A STUDY ON MSME LENDING BY PUBLIC SECTOR BANKS IN INDIA WITH SPECIFIC REFERENCE TO INDIAN OVERSEAS BANK

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ABSTRACT

Micro, Small and Medium Enterprises (MSME) sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades. MSMEs not only play crucial role in providing large employment opportunities at comparatively lower capital cost than large industries but also help in industrialization of rural & backward areas, thereby, reducing regional imbalances, assuring more equitable distribution of national income and wealth. MSMEs are complementary to large industries as ancillary units and this sector contributes enormously to the socioeconomic development of the country.

MSMEs contribute significantly to the national economy in terms of production, employment and exports. MSME sector is an important pillar of Indian economy as it contributes greatly to the growth of Indian economy with a vast network of around 3 crore units, creating employment of about 7 crore, manufacturing more than 6,000 products, contributing about 45% to manufacturing output and about 40% of exports, directly and indirectly.

This study highlights the lending policies taken by Government of India for the MSME sector and the role of Indian Overseas Bank in this regard. A small case on Credit Appraisal process of a Micro Enterprise has been included in the study to understand the concepts better.

Keywords: MSME, MSMED Act 2006, MSME Finance, CGTMSE, Credit Appraisal, Trend Analysis, Pay Back Period.

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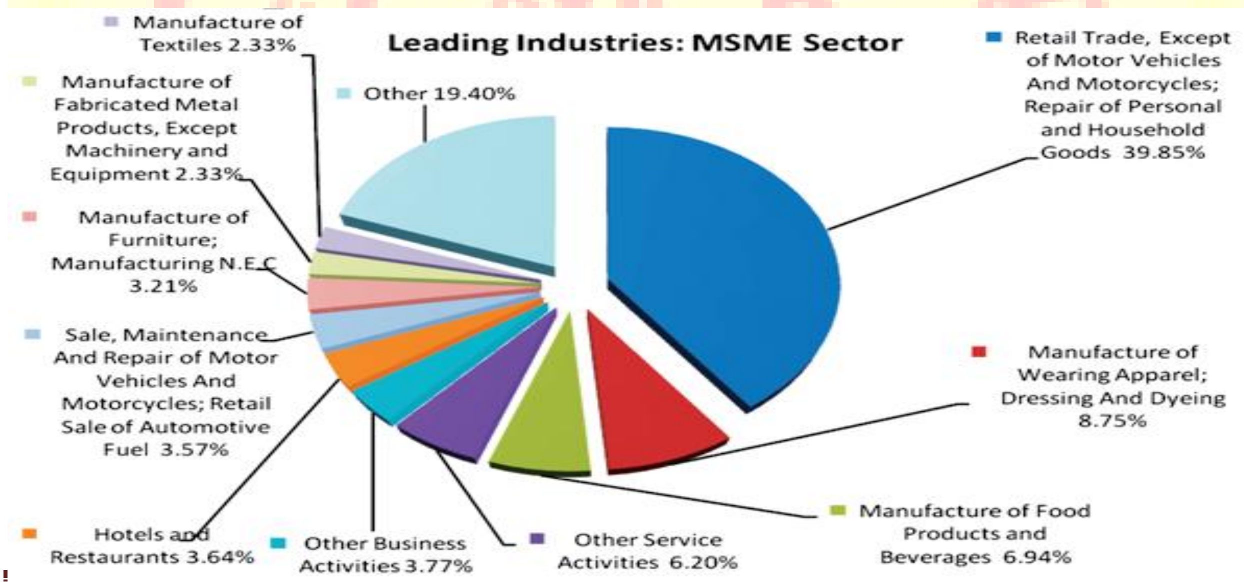
Introduction:

Micro and Small Enterprises plays vital role in the economic well being of the country due to their ability to generate employment, foster entrepreneurship. They provide depth to the industrial and commercial base of the economy. They also contribute in significant measure to the GDP and exports from the country.

