



CAIIB

Module-B Unit-5

Rural Banking



CAIIB Rural Banking Module B Unit 5- SME Finance

MSME

- **The Ministry of MSME came into being from 1999** to provide focused attention to the development and promotion of this sector.
- **In July 2006, the Micro, Small and Medium Enterprises Act was in place.**
- MSMEs need low capital investment, in terms of per unit of output. They make use of natural resources and domestic skills to cater to the domestic market. The growth of the sector therefore helps in socio economic upliftment as it generates employment opportunities for untapped masses, living in urban and rural regions.

Difference Between Micro, Small & Medium Enterprises

<u>MICRO ENTERPRISES</u>	<u>SMALL ENTERPRISES</u>	<u>MEDIUM ENTERPRISES</u>
The investment in plant and machinery or equipment does not exceed Rs. 1 crore	The investment in plant and machinery or equipment does not exceed Rs. 10 crores	The investment in plant and machinery or equipment does not exceed Rs. 50 crores
Turnover does not exceed Rs. 5 crores	Turnover does not exceed Rs. 50 crores	Turnover does not exceed Rs. 250 crores

Importance Of The Sector To The Indian Economy

Sixth Economic Census (2013)

- 58.5 million establishments were found to be in operation, of which, 34.8 million establishments (59.48 per cent) were found in rural areas and nearly 23.7 million establishments (40.52 per cent) were found to be located in urban areas.
- Out of 58.5 million establishments, about 77.6 per cent establishments (45.36 million) were engaged in non-agricultural activities (excluding public administration, defence and compulsory social security activities) while the remaining 22.4 per cent establishments (13.13 million) were found to be engaged in agricultural activities (excluding crop production and plantation).
- Out of the total establishments, 22.6 per cent belong to primary sector of which agriculture sector constitutes 22.45 per cent, mining and quarrying constitutes 0.15 per cent. Secondary sector accounted for 19.72 per cent (including construction which contributes 1.66 per cent) and tertiary sector accounted for 57.68 per cent.
- Out of 58.50 million establishments, around 96.4 per cent establishments were under private ownership and remaining 3.6 per cent establishments reported their ownership as Government or PSU.

- Livestock was the major economic activity (86.74 per cent) of agricultural sector. Retail Trade (35.41 per cent) followed by Manufacturing (22.77 per cent) were the dominant ones within the nonagricultural sector.
- Manufacturing sector was the largest employer providing employment to 30.3 million (23.1 per cent) persons. This was followed by retail trade employing 27.19 million persons (20.7 per cent) and livestock sector employing 19.4 million persons (14.8 per cent).

Arrangements For Provision Of Credit To The MSME Sector

- Major portion of the credit requirements of MSME sector are met by banks and credit agencies (Commercial Banks, Cooperative Banks, Regional Rural Banks, Small Finance Banks).
- Venture capital companies are also engaged in funding the formation of small and medium enterprises in their early stages of development. Development Banks and Specialized financial institutions (**SIDBI and NABARD**) provide refinance to the credit institutions in augmenting the credit flow to the sector besides engaging themselves in various promotional role for the development of the sector.

Appraisal Of MSME Loan Proposals

- First and foremost, the bankers should know the type of industry/activity which the enterprise is pursuing/intending to pursue. Whether the industrial activity pursued/intended to be pursued belongs to the category of growing industrial activity or not.
- The banks should examine the vintage proof which includes year of establishment, registration, trade licence, sales tax certificates, cash flow statements etc.
- The banks should also verify the identify the identify/address proof of the founders/entrepreneurs/ proprietor/partners of the enterprise, apart from examining their bank statements, for the last 6 months.
- The class of enterprise to which the enterprise belongs to, need to be examined. Whether the enterprise is registered as an individual enterprise or registered as an enterprise with group of individuals, partnership, private limited company, etc. need to be ascertained.
- A detailed examination of the production related, sales/marketing related issues and the debt service capacity/ productivity shall give an insight of the strengths and weakness of the enterprises to the financed, which would help the bank not only to make financial decisions but also to stipulate appropriate terms for sanction and effect close monitoring of the relevant aspects during the currency of the loan.

