Industries Development Bank of India (SIDBI), backed by a Government of India guarantee. The loan, which is the first Bank financial sector loan to India since the early 1990s, finances the *India Small and Medium Enterprises (SME) Financing and Development Project.* The objective of the Project is to improve SME access to finance and business development services, thereby fostering SME growth, competitiveness and employment creation, which are key to achieving the Government of India's overall objectives of economic growth and poverty reduction. The US$120 million IBRD loan is a fixed spread loan, repayable in 15 years (including a five year grace period). The all inclusive cost of this loan is around LIBOR+40 basis points.

The role of SMEs, the constraints they face in India, and the need for the Project. The Indian economy needs to grow at around 8 percent per annum over the next decade to reduce the poverty rate to 11percent, as targeted by the Government of India's (GoI) Tenth Five Year Plan (2003). The Plan also notes that achieving and sustaining such growth and higher employment will require a sharp step up in industrial and services growth, spurred by small and medium enterprises (SMEs) – which have the greatest potential to provide high-wage employment for the 70 percent of the labor force still working in agriculture. Indeed, there is now widespread recognition within India that vibrant SMEs are potentially a key engine of economic growth, job creation and greater prosperity.

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But Indian SMEs have been unable to achieve the competitiveness that would allow them to drive manufacturing sector and overall economic growth, employment and poverty reduction. Key among the constraints to SME growth and competitiveness is the problem they face in accessing adequate, timely financing on competitive terms. Absolute amounts of lending to the Small Scale Industries (SSI) sector have been increasing over the years, but as a percentage of net bank credit, commercial bank credit to SMEs has declined sharply since the late 1990s[1]. Furthermore, whereas Indian SMEs have a strong demand for term-financing (maturity of 3 years++) to meet their capital formation and technological up-gradation needs, bank financing currently available to SMEs is of a shorter tenor because banks face difficulty in raising longer-term resources. At present, more than 80percent of the total deposits of India's commercial banks have a maturity of less than 3 years.

The financing constraint faced by Indian SMEs is attributable to a combination of factors that are rooted in: (a) a legal/regulatory framework that makes recovery of bad loans to SMEs, bankruptcy and contract enforcement difficult for creditors; (b) institutional weaknesses, such as the absence of good credit appraisal and risk management/monitoring tools, that increase banks' transactions costs in dealing with SMEs; (c) absence of reliable credit information on SMEs, and (d) lack of sufficient market credibility of the SME sector. This has made it difficult for lenders to assess risk premiums, creating differences in the perceived versus real risk profiles of SMEs and resulting in untapped lending opportunities to SMEs.

Bankers' risk perception towards SMEs is heightened by the poor historical performance of SME loan portfolios, particularly loans made by the public sector banks, which account for more than 90percent of all lending to SMEs. While these banks have large SME portfolios, some report non-performing loans (NPLs) of more than 15percent of their total SSI loan portfolio, and are hence risk averse to expanding their SSI portfolios. The other group of banks engaged in SME lending are the newer, private sector banks. These banks view SME lending as a profitable business (they lend to SMEs in order to cross-sell fee-based products, while taking advantage of non-interest bearing deposits from SMEs). So far, their experience with SME lending has been quite good: A few of the new banks report NPLs lower than 2percent of their total SME portfolio. (It is important to note that the NPLs of the public and new private sector banks are not directly comparable as the private sector banks have newer portfolios and losses may not yet be recognizable). However, the NPL experience of the public sector banks with SME lending has made the newer, private sector banks cautious and risk averse to scaling-up SME lending, and they have concentrated their SME business mainly on channel-financing and cluster financing.

