
Financing MSME in India

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Abstract

Micro, small, and medium-sized enterprises (MSMEs) have played an important role in Indian economy. About 56 million MSME units employ 124 million people, contributed up to 31% of the GDP and 45% of the total export. Even after making such a commendable contribution, they are facing problems to avail loans. Most of the Banks and financial institutions neglect them in giving loans. Large enterprises can easily get long-term loans at lower rate of interest but MSMEs faced difficulties in getting such loans at such easy rate. The availability of sources of finance and the accessibility to these sources are the most crucial factors to promote growth of MSMEs in developing economies like Indian economy. In this paper, loans supplied to the MSMEs in 2017 by the different financial agencies are shown. Lastly, several factors are also identified for which the MSME units are not availing the long-term loans from financial institutions.

KEYWORDS: MSME, MSMED Act, 2006, NBFCs, Information asymmetry, Inadequate collateral

INTRODUCTION

Micro, small, and medium-sized enterprises (MSMEs) have played an important role in Indian economy. Indian economy predominantly an agriculture based economy often failed to perform to its full effect because of its inherent problems. One of the major problem is the dependence of rainwater. As the irrigation facilities do not cater to all over India due to the paucity of the infrastructure agricultural production hampers whenever monsoon is bad. It causes the agricultural activities too uncertain that often the farmers unable to fetch good returns commit suicide.

The Micro, Small and Medium Enterprises in India employs more than 805 lakh persons (MSME Annual Report, 2016-17) and has become the second largest employment provider after agriculture (As per 4th Census in MSMEs). MSMEs have played a prominent role in transforming Indian economy from an agrarian based economy to an industrialized one.

MSME is basically used to describe small businesses not having proper institutionalized authentication. First of all there are varied definitions around the World. There are different criteria to define MSME. Often number of employees, total

asset, total sales, types of production, investment limits are used to classify small, micro and medium enterprises.

In India MSME is defined based on investment limit to the manufacturing enterprise and also to the service enterprise following Micro, Small and Medium Enterprise Development Act (MSMED Act) 2006. The following table summaries the definition used in MSMED Act, 2006.

MSMED Act Definition of MSMEs

Size	Manufacturing Enterprise Investment limit	Service Enterprise Investment limit
Micro	INR 2.5 million (USD 40,000)	INR 1 million (USD 15,000)
Small	INR 50 million (USD 0.8 million)	INR 20 million (USD 0.3 million)
Medium	INR 100 million (USD 1.5 million)	INR 50 million (USD 0.8 million)

Source: MSME Annual Report (2015), MSMED Act

However International Finance Corporation (IFC) uses the following definition particularly based on the number of employees, the value of total assets and the value of total sales.

IFC MSME Definition

Size	No. of employees	Total asset	Total sales
Micro	Less than 10	Less than INR 6.5 million (USD 100,000)	Less than INR 6.5 million (USD 100,000)
Small	10-50	INR 6.5 195 million (USD 100,000–3 million)	INR 6.5 195 million (USD 100,000–3 million)
Medium	50-300	INR 195 975 million (USD 3–15 million)	INR 195 975 million (USD 3–15 million)

Source: https://www.ifc.org/wps/wcm/connect/de7d92804a29ffe9ae04af8969adcc27/InterpretationNote_SME_2012.pdf?MOD=AJPERES

In the following two tables we depict the size of MSME Sector in India. MSME can be sub-divided into micro, small and medium units. We see that Micro units dominate as about 95% of MSMEs are Micro units. Out of total 56 million units Micro units are 53 million.

Size of the MSME Sector in India (in million)

Type	Number (percentage)
Micro	53 (94.9)
Small	2.7 (4.9)
Medium	0.1 (0.2)

Source: MSME Annual Report (2017), WBG-Intellectap Analysis

On the other hand, we see that 85% of the MSME is unregistered.

