

## MSME Growth for Inclusive Growth: Importance of a Vibrant Eco-System

Subhransu S Acharya<sup>a</sup>, L K Vaswani<sup>b</sup>

<sup>a</sup>Research Scholar, KIIT School of Management, KIIT University, Bhubaneswar, India

<sup>b</sup>Director, KIIT School of Rural Management, KIIT University, Bhubaneswar, India

### Abstract

The Micro, Small & Medium Enterprises [MSME] sector plays a pivotal role in the fabric of Industrial Economy of a Nation. The contribution of this sector to a country's development goals is by far well known. This sector covers an entire gamut of micro to medium enterprises, both at manufacturing and services. With its potential for creating incremental employment, the MSME sector can prove to be a very strong reagent for inclusive growth agenda of the nation. The development policy framework accordingly needs to lay further stress on strengthening the existing eco-system for holistic development of MSMEs so as to achieve the objective of economic and financial inclusion of a larger population. Availability of timely and adequate finance is one of the most important requirement for MSME growth. Hence, the present work has attempted to the study of financing eco-system and proposes strengthening of the same for ensuring better flow of institutional credit for the sector towards achieving the inclusive growth agenda of the nation.

**KEYWORDS :** MSME, Credit Guarantee, Cluster, Securitization, Credit bureau

### INTRODUCTION

Through out the world, the Micro, Small & Medium Enterprises [MSMEs] contribute significantly to the process of economic progress and growth. The share of MSMEs in the economy varies from country to country. The MSMEs have a significant role in growth and development of almost all nations. It has been estimated that, "*in low income countries with GNP per capita between \$100 and \$500, MSMEs account for over 60 per cent of GDP and 70 per cent of total employment; in middle income countries they produce close to 70 per cent of GDP and 95 per cent of total employment*" [Fan, Criscuolo, Ilieva-Hamel]. The MSMEs are believed to be one of the biggest job creators. The following Table depicts the contribution of MSMEs to the GDP and employment in select countries.

**SME Conditions in East and Southeast Asia**

	Number of Enterprises (% of total)	Number of Employees (% of total)	Contribution to GDP (%)
<b>East Asia</b>			
Japan	99.7	69.4	47.7
Korea, Rep. of	99.9	87.7	47.6
China	99.0	75.0	58.5

## Southeast Asia

Brunei	98.4	58.0	22.0
Cambodia	98.5	-	85.0
Indonesia	99.9	97.0	56.5
Laos	99.8	83.0	6 to 9
Malaysia	99.2	59.0	31.90
Myanmar	92.0	-	-
Philippines	99.6	63.2	35.70
Singapore	99.4	62.3	46.3
Thailand	99.8	78.2	36.7
Vietnam	97.4	77.3	26.0

Source : Asian Development Bank

Studies by Government agencies and also by scholars have established that MSMEs provide large employment opportunities at comparatively lower capital cost and help more equitable distribution of growth and wealth. However, MSME sector across the world face the common problems of 'technology obsolescence', 'supply chain problems', 'difficulties in accessing institutional credit', 'increased competition' etc. These problems are often related to their small size.

### PURPOSE, HYPOTHESIS & METHODOLOGY

The current work envisages to explore the inclusion potential of the MSME sector and examine the existing Ecosystem and its efficacy. The work has tried to hypothesize that a vibrant eco-system is a pre-requisite for increased flow of credit to the MSME sector. The current work is 'exploratory research' and relies on existing available literature and primary and secondary data sources. The primary data has been collected by way of 'Interview method'. The interview was conducted amongst 121 first generation entrepreneurs and 117 bankers of Odisha. Only those bankers were selected who are working or have worked in MSME financing.

### ACCESS TO FINANCE

Amongst the plethora of issues faced by the MSMEs, possibly the most important one is their difficulty in accessing credit from the banking system. According to an IFC report on SMEs, "between 45% and 55% of formal SMEs do not have loans from formal financial institutions in developing countries". The Consultative Group to Assist the Poor (CGAP) have arrived at that about 32% of the SMEs had received institutional financial assistance as against 56% of large firms (Financial Access 2010). The share of credit outstanding to SMEs vis-à-vis GDP is over 30% in upper middle income countries such as China, Thailand etc. However, the share is very small in lower middle income countries like India, Indonesia etc.