In recent years, the Indian authorities have taken several steps to support SME financing and development. First, there has been a welcomed shift in focus from small-scale Industry ("SSI") to small and medium enterprises ("SME"), as reflected in the GoI's recently announced Rs100 billion (US$2.3 billion) SME fund operated by SIDBI, the apex bank for SMEs in India. The past approach based on preferential treatment of SSIs and targeted loans at subsidized interest rates is being challenged by a realization that artificial barriers to entry and regulated credit markets are not suitable for optimal size and efficiency of SSIs. Second, to strengthen the framework for tackling loan defaults and contract enforcement, India enacted in 2002 the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI). Also, a new bankruptcy legislation was enacted in end-2003.Third, recognizing that better credit information can directly increase the amount of financing for SMEs, by reducing the risk and costs arising from information asymmetries, GoI has recently supported the creation of the Credit Information Bureau of India Limited (CIBIL) as a public-private partnership. CIBIL is mandated to collect and disseminate credit information on individuals and firms of all sizes. Fourth, the Reserve Bank of India (RBI) has issued a directive requiring all banks to introduce standardized credit appraisal systems and guidelines. Fifth, efforts have also been made in recent years by SIDBI and others to improve business development services (BDS) for SMEs. But the following important challenges remain:

- Removing any remaining policy distortions that create perverse incentives for small business to graduate into medium-sized firms, reaping economies of scale and contributing to growth and employment.
- Ensuring the efficient implementation/enforcement of the new legal framework for loan defaults, contract enforcement and bankruptcy.
- Facilitating information sharing between banks and CIBIL. In this context, the challenge for banks is to organize credit information on SMEs in a format that can be easily transferred to CIBIL, and in a format that would enable banks to use this data for their own credit decision[2]. While no individual bank or its client may see the benefits of data sharing, collectively, this would reap significant benefits to both the banks and their clients.
- Broad-basing the use of credit-scoring and other SME credit appraisal tools in banks. While the majority of banks do have standardized credit appraisal systems and guidelines, most banks have credit-scored only a small proportion of their accounts, and these are generally corporate rather than SME accounts. So the challenge for banks is to credit score all accounts; most public sector banks require an up-grading of credit scoring tools for SME loans, and both public and private banks need the credit information required to "populate" the credit scoring models with reliable data (data sharing and cooperation among all concerned parties is critical to getting valid credit scores). Transparent appraisal tools such as credit scores can help reduce transactions costs in assessing SME credit risk at the branch level (where SME lending decisions are taken at the public sector banks), and help branch managers to identify and eliminate those borrowers most likely to default. The latest credit scoring tools would help branch managers better understand, appreciate, and mitigate SME credit risk, making them more confident in lending to the sector.
- Improving the quality and expanding the outreach of business development services (BDS) and market linkage programs for SMEs. In particular, public-private partnerships among BDS providers is necessary to enable private providers to emerge and public providers to move increasingly from direct BDS provisioning to a facilitating role, thus optimizing the use of subsidies. This requires a critical number of pilot interventions that can create models for replication across India. Against this background, GoI, SIDBI, and a number of commercial banks, requested the World Bank to support efforts to remove the bottlenecks that constrain SME access to finance (including term financing), and to foster SME development. Over the medium to longer term, this requires addressing the remaining policy and regulatory issues, institutional weaknesses and capacity constraints that have hitherto distorted bankers' risk-return signals in SME financing and hampered the efficient functioning of SME credit markets. It also requires improving business development services for SMEs so that they become more efficient, creditworthy and "bankable". Over the short-term, measures are required to kick-start bank financing, particularly term loans, to commercially viable SMEs.

The Project catalyzes funds from the private sector (e.g., in the delivery of business development services and SME credit rating), and also sizable funds from donors such as DFID and SECO. The Project dovetails GoI's SME fund being implemented by SIDBI. It is expected that the institutional support provided to SIDBI under the Bank-led Project will have a wider benefit by strengthening SIDBI's capacity, where necessary, to implement the larger SME fund and facilitate sector reforms. The Project is therefore expected to add significant value, beyond the financial resources and technical advice that it will bring to the table, and to leverage policy, regulatory and institutional changes far beyond what the Bank would have been able to achieve on its own.

The Project includes three components, the most innovative of which is a ***Pilot Risk Sharing Facility (RSF),*** the first of its kind in India. This facility, which will be capitalized using the proceeds of the bank loan and supplemented by funds from SIDBI and donors, aims to immediately accelerate commercial bank lending to SMEs. It involves the establishment of a commercially viable, self sustaining credit guarantee facility that will provide partial credit risk cover to banks for their SME lending, on a portfolio basis. The facility is designed to achieve a maximum leverage impact: it is expected to guarantee liabilities amounting to at least eight times its net worth by the end of the fifth year of its operation; by sharing up to 50 percent of the credit risk (principal only) with banks on a *pari passu* basis, the facility will leverage lending from

banks to SMEs amounting to at least 16 times the net worth of the entity. All Indian commercial banks can apply for the guarantee cover, from RSF, provided they meet predetermined eligibility criteria established at the level of banks and their loan portfolios.

