

# E-FINANCE IN A DEVELOPING COUNTRY LIKE INDIA

**Sushant Kumar\***

**Head-SME, ICICI Bank, India**

## **1. Introduction**

The Internet has evolved from a mere information dispensing vehicle into a robust transaction facilitating environment. New software tools and safer architecture with multiple security and access control structures have enabled banks to take advantage of Internet Technology and software protocols for devising a host of products and services which could be distributed and made available through the Internet.

E-finance encompasses all financial products and services which are available to the consumer through the Internet. A few banks and financial institutions in India, including ICICI Group, have realised the immense power of the Internet and have taken bold initiatives by way of innovative products and services which are being hosted on the web (Internet) platform.

The ICICI Group has not only offered a host of services through the Internet but is in the process of developing the web channel as a parallel channel for distribution of all its products. The ICICI Group has realised that the web channel not only lowers cost but also increases reach and helps customize products and services for various customer segments. It also facilitates privileged access to a host of related services (through tie-ups with the service providers) and enables a one-to-one relationship with the customer, irrespective of where the customer or the bank branch itself is located. This is the critical advantage the web as a channel provides to the Bank, especially for catering to SME customers in remote areas.

## **2. An Overview**

This paper would begin with a backdrop outlining the importance of Small and Medium Enterprises (SMEs) in a developing country like India, the distinctive profile and needs of an SME customer and the unique challenges in SME banking. Against this backdrop the paper would then highlight the weaknesses in traditional lending models followed by Indian banks, and which later set the pattern of lending even for the newly formed private sector banks. The paper would then emphasize how e-finance is a window to a new opportunity for SME customers as also for banks which cater to them. A brief perspective of the peculiarity found in the Asian and Indian business environment would be included to underline the complexity and therefore the added difficulties faced by Banks to facilitate e-finance models for SME customers.

*\*The author is thankful to his colleagues Sanjay Shiroley and Suraj Tripathy for their assistance in preparing this paper and the valuable guidance provided by Dr.Nachiket Mor Executive Director, ICICI Bank.*

After a brief summary of the regulatory environment, which has enabled new banks to respond innovatively and would now facilitate the orderly development of e-finance in the country, the paper will detail the strategy followed by ICICI Group (including the ICICI Bank) for extending e-finance to SMEs with three actual case studies. The paper would conclude with a conceptual outlook on the Bank's future strategies on e-finance, especially for the SME customer.

### ***3. Importance of SMEs in a developing country like India***

A Small and Medium Enterprise (SME) is defined differently by individual banks. The business turnover is generally used as a criterion for defining an SME unit and banks generally follow a norm of up to US\$ 25 million turnover. A few foreign banks operating in India consider a unit with turnover of up to US\$ 50 million as an SME client. ICICI Bank instead follows a criterion based on owned funds (net worth) of US \$ 5 million for demarcating an SME unit.

The SME sector occupies an important position in any developing economy. The classical perspective looks upon the SME sector as vital for employment generation, local wealth creation, development of economically backward regions, development of local skills and resources leading to rise in income fuelling economic growth for the entire region and onward to rise in the national income. However SMEs are vital even in the globalised and deregulated economy towards which India is steadily progressing. India depends on the SME sector for early adoption of innovations in technology and products, absorption of latest manufacturing practices, experimentation in new markets, linkages to new global partners etc. SMEs are critical constituents to make a developing economy self sustaining in innovations and growth.

However, unlike developed countries like the USA, SME development effort in India is hampered due to lack of quality data and opaque financial information. Government efforts have in the past either focussed on micro-enterprises or the Small Scale Industries (SSI) which are units with an investment in plant and machinery of US \$ 200,000, leaving a vast segment of service or trade related sectors unresearched. Also, no statutory definition of an SME nor a systematic study was attempted for the overall SME sector. The SME sector would not only include SSI units but also non-manufacturing units engaged in trade and services.

While the micro and SSI sectors were unarguably more important from the development perspective, the SME service sector has now become equally important with the service sector gaining over manufacturing and agriculture sectors.

As per a study commissioned by ICICI Bank, the SME banking assets size is estimated to be Rs. 1200 billion (US\$ 25 billion) and the liability pool is estimated to be Rs. 2000 billion (US\$ 41 billion). But the banking space of SME is fragmented into a variety of business needs and addressing the diverse banking needs of SME therefore requires a comprehensive organisational response and innovative thinking.

