Vepa Kamesam: Financing for entrepreneurship and SMEs - an Indian perspective

Address by Mr Vepa Kamesam, Deputy Governor of the Reserve Bank of India, at OECD "Workshop on Entrepreneurship in a Global Economy: Strategic Issues and Policies" in the panel "Identifying the Real Policy Issues" in the Session on "Improving Financing for Entrepreneurship and SMEs", Budapest, 9 September 2003.

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I am indeed thankful to OECD for inviting me as speaker at this important workshop on "Entrepreneurship in a Global Economy". In my address, I shall share with you some of the initiatives that are being taken by the Indian authorities with regard to the Small Scale Industries (SSI), against the backdrop of the SME financing in a cross-country perspective.

In view of the continuing financing problems of the SMEs, at least two broad approaches have been adopted at the national level viz.,

(i) facilitating access of SMEs to extant sources of financing; and

(ii) developing newer sources of financing in terms of venture capital and business angle networks.

As far as existing sources of financing are concerned, the trend is towards reduced and more flexible loan schemes as well as loan guarantees. Competitive markets and a deregulated interest rate regime generally ensure that interest rates on guaranteed loans (including guarantee premium) are relatively low.

With regard to newer sources of financing, many OECD countries are considering liberalizing the rules regarding venture capital investment. On-going research at the OECD indicates that effective venture capital policies include diversifying venture investors, channeling venture capital to seed firms in growth sectors and phasing out of Government equity schemes as private markets develop.

Like any other developing countries, in India also, the Small Scale Industry (SSI) plays a very significant role in terms of balanced and sustainable growth, employment generation, development of entrepreneurial skills and contribution to export earnings. As at the end of March 2002, there were around 3.6 million SSI units - constituting 95 per cent of the industrial units in the country - which produced a large number and a wide range of items with associated technology varying from traditional to state-of-art. These SSI units provided employment to nearly 20 million persons, accounted for 40 per cent of the value added in the manufacturing sector, 34 per cent of total national exports and 7 per cent of GDP during 2002-03.

In the Indian context, the definition of the SSI sector is largely framed in terms of cumulative investment in plant and machinery while most of the countries adopt the level of employment as the criterion for defining the SSI sector. According to the official definition adopted in India since 1998, the investment limit up to Rs.10 million in plant and machinery is treated as SSI sector. However, in respect of certain specified items such as hosiery, hand tools, drugs & pharmaceuticals and stationary items above investment limit in plant and machinery has been enhanced up to Rs.50 million. Since 1967, there is a policy of reserving selected products in the manufacturing sector for exclusive production in the SSI sector. The list of reserved items has been revised from time-to-time.

The policy initiatives in India have always recognised that SSIs contribute to the material progress of the country. Small firms are capable of producing a larger quantum of consumer goods than before to meet the possible increase in demand that would arise on account of the spurt in incomes, generated by fresh investments in heavy and basic industries. It is also taken for granted that small firms would, in the process, create additional employment opportunities. Implicit also is the assumption that SSIs are less capital intensive and more labour absorbing. This is regarded as an important gain of promoting SSIs, given the country's resource endowments, namely labour abundance and scarcity of capital.

Among the developing countries, India was the first to display special consideration to SSIs. As alluded to earlier, the basic focus of Indian Government has been that, employment generation is of paramount importance in a labour surplus economy. Small enterprises manufacturing labour-intensive products make economical use of capital and absorb the abundant labour supply that characterise an underdeveloped economy. Various measures used for the development of SSI have included product reservations, fiscal concessions, preferential allocations of credit and interest subsidy in a credit rationing framework, extension of business and technical services by the government and preferential procurement by the government. SSIs have been given preferential treatment through the provision of lower interest rates as well as requirement for a minimum credit allocation from the commercial banks. Since 1986, fiscal incentives have also been provided to the SSI units in terms of complete exemption from excise duties or payment of lower rates, under specified conditions. Since April 1995, SSI units are allowed a deduction of 25 per cent of the profits for a period of ten years, for taxation purpose. In case the SSI units set up in specified backward area, full tax exemption is allowed for the first five years and a deduction of 25 per cent in the subsequent five years.

In recognition of the contribution and the vast potential of the SSI sector as well as its inherent infirmities, provision of adequate credit to this sector has continued to be an important element of banking policy, even though economic and financial policies themselves have undergone significant transformation, particularly after the initiation of structural reforms in 1991. Bank credit to the SSI sector increased from Rs.168 billion in March 1991 to Rs.530 billion in March 2003.

