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Financing of SMEs and Credit Risk: The Inevitable 5Cs

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Abstract

Financing of Small and Medium Enterprises, popularly known as SMEs, is a priority for banks. These little growth engines play a crucial role in the overall economic development of the country as they contribute greatly in terms of output, exports and employment. But as the sector is characterized by information asymmetries, high processing cost and unsophisticated management; financing of SMEs remains a major policy concern. Whenever we talk of strategic areas for SME Banking performance, Credit Risk Management emerges out to be an important one. Assessing credit risk involved in the proposal of small entrepreneurs is a challenging task which is culminated by means of a proper study of the famous five Cs– Character, Capacity, Capital, condition and Collateral. The paper analyzes these inevitable factors in relation to the financing of SMEs.

1. INTRODUCTION

Small and Medium sized business are the backbone of any country's industry as they play a crucial role in the overall economic development of the country. According to United Nation Industrial Development Organization (UNIDO) estimates, SMEs around the world account for almost over 90% of all enterprises and 50-60% of total employment. In India too the sector contributes greatly in terms of output, exports and employment therefore the acceptance of SME sector as the engine of economic growth is not without reasons. It is the only sector with an employment potential at a low capital cost.

Banks in India have been growing from strength to strength, acquiring and justifying newer and more challenging roles. It is often said that one of the objective behind nationalization of major banks was to help small business prosper. Over the years a number of schemes have been formulated and implemented for promoting and assisting entrepreneurship. Despite all this we cannot ignore the reality that the techniques of credit appraisal suggested by various committees are applicable only to the assessment of large proposals. It is true that the basic principles for appraisal would remain the same but the approach will have to change. Assessing credit risk involved in the proposal of small entrepreneurs is a challenging task which is culminated by means of a proper study of the famous five Cs– Character, Capacity, Capital, condition and Collateral. The study of these factors is inevitable while financing SMEs.

2. CREDIT RISK : WHY SO CRITICAL

Credit risk is defined in simple terms by the Basel Committee on Banking

Supervision (BCBS) as “the potential that a bank borrower or counterparty will fail to meet its obligation in accordance with agreed terms”. So credit risk arises from the possibility that a borrower is either unwilling to perform an obligation or his ability to perform the obligation is impaired. In both the cases the bank stands at loss.

In such a scenario the bank not only loses the loan amount but also the profit it could have earned by simultaneous investment of this amount. Thus credit risk is a risk of major economic loss which banks sustain from the failure of counter party (borrower) to fulfill its contractual obligations. In order to avoid such risk banks have to be cautious. The first line of defense against Credit Risk is a good credit granting process and efficient approval preceded by meticulous evaluation of the proposal.

Credit risk has two components being Business Risk and Borrower Risk. Business Risk is associated with inability arising out of income generation capacity of the business which night be affected by adverse internal or external conditions of the business. While Borrower Risk is based on the promoters /owners and management of an enterprise. This emphasizes the need to know a borrower and to know him vis-a-vis his business. For the purpose of judging and analyzing a borrower the combination of five Cs plays a pivotal role.

3. FINANCING OF SMEs

Over the years financial institutions have been playing an important role in providing financial assistance as well as counseling to entrepreneurs for starting new business as well as for expanding or modernizing an existing one. Banks, in general and Commercial Banks in particular have been assisting the promotion of small and medium enterprises. But as the sector is characterized by information asymmetries, high processing cost and unsophisticated management financing of SMEs remains a major policy concern. Still, keeping the important role played by the sector in mind the question arises can SMEs be banked profitably and safely, can credit risk be avoided while financing the sector?

Though financing small enterprises and managing the risk involved too seems to be a key concern for banks yet they remain to be a priority sector. For solving this problem banks need to follow a process which starts with generating a clear understanding of the SME market. A compact view of this process can be seen in figure 1.