In a study of Banks' Lending criteria to SMEs, Kouser, Durani, Hussain & Hassan (2012) have argued that "the financing problem of SMEs is one of the major constraints for their success because banks normally try to avoid the risk of loaning in SMEs due to their small scale of operations". There are several reasons why as to Bank lending to the sector

is not in the expected lines or in consonance with their number. The reasons vary from a perceived bias as to the risky-ness associated with such small units, lack of supporting financial data, lack of past records, information asymmetry issues, availability of alternative avenues for investment by banks, difficulties in enforcement of legal rights, inability of the MSMEs to offer collaterals for securing their exposure etc. The same authors (Kouser et.al.) add that “for Banks, collateral is the most important factor that is considered at most for the provision of loans to SMEs”. In their seminal work, Stiglitz & Weiss (1981) had outlined information asymmetry as one of the major reasons for adverse selection of right MSMEs in the credit market.

Keeping in view such restricted access of MSMEs to the credit market, Governments across the world resort to various policy measures which include directed credit, administered interest rates, Credit Guarantee etc.

### **MSMEs in INDIA**

The Micro, Small and Medium Enterprises [MSMEs] in India is the cornerstone of Indian Economy. With over 30 million units providing employment opportunities to over 70 million population, the MSME sector contributes greatly with 45% of the total manufacturing output and over 40% of exports. The MSME sector produces over 6000 products.

Considering the importance of the sector, the Parliament of India has enacted the ‘Micro, Small & Medium Enterprises Development Act’ 2006 to provide a legal framework for development and enhancing the competitiveness of the MSME Sector. The Act has ushered in the concept of ‘Enterprises’ as opposed to ‘Industries’ to bring into its fold the growing number of Service Sector entities to its fold. The Act defines the Micro, Small and Medium Enterprises [MSMEs] based on their respective ‘Investment ceiling’ in ‘Plant & Machinery’ for manufacturing enterprises and ‘Equipments’ for service enterprises.

The MSME sector, after the Agriculture sector, provides the maximum employment opportunities, both for self-employment as well as wage employment. *“The sector contributes not only to higher rate of economic growth, but also in building an inclusive and sustainable society in many ways through creation of non-farm livelihood at lower cost, balanced regional development, gender & social balance, environmentally sustainable development and above all recession proofing of economic growth, which the sector has proven time and again.”* (SIDBI Report on MSME Sector, 2011).

Recognising the importance of the sector, Governments, both at National and State levels have put in place elaborate institutional mechanism for enabling holistic growth of the MSMEs. The sector as such is highly heterogenous in terms of size, capacity, technology employed, products & services, areas of operation, scale of operation, legal status, so on and so forth. In order to support this diverse multiplicity, an elaborate and multi-disciplinary support system has evolved. These include, (a) institutions at policy level such as Ministry of MSME, Reserve Bank of India, (b) institutions at Apex Level such as

Small Industries Development Bank of India (SIDBI), National Small Industries Corporation (NSIC) etc, (c) financing institutions such as scheduled commercial Banks, Regional Rural Banks (RRBs), State Finance Corporations (SFCs), State Industrial Development Corporations (SIDCs) etc, (d) infrastructure providing entities like SSIDCs, (e) institutions providing extension services like Tool Rooms, MSME Development Institute etc besides (f) various Research & Development organizations. In addition, there are a host of other support institutions like Credit Information Companies (CIC), Rating Agencies, Business Development Services (BDS) providers etc.

### **CREDIT to MSMEs in INDIA**

Credit is the life blood of any organization and availability of adequate and timely finance is 'sine-qua-non' to the growth of any sector. MSMEs are no different. In earlier times (prior to 1991, pre-Liberalisation period), Term Credit was mostly available from State Financial Corporations (SFCs) and Bankers were providers of Working Capital facilities. However, later on, with decline in operations of SFCs, the Banks have assumed the role of sole purveyors of both Block capital and Working capital for MSMEs.