Project Approach for Lending and Appraisal Techniques

- Project approach can be applied for financing small as well as large investments. It is a flexible approach to development, wherein, each 'project' is considered to be an independent unit, having its own costs and benefits. Careful project preparation and analysis are important for efficient use of financial resources.
- The essential features of the methods adopted in appraisal viz., discounted cash flow techniques for arriving at the viability parameters such as Net Present Value (NPV), Benefit Cost Ratio (BCR), and Internal Rate of Return (IRR).

Investment and Cash Flow Concept

- The project should be able to service the debt and ensure expected returns to the investor. The aspects which are examined while conducting financial appraisal are investment outlay, means of financing, projected financial statements, viability and profitability, breakeven point analysis, sensitivity analysis and risk analysis. Cash flow statement is the basis for financial analysis.

Discounted Cash Flow Technique

- Time value of money is estimated by 'discounting' the future cash flows to their present value.
- Where d is the discount factor for Re 1; r is the rate of interest and n is the period which could be number of years or months.

Thus, the discount factor at 10 per cent per annum after one year will be

$$d = \frac{1}{(1 + 0.10)} = \frac{1}{1.1} = 0.909$$

Measures of Financial Viability – NPV, BCR, IRR and DSCR

Net Present Value (NPV): representing wealth creation by the Project, is calculated by taking the discounted sum of the stream of cash flows during the project life.

where C = Cash flows for different periods; r = discount and n is the number of years.

Benefit Cost Ratio (BCR): BCR is the ratio of discounted value of benefit and discounted value of cost.

$$BCR = \frac{\text{Summation of discounted value of benefits}}{\text{Summation of discounted value of costs}}$$

The project is viable when BCR is one or more than one and is unviable when it is less than one.

Internal Rate of Return (IRR): IRR represents the returns internally generated by the project. This is also the rate which makes the net present value equal to 0.

$$\text{Exact IRR by interpolation method} = \frac{[L + (H - L) * NPV \text{ at } L]}{[(NPV \text{ at } L) - (NPV \text{ at } H)]}$$

Where, IRR = Internal Rate of Return; L = Lower discount rate where NPV was positive; H = Higher discount rate at which NPV was negative.

Debt Service Coverage Ratio: Debt Service Coverage Ratio (DSCR) is a crucial ratio to assess 'Bankability of Projects'. As the name indicates, this ratio gives an indication of the debt service capabilities of the project. It can be computed as under:

$$DSCR = \frac{PAT + D + I}{I + L}$$

Where PAT is profit after tax, D is the depreciation, I is the interest on long term loans and L is the principal instalment.

Sensitivity Analysis, Scenario Analysis and Risk Analysis

- **Sensitivity Analysis:** Projects are sensitive to fluctuation in values of critical variables like costs of inputs and prices of outputs. It is important to examine as to how sensitive is the project to fluctuations in the values of these variables. A project, which is highly sensitive to even small fluctuations in cost and price, is a risky project for financing.
- **Scenario Analysis:** Scenario analysis is the process of examining and evaluating possible events or scenarios that would take place in the future and predicting the various feasible results or possible outcomes. In financial modeling, the process is typically used to estimate changes in the value of a business or cash flow, especially when there are potentially favourable and unfavourable events that could impact the project.
- **Risk Analysis:** Under risk analysis, probabilistic analysis is done by identification of key risk variables, finding out values of each risk variable, assigning probabilities for each value to each of the risk variables, using these values for risk analysis and finding out the probability of negative outcome of the project.
- **Economic Appraisal:** The objective of economic appraisal is to examine the project from the entire economy's point of view to determine whether the project will improve the economic welfare of the country. Examples of the projects where economic analysis is conducted are big dams, forestry projects and big industrial projects.
- **Social/distributive Appraisal:** The social analysis consists of two parts: measurement of the distribution of the income due to the project and identification of the impact on the basic needs' objectives of the society. The steps involved in social appraisal are conducting financial analysis, economic analysis and appraisal of distributional effect of the net benefits (externalities) of the project. Here, the affected parties like farmers, dealers of the goods, existing operators and Government are to be identified.
- **Environmental Aspects:** Developing countries including India are now becoming increasingly aware of the urgency to integrate environmental concerns into their project formulations and appraisal. This has led to the increased importance being attached to the environmental aspects in the projects and now

most of the banks and financial institutions insist on what is known as Environmental Impact Assessment (EIA). The essence of EIA is a prediction of the consequences to the natural environment from development projects. A separate ministry has been formed and Environment (Protection) Act, 1986 was enacted by GOI. Further, the Central Pollution Control Board (CPCB) has been formed for ensuring proper implementation of the provisions of the Act.