Size of the MSME Sector in India (in million)

Type	Number (percentage)
Registered	8.5 (15%)
Unregistered	47.6 (85%)

Source: Ministry of MSME-Udyog Aadhaar, WBG-Intellectap Analysis

The contribution of MSME to the Indian Economy is commendable. About 56 million units employ 124 million people. Its contribution to the GDP is 31% while to the total export is 45%.

Even after making such a commendable contribution, they are facing problems to avail loans. Most of the Banks and financial institutions neglect them in giving loans. Large enterprises can easily get long term loans at lower rate of interest but MSMEs faced difficulties in getting such loans at such easy rate. In the literature it is well established that the size of the enterprise determines the credit conditions. SMEs continued to face the dual challenge of an uneven recovery and bank deleveraging through 2012. Subdued growth and demand overall translated into declining profits for SMEs and reduced availability of internal funding in most countries. At the same time, the financial sector continued the deleveraging process started in the aftermath of the global financial crisis. In countries hit by the sovereign debt crisis, deficiencies in capital adequacy squeezed credit availability for the entire banking system, but impacted SMEs more than large firms, due to their greater dependence on bank financing. The report illustrates that payment delays added to cash flow constraints, and bankruptcy figures remained high in most countries. (OECD Report 07/07/2014). Most of the banks and financial institutions hesitate to support them financially due to the risk involved, as the MSMEs lack proper registration, openness about their production and marketing, not maintaining proper financial transactions etc. The banks and other financial institutions have doubt about the financial health of the MSMEs and are not willing to get involved with them because of the adverse selection and moral hazard.

FINANCING MSMEs

In the following section loans supplied to the MSME sector in 2017 as reported by the different agencies are shown and discussed. First we see that the informal sector dominated in supplying loans to the MSME sector. This informal sector supplied loans amounting to Rs. 58.4 trillion out of total Rs. 69.3 trillion supplied to the MSME sector.

Supply of Debt to the MSME Sector – 2017 (in INR Trillion)

Source	Amount (in INR trillion)	Amount (in USD billion)
Formal	10.9	168
Informal	58.4	898
Total	69.3	1066

Source: RBI, Primary Research, WBG-Intellectap Analysis

However if we categorised the informal sector we see that the unregistered sources here dominated. That means the unregistered informal sector supported mostly unregistered MSME sector.

Supply of Informal Debt to the MSME Sector – 2017 (in INR Trillion)

Informal Source	Amount (in INR trillion)	Amount (in USD billion)
Registered Chit funds	0.2	3
Unregistered sources	58.2	895
Total	58.4	898

Source: RBI, Primary Research, WBG-Intellectap Analysis

On the other hand in the formal supply source it's the banking sector that dominates in supplying the loans.

Supply of Formal Debt to the MSME Sector – 2017 (in INR Trillion)

Formal Source	Amount (in INR trillion)	Amount (in USD billion)
Banking institutions	9.4	144
Non-banking institutions	1.5	24
Total	10.9	168

Source: RBI, SIDBI, Annual Reports of NBFCs, Primary Research; IFC-Intellectap Analysis

If we investigate the Scheduled Commercial Bank (SCB) section we see that the Public sector is leading followed by the private sector and then the foreign banks. It is quite obvious as the high risk involvement and low chance of getting return is the common perception amongst the financial environment.

SCB Debt Supply to the MSME Sector – 2017 (in INR trillion)

Banks	Amount (in INR trillion)	Amount (in USD billion)
Public sector banks	5.4	84
Private sector banks	3.1	47
Foreign banks	0.3	4.5
Total	8.8	135.5

Source: RBI, Primary Research; WBG-Intellectap Analysis

The following table simply depicts the number of branches as well as their share in supplying the loans to the MSME sector.

Statistics on Branch Network – 2017

Type of Bank	Number of Branches	Share (%)
Public sector banks	91445	65.8
Private sector banks	24661	17.8
Small Banks	22482	15.1
Foreign banks	288	0.2
Total	128835	100

Source: RBI, NABARD Annual Report 2016-17

In the following section we depict the debt supplied to the different category of MSMEs. Here the Small units get the major share (45%) followed by the Micro units and then the Medium units.

