Role of Banks and Financial institutions in Financing of Small scale Industries

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Abstract :

Finance is one of the factors occupying an important place in all types of economic activities. The growth of any industry largely depends upon the availability of adequate finance in proper time. Financing of Small Scale Enterprises is that critical aspect which gains special attention of banks and other financial institutions. It is included in priory sector lending. This paper presents views of different authors about the financing of small scale industries. More specifically, it throws light on the significance of informal (family or personal) and formal (banks) sources of finance at different stages of growth. The literature suggests that both formal and informal institutional support have played a limited role in fostering small entrepreneurial expansion. Although bank finance is valuable in for small industries but small entrepreneurs do not rely on it at the initial stage of business. There is a great scope of research in this field, especially in the Indian context because the SSIs occupies a unique position in the Indian Economy for its contribution towards value addition, employment generation, and the expansion of entrepreneurial base and also for the diversification of the industrial sector.

Introduction

Small-scale industries have a significant role to play in socio-economic upliftment of developing countries. This sector continued to receive special thrust by the Government of India due to its contribution towards achieving the multiple objective of employment generation, regional dispersal of industry and developing as a seedbed for entrepreneurship. The SSIs also occupies a unique position in the Indian economy for its contribution towards value addition, and expansion of entrepreneurial base and also for the diversification of the industrial sector. This sector contributes about 40 per cent of the gross industrial value-added and about 45 per cent of the total exports from India. In India, the Small-Scale Enterprises (SSEs) is the second largest employer of human resources after agriculture. This sector employs about 300 lakh people. The suitability of the SSIs for the Indian economic environment is even more due to their nature of low capital-industry. Further, it suits, the rural economy, which is characterized by scarce financial resources and a huge population base.

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In recent years, financing has attracted much attention on account of the new economic and business environment, setting up of WTO and fast growth of information and computing technology, development of new tools of performance analysis like EVA (Economic Value Addition), Balanced Scorecard, etc. The Indian corporate managers are now required to take new and bold initiative to make appropriate changes in their financial goals, policies, procedure and other such aspects. The small scale enterprises are not exception to the above. In the current scenario of liberalized financial sector, the small enterprises are required to transform their management practices in general and financing practices in particular.

Studies conducted on the financing of small scale industries have generally pointed out that finance of the "life blood" of an industry and it is one of the major hurdles of small scale industries. Thus an adequate provision and efficient use of capital is the essence of financial management of SSEs. In view of the above issues, it becomes necessary to survey research studies with the objective of bringing out the financing practices of Small Scale Sector. This type of studies would enable to understand the role of banks and other financial institutions in financing this sector. Some propositions have been taken on the basis of research studies being surveyed.

Financing of Small Scale Sector

As very few researchers have attempted to study financing practices of Indian small firms. One of such research work utilizing data from survey carried out by the Allen *et al.* (2006) examined the second largest emerging economy in the world, India. According to their survey on 213 entrepreneurs, the three most important financing channels for these firms during their start-up and growth periods are founders' family and friends, trade credits and loans from financial institutions, including state owned banks and banks specialized in lending to small- and medium-sized firms (e.g. the Small Industry Development Bank of India, or SIDBI, and State Financial Corporations, or SFCs). In the start-up phase, family constitutes the "extremely important" source of funds for an overwhelming majority (over 85%) of the respondents. Internal funds appear to constitute a crucial source of funds at the growth stage. They also found that entrepreneurs and investors rely more on informal governance mechanisms, such as those based on reputation, trust and relationships, than formal mechanisms (e.g., courts), to resolve disputes, overcome corruption and finance corporate growth.

Many international studies also confirm to this fact. In this line Business Research Centre, (Moore 1994) observed that a sample of 89 high-tech companies raised only 7% of its start-up finance from banks (compared with a figure close to 40% for SMEs generally). Charles Ou's (1998) survey revealed that the percentage of small firms using credit normally increases with firm size. Only 22 percent of firms with no employees used credit from depository institutions, while 78 percent of firms with over 100 employees used depository institutions. The use of owners' loans and personal credit cards leveled off or diminished as firm size increased.

