Throwing good money after bad

Unless bank credit is sensibly directed at small units, it only ends up encouraging inefficiency

THILLAI RAJAN A / DEEPA RAJU

At the outset, the case seems fairly straightforward. The crying baby needs to be fed. We are talking about the small and medium enterprise (SME) sector, which forms the backbone of India's economy.

SMEs employ over 45 per cent of the workforce, contribute to over 40 per cent of the exports, but account only for 17 per cent of the country's GDP. The chorus that SMEs in the country face tremendous constraints, which prevent them from scaling up, is getting louder. The consensus seems to be that, among other things, growth is hampered by the lack of capital. The latest census of the SME sector would seem to support that — only 22 per cent of SMEs have taken loans from institutions and banks. According to the RBI, only 19 per cent of the total bank credit has been to the micro and SME sectors.

In a comprehensive study on bank credit to SMEs, we analysed both the yin and the yang: How does bank credit help SMEs? Where does it falter?

Credit and growth

The evidence on bank credit and growth is very strong. Small enterprises that received bank credit have grown seven times as fast as those that did not. For medium enterprises, the difference in growth rates was more than twofold.

The reasoning is not difficult to fathom. Access to capital helps SME firms make larger investments, thereby enabling them to achieve faster growth. This is also reflected in the comparative sizes of firms. The gross output of small enterprises with bank loans was more than twice as large as the output of those without bank loans. The number of employees in small enterprises with bank loans was more than double that of those firms that did not have bank credit. The trends were similar for medium enterprises as well.

The evidence seem to point to the obvious: Credit from banks provides the ammunition for growth. Bigger firms, yes. But, are they better firms?

All about efficiency

To answer this, we compare the efficiencies of firms. Broadly, efficiency is the ratio of output to input. An efficient firm achieves more from the same resources compared to a less efficient firm. It goes without saying that we would want to create an army of efficient firms.

The comparison of gross output to total input ratio shows interesting trends — firms that did not have bank credit had much higher efficiencies. How do we explain this? A possible reason could be that firms that obtain credit make sub-optimal investments; in essence, they seem to squander their capital. On the other hand, firms that have not obtained bank loans seem to handle capital with a lot of care. A poorly run firm is more likely to fail compared to firms that are efficient. A comparison of incidences of poor performance confirms this. SMEs with bank credit have a significantly higher incidence of poor performance.

We also analysed the comparative impact of bank credit on three important indicators of performance: profitability, return on assets, and asset turnover. Our dataset for this analysis consisted of a sample of 323 SME firms. Our results are similar to what was seen in census data. Bank credit does not have as much impact on performance as internal funds do. For example, an additional unit of bank credit increases the profit margin 1.33 times, whereas a unit of retained earnings increases the profit margin 25.68 times. Similar differences were seen for return on assets and asset turnover.

Not by credit alone Efficiency also counts in SMEs' performance GRN SOMASHEKAR

Extracting optimally

All our findings thus point to the same phenomena. SME firms tend to be lax with external capital such as bank funds. On the other hand, when the firms put in valuable equity, they exercise more diligence and are able to extract a lot more return from a rupee. So, the question is not just about availability of credit, it is also about the return on credit: that is, how much can be achieved on the loans given to SMEs. Simply increasing allocations to the SME sector because it is priority is not an effective way to grow the sector. Creating institutional mechanisms that ensure the most productive deployment of credit is essential. What would it involve?

First, there is a need to improve the selection process adopted by banks. Currently, banks wait for SMEs to approach them for a loan. Instead, banks should take a more proactive approach in selecting better performing companies to whom they would provide loans. For example, the incidence of poor performance shows that SMEs experiencing difficulties are more likely to approach banks. Bank lending significantly alters the incidence of failure.

Second, the loan covenants should incentivise good performance. How is it that firms are able to achieve more when they use retained earnings? Why is the slack creeping into the performance of SMEs that have bank loans?

Third, setting up specific institutions tailor-made to the SMEs would be desirable. The operating context of SMEs differs significantly from what prevails for larger firms. Lending institutions should factor that into their scheme of things. While we acknowledge that there may be practical difficulties in the traditional banking system to incorporate such changes, it is equally imperative that creative solutions be found. The proposed Mudra Bank to cater to the needs of micro enterprises is one such attempt. Setting up a similar entity exclusively for SMEs would go a long way in addressing some of these issues.

Rajan is a professor in the department of management studies, IIT-Madras, where Deepa Raju is a post-doc fellow