From a development perspective the Government has taken several measures ranging from reservation of items for exclusive SSI manufacturing, seed capital schemes, bill culture guidelines for corporates, tax breaks, subsidies, cheaper credit, market making, technological upgradation etc. New initiatives include mutual guarantee

---

schemes and venture capital regulations, which are being made further user friendly. However initiatives, in the areas of credit insurance for example, are still awaited. Further there is still a lot of scope for increasing the use of technology in the SME sector to make it globally competitive.

#### **4. SME Banking: Customer profiles**

SME banking needs include not only asset products and deposit products but also value added products like business, legal and tax advisory services, pension and salary processing services, outsourced human resource placement and development services etc. For an SME customer, aspects like convenience in executing transactions, having a familiar and dependable relationship, as well as speedy and informal procedures without too much paperwork and formalities are significant value propositions that ultimately determine the bank he chooses to do business with. At the same time SME customers confer to their bank a higher "stickiness" than a corporate customer and also the opportunity to tap the personal banking needs of the SME entrepreneur.

This aspect of 'cross-sell' of financial and non financial services is being aggressively tapped by private and foreign banks to build lasting relationships with their SME clientele. A majority of banks, despite their longer presence in the SSI/trade asset segment, have however been unable to build lasting relationships with SMEs because of a vanilla asset driven approach.

#### **5. Challenges in SME banking**

There is no commercial bank in India which has exclusively targetted the small business segment (like for example, Wells Fargo in the US) with customised value propositions to meet the specific needs of the SME customer. Banks in India have focussed on SME segment largely as a generic group rather than on a comprehensive relationship footing with specific product offerings. The Branch based delivery of credit is high cost with an adverse risk-return trade off. The cost of servicing and the returns from SME also did not justify focus on this segment. New generation banks like ICICI Bank have thus looked at alternative ways to address the segment.

SMEs in India, unlike the US, have generic problems like inability to provide quality data and exhibit formal systems and practices and lack of asset cover. This has resulted in the unwillingness of banks to increase their SME lending. Legal and regulatory compliance has also been inadequate. Traditional drawbacks like opaque and asymmetric data and low capital base continue to characterise SME balance sheets. This problem is further compounded due to preponderance of a large cash economy in this segment.

SME lending has thus met with limited success. The lending in the past has not been hugely successful and self sustaining also due to the lack of forward and backward linkages in the economy due to which SMEs had a low survival rate. SME banking space has also been skewed by major Indian banks, which account for most of the volumes in SME business, restricting themselves to low cost but rigid lending with no focus on cross-sell or flexibility.

#### **6. SME Lending: The Traditional Model**

---

Banks in India, traditionally, have not been flexible enough to design new products. Most Indian banks have no targeted or differentiated value proposition for SMEs albeit apart from a few banks like ICICI Bank . SME business globally has necessitated an innovative organisational response and which has been lacking in India till recently. The complexity and variety in SME banking space requires a matching flexibility which only the new or foreign banks have demonstrated. These responses are largely through the help of e-finance models.

Larger banks have typically been unable to extend the informality and convenience so essential for the SME customer which not surprisingly the smaller, locally based and thus more flexible co-operative banks have been able to provide to some extent.

Most banks have no coherent strategy for SME lending and have undifferentiated product offerings. Banks have traditionally looked at SMEs either as a low cost source of deposits or as priority sector obligated lending. Banks have thus made only feeble attempts at building relationship-based products despite good working relationships at the branch level. However newer banks have found that e-finance models can greatly facilitate such relationship-based selling of products as demonstrated by initiatives taken by the ICICI group.

### ***7. E- finance for SME is a new window of opportunity***

E-finance for SMEs stands on the basic premise of the linkage that the SME has with the parent corporate to which it sells as a vendor or from which it buys as a dealer or supply chain partner. In all such cases the Corporate can provide credit enhancement (by way of non-financial but effective measures like discontinuance of supply chain relationship etc) and also bring the SME onto the e-finance linkage. The supply chain linkages can be put online on a B2B platform involving an e-finance network around the corporate. This makes the finance cum payment network more credit worthy and the financing model more robust in continuity than stand alone financing to SMEs. E-finance delivery is low cost vis-à-vis the traditional branch based finance and at the same time has far greater reach. E-finance models permit flexibility in product parameters as well as facilitate a one-to-one relationship (which is used to cross-sell of other products) to a larger base of SME customers without the need to open branches. The web based banking model can thus construct a lasting and profitable relationship of the SME and the Corporate and also with the facilitating bank.