The guiding principles underpinning the structure of the RSF are the need to avoid moral hazard (i.e. the risk that through providing the guarantee could result in a deterioration in the quality of bank loans to SMEs) and adverse selection (the risk that banks pass on their worst loans to the RSF). The moral hazard issue has been addressed by ensuring that at all times the participating commercial banks retain 50percent of the risk related to any portfolio that is transferred to the RSGC. To address the adverse selection risk, stringent criteria have been agreed on bank and portfolio selection. Each portfolio to be transferred will undergo a rigorous risk assessment by a third party (rating agency). Portfolio selection will be based on statistical principles aimed at avoiding adverse selection; any portfolio selected for risk sharing would need to have a risk profile no worse than the average SME portfolio of the commercial bank or that of the segmented (by product/sector/procedure) portfolio offered by the commercial bank to the RSGC. This avoids cherry picking, while, at the same time, ensuring that banks do not selectively transfer their worst loans to the RSGC.

The structure of the RSF ensures good corporate governance and incentivization of managers to maximize profits, coupled with prudent risk management. The RSF has been so structured, as a Limited Liability Company, that its owners have every incentive to ensure that it is well run, so as to preserve its capital.

To this end, the RSF will be operated on a commercial basis aimed at controlling costs, charging appropriate fees, and maintaining prudent treasury management. It will be a self-sustaining entity to be run by professional managers, selected through a competitive process. Through its income sources (investment income and income on guarantee business), the RSF will be able to cover all costs of payouts on defaults, and operating and due diligence expenses. The RSF will manage its own risks through a well developed risk management strategy. The RSF will have a reasonable equity base in terms of its capital structure, sound investment policies and a lean but 'control and audit' focused staffing policy. To further mitigate risk, on a case by case basis, and to help lower its risk exposure, the RSF may also enter into counter-guarantee agreements with IFC and/or other such agencies on a pre-determined fee sharing basis, for covering all risk assumed by the entity above a threshold level ("critical default rate"). The critical default rate will be defined separately for each loan portfolio guaranteed, based on expected losses. Also the RSF will have internal exposure limits such that it avoids exposure to portfolios with any loan that is greater than 25percent of the paid up capital of the RSGC.

Innovative design features of the pilot RSF that are worth highlighting are as follows: (i) the risk sharing with banks is based on a *portfolio* approach (rather than sharing the risk on individual loans); (ii) the facility covers both retrospective and prospective SME loan portfolios (loan pools) of commercial banks; and (iii) it is designed to be a commercially viable, self sustaining entity, which will be run by professional managers who will be given appropriate incentives to maximize profits while managing risks in the most prudent manner.

Establishment of the RSF also involved a key innovation in the Bank's disbursement procedures: The RSF will be capitalized through an upfront disbursement of IBRD funds that will not be against expenditures for goods, works or services, but rather, will be used to create the guarantee reserves solely for the purpose of future guarantee payouts. In the past, such upfront disbursement of funds has required a waiver of the requirements under OP 12.00 in respect of the Bank's disbursement policies and procedures. But discussions with OPCS, LEG and LOAG on the disbursement mechanisms for the RSF led to LEG and OPCS taking a closer look at OP12.0 and allowing a more liberal interpretation of the policy. This should pave the way for similar guarantee facilities to be set up with greater ease in other countries.

