Case Study on

SIDBI – A Successful Financial Institution in SME Financing

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"Good things in life begin small"

Case on successful SME financing – SIDBI

Worldwide, the wind has been changing in the finance sector in general and banking-investment sector in particular. Such a panorama teaches us that now, is the time of cooperation rather than a competition, now it's a time of convergence rather than cutting each other's neck over customers and markets, now it's a time of consolidation rather than antagonism. Curing the fatal disease requires the doses of small pills; impressive thoughts come out from the small brain, similarly, India requires prominence of small and medium enterprises for curing its problem of low economic growth vis-à-vis developed nations.

To cure the overall disease of lack of appropriate growth of Indian SMEs – Small and Medium Enterprises, India needs several small pills such as adequate credit delivery to SMEs, better risk management, technological upgradation of Banks esp. Public Sector Banks, attitudinal change in Bankers and so on. Among them, the major problem of inadequate financing to SMEs needs an urgent attention. Having said this, it is pertinent to mention that Small Industrial Development Bank of India has achieved landmark results in the domain of small and medium enterprise financing and fulfilling their credit requirements time to time in various forms such as long term project finance, working capital finance, bill discounting etc. However considering the level of appetite for credit facilities of Indian small and medium enterprises, private and public sector banks in India need to work out an unique and innovative model of financing to this vital sector (SME) of Indian Economy.

In today's changing world, retail trading, SME financing, rural credit and overseas operations are the major growth drivers for Indian banking industry. The scene has changed since the adoption of financial sector restructuring programme in 1991. The reform in the financial sector in India along with the overall second generation economic reforms in Indian economy has transformed the landscape of banking industry and financial institutions. GDP growth in the 10 years after reforms averaged around 6 %.

With the introduction of the reforms especially in financial sector and successful implementation of them resulted into the marked improvement in the financial health of the commercial banks measured in terms of capital adequacy, profitability, asset quality and provisioning for the doubtful losses.

Now, the rules of the game have completely changed. Consolidation has become the new mantra for survival. Due to the growing influence of globalization on the Indian banking industry, the author is of the opinion that the financial sector would be opened up for greater international competition under WTO. Opening up of the financial sector from 2005, under WTO, would see a number of global banks taking large stakes and control over banking entities in the country. They are expected to bring with them capital, technology, and management skills which would increase the competitive spirit in the system leading to greater efficiency. Government policies to allow greater FDI in banking industry and the move to amend Banking regulations Act to remove the **existing 10 per** cent cap on voting rights of shareholders are pointer to these developments.

The pressure on banks to gear up to meet stringent prudential capital adequacy norms under Basel II and the various Free Trade Agreements (FTAs) that India is entering into with other countries, such as Singapore, will also impact on globalization of Indian banking.

However, the flow need not be one way. Some of the Indian banks may also emerge as global players. As globalization opens up opportunities for Indian corporate entities to expand their overseas operations, banks in India wanting to increase their international presence could naturally be expected to follow these corporate entities and other trade flows out of India.

Alongside, the growing pressure on capital structure of banks is expected to trigger a phase of consolidation in the banking industry. In the past mergers were initiated by regulators to protect the interest of depositors of weak banks. In recent years, there have been a number of market-led mergers between private banks. This process is expected to gain momentum in the coming years. A merger between two public sector banks or between a public sector bank and a private bank could be the next logical development. Consolidation could also take place through strategic alliances or partnerships covering specific areas of business such as credit cards, insurance, SMEs financing etc.

Secondly, risk management has become the key to success in which adoption of the state-of-the-art technology and latest rating and management skills turn out to be the significant aid for better risk management. The ability to gauge the risks and take appropriate position will be the key to successful financing in the emerging Indian banking scenario. Risk-takers will survive, effective risk mangers will prosper and risk-averse are likely to perish.

In this context, Indian banks have to ensure:

1. Risk management has to trickle down from the corporate office to branches. They should be made more accountable and responsible towards their duties.
2. As audit and supervision shifts to a risk-based approach rather than transaction oriented, the risk awareness levels of line functionaries also will have to increase.
3. There is a growing need for banks to deal with issues relating to `reputational risk' to maintain a high degree of public confidence for raising capital and other resources.

In this process, the technological advancement of Indian banks would create a soothing climate to manage their risk in a better way. In the years to come, technological developments would render flow of information and data faster, leading to prompt appraisal and decision-making. This would enable banks to make credit management more effective, besides leading to an appreciable reduction in transaction cost.

In order to reduce investment costs in technology, banks are likely to resort sharing of facilities such as ATM networks. Banks and financial institutions will join together to share facilities in the areas of payment and settlement, back-office processing, data warehousing, and so on – majorly for cost effectiveness and secondary motto would be to provide everything under one head.

The advent of new technologies could see the emergence of new players doing financial intermediation. For example, we could see utility service providers offering, say, bill payment services or supermarkets or retailers doing basic lending operations. So for better profit margin, with the help of technological innovation, consolidation and innovation in corporate lending, the conventional definition of banking might undergo changes.

Considering such developments in the banking industry of India, it seems that the next decade will be an era of consolidation and integration. In such a scenario, the expected integration of various intermediaries in the financial system would require a strong regulatory framework. It would also require a number of legislative changes to enable the banking system to remain contemporary and competitive. There would be an increased need for self-regulation among Indian banks since development of best international standard practices could evolve better through this rather than based on mandatory regulatory prescriptions. For instance, to enlist the confidence of the global investors and international market players, the banks will have to initiate adopting the best global practices of financial accounting and reporting. It is expected that banks should migrate to global accounting standards smoothly rather than waiting for the regulatory circulars and guidelines, although it would mean greater disclosure and tighter norms.

Last and the most important development in the Indian banking industry is its change of focus in corporate lending on account of above mentioned changes and challenges. In the sheltered days of corporate lending by banks, when customers could be freely charged, banks concerned themselves with only `revenue' which was equal to cost plus profit. Post-reforms- after 1991, when the cost of services became nearly equal across banks and cost-control was a key to higher profits, the focus of financial institutions especially banks shifted to `profit', which **was equal to revenue minus cost**. This was an alternative measure of revenue stream which every bank thought of due to effects of external environment on their workings. **And in the future, as domestic and international competition hots up, financial institutions including banks may have to shift their focus to `cost' which will be determined by revenue minus profit.**

In other words, cost-control in tandem with efficient use of resources and increase in productivity will determine the winners and laggards in the future. The economic theory of 'survival of the fittest' works everywhere it seems through this example.

The ray of hope is Small and Medium Enterprises (SMEs) [1] which is an emerging, inevitable and profitable target market for the financers' i.e. financial institutions and banks. However, that need not mean banks and financial institutions will back-up the social banking. Rather than being seen as directed and philanthropic-like financing, such lending should have been now more business driven.

On the contrary, the authors believe that all the sources or market of revenues have not been vanished yet. The SMEs sector is considered to be an untapped market for financial institutions in India. We just need to combat certain obstacles. The hurdles which need to be removed are:-

1. Minimization of probabilities of skewed returns from SMEs by better risk management
2. Eradicate inconsistency in the knowledge of SMEs business. For example, entrepreneurs may possess more information about the nature and characteristics of their products and processes than potential financiers.
3. Absence of managerial and technical expertise of intermediaries whose role is to evaluate and monitor companies
4. Lack of international infrastructure and expertise in SME financing

SMEs Financing – "The Rising" India

The only way out of the mire is that the Indian manufacturing sector could be strengthened by the existing rural systems and making them self-sufficient. This could take place only by helping Small and Medium Enterprises and the rural artisans (people with innate skills and talents) in becoming effective and competitive enough to face the future. A number of issues and business practices of global players and markets can be observed, learnt and adapted for ensuring competitiveness of Indian SMEs.

Let us take an anecdote, which is a part of the school days about the meaning of domestic and global competition. It is about two friends who while walking through a dense forest suddenly hear the roar of a bear. One of them immediately changes his shoes that he is wearing in, to the one, he uses for running. His friend asked him: "If you change your shoes, do you think you can out beat the bear?" The other one replied: "The idea is not to beat the bear, but you." The moral of the story is that the Indian SME sector should be strong enough to out beat the other players in the economy and not the competition itself.

SMALL and MEDIUM enterprises (SMEs) play a catalytic role in the development of any country. They are the engines of growth in developing and transition economies. In India they account for a significant proportion in manufacturing, exports and employment, and are major contributors to GDP. [2]

Considering the growth potential of Indian SMEs, the Government of India has asked public sector banks to achieve a minimum 20 per cent year-on-year growth in the funding of SMEs that will lead to double the flow of credit to the sector from Rs 67,000 crore in 2004-2005 to Rs 1, 35,000 crore by 2009-2010.[3] A small-scale unit is defined as one having original investment in plant and machinery not exceeding Rs 1 crore. While recognizing the needs for larger investment in some of the more important segments of small scale industries (SSIs), the Government has enhanced this to Rs 5 crore for specified industries.

The Government felt that a separate category of medium enterprises (MEs) needs to be recognised and, accordingly, the new policy package clearly defined the medium enterprises as those units having investment in plant and machinery above the small-scale industry limit and up to Rs 10 crore, as recommended by the Working Group on Flow of Credit to the SSI sector, headed by Mr A. S. Ganguly.

The Importance of Small and Medium Enterprises (SMEs) in any economy cannot be overlooked as they form a major chunk in the economic activity of nations. They play a key role in industrialization of a developing country like India.

They have unique advantages due to:-

- their size
- their comparatively high labor-capital ratio
- need a shorter gestation period
- focus on relatively smaller markets
- need lower investments
- ensure a more equitable distribution of national income
- facilitate an effective mobilization of resources of capital and skills which might otherwise remain unutilized and
- Stimulate the growth of industrial entrepreneurship.

According to a UNIDO report, [4] supports for SMEs are generally based on three assumptions.

- it sustains a broad and diversified private sector and creates employment and thus benefits the country as a whole
- second, a strong SME sector will not emerge without support from the state, but they suffer disadvantages in the markets because of their size
- the programs aimed at smallest enterprises, have been justified more in terms of their welfare impact than their economic efficiency.