### ***8. The current state of e-finance in India***

The state of e-financing is in the nascent but growing stage in India. The transition to a full-scaled digital economy would depend on speedier deregulation which will follow once the macro-economic reforms process matures further. The gradual acceptance of e-finance models is precisely the indicator of this interconnectedness of e-financing structures with parallel developments and advances in the legal, regulatory spheres as well as the modernisation of business and industrial markets. Corporates have however taken up modernisation like implementing ERP systems which permit the use of advanced management techniques like CRM, Data warehousing etc, with enthusiasm and are thus more and more prepared to bring their entire supply chains onto e-financing structures.

---

### **9. Asian Obstacles to e-banking**

Asian and Indian markets rely on traditional market intermediaries which are not amenable to formal business practices and maintain opaque financial records. The lack of willingness for transparency leads to low acceptability of the Internet as a channel for doing business. The half-hearted legal and regulatory compliance cultures also add to the general apathy towards formal business structures. In some spheres like wholesale trade of commodities for example, there are too many market intermediaries often with an ancestral lineage of involvement in that market and who operate like community networks and closed clubs. Such islands also do not support or facilitate the open architecture of e-markets. As privatisation and deregulation have just begun, regulation in areas like digital certification, cyber laws etc are only now catching up. Even if online practices (online pre-sale processing like ordering, price discovery, invoicing etc on the internet) are followed, progress in smoother offline fulfillment (actual payment and delivery of goods) is crucial and is still dependent on the legacy clearing and payment networks of state owned banks. Even necessary advancement in third party logistics (transporters which take up integrated Carrying & Forwarding Contracts with companies) and payment gateways (where online instructions for payment to and from a bank account are executed and completed by a bank) have only just begun.

### **10. E-finance regulations in India**

There are at present 3 major statutes/guidelines governing e-finance in India, namely

1. The Information Technology Act 2000
2. The Information Technology (Certifying Authorities) Rules 2000
3. Central Bank (Reserve Bank of India (RBI)) guidelines on Internet Banking in India

The RBI guidelines lay down the operational framework on Internet Banking and focuses on security issues. While RBI has mandated that the commonly used Public Key Infrastructure (PKI) technology standard should be followed no mandatory time-frame has been set. The guidelines detail the organisational, operational, and supervisory structures to be implemented by all banks offering Internet Banking.

Being a Bank already benchmarked against global best practices these guidelines do not constrain the activities in any way. However such guidelines go a long way to standardize the path to be followed by other banks to adopt e-finance in a big way.

The IT Act 2000 and the IT Rules for Certifying Authorities have been recently enacted and lay down the framework for appointment of digital certifying authorities, acceptance of digital signatures etc. These regulations would thus enable the orderly development of cyber business.

### **11. ICICI Group's strategy for SME e-finance**

It has been a world-wide phenomenon that successful banks have entered the SME lending market with innovation across their business systems. The ICICI Group stands out as a pioneer in e-financing in India. The group has taken several innovative web-based initiatives which include online trading in securities (ICICI Direct), a bill

payment module (Billjunction) a shopping mall facilitator (Khulja sim sim) an internet based travel services site (Traveljini) and an e-based escrow service (Payseal and Smart Pay).

The Group has also put in place a comprehensive front end tool for all banking products (ICICI Markets) which incorporates an internet banking vehicle for corporates. The ICICI Markets is a portal which offers a host of products like forex remittances, financial information through linkages with Reuters and Capital Line, a facility to trade in debt and equity instruments, a calculator to plan investments etc. The portal offers linkages to other e-finance services as detailed above in addition to housing channel partners catering to non financial services.

The ICICI group strategy for e-finance for SMEs aims finally to put SMEs on a full fledged relationship platform through linking all products offered to SMEs on an exclusive SME Portal which would disseminate information relevant to SMEs and host value added services like financial accounting and advisory services and have linkages with channel partners like travel agencies, hotel booking services etc.

