Bank Finance to MSMEs in India – A Discussion on Pre and Post MSMED Act

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Abstract
Availability of adequate and timely credit at affordable cost is an important determinant of the success or failure among small business enterprises. Indian MSME sector contributing significantly to domestic economy has been experiencing difficulties in this regard. Using historical data from the website of the Reserve Bank of India (RBI), we have examined the supply of credit by domestic banks to MSMEs in two phases; Pre and Post Micro, Small and Medium Enterprises Development (MSMED) Act, 2006. We find that rate of growth of bank credit is relatively better during post MSMED period and therefore, the relative share of small enterprises in the total bank credit is on increasing trend. We also find that overall performance of public and private sector banks in lending SSIs and MSEs during pre and post MSMED Act are similar.

Keywords: SSIs, SMEs, MSMEs, MSEs, MSMED Act, Net Bank Credit, Priority Sector Credit, CAGR, Public Sector Banks, Private Sector Banks, India.

Introduction
Micro, Small and Medium Enterprises have long been the center of attention of industrial policies by the Governments around the world. The reason is the contribution of small industrial units in industrial production, employment generation, contribution to GDP, poverty alleviation, balanced regional development and overall economic development of different countries. SMEs account for large number of enterprises and are main providers of employment in different countries (Hallberg, 2001; European Commission, 2005; Ayyagari, Beck and Demirgüç-Kunt, 2007). In China, 68 percent of the country’s exports come from SME sector (UNIDO, 2011). Canadian SMEs account for 45 percent of country’s GDP (Statistics Canada, 2003). A Report by Japan’s Ministry of Foreign Affairs in 2003 revealed that SMEs contribute over 55 percent of value added in the manufacturing sector. Economic importance of SMEs is also documented by other studies (e.g. Havas, 2002; Klapper, Luc and Raghuram, 2006). This implies that a vibrant and well developed MSME sector can benefit the overall economy and well-being of the population hence, creating such an environment for MSMEs to develop, has been top on agenda for the Governments of India.

In India, the second populous country in the world, employment generation is an important step towards reducing the poverty rate which has been a major setback in the country. Evidence suggests that the labor-capital ratio in SMEs is much higher compared to larger industries. Moreover, in a rural dominated country like India, SMEs facilitate balanced growth by tackling regional imbalances. Studies by Murthy, (2004); Sahoo, (2004); Rani and Rao (2008) and Raju (2008) reflect the importance of SME sector in India. The importance of this sector in economic development of India and achieving the growth objective is widely recognized.

Despite their importance in national economies, SMEs are often constrained by a number of problems such as management capabilities, marketing, obsolete technology, unskilled workforce, poor infrastructure, access to timely, adequate and cost-effective credit etc., which are related to their nature and size of operations. As finance which is said to be the life blood of every business organization is important to its survival and smooth functioning, adequate and timely provision of credit is even more crucial especially at growth stages of the business. Availability of formal bank credit in the form of working capital and long term loans is extremely important in this regard, shortage of which is the responsible factor for sickness and closure of many MSME units. Hence, addressing the problem of
SME financing as hindrance factor to development of the sector and overall economy and poverty alleviation is extremely important.

Review of Literature
Of all the problems faced by the MSMEs, non-availability of timely and adequate credit at reasonable interest rate is one of the most important. Cross country evidence reveals that the SME sector faces impediments to bank financing (Binks and Ennew, 1997; Poutziouris, P., Nicos M., and Khaled Soufani, 2005; Hutchinson, 2006; Stephanou and Rodriguez, 2008). Berger and Udell, (1998) and Galindo and Schiantarelli, (2003) discuss that constrained faced by SMEs in their access to finance is the case in both developed and developing countries. It has also been claimed that SMEs are more financially constrained than large firms (Beck, Demirgüç-Kunt, and Maksimovic, 2008).