In the policy context, there has been a paradigm shift. The Indian industry remained within a inward oriented policy framework up to the 1990s. With globalisation, liberalization, financial and real sector reforms, the country adopted an outward looking approach. At present, both the industrial sector in general and SSI sector in particular are exposed to international competitive environment. However, the most significant aspect is that India has evolved a sound institutional set up for financing of the SSI sector. A separate industrial policy was announced as part of the structural reforms in 1991 which not only eliminated various controls on the industrial sector, provided a greater role for the private sector and encouraged inflow of foreign investment and technology, but also contained specific initiatives for the development of the SSI sector. The introduced a comprehensive policy package which includes fiscal, credit, infrastructural and technological. Now the emphasis is on quality improvement, marketing and streamlining regulations.

There are multiple institutions in the public, private and cooperative sectors of the Indian economy that cater to the credit needs of the SSI sector, both for fixed assets creation as well as for working capital. Consequent to the nationalisation of major banks in 1969, banking policy mandated that at least 40 per cent of bank credit should be directed towards the priority sector constituting agriculture, SSI and individual service and business sectors. Preferential treatment was also provided to the SSI sector via lower rates of interest on bank credit. The Small Industries Development Bank of India (SIDBI) was set up in April 1990 as the principal financial institution for promotion, financing and development of the SSI sector and for coordinating the activities of other institutions engaged in similar activities. A Fair Practices Code has also been adopted by SIDBI which, *inter-alia*, clearly sets out the procedures that would be followed in respect of loan applications, appraisals and disbursements. In order to boost investment in SSI sector, the benefits of exemption of capital gains arising from the transfer of long-term capital assets are allowed if such capital gains are invested in bonds by the Small Scale Industries Development Bank of India (SIDBI) with effect from April 2002.

A Credit Guarantee Fund Scheme for Small Industries has been launched and the SIDBI set up the Credit Guarantee Fund Trust for Small Industries (CGTSI), to implement the Guarantee Scheme. The main objective of CGTSI is to facilitate hassle-free credit to the SSI sector and encourage banks to shift from collateral-based or security-oriented lending to. The CGTSI is in the process of developing a Mutual Credit Guarantee Scheme (MCGS) on the lines of similar schemes in Italy and other European countries; such schemes essentially involve a guarantee from industry associations in which the borrower is also a member which, in turn, enhances the lender's confidence. The SIDBI has also encouraged the growth of the venture capital industry for hi-tech SME units in India by promoting 13 State / regional level funds and setting up an all India Venture Fund.

The Government of India had launched many Schemes for technological upgradation and modernisation, protection of workers affected by technological upgradation and modernisation, infrastructure development, entrepreneurship development, as well as increase in the investment limit (to Rs.50 million) for SSI units producing certain items. The Government of India set up a new Ministry in October 1999 to provide more focussed attention to the development of the SSI sector. Several expert committees had also been set up over the 1990s to assess the problems of the SSI sector. Most of the recommendations of these Committees relating to simplification of loan application forms, launching of a new Credit Guarantee Scheme, raising of composite loans, etc have been accepted and implemented.

The Reserve Bank of India (RBI) has also been emphasising on the flow of bank credit to micro enterprises in rural and semi-urban areas set up by vulnerable sections of society including women. A number of initiatives have been taken in this regard and banks have been advised to provide maximum support to Self Help Groups. Furthermore, four informal Groups have been set up by the RBI to analyse various micro-finance issues relating to (i) structure and sustainability; (ii) funding; (iii) regulations; and (iv) capacity-building. The RBI will discuss the recommendations of the informal Groups in a wider forum for possible implementation.

The SSI sector has so far been resilient to the impact of the policy changes - increasing domestic and foreign competition following the de-reservation and import liberalisation of items as well as the relatively high interest rates - and has withstood the general deceleration in the industrial sector during 1997-98 to 2002-03. It has been well recognised that the investment limit of Rs.10 million for the remaining SSI units leaves little scope for such producers to achieve economies of scale and scope and become competitive. Today, it is, in fact, incentive-compatible for SSI units to remain deliberately small - by fragmenting production - in order to avail of fiscal benefits and to stay outside the purview of labour laws. The pace of de-reservation of SSI items, therefore, needs to be accelerated so as to ensure that size does not remain a constraint to higher production, cost-efficiency and technological upgradation.