Indian SME at a Glance

In India, SME sector accounts for around 95% of the industrial units, 40% of the value added in the manufacturing sector output, 34% of exports and provides direct employment to 20 million persons in around 3.6 million registered SME units. The SME sector in India contributes to about 7% of India's GDP during 2002-03. Now, the question is, Can it overtake the invasion of foreign companies through their innovative, quality, affordable/reasonable and readily available products?

In developing countries like India, making the SMEs more competitive is particularly pressing as trade liberalization and deregulation increase the competitive pressures and reduce the direct subsidies and protection that Governments offer to SMEs. If our SMEs are to be competitive enough to withstand and fight back the foreign

MNC products, they have to be nurtured. **According to Porter**, "the only meaningful concept of competitiveness at the national level is **Productivity**, which is the value of output produced by a unit of labor or capital. Productivity in turn depends on both the quality and features of products (which determines the prices that they can command) and the efficiency with which they can be produced. Productivity is the prime determinant of a nation's long-run standard of living; it is the root cause of national per capita income". Further, "to find answers, we must focus not on the economy as a whole but on specific industries and industry segments. We must understand how and why commercially viable skills and technology are created, which can only be fully understood at the level of particular industry".

International trade and foreign investment can both improve a nation's productivity as well as threaten it. They expose the nation's industries to the test of international standards of productivity. An industry will lose out if its productivity is not sufficiently higher than its rivals to offset any advantage in the local wage rates. As wage rates in India are sufficiently less to attract multi-nationals, the only way is to increase the productivity of local small industries. This means, the increase in the productivity of **labor** i.e. human resources, the productivity of **capital** and that of the **process**, which in turn relates to the use of **technology** that yields quality and innovative products.

According to Ex-Commerce and Industry Minister and President of the National Productivity Council, Mr. Arun Jaitley at the 47th meeting of NPC, "It has become so competitive these days that bulk of the labor, for reasons of higher productivity, has now shifted to female labor. If we look at other Asian economies, Bangladesh or Srilanka, Cambodia or Myanmar, we find that in manufacturing, it is female labor, which is being encouraged because they have been found more disciplined and hence with higher Productivity".

As every coin has two sides, similarly, even SME financing has a share in the overall financing. The following are the issues of SME financing:

- They are unable to capture market opportunities, which require large production facilities and thus could not achieve economies of scale, homogenous standards and regular supply.
- They are experiencing difficulties in purchase of inputs such as raw materials, machinery and equipments, finance, consulting services, new technology, highly skilled labor etc.
- Small size hinders the internalization of functions such as market research, market intelligence, supply chain, technology innovation, training, and division of labor that impedes productivity.

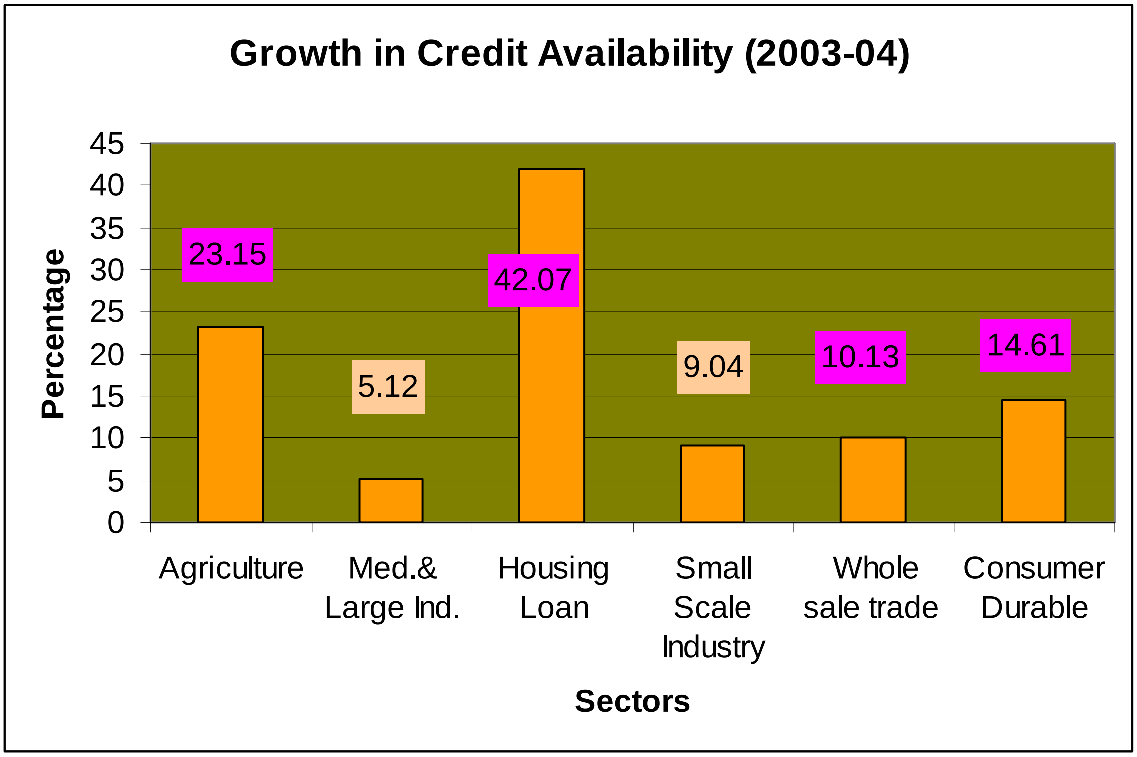
- Emphasis to preserve narrow profit margins makes the SMEs myopic about the innovative improvements to their product and processes and to capture new markets.
- They are unable to compete with big players in terms of product quality, range of products, marketing abilities and cost.
- And most importantly, absence of a wide range of Financing and other services those are available to raise money and sustain the business.
- Absence of Infrastructure, quality labor, Business acumen and limited options / opportunities to widen the business.
- Poor IT and Knowledge infrastructure.

To overcome all these difficulties, Indian SMEs and rural artisans deserves all the policy support the Government can offer. What they need is, not protection but institutional support to fund modernization and technology up gradation, infrastructure support and adequate working capital finance. Also they have to have professional inputs and knowledge about various happenings in their own industries in and around the country. This brings in the concept of SME networks and clusters that stimulate innovative and competitive SMEs. These concepts (are not something new, but can be traced back to Alfred Marshall's analysis of industrial districts in Britain in 1890s) essentially bring together various stakeholders like technology providers, labor force, financing arms, consultants, marketing arms, and others, for a common good that will help in enhancing the strength of SMEs.

THE Indian SME (small and medium enterprise) market seems to be emerging a promising hunting ground for banks and financial institutions because it poised for tremendous growth. As the access of SMEs to capital markets is very limited, they largely depend on borrowed funds from banks and financial institutions. In majority of the economies, while the investment credit to SMEs was being provided by financial institutions, commercial banks extended working capital. In the recent past, with growing demand for universal banking services, the term loan and working capital are becoming available from the same source. Besides the traditional needs of finance for asset creation and working capital, the changing global environment has generated demand for introduction of new financial and support services by SMEs.

Here, **Figure-1** reveals the lackluster approach in industrial credit disbursement especially Small and Medium Enterprises sector in India. The segment of medium and large Industries where major chunk of credit has been absorbed by the big industrial houses, the growth rate is only **5. 12 %** in Financial Year (FY) 2003-04 as compared to previous FY 2002-03. The growth rate is 9.04 % in FY 2003-04 in the Small Scale Industry segment whereas housing loan segment register the landmark 42.07 % growth in the same year. It clearly reveals the lack of adequate credit facility to small and medium enterprises despite its lucrative growth prospects in Indian economy.

Figure: 1 Industrial Credit Disbursement Scenario



(Adopted from Chapter -35, Monetary and Banking Development, page no. 65, Economic Survey – 2004-05, published by Department of Economic Affairs, Ministry of Finance, Government of India)

However, some leading financial institutions such as Small Industrial Bank of India (SIDBI) has been started with the aim of contributing to industries that have the ability to grow and contribute towards GDP, till now SIDBI has satisfactorily contributed in credit disbursement to small and medium enterprises in India. In fact, it owns the major chunk of pie in the graph of overall SME financing in India.

SIDBI

SIDBI (small industrial development bank of India) was started with the motto of refinancing as the sole business. RBI considers SIDBI and NABARD as two refinancing institutions. As the main focus always has been this rather than direct financing, the brand image of SIDBI has not changed in so many years. In the banking sector as a whole, there are too many middle level banks that come in direct contact with the customer and this has been the main reason SIDBI is considered as the last resort for financing. SIDBI almost had a monopoly in refinancing the small scale units but now there have been competition form other commercial banks as well that have started initializing the SME finance like ICICI and SBI. SIDBI has also started tying up with other nationalized and commercial banks in this regard that can help it gain some more visibility and selling the products that need aggressive marketing.

SIDBI has a special corporate status because it has got an expertise since 1964 and has been an agent in government schemes and finance is provided considering all expenses related to the project from conceptualization of the project to the successful execution of the project. They target the SME as they are serving the niche market. It is also synonym to developmental banking as they have soft corner for the SME's and for this section of industry they have liberal policies, promote and develop small scale industries. Helping entrepreneur is also one of the functions and duties of SIDBI.
Thus its broad functions are promotion, financing and development of Industries in the small scale sector and Co-ordinating the functions of other institutions engaged in similar activities**.** SIDBI was established on April 2, 1990. The Charter establishing it, The Small Industries Development Bank of India Act, 1989 envisaged SIDBI to be "the principal financial institution for the promotion, financing and development of industry in the small scale sector and to co-ordinate the functions of the institutions engaged in the promotion and financing or developing industry in the small scale sector and for matters connected therewith or incidental thereto.