To address the credit related problems faced by SMEs in India, several committees and working groups have been setup by the Governments. These committees and working groups have recognized the credit related problems, especially the problems of tiny enterprises and also suggested several measures to improve the flow of bank credit to SME sector. Nayak Committee (1991), Abid Hussein Committee (1997) and Prime Minister’s Task Force (2010) recognized the credit related problems faced by small units, especially tiny sector. Major complaints of the SMEs in India in regard to bank finance has been inadequate credit, inordinate delay in obtaining credit and high cost of credit. A study by Das et al (2007) categorically brought out that bank credit to SMEs was grossly inadequate, whereas the un-timeliness aspect was revealed in another study (Narayana, 2004). The relationship between access to and cost of bank credit is rather well known. While access to bank credit by small enterprise is difficult, cost if accessed is substantially high relative to large enterprise (Mehta, 2009). According to the Fourth All India Census of MSMEs conducted by the office of Development Commissioner in 2007, shortage of working capital was among the most important causes of sickness/incipient sickness among registered MSMEs. To tackle various constraints and remove barriers, during decades, the Governments of India have pushed forward attempts to support SME sector in the country through various financial policies and measures lead by RBI. Nair Committee Report in 2011 revealed that despite the policy initiatives, banks prefer to finance medium and large enterprises. There is a considerable institutional finance gap in meeting small sector’s credit needs (IFC, 2012).

Analytical Framework
In view of the increasing competition imposed by international laws, Indian small sector and its well-being is adversely affected. In addition, following the recent financial crisis and with the enforcement of Basel III capital accord, it is believed that banks emphasize on additional collateral and guarantees for lending to firms (The Banker and IFAC, 2009; Härle, et al., 2010). With SMEs contributing significantly to employment generation, national product and exports, SME development is high on the reform agenda of many Governments and a broad range of policies and programs target improvements in SME business environments, as well as financial support to SMEs.

The proposed study relies on secondary sources of information and data mainly from Reserve Bank of India and ministry of MSMEs, Government of India. Though often we have used acronym MSMEs, it must be pointed out that RBI sources on bank finance to small enterprises capture only MSEs or micro and small enterprises and not medium enterprises. However, the ministry information includes MSMEs. Therefore, the findings may have their own limitations. We have examined the supply of bank credit to small enterprises sector under two distinct phases, i.e., before the enactment of MSMED Act in 2006 (2002-06) and after the enactment (2008-12). It is important to note that the services sector enterprises were included into the fold of ‘Small Enterprises’ in 2006. In other words, before MSMED Act, supply of credit by banks to small enterprises (known as Small Scale Industries) was largely to small enterprises from manufacturing sector. This facilitates a meaningful analysis and comparison between SSI sector prior to 2007 covering manufacturing enterprises and MSMEs from 2008 onwards that takes into account both the manufacturing and services sectors.

Policy Initiatives for Promotion of MSMEs in India
Industrial policies since 1948 have recognized the significant role played by Small Scale Industries in creating large scale employment at low capital cost, dispersal of industries and development of the
national economy in whole. Reservation of specific items for exclusive manufacture in the SSI sector was introduced following the industrial policy of 1977. A number of organizations and institutions have also been established by Governments to assist in promotion and development of Indian MSMEs by initiating a number of protective and promotional policy measures. Under the promotional package for supporting MSMEs in India announced by the Ministry of MSMEs, policies with regard to credit support, cluster based development, marketing supports, technologies and quality up-gradation support and others have been initiated. Following the enactment of Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, new definition of MSMEs came into force. For the first time in India, concept of “enterprise” was recognized for both manufacturing and services sectors. It is worthwhile to mention that in the past ‘Small Enterprises’ meant small enterprises from manufacturing sector only for official purposes. The current definition of MSMEs in India is given in the following table.

