

*Bank Credit to MSMEs: Present Status and Way Forward**

K. C. Chakrabarty

Dr. P. M. Mathew, Director, ISED, Dr. K. N. Kabra, Chairman, ISED, Shri. T. O. Sooraj, Director, Industries and Commerce, Government of Kerala, Dr. Yerram Raju, senior fellow, ISED, senior bankers, MSME entrepreneurs, other distinguished guests, ladies and gentlemen. I am indeed very happy to be in your midst today for the release of the thirteenth issue of the India, Micro, Small and Medium Enterprises Report Series of your Institute. The MSMEs, given their limitations and constraints need professional support, to analyse their own environment, articulate their needs and understand the impact of policies that get shaped there from. I am glad that the Institute is endeavouring to provide this support.

2. In a nation's economy, it's the small and micro enterprises which play a vital role. For, they not only give employment to a large number of unskilled and semi-skilled people but also support bigger industries by supplying raw material, basic goods, finished parts and components, *etc.* The critical role and place of the MSME sector in the Indian economy in employment generation, exports and economic empowerment of a vast section of the population is well known. There are about 2.6 crore enterprises in this sector. The sector accounts for 45 per cent of the manufactured output and 8 per cent of the Gross Domestic Product (GDP). MSMEs contributed close to 40 per cent of all exports from the country and employ nearly 6 crore people which is next only to the agricultural sector. MSME is the best vehicle for inclusive growth, to create local demand and consumption. MSMEs cater to niche markets. The MSMEs of yesterday are the large corporates of today and could be MNCs of tomorrow. Thus the

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banks and other agencies should take pride while servicing the MSMEs as they are playing an instrumental role in the formation of MNCs of tomorrow.

3. It was, therefore, only appropriate that the Government of India enacted the Micro, Small and Medium Enterprises Development Act, 2006. Public Policy has rightly accorded high priority to this sector in order to achieve balanced, sustainable, more equitable and inclusive growth in the country. Advances extended to the MSE sector are treated as priority sector advances and as per the extant Reserve Bank guidelines, banks are required to extend at least 60 per cent of their advances to the MSE sector to Micro Enterprises.

4. An increasingly globalised world, marked by competition and innovation, is posing newer and varied challenges to the MSEs. Because of their small size, individual MSEs are handicapped in achieving economies of scale in procuring equipment, raw materials, finance and consulting services. Often, they are unable to identify potential markets to take advantage of market opportunities, which require large volumes, consistent quality, homogenous standards and assured supply. In today's globalised economy, improvements in products, processes, technology and organisational functions such as design, logistics and marketing have become key drivers in delivering competitiveness, for the MSEs.

5. MSEs primarily rely on bank finance for a variety of purposes including purchase of land, building, plant and machinery as also for working capital, *etc.* Availability of timely credit at reasonable rates is the need

of the sector. As at the end of March 2009, the total outstanding credit provided by all Scheduled Commercial Banks (SCBs) to the MSE sector was Rs.2,56,128 crore, constituting 11.4 per cent of the Adjusted Net Bank Credit. Credit flow to MSMEs had therefore, doubled from Rs.1,27,000 crore in 2006-07 to Rs.2,57,000 crore in 2008-09. In 2007-08, credit flow to the sector was Rs.2,13,000 crore. In September 2009 the total outstanding credit stood at Rs.3,23,565 crore and in February 2010 it further increased to Rs.3,69,866 crore. Despite the global financial crisis, there was enough liquidity in the Indian banking system and banks were willing to extend credit to viable projects. Despite the fact that there is no dearth of credit in the system there exists a gap in perception of the lenders and SME borrowers. While the lenders felt that credit to the sector is expanding, the SME borrowers felt that the lenders are not doing enough for the SMEs and are catering more to the needs of the large corporate. As only 4-5 per cent MSMEs are covered by institutional funding given that approx 95 per cent of villages are not covered by banks. There is, therefore, a need to bridge this gap through enabling policies. Reserve Bank has recently advised all the SLBC Convenor banks to constitute a Sub-Committee of the District Consultative Committees (DCCs) to draw up a roadmap by March 2010 to provide banking services through a banking outlet in every village having a population of over 2,000, by March 2011. Such banking services may not necessarily be extended through a brick and mortar branch but can be provided through any of the various forms of ICT- based models, including through BCs". Reserve Bank will closely

monitor extension of banking services. My message to the MSME sector is that as interest costs are a very small fraction of your operating costs, only approximately 4 per cent, do not ask for low interest rates from the banking sector, and instead ask for credit at competitive rates. Credit has to be self-liquidating on a viable project and has a cost.