The business domain of SIDBI consists of small scale industrial units, which contribute significantly to the national economy in terms of production, employment and exports. Small scale industries are the industrial units in which the investment in plant and machinery does not exceed Rs.10 million. About 3.1 million such units, employing 17.2 million persons account for a share of 36 per cent of India's exports and 40 per cent of industrial manufacture. In addition, SIDBI's assistance flows to the transport, health care and tourism sectors and also to the professional and self-employed persons setting up small-sized professional ventures.

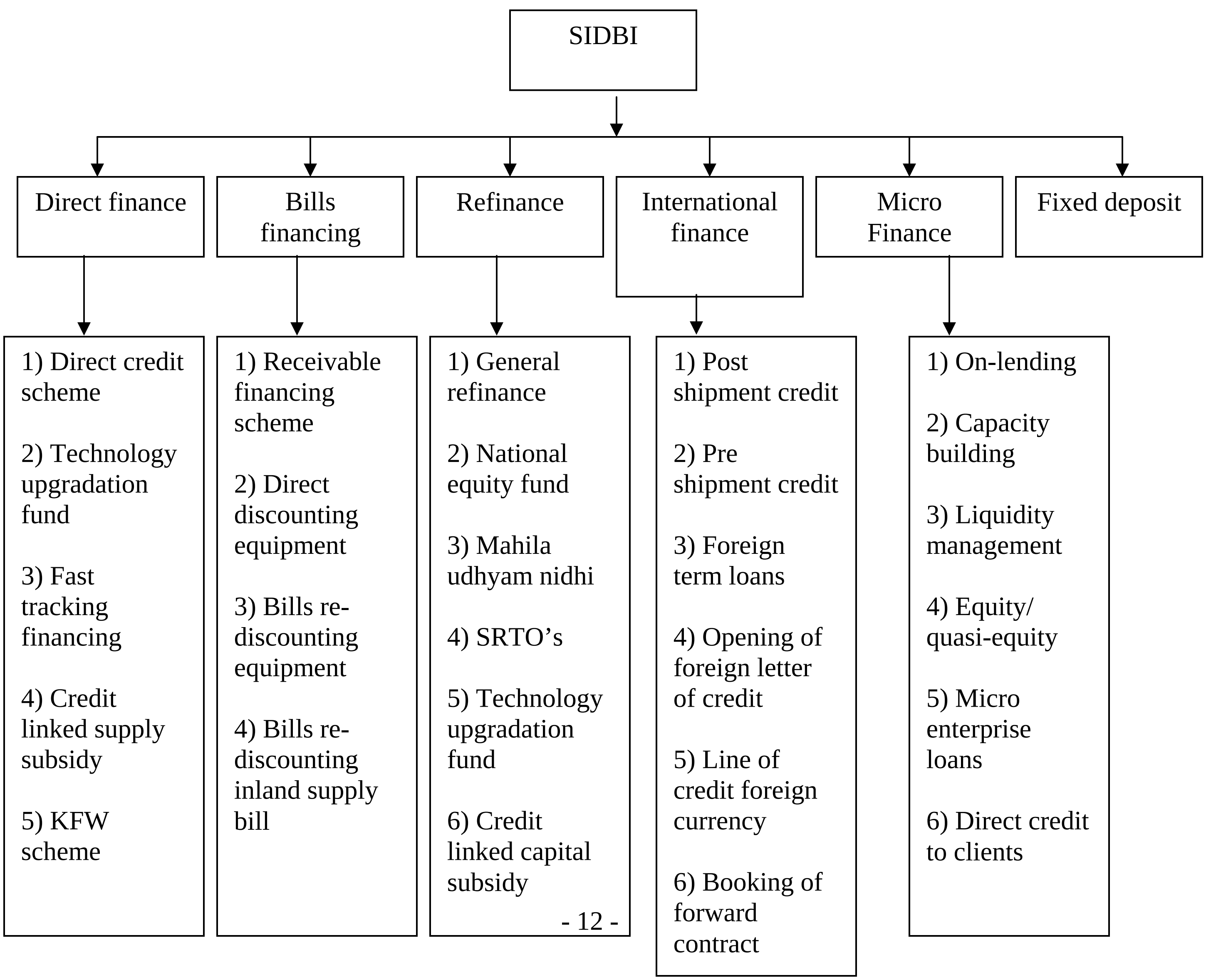
SIDBI retained its position in the top 30 Development Banks of the World in the latest ranking of The Banker, London. As quoted in the May 2001 issue of The Banker, London, SIDBI ranked 25th both in terms of Capital and Assets.

State-owned SIDBI provides financial assistance to units in the small-scale sector. SIDBI provides refinance against term loans granted by banks to SSIs, equity assistance, bills financing, project financing and resource support to institutions that are engaged in the development of SSIs.

It provides assistance to wide-range of industrial sectors including transport, health care, hotel and tourism and infrastructure.

It also provides funds to the professional and self-employed persons setting up small-sized professional ventures.

<u>Details about product & Services segment wise</u>



(Adopted from the official website of SIDBI)

As seen in the above chart, SIDBI has 6 product divisions, namely direct financing, bills financing, Refinancing, international finance, micro finance and fixed deposit.

SIDBI's objective was to help the masses and the industry that is the base of all development, i.e. small scale industries. Thus came up the idea of financing these industries directly and on selective basis. So it was decided to introduce direct assistance schemes to supplement the other available channels of credit flow to the small industries sector. Since then, SIDBI has evolved itself into a supplier of a range of products and services to the Small & Medium Enterprises [SME] sector.

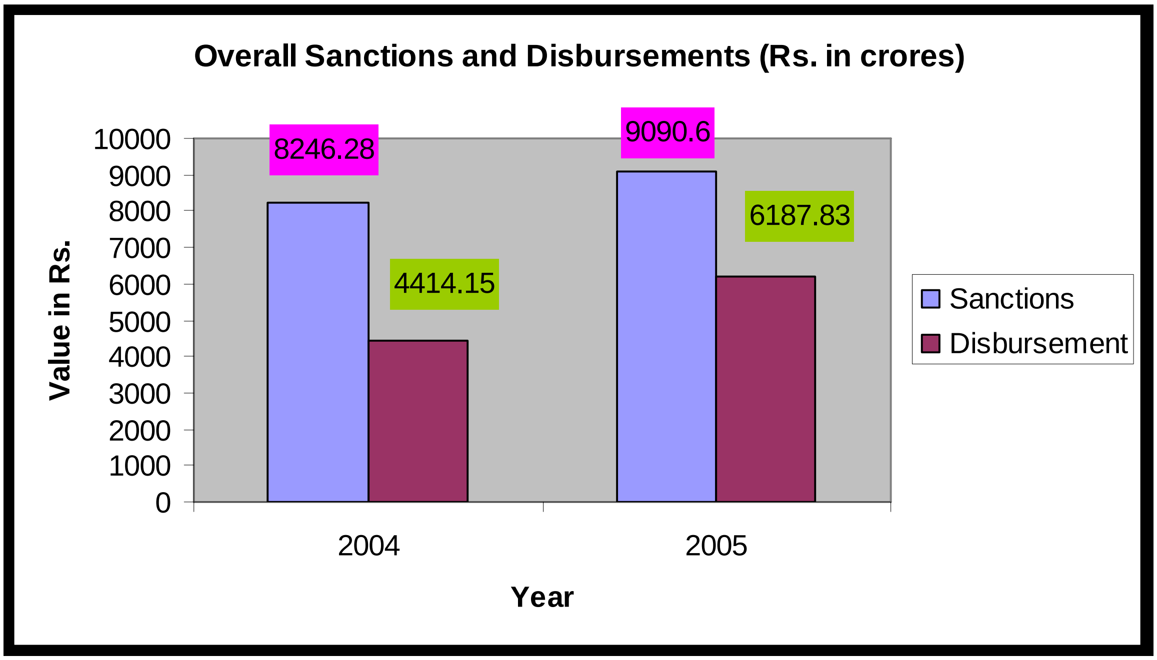
Considering the level of competition in banking business due to globalized environment, SIDBI has now started spreading its wings either by way of diversifying its product portfolio or entering into the strategic alliance with other leading private sector banks, public sector banks and Non Banking Financial Institutions in order to achieve market development of its existing portfolio of services. It aims to provide all the services a Small and Medium Enterprise needs under one roof. Secondly, with the adoption of cluster development as the key strategy to develop manufacturing sector's competitiveness, SIDBI has envisaged to adopt the cluster financing method to assist SMEs. Finally, the bank is planning to get into the business of commercial banking in a bid to serve the banking needs of the existing customers since they have to approach commercial bank for daily routine transactions. However, considering the quantum of competition in commercial banking business in India, SIDBI is not aiming to enter into commercial banking business in haste.

Operations

Any bank's operational excellence is measured by aggregate sanctions, subsequent disbursement of the sanctioned amount, the amount of revenue generated from the difference in spread over the loan taken and advances granted, higher amount of fee based income and the last and the most important timely recovery of dues. In addition, the bank's assistance towards promotional and developmental efforts in the form of loans and advances for project financing as well as its overall utilization of available resources lying with the bank under study is another significant indicator of operational effectiveness. However, an analyst has to keep in mind that these are not the eventual pointers of the efficiency of any bank since it varies from bank to bank depending upon the area of operations, profile and status of the bank (Public, private, foreign, cooperative bank), geographical spread, its target groups and historical achievements.

