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Access to finance for MSMEs: an Analysis of Supply Side Issues

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ABSTRACT

The importance of micro, small, and medium-sized businesses (MSMEs) in social and economic growth is well accepted. Despite its enormous contribution to the Indian economy, this industry confronts numerous challenges, the most prominent of which is finance. MSMEs require quick and appropriate loans at a reasonable cost in order to grow. Because of the tiny loan ticket size, increased servicing costs, and limited ability to provide immovable security, financial institutions have curtailed their involvement to this sector.

The Micro, Small and Medium Enterprises (MSME) was one of the most noticeably affected sector because of the COVID-19 pandemic. The Union Government of India has reported a large number of measures to counter the difficulties presented by the pandemic. In addition, it also changed the definition of MSMEs. Nonetheless, access to credit is one of the key challenges faced by the MSMEs. This paper tries to address the issues relating to the access to finance for MSMEs from supply side.

KEYWORDS: access, challenges, contribution, credit, economic growth**.**

I. INTRODUCTION

The Micro, Small and Medium Enterprises (MSME) sector is vital to encourage economic development, advance business and to eliminate poverty. As a key element in creating employment and adding to the nation's GDP and industrial output, the MSME area is fundamental to the development and improvement of the Indian economy. MSMEs are necessary for the growth of local and global markets and support the progress of various stakeholders like producers, suppliers, retailers and distributors.

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MSME New Definition: The new definition of MSME was implemented on July 1, 2020. This was done to make a target grouping framework and to work with simplicity. The MSMED Act of 2006 arranged MSMEs based on their investment in plant and machinery. The economy has gone through extraordinary changes from that point forward. The characterization of units was distinctive for production and service units. The new definition of MSME has various benefits that will help the MSMEs to expand. Since the export turnover excluded in the turnover limits of any type of MSME unit which is an improvement in the criteria of classifying MSMEs will surely provide a relief to the exporters.

Table 1: MSME Classification

MSME Classification 2006			
Criteria: Investment in Plant and Machinery or Equipment			
Classification	**Micro**	**Small**	**Medium**
Manufacturing Enterprises	Investment <□ 25 lakhs	Investment <□ 5 crore	Investment <□ 10 crore
Service Enterprises	Investment <□ 10 lakhs	Investment <□ 2 crore	Investment <□ 5 crore
Revised Classification 2020			
Composite Criteria: Investment and Annual Turnover			

Classification	Micro	Small	Medium
Manufacturing Enterprises & Service Enterprises	Investment <₹ 1 crore and Turnover <₹ 5 crore	Investment <₹ 10 crore and Turnover <₹ 50 crore	Investment <₹ 20 crore and Turnover <₹ 100 crore

Source: Compiled by author

Table 2: Brief Profile of MSMEs in India

In term of Location	In term of Sector	In terms of size	In terms of ownership	In terms of their form	In terms of the status of registration	In terms of financing
51% units are in rural areas	36% of the units were into trading	99.47% are micro enterprises	84% are owned account enterprises	96% are proprietorship-based (76.4%-male, 19.6%-female)	69% are unregistered	78.2% are self-financed
49% units are in urban areas	33% in services	0.52% are small enterprises	16% are establishments	2% are partnerships	31% are registered	9.7% from formal sources (government, FIs, SHGs)
	31% in manufacturing	0.01% are medium enterprises		1.8% are SHGs		12.1% from informal sources
				0.2% are others, such as trusts and other organizations		

Source: 6th Economic Census

Table 3: Supply of finance to MSMEs:

Particulars	Amount (₹)
Overall demand for credit (estimated)	₹105.49 lakh crore (USD 1,431 billion)
Un-addressable or excluded credit (47%)	₹ 49.57 lakh crore (USD 673 billion)
Demand met by Formal Sources	₹16.94 lakh crore (USD 229 billion)
Amount Directed to Micro Enterprises	27% (₹4.5 lakh crore)
Amount Directed to Small Enterprises	40% (₹6.81 lakh crore)
Amount Directed to Medium Enterprises	33% (₹ 5.64 lakh crore)
Total Credit Gap (estimated)	₹39 lakh crore (USD 529 billion)

Source: MSC analysis and IFC report (2018)

It is evident from the above table that the overall demand for credit is estimated to be ₹105.49 lakh crore (USD 1,431 billion). The demand met by the formal sources is less than one-sixth of the demand i.e.,₹16.94 lakh crore (USD 229 billion). Of the ₹16.94 lakh crore of credit through formal sources, 27% (₹4.5 lakh crore) is directed to micro, 40% (₹ 6.81 lakh crore) to small, and 33% (5.64 lakh crore) to medium enterprises.