6. As regards the cost of credit, as per extant guidelines, all loans up to Rs.2 lakh are charged interest not exceeding PLR of the bank. The rates of interest on loans above Rs. 2 lakh have been deregulated and banks are given the freedom to fix the interest rates based on cost of funds, risk cost, transaction cost, *etc.* Further, banks have been advised that with effect from July 1, 2010 the Base Rate system would replace the BPLR system whereby banks would determine their actual lending rates on loans and advances with reference to the Base Rate. Since the Base Rate would be the minimum rate for all commercial loans, banks could not resort to any lending below the Base Rate. Accordingly, the current stipulation of BPLR as the ceiling rate for loans up to Rs. 2 lakh would be withdrawn. It is expected that deregulation of lending rates will increase the credit flow to small borrowers at reasonable rate.

Measures by RBI

7. RBI has recently taken several measures to enhance credit delivery to the employment intensive micro and small enterprises (MSE) sector. One of the major concerns of the MSE sector is the inability to arrange for collateral security and or third party guarantee. As a result, new entrepreneurs find it difficult to access

credit from the banking system. Accordingly, RBI have issued guidelines from time to time thereby advising banks to grant collateral free loans up to Rs. 5 lakh sanctioned to the units of MSE sector (both manufacturing and service enterprises). Further, banks have also been advised to lend collateral free loans up to Rs.25 lakh, based on good track record and financial position of the units. We have received enquiries as to whether these guidelines are advisory or mandatory in nature. We have since clarified that these guidelines regarding extending collateral free loans up to Rs. 5 lakh sanctioned to the units of MSE sector (both manufacturing and service enterprises) as defined under MSMED Act, 2006 are mandatory in nature and banks must not obtain collateral security in the case of loans up to Rs. 5 lakh extended to all units of the MSE sector.

8. A Working Group was set up by Reserve Bank of India to review the Credit Guarantee Scheme of the Credit Guarantee Fund Trust for Micro and Small Enterprises and suggest measures to enhance its usage. The Group has submitted its final report which was released on March 6, 2010. Some of the main recommendations of the Working Group include mandatory doubling of the limit for collateral free loans to micro and small enterprises (MSEs) sector to Rs.10 lakh from the present Rs. 5 lakh, increase in the extent of guarantee cover, absorption of guarantee fees for the collateral free loans by Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) subject to certain conditions, simplification of procedure for filing claims with CGTMSE and increasing awareness about the scheme, *etc.* Guidelines have been issued on May 6, 2010

by Reserve Bank on the recommendations of the Working Group to enhance the limit of collateral free loans to Rs.10 lakh from the present level of Rs.5 lakh and these guidelines are mandatory for all scheduled commercial banks. On the other recommendations the CGTMSE has been advised to initiate appropriate action. The implementation of the recommendations of the Working Group is expected to result in enhanced usage of the Credit Guarantee Scheme and facilitate increase in quality and quantity of credit to the presently included as well as excluded, MSEs, leading eventually to sustainable inclusive growth.

9. The Reserve Bank had constituted a Working Group on Rehabilitation of Sick SMEs (Chairman: Dr. K.C. Chakrabarty) and based on the recommendations of the Working Group, banks have been advised to undertake a review and put in place a Loan Policy governing extension of credit facilities, Restructuring/ Rehabilitation policy for revival of potentially viable sick units/ enterprises and a Non-discretionary One Time Settlement scheme for recovery of non-performing loans.

10. As on date, 41 scheduled commercial banks have reported to have complied with the requirement of setting up a dedicated loan policy on MSE, 40 scheduled commercial banks with the requirement of setting up a rehabilitation/restructuring policy and 39 scheduled commercial banks on setting a non-discretionary One Time Settlement scheme for recovery of non-performing loans. Among the 39 scheduled commercial banks who have reported to have complied with the requirement of setting up of a non-discretionary One Time

Settlement scheme for recovery of non-performing loans, 30 banks have indicated to have placed the policy on their respective banks' websites.