SIDBI's aggregate sanctions under all schemes during the FY 2004-05 were Rs. 9090.60 crore registering a growth of 10.24 % over the previous year. The disbursements during the year were Rs. 6187.83 crore recording an impressive growth of 40.18 % over the disbursement in previous year. **(Figure 2)**

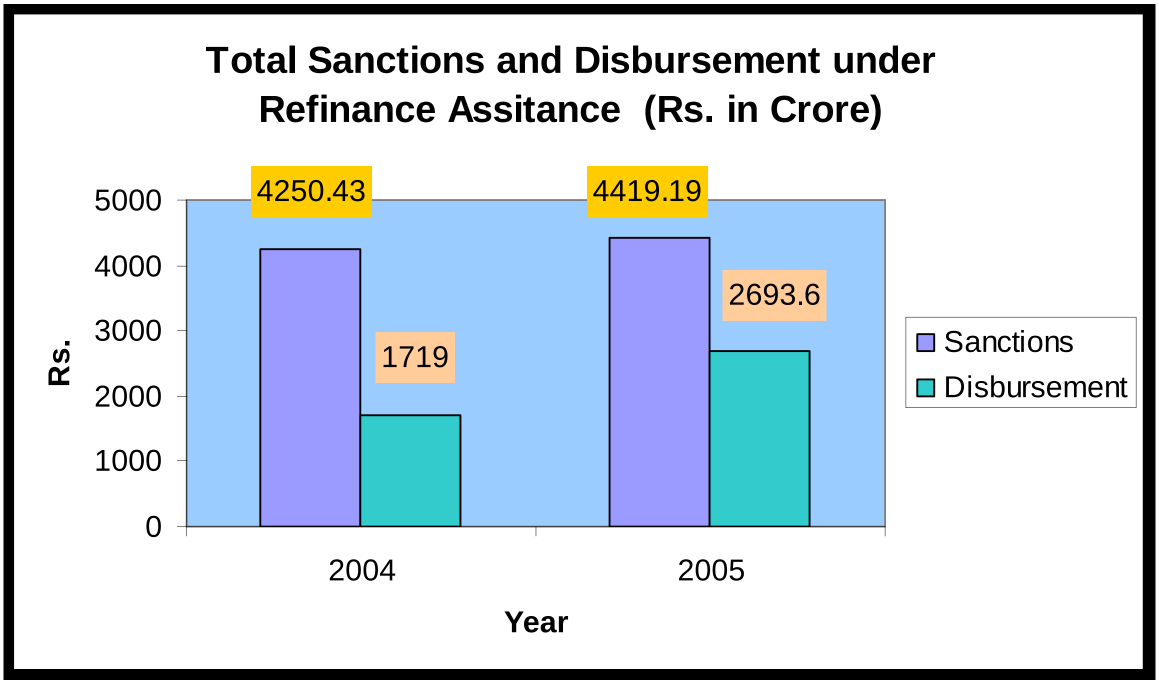
Figure – 2 Overall Sanctions and Disbursements of SIDBI



Refinance Assistance

SIDBI has remained the premier refinancing institute for the promotion and development of small and medium enterprises. The mechanism used by SIDBI is it lends to Primary Lending Institutions (PLIs) and they deliver the credit facility to existing entrepreneurs and first generation entrepreneurs. **Figure -3** reveals the total sanctions and disbursement under refinancing assistance.

Figure: 3 Total Sanctions and Disbursement – Refinance Assistance



The aggregate sanctions and disbursements under refinance schemes during 2004-05 were Rs. 4419.19 crore and Rs. 2693.60 crore respectively. It shows the net growth of 3.98 % increase in Sanctions and impressively 56.69 % increase in disbursement. This is the result of the extra efforts in policy making and aggressive help provided by the bank for the overall welfare of the small scale industries.

SIDBI has floated an excellent programme to meet gap in prescribed minimum promoters' contribution and/or in equity considering the practical constraints faced by the promoters. For instance, an entrepreneur visualizes an outstanding project on biotechnology which requires Rs. 10 Lacs as an initial investment. Suppose, he approaches to a commercial bank for financial assistance. The first question he faces is how much he (an entrepreneur) is contributing towards the project. Now, assume that bank's conventional practice is that a loan applicant must contribute at least 25 % of the total project cost. He has to contribute at least Rs 2.5 lacs as a promoter's contribution in the above example. He may not able to initiate the project unless he has the amount stated above (i.e. < 2.5 lacs) howsoever innovative, profitable and unique his proposition is. SIDBI has started National Equity Fund Scheme in a bid to impart financial assistance for gap in promoter's contribution.

The eligible borrowers for the NEF are:

⇒ Small entrepreneurs for setting up new projects in tiny / small scale sector and rehabilitation of potentially viable sick SSI units irrespective of the location.

⇒ Existing tiny and small scale industrial units and service enterprises [tiny enterprises would include all industrial units and service industries (except Road Transport Operators) satisfying the investment ceiling prescribed for tiny enterprises] undertaking expansion, modernization, technology upgradation and diversification can also be considered irrespective of the location.

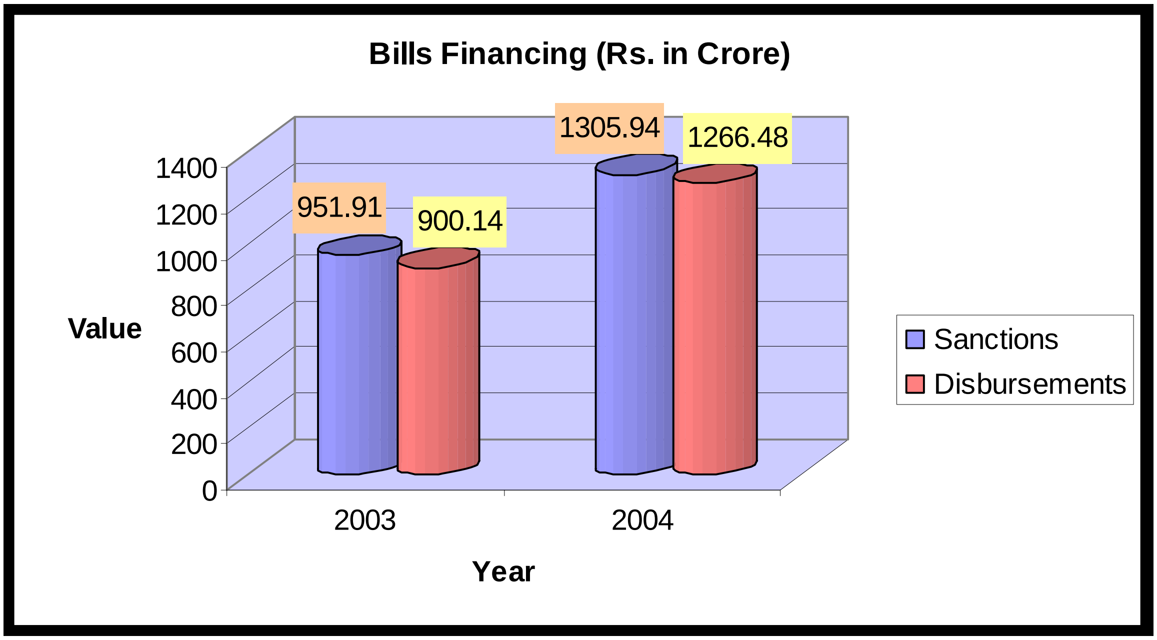
It has been surprising to note that such unique scheme along with Mahila Udhyam Nidhi and scheme of self employment for ex-servicemen have worked wonders since their inception. The results of the aggregate sanctions and disbursements during the FY 2004-05, under these schemes have been Rs. 43.97 Crore and Rs. 39.97 crore respectively.

A Global survey conducted in 18 countries by HSBC among SME's to find out how this business feels about current and future economic climate as well as their involvement in international trade, threw up some interesting facts. The report said that working capital requirement, cash management and export finance are three important factors that hinder the growth of the SME's worldwide.

Given the potential of SME's, several initiatives have been adopted by SIDBI to remove working capital financing barriers. It has diversified its portfolio of financing considering the current problems facing the development of SME's and SSI's.

Bills financing have been another feather in the cap for SIDBI's portfolio of financing for assistance of the SME's. The objective of the scheme is to mitigate the problem of delayed payments to SSI units. The schemes operating under Bills financing are Bills Re-discounting, Bills direct discounting, receivables financing scheme. This is for short term purposes and entrepreneurs in need of such short term requirements for working capital have favored this scheme along with their financing options.

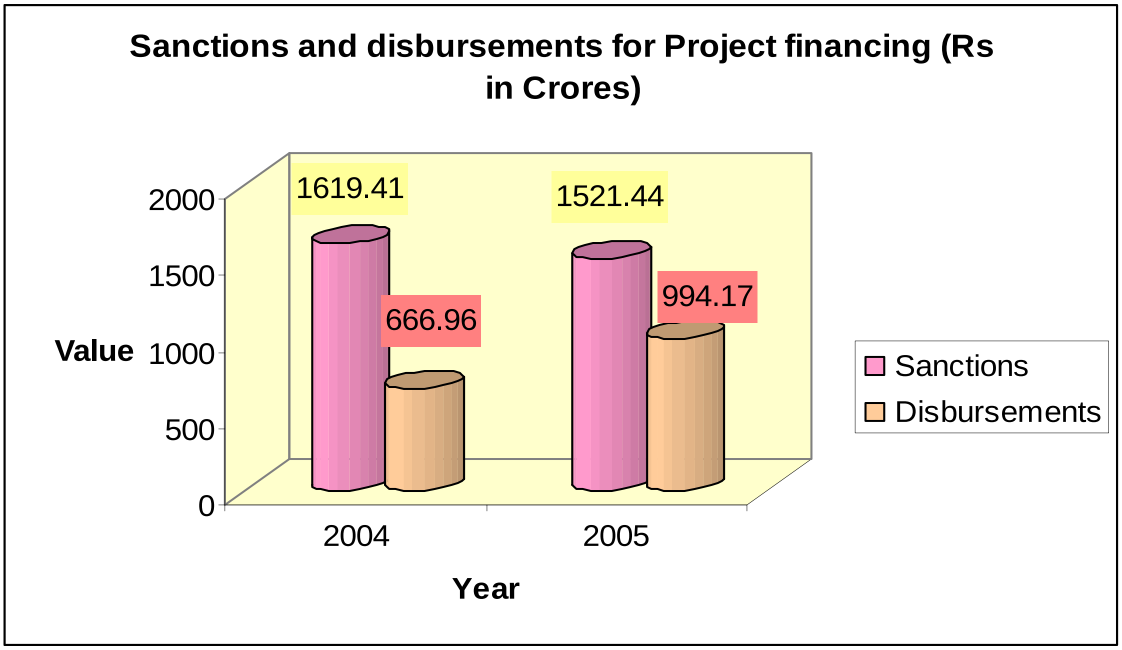
Figure-4 Sanctions and Disbursement for Bills Financing



Total sanctions and disbursements for the FY 2003 and FY 2004 can be seen from **figure- 4,** where the sanctions have increased by 37.19% in the year 2003 and disbursements have increased by 40.69% in the year 2004 which shows that the sanctions and disbursements have been at par with the target of SME's being able to attain the credit available.