Table 1: Definition of Micro, Small and Medium Enterprises in India

<table>
<thead>
<tr>
<th>Classification</th>
<th>Manufacturing (Investment in Plant and Machinery)</th>
<th>Services (Investment in Equipment)</th>
</tr>
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<tbody>
<tr>
<td>Micro</td>
<td>Upto Rs. 25 lakhs</td>
<td>Upto Rs. 10 lakhs</td>
</tr>
<tr>
<td>Small</td>
<td>More than Rs. 25 lakhs and Less than Rs. 5 crore</td>
<td>More than Rs. 10 lakhs and Less than Rs. 2 crore</td>
</tr>
<tr>
<td>Medium</td>
<td>More than Rs. 5 crore and Less than Rs. 10 crore</td>
<td>More than Rs. 2 crore and Less than Rs. 5 crore</td>
</tr>
</tbody>
</table>

* One lakh is equal to 100,000 Rupees and one crore is equal to 100 lakhs
Apart from revised definition, MSMED Act also provided for the creation of National Board for Micro, Small and Medium Enterprises to examine the factors affecting the promotion and development of MSMEs and review the policies and programs of the Union Government.

MSMEs in India – A Snapshot
Following the change in the definition of MSMEs, 4th All India Census of MSMEs was launched by the MSME-DO ¹ in 2007. The data have however been updated from time to time based on surveys and estimations and this has given a sharp rise in the number of units and other related data from 2007 onwards.² As per the statistics and estimations, there are 36.17 million MSMEs that provide employment to total number of 80.52 million individuals. The Census revealed that the MSME sector is dominated by unorganized enterprises in terms of number of units and employment generation and 55.34 percent of units are located in rural areas of the country. Per unit employment within the ‘registered’ units is almost 6 persons and the same was 2 persons in the case of unregistered sector. Census also revealed that micro enterprises dominate the sector in terms of number of working enterprises. This implies that a great number of units in the sector are more vulnerable to sickness compared to small and medium units as their small size makes it more difficult for these units to obtain funds from institutional sources.

Over the years, the production from small enterprises’ sector has grown at a higher rate than the industrial sector, and as of the day, sector contributes to 45 percent of the total industrial production, 40 percent of the total exports of the country and around 8.7 percent of GDP (Ministry of MSMEs, Annual Report, 2012). Thus the importance of this sector in economic development of the country needs no emphasis.

Table 2: Performance indicators over the two phases

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Total Working Enterprises</th>
<th>Employment</th>
<th>Gross Output</th>
<th>Employment Per Unit</th>
<th>Output Per Unit</th>
<th>Output Per Employee</th>
</tr>
</thead>
</table>

¹ Earlier known as Development Commissioner, Small Scale Industries (DC-SSI).
² Sample surveys with respect to unregistered sector were conducted to estimate number of units in this sector. Data related to other activities such as wholesale/retail trade, legal, educational & social services, etc. were also extracted from Economic Census, 2005 and included in dataset.
From the table given above, it is rather difficult to infer any meaningful conclusion. However, between pre and post MSMED Act periods, the rate of growth of the number of working enterprises has been rather similar. To some extent, the same conclusion can be drawn in the case of employment as well. However, the gross output which recorded CAGR of around 15 percent during the pre MSMED Act period showed only around 6 percent. What is rather enigmatic is during post MSMED Act period that the rate of growth of GDP was better than pre MSMED Act and therefore, this growth differential may be attributed to inconsistencies in data, which holds good for output per unit and output per employee as well.

Credit Flow to the Sector – Some Initiatives
To deal with problem of MSMEs’ access to financial resources and financial adequacy, various steps have been taken by the Governments in India. These include setting up committees to ensure that the most vibrant sector of Indian economy receives adequate support and policies and guidelines in favor of MSME units are enforced and reviewed from time to time to ensure they are effective and remove bottlenecks, if any. The recommendations by these committees have been given due attention by RBI and banks were required to follow these recommendations. As an attempt, cluster approach to SME finance was recommended by Ganguly committee and banks were required to open specialized branches in recognized clusters and target these clusters for financing small enterprises. This would reduce monitoring costs and cost of assessing credit risk due to similarity of needs and characteristics of firms within a geographically bounded cluster.