“There is widespread recognition of the fact that, with the deregulation of the financial sector, the ability of the banks to service the credit requirements of the MSME sector depends on the underlying transaction costs, recovery process efficiency and assets available to secure the exposure. However, for a number of reasons, there is a wide belief that the financing to MSMEs has not been to the desired extent. Though several reasons are attributed to the same, perhaps the most prominent are the information asymmetry between the borrower MSMEs and Banks. This arises mostly from small businesses' lack of standardized financial statements. Coupled with the bank's limited knowledge about the nuances of workings of the borrower company vis-à-vis the particular sub-sector, the gap only widens. Further, due to inadequate risk perception which is on account of the fact that the strength of these units are not always manifested properly, pricing too gets impacted. As a result, the lenders prefer to be conservative and cautious. While Credit Information Bureau of India Limited [CIBIL] has built up a data base of borrowers including MSME borrowers, the same has not been able to help the matter of 'perception' in any substantive manner.

“The MSMEs primarily rely on bank finance for their operations and as such ensuring timely and adequate flow of credit to the sector has been an overriding public policy objective” (SIDBI, 2011). The Reserve Bank of India classifies only the advances to Micro and Small Enterprises [MSEs] as part of priority sector and as such compiles the data on credit flow to this sector. As per RBI, the credit flow to MSEs by scheduled commercial banks has increased from Rs.2.14 lakh crore in March 2008 to Rs.4.79 lakh crore by March 2011. Critics say that the apparent jump in credit flow to MSE sector is because of the inclusion of 'retail trading' credit in to the gamut of 'Service Sector'. Nonetheless, the Banking sector has been witnessing growth in credit to MSMEs. However, keeping in view the fact that only less than 10% of MSMEs have access to institutional finance [as per MSME Census, 2011], there is ample scope for upscaling the reach of institutional credit to MSME sector.

## SURVEY DATA RESULTS

The survey of the entrepreneurs and bankers revealed very interesting phenomenon. While it was observed that the entrepreneurs felt that lack of collateral security hurt them most for getting bank finance, the bankers perceived ‘small ticket size’ and ‘poor contract enforcement’ as the most important factors followed by ‘collateral security’ and ‘poor book keeping’. The survey results are graphically represented in Fig 1 and Fig 2.