For the Bank, SME banking thus goes beyond the traditional asset led fund based banking to a complete revenue model which also includes fee based services. This is a most challenging task as Banks in India have historically limited their product suite for SMEs mostly to standardised loans and vanilla deposit products.

For a new private bank like the ICICI bank however, building up capacity in SME e-finance has been all the more difficult as it has to not only replicate online, the same traditional products available off-line but also to innovate boldly without any reference model internally and in an area without sufficient legislation. This is because the present e-regulations only provide the ground rules for setting up security systems, digital certificate authorising systems etc but are yet to provide regulations to govern e-business as well as institute changes in banking related regulations like the Negotiable Instruments Act, The Sale of Goods Act etc. The Bank had to thus evolve a rigorous systems of checks and balances as well as experiment with adequate risk mitigating measures.

ICICI Bank has adopted the Corporate linked route for SME e-lending in the initial phase so as not to repeat the traditional lending model which has led to high Non Performing Loans (NPLs). Thus the uniquely different business and legal environment and its limitations in India have forced the Bank to be innovative and design an e-finance solution organically designed for the Indian SME. In doing so the Bank has unconsciously adopted global best practices in its drive to innovate for serving the SME customer. The various initiatives can be summarized as under :

1. A web trade solution is offered by ICICI Direct.com for retail and SME clients for trading in equities. ICICI Direct has over time evolved as the leading web based brokering service in the country.
  2. A smart card solution is being developed specially for fleet operators and transporters. This, is in addition to substituting the high cost cash-based transactions, also rewards users by way of redeemable loyalty points.
  3. A direct marketing strategy is envisaged for the SME Portal, which is a strategy followed by most successful banks world-wide.
-

4. The SME Portal would also focus on relationship (which is based on cross selling) marketing and products for the entire needs of the SME.
5. A call centre for SME customers is being implemented and the assets would be serviced through centralised remote networks without reliance on branches. The purpose of this structure is clearly to wean away the SME clients from a costlier brick and mortar delivery platform to a relatively cheaper and scalable electronic channel.
6. A credit scoring model is being built to standardise credit assessment and facilitate automated schematic lending. This model which will initially be based on empirical experiences will gradually migrate to a statistical platform for credit assessment.
7. An integrated offering combining asset, liability and third party products (insurance, mutual funds, venture capital etc managed by non-banking associate companies) as also a range value added products like travel, personal finance advisory sites, tax planners etc is also being made available through a host of channel partners on the SME Portal.

A few banks, including ICICI Bank have implemented a non- branch remote based SME lending model. ICICI Bank is also going ahead in the card acquiring business which will give it the necessary network to build the SME Business Card, another product which can offer remote-access without the need for branches. Thus the e-finance strategy of the Bank is not just a defensive one for mitigating the risk, though risk mitigation is certainly facilitated by e-finance models by centralised credit scoring and portfolio monitoring.

ICICI Bank firmly believes that the e-channel should offer process or relationship benefits and not just another channel point solution. That is, the SME customer should be offered a greater value proposition from e-lending and not just another product.