Recognizing the fact that micro and small enterprises are relatively more vulnerable with limited ability to provide adequate collateral for loans due to low level of investment in fixed assets, a Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGTMSE) was set up. The scheme is to provide credit facilities without any collateral security and/or third party guarantees for loans upto Rs. 25 lakh. Government has also introduced the Credit Linked Capital Subsidy Scheme for Technology up-gradation of these enterprises. Under this scheme, 12 percent back ended capital subsidy would be admissible on the loans advanced to the sector by banks/financial institutions for technology up-gradation in certain select sectors.

A High Level Task Force was constituted by the Government of India to consider various issues raised by MSMEs. Followed by the recommendations, a target of 20 percent year-on-year growth in credit to micro and small enterprises, allocation of 60 percent of funds to micro enterprises and achieving 15 percent annual growth in number of micro enterprise accounts are to be followed by all scheduled commercial banks.

MSME sector is a part of Priority Sectors. The purpose was to ensure that adequate credit is available to certain neglected sectors particularly in the rural areas. Against this background, domestic commercial banks have been required to meet the target of 40 percent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher. As recommended by Nair Committee on priority sector lending, a sub-target of 7 percent of ANBC for credit to micro enterprises under MSEs needs to be achieved by banks. The committee also recommends an increase of 15 percent in number of accounts every year.
Bank Finance to MSMEs in India

In view of the important role played by MSMEs in contributing to total industrial production, exports and employment generation in the country, from a developmental perspective it is essential to look into the status of credit flow to the sector by domestic banks. We have collected information relating to bank finance to small enterprises sector from the RBI sources for the period 2002 to 2012 and analyzed the same.

Public Sector Banks

Public Sector Banks (PSBs) rank first among all banking sectors to finance MSMEs in India in terms of total loan portfolio. The following facts may be given with regard to financing small enterprises:

- The evidence (table 3) suggest that while NBC and priority sector credit from public sector banks have grown substantially in terms of CAGR, public sector banks’ credit to small scale sector which is an important component of priority sectors has grown at only 13.48 percent. In fact, growth in SSI advances in pre MSMED Act did not keep pace with growth in priority sector advances and NBC. During this period (2002-2006), credit to other priority sectors grew at a higher rate than SSI credit.

| Table 3: Compound Annual Growth Rates related to three values of PSBs |
|-----------------------------|-----------------------------|-----------------------------|
| CAGR                        | Net Bank Credit             | Priority Sector Advances    | SSI/MSE Advances |
| 2002-06                     | 26.54 %                     | 24.43 %                     | 13.48 %          |
| 2008-12                     | 22.17 %                     | 16.66 %                     | 27.28 %          |

Source: Based on data from RBI

- During the post enactment phase (2008-2012), credit to micro and small enterprises has grown at a much faster rate compared to SSI credit in the pre MSMED Act phase. Moreover, advances to MSEs grew at higher compound annual growth rate compared to priority sector credit and NBC.
- The compound annual growth rate of priority sector advances has declined in post MSMED Act phase and during 2012, priority sector advances constituted 37.2 percent of NBC, which is at its lowest since 1997 and below the 40 percent target. This is supported by the fact that majority of PSBs failed to meet the priority sector target in 2012 (RBI, 2012).

It is to be noted that despite the target set by RBI, it was revealed by the same authority that in 2011, of the total credit outstanding to the MSEs, only 21.1 percent was disbursed to micro enterprises as against the prescribed target of 60 percent (RBI, 2012). It is relevant to point out that the MSE advances recorded the minimum growth rate of only 5.3 percent in 2012 and the recommended target of 20 percent growth in credit to MSEs was not achieved by PSBs.

Figure 1. Graphical presentation of the relative shares of different elements by PSBs

[Graphical representation of the relative shares of different elements by PSBs]

3 On account of relatively negligible share of foreign banks in MSME financing in India, data relating to SSI/MSE advances by these banks have not been included in this paper.
Source: Based on data from RBI
The above figures depict how the shares of different elements in relation to each other changed over the two phases.