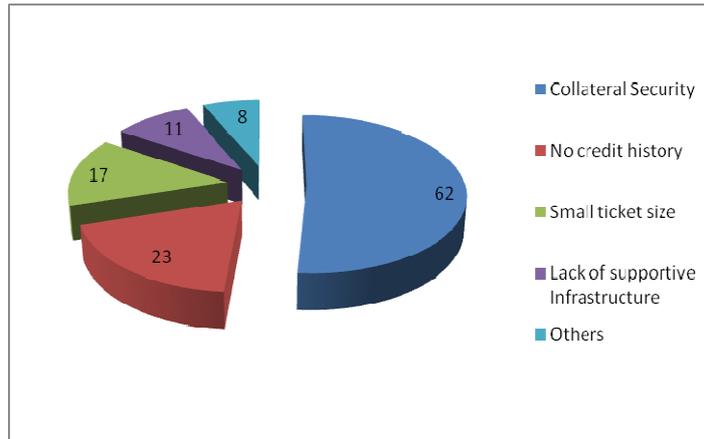


Fig 1 : Views of entrepreneurs on low share of bank credit for MSMEs

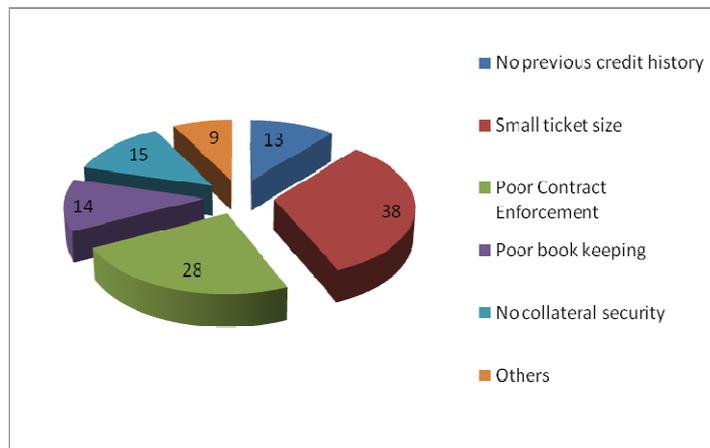


Fig 2 : Views of bankers on low share of bank credit for MSMEs

### INGREDIENTS OF FINANCING ECO-SYSTEM FOR MSMEs

Enhancing the efficiency of bank lending for MSMEs is a priority public issue. Towards this end, it is effective to elaborate the strategic framework needed to reduce the demand supply gap of SME finance caused by information asymmetry and high transaction costs. The policy framework to improve MSMEs’ bankability must address the issues below:-

- a. proper financial and legal infrastructure for MSMEs

- b. innovative financing instruments that facilitate MSMEs' access to banks, and
- c. frame work for mitigating credit risks associated with MSME financing.

World-wide, establishment of proper financial infrastructure such as Credit Bureaus and Collateral registries are propounded to mitigate asymmetric information conditions. According to an IFC report, Credit bureau coverage in developing economies is much lower than the Organisation for Economic Co-operation and Development (OECD) country average. Credit bureaus reduce obstacles in small firms' path to accessing finance and increase their use of external financing. It is expected that if lenders use comprehensive financial data including both positive and negative information, it should result in decreasing credit default rates and increasing loan approval rates for MSMEs.

In Banking sector in India and many other countries, it is common for Banks to take real estate security (collateral) and third party guarantees to hedge credit risks. However, because of information asymmetry, excessive collateral and guarantee requirements have often been imposed on MSME borrowers. Moreover, accounts receivables are not regarded as collateral in many cases. In order to improve this condition, innovative financing instruments those are not dependent on real estate securities and third party guarantees should be developed. Thus, Lending schemes with accounts receivables as Collaterals and Credit score based lending are promising alternatives to pure mortgage based lending. These instruments have the potential to enable banks to expand their client base, especially among MSME borrowers and reduce transaction costs [Source – ADB].

Developing Cluster specific financing scheme for the MSME Cluster is an approach to enhance the efficiency of MSME finance and to stimulate trade. Clustering is beneficial to MSMEs which are smaller as it facilitates connections with the external economy, including suppliers, workers, trade parties and financial institutions. A mechanism to channel funds smoothly to individual MSMEs through a proper credit screening system is necessary to implement cluster financing. Instruments like 'Mutual Guarantee' need to be propagated and popularized as a means towards achieving higher scalability in MSME financing in Clusters. Securitisation of MSME asset pools backed by Mutual Guarantee, Credit Guarantee would provide Banks more elbow room for increasing financing and enhance profitability within the Capital stipulations under BASEL accord.

Innovating different funding instruments for various strata in the MSME spectrum depending on their stage of development is very important. The needs of a start up can vary from that of an early stage firm, the needs of an early stage firm may differ from a growth firm etc. It is also not right to expect Banks to meet the needs of all MSMEs in the entire spectrum. Thus, the share of institutional credit is still so low. Hence, it is imperative to nurture supplementing institutions like start up funds, venture funds, non-banking Finance Companies and MSME specific Capital market.

#### **POLICY MEASURES FOR A CONDUCTIVE ECO-SYSTEM IN INDIA**

The policy response towards holistic growth of this sector has been very wide. Starting from the 1<sup>st</sup> Industrial policy resolution after independence to the setting up of District Industries Centres (DICs) to setting up of a separate administrative Ministry for the sector

in 1999, there are no dearth of initiatives. As far as Credit flow is concerned, measures like directed credit [credit to SSI sector (now MSE sector) being part of priority sector by Banks], administered interest rates, special simplified dispensation for working capital calculation (Nayak Committee) etc came into play. However, the biggest challenge was the problem of information asymmetry between the lender and borrower. This information asymmetry was perceived as one of the reasons for the Credit market imperfections for MSEs. This problem was further accentuated by a perceived bias that the lending to this sector was risky. Thus, the Banks, in order to protect their interest, in the event of future default were insisting on 'Collateral security' from the borrower. Kouser, et al., (2012) observe that *"for Banks, collateral is the most important factor that is considered at most for the provision of loans to SMEs"*. As many new first generation entrepreneurs were not in a position to provide collateral security, they were deprived of bank credit. Hence, the State intervention was necessitated to address these imperfections and thus, a 'Credit Guarantee Scheme' for MSEs was conceived.