Government of India, is attaching great importance to this sector and taking various policy measures to enhance the flow of credit to MSME sector. To ensure systematic and smooth growth of the MSME sector, the Government of India enacted the Micro, Small and Medium Enterprises Development Act 2006 (MSMED Act 2006) on 16.06.2006, which came into effect from 02.10.2006. The act replaced the concept of tiny/small scale industries sector with the expanded Micro, Small and Medium Enterprises Sector which includes Micro, Small and Medium manufacturing as well as service enterprises.

The problems of the MSME sector are multifarious and credit related issues are diverse, which call for multi-pronged, integrated, and balanced approach on the part of the bank. Hence it is necessary to have a comprehensive liberal and forward looking policy on funding of MSMEs.

To address the problems faced by the MSME sector, RBI had constituted a working group under



the chairmanship of Dr. K.C. Chakrabarty to suggest measures for Rehabilitation of sick MSME units and for improving the flow of credit to MSME sector. The working Group, in their report has given various recommendations and suggested measures to be adopted by Banks, Government and other Agencies. RBI advised all Banks to formulate a loan policy governing the extension of credit to MSME sector in the light of recommendations of the working group and BCSBI‘s (Banking Codes and Standard Board of India) code of commitment to Micro and Small Enterprises.

Loan Policy of Indian Overseas Bank For SME Sector

- **Definition Of MSME**

Micro, Small and Medium Enterprises Development Act 2006 defines Micro, Small and Medium Enterprises based on,

(a) Investment in Plant and Machinery in respect of manufacturing enterprises and

(b) Cost of equipments in respect of Service Enterprises.

CLASSIFICATIONS	MFG/SERVICE SECTOR	INVESTMENT IN PLANT & MACHINERY/ EQUIPMENTS
MICRO LEVEL - I	MANUFACTURING	Upto Rs. 10 lacs
	SERVICE	Upto Rs. 4 lacs
MICRO LEVEL - II	MANUFACTURING	Rs. 10 lacs to Rs. 25 lacs
	SERVICE	Rs. 4 lacs to Rs. 10 lacs
SMALL ENTERPRISES	MANUFACTURING	Rs. 25 lacs to Rs. 500 lacs
	SERVICE	Rs. 10 lacs to Rs. 200 lacs
MEDIUM ENTERPRISES	MANUFACTURING	Rs. 500 lacs to Rs. 1000 lacs
	SERVICE	Rs. 200 lacs to Rs. 500 lacs

For computing the investments, the original cost of plant and machinery/equipments should be taken into account and cost of land and building and other specified items such as installation charges, transportation charges, wiring and cabling charges etc., should be excluded.

❑ Difference Between Investment Norms For Manufacturing & Service Units

There are two differences,

(a) For Manufacturing units, investment in "Plant and Machinery" is taken into account. But for Servicing units, investment in "Equipments" is taken into account.

(b) The ceiling on investment is also higher for manufacturing units as compared to service units as shown in the previous table.

❑ Guidelines On MSME Finance

Advances to MSE sector will be assessed like any other advance (except for the specific relaxations and concessions) and credit decisions will be taken based on viability, merits and commercial judgment in each case as per general norms of lending. The credit appraisal will be made in a transparent and non-discriminatory manner. All genuine and just requirements of the MSE units will be considered and adequate amount of credit will be sanctioned to ensure that the unit does not suffer for want of funds at a later date.

Necessary credit support will be extended to MSE units for business restructuring, modernization, expansion, diversification and technological up gradation as may be required from time to time.