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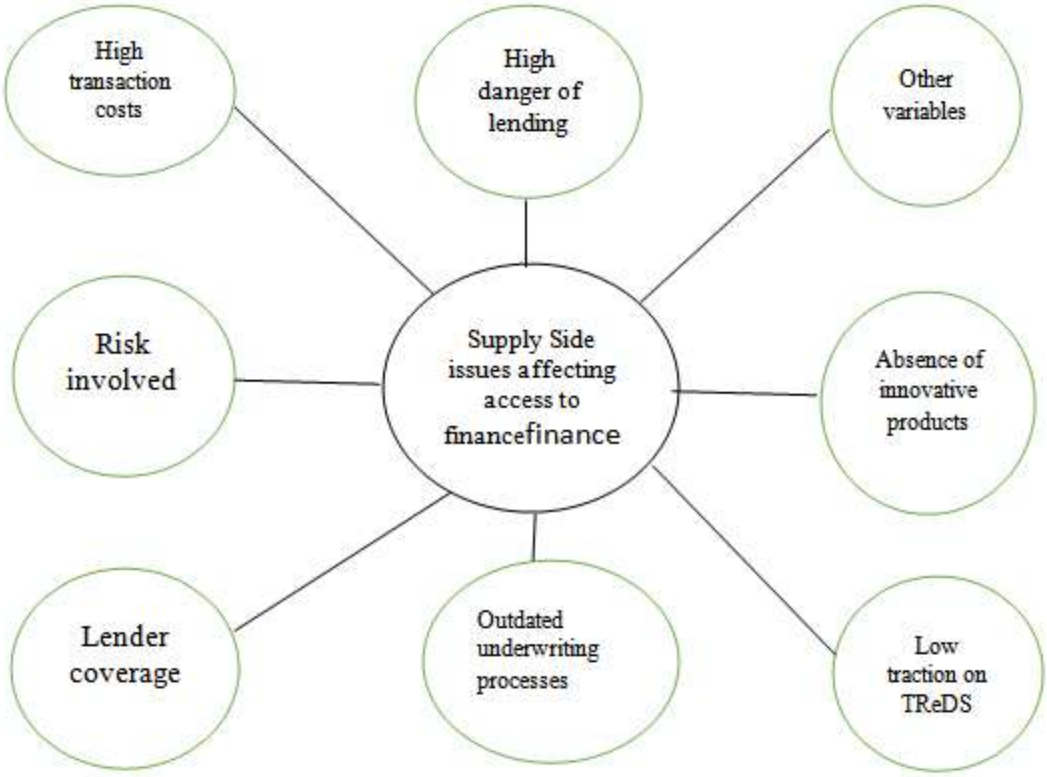
SUPPLY SIDE ISSUES THAT AFFECT ACCESS TO FINANCE FOR MSMES

While there are a demand side issues that decrease the access to finance by MSMEs, issues in the supply side also influence financing for MSMEs. The MSME ecosystem is biased toward lending to medium enterprises over micro and small units. Approximately 5,000 medium enterprises account for an exposure of □5.64 lakh crore, which is one-third of the total supply of □16.9 lakh crore to the MSME sector (as on 30th September 2020). Thus, within the MSME ecosystem, medium enterprises seem to be adequately financed with an average exposure of more than □100 crores per firm. Therefore, medium enterprises face no gaps in the demand and supply of finance at least in quantitative terms. Of the total gap of □39 lakhscrores, one-third comes from microenterprises while the remaining two-third from small enterprises. Besides the size bias, aspects related to gender also need to be corrected. This paper highlights the key reasons that exclude MSME from access to credit.



Source: Compiled by author

(a) **High danger of lending to MSMEs**: The capacity of the MSMEs to pay is compromised because of a few risk factors connected to the business. These include delayed buyer payments inserted in supply chains and other business risks, including changes in consumer demand or incidental events that create a slowdown in the market. MSMEs frequently have little to no equity buffers to tide over adverse events, while risk mitigation mechanisms are available neither to the MSMEs nor their lenders. This definitely converts into critical credit misfortunes. Additionally, even the normal misfortunes on these credits are not evaluated judiciously.

