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MSME FINANCING: NEED FOR INNOVATION

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MSMEs worldwide play a leading role in propelling economic growth, sustaining livelihood and in promoting equitable regional development. Significance of MSMEs can widely be observed in the developing economies where this sector constitutes over 90% of total enterprises and substantially to industrial production, exports and employment generation. In India also MSMEs play pivotal role in overall industrial economy of the country. A unique feature of Indian MSMEs is that a very large proportion of them are concentrated around an estimated 6600 clusters including 1157 traditional industrial clusters, 3091 handicrafts clusters and 563 handloom clusters. (www.clusterobservatory.in)

With the opening up of Indian economy in 1990s, MSMEs are no more insulated in the controlled economy; the competitive pressure of free market economy is catching up. MSMEs are transitioning into a new business environment characterized by the emergence of national and global supply chains where they share symbiotic relationship with large corporations. Yet a large number of MSMEs cater only to regional domestic markets through local supply chains. With the advent of foreign direct investment in organized retail sector and opening up of government market for MSMEs through a new bill that will ensure procurement of products and services from this sector, the opportunities will increase for many of the MSMEs who will need to upgrade their production, quality and supply systems according to the buyers' upgraded requirements. This will therefore also require increased credit requirements among MSMEs. Credit flows to the sector will also be needed for plugging infrastructure bottlenecks more particularly power generation and other common facilities.

Without adequate and timely flow of credit, sickness among MSMEs and NPAs for the banks will only increase. The major reasons identified by the Economic Survey of India 2009-2010 behind the increasing sickness among Indian MSMEs are the lack of market demand and lack of working capital. The survey for 4th All India Census of MSMEs identified 48% units among the sick units are suffering due to the lack of working capital. The major reason suggested by experts in the field of MSME development for lower access to credit among MSMEs is the high risk perception among the banks about this sector and high transaction cost for loans appraisal that restricts access of MSMEs to institutional credit mechanism.

While developing mechanisms for enhancing flow of credit to MSMEs, it needs to be recognized that the MSMEs access credit not only from the formal institutions but also informal sources. The effectiveness of any channel for credit delivery depends on transaction cost, ease of access and turnaround time for delivery. In India, according to the 4th All India Census of MSMEs, a mere 5.2% of total MSMEs have access to institutional finance, most of which are registered formal enterprises. It is therefore very important to provide a thrust to financing through informal channels as well.

The Government of India while realizing the potential of MSMEs with respect to job creation and industrial and economic growth has taken various measures to facilitate MSME development including enacting Micro, Small, Medium Enterprises Development (MSMED) Act, 2006, implementing various promotional initiatives including National Manufacturing Competitiveness Program. The Prime Minister's Task Force on MSMEs Report 2010 advised banks to achieve 20% annual growth in outstanding credit to micro and small enterprises. Government of India launched Credit Guarantee Fund Trust for Micro, Small and Medium enterprises (CGTMSE) with SIDBI for creating an institutional mechanism to support banks and financial institutions to ensure availability of credit facility and easy access to institutional funds to MSME sector. The slew of measures taken by the government has certainly resulted in increased credit flow to MSME sector by 5.5 times from Rs 746 billion as at end 2004-05 to Rs 4079 billion on November 19, 2010. A significant amount of increase is due to change in the definition of MSMEs with inclusion of service enterprises in the year 2006-07 and manufacturing enterprises with higher investment limits upto Rs. 10 crores instead of Rs. 1 crore earlier as applicable to the then small scale industries. However despite the increase most of the micro and small enterprises still remain uncovered through institutional finance.

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SIDBI during a study undertaken in the year 2011 identified several constraints that hinder MSMEs access to credit and acknowledged in its report the need for financial innovation by adoption of several international best banking practices for MSMEs sector. Many of these measures indicated the need to adopt revenue based financing instead of collateral based financing that is currently in vogue in most of the institutional financing. There is also need to come up with new institutional mechanisms that can address the smaller loan requirements of the MSME segment ranging from Rs. 50,000 to Rs. 10 lacs that is most starved of formal credit. This is also classically called the missing middle between the extremes of micro finance and larger institutional credit beyond Rs. 10 lacs requirements where banks are more comfortable to lend.

Sarkar et.al (2011), studied around 100 MSME clusters and found accessing finance as the major concern in 43 clusters. The study found that most of the units in these clusters stay away from institutional finance either due to perceived high rate of interest, non availability of institutional finance mechanism or because of improper documentation, inability to provide physical collateral and tedious and/or lengthy documentation process of the banks. All these resulted in problems like inability of enterprises to stock raw materials and finished products to meet the peak season demand, securing domestic supplies and leaning towards informal markets for credit at higher rate of interest thus increasing the production cost and reducing the viability of businesses. Very little work has been done to study and find ways to strengthen alternate institutional mechanisms to plug missing middle financing and improve efficiency of the informal financing markets. This paper therefore advocates the need for designing, piloting and scaling up of various innovative methods for improving access to credit for MSMEs through various alternate routes.