In one more study by Hussain and Matlay (2007) family and close associate networks are found very important for the support of both ethnic minority and white owner/managers. Allen *et al.* (2005) demonstrated that in China alternative financing channels and informal governance mechanisms have substituted for formal channels and mechanisms to support corporate as well as overall economic growth in China.

Proposition 1a: Informal (family and friends) sources of finance constitute the most important source especially at the start-up stage of small business.

Baldwin *et al.* (2002) observed that almost half of new firms' financing (47%) is equity financing. Retained earnings are the single most important type of financing for small firms, representing, on an average, nearly 40% of the capital structure. The authors found that equity is more important than debt in industries which are both more risky and knowledge industries, where substantial investments in R&D (Research and Development) are being made. In addition to this it was also found that firms that devote a larger percentage of their investment to R&D are even more likely to have more equity.

Some other empirical studies also confirm that debt finance is less important to equity finance in Small Sector. In this line Himmelberg and Petersen (1994) reported that SMEs pursuing innovation strategies tend to have lower debt levels than other SMEs. This finding is also supported by Jordan *et al.* (1998), who concluded that the most innovative SMEs are those with the lowest debt-equity ratios.

Hussain *et al.* (2006) evidenced that there are similarities as well as differences between SME financing in the UK and in China. In terms of initial (start-up) funding, a large proportion of respondents relied exclusively on financial support from their immediate family. After two years in business, respondents exhibited a higher reliance on own savings and the financial support of bank and other financial institutions. At the end of five years of uninterrupted economic activity, most of the owner/managers in the UK sample relied for their borrowing needs primarily on financial institutions. Magri (2007) showed that small innovators rely less on financial debt and more on internal financial resources; no important differences appear for large firms. Venture capital is the form of equity finance that could be best suited to address financing problems of small innovative firms. Venture capitalists monitor firms and can at least partially overcome information and agency problems.

Proposition 1b: Equity is more preferred source than debt in Small Scale Industries. This phenomenon is more persistent in risky and R & D based industries.

Padachi *et al.* (2008) examined the working capital structure and financing pattern of 58 small manufacturing firms, operating in five industry groups for the period 1998-2003. It was revealed that short-term bank credit plays a significant and dominating role as a major external source of financing working capital requirements of SSIs. One more such study by Hossain and Akon (1997) also evidenced that bank finance is a dominant source in case of working capital finance. They examined the financing of working capital of Bangladesh Textile Mills Corporation (BTMC). Among the various components of current liabilities, bank loan accounted for a predominant share (59-81percent) of total current liabilities (5-19 per cent), trade credit (3-21 per cent) and tax provision (4-13 per cent). The important reason for high percentage of bank finance was its easy accessibility under cash credit facilities.

Proposition 2: Bank finance plays a major role in financing working capital.

Role of Banks and Other FIs in financing SSEs

The second set of research work in the field of financing focuses on the role of banks and other financial institutions where they are having a very important role to play. We are having mix type of results in this context. Some studies argue that these institutions are playing a vital role while some others conclude that their contribution is not up to the mark. Several national and international studies have examined the role of banks and other financial institutions like SFCs and SIDBI (Small Industries Development Bank of India) etc. in financing Small Scale Industries. Study by Subramanian (1999) stresses the vital role of State Financing Corporation (SFCs) by virtue of ongoing economic liberalizations in the country. The study concluded that SFCs are equally important as all India DFIs (Developmental Financial Institutions) and commercial banks for national development and therefore, should be treated on par. Chadha (1999) indicated that the growth in hire-purchase of machinery supplied by NSIC (National Small Industry Corporation) has increased from 9.16 crore in 1972-73, to Rs. 17.58 crore in 1988-89, showing an average annual growth of 9.48%. IDBI (Industries Development Bank of India) has provided finance for setting up industrial estates at an annual rate of about 18 percent. Same way IFCI (Industrial Finance Corporation of India), ICICI (Industrial Credit and Investment Corporation of India) , SIDBI, SFC, SSIDC and some agencies such as Khadi and Village Boards etc. had played a vital role in sanctioning finance to Small Scale Industries. He suggested that in order to provide adequate finance for technological modernization of the SSIs, FIs shall develop and consolidate venture capital finance to participate in the equity capital of the small industrial units. Patra (2002) analyzed the role of various financial institutions in assisting Small Scale Industries. SIDBI was established for the promotion, financing, and development of industries in the small scale sector. It provides various kinds of assistance in collaboration with voluntary organizations. Same way NSIC, KVIC (Khadi and Village Industries Commission), SFCs and RRBs (Regional Rural Banks) are also working to provide financial assistance in the form of term loans and working capital for strengthening the Small Scale

