

Micro, Small and Medium Enterprises Financing in India - Issues and Concerns

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Micro, Small and Medium enterprises (MSME) constitute the dominant form of business organisation worldwide. For instance, 99% of enterprises in European Union and about 80% in USA were small enterprises. In India too, SSIs' share is as high as 97%. Out of 42.12 million non-farm enterprises, 0.58 million are factory units. (Source – 5th Economic Census – Provisional Result – June 2006). It is estimated that out of 5.8 lakh factory units, about 5 lakh are factory SSIs and “Medium Enterprises” as per the new definition of MSMEs adopted by the Government of India in June 2006.

Finance forms the most critical input for a business enterprise whether large or small. All firms require financing to grow and survive. Sources may be external, such as loans, equity infusions, subsidies and government grants, or internal such as generated cash flows. Many firms are self-financed in the beginning. Once the firms reach certain degree of maturity in the development of their product line and customer base, external finance becomes available. The flow of institutional finance is linked with the creditworthiness of the enterprise. Small enterprises, due to their small size and low capital base, generally find it difficult to satisfy the conditions laid down by the banks, particularly, in establishing the viability of the



project, meeting collateral requirements and making timely repayment of loans. Hence, they do not find a place among the preferred clients of the banks.

Third Census of SSIs

According to the 3rd All India Census of Small Scale Industries (2001–02), of the total number of 10.5 million small enterprises in 2001–02, about 87% units were unregistered while 2.95 lakh units were factory units (employing more than 10 workers with power and registered under Factories Act). 99.5% of the SSI units were tiny units having investment in plant and machinery less than Rs. 25 lakh. While a registered unit employed on an average 4.48 persons, in the case of unregistered units this was only 2.05 persons per unit. Per unit investment in plant and machinery was found at Rs. 2.21 lakh in the case of registered units and Rs. 0.27 lakh in the case of unregistered units. Per unit fixed investment was Rs. 6.68 lakh for registered units and Rs.0.68 lakh for unregistered units. The average for the SSI sector was Rs. 1.47 lakh. Average per unit output for registered unit was Rs. 14.78 lakh and for unregistered unit it was Rs. 0.86 lakh. Average for SSI sector was Rs. 1.47 lakh.

The Census of SSIs found that only 14.26% of the registered units availed bank finance, while only 3.09% of the unregistered units

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had access to bank finance. This means that 97% of the smaller among the small enterprises were deprived of the institutional credit. In other words, most of tiny and micro enterprises use self finance or borrowed funds from friends, relatives and moneylenders. Moneylenders continue to play important role after self-finance. The recent All India Debt and Investment Survey has revealed that the share of moneylenders in total dues of rural households rose from 17.5% in 1991 to 29.6% in 2002. A recent World Bank survey (August 2006) on the status of flow of credit to SME sector has revealed that in the start-up phase, family constitutes an extremely important source of funds for overwhelming majority (over 85%) of the respondents and 'trade credit' came next in importance, representing extremely important source of funds for 27% of the respondents. In comparison, bank loans from state-owned banks make up an extremely important source for 15% and very important source for about 17% of the firms surveyed.

Micro, Small and Medium Enterprises Act, 2006

With the passing of Micro, Small and Medium Enterprises Development Act in June 2006, various components of this sector have been given a clear cut definition. For the first time, micro enterprises, the segment which was earlier known as tiny sector, have been recognized through a formal definition (investment in plant and machinery upto Rs. 25 lakh). For the first time, a reasonable investment ceiling in investment in plant and machinery upto Rs. 5 crore has been prescribed for small enterprises engaged in production or manufacturing as against Rs. 1 crore earlier. It is expected that this enhancement will allow these enterprises to go for technology upgradation and modernization which is one of the prime requirements for enhancing competitiveness in the context of liberalization, globalization and WTO conditionalities. For the first time, official recognition and definition has been given to "medium enterprises" engaged in production or manufacturing as those having investment in plant and machinery between Rs. 5 crore and Rs. 10 crore. And for the first time, the concept of 'enterprises' has been accorded its due role replacing the term 'industries'. This shows the growing importance of service sector in employment generation.