Sanction Procedure & Follow-up

- In respect of borrowers/borrowing units who are enjoying aggregate fund based working capital limit up to Rs. 5.00 crore from the ban, the turnover method is generally followed for sanction credit limits to them. In turn over method working capital requirement is computed based on the projected turnover taking into account the previous year turnover or the average of the previous three years turnover.
- For all other borrowers enjoying fund based working limit over Rs. 5.00 crore, the banks generally follow the MPBF (2nd method of lending) system of assessment of working capital requirement.
- Periodical visits/inspection shall be undertaken to ensure that the borrowing units maintain necessary stocks against which cash credit hypothecation limits are considered.

SIDBI'S Assistance To The MSME Sector And Its Development Role

Micro and Small Enterprises Refinance Scheme (MSERS)

- Under this scheme, SIDBI provides assistance by way of refinance to Scheduled Banks and select Financial Institutions, provided that they have been in operation for a period of three years, that they had earned profit during the previous two years, net worth of not less than Rs. 50 crores, capital to risk weighted assets (CRAR) of not less than 9 per cent and the level of net NPAs not exceeding 10 per cent.
- The entire loan is generally required to be drawn within three days from the date of sanction. The refinance is generally repayable within a period of six months to five years.

SIDBI Make in India Fund

- The objective of setting up the 'SIDBI make in India' fund is to make MSMEs, a world class manufacturing hub, with focus on 25 sectors of the economy. Under this fund, concessional finance is provided to identified sectors. SIDBI has created a Rs. 10,000 crores '**SIDBI Make in India Soft Loan Fund for Micro Small and Medium Enterprises (SMILE)**' to make available soft loan to MSMEs.
- Under the startup India program, to help MSME startups SIDBI has created Rs. 2000 crore '**India Aspiration Fund**' to be utilized as 'Fund of Funds' for making investments in venture capital funds (VCF) which would in turn make investments in MSMEs to the extent of twice the commitment of SIDBI or 50 per cent of the corpus of VCF whichever is higher.

Promotion of MUDRA as a fully owned subsidiary

- GOI launched a flagship scheme called **Prime Minister Mudra Yojana (PMMY)** on 8th April 2015 to extend affordable loans to the non-corporate, non-farm micro and small enterprises to cater to their funding needs.
- **Micro Units Development and Refinance Agency Limited (MUDRA)** has been created as a refinancing institution, providing loans up to Rs. 10 lakhs maximum to the eligible enterprises, through the banks, NBFCs and MFIs. MUDRA is a wholly owned subsidiary of SIDBI as a refinance company with an authorized capital of Rs. 1000 crores and a paid-up capital of Rs. 750 crores.

The key benefits of MUDRA loan:

- Micro and small enterprises engaged in income generation are the prime target for extension of loan facilities.
- The borrowers are not required to provide any collateral or security to avail of Mudra Loan.
- There are no processing charges for availing of the loan.
- There is a flexibility in the usage of funds
- The loans can be in the form of term loans, overdraft facility, letters of credit or bank guarantees, thus catering to a wide array of requirements.
- The Mudra loan scheme does not prescribe any minimum amount

SIDBI has established the following associate institutions for the growth and development of the SME sector

- **India SME Technology Services Ltd (ISTSL):** It provides a platform where Micro, Small and Medium Enterprises (MSMEs) can tap opportunities at the global level, for acquisition of new and emerging technology or establish business collaboration.
- **SME Rating Agency of India Ltd (SMERA):** SMERA is the country's first Rating agency that focuses primarily on the Indian Micro, Small and Medium Enterprise (MSME) segment. Its primary objective is to provide ratings that are comprehensive, transparent and reliable, which would facilitate greater and easier flow of credit from the banking sector to MSMEs.
- **India SME Asset Reconstruction Company Ltd (ISARC):** It is the country's first ARC supported by a large number of public sector banks and undertakings with the focus of speedier resolution of NPAs in the MSME sector.
- **Receivables Exchange of India Ltd (RXIL):** Receivables Exchange of India Ltd (RXIL) was set up on February 25, 2016 as a joint venture of Small Industries Development Bank of India (SIDBI) and National Stock Exchange of India Limited (NSE), with an objective to operate India's First **Trade Receivables Discounting System (TReDS) - an online platform for financing of receivables of MSMEs.**