The following type of credit facilities will be extended to MSME units,

1. Term Loans
2. Project Finance
3. Working Capital Finance
4. Purchase and discounting of Bills
5. Negotiation of Bills
6. Non fund based facilities such as LC and LG
7. Pre shipment/Post shipment finance
8. Credit facilities under Bank's special credit schemes such as Sanjeevani, Easy Trade Finance, Commercial Cash Credit against Jewellery etc.,

9. Any other type of credit depending on specific need.

10. Line of credit in specific cases as per requirement.

Assessment of Credit for MSME Units

(a) Simplified procedures will be adopted for sanction of working capital limits. 20% of the projected and accepted annual turnover will be extended as working capital limit to MSME units requiring aggregate fund based working capital limits up to Rs.7.5 crore. Borrower has to bring in 5% of the accepted turnover as margin. Current Ratio of 1.25 will be acceptable in such cases.

(b) For MSE units requiring working capital limits above Rs.7.5 crore and up to Rs.10 crore, the Maximum Permissible Bank Finance (MPBF) method based on Credit Monitoring Arrangement (CMA) data will be followed.

(c) For MSE units requiring working capital limits over Rs.10 crore, Cash budget system or MPBF method, at the option of the borrower, will continue to be followed.

(d) A combined working capital limit will be allowed against the stock and receivables without any sub limit for Cash Credit against receivables. However, different margins may be fixed for stock and receivables.

(e) Lending will be based on scoring model for advances upto Rs.2 crores. Information required for scoring model will be incorporated in the application form itself. No individual risk rating is required in such cases.

(f) If the bank sanction term loan solely or jointly with one or more Banks, working capital limit will also be sanctioned solely or jointly (in the ratio of term loan) to avoid delay in commencement of commercial production. It will also be ensured that there are no cases where term loan has been sanctioned but sanction of working capital facilities is awaited.

(g) The interest payable up to six months after commercial production may be included as part of the project cost for assessment of credit requirements. Sufficient moratorium period say, upto six months, after commencement of commercial production, may be allowed for repayment of principal amount wherever required, to enable the unit establish itself in the market.

(h) When the sanctioning authority decides to reject a MSE credit application, the same will be conveyed to the applicant only after obtaining approval from the next higher authority.

Margin Norms

I . No margin is required for loans upto Rs.50000/-

II. Minimum margin requirements for loans/credit facilities above Rs.50000/- are as under:

A. Term Loans

1. For loans above Rs.50000/- and up to Rs.5 Lac -10%
2. For loans above Rs.5 Lac -15%
3. In case of Term Loans for acquiring second hand machineries, higher margin may be stipulated on case-to-case basis.

B. Working Capital Finance

1. Working Capital against hypothecation of Raw materials, Work in Process, Finished goods etc.,
   Above Rs.50000/- and up to Rs.5 Lac - 15%
   Above Rs.5 Lac - 20%
2. Working Capital against Book Debts/Receivables,
   Margin to be taken as per our Bank's general loan policy document, without any concession.

C. Minimum cash margin of 10% will be prescribed in respect of **Non Fund Based limits** such as **Letter of Guarantee** and **Letter of Credit**.

D. For loans under Government sponsored schemes and Bank's special credit schemes, margin will be obtained as stipulated in the scheme even if it is different from the levels indicated above.

E. In exceptional cases, margins lesser than indicated above can be prescribed with the approval of the appropriate authority as per powers delegated in bank's concession policy.

Security Norms

(a) No collateral security or third party guarantee is required for loans to micro and small enterprises upto Rs.10 lacs. Such loans have to be compulsorily covered under Credit Guarantee Scheme of CGTMSE.

(b) Loans above Rs.10 lacs and upto Rs.100 lacs (to micro and small enterprises will also be considered for sanction without collateral security or third party guarantee subject to following conditions:

I. The unit should be eligible to be covered under Credit Guarantee Scheme of CGTMSE

II. The bank is fully satisfied with regard to viability of project and track record of the promoter/units.

(c) In all other cases of credit facilities to micro and small enterprises (other than a and b) suitable collateral security and or third party guarantee will be obtained based on risk perception and judgment of sanctioning authority.

