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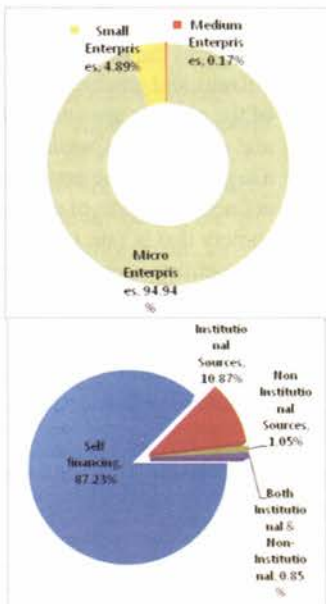
Improving the Financial Ecosystem in the MSMEs Space

MSMEs are the backbone of an economy and a major source of entrepreneurial innovation and skills. The development of MSME sector is crucial in ensuring balanced growth and shared prosperity. They have been playing a pivotal role in country's overall economic growth and have achieved sturdy progress over the last couple of years. They account for a significant proportion of manufacturing and exports, creating around 1.3 million jobs per year and employing about 60 million people. The MSME sector's contribution equals 40% of India's total exports and 8% of India's GDP. In particular, the sector contributes significantly to poverty alleviation as the micro enterprises make up approximate 95% of total MSMEs.

Further, MSMEs have huge potential to grow but one of the major obstacles is that they have traditionally been facing constraints of lack of adequate & timely finance. MSME sector is expected to face a funding gap of about Rs.5000 bn by the end of 12th plan period i.e. March 2017 as per the Planning Commission Report. This would mean a shortfall of finance by almost 43% of total requirement of the sector. Although, bank credit to this segment has also grown at a CAGR of 30% in last five years ending FY13, this is not enough as almost 9 out of 10 MSMEs are yet to get access to the banking finance.

To address the perception of high risk associated with MSMEs requiring high level of collaterals, government had implemented CGTSME scheme (Credit Guarantee Fund Trust for Micro and Small Enterprises) under which collateral free loans upto Rs.100 lakh are given to MSMEs.

In order to address this situation, one needs to analyze the MSME Financing Ecosystem and the avenues for the improvement in the same.



Breakup of MSMEs in India and their financing pattern (Source: MSME Census 2006-07)

MSME Financing Ecosystem

The initial stages of building a financing ecosystem involve developing key infrastructure and institutional arrangements that widen the access to financing while promoting a sound credit culture. Over the years, Indian government has laid strong foundation of MSME ecosystem with was strengthened with enactment of MSME Act, 2006 which now needs to be developed with increased penetration.

Infrastructure for MSME Financing

Indian Banks (mainly PSUs) had been the cornerstone of MSME financing infrastructure and will continue to be the major source of financing in future as well. The next step is the strengthening of infrastructure and increasing penetration for which RBI had taken steps with mandating

new banks to set-up their 25 per cent of its branches in rural areas as well as increase the limits of loans to MSME under priority sector lending. This would provide boost to the MSME lending.

However, conventional sources like bank finance have their limits. India has started the SME exchanges (BSE SME Exchange and NSE Emerge) to address these concerns but the information asymmetry results in lower investor confidence and consequently has promising but limited impact. This is where bond market could be a better alternative financing option. The international experience suggests that SME bond markets are most likely to thrive on a national or regional basis that unites local borrowers and investors through dedicated exchanges. While Indian households have one of the highest savings rate in the world which are parked in bank deposits, gold and real estate, with almost negligible investment in corporate bonds, SME bond market is expected to have huge potential but requires strong and dynamic regulatory environment which instils confidence in the investors.

Another avenue is development of Private Equity market for MSMEs which could be pivotal for MSME financing ecosystem as it addresses concern for equity requirement (apart from SME exchanges). For CY2013, the PE investment in India in small and medium enterprises remained flat when compared in terms of total investments viz. for CY2013, MSMEs attracted US\$1.25bn which is 3% down when compared with US\$1.30bn in CY2012.

Thus, the Banks together with the financial sector, Government agencies and other stakeholders need to collaborate to spur investments and financing to MSMEs.

Financing Products and Guarantee Schemes

With the changing MSME financing landscape, one must understand the dynamics of MSME financing and use innovative tools to meet the requirement of MSMEs while dealing with information asymmetry issues. Apart from traditional products of cash credit, term loans, bills discounting, packing credit etc. one must resort to innovative products like factoring, reverse factoring, SME collective bonds and SME IPO without book building process. Furthermore, a separate vertical in banks can be setup which would be mandated to provide finance to MSMEs at a lower rate by borrowing through External Commercial Borrowings (ECB).

To address information related issues while reducing the cost involved, one option can be extensive use of credit score model. Another option can be use of credit rating and due diligence services offered by Credit Rating Agencies (CRAs). Credit scoring offers a modern alternative for the traditional method of evaluating loans for small businesses where loans were approved on the basis of the banker's qualitative judgment and the financial condition carried significant weight in the appraisal process. Due diligence

report provides valuable inputs to sanctioning authorities on the profile verification and SWOT analysis of the MSMEs.

