MSME Banking Excellence Awards' 13 – 9th January 2014.

Speech by Mr. D. R. Dogra – MD & CEO, CARE Ratings

Good Morning:

I am pleased that CIMSME is organising this Banking Excellence Awards for MSMEs. MSMEs are truly the strength of the Indian economy and rewarding the credit growth and related initiatives in this segment is really a commendable initiative.

MSMEs are to be seen as the backbone of industrial and services sector growth and a major source of entrepreneurial innovation and skills. They have been playing a pivotal role in country's overall economic growth and have achieved decent progress over the last couple of years. Bank credit to this segment has also grown at a CAGR of 30% in the last five years up to FY13. However, this is not enough. Almost 92% MSMEs are yet to get access to the banking finance. We are still to cover miles to realize the full potential in this sector. It is a matter of concern that despite recognizing a widespread need for supporting the sector, the progress on the ground leaves gaps and the extent of financial exclusion in the sector continues to be high.

Hence, I believe that banking in SME segment requires a different approach not only because we need to reach out the entities dispersed across the country and manage a trade-off between growth & margins, but also the quality of advances has to be proper with a system of continuous monitoring of the large portfolio. Some innovative financing tools may be useful in this regard.

The first one can be reverse factoring. In the traditional factoring, the factor purchases the receivables from the various buyers of a single seller i.e. the credit risk of many buyers is sold to a single factor. Though the reverse factoring technique is similar to the traditional factoring in many ways, the prime distinctive parameter here is the initiating party. In reverse factoring, the buyer (generally large corporate) initiates the transaction in order to help their small suppliers finance their receivables. This facilitates banks' exposure to the credit risk of the large corporate factor rather than the SMEs. This also helps to circumvent the need for comprehensive credit information from MSMEs.

The second could be extensive use of credit scoring model. The banks, in developed countries, use a version of a computerized loan-evaluation system, referred to as credit scoring, to assess prospective borrowers. The credit scoring approach, which is based on use of computer technology and mass production methods, was originally designed to handle consumer loans, but are now being used effectively for lending to small businesses by predicting their potential loan delinquency. Credit scoring offers a modern alternative for the traditional method of evaluating loans for small businesses where loans were approved on the basis of the banker's qualitative judgment and the financials carried significant weight in the appraisal process. While the internal rating models are used by the banks, the credit scoring model is much simple to use and apply in case of MSMEs.

The third could be the use of credit rating and due diligence services from CRAs. Presently, less than 75,000 MSMEs are rated, which represents small fraction of the universe. CARE and NSIC have an MOU to rate SME units, with 75% of rating fees being subsidized by NSIC for the unit. Further, the subsidy scheme had been enhanced from the current Rs 174 crore to Rs 600 crore in the 12th Five Year Plan. Exposure to credit rating facilitates SME units to engage in innovation, better financial discipline and benchmarking among the peers. Due diligence report provides valuable inputs to the sanctioning authorities in banks on the profile verification and SWOT analysis of the MSMEs. It also covers the feedback from customers & suppliers, and in many cases, brings debt servicing issues of any group entities also to the fore. This helps the lenders to take an informed decision. Overall, developing a proper understanding of the business of MSMEs and keeping a control over operating cost per MSME would be the key for extending the reach of the banks. On both these counts, CARE can partner the banks.

Fourth would be balancing the equity needs of MSMEs through seed equity financing alongwith normal bank credit. PE deals in July-Sept quarter of 2013 grossed USD 2.1 billion taking the total for the first 9 months to USD 8.13 bn; which is 34% higher compared to same period in 2012. However, when we look towards equity investments in SMEs, it had witnessed 25% fall on year to date basis. In 2013, investments into SME space totaled USD 970 mn across 132 transactions; whereas in 2012, investments for the similar period totaled USD 1,296 mn across 176 transactions. I feel introduction of a proper equity-cum-loan scheme for MSMEs by some banks in future can be very useful for this segment.

SMEs were facing serious challenge because of demand pressures in the recent past and the rising working capital requirements. At the same time, the sluggish credit markets compounded the MSMEs' need for liquidity. However, given the level of tolerance that MSMEs have demonstrated in past four years and the financial discipline they have demonstrated as compared to the large corporate apart from the importance of the sector for the overall economy, banks need to urgently step up lending to the sector. For evaluating loan proposals and for facilitating SME financing, banks need to employ low cost and quick decision making alternatives which would help accelerate the credit flow to this sector.

In this context, I would like to invite your attention to the theme paper prepared by CARE Ratings and CIMSME, which is based on our research studies. It has tried to highlight the way in which the credit profiles of SMEs have moved during this period and how they have managed their business and financial profiles. The studies also highlight the fact that Impaired Asset Ratio (IAR) is interestingly better in SME segment compared to large corporates. It also brings out a conclusion that higher rated SMEs have followed a better credit discipline, relied less on the borrowings and managed their operating cycle efficiently. I hope these studies will initiate a different thinking for those who believe SME lending is intrinsically riskier.

I sincerely believe that with such motivating and knowledge sharing events, we can really see the SMEs transforming to become emerging corporates through better financial management internally and Banking support externally. I am sure the sessions we have lined up for the day will show us the way.

Thank you.