Policy Prescriptions of RBI For The Growth Of MSME Sector

- As per the extant policy, banks are required to achieve a 20 per cent year-on-year growth in credit to micro and small enterprises, a 10 per cent annual growth in

the number of micro enterprise accounts and 60 percent of total lending to MSE sector as on corresponding quarter of the previous year to Micro enterprises.

- Public sector banks have been advised to open at least one specialized branch in each district. The banks have been permitted to categorize their MSME general banking branches having 60 per cent or more of their advances to MSME sector, as specialized MSME branches for providing better service to this sector as a whole.
- As per Nayak Committee Report, working capital limits to SSI units is computed on the basis of **minimum 20 per cent of their estimated turnover up to credit limit of Rs. 5 crore.**
- Banks are mandated not to accept collateral security in the **case of loans up to Rs. 10 lakh extended to units in the MSE sector.** Further, the banks have been advised by RBI that on the basis of good track record and financial position of MSE units, increase the limit of dispensation of collateral **requirement for loans up to Rs. 25 lakh** with the approval of the appropriate authority.
- As delay in getting payments is one of the perennial problems faced by MSMEs, RBI has introduced the **Trade Receivables Discounting System (TReDS)** in the year 2014. TReDS is an electronic platform where receivable of MSMEs drawn against buyers (large corporates, PSUs, Government Departments) are financed through multiple financiers at competitive rates.

Banks are advised to provide the following services and guidance to MSE entrepreneurs:

- **Rural Self Employment Training Institutes (RSETIs):** At the initiative of the Ministry of Rural Development (MoRD), RSETIs have been set up by various banks all over the country. These RSETIs are managed by banks with active co-operation from the Government of India and State Governments. RSETIs conduct various short duration (ranging from 1 to 6 weeks) skill upgradation programs to help the existing entrepreneurs compete in this ever-changing global market.
- **Financial Literacy and consultancy support:** Banks have been advised to either separately set up special cells at their branches, or vertically integrate this function in the Financial Literacy Centres (FLCs) set up by them, as per their comparative advantage.

Initiatives Taken By GOI For The Development Of MSME Sector

- **Udyog Aadhaar Memorandum (UAM):** As part of 'Ease of Doing Business', the Ministry notified and launched Udyog Aadhaar Memorandum (UAM) in September, 2015 to enable entrepreneurs to register themselves, by filing an online simple one- page form on Self-Certification basis. No fees and supporting documents are required for the online filing of the UAM.
- **A Scheme for Promoting Innovation and Rural Entrepreneurship (ASPIRE):** The main objectives of the ASPIRE scheme are to **(i)** to create new jobs and reduce unemployment; **(ii)** to promote entrepreneurship culture in India; **(iii)** to ensure grassroots economic development at the district level; **(iv)** facilitate

innovative business solution for unmet social needs; and (v) promote innovation to further strengthen the competitiveness of the MSME sector. The scheme fund has an Rs. 200 crore corpus.

- **National Manufacturing Competitiveness Program – Lean Manufacturing Competitiveness Scheme for MSMEs:** Under the Scheme, MSMEs will be assisted in reducing their manufacturing costs, through proper personnel management, better space utilization, scientific inventory management, improved processed flows, reduced engineering time and so on. LMCS also brings improvement in the quality of products and lowers costs, which are essential for competing in national and international markets.
- **Certification Reimbursement Scheme:** In order to enhance the competitive strength of the MSEs, the Government introduced a scheme to provide technological upgradation, quality improvement and better environment management by the MSMEs. The scheme reimburses 75% of the fees, subject to a maximum of Rs. 75,000 for acquiring Quality Management System.
- **Scheme of Fund for Regeneration of Traditional Industries (SFURTI):** With a view to making the traditional industries more productive and competitive and facilitating their sustainable development, GOI announced setting up of a fund for regeneration of traditional industries. The objective of SFURTI is to organize the traditional industries and artisans into clusters to make them competitive and provide support for their long- term sustainability and economy of scale, and provide sustained employment for traditional industry artisans.