Industries. Kulkarni (2002) observed that the working capital credit provided to small scale sector has improved over the years. Srinivas (2005) made a study on the role of bank finance to the SME sector. cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms. Raju (2008) concluded in his working paper that the lending to the SME sector grew by 69% between 2000-01 and 2005-06. But there exists a stark disparity amongst small players and big players within the SMEs sector. It was found that loans to bigger companies are growing at a faster pace than loans to the SSI sector. Thorsten *et. al.* (2004) found that small firms and firms in countries with poor institutions use less external finance, especially bank finance. Results indicated that firm size plays an important role in understanding financing patterns. Small firms use less external finance, especially bank finance. Interestingly, finance from development banks and other government sources are used to a greater extent by larger firms within SSI.

Proposition 3: Banks are playing a vital role in financing Small Scale Industries. But there exists a disparity amongst small players and big players within the SSI sector

Quite contrary to the above mentioned arguments, many of the studies show that liberalization is having a negative impact on the performance of such financial institutions. SFCs and SIDCs are two major institutions which provide finance at state level. It is desperation to see that share of assistance to the SSI sector by way of loan sanctions has declined from 81.8% in 1993-94 to 67.3% in 1997-98. The assistance provided by SIDCs to the SSI sector has declined from 23.84% in 1993-94 to 16.99% in 1997-98. It means that SIDCs are now concentrating more on larger projects (Kulkarni, 2002). Kumar and Garg (2002) analyzed the role of HFC (Haryana Financial Corporation) in financing of Small Scale Industries during post reform period. The trend growth rate for loan sanctioned has been just 0.62% per annum during the period of study. The growth rate for loan disbursed from 1991-92 to 1995-96 has been positive, thereafter, the growth rate of amount of loan disbursed experienced a negative trend up to 1998-99. Singh *et al.* (1991) made a comparative study on the performance of HFC and PFC. They concluded that PFC is performing better than HFC on the basis of solvency and profitability ratios. Rao *et. al.* (2006) found that despite increase in the coverage of the SSI sector, its share in bank credit decreased during the period of study and experienced fluctuating growth. Of late, in the post-2000 period, the growth in credit to the SSI sector has decreased compared to that in the earlier period. In the absence of any specific quantitative restriction within the priority sector, commercial banks will try to play safe and divert funds to other sectors that yield higher returns. Bodla and Verma (2008) concluded in their study that the share of SSIs in net bank credit was significantly high in 1991-2000 than the later period (2001-2006). Average percentage share of SSI in total bank credit was 15.96 in 1991-2000 periods against to just 11.52 during 2001-2006.

Mudgil (2005) questioned the relevance of State Financial Corporations (SFCs). According to him as a result of de-regulation of the financial sector and gradual move towards universal banking, the SFCs have been steadily losing their ground and facing formidable problems in the competitive environment.

The Hindu Business Line (2007) also showed that to promote commercially viable SMEs, there is a need to increase the credit flow to them. Even the RBI report points out that in the absence of a common definition of what constitutes a small or medium enterprise, different banks have interpreted differently. Risk-averse bankers have tended to stay away from SME enterprises, as lending to them is considered less safe than to large companies. Bodla (2004) concluded in his study that the shrinkage of credit to SSI sector by banks is alarming. Timely and adequate credit is the most crucial input that can make the SSI sector competitive. Technology up gradation and modernization is possible with liberal credit at low cost.

Proposition 4: Liberalisation and de-regulation of financial sector have a negative impact on the flow of net bank credit to SSIs

These findings seem to be contrary the previous studies revealing the contribution as most of these agree that specialized institutions are facing various problems and not performing up to the mark. These institutions require some changes in regulatory framework. This helps one in understanding that the accountability procedures are not yet properly established in this field. So the monitoring of role of financial institutions is thus questionable. Also the inefficiency of firms contributes to this phenomenon.