(d) Even when the loan is eligible to be covered under the Guarantee cover of CGTMSE, if the borrower prefers to bring acceptable collateral security and third party guarantee, in lieu of the CGTMSE Guarantee Cover, the same will be considered, after obtaining a letter from the applicant stating that he is offering collateral of his own volition and he is aware of the credit guarantee available for his credit facilities.

- **Follow Up of MSME Credit**

MSE loan portfolio will be monitored at branch and controlling office levels on regular basis. Warning signal with regard to irregularities in the accounts will be picked up promptly and probed into. Corrective measures will be initiated without loss of time to avoid the accounts slipping into sub standard category. Borrowal accounts will be restructured, wherever necessary, under the provisions of debt restructuring mechanism for SME enterprises.

If any account becomes sick, inspite of close monitoring and follow up action, such accounts will be dealt with sympathetically and shall be rehabilitated under bank's policy on nursing and rehabilitation of sick SME units, if they are potentially viable.

❑ Credit Guarantee Fund Trust For Micro And Small Enterprises (CGTMSE)

Objective

Availability of bank credit without the hassles of collaterals / third party guarantees would be a major source of support to the first generation entrepreneurs to realize their dream of setting up a unit of their own Micro and Small Enterprise (MSE). Keeping this objective in view, ***Ministry of Micro, Small & Medium Enterprises (MSME), Government of India launched Credit Guarantee Scheme (CGS) so as to strengthen credit delivery system and facilitate flow of credit to the MSE sector.*** To operationalise the scheme, Government of India and SIDBI set up the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) in the year 2000-01.

The main objective is that the lender should give importance to project viability and secure the credit facility purely on the primary security of the assets financed. The other objective is that the lender availing guarantee facility should endeavor to give composite credit to the borrowers so that the borrowers obtain both term loan and working capital facilities from a single agency. The Credit Guarantee scheme (CGS) seeks to reassure the lender that, in the event of a MSE unit, which availed collateral free credit facilities, fails to discharge its liabilities to the lender, the Guarantee Trust would make good the loss incurred by the lender up to 75 / 80/ 85 per cent of the credit facility.

Salient Features of CGTMSE

a) Maximum credit Rs. 100 lacs
b) Term Loan / Working Capital or both can be considered under the scheme.
c) Manufacturing & Services Sectors are eligible.
d) Guarantee cover available maximum of 75% of advance.
e) Maximum amount of guarantee cover available is Rs.62.50 lacs.

To cover loans under CGTMSE scheme, one time guarantee fee of 1% of loans upto Rs.5 lacs and 1.5% for loans above Rs.5 lacs to be paid.
Further Annual Service Fee @ 0.50% for loans upto Rs.5 lacs and 0.75% for loans above Rs.5 lacs are also to be paid.

Indian Overseas Bank's Role:

As per IOB's policy, ***all collateral free loans above Rs.10 lacs and upto Rs.100 lacs will be brought under cover of Credit Guarantee Scheme of CGTMSE***.

One time guarantee fee paid by MSE borrowers covered under the Credit Guarantee Scheme of CGTMSE upto credit limit of Rs.10 lacs will be reimbursed by the Bank after a period of 5 years or on the date of closure of a performing loan whichever is earlier.

The Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) has signed an agreement with Indian Overseas Bank on 21st December 2012 under the Risk-Sharing Facility scheme for guaranteeing collateral-free credit facilities to eligible small units.