Debt Supply to Micro, Small and Medium Enterprise Segments –2017 (in INR trillion)

Share of credit supply	Amount (in INR trillion)	Amount (in USD billion)	Percentage
Micro	3.9	59.3	35
Small	4.8	74.5	45
Medium	2.2	34	20
Total	10.9	167.8	100

Source: RBI, NABARD Annual Report 2016-17, Primary Research, WBG-Intellectap Analysis

However the Service enterprises are leading in getting the debt (58%) followed by the Manufacturing units.

Debt Supply to Manufacturing and Service Sectors –2017 (in INR trillion)

Share of credit supply	Amount (in INR trillion)	Amount (in USD billion)	Percentage
Manufacturing	4.6	70.4	42
Services	6.3	97.4	58
Total	10.9	167.8	100

Source: RBI, NABARD Annual Report 2016-17, Primary Research, WBG-Intellectap Analysis

Geographically also the distribution of debt is categorised. Here also the North-East states lagged behind getting only the 2.5%, while low income states got 25.5% and the remaining 72% of debt supplied to the Rest of India.

Debt Supply to NES, LIS and RoI –2017 (in INR trillion)

Share of credit supply	Amount (in INR trillion)	Amount (in USD billion)	Percentage
North-east states	0.2	2.54	2.5
Low income States	2.8	42.8	25.5
Rest of India	8	122.4	72
Total	11	167.74	100

Source: RBI, NABARD Annual Report 2016-17, Primary Research, WBG-Intellectap Analysis

The availability of sources of finance and the accessibility to these sources are the most crucial factors to promote growth of MSMEs in developing economies. In the Indian context, both of these issues pose inherent challenges to financing of MSMEs due to lack of awareness of funding schemes among MSME entrepreneurs and the limited role of venture capitalists, nonbanking financial companies (NBFCs), foreign banks, angel investors, and initial public offerings in financing MSMEs.

The growth of the MSMEs is needed for the developing economies. This needs technological upliftment, product diversification, marketing strategy. But all these need finance. There are several factors responsible for not availing finance from the financial institutions to fund their long-term growth.

Information asymmetry: There is a large gap in the information available on the lending processes and enterprises are overwhelmingly unaware of how to procure a loan.

Inadequate collateral: Micro and early-stage small enterprises typically do not have adequate access to immovable collateral that meets the criteria of financial institutions. This increases the credit risk perception of MSMEs.

Limited equity base: On account of their inadequate equity base, MSMEs often take loans from multiple lenders, overextending themselves financially and making them vulnerable to defaulting.

High transaction cost and lower margins: For banks and NBFCs, financing MSMEs is both an expensive and a high-risk proposition. Constantly monitoring and engaging with MSMEs is considered too high a cost of business.

Low-risk appetite: Financial institutions have typically perceive MSMEs as a high-risk segment on account of their incomplete understanding of MSME businesses.

Lack of Product Innovation: Traditional lenders continue to lack understanding of the MSME sector, and, therefore, they have not changed their approach to lending.

In view of the fact that banks are the predominant source of finance in India, the Reserve Bank of India includes micro and small enterprises in the list of priority lending sectors. Banks have also been advised to achieve a year-on-year growth of 20% in credit to micro and small enterprises and an annual growth of 10% in the number of microenterprise accounts. In view of such policies, this study attempts to understand whether such incentives and schemes have percolated down to the MSMEs and if entrepreneurs are aware of them.

CONCLUSION:

Thus we see that MSMEs play an important role in Indian economy. Their contribution to the GDP of India as well as their capability to generate employment is commendable. But they face some problems, like product differentiation, marketing, technological up gradation etc. which are interrelated. The main problem in doing business is to find the source of finance. Here also MSMEs are unable to mobilize sufficient finance from formal sources like banks and other financial institutions. The Reserve Bank of India took the initiative to include them into priority sector and directed the scheduled banks to give loans on the priority basis. This may be the solution of the problem of MSMEs so far as the financing is concerned.

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