Project financing being another area where SIDBI finances the whole project that is innovative, economically and financially feasible and unique which would lead to a birth of an industry in the near future. Under the direct financing of projects, though the sanctions declined a bit during the last year, the disbursement showed an increase during the corresponding year.

Figure-5 – Project Financing Scenario of SIDBI



The above **figure-5** shows that the overall sanctions for Project Financing by SIDBI has shown the dramatic fall in FY 2005 from total sanctions amount of Rs. 1619.41 crore in the financial year 2004 to Rs. 666.96 crore in the FY 2005 which is almost 59% lesser than the previous year. The underlying reason for low sanctions is stringent risk management practices adopted by the bank. However, if one looks at the total disbursements under Project Financing of SIDBI, he will find the increase in disbursements rate in FY 2005 as compared to FY 2004 when total disbursements were Rs. 1521.44 crore.

Besides good track record in total sanctions and disbursements, SIDBI has performed pretty well in rationalizing of all its existing schemes and programmes in a bid to simplify the procedures, streamline the credit delivery mechanism and enhance the customer base. The modus operandi adopted by SIDBI in streamlining its operations is either merging the existing schemes with related schemes serving the same target market or extending the different schemes to the target market of only one or two schemes. For instance, pursuant to the announcement by the Ministry of Small Scale Industry, Government of India, units assisted under National Equity Fund Scheme have also been made eligible for availing subsidy under Credit Linked Capital Subsidy Scheme, provided other terms and conditions of the same were satisfied.

Secondly, in an effort to simplify procedures, SIDBI has developed an electronic workflow system which integrates and automates the main credit functions of sanctions, documentation and disbursement. This process is known as

Direct Credit Process. The system has generated spectacular results in standardizing the processes and reducing the transaction time.

The real measure of operational excellence for a customer focused bank is the transaction time taken from application of loan to the ultimate disbursement of the same. SIDBI has this exceptional method of appraising the proposals interested in acquiring credit from the bank.

- The loan procedure in SIDBI is handled first by the pre-sanction department which is similar to all the other banks as well. The process starts from initial screening where feasibility of the project is checked with keeping in mind the profile of the management. Emphasize is laid on the promoters capacity to manage.
- Once it is approved from the pre-sanction department, the next step is physical inspection where the 3 C's that is Character, Capacity and Capital are judged on the basis of on-site scrutinization of the promoters and their proposed activities.
- Once the project idea passes the 3 C's test and the feasibility scan, it goes through the appraisal by CART system which is a unique credit appraisal system set by the in-house system in SIDBI. CART analyzes credit-worthiness of an applicant. The system has a two-level security – a creator and a checker who can also be the same person. CART allows for three basic forms-the appraisal, documentation of verification and the disbursement note on approval. SIDBI has developed expertise in quick appraisal of small credit proposals of existing well performing units (up to Rs 50 lakh) through the Credit Appraisal & Rating Tool (CART) model. The same model shall be suitably modified by SIDBI to cover i) green field projects, ii) working capital assessment and iii) composite loan.
- For tiny units, individual banks may develop suitable rating model for quick appraisal. SIDBI will also develop a simplified appraisal model for adoption by banks. SIDBI has developed certain automated systems for loan documentation processes and the same may be offered to the banks. After studying the processes, if the banks are interested they may effect the necessary modifications.

- After the CART system, comes the branch credit committee that is "centralized loan processing cell". This cell decides on the final feasibility of the projects and thus, the loan/credit is granted for that project.
- Documentation is the last step of the credit grant process.

In order to pursue the stringent risk management in providing loan assistance, the SIDBI has adopted risk management system in line with the Credit Risk Management (CRM) policy and comprehensive Credit Risk Management Systems and Operational Risk Management Systems, developed by CRISIL Ltd. Its credit risk management system lays down the Bank's Risk Philosophy and covers inter alia, the credit risk organization, risk measurement, exposure limit framework, and pricing of the loan. In addition to CART, the bank has developed some software tools known as Risk Assessment Models for credit risk rating of various borrower segments. There is also a Risk Management Committee comprising senior executives of the bank which guides the risk management functions of the bank and also overseas and monitors the effective implementation of the CRM policy.

The mettle of efficient risk management system is measured thorough the efficient recovery of dues and curbing of non-performing assets (NPAs) to the greatest possible extent. As far as SIDBI's risk management system is concerned, it has an important tool of assets management in which due emphasis is given on credit monitoring in the following ways:

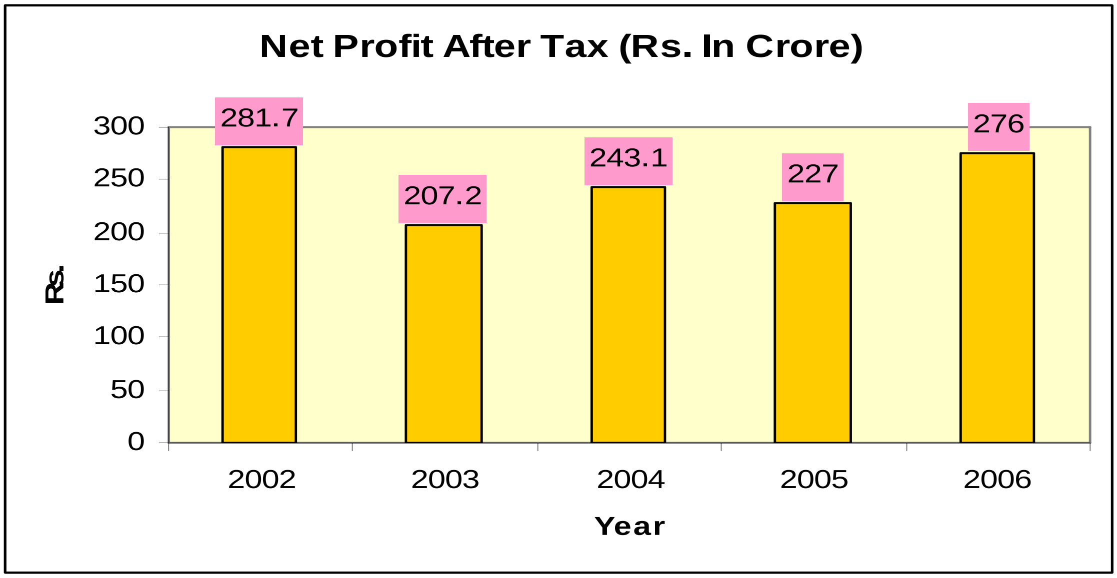
- As a part of the intensive monitoring system, slippages of accounts into NPA category are being restrained by identifying stressed assets periodically. In addition, SIDBI has designed a system of identification of trigger points to help Regional Offices and Branch offices to contain individual accounts from slippage into NPA category along with an indicative list of early warning signals.
- It has set up well defined distribution of monitoring responsibilities required at Branch level, Zonal level and at Head Office depending on loan size and monitoring.
- It has set up default review committees at branch and zonal offices to review all direct finance cases at monthly intervals.
- Finally, it has established a system of study of 'failure-cause analysis" in respect of fresh NPA cases for taking preventive measures.

Financial Analysis of SIDBI

The standard way of financial analysis is ratio analysis of financial statements of any corporate entity. Here, in this case, the author has analyzed almost last five years financial statements.

Net Profit after Tax

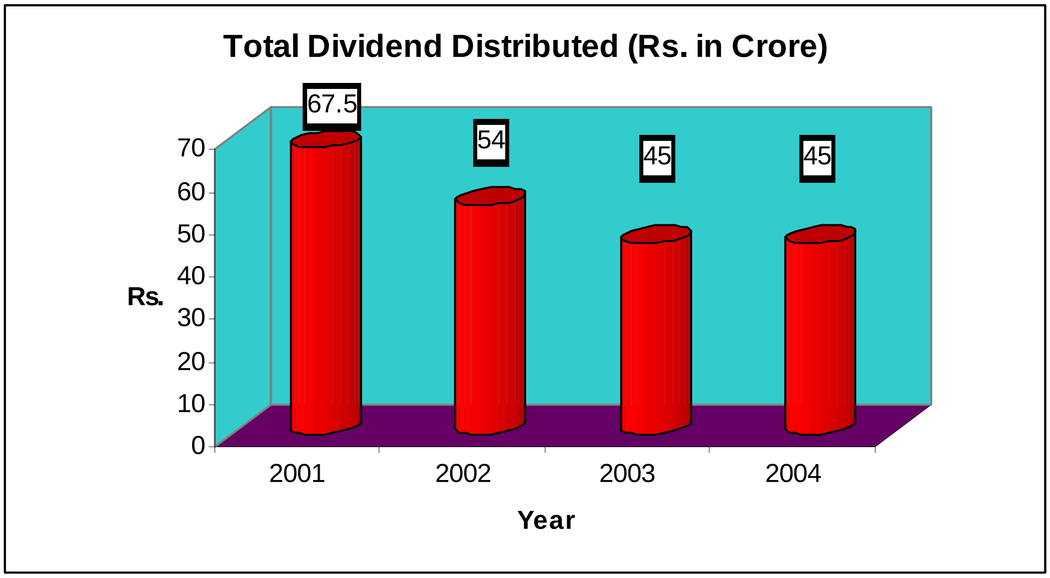
Figure-6 Net Profit after Tax situation of last five financial years



Net profit after tax for SIDBI over the years have been pretty fluctuating as seen in the above **figure-6.** If we look at the Net Profit position of the SIDBI of the last five years, we will find that Net Profit has registered downfall in two years as compared to its previous year. For example, the net profit declined in the FY 2003 by 26.44% from the previous year's Net profit. Again as seen in the figure, the net profit shows reduction in the FY 2005 by 6.6% as compared to its previous FY 2004. The underlying reasons for such deviations are presence of large number of entries of private sector banks and their thrust of industrial financing, change in the bank's portfolio i.e. introduction of new schemes for new target market like women entrepreneurs, ex-servicemen etc. and shift in the consumer's needs where by they want everything under one head. However, in the financial year 2006, net profit has shown northwards movement by 21.58 % due to its sound risk management system and judicious use of available resources.