CASE STUDY

Credit Appraisal of a Term Loan of Rs. 10 Lacs Under CGTMSE Scheme

❑ **Case Details :**

Name of the Firm	**Naiya & Company**

Type of Firm	Comes under **MSME** sector.
Business Address	Garia Station Road, Kolkata – 700084.
Constitution	Proprietary
Name of the Proprietor	Mr. XYZ
PAN	
Nature of Activity	Contractor & General Order Supplier of Construction materials.
Past Experience	15 years in this line.
Present Banker	IOB - Garia branch
Nature of Account	Current Account. (A/c No. XXX)
Existing Credit Facility	Nil
Credit Facilities Required	Term Loan under CGTMSE scheme
Limit Applied	Rs. 10,00,000/-
Purpose of Loan	To purchase new Machinery for his latest Project (i.e. Piling work of 700 pillars)
Total Cost of Machinery	Rs. 15,02,760/-
Contribution	**Bank's** – 10,00,000/- **Promoter's** – 5,02,760/-
Securities Offered : **Prime -** **Collateral -**	 Hypothecation of machinery to be purchased utilizing the Term Loan Nil.
Proposed Guarantor	NA (not required under CGTMSE scheme)

❑ Data Analysis & Comments

Table 1- Brief Financial Indicator :

PARTICULARS	2012	2013	2014
Fixed Asset	25391/-	24050/-	1525604/-
Current Asset	471444/-	624877/-	648881/-
Misc. Asset (ONCA)	Nil	Nil	Nil
Total Asset	496836/-	648928/-	2174486/-
Current Liabilities	150000/-	171125/-	253010/-
Deferred Liabilities	Nil	Nil	1200000/-
Net Worth	346836/-	477803/-	721476/-
Total Liabilities	496836/-	648928/-	2174486/-
Tangible Net Worth (TNW)	346836/-	477803/-	721476/-
Net Working Capital (NWC)	321444/-	453752/-	395871/-
Current Ratio	3.14	3.65	2.56
Total Outside Liabilities / TNW	0.43	0.358	2.01
Sales	2922290/-	3513492/-	4892615/-
Operating Profit	334549/-	480251/-	799963/-
Net Profit	237412/-	380967/-	393673/-
Net Profit / Sales (%)	8.12%	10.84%	8.04%
Debt Service Coverage Ratio (DSCR)	Nil	Nil	3.03
Break-Even Point (% of Sales)	Nil	Nil	31.13%
Margin of Safety	Nil	Nil	68.87%

Comments Regarding Financial Indication :

TNW: The Firm shows TNW of Rs. 3.47 lacs in the FY 2011-12 & Rs. 4.78 lacs in the FY 2012-13. The estimated TNW for the FY 2013-14 is Rs. 7.21 lacs which is showing an increasing trend due to higher Net Profit.

Current Ratio: The Current Ratio for FY 2011-12 was 3.14 & for FY 2012-13, it increased to 3.65. The firm has estimated a Current Ratio of 2.56 for FY 2013-14 which is well above the standard norms of 1.33:1. The NWC for 2012-13 was 4.54 lacs which is estimated to be 3.96 lacs for 2013-14. The NWC is sufficient to take care of the margin requirement of the company.

Net Profit: Net Profit for the FY 2011-12 & 2012-13 were Rs. 2.38 lacs & Rs. 3.80 lacs respectively. The Estimated Net Profit for the FY 2013-14 is Rs.3.94 lacs which shows a steady growth.

All other parameters are satisfactory & within the acceptable level.

Current Years Performance and whether Estimated Sales Achievable :

Current year's sales shows a growth of 20.23% as compared to FY 2011-12 & the firm expects to see 40% growth in FY 2013-14. Seems achievable.

Trend Analysis Of Cash Flow After Tax Using Least Square Method

Year	Y (CFAT) (Rs.)	X = Year – 2013	X^2	XY
2012	238896	-1	1	-238896
2013	382308	0	0	0
2014	495063	1	1	495063
n = 3	$\sum Y = 1116267$	$\sum X = 0$	$\sum X^2 = 2$	$\sum XY = 256167$

Straight line equation,

$$Y = a + bX$$

$$\sum Y = na + b\sum X \ldots\ldots\ldots\ldots\ldots\ldots (1)$$

$$\sum XY = a\sum X + b\sum X^2 \ldots\ldots\ldots\ldots\ldots (2)$$

Putting the values of $\sum Y$, n & $\sum X$ in equation no. (1),	Putting the values of $\sum XY$, $\sum X$ & $\sum X^2$ in equation no. (2),
$1116267 = 3a + 0$	$256167 = 0 + 2b$
Or, $a = 1116267/3$	Or, $b = 256167/2$
Or, $a = 372089$	Or, $b = 128083.5$