Schemes for Coir Sector

- **Coir Vikas Yojana:** Coir Board is implementing the Export Market Promotion Scheme for adoption of strategic and aggressive products specific and markets specific promotional programs for popularizing coir and coir products in markets abroad. Assistance for publicity material up to 25% of the production cost with over all ceiling of Rs. 15,000 is also admissible.
- **Coir Udyami Yojana:** The objective of the scheme is to rejuvenate, modernize and technologically upgrade the most crucial link in the coir production chain, namely spinners and tiny Household sector. The scheme provides 40% as subsidy, 55% as Bank loan and 5% beneficiary contribution for setting up of coir units with project cost up to Rs. 10.00 lakh.

Scheme for Credit Linked capital subsidy for technology upgradation (CLCS-TU)

- The Credit Linked Capital Subsidy Scheme (CLCSS) was launched on 1st October, 2000. The Cabinet Committee on Economic Affairs (CCEA) has approved the changes in ceiling of credit **from Rs. 40.00 lakhs to Rs. 1.00 crore with the rate of subsidy enhanced from 12% to 15%.**
- The Scheme aims at facilitating technology up-gradation by providing 15% upfront capital subsidy up to a maximum cap of Rs. 15.00 lakhs. Online Application and Tracking System has been introduced by the Government and the SME units need to upload their subsidy claim application through their PLIs.

Credit Guarantee Fund Scheme for MSEs

- GOI launched the Credit Guarantee Fund Scheme for Micro and Small Enterprises in August, 2000, with the objective of making credit available to micro and small enterprises (MSEs), particularly micro enterprises, without collateral/third party guarantees.
- The Scheme is being operated through the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) set up jointly by the GOI and SIDBI.
- The objective of the scheme is to make available credit to SSI units, particularly tiny units, for loans up to Rs. 200 lakh without collateral / third party guarantees.

Category	Maximum extent of guarantee where credit facility is		
	Up to ₹ 5 lakhs	Above ₹ 5 lakhs and up to ₹ 50 lakhs	Above ₹ 50 lakhs and up to ₹ 200 lakhs
Micro Enterprises	85% of the amount in default subject to a maximum of ₹ 4.25 lakhs	75% of the amount in default subject to a maximum of ₹ 37.50 lakhs	75% of the amount in default subject to a maximum of ₹ 150 lakhs
Women entrepreneurs/ units located in NER (other than credit facilities up to ₹ 5 lakh to micro Entrepreneurs)	80% of the amount in default subject to a maximum of ₹ 40 lakhs		
All other category of borrowers	75% of the amount in default subject to a maximum of ₹ 37.50 lakhs		
Activity	From ₹ 10 lakhs up to ₹ 100 lakhs		
MSE Retail Trade	50% of the amount in default subject to a maximum of ₹ 50 lakhs		

Performance And Credit Rating Scheme (PCRS)

- The scheme is being implemented through **National Small Industries Corporation (NSIC) Limited**. The main objective of the scheme is to provide a trusted third- party opinion on the capabilities and creditworthiness of the MSEs, so as to create awareness amongst them about the strengths and weakness of their existing operations.
- Rating under the scheme is being carried out through empaneled rating agencies i.e., CRISIL, CARE Ratings, ONICRA Credit Rating Agency of India Ltd, SMERA (SME Rating Agency of India), ICRA Ltd and Brickwork India Ratings.
- Under this Scheme, rating fee payable by the micro & small enterprises is subsidized for the first year only and that is subject to maximum of 75% of the fee or Rs. 40000/-, whichever is less.

Framework For Revival And Rehabilitation Of MSMES

- The Reserve Bank of India has advised revised guidelines for the revival and rehabilitation of MSMEs having loan limits up to Rs. 25 crores. As regards restructuring of loan accounts with exposure of above Rs. 25 crores, they will continue to be governed by the extant guidelines on Corporate Debt Restructuring (CDR)/Joint Lenders' Forum (JLF) mechanism.

- On the basis of the warning signals in respect of accounts in SMA-2, the branch should forward the details of stressed account with aggregate loan limits above Rs. 10 lakh to the Committee within five working days for a suitable corrective action plan (CAP).
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