Dividend Distributed

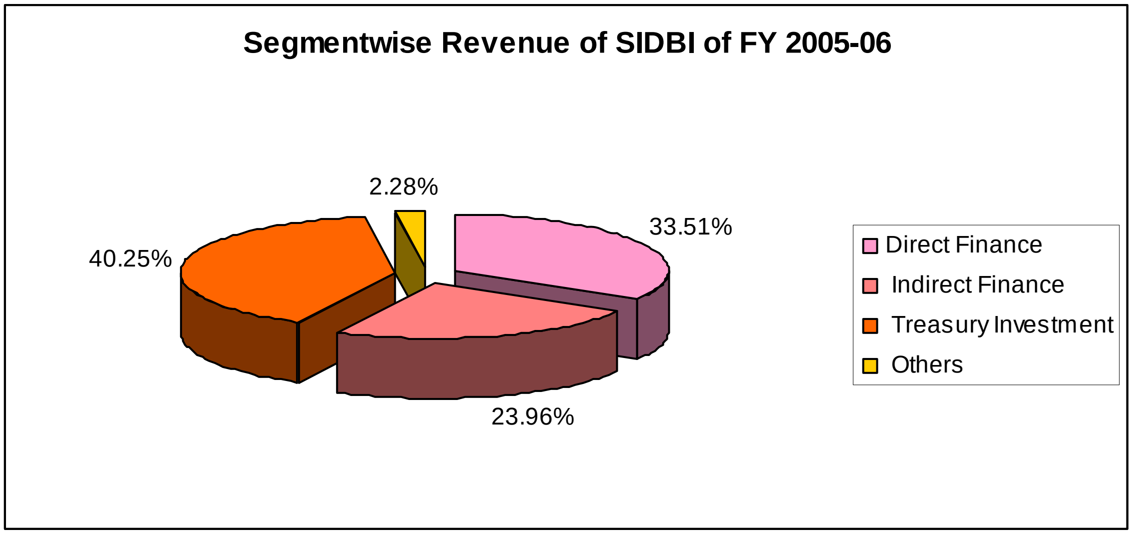
Figure-7 Dividend Distribution of SIDBI since Last four years



The total dividend distributed by SIDBI has been decreasing for two years consecutively which results from the decline in the net profit of the bank. The dividend distributed for the FY 2001 has been 67.5 Rs. that declined to 54 Rs in FY 2002 which was a 20% decrease and this further came down to 45 Rs. in FY 2003 i.e. 16.67% decrease and this remained constant even in FY 2004. The reasons for such a decrease have been the overall performance set back due to low profits which resulted in low sales in services.

Segment wise Revenue

Figure-8 – Revenue Segmentation of SIDBI

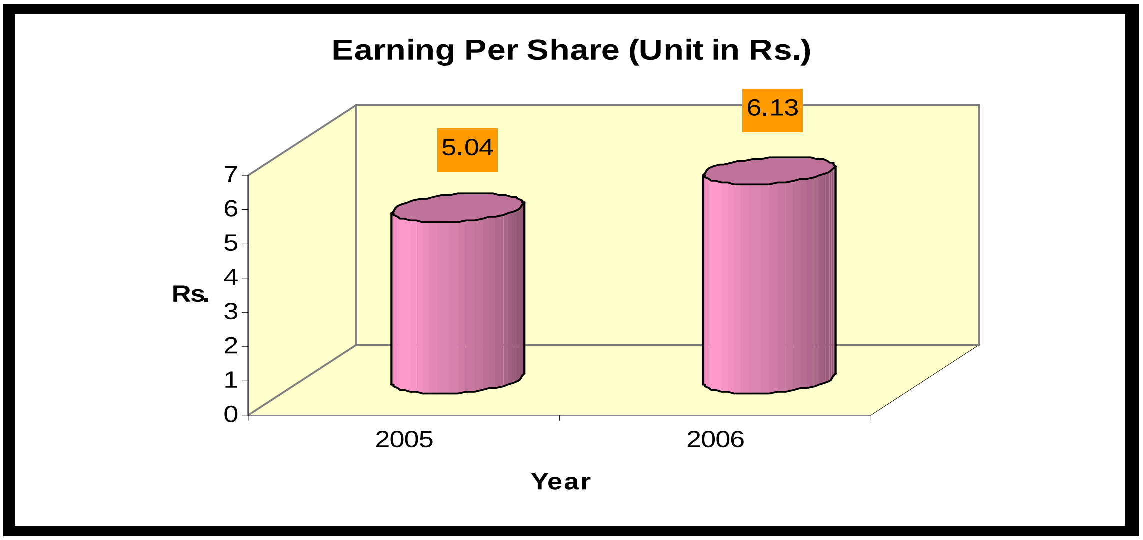


The segment wise revenue for SIDBI is divided in 4 sections namely, direct finance, indirect finance, treasury investment and others nominal sources. The figure clearly reveals that it is actively engaged in refinancing (indirect finance) business where the bank has employed Rs. 8428 Crore in FY 2006 as compared to Rs. 6981 crore in FY 2005. Such huge capital employed in indirect finance has contributed 40.25 %(Rs. 231 crore) of the total revenue generated in the FY 2005-06. The next performing segment is the direct finance whereby SIDBI directly assists small and medium enterprises. It contributes the 33.51 % of total revenue. Like wise, treasury investment and other sources of revenue have share of 23.96 % and 2.28 % respectively in the overall pie of SIDBI's revenue.

Earning Per Share

Earning per Share is the true measure of the net profitability of a company available to its owners who are commonly known as Equity Shareholders. Theoretically speaking, higher Earning per Share (EPS) reveals the better profit available to shareholders after distributing dividend to preference share holders.

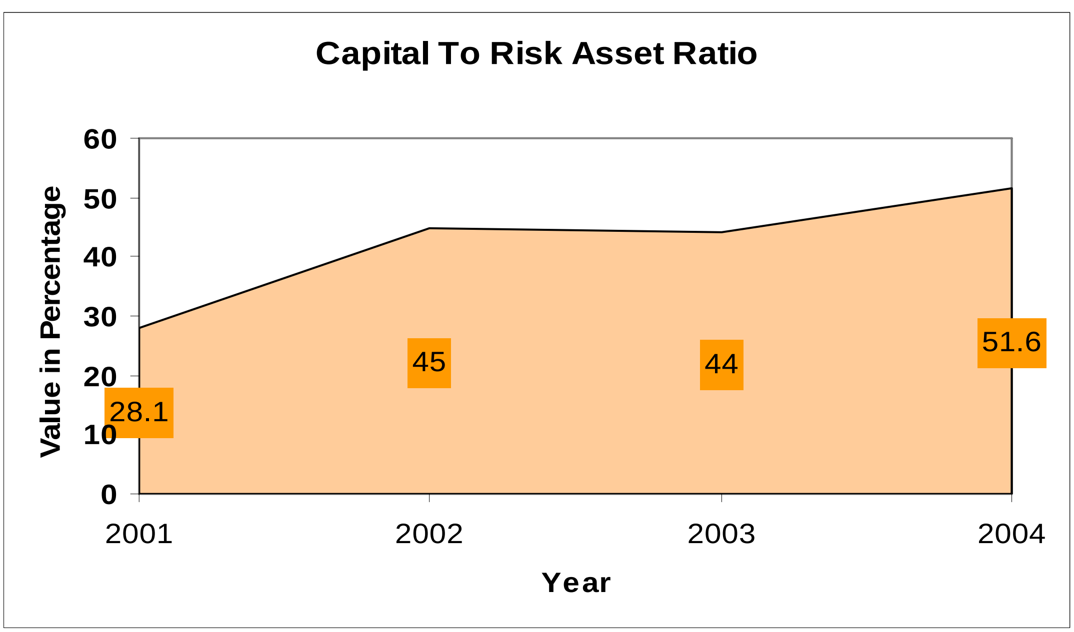
Figure-9 EPS position of last two Financial Years



As far as SIDBI is concerned, its overall shareholding belongs to financial institutions, (6.42 %), Insurance Companies (21.43 %), and PSU banks (72.15 %). Their return per share in FY 2005 is Rs. 5.04 registering 21.62 % growth in FY 2006 reflected from Rs. 6.13 EPS in the same year.