As we can see the process begins with defining the SME sector and understanding its needs and culminates with the modeling and managing of risk. At the centre of the process is the step of screening the SME clients which is of great

Figure 1

Stages of the SME Banking Value Chain Risk Management

Understand the SME Market	Develop product and services	Acquire and screen SME clients	Serve SME clients	Manage information and knowledge
· Define the SME sector · Research SME needs and preferences · Sub-segment the market	· Design and bundle lending and non-lending products · Ensure profitability of product offering · Develop SME-specific lending technologies	· Market product and service offering to clients · Build a growing and diversified portfolio · Distinguish profitable from unprofitable prospective clients	· Meet the needs of existing clients · Cultivate new business through cross-selling · Monitor loans · use teams organized for front and back end servicing	· Model and manage risks using portfolio data · Use current customer data to adapt service approaches · Analyze and respond to profitability data at segment, product and client level

Source : The SME Banking Knowledge Guide, IFC importance in the management of credit risk. At this stage a distinction between profitable and unprofitable prospective clients is made by thorough assessment.

4. THE 5 CS

Whenever we talk of strategic areas for SME Banking performance, Credit Risk Management emerges out to be an important one. For this evaluation of proposal is necessary, by evaluation we mean careful selection of borrowers by understanding their creditworthiness. During evaluation the bank does not assess the ability alone but also the willingness of the client to repay. As pointed out earlier the five Cs play a very decisive role in the management of credit risk so let us analyze them individually in relation to SME financing.

a) Character: It is rightly said "Character makes the Man". The first of the Cs is always character as it is the main criteria of determining the credit worthiness of the borrower. It alone spells out how the borrower would respond to a situation where all the other Cs have turned bad. The analysis of character rests on traits such as honesty, reasonableness, acumen, industriousness, integrity, attitude and commitment. Character of the borrower is reflected in two ways :

a) Disclosing of business affairs with the banker, and

b) Use of funds for the purpose approved

Analyzing the character of a SME borrower requires special care as most of the account are not audited and in such a case losses can be hidden to face lift a Balance Sheet. The problem of the first C becomes even more challenging for the bank when dealing with first generation entrepreneurs as there is no record of post dealings with any bank. In such cases the personal prosperity of the director/ entrepreneur plays a decisive role. Their succession plan, age and health also matters. It becomes necessary for the bank to ensure that the business of the entrepreneur should not end with his life.

The other code relating to proper use of funds is also at times violated by SME clients, but this may tarnish their image forever. By proper monitoring banks can keep a check on unauthorized use of funds. The assessment of character is highly subjective task and very vital too so much concern and effort goes into it.

DOs for SMEs

- Being honest and upfront about the past performances of the business, problems in business (if any) and credit history.
- Ensuring utilization of funds for the purpose for which they were sanctioned. Otherwise they would be losing business character.

b) Capacity: Here capacity does not means just the legal status of the borrower to enter into contract, rather it includes the ability of the business to generate sufficient cash flows to service the obligation. Here it must be noted that profit is not the main criteria for judging capability, as not the entire profit is available in cash, a portion of it is blocked in current assets. This point is often missed by the SME owners. They end up depicting high profit figures which does not go down well with the bankers as it is not by profits one can repay loans but by cash. Bankers require a detailed financial forecast and a cash flow statement since it is the real measure of the ability of a business to repay its obligations. Also the banker has to be ensured as to how the obligation will repaid if the business does not develop as planned.

DOs for SMEs

- Showing realistic profit figures not high profit figures, as it is not the profitability but encashability on which the repayment capacity of the borrower depends.
- A detailed cash flow analysis should be ready along with a back-up plan is case business fails to grow as planned.
- The repayment plan should be structured in such a manner so that it does not impose undue strain on the business.

c) Capital : Capital represents the money that the borrower has himself put in the project. Often referred to as net worth it is the financial factor which provides the ability to absorb unanticipated losses. At the same time the amount of capital contributed by the owner to a large extent indicates his commitment towards the business. It is not just the equity capital that the banks look into. To an analyst net worth in isolation conveys nothing; it must be compared with the volume of debt of the business. Thus the equity debt ratio is very important indicator; a downward trend of the ratio spells danger to any banker. This is so because debt capital must be repaid to the lender, also it comes at a cost, i.e., interest, therefore the more the debt in relation to equity, the higher the level of risk. Looking into the capital structure of a SME borrower becomes all the more important, as often Moral Hazard is associated with SME financing. To some extent the contribution assure the banker against any reckless behaviour at a later stage.