To address the perception of high risk associated with MSMEs requiring high level of collaterals, government had implemented CGTSME scheme (Credit Guarantee Fund Trust for Micro and Small Enterprises) under which collateral free loans upto Rs.100 lakh are given to MSMEs. But there is a need to increase this limit considering current market prices and necessary push to lending bodies.

Regulatory Bodies and Redress Forums

According to the list published by the World Bank in 2013 on "Ease of Doing Business", India was ranked 132nd among 181 countries signaling the necessity of sea change in the regulatory environment to promote growth. The absence of single countrywide tax policy, Intellectual Property Rights (IPR) related issues, slow judiciary system/redress forums and absence of a wholesome bankruptcy system are the key impediments of growth. Therefore, new products and institutions suggested above

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would not give desired results in absence of dynamic regulatory bodies.

Hence, the utmost importance should be given to the requirement of a one-stop agency for MSME development, for forming as well as monitoring the policies, establishing standardized systems of MSME financing, dynamic regulatory body for Equity and bond market, bankruptcy laws and implementation of Goods and Service Tax (GST).

Debt Resolution and Management Department

Another component of financial ecosystem is debt recovery and management department. Presently, in India there is no specific debt recovery guideline for MSMEs which becomes a key hurdle in the recovery of sick units. Unlike large corporates which have the flexibility to sustain over a longer period of time in case of financial crisis, MSMEs with low capitalization requires quick debt restructuring to sustain over a longer period. Furthermore, in case of liquidation there is long legal trial in India to

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declare bankruptcy or insolvency resulting in necessity of faster debt recovery process so that entrepreneur can move to different business and creditors (especially banks) could take control of distressed assets and put them again to productive use quickly and efficiently. Thus, for the improvement of MSME financial ecosystem, one needs a separate vertical in Financial Institution and Corporate Debt Restructuring Empowerment Group which should be targeted for faster processing of MSME cases.

Awareness Programs

The last and most important component of Financing Ecosystem is Awareness programs. Information has power and unless it is available to masses it cannot be harnessed. Information related to various schemes, programs, institutions, products and policies must be easily available to the MSMEs at a point. Furthermore, various awareness programs must be undertaken by industry associations (CII, FICCI and other regional associations) and government bodies to ensure that its benefits reach to the MSMEs on a wider scale.

At present, there are three levels of policies and schemes for MSMEs viz. Central level, State level and then Individual financial institutions level. For example, Central government has TUFs scheme to promote textile industry, other state governments have their own interest subsidy schemes (over and above TUFs) for textile industry. Then there are bodies like Khadi & Village Industries Commission (KVIC) which promote the development of khadi and other village industries and National Small Industries Corporation (NSIC) which promotes MSME participation in trade fairs, exhibitions, buyer-seller meetings at the national and international levels, technological upgradation and offer technical assistance to rural MSMEs. Each state government and institution has setup its own website for dissemination of information. This creates ambiguity among the MSME entrepreneurs resulting in their inability to avail the full benefits of such schemes and benefits. Thus, it also shows the need of setting up of one stop agency for proper information dissemination.



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Conclusion

Growth of MSMEs is the key component of balanced and sustainable growth for developing countries. India's MSME segment is well equipped to grow and the fundamental drivers are in the right place and hence continued empowerment of MSMEs will enable them to attain high and sustainable growth in the long-run. But it is essential to ensure that the financial ecosystem keeps pace with their requirements so as to ensure smooth growth over the medium run.

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High Optimism amongst SMEs : Survey

Despite the present gloom in the economy, SMEs remain optimistic of the FY 2014-15 and expect high growth rate in the current year. According to the latest SME Sentiment Survey conducted by IndiaMART.com. About 66 per cent SMEs predict improved business conditions in the coming quarter (2014-15) that will yield them better growth. The Survey conducted amongst SMEs across industries throws light on the past year's business experience, challenges, exports demand, business confidence and major expectations from the coming year.

What is interesting is the fact that the business confidence amongst SMEs remains high as almost 21 per cent respondents have given a rating of 7.3 on a scale of 10. The same ratings dropped drastically (5.8) when the SMEs were asked to rate on the prospects of India's economy.

Dinesh Agarwal, Founder & CEO IndiaMART.com, said, "SMEs' growth prospects have been stunted due to slowdown witnessed in the economy. However, they seem to have a positive outlook for this year and hope to have a good business year ahead. The SME Sentiment Survey is a holistic reflection of their past experience and future expectations."

Unveiled early May this year, the survey results showed that most SMEs (38 per cent) have had a growth under 5 per cent in the financial year 2013-14. During the same poll, a whopping 82 per cent participants have admitted that their input costs had escalated in the past year, which could be the reason for the slow growth. But all hopes haven't been lost yet as over 50 per cent of the respondents have reported a growth expectation of more than 20 per cent in 2014-15.

On account of challenges being faced by the sector, marketing remains a key challenge for SMEs while factors such as poor sales, competition from large businesses, Government regulations were ranked second, third and fourth respectively. This was followed by shortage of skilled employees, taxes, finance and access to IT. The survey also revealed the movement of exports demand in the last year.