Since finance is required by the enterprises to meet various needs, particularly fixed capital and working capital, it is essential to estimate the size of MSMEs in the country. As per the annual report of Ministry of SSI, the estimated number of SSIs, including tiny/micro units in the country, at the end

of fiscal 2004-05 was 11.86 million. Though, so far no firm data are available about the number of small scale enterprises which would get added due to enhancement of investment ceiling from Rs. 1 crore to Rs. 5 crore and due to inclusion of medium enterprises upto investment of Rs. 10 crore, it is roughly estimated that the number of such enterprises would be about two-third of the existing factory units other than existing SSI factory units. It is estimated that out of 5.8 lakh factory units, about 3.5 lakh are existing SSI factory units and 1 lakh newly defined SSIs and medium enterprises. Thus assuming a growth rate of 9% in the SSI Sector (going by past trend) and due to addition of higher segment of SSI and inclusion of medium enterprises, the number of MSME in the country may be around 13 million now, consisting of 12.9 million small and micro enterprises and 0.1 million new high investment small enterprises and medium enterprises. This estimate does not include traditional industries like handloom, handicraft, khadi and village industries, coir and sericulture.

Institutional Credit Structure

A multi-level institutional structure exists for financing of small enterprises and non-farm enterprises in India. This consists of commercial banks, cooperative banks, RRBs, State Financial Corporations. Credit to small enterprises comes under priority sector lending programme of banks. The Reserve Bank of India (RBI) constantly reviews the flow of credit to this sector. To improve the flow of credit, the RBI has constituted several committees and working groups since 1991. Notable among the committees are Nayak Committee, Kapur Committee and Ganguly Committee. Appropriate measures are taken by the RBI and Government from time to time based upon the decision of the Standing Committee on SSI set up at the RBI. An exclusive refinancing bank, called Small Industries Development Bank of India (SIDBI) was set up in 1990. The issue of providing micro credit to micro-enterprises through development of SHG-Banks Linkage rests mainly with National Bank for Agricultural and Rural Development (NABARD). However, major part of SHG-Bank Linkage credit is in the form of micro credit to meet production and consumption needs and not for micro – enterprises.

Status of Credit Flow to MSMEs

Major complaints of the MSME sector relating to bank finance are that it is inadequate, delayed and costly. The status of SSI sector and flow of credit to the sector from scheduled commercial banks and public sector banks could be obtained from the Table 1.

TABLE – 1
Status and Contribution of SSIs in India

Year	No. of Units registered (in lakh)	Un-registered (in lakh)	Total Units (in lakh)	Production (Rs. in crore) (Constant price Base 1993)	Employment (in lakh)	Export (Rs. in crore)
2000-01	13.10	88.00	101.10	184428	239.09	69797
2001-02	13.75	91.46	105.21	195613	249.09	71244
2002-03	13.68	94.81	108.49	210636	260.13	86013
2003-04	15.54	98.41	113.95	228730	271.36	97644
2004-05	16.38	102.15	118.53	245747	282.82	NA

(Source: Annual Report 2005 – 06, Ministry of SSI)

During the five year period, number of SSIs has increased from 101.1 lakh in 2000 – 01 to 118.5 lakh in 2004 – 05 and employment from 239 lakh to 283 lakh during the same period. The sector recorded an annual growth of 4.4% in units, 8.2% in output and 5.2% in employment during 2000 – 01 to 2004 – 05. Currently it contributes 39% of industrial production and 30% of national export.

In view of the important role played by SSIs, it is essential to look into the status of credit flow to SSIs from the scheduled commercial banks which is the prime source of credit to the sector. It may be clarified here that in banking parlance, 'SSI sector' covers both modern SSIs eligible for registration at DICs and traditional industries like khadi and village industries, handloom, handicraft, coir, sericulture, etc.