DOs for SMEs

• Making sufficient and justifiable contribution to the capital as this ensures the bankers of the financial commitment and involvement of the entrepreneur in the business.

• Monitoring the equity debt ratio and arresting any downward trend in the ratio as this shows the enterprise as becoming more and more vulnerable to shock which could lead to a negative assessment by the bank.

d) Condition: The conditions surrounding any business have a great impact on the success or failure of any business. The prevailing trends in the sector of the borrowing enterprise as well as the overall economy are crucial factors. Opportunities and threats may arise from external factors such as competitive conditions, technology, demand for the product, regulations and economic changes. Although these are largely uncontrollable yet the banker should be aware and alert about these. Cyclical fluctuations are encountered by almost every business; the banks should know which side of the cycle is the borrowing enterprise operating in. Particularly in case of small business, bankers are extra cautious in analyzing the surrounding conditions. As these external influences will have both direct and indirect effect on the performance of the business and in case of small enterprises due to concentrated market area and lack of diversity in product/services even small problems have great impact. Obsolescence especially in terms of technology is another area of concern in case of small enterprises. Even CII through its study, Technology Imperative of MSMEs has asked the sector to harness technology to a greater degree.

Dos for SMEs

• Being aware of the external factors which influence the business is a must, fighting the known is always easier than fighting the unknown.

• A ready assessment of the market and how the business will cope with the potential changes in market condition can make a good impression on the bank.

e) Collateral : It refers to the asset or security which the borrower may charge or pledge against the loan. Although it reduces credit risk to a great extent yet collateral must not drive lending decisions, collateral is meant to enhance the creditworthiness of the borrower. If the business is unable to generate enough cash to repay the credit facility then the lender (bank) may have recourse to the collateral. In such a scenario saleability/ marketability of the collateral is an important criterion, higher the marketability the better the collateral. Therefore bankers do not view immovable property as good collateral. The non availability of collateral is a big impediment in the path of obtaining credit by small entrepreneurs.

Although collateral is meant to compensate/ mitigate the weakness in the other four credit factors yet in case of SMEs the bank's perception of high default risk translates into high collateral requirement. In a recent research conducted by Dun and Bradstreet in 2010 in NCR and Mumbai region collateral requirement emerged as a major obstacle in front of SMEs while applying for loans.

5. BANKING ON THE Cs

As we have seen in our discussion financing of SMEs truly seems to be an account of the 5 Cs. Out of the five Cs, character, capacity and capital are considered to be the most important variables in judging the creditworthiness of borrowers. Based on detailed, complete and accurate information about these three Cs the bankers can decide whether to grant the loan or not. Many researchers have

Figure 2

Decision Table for Lending Decision based on Character, Capacity and Capital

Risk Category	Risk Character	Variables Capacity	Capital	Decision
0. Excellent	Strong	Strong	Strong	Accept-Minimum control
1. Very Good	Strong	Strong	Strong	Accept-Moderate control
2. Good	Strong	Weak	Strong	Accept-Tight control
3. Fair	Weak	Strong	Strong	Accept as the last option –Tighter control and monitoring
4. Doubtful	Weak	Strong	Weak	Can be accepted under exceptional circumstances continuous control and monitoring
5. Poor	Weak	Weak	Weak	Reject

Source : Banking Strategy, Credit Appraisal and Lending Decisions, Hrishikes Bhattacharya.

developed decision trees based on these three Cs. An adapted presentation of these combinations is made in figure 2.

6. CONCLUSION

To sum up, we can say that credit risk management will always be a thrust area for banks since the lack of it may deteriorate its asset quality. Credit risk also being intricately linked with interest rate risk and liquidity risk becomes even more critical to banks. At the same time it is equally true that SMEs have been an important plank in Industrial Policy of India and finance is a critical input for this sector. For banks to become partner in their development a proper system of credit risk management should be set in place by banks and from the side of SMEs to make the partnership possible they have to prove good on the touchstone of the five inevitable Cs.

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