## ***12. Case studies in e-finance models for SME finance***

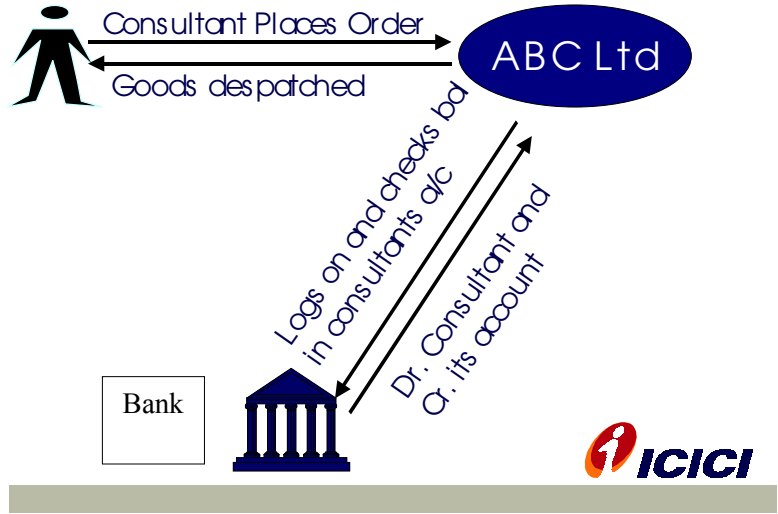
### **Case Study 1**

ABC Ltd is an associate concern of a leading player in the FMCG and food sector and a part of the UK based consumer giant. The company is engaged in distribution of cosmetics through a combination of multi level and direct marketing. They have nominated a chain of beauty consultants who are franchisees for the company's range of cosmetic products as well as service providers. These consultants are growing SME entities and ICICI Bank has devised a closed e-payment network for these units.

- The consultants places orders with the nearest company office.
- The orders are processed by the regional centres of the company.
- The company debits consultants account with the Bank directly
- Direct Benefit to the company which then as no 'receivables' on its books.
- Transaction is executed directly with no intervention at branch level.

---

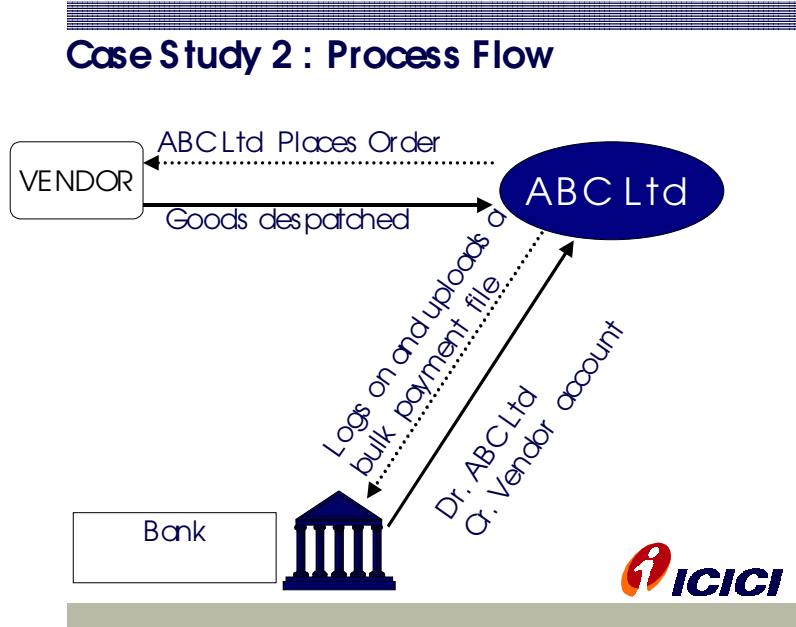
## Case Study 1 : Process Flow



## Case Study 2

ABC Ltd, which is a JV between a large US based auto maker and a leading Indian player in the Medium and Heavy Commercial Vehicles and Tractor Sector. They make premium segment automobiles in India and they have one of the most popular brand in the segment. The Vendors which are SMEs are able to have a payment cum financing solution using e-payment systems.