Let me now focus on the major problems/challenges faced by the SSI sector which are enumerated as under:

Collateral

The limit for collateral free loans to tiny sector is Rs. 0.5million and that for other SSI units was Rs. 0.1 million. This limit has since been raised to Rs. 0.5 million for other SSI units also. Many small-scale entrepreneurs are facing difficulties in providing collateral security as per the requirements of the financing banks. The limit of 0.5 million has been further increased to Rs.1.5 million in respect of SSI units with good track record and financial position. The problem is addressed to a certain extent with the introduction of the Credit Guarantee Fund Trust Scheme under which collateral free loans up to a limit of Rs. 2.5 million are guaranteed.

Cost of loans

The high cost of borrowings was a major constraint affecting the growth of the sector. The Bank Rate changes by the RBI combined with CRR and repo rate charges have emerged as signalling devices for interest rate changes. The reduction in Bank rate announced in the last Monetary and Credit Policy or outside the policy from time to time has resulted in a consequential reduction in the lending rates. Banks have now the flexibility to offer lending rates on a fixed rate or on a floating rate. The reduction in interest rates and the offer of floating rates will help the SSI units to procure funds at lower costs than what was prevailing in earlier years.

Delayed payments

Considerable delay in settlement of dues/payment of bills by the large-scale buyers to the SSI units adversely affected the recycling of funds and business operation of SSI units. Though the Government has enacted the Delayed Payments Act, many of the SSI units are reluctant to pursue cases against major buyers. The Act since amended in 1998 has made it compulsory that the payment of SSI suppliers should be made within 120 days. To improve the plight of SSI entrepreneurs due to delayed payments, steps for strengthening and popularizing factoring services, without recourse to the SSI suppliers may have to be thought of seriously.

The banks have also been advised about sub-allotting overall limits to the large borrowers specifically for meeting the payment obligations in respect of purchases from SSI. It is expected that these measures will improve the situation of delayed payments.

Marketing

Marketing remains the most critical area for the SSI Sector as some of the units are very small and so is their output individually. Adopting consortium approach could best solve the marketing problems of the SSI sector. Besides finance for marketing related activities, dissemination of requisite information on demand pattern, futuristic trend, etc. could be made available by the Development Institutions/SSI Associations, etc.

Challenges emanating from the WTO

To face the challenges emanating from the WTO agreement, SSI units irrespective of their size need technology up-gradation and modernisation. An awareness about the implications of WTO agreement has to be created. The preparation for competitiveness needs to be done by the Government as well as entrepreneurs and the corporate. The Government should provide good infrastructure and create level playing field for the industry. Considering the fund constraints with SSI Sector Government has introduced the credit linked capital subsidy scheme for Technology up gradation of Small Scale Industries under which 12% back ended capital subsidy would be admissible on the loans advanced to the SSIs by banks/financial institutions for technology up gradation in certain select sectors.

Sickness

Growing incidence of sickness of SSIs is yet another area of concern. When the sickness prolongs it leads to the closure of units and unemployment. Lately mortality of the SSI units has been showing increasing trend. This has wider implications including locking of funds of the lending institutions, loss of scarce material resources and loss of employment. The number of sick SSI units as a percentage to the total number of SSI units is around 10. The number of units identified as potentially viable as a percentage to total sick SSI units is around 8. The causes of sickness are both internal and external. The major causes are limited financial resources, lack of organisational, financial and management skills and expertise, diversion of funds, diversification/expansion before stabilisation, non-availability of power supply shortage of raw materials, marketing difficulties, delayed and inadequate credit, globalisation and liberalisation of the economy, obsolete technology, inadequate infrastructure, etc. With a view to ensuring that potentially viable sick SSI units are provided with the timely and adequate assistance by all agencies concerned, there are State Level Inter Institutional Committees (SLIIC) constituted in each state involving State Government, Financial institutions, commercial banks and SIDBI. SSI Associations are also invited to the meetings of this committee. A sub-committee of SLIIC has also been set up in each state to examine the individual cases referred to it for rehabilitation. To address the incidence of growing sickness in the sector RBI has recently issued a complete set of revised guidelines drawn up on the basis of the recommendations of a Working Group constituted by it for the purpose.