Capital To Risk Asset Ratio

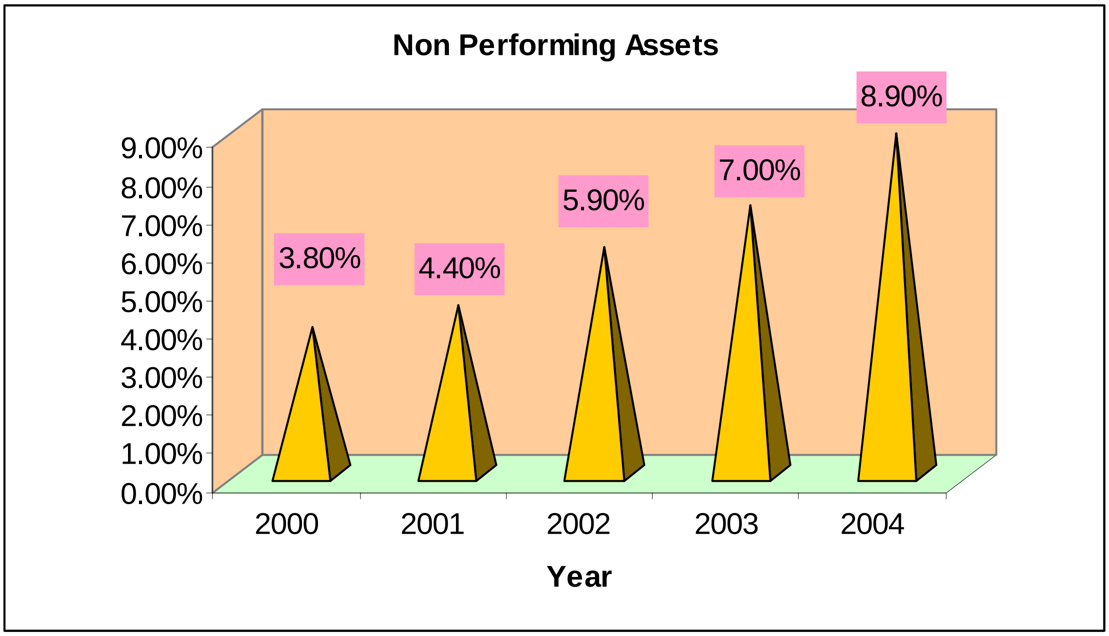
Figure-10 CRAR of SIDBI since 2001 to 2004



In banking business, the amount of capital maintained against the various types of risky assets as per their risk weights is known as the Capital to Risk Asset Ratio (CRAR). SIDBI is in the business of financing and refinancing small and medium enterprises where the amount of risk involved can not be fully identified. The bank has been setting aside appropriate amount as capital to risk weighted assets over the last four years. CRAR has increased from 28.1 % in the year 2001 to 51.6 % in the FY 2004, which shows that they have adequate risk carrying capacity in comparison to the risky assets.

Non Performing Assets

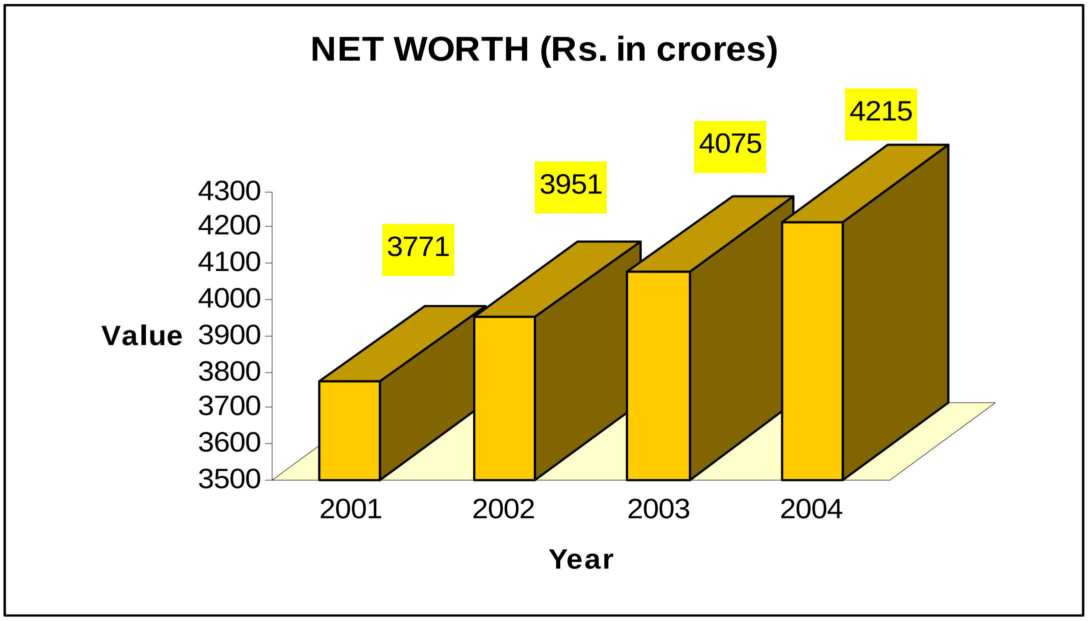
Figure-11 SIDBI's Non Performing Assets Scenario from 2000 - 2004



Non performing asset, in common parlance means, any asset that is not effectively producing income. The asset is "non-performing" if interest or installment are due but unpaid for more than 180 days. In the case of SIDBI, the NPA is increasing every year since FY 2000, reason being increase in amount of loans and disbursements. Usually, lower level of NPA is considered as a proof of efficient working in the banks but considering the level of competition in the market, the increasing level of NPA are satisfactory in comparison to the revenue generating accounts. The moment this revenue generating accounts also fail to deliver and get into Non-paying assets is a time to evaluate the bank's performance.

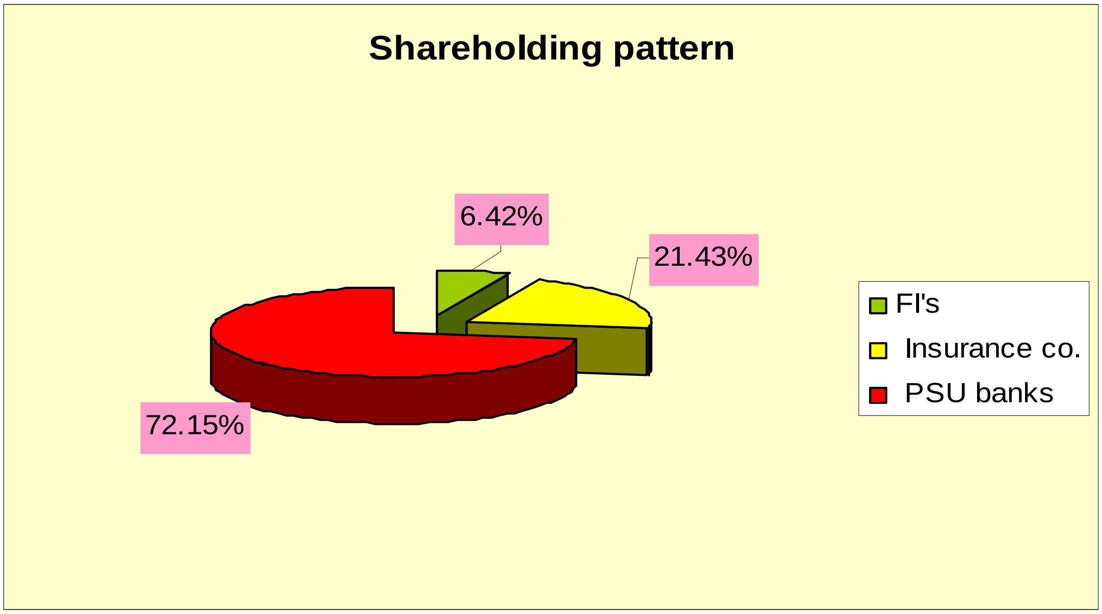
Net worth

Figure-12 Net worth position of SIDBI from 2001-2004



For a company, Net worth means total assets minus total liabilities. Net worth is an important determinant of the value of a company, considering it is composed primarily of all the money that has been invested since its inception, as well as the retained earnings for the duration of its operation. Net worth can be used to determine creditworthiness because it gives a snapshot of the company's investment history. This is also called owner's equity, shareholders' equity, or net assets. SIDBI's net worth is on an increasing trend since FY 2001 as seen in the above **Figure-12.** The shareholding pattern for SIDBI's net worth shows PSU banks having majority of the stake with 72.15% (**Figure-13).** Secondly insurance companies have considered SIDBI as a viable option to invest because of its timely payment of dividend, rising earning per share and stable operating profit. And lastly, even financial institutions have started showing interest in the workings and returns from investment in SIDBI. This shows that the banks performance has been impressive over the years and is continuing the same trend.

Figure – 13 Shareholding Pattern of SIDBI as on 31st March, 2004



SIDBI – Move of aggressive refinancing

The business landscape has been transformed worldwide. It is an age of cooperation rather than competition. It is the age of synergy where two or more than two business houses collaborate and use each other's competitive advantages either to penetrate in the new market or to expand the product portfolio. SIDBI has realized this fact on time. It has till today made strategic alliance with leading public sector banks, private sector banks, venture capitalist and Non-Banking Financial Companies. The purpose may vary from partner to partner but ultimate goal remains to enhance the credit flow to small and medium enterprises of first generation entrepreneurs as well as existing players.

SIDBI, which signed a MoU with UCO Bank and BANK of India (BoI) to increase the flow of credit to SMEs, has started cooperation with newly established nine branches. The two banks have set an incremental lending target of Rs 3,000 crore for this sector in 2005-06.

As per the MoU, either SIDBI or BoI would finance the term loans, while BoI would exclusively meet the working capital requirements of SMEs. Financing of term loans will carry an interest of 9.5 per cent (fixed) and working capital 10.75 per cent (floating). BoI and SIDBI will also jointly work to extend the reach of micro-credit through branches.

BoI hoped to see an increase of Rs 3,000 crore in its lending to the SME sector. Currently, the bank's credit exposure to SME units is about Rs 12,600 crore, while for the small-scale industry (SSI) , it is Rs 6,000 crore.

This shows that banks are looking at the SME sector as a commercially viable sector.

This is part of RBI's initiative to further smoothen the flow of credit to SSIs, which primarily depend on finance from banks and other financial institutions. Under the proposed scheme, banks will be encouraged to establish mechanisms for better coordination between their branches and those of SIDBI that are located in the 50 clusters identified by the Ministry of Small Scale Industries.

The existing branches of SIDBI (re-designated as Small Enterprises Financial Centres) would take up co-financing of term loan requirements of SSI units, along with the bank branches. The banks will meet the working capital requirements of these units.

Further, the branches of commercial banks will leverage the expertise of SIDBI in appraisal of credit requirements of SSI units by payment of a nominal fee. SIDBI will help banks in simplifying the application forms, documentation and disbursement procedures.

Under this tie-up, IDBI and SIDBI will offer anywhere banking facility for SMEs. SIDBI's current account with IDBI will allow its assisted SMEs to avail themselves of banking services through IDBI Bank branches in their vicinity, said an IDBI press release.