The Working Group has also recommended to the GoI for creation of several Funds by the Government such as a) National Equity Fund, b) Fund for Technology Upgradation, c) Marketing development Fund, d) Rehabilitation Fund, e) Venture capital / mezzanine finance to encourage the entrepreneurs to innovate new ideas, *etc.*

11. As the progress in rehabilitation of sick units was found to be tardy, the Regional Directors who head the Empowered Committees set up by RBI at its Regional Offices have been advised to ensure that banks strive for timely action for rehabilitation of sick units in the MSE sector, and put in place a credible, pro-active and a functional monitoring mechanism to review the progress in actual concrete outcomes. The same is being monitored at the Central Office level.

12. The non credit related factors which affect the growth rate of small enterprises sector are non-availability of power and other infrastructural facilities, delay in getting clearance from different agencies, lack of entrepreneurship development, infrastructure and historical/social bottlenecks *etc.* The solution thus lies in the engagement of the Central and State Government in easing the licensing and documentation requirements, exit policy and labour laws, putting in place an efficient tax structure in conformity with public finance principles, appropriate infrastructure development *etc.*

GoI and MSMEs

13. Recognising the importance of the sector and the various constraints being faced by the sector a High Level Task Force has been constituted by the Government of India under the chairmanship of the Principal Secretary to the Hon'ble Prime Minister to consider various issues raised by various MSME associations and draw up an agenda for action. The Task Force which submitted its final report on January 30, 2010, has made several recommendations on issues relating to credit, taxation, marketing, labour, exit policy, infrastructure/technology/skill development and special packages for North-East and Jammu and Kashmir, *etc.* A Steering Group on MSME has been set up by the GoI to review the implementation of the recommendations of the Task Force. In particular, three important recommendations made by the Task Force relating to credit have been considered by the Steering Group and it has been decided that:

- i. all scheduled commercial banks should achieve a 20 per cent year-on-year growth in credit to micro and small enterprises to ensure enhanced credit flow;
- ii. to increase the flow of credit to micro enterprises all scheduled commercial banks should lend 60 per cent of their MSE lending to micro enterprises in stages *viz.* 50 per cent in the year 2010-11, 55 per cent in the year 2011-12 and 60 per cent in 2012-13.
- iii. all scheduled commercial banks should achieve a 10 per cent annual growth in the number of micro enterprise accounts

The recommendations of the Task Force are expected to go a long way to facilitate credit flow to the sector and the implementation of the recommendation is being monitored at the highest level by the Government of India.

Way Forward

14. If India has to have a growth rate of 8-10 percent for the next couple of decades, it needs a strong MSME sector, without which it cannot be achieved. There are approximately 3 crore MSMEs in the country. The SMEs have shown an average growth of 18 percent over the last five years. Around 98 percent of the production units are in the SME sector.

15. There has been a burst of entrepreneurship across the country, spanning rural, semi-urban and urban areas. This has to be nurtured and financed. It is only through growth of enterprises across all sizes that competition will be fostered. A small entrepreneur today will be a big entrepreneur tomorrow, and might well become a multinational enterprise eventually if given the comfort of financial support. But we also have to understand that there will be failures as well as successes. Bank will therefore have to tone up their risk assessment and risk management capacities, and provide for these failures as part of their risk management. Despite the risk, financing of first time entrepreneurs is a must for financial inclusion and growth.

16. In MSME sector, the failure rate is relatively higher – the reasons for which range from delayed/inadequate availability

of credit to non-availability of backward and forward support system. Despite the risk, financing of first time entrepreneurs is a must for financial inclusion and growth. Asymmetry of information and lack of transparency and reliability of data has been a major concern for organisations dealing with MSMEs the world over. The main reasons for the financial constraints faced by SMEs are quite generic, and high on the list is the perception that SMEs are historically a high risk group lacking in financial discipline and unable to provide trustworthy financial track records. To overcome this perception, there should be adequate and reliable credit information mechanism, such as an SME credit bureau, that serves the needs of both the SMEs' and the potential lenders'. Bodies such as the ISED could disseminate information on various relevant issues such as rating, SME policies and schemes, provide consultancies *etc.* Transparency shall facilitate them in obtaining finances, getting favourable contracts and improving their business prospects. A World Bank report stated that a good credit information infrastructure can contribute significantly towards assisting SMEs' access to capital. The report further highlighted that small firms with access to credit bureaus have a 40 per cent chance of obtaining a loan, whereas firms without access to credit bureaus have only a 28 per cent chance of receiving a loan. Therefore, significant opportunities exist to increase lending activities to MSMEs with the establishment of MSME credit bureaus.