### **Credit Guarantee Scheme**

Boocock and Shariff (2005, p. 428) describe the Credit Guarantee Scheme (CGS) where...."financial institutions are encouraged to make loans available to small enterprises on the understanding that a government or quasi-government body will reimburse a percentage of the loan should the firm default". The importance of CGS can be gauged from the fact that *"in response to the 2008 financial crisis, 19 of the 23 countries within the Organisation for Economic Co-operation & Development (OECD) developed policies to create or extend CGS to improve SME access to liquidity (Uesugi, Sakai & Yamashiro (2010)."*

In India, to address the above market imperfection, Credit Guarantee Trust for Micro & Small Enterprises (CGTMSE) was set up in the year 2000. The Trust facilitates collateral free loans from Banks to MSEs by providing Guarantee to the Banks up to a limit of Rs.100 lakh. The eligible Banks and Financial Institutions get affiliated as a 'Member Lending Institution' (MLI) to get coverage of their collateral free loans to MSE sector.

It is noteworthy that even despite availability of CGTMSE, collateral security is still a very big issue both with the MSMEs and Entrepreneurs. Perhaps, a continuous input delivery through individual MLI's internal training programs, awareness meets as also continued regulatory forbearance for CGTMSE coverage shall be of help to further popularize collateral free lending.

### **Credit Bureaus and Security Registry**

The 'Credit Information Companies Act' has ushered in an era of transparency in knowing the Credit history of borrowers. The 'Credit Information Bureau of India Limited' (CIBIL) is a source of great comfort to Lenders as it provides the credit history of all customers having exposure to banking system. On the other hand, the 'Central Registry of Securitisation, Asset Reconstruction and Security interest (CERSAI) is providing a ready reckoner to Banks and Financial Institutions to cross verify the encumbrance of security interests on the securities offered to them. Increased use of

CIBIL and more such Credit Information Company reports will address the issue of 'previous credit history' portion.

### **Cluster based Financing approach**

MSMEs tend to grow in clusters. There are about 400 recognised Clusters in India [UNIDO]. Besides, there are thousands of small Clusters. The Clusters are characterized by homogeneity. Thus, it offers scope for rapid quality credit build up by Banks at shorter time. The 'Risk Profile' of the Cluster could be studied and Banks may put in place adequate mitigation mechanism for the identified risks. Thus, with such an approach, a win-win situation could emerge in the clusters for both MSMEs and Banks.

### **CONCLUSION**

MSMEs as growth drivers across various economies have varied, typical and often very different needs. Credit being one of the critical factors of success of enterprises, the growth of an ambient and vibrant eco-system is critical to the growth of this sector. With its potential for equitable growth through wider geographic dispersal, incremental and higher employment generation potential, it can be a very powerful medium for 'Inclusive growth' agenda. MSMEs comprise a wide range of firms in terms of sector, scale and management style. Hence, a one-size-fits-all approach to MSME financing needs to be gradually supplanted with a more dynamic and flexible approach. Though regulations are necessary, often despite all best intentions, regulations stifle innovation. Having accepted that innovation and dynamism are required for increasing the flow of institutional credit, it is also important to imbibe in the system that certain innovations or interventions may not succeed. An eco-system to recognize this fact, ring fencing the stake holders from Credit risk and inculcating a culture to shun risk aversion and more co-ordinated approach involving policy makers, regulators, academia and financing institutions would go a long way in achieving the common objective of creating a vibrant eco-system for MSME growth towards meeting the objective of 'Inclusive growth'. With its potential for creation of additional incremental employment opportunities, the MSME sector holds a great promise for 'Economic Inclusion' of a large section of our population.

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