Now, putting the values of a & b in the straight line equation, we get

Y = 372089 + 128083.5X

CFAT for the year 2015	CFAT for the year 2016
X = (2015 - 2013) = 2 So, Y = 372089 + 128083.5×2 Or, Y = 628256	X = (2016 - 2013) = 3 So, Y = 372089 + 128083.5×3 Or, Y = 756340

<u>Calculation of Pay Back Period :</u>

Year	NPAT + Depreciation @ 10%	CFAT	Cumulative CFAT
2014 (1)	393673 + 101390	495063	495063
2015 (2)	487998 + 140258	628256	1123319
X (PBP)			**Initial Investment - 1502760**
2016 (3)	630108 + 126232	756340	1879659

We can see that the Pay Back Period (Say, X) of the Investment (Rs. 1502760/-) lies between the years 2015 (2) & 2016 (3).

So, PBP (X) = 2 + [(1502760 - 1123319)/(1879659 - 1123319)]

Or, X = 2 + (379441/756340)

Or, X = 2.502

Therefore, Pay Back Period = 2 years & 6 months (approx).

<u>Remarks</u>: It is considered to be a short period and short periods are more preferable to long period. Therefore this project is feasible and should be accepted for appraising loan because the initial cost of the project will be recovered within 3 years (i.e. October 2015).

Proposed Securities : Machinery to be purchased out of the credit facility.
(Under CGTMSE scheme)

Prospect of Deposit Business Expected : Has good orders for construction related work.

Terms & Conditions proposed :

(1) Invoice amount is Rs. 15,02,760/- ; Loan sanctioned is Rs. 10,00,000/-.
Margin of Rs. 5,02,760/- is to be provided by the borrower (already paid Rs.4,95,500/- advance on various dates)

(2) Payment will be directly made to the dealer and necessary margin thereof is to be deposited in borrower's current account.

(3) Margin / Promoter's contribution= 33%

(4) Rate of Interest is Base rate + 1.75% = 12.00% (presently)

(5) Proposed loan is to be covered under CGTMSE scheme.

(6) CGTMSE guarantee fee as & when applicable to be provided by borrower.

(7) Processing charges will be levied.

(8) Machinery to be purchased is to be hypothecated to IOB & name of the bank is to be painted as financer on the machinery.

(9) Machinery is to be insured for full value with bank clause.

(10) EMI – Rs. 22245/- X 60 months (going to start from 30.10.2013)

(11) The entire business transactions are to be routed through this current account.

(12) Overdue interest is chargeable @ 2.00% over and above the normal interest rate on the overdue amount.

(13) The interest rate mentioned above is linked to Base Rate and is subject to be changed from time to time as per the discretion of the Bank / RBI.

(14) Any terms and conditions are subject to change as per discretion of bank of its own or RBI.

(15) Loan portfolio will be reviewed at the end of each year.

Recommendations :

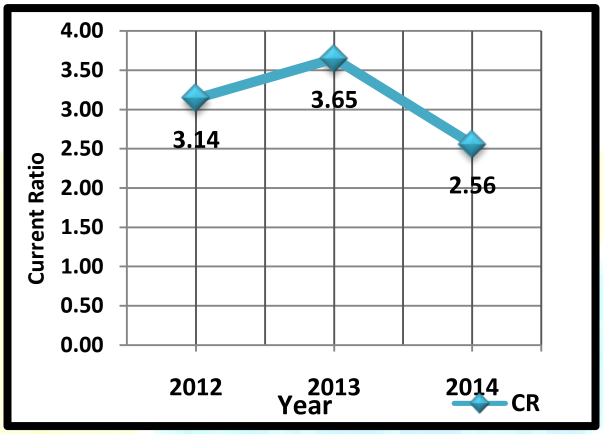
Borrower is an old & valuable customer of that branch. Earlier he has taken Home loan from IOB & successfully repaid. Repayment record of existing Home loan is also satisfactory. After analyzing borrower's financial statements & considering his CIBIL [Credit Information Bureau (India) Limited] report, past experience & risk taking attitude, IOB-Garia recommends sanction of Term Loan of Rs. 10.00 lacs under CGTMSE scheme.