The alliance will also focus on joint initiatives in the areas of micro credit, cluster development and other development initiatives.

SIDBI and IDBI will create a joint mechanism for appraisal of projects including merchant banking.

One another leading public sector bank State Bank of India (SBI) signed a memorandum of understanding (MoU) with Small Industries Development Bank of India (SIDBI) for co-financing small and medium enterprises in Andhra Pradesh, Tamil Nadu, Uttar Pradesh, Jammu & Kashmir, Jharkhand, Delhi and Bihar whose development is the need of the hour to ensure the regional balanced growth and eliminate regional development disparity.

The agreement would help to bring in transparency in the working of SME units. which would in turn reduce the risks associated with funding SMEs and make credit available to them at better interest rates of interest in all the states mentioned above.

In addition to it, Punjab National Bank (PNB) also entered into a memorandum of understanding with the Small Industries Development Bank of India (SIDBI) to strengthen efforts to support small and medium industries. Both of the institutions would jointly explore possibilities for extending credit to SMEs.

SIDBI has not restricted itself to the public sector banks but also spread its wings and allied with private sector banks such as Yes Bank and Non Banking Financial Institutions. In order to promote infrastructure and financial support to develop textile parks it has made strategic alliance with IL&FS. Under a MoU signed between the two institutions, it was agreed that IL&FS will give infrastructure and marketing support and SIDBI will provide short-term and long-term capital to textile parks.

In order to ensure effective implementation of MOU signed between SIDBI and IL&FS, they have already identified seven textile parks — four in Tamil Nadu, two in Andhra Pradesh and one in Karnataka — for development. The entrepreneurs in the park will form a special purpose vehicle to develop the park. Each of these parks will have land, infrastructure such as road, water supply, power supply, telecommunication, factories, plant and machinery for individual entrepreneurs. They will contribute 20 per cent of the entire cost of setting up and maintaining the park. The Government grant forms 40 per cent and institutions will meet the remaining 40 per cent. If required, SIDBI and IL&FS will also prepare to pick up equity in the SPVs. The SPV will also provide other linkages such as marketing of the finished goods, once the park is set up.

It is important to note here that exports from the textile industry are likely to increase by Rs 15,000 crore once the textile parks are set up. Thus, SIDBI-IL&FS MoU will help not only financing the gap between government grant on reimbursement basis and overall financing requirement of the project but also overall competitiveness development of the textile sector in India.

Non Banking Financial Companies have unique status in Indian Financial system especially in terms of autonomy of operations, risk management and debt recovery. SIDBI began to give loans to SMEs directly only three years ago. (Earlier, it was only refinancing banks.) Now its direct-lending portfolio stands at Rs 4,660 crore, more than a third of its total loan portfolio of Rs 13,890 crore. Today, one out of every two rupees lent by SIDBI is loaned directly to borrowers.

The bank intends to raise its direct lending portfolio to 70 per cent in three years. To do this, it needs geographical reach. SIDBI today has 56 branches — 12 of which were added last year — and it has committed to the government that it would put in place 100 branches by 2007-08. However, even 100 branches are not enough to disburse loans directly to borrowers. Hence it started tie-up with NBFCs. SIDBI tied up with Sundaram Finance Ltd under which the Chennai-based NBFC would originate loans for a fee.

In a bid to increasing loans given directly to small and medium enterprises, the Small Industries Development Bank of India (SIDBI) intends pacts with more non-banking finance companies (NBFCs) for loan origination.

As an important development in the bank's effort to seek strategic alliance , seven of the country's leading public sector banks are set to propel the Small Industries Development Bank of India (SIDBI) to its next orbit in funding the growth of the small and medium sector. The seven banks that are likely to join hands with SIDBI are State Bank of India, Punjab National Bank, Canara Bank, Bank of Baroda, Union Bank of India, Oriental Bank of Commerce and Bank of India.

The tie-ups with the banks, which are in an advanced stage of negotiations, will help formalize a comprehensive package to boost the credit flow to the SME sector. Once the plans are set rolling, there would be enough comfort for lenders to fund units in the SME sector. SIDBI is tying up with SBI, PNB, Canara Bank, BoB and Union Bank to participate in the corpus of the proposed **VCF - the SME Growth Fund**. The CRA tie-ups are being formalised with PNB, Canara Bank, OBC, BoB, BoI and Union Bank.

The VCF would provide support to start-ups that have good growth and export potential. It would start with a corpus of Rs 100 crore which we plan to raise to Rs 500 crore in two to three years. The fund, which will identify SME sector projects in areas such as agriculture, biotechnology, food processing and auto ancillaries, is to be launched in September.

SMALL Industries Development Bank of India and Yes Bank has tied-up to provide credit and other financial products to the small and medium enterprises sector, under a new co-brand called Yes SIDBI. This is the first tie-up between SIDBI and a private bank. This tie-up is different from other tie-ups because Yes Bank has special skills in derivative products and technology, which SIDBI lacks. Bundling of products is the global concept and they offer that to the SME sector through the medium of SIDBI. On the other side, with this tie-up, YES Bank will accelerate their focus on the SME sector. Whose exposure to the emerging corporate entities and the SME sector is around Rs 350 crore.

Looking into the growth prospect of the SMEs in India and credit availability as a major constraint, the Reserve Bank of India is drawing up a scheme to forge a strategic alliance between the branches of different commercial banks and those of SIDBI to enhance the flow of credit to the small-scale industries (SSI).

Direct lending

In addition to aggressive indirect financing or refinancing, SIDBI since its inception 1990 has launched a series of innovative products and schemes for directly catering to the credit requirements of different segments of the SSI sector. During the year 2004-05, the bank continued these initiatives with renewed efforts in the direction of simplifications of the schemes, decentralization of powers, opening of new branches and other steps to expand bank's direct reach to the customers. The bank has put in place its Credit Appraisal and Rating Technique (CART) in direct lending that analyzes credit worthiness of the proposals. With the high level of automation in the bank, the said model has facilitated SIDBI to take up the appraisal, document verification and the disbursement on a fast track basis.

One of the reasons for SIDBI's penchant for direct lending is the loans' amenability to better control. For instance, only six accounts together involving an amount of Rs 1.97 crore, turned non-performing in its direct-lending portfolio.

Secondly, with rating mechanism in place for small and medium enterprises popularly known as SMERA[5], SIDBI feels more comfortable lending directly to borrowers.

Finally, if we take a look at the efficiency aspect in terms of return generated from the total investment of each segment, some surprising facts come up to the surface. **Table - 1,**

Table: 1 Segment Reporting with Return on Investment (ROI) of each segment as well as Total ROI

(Rs. in Crore)

Seg. No	*Segment*	*Year wise Segment Assets*		*Year wise Segment Revenue*		*Return on Investment*	*Return on Investment*
		2005	2006	2005	2006	2005	2006
1	Direct Finance	3901	5463	220	323	**5.63 %**	**5.91 %**
2	Indirect Finance	6981	8428	237	231	**3.39 %**	**2.74 %**
3	Treasury/ Investment	5644	4738	465	388	**8.23 %**	**8.18 %**
4	Others	1638	1723	26	22	**1.58 %**	**1.27 %**
	Total	18,164	20,352	948	964	**-**	**-**
	ROI	**-**	**-**	**-**	**-**	**5.21 %**	**4.73 %**

In spite of the SIDBI's primary role is to refinance for promotion of small and medium enterprises by way of primary lending institutions, cooperative banks, commercial banks, and public sector banks, it has aggressively started direct lending since three years back because the return on investment is higher than the returns generated from indirect finance. For instance, ROI in direct finance in FY 2005 and FY 2006 is 5.63 % and 5.91 %

respectively whereas ROI in indirect finance in the same years are 3.39 % and 2.74 % respectively. Additionally, it is also found that the ROI is declining over the years in indirect finance unlike the growing trend in revenue generation with the increased used of direct finance segment. The most rewarding segment is SIDBI's treasury and investment segment where annual ROI in FY 2005 and FY 2006 is 8.23 % and 8.18 % respectively. The investments were made mostly in government securities, debentures and bonds and investment in subsidiaries/joint ventures. One may raise the point that if the return on investment is relatively high in treasury/investment segment, SIDBI should invest more in this segment. However, it should be noted that SIDBI is not the commercial banking entity but development financial institution. Thus this is not its main activity so it can't pursue this exercise. The last segment named as 'others' contributes 1.58 % and 1.27 % ROI in FY 2005 and FY 2006 respectively. Overall ROI – a measure of revenue generated from the total capital invested is 5.21 % in FY 2005 and 4.73% in FY 2006 which shows nearly 10 % decline in the ROI as compared to previous year's ROI. It can be easily concluded that the bank has been generating lower revenue with higher investment from indirect financing and more return from direct financing with relatively lesser capital employed in this segment. So, it must start focusing on direct financing since it is more rewarding as well as socially viable than refinancing where processing time is more due to intermediation of different types of banking entities.

To a common reader, it seems as a contradictory phenomenon. On the one hand, SIDBI is trying hard to stimulate credit growth through refinancing or indirect credit by way of forging strategic alliance with PSBs, Private sector Banks and NBFCs where Return on Investment is unattractive and declining and on the other hand, it is not focusing adequately in direct financing except few cosmetic measures where ROI is highly attractive and rising year on year basis.

In this age of immense competition, survival is the key for any organization be it public or private. Same goes in case of SIDBI and other banks that are in its competition now. Though with a strong background, SIDBI's image hasn't shifted in the minds of the masses. The awareness level is still low and it will take a lot of aggressive marketing to actually build a place in the consumer's mindset. Secondly, SIDBI being into only industrial financing, cannot compete directly with commercial banks providing them with all kinds of deposits and schemes as the mission of SIDBI is different from other banks.

Other than that, SIDBI always catered to small enterprises and when the small industries turned into medium enterprises, the bank's role seemed to vanish. This became tough to target the same company's again as the scope of

SIDBI remained only till the small industries start performing. In nutshell, it can be concluded that SIDBI's role towards SMEs has become to "Catch them young and Watch them grow".

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