TABLE – 2
Flow of Credit from Commercial Banks to SSI Sector

Year	Net Bank Credit (Rs. in crore)	Annual Growth (%)	Credit to SSI (Rs. in crore)	Annual Growth (%)	SSI as % of Net Bank Credit
1994-95	192424	—	29175	—	15.17
1995-96	228198	18.75	34246	17.12	14.98
1996-97	245999	17.89	38196	11.40	15.52
1997-98	297265	21.20	45771	19.60	15.40
1998-99	339477	14.14	51679	12.66	15.22
1999-00	398205	17.40	57035	10.46	14.31
2000-01	467206	17.33	60141	5.43	12.86
2001-02	535063	14.56	67107	11.65	12.53
2002-03	668576	25.04	64707	(-) 3.60	9.67
2003-04	763855	14.20	71209	10.04	9.32
2004-05	971809	27.22	83179	16.71	8.55

(Source – RBI Statistical Tables Relating to Banks in India 2004 – 05)

The pace of growth in SSI credit has not kept pace with the growth in net bank credit (NBC) (see Table 2 and 3). While NBC grew by 17.33% in 2000 – 01, SSI credit grew by only 5.43% that year and while NBC grew by 25.04% in 2002 – 03, SSI credit recorded a negative growth of 3.60%. Though SSI loans come under priority sector lending programme of the scheduled commercial banks, the most disturbing trend to note is the decline in flow of credit to SSI in percentage

terms in relation to NBC. It has declined from 15.52% in 1996-97 to 8.55% in 2004-05. In the absence of any quantitative restriction to SSI lending within the priority sector, the commercial banks have enough scope for deploying funds to other priority sectors like housing, retail trade, education, consumption and transport purposes, etc. and thus, try to meet the overall target.

TABLE - 3
Credit Flow to SSI Sector from Public Sector Banks (PSBs)

(Rs. Crore)

S. No.	Year	As at the end of March		
		Net Bank Credit (NBC)	Credit to SSI	% to NBC
1.	1998	218219	38109	17.5
2.	1999	265554	42591	16.0
3.	2000	316427	46045	14.6
4.	2001	341291	48400	14.2
5.	2002	396954	49743	12.5
6.	2003	477899	52988	11.1
7.	2004	558849	58278	10.4
8.	2005	718722	67634	9.4
9.	2006	966452	82275	8.5

(Source: RBI)

Further, while the absolute amount of advances from the public sector banks to SSIs had increased from Rs. 38109 crore in 1998 to Rs.82275 crore in 2006 (Table – 3), the share of the credit to the SSI sector in the NBC had declined from 17.5% as at the end of March, 1998 to 8.5% as at March, 2006. The continuing decline of credit to SSI sector is a matter of serious concern as adequate credit flow is vital for achieving

12% annual growth rate for the SSI sector as envisaged in the 10th Plan.

Tiny Units

Sixty per cent of the total SSI credit is earmarked for tiny units, (now micro enterprises) as per the guidelines of the RBI. The flow of credit to tiny sector since 2000 is as under:

TABLE – 4
Credit Flow to Tiny Units from Public Sector Banks

(Rs. Crore)

Net Bank credit to tiny sector	24742	26019	27030	26937	30826	28062	33314
Credit to tiny sector as % of net SSI credit	54.0	53.7	54.3	50.8	52.9	41.5	40.5

(Source: RBI)

There had also been a decline in the credit flow to the tiny sector as a percentage of SSI advances from 54.3% in March, 2002 to 50.8% in March, 2003. This somewhat improved at the end of March, 2004 (52.9%). However, thereafter it declined sharply and as against the target of 60%, actual credit was only 40.5% of total SSI credit by the end of March, 2006.