- Share of SSI credit to priority sector advances and NBC consistently declined from 29 percent and 12.5 percent in 2002 to 20.1 percent and 8.1 percent in 2006 respectively.
- The relative trend lines indicate that since 2008, share of MSE advances to priority sector advances and NBC has increased, while, during the pre enactment phase, share of SSI advances to priority sector advances and NBC had an overall decreasing trend.
- Share of priority sector advances in NBC has declined at a faster rate during the second phase.

**Private Sector Banks**
The share of private sector banks in total small enterprise financing by banking sector is relatively small. The following points may be drawn:

- During the pre MSMED Act period, NBC and credit to priority sectors grew at more than 40 percent in terms of CAGR which is substantially high compared to credit to small scale industries which grew at a marginal rate of only 4.88 percent.
- Over the years 2008 to 2012, MSE advances witnessed a considerably higher CAGR compared to SSI advances in the first phase. In addition, credit to micro and small enterprises recorded a higher CAGR against NBC and priority sector credit.
- Once again the compound annual growth rate of priority sector advances declined from over 42 percent to just around 15 percent in the second phase. Compound annual growth rate of NBC has also declined at a considerable rate during the second phase.

**Table 4: Compound Annual Growth Rates related to three values of private sector banks**

<table>
<thead>
<tr>
<th>CAGR</th>
<th>Net Bank Credit</th>
<th>Priority Sector Advances</th>
<th>SSI/MSE Advances</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-06</td>
<td>41.08 %</td>
<td>42.69 %</td>
<td>4.88 %</td>
</tr>
<tr>
<td>2008-12</td>
<td>20.60 %</td>
<td>15.09 %</td>
<td>24.45 %</td>
</tr>
</tbody>
</table>

Source: Based on data from RBI

As reported by RBI in 2012, 6 private sector banks did not meet the overall priority sector target of 40 percent. With regard to financing MSEs, the recommended target of 20 percent year-on-year growth in credit to MSEs has been achieved.

**Figure 2. Graphical presentation of the relative shares of different elements by private sector banks**

Source: Based on data from RBI

- It is evident by the above figures that the share of SSI credit to NBC declined by 9.5 percent during the four years period of the first phase. Similarly, share of SSI credit to priority sector credit shrunk at a considerable rate.
While the share of priority sector credit to NBC has gone down in four year period from 2008 to 2012, share of MSE credit to NBC and priority sector credit has increased during the same period.

Conclusion
The fact that SMEs are one of the major players in economic activities in different countries has attracted the attention of many researchers and policy makers around the world. In India, contributions made by MSMEs are viewed against providing large scale employment at low capital cost particularly in rural areas of the country, reducing poverty rate by income generation among people and facilitating balances regional growth. The Indian MSME sector produces a wide range of products and services and contributes significantly to GDP and exports of the country as well. Despite their great potential, a number of problems often constrain these units of which, access to adequate and timely credit at affordable cost is the most crucial of all, responsible for sickness and failure among many units. Against this background and understanding the unique characteristics and special credit needs of MSMEs and the fact that credit deployed to SSI sector decelerated since 1998, Governments have initiated various policies and measures intended to enhance the flow of institutional credit to the sector by eliminating obstacles such as; emphasis on collateral required by banks and FIs, information asymmetry and opacity, high risk perception by banks and FIs and other issues that created a gap between demand and supply of credit to these units. Our findings reveal that the flow of credit to the sector has improved during the post MSMED Act period, supported by the fact that growth of credit extended to MSEs is greater in quantitative terms compared to credit extended to SSIs before the enactment. Moreover, share of the sector in net banks credit and priority sector credit by public sector and private sector banks have increased since the enactment. The above findings remain true for both public and private sector banks in terms of lending patterns.

Reference
27. RBI, Operations and Performance of Commercial Banks, (various years). Available at: www.rbi.org.in