The Project also includes a ***Credit Facility***, which is designed to primarily address the term financing constraints faced by commercial banks, and hence, enable SME clients to access longer term funds needed for capital formation and technological up-gradation. And a comprehensive ***Policy and Institutional Development Technical Assistance program*** will help address the medium term policy, regulatory and institutional constraints that hamper the efficiency of the SME credit market in India. The technical assistance, which will be financed through a grant from the U.K. Department for International Development, and cost sharing by local counterparties, will aim to: (i) strengthen the policy/legal/regulatory framework underpinning SME financing and development; (ii) improve credit information (positive and negative information) on SMEs, including through supporting the newly created Credit Information Bureau of India Limited (CIBIL) and providing assistance to SIDBI and commercial banks to verify and collate historic data on SMEs, which can be made available to CIBIL and also retained for use under the Project; (iii) build institutional capacity of banks to reduce banks' transactions costs and help them better manage their risks related to SME lending; (iv) strengthen Business Development Services (BDS) and market linkage programs for SMEs, including support to SME clusters; and (v) provide institutional support to SIDBI. The TA program incorporates lessons from best practice. It involves cost-sharing with beneficiaries to ensure greater ownership.

Lessons learned from other projects that were incorporated into the design of the India SME Project. The project was rigorously scrutinized by the India Management Team and the Financial Sector Board with respect to its use of the line of credit (LOC) instrument, guarantees and technical assistance. The final design benefited greatly from these discussions and a Quality Enhancement Review. The Project design also reflects lessons from recent analytical work[3], it draws on successful SME finance initiatives from other countries,[4] and past experience with Bank projects involving LOCs. Recent evaluations of LOCs indicate that the problems have stemmed mainly from weak borrower accountability and management capacity, lack of clearly defined and transparent indicators for monitoring the financial performance of the concerned financial intermediaries as well as poor monitoring of the overall project impact, inadequate demand from ultimate beneficiaries/lack of bankable sub-projects, and inflexibilities in project design that make it difficult to adjust design to reflect changing ground realities. Each of these issues has been addressed carefully and transparently by the India SME Project.

On successful completion of the Project, the *principal outcomes* are expected to be as follows: (i) increased lending (including term lending) to SMEs by all participating banks on market-based terms; (ii) reduced NPL ratio on the SME loan portfolios of participating banks; (iii) improved credit information on SMEs, organized in a format that can provide the necessary guidance to banks in making credit decisions, and can be shared easily with the credit bureau; (iv) banks improve credit assessment as well as risk monitoring and management techniques and practices; (v) improved profitability of SME business in all participating banks; (vi) a more efficient policy framework underpinning SME financing is developed (through such means as facilitating the better enforcement of NPL recovery and bankruptcy, developing a more customer friendly mortgage registration system, addressing the problem of delayed payments, streamlining the tax and accounting framework to foster the development of leasing finance, establishing a supportive financial environment that can offer SMEs with better access to equity financing, etc.); (vii) improved access to demand-oriented financial and non-financial business services for SMEs; (viii) SMEs record growth in investment, productivity and turnover, as well as in employment, and become more creditworthy clients. Progress towards achieving the principal Project outcomes will be measured through agreed *project monitoring indicators* (both quantitative and qualitative), for which data will be gathered through baseline studies/surveys, updated on a regular basis.

1. In the past, non-bank finance institutions (NBFIs) played an important role in SME financing, but this source of financing dried up after the collapse of the sector in 1997.
2. The Indian public sector banks have historic data on borrowers, but it is not in a form that would enable banks to use this data easily for their own credit decisions. Collating this data in a form that would enable banks to use this data easily for their own credit decisions and share it with the credit bureau, represents a significant technical challenge that could well take two to three years of intensive efforts. The private sector banks typically tend to have data in electronic form but many of these banks do not currently have the systems in place that would enable using this data in the most effective manner.
3. SME Development in India, World Bank, 2004 (EW-P084703-ESW); Improving India's Investment Climate, World Bank, 2002 and India Investment Climate Assessment, World Bank, 2004.
4. For example, Hong Kong's SMELOAN, Wells Fargo of the US, Citigroup's Citibusiness Initiative, Standard Bank South Africa's Scored Lending model, and SME Finance initiatives of MiBanco Peru; SME finance initiatives sponsored by governments and IFIs (e.g., the Small Business Guarantee Finance Corporation of the Philippines, US Department of Commerce Export Finance Matchmaker Initiative, an SME initiative in Ghana, and various IFC initiatives.

For More Information on the Project, please refer to the Project Appraisal Document (Report No.: 30400-IN, October 27, 2004) or contact the author of this article.