(b) **High transaction costs and lower margins:** Banks and NBFCs find it costly to finance MSMEs. Continuously checking and engaging with MSMEs is viewed as too high a cost for business. Analysis recommends that the average size of credit demand from micro and small businesses is □5.68 lakhs and 1.56 crore lakhs respectively. The average size of credit stretched by formal FIs based on assessed reimbursement limit is even lower. The net revenue from MSME loans is generally low, particularly for traditional financial institutions. This is due to factors, such as smaller ticket size and high cost of due diligenceand collections. These innate difficulties make it harder for these organizations from seeking after MSME accounts effectively.

(c)Risk involved: Financial organizations normally see the MSMEs as a high risk segment by virtue of their incomplete understanding of MSME organizations. Given their restricted tasks and assets, when banks advance loans they prefer medium ventures. That is because these organizations have more steady incomes, formalized functional cycles, sufficient security and it is easy to understand their business model. Risk avoidance is highest worry on account of public sector banks officials because of the reason that they have to face investigation when the loans sanctioned by them go bad.

(d) **Lender coverage**: While urban areas generally have adequate lender coverage, many parts of the country actually have helpless credit profundity. This distance makes an interpretation of weaker access to formal credit. According to the IFC report (2018), low pay states (LIS)18 and Northeastern states (NES)19 get just 27% of the supply of debt finance.This represents enormous shortage, if one considers that of the 5.85 crore business units enumerated in the 6th economic census, the LIS and NES represents around 44% of the total enterprises.

(e) **Outdated underwriting processes**: The issue of higher hazard avoidance on account of MSME advances, especially loans to MSEs, is deteriorated by obsolete norms of credit assessment. These spot an excess of accentuation on security and don't genuinely illustrate a borrower's capacity to reimburse a credit. Since numerous FIs don't spend much time to understand the business idea and business performance of the MSMEs conventional moneylenders think that it's difficult to make credit endorsing frameworks pertinent to MSMEs. By and large, FIs depend on the past execution of the undertaking instead of future opportunities.

(f) **Low traction on Trade Receivables Discounting System and Government e-Market Place**: The Government of India commanded public sector undertaking to enroll on the TReDS stage. In November, 2018, the Government of India reported that organizations with a turnover of more than 500 crores should enlist on the TReDS stage. Further, the government had postponed on-boarding charges for MSMEs till March, 2021. In spite of the drives taken by the government and the RBI, the utilization of this facility remains fairly low, as only a few institutions on boarded on the platform remains low. Finally, while the Budget discourse of 2018 proposed connecting the Trade Receivables Discounting Systemwith the GST information base may help banks to take fast decisionsregarding lending to small enterprises.

(g) **Absence of innovative products**: Traditional lenders continue to lack understanding about the MSME sector and they have not changed their way to deal with lending. They actually constraintMSMEs to look for finance through different roads. A grassroots way to deal with creating novel strategies to serve MSMEs with debt finance is important for banks and different institutions to propel the development of the sector.

(h) **Other Variables**: Various different factors likewise add to the size of the gap. For example, credit bureaus in India have limited information about MSMEs. Moreover, the huge number of laws that administer bankruptcy in India has hindered the interaction of legal cure. Latest changes in the Insolvency and Bankruptcy Law, aims to address these concerns. Its execution will be essential to the development of MSME sector.Financial institutions have decided to take the safe road, lending only when firms fit the requirements laid forth in a specific scheme, even though government programmes were intended to increase credit flow to the MSME sector. As a result, businesses that are not part of the target sectors for which banks are required to offer specific loan products stay stagnant, unable to benefit from the much-needed boost.

II. CONCLUSION

Lack of access to timely credit has been accepted as the major hindrance in the path of the MSMEs and it has been pointed out as the prime reason for their slow growth. Not only in India but throughout the globe, access to finance for the MSMEs has emerged as a major challenge that needs the attention of the policymakers. Small firms are unable to have access to the formal credit and therefore are unable to expand their businesses. Most of the financial institutions consider MSMEs as unstable firms and often impose strict lending norms and high risk premiums on the loans sanctioned to the MSMEs.

There is also a need to ensure that remote unbanked/under-banked areas have access to banking services. Banks play a vital role in addressing a number of issues that MSMEs confront in India. Banks must see themselves as more than just credit providers; they must see themselves as partners in the success of these businesses, providing hand-holding support to first-generation entrepreneurs and startups.

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