Ibbotson and Moran (2005) highlighted the important role played by local branch managers in the support and development of SMEs. Approximately 70 per cent of those surveyed as part of the study felt that their bank has supported their growth a lot or at least a little. SMEs (74 per cent) felt that their local branch manager was both understanding and sympathetic to their business needs.

Some of the studies try to give suggestion to these institutions to improve their performance. Chopra (2004) explained various steps taken by the GOI / RBI to enhance the flow of credit to SMEs in the recent past. These are (i) increase in the loan limit of composite loan scheme for SSIs upto Rs.5 million, (ii) providing loans to SSIs within the interest rate band of 2 percent above and below the respective bank's PLR, (iii) setting up of Technology Bureau for Small Enterprises to address the technology related need of SSIs and proposal to convert TBSE into a full fledged Technology Bank. (iv) opening of specialized SSI branches throughout the country, presently numbering 417, (vi) introduction of Laghu Udyami Credit Card for SME borrowers with satisfactory track record, (vii) identification of 60 clusters for focused development by including their credit requirements in the respective State Credit Plans, and (viii) setting up of a Credit Guarantee Fund Trust for Small Industries, Upadhva (2005) suggested that the public, private and cooperative financial institutions may encourage SMEs by offering some incentives to SMEs. SMEs shall mould themselves into the changing scenario and work more professionally to gain the strong financial support and build market for themselves and also their products.

Rani and Rao (2008) pointed out that concerted and well orchestrated efforts are needed to achieve a high degree of success. An effective monitoring mechanism, creation of credit-rating facilities, adoption of standards for quality and environmental management, promotion of SME brands, and development of appropriate capital markets, can improve the situation. Jain (2004) also expressed that simplification of procedure and liberalized financing by the banks to this sector at concessional rate of interest will help the small scale industry to modernize and compete. This implies that smaller firms are facing difficulty in obtaining debt finance for start-up and early stages of development.

Proposition 5: Smaller firms need to mould themselves into the changing scenario and work more professionally to gain the strong financial support and build market for themselves and also their products.

Johnsen and McMohan (2005) reported in their paper that cross-industry differences in financing behavior do exist even after controlling for other relevant influences on SME financing choices such as enterprise size, business age, profitability, growth, asset structure and risk. Soufani's (2000) paper examined the role of factoring in small business finance and the profile of firms using it. From the interviews, it was clear that younger firms (start-ups) with turnover lower than £250k were less attractive to factors (mainly bank- owned) because they were often too small, had an inadequate customer base and lacked a track record in sales and economic management.

McMohan (2001) revealed that business growth and performance outcomes for the manufacturing SMEs are significantly interrelated. They reported that greater dependence upon external finance seems associated with better business growth outcomes and better business preferences in terms of profitability.

Propostion 6: Small Industries with better business growth get better chances to acquire external finance

So this can easily be interpreted from the above that if SSIs can improve their performance in terms of profitability, it would be more easy for them to get finance from development and commercial banks. Informal financial institutions are also coming forward for the growth of this sector.

Conclusion

The literature above shows that there is no unanimity on which financing of small firms can be known concretely. Different studies bring out different kinds of results.

In the start-up phase, family constitutes the "extremely important" source of funds for an overwhelming majority (over 85%) of the respondents. Internal funds appear to constitute a crucial source of funds at the growth stage. Subramanian stressed the vital role of State Financing Corporation (SFCs) by virtue of ongoing economic liberalizations in the country. Same way IFCI, ICICI, SIDBI, SFC, SSIDC and some agencies such as Khadi and Village Boards etc. had also played a vital role in sanctioning finance to small scale industries. Jain expressed that simplification of procedure and liberalized financing by the banks to this sector at concessional rate of interest will help the small scale industry to modernize and compete.

To conclude, the paper has attempted at covering different aspects of small firms' financing literature in a more organized manner to get an insight into the concept. But still there are huge gaps which can be filled by quality research work in India. New vistas remain to be explored in this very dynamic and more liberalized economic system, especially in the Indian context.

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