17. Micro and small enterprise are the worst sufferers when disaster strikes. It suffers from discontinuity of business, which it is normally not in a position to

bear. It renders the recovery of already supplied goods difficult, besides affecting future supplies. These units need support in such situations. It has, therefore, felt that a separate umbrella organisation be set up to provide all comprehensive services to the SME sector under one roof and also look at providing disaster assistance to small enterprises on the lines of Small Business Administration, USA. An expert Group has been set up by the GoI of India to examine the modalities to set up such a body in India.

18. The GoI, may consider setting up a National Equity Fund to help green field projects and new generation entrepreneurs to tide over difficulties faced in start - up finance. The ability of MSMEs (especially those involving innovations and new technologies) to access alternative sources of capital like angel funds/risk capital needs to be enhanced considerably has been acknowledged by the Prime Minister's High Level Task Force on MSMEs and has recommended the need for removing fiscal/regulatory impediments to use such funds by the MSMEs on priority.

19. There is a need to promote factoring services without recourse in the country for MSMEs and a suitable legal framework for promotion of factoring services without recourse in the country for MSMEs needs to be evolved. The Industry Associations have often been often representing on the delayed payments from large corporate. While banks have been advised to allocate a sub-limit in respect of large borrower accounts, for making payments to the MSE units against purchases from them but it is not possible for banks to force the large

buyers to utilise the limit for making payments. This problem could be institutionally tackled by factoring. The Prime minister's Task Force on MSMEs also has recommended that a suitable framework for promotion of factoring services without recourse in the country for MSMEs. The Reserve Bank has also constituted a Working Group on Securitisation of Trade Credit Receivables to examine various options for liquidating the receivables before maturity. There is 96 per cent exclusion of the small entrepreneurs, it is, therefore, imperative that they are financially included and brought in the formal banking system, the GoI, based on the recommendations of the PM's Task Force on MSMEs has decided that there should be an annual growth in the number of micro enterprise accounts be for the present fixed at 10 per cent for banks to achieve and also strict adherence by banks to the allocation of 60 per cent to micro enterprises of the total MSE lending which should be done in stages *viz.* 50 per cent in the year 2010-11, 55 per cent in 2011-12 and 60 per cent in the year 2012-13. Necessary instructions are being issued shortly to the banks in this regard and the Reserve Bank will monitor the performance of banks.

20. The various fora set up by the Reserve Bank, such as the Empowered Committees, and the Standing Advisory Committee, State level Banker's Committee meetings *etc.* meet at periodic intervals to monitor the credit flow to this sector. It is necessary that the efficacy of such fora / meeting are monitored to assess the impact at the ground level.

21. With increasing competition, introduction of new products and stringent regulatory

environment, the role of banks needs to change from mere lenders to partners in business. There is a need for greater participation of banks in the affairs of their constituents by convergence of credit services and non credit services. The banks should not only provide differentiated products for MSMEs, but also provide counselling & guidance to new and established businesses, extending marketing support *etc.* Similarly, the Government and other institutions entrusted with development of the MSME sector need to focus providing an enabling environment, infrastructure and forward & backward linkages so that the credit function being discharged by the banks is adequately supplemented by their non credit functions.

22. Entrepreneurship and lack of adequate capacity is the key feature, as regards micro, small and medium enterprises. Entrepreneurship development is important in view of its visible impact on wealth creation and employment generation. To facilitate and encourage this, skill building has been impressed upon by the Prime Minister's Task Force for MSMEs. Enterprise Development Centres (EDC) should be set up by the Central/State Governments with incubators to provide training not just for setting up of new units but also provide continuing education on different aspects like product design, packaging, technology upgradation, financial management and marketing *etc.*

I would also urge upon the Institute, which has emerged as an institutional response to several of the issues relating to enterprise development to continue its endeavour to

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facilitate skill building for the micro and small enterprises.

At present, SME units which have been incorporated as a company have to follow the Balance Sheet, Profit and Loss Account and other disclosures in the format prescribed in Schedule VI of Companies Act. They are also required to follow the accounting standards as prescribed by the Institute of Chartered Accountants of India (ICAI) for large corporates. As Government has already set up a committee for amendment of Companies' Act, it is probably necessary that the revised Companies' Act should prescribe

simplified disclosures norms and ICAI should come out with simplified account standards for SMEs.

23. Lastly, banks need to effectively implement the RBI guidelines and significant policy initiatives which facilitate ease of credit flow to small entrepreneurs.

Conclusion

24. I would like to compliment the Institute of Small Enterprises and Development for their support to the sector and it was indeed my privilege to release their Report.