Some other disturbing trends noticed with regard to bank credit to MSMEs are: (i) inadequate working capital which is currently ranging between 10-13% against RBI norm of 20% of projected turnover to be given as working capital, (ii) high cost of credit normally ranging between 13-16% as against relatively lower rate of interest of 6 to 9% charged from large units on the ground of latter's better creditworthiness and 7% from agricultural sector, (iii) insistence on collaterals even on loan upto Rs. 5 lakh in spite of the RBI guidelines to this effect (loans without collateral out of total loan below Rs. 5 lakh to SSI was 25.9% in 2004-05), and (iv) neglect of small loan as the share of loan below Rs. 25000 had declined from 21% of total outstanding of banks' credit in June 1985 to 3.7% in March, 2005. Scheduled commercial banks' credit to the large and medium industries was of the order of Rs. 290186 crore in the year 2004-05 which was 30% of the gross bank credit for that year. Though separate figure for medium industries is not available, it is assumed that about 20% this credit, amounting to Rs. 58083 crore might have gone to medium enterprises. Thus, the total credit from the scheduled commercial banks for the year 2004-05 was Rs. 141217 crore, including Rs. 83179 crore for SSI. To this, we may add Rs. 34313 crore being the credit to small business, retail trade, transport operation, etc in 2003 – 04. In addition, a sum of Rs. 37483 crore flowed to small enterprises including traditional industries and small business from sources like regional rural banks (Rs. 14393 crore), cooperative banks (Rs. 15117 crore), SIDBI direct finance (Rs. 2695 crore), SFCs (Rs. 864 crore) and SIDCs and NSIC (Rs. 4414 crore) in the year 2003-04. Cooperative banks' credit is mostly going to handloom, handicraft and traditional cooperative industries. Thus it is expected that entire MSME Sector received a total credit of over Rs. 2 lakh crore (rough estimate) by the end of March 2005.

Banks, it seems, are not favourably inclined to finance the small enterprises, particularly, smaller among the small enterprises for various reasons. Notable among them are (i) inability of small entrepreneurs to meet collateral requirement (ii) high non-performing assets in SSI sector which is currently at 15% as against 8% for large industries (iii) high incidence

of sickness (though official RBI data indicates a decline in the number of sick SSI units from 3.04 lakh in 2000 to 1.39 lakh in 2004 (iv) higher transaction cost to banks in processing large number of small loan applications. Normally, the cost of processing small loans has been found in the range of 18 to 21% whereas the rate of interest on small loans below Rs. 25,000 is 12% and other loans upto Rs. 5 lakh is 15 to 16% (v) difficulty in establishing the creditworthiness of the project proposals. Poor borrowers do not require project finance; instead they need production, consumption and housing loan.

Among the measures taken by the Government in recent years to improve the flow of credit to MSME Sector, two measures deserve special mention.

(1) Launching of Credit Guarantee Scheme in the year 2000 to enhance the confidence of banks in SSI lending. Credit Guarantee Scheme provides for collateral free loan upto Rs. 25 lakh by member lending institutions. Government guarantees 75% of the loan which is made available to borrowers at nominal service charge of 1.5%. Initially the progress of the scheme was slow but now the scheme has started picking up. Loans of more than Rs. 1100 crore have been guaranteed by now.

(2) One of the most important components of the SME credit package announced in August 2005 is the direction to banks to achieve a minimum of 20% year-on-year growth in credit to the SME sector. The objective is to double the flow of credit from public sector banks to SME Sector from Rs. 67500 crore in 2004-05 to Rs.135000 crore by 2009-10 i.e. within a period of 5 years. The policy package, it seems has started showing results since at the end of March 2006, credit to SSI Sector from public sector banks stood at Rs. 82275 crore as against Rs. 67634 crore at the end of March 2005. This gives an annual growth of over 21% thus exceeding the target of 20%.

Micro Finance

A notable development in recent years has been the phenomenal growth of micro-credit to the poor and needy segment considered as altogether non-bankable segment by the banking sector. This has been possible by the initiative of the RBI and the lead role played by NABARD and SIDBI. Though there are 3 accepted models in micro financing in India namely (1) SHG-Bank Linkage model (II) Grameen model (based on Grameen Bank of Bangladesh and (III) Individual Banking Model operated through Micro Financing Institutions (MFIs), the first model is most popular in India.