These models must aim at reducing transaction costs particularly for smaller credit requirements and yet help banks provide loans with mutually win-win synergy. Several Innovative models for facilitating MSMEs access to finance are developed around the world some of which have also been tried in India. The ones that have been successful must be taken up for piloting at bigger scale and then replicating at still higher levels by designing them to suit local context. Some of these models are illustrated here in this paper.

Customised financing systems among banks: Strengthening internal knowledge systems in banks can help them customize credit facility suiting common local needs of enterprises, often in the same or similar sector. There is a lot of scope for customisation of financial products with respect to the business needs in terms of their seasonality, production cycles and cash flows of the businesses through flexibility to meet differential need of the groups of enterprises. Over the last two decades several banks including State Bank of India, SIDBI, Punjab National Bank and ICICI Bank have claimed to set up cluster based branches to capitalise on building an understanding of common needs of cluster based MSMEs. There is however a great deal of improvement required in the methodologies adopted for capitalising on this opportunity. Sarkar et.al (2011) emphasized the fact that credit needs vary with the level of maturity of the cluster. It was found that clusters where units are value chain linked with large enterprises need credit for technology, expansion, creation of sheds and building etc. Other enterprises demand credit for basic working capital requirement. The paper identified huge difference between felt credit needs and the credit accessed by banks in 90% cases. The process includes involving local industry associations (also called Business Membership Organisations or BMOs) to facilitate better communication between MSMEs and the Banks. Faridabad Small Industries Association (FSIA) and SIDBI have developed a successful model where the BMO provides further value added services to help screen applications thus giving further comfort level to SIDBI.

Order based financing: It is often observed with micro and small enterprises that they do not have adequate working capital due to which they are unable to fulfil the orders. Order based finance could be a well suited model in such a situation and is well practiced in South Korea. Under this model purchase order can be used as collateral for the loan. The accounts receivable is transferred to the lending institutions and becomes the source of loan repayments. The financial institution may then collect full interest, fee and part payment for the loans. The model reduces the risk for the financial institutions by creating an accounts-receivable mechanism of lending based on buyers demand.

Purchase based lending: Where there is less surety of orders in the short term or where MSMEs are involved in their own marketing, purchasing raw material at appropriate time and price becomes a major issue. Under such circumstances, raw material need of the MSMEs can be fulfilled by giving vouchers to bank approved raw material suppliers (RMS). RMS in this case would just be a facilitating agent. Here the liability will not be on the RMS but the relationship of enterprise as gauged by regular transactions and history of buying selling with RMS could act as a comfort. Similar mechanisms can be applied to meet technology needs of the enterprises where credit is required to buy equipment from pre-approved higher end technology provider. The order based financing and purchase based financing are transaction based models.

Mutual credit guarantee system that provide collective guarantee to member firm is another way of improving MSMEs' access to credit. Joint liability groups like these reduce the need of intermediaries between the banks or other financial institutions and MSMEs. It is a well practiced model with its genesis in Italy and several other European countries. However, for this the banks need to recognize the consortia of MSMEs organizing themselves into a Mutual credit guarantee group. There are well documented institutional mechanisms that enable enterprises to become members of such organisations that can have thousands of members and in house established systems of screening applications for credit and sharing of profit evolved from good functioning of such institutions.

Finance plus services: Credit delivery needs to be often supplemented with credit advisory services that can help MSMEs make effective use of credit and also provide improved monitoring system for the banks. These services can be charged for either upfront or subsequent to credit delivery. In other cases provision of linkages with differential value added service providers in the cluster for providing technical guidance and hand-holding support can be provided thus mitigating the risk associated with financing. There is in fact a wide gap between the existing and potential productivity levels that such services can help to reduce thus giving synergic advantages to all stakeholders involved. The State Bank of India's Uptech programme implemented since 1989 is one such model that has immense potential for scaling up.

Strengthening capacities of other intermediary institutions: The missing middle financing can also be taken care of by bringing in micro finance institutions, non banking financial institutions and regional rural banks to start financing micro & small enterprises. This will require building their capacities to identify the needs of local MSMEs and help build systems to effectively meet the requirements. This will ensure bringing in new supply institutions that are not traditionally involved with MSMEs. Moreover

NBFCs and MFIs can develop or use their own systems of appraisal and risk financing suiting the requirements of this heterogeneous sector across diverse economic geographies.

Risk participation in financing innovative MSMEs: Banks traditionally provide lending using safe norms and securities. Risk participation by banks among a basket of innovative enterprises particularly at small levels of financing practically does not exist. The appraisal and recovery systems for financing currently in vogue do not provide for risk based financing of innovative enterprises. This does not necessarily allow start up entrepreneurs access credit as their business plans fall short on parameters like DSCR, leverage etc. (Aruna Balamurgan, SME World, 2010). There is need to build new windows for such financing.

SIDBI has undertaken to undertake trials through certain developmental projects financed by international agencies such as JICA, KFW, GIZ, World Bank, DFID and more recently European Union in the areas of energy efficiency, green financing, sustainability financing and innovative financing. An intervention aimed at improving energy efficiency of 500 enterprises under an EU Switch Asia project initiated in 2012 has targeted to reach out to at least 100 enterprises through different means, thus providing lessons for future replication. Similar trials are also being undertaken by other banks, a repository of which must be built to share learnings among the institutions and help scale up successful pilot interventions.

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