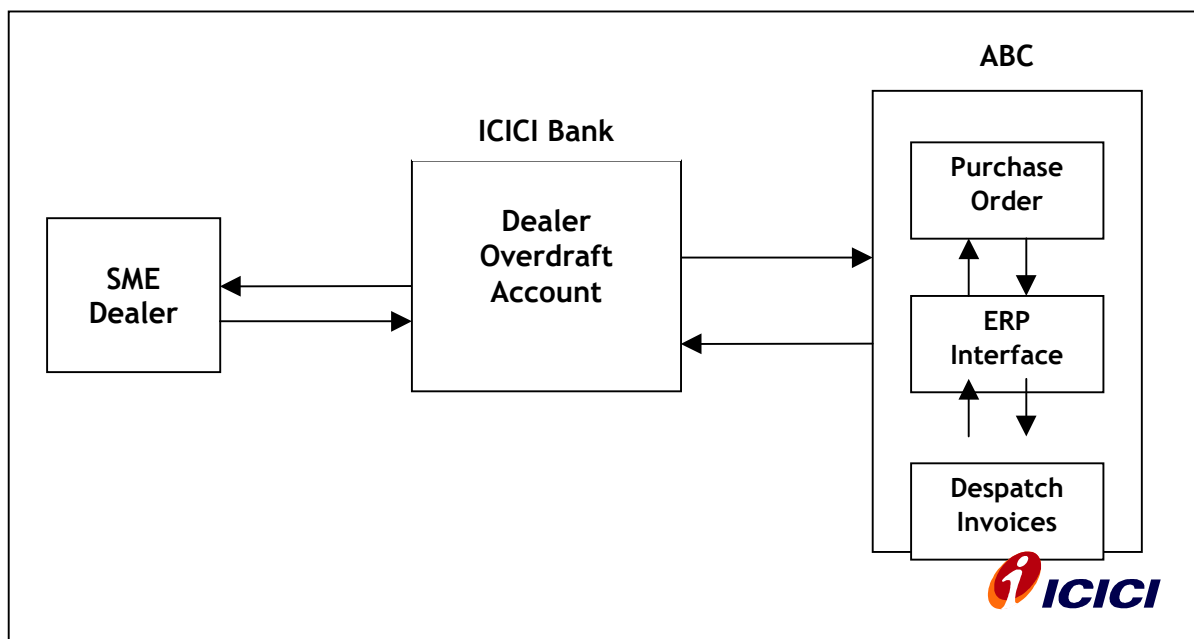
- ◆ ABC Ltd has 85 vendors supplying critical components and sub-assemblies
- ◆ The company's ERP System generates a output text file listing the vendor account numbers, amount, remarks, etc
- ◆ The payment file is uploaded into Corporate Internet Banking (an internet based intra bank transaction and settlement vehicle on ICICI Markets platform). The validations are carried out by the System.
- ◆ The company's account is debited and the vendor accounts credited directly.
- ◆ No intervention at branch level.
- ◆ Automated Interface to Payments



Since the data was encrypted in transit an intricate encryption solution with credit validation was devised which met with approval by the JV's US partner. This is an inevitable feature of e-finance. Banks would be called upon to develop better and better security features like encryption, firewalls etc as e-finance systems establish themselves.

### Case Study 3

ABC Ltd is a leading Swiss FMCG player recognised for its well known brands and an aggressive market oriented company, have requested us for clean overdraft (OD) limits be provided to their dealers so as to facilitate quicker off-take of merchandise from the corporate. These accounts of the dealers with credit limits are connected online with the ERP system of the company. An automated file transfer system has been designed to update the unutilized balances in the dealer OD accounts directly into the records of the company, based on which the sales despatch system and invoicing is initiated. This data is re-transferred to the Bank's system and the respective files are updated. On the updation of files, the OD accounts are debited for the amount of the new invoices and the Bank makes the corresponding payment to the Company. The financing limits of the dealer are thus linked to the Company's C& F systems thereby generating a push effect for the sales.



### 13. Going Forward

The bank is thus committed to a web based relationship banking model for SME financing. Such a model overcomes branch capacity constraints, increasing reach at the same time lowering costs. Facilitating automated lending, crucial skills can be centralized and the factory approach to back office processing with emphasis on Six Sigma standards (on turnaround and cycle times etc), online processing can be implemented. Working towards a real time solution process, the Bank can mitigate systemic bottlenecks, like India's fragmented payment systems, lack of a Real Time Gross Settlement System (RTGS), a commonly accepted payment gateway etc. ICICI Bank has adopted the single sign-on facility for all the products offered by the portal window, ICICI Markets, which give the Bank a strategic edge as the same becomes a relationship point for the SME. The Bank is now focussing on migrating existing SME assets to the web and building the brand on the web. The Bank is also actively collaborating with others to facilitate the use of Public Key Infrastructure (PKI)

technology which would put e-finance on a globally accepted standard enabling cross-border transactions.

ICICI group would be shortly rolling out shopping mall arrangements for SMEs besides e-payment escrow services as well as B2B settlement products in the future as part of the e-finance strategy.

#### **14. In conclusion**

ICICI Group firmly believes in a customer-centric organisation and the SME strategy incorporates e-lending models facilitated to do precisely that i.e. to transform the traditional product driven culture to a customer driven one. SME development after all depends on giving the SME customer whatever he wants, wherever he wants, and in whichever form he wants. It is towards achieving this objective that SME e-finance models are being designed.

*Note: To maintain the confidentiality of our customers, their names have not been mentioned in the case studies*

---