Documentation:

Application form for Credit facilities upto Rs.10 lacs for SME units, KYC documents (for both Proprietor & Firm), CIBIL Report (Score – 685), IT Returns for last 3 years, TDS certificate, Financial Statements for FY 2011-12, 2012-13 & 2013-14, Copy of latest work order, CGTMSE Registration form, Asset - Liability Statements of borrower, Term Loan Agreement, Letter of Hypothecation for securing Machineries, Demand Promissory Note, Repayment Letter, Sanction Letter / Credit Sanction Advice, 2nd Line Certificate (Certificate from the 2nd Commanding officer, i.e. Assistant Manager), Appraisal Note prepared by the Branch.

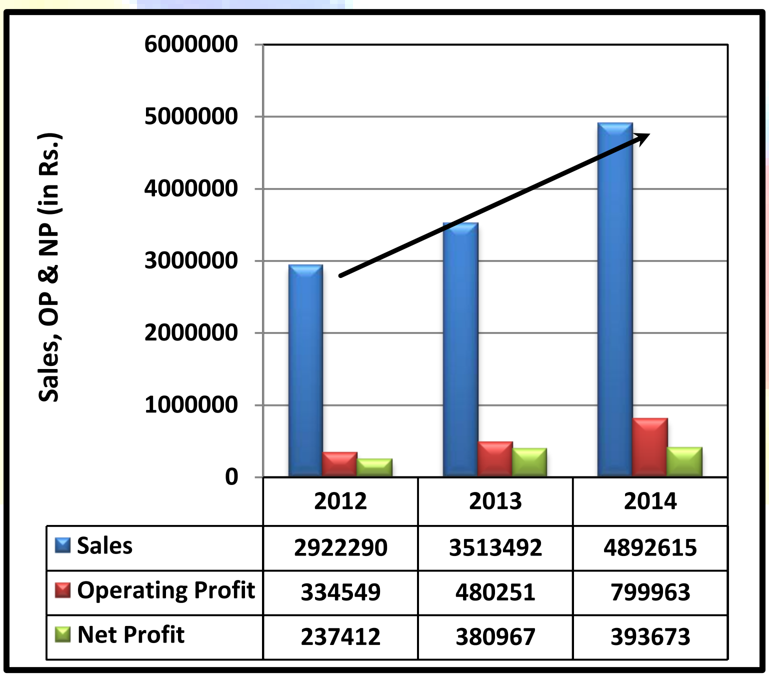
1. CHARTS & GRAPHS:

❑ TL 1.1- CURRENT RATIO:



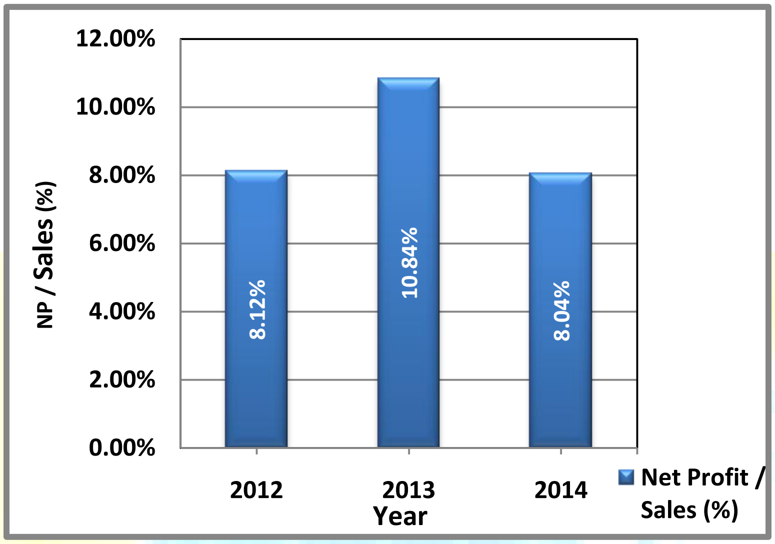
Current Ratios for the FY 2011-12 & 2012-13 are 3.14 & 3.65 respectively. The estimated ratio for the FY 2013-14 is 2.56 which has come down to a acceptable level. The ratios are higher as compared to the benchmark level of 1.33:1 due to higher value of current assets in the form of receivables. It shows good capability of the firm in meeting the current obligation.

❑ TL 1.2- SALES, OPERATING PROFIT & NET PROFIT:



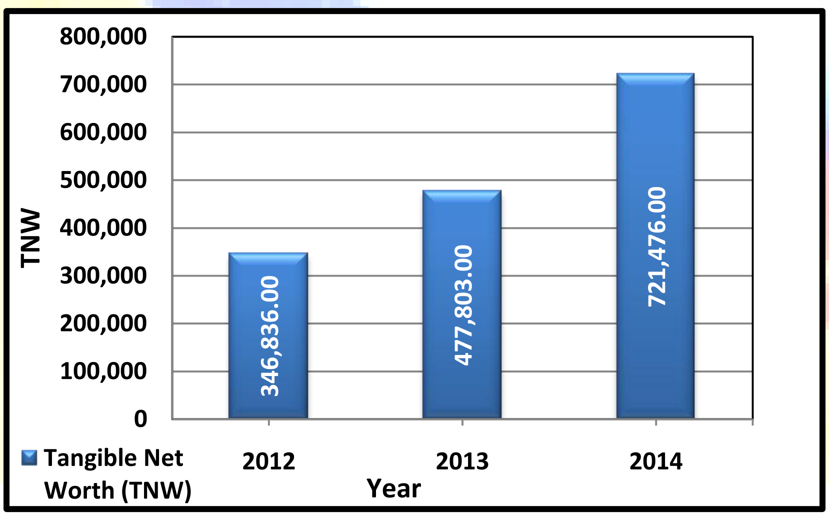
Sales for the FY 2011-12 was Rs. 29.23 lacs. In the FY 2012-13, the firm achieved a revenue of Rs. 35.13 lacs with an increase of 20.23%. The firm has estimated the sales of Rs. 48.93 lacs for the FY 2013-14 which is 40% more than the previous financial year. After purchasing the new machinery the firm is expecting higher return from the business. The above chart indicates the rising trend in Sales, Operating profit & Net profit.

- **TL 1.3- NET PROFIT / SALES:**



The firm has been maintaining a standard Net profit margin since FY 2010-11. In 2012-13, it has reached to 10.84%. The firm has estimated a Net profit margin of 8.04% in the current financial year which seems achievable.

- **TL 1.4- TANGIBLE NET WORTH:**



The Firm shows TNW of Rs. 3.47 lacs in the FY 2011-12 & Rs. 4.78 lacs in the FY 2012-13. The estimated TNW for the FY 2013-14 is Rs. 7.21 lacs which is showing an increasing trend due to higher Net Profit.

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. Banks are the main source of external finance for SMEs. Furthermore small banks are more engaged in relationship lending where as the large banks have a comparative advantage at financing SMEs through arms-length lending technologies (eg., asset-based lending, factoring, leasing, fixed-asset lending, credit scoring, etc.) instead of relationship lending. Both small and large banks play a vital role in financing SMEs.

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