Policy initiatives

The Indian industry remained within an inward oriented policy framework up to the 1990s. With globalisation, liberalization, financial and real sector reforms, the country adopted an outward looking approach. At present, both the industrial sector in general and SSI sector in particular are exposed to international competitive environment. However, the most significant aspect is that India has evolved a sound institutional set up for financing of the SSI sector. New industrial policy was announced as part of the structural reforms in 1991, which eliminated various controls on the industrial sector, provided a greater role for the private sector and encouraged inflow of foreign investment and technology, but also contained specific initiatives for the development of the SSI sector.

The pace of de-reservation of SSI items, needs to be accelerated so as to ensure that size does not remain a constraint to higher production, cost-efficiency and technological upgradation. The case for de-reservation of the SSI sector becomes even stronger in the light of the experience of South-East Asian economies which indicates that (a) their export basket transformed from labour-intensive and relatively low technology products (textiles, clothing, shoes, toys, etc) in the 1980s to higher-technology consumer goods and capital-intensive goods (capital goods and petrochemicals) in the 1990s and (b) production of such consumer goods could be achieved by large-scale final assembly operations coupled with copious out-sourcing to small enterprises in order to maintain their competitiveness. Thus, with the de-reservation of the SSI sector in India, a larger number of industrial units would be in a position to exploit the opportunities provided by globalisation, given the vast potential of exports from this sector.

Ministry of SSI under Govt. of India has been laying more emphasis on cluster-based approach for development of SSI sector. So far Ministry has identified 60 clusters for focused development of SSI and banks in these areas are initiating necessary steps to meet their credit requirements effectively.

Future action

As the evidence shows, several initiatives are being taken at the national and international levels to foster the development of SMEs and improve their access to finance. Notwithstanding these initiatives, impediments to SME finance remain, in different degrees, in both developed and developing economies, which constitute the single most important factor that could circumscribe their growth trajectory. Accordingly, the attention of policy makers may need to focus on the following three broad issues, viz., creating a conducive business environment, development of clusters, and enhancing credit flows to SMEs as these are widely debated in the contemporary discussions.

Governments need to take initiatives to ensure that the overall policy environment encourages industrial activity in general, and SME activity, in particular, given the latter's significant contribution to general economic activity in many countries. This would entail efforts to maintain macroeconomic stability in terms of low fiscal deficits and debts (such that private savings are not pre-empted), low and stable inflation, low real rates of interest and a sustainable current account. This apart, initiatives would need to be taken, wherever necessary, to remove outdated and anomalous restrictions on domestic production, bring about a reduction in tariff and tax rates to internationally competitive levels, create a competitive environment through appropriate legislation, if necessary provide public infrastructure support, reduce inflexibilities in the labour market with due cognizance to the need for appropriate social safety nets and invoke necessary reforms in bankruptcy and exit procedures. Streamlining of procedures to disburse loans to SMEs, creating a regulatory/legal framework that ensures timely payment of dues to SMEs, providing technical training to staff of financial institutions and organising general awareness programmes on SME financing would also be necessary. These measures would not only encourage SME activity but also have a salutary impact on their efficiency and hence, on their overall requirements of finance.

Newer forms of SME financing need to be fostered viz., venture capital and leasing. Commercial banks and local government funding agencies would need to play a major role in venture capital financing while insurance funds and pension funds could be tapped as important sources of finance. Leasing, on the other hand, requires a less rigorous legal and regulatory framework vis-à-vis bank lending, since the leasing company retains the ownership of assets till the end of the lease. Even so, strengthening of leasing laws, encouraging banks and financial institutions to support leasing companies and appropriate training through technical assistance would help foster the development of this alternative important source of finance for SMEs.

In conclusion major problems/challenges faced by SSI sector in India are:

- availability of collateral free loans
- cost of loans
- delayed payments
- marketing
- challenges emanating from WTO related issues
- sickness

A number of steps have been initiated to promote the healthy growth of SSI Sector. However, to ensure the prospects of these enterprises, SMEs, in the coming years will have to gear up to face the challenges of liberalisation. I am confident that given the inherent strength, the sector will develop a global vision, respond to more demanding standards of the customers and adopt key strategies that could take them ahead in competition. Credit should not be a constraint for viable projects.

I believe that the workshop would bring out valuable policy recommendations for shaping future policy initiatives.