90% of the micro credit is being disbursed through the SHG-Bank Linkage Model. In fact, with emphasis on capacity building of MFIs and intermediaries, micro credit has transformed to micro financing.

The phenomenal growth of micro financing is evident from the fact that the number of SHGs which was 4757 in 1995-96, had increased to 1.83 million by the end of December, 2005 and the volume of credit had increased from Rs. 6 Crore to Rs. 8319 crore during the same period. However, in spite of this phenomenal growth, micro financing has not attained the shape of a movement. There exists a vast gap in demand and supply of credit. As per one study, micro credit requirement was assessed at Rs. 50000 crore for the year 1999-2000. By adding other requirements such as housing loan, education loan and micro-enterprise loan, the upper ceiling of loan requirement was assessed at Rs. 2 lakh crore of micro credit. At present rate of cost escalation and taking the base at Rs.50000 crore, it is estimated that the present minimum requirement of micro credit may be Rs. 70000 crore. As against this, the supply is not more than Rs. 10000 crore.

Innovative Financing

The small enterprises have, so far, depended mostly on banks and traditional modes of financing namely term loan and working capital from banks. Micro finance through MFIs and SHGs, no doubt an innovative means of financing, is only in its initial stage and at best only an indirect form of bank finance. Unlike large enterprises which raise finance from capital market and external sources like foreign financial investors besides commercial banks, small enterprises and other non-farm enterprises are solely dependent on banks. With the growing financial need, emergence of new product lines, emergence of risky and untried ventures, it is high time that some innovative means of financing for the non-farm unorganized enterprises are explored.

The possibility of linking SMEs, with capital market needs to be explored. Capital market has huge amount of money and institutions like SIDBI will have to design instruments to link SMEs with capital market. The emergence of clusters and with emphasis on making them as the strategy of SME development, would make it possible to rope in capital market to SME financing. This will bring new capital to this sector. Another, innovative instrument to be tried for newly emerging ventures like bio-tech, food processing, IT, pharmaceutical and other knowledge based sectors in India is creation of

venture capital funds to meet the equity requirements of these units in the initial phase of their working and the knowledge sector including BPO, KPO, Life sciences, on-line business, technology-enabled design and manufacturing as well as in emerging areas of nano-technology and environmental technology. Some venture funds, have already been set up by SIDBI, SBICAP, etc. Third area of innovative financing, which needs popularization in India, is the development of factoring services. This is necessary since a major problem faced by MSMEs, is delayed payment from the units to whom they have supplied goods. Banks can work as factors on behalf of MSMEs, to collect the dues on their behalf by discounting the bills at nominal service charge. Likewise, other means of financing SMEs, such as lease finance, hire-purchase finance and propagation of incubation centres could be undertaken to inject additional fund to the MSMEs in order to bridge the financial gap.

The Sum up

The development of an efficient MSME lending environment requires that economic agents involved i.e. the lenders and borrowers should receive incentives to make correct economic choices. For this, they must have the relevant information needed to make such decisions. Available evidence suggests that in the case of lending to even larger small enterprises, these requirements are not always met. In a market led economy, in the presence of information asymmetries, prospective lenders may not be able to correctly appraise true value of the project proposals. The protection of creditors' right is of particular importance in the case of bank finance. At the same time, government intervention is required for micro enterprises and smaller among small enterprises. Since in the normal commercial operation of the commercial banks, there is practically not much scope for this category of enterprises. This calls for a proper mix of policy support for lower segment and demand – supply based credit policy for upper segment of MSME sector. In the context of jobless growth in formal sector, such a mix is necessary. Banks should also diversity the loan portfolio from existing production loan to include technology loan, marketing loan and cluster development loan. Some innovative instruments should be tried to bridge the financing gap. The task of financing MSMEs is challenging but not unachievable. The sector needs proper attention since it has the potential to generate large scale employment and also emerge as the engine of growth. ■