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"Financing Constraints for MSME Sector"

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Abstract

MSMEs are defined in different ways in different parts of the world. In some countries, they are defined in terms of assets, while few countries use employment as a parameter for defining MSMEs. The MSME sector is responsible for about 40 per cent of the exports and 45 per cent of the total manufacturing output of the country. Today, it accounts for nearly 35% of the gross value of output in the manufacturing sector and over 40% of the total exports from the country. The MSME sector has grown rapidly over the years. The growth rates during the various plan periods have been very impressive. MSMEs not only play crucial role in providing large employment opportunities at comparatively lower capital cost than large industries but also help in industrialization of rural and backward areas, thereby, reducing regional imbalances, assuring more equitable distribution of National Income and wealth. Though, the contribution of MSMEs in any economy cannot be overlooked but MSMEs face several constraints and barriers. The main constraint that MSMEs face today is getting timely access to finance. The researcher tries to analyze the various constraints that the MSMEs are facing today. The paper has been prepared on the basis of available literatures. The present research paper reveals that there is a substantial amount of gap in the overall finance for the MSME sector.

Keywords: MSME, Gap, Financial Constraints, Financial Problems

Introduction

MSMEs are defined in different ways in different parts of the world. In some countries, they are defined in terms of assets, while few countries use employment as a parameter for defining MSMEs. The MSME sector is responsible for about 40 per cent of the exports and 45 per cent of the total manufacturing output of the country (MSME Annual Report, 2012[1]). This sector is the nursery of entrepreneurship and has been recognised as the engine of growth. The MSMEs also have a vital role in the dispersal of industries and generation of employment opportunities. The main advantage of this sector is that it provides a large employment at a low capital cost. Till 2005, the term SSIs and MSMEs were used interchangeably but in the year 2006, MSME Act was implemented to have a greater clarity in defining this sector. The MSME Act 2006 was enacted to attain certain objectives. The main objective behind implementing this act was to facilitate promotion and development of Micro, small and medium enterprises. It was enacted to increase the competitiveness of MSMEs. Table-1 reflects the segregation of enterprises according to MSME Act 2006.

Micro, Small and medium enterprises (MSMEs) are a key driver for economic growth and access to finance is a key constraint to development of micro, small and medium enterprises (MSMEs) in emerging economies. These factors have been widely recognized by Finance Ministers (in their Declarations of 2010) and in the report of the G20 MSME Finance Sub-Group of the Financial Inclusion Experts Group. The IFC was the technical advisor for the report.

Despite the significant contributions of the MSME sector, the sector continues to face certain constraints like, as pointed out in PM's Task Force Report, 2010, availability of adequate and timely credit, high cost of credit, collateral requirements, access to equity capital and rehabilitation of sick enterprises, etc. It thus emerges that adequate, timely and affordable credit is one of the bigger issues for the MSME sector.

Review of Literature

Globally SME sector has been reporting difficulties in access to finance (Bebczuk, 2004[2]; Slotty, 2009[3]; Balling et al. 2009[4]; Irwing & Scott, 2010[5]; Yongqian et al., 2012[6]). Access to external finance to SMEs has become more costly and troublesome while their accessibility has done sharply declined. SMEs' financing constraints limit their investment opportunities and stagnant growth. Access to finance is widely perceived to be an essential factor for firms, and especially SMEs, to maintain their daily business operation as well as to achieve long-term investment opportunities and development targets.

Studies point out that in developed and developing economies SMEs contribute on average 60% of formal employment in the manufacturing sector (Ayyagari et al., 2007[7]). An important aspect for SME sector development is access to finance particularly from financial institutions. Le, Venkatesh and Nguyen (2006[8]) pointed out that the achievement stage for any particular SME is to have adequate access to external sources of finance.

Firm-level data collected by the World Bank show that shortage on access to finance perceived to be one of the main obstacles to doing business. Several studies have revealed that financing is a major constraint for SMEs to grow than for larger firms, mainly in the developing world (Beck et al., 2005[9]; Beck et al., 2006[10]; Fatoki & Assah, 2011[11], Kira & He, 2012[12]).

Conservative viewers argue that bank or commercial finance company lending would typically not be available to SMEs until they achieve a level of production where their balance sheets reflect substantial tangible business assets that might be pledged as collateral such as inventory, equipments and accounts receivable. This sequencing of funding over the growth cycle of a firm can be viewed in the context of the modem information-based theory of security design and the notion of a financial pecking order. Costly state verification (Townsend 1979[13], Diamond 1984[14]) and adverse selection (Myers 1984[15], Myers and Majluf 1984[16], Nachman & Noe, 1994[17]) arguments suggest the optimality of debt contracts after insider finance has been exhausted that firm has to search for external sources such as debt and equity to enjoy the benefits on utilization of external debt (Modigliani & Miller, 1963[18]). These debt contracts could include trade credit, loans from commercial bank and finance companies. Conversely, moral hazard can make debt contracts quite problematic. Moral hazard problems are likely to occur when the amount of external finance needed is large relative to the amount of insider finance (inclusive of any personal wealth at risk via pledges of personal collateral or guarantees). This suggests that external equity finance specifically angel and venture capital may be particularly important when these conditions hold and the moral hazard problem is acute. The fact that high-growth, high-risk new ventures often obtain angel finance and/or venture capital before they obtain significant amounts of external debt finance suggests that the moral hazard problem may be particularly acute for these firms.

In Bangladesh, Small and medium enterprises have been facing multifarious problems related to raw materials, power, land, marketing, transport, technical facilities, and finance. De Haas and Van Horen (2010[19]) analyzed the syndicated loan market and how banks adjust their lending behaviour during a financial crisis and found that the reduction in bank lending during the crisis can at least partly be attributed to banks' increased monitoring and screening efforts.

Today, a number of studies find that SMEs are frequently faced with constraints and challenges (Bannock et al. 2002[20]; Batra and Mahmood 2001[21]; Batra and Tan 2003[22]; Beck et al. 2004[23]; Brunetti et al. 1998[24]). For most developing and transition economies, the common challenges for SMEs typically include financing, overcoming institutional, legal and administrative barriers and accessing network support. The inability to access credit is one of the major bottlenecks of SME, as almost all of these economies have poorly developed banking sectors (EBRD 2004[25]; Hossain 1998[26]; PECC 2003[27]).

Puri, Rocholl and Steffen (2010[28]) studied the effects of the financial crisis on retail lending at German savings banks and found a general decrease of loan demand after the beginning of the crisis.

Bari, Ali & Haque (2005[29]) examined the key constraints faced by the SME sector in Pakistan, including lack of access to credit, excessive government regulation, an arbitrary and exploitative tax administration system, a weak technological base, and the lack of business support services. It also provides a set of concrete strategic recommendations to address such constraints in order to promote SME growth for greater income generation and employment creation.

Objectives

- To identify the problems that MSMEs are facing.
- To identify the constraints and barriers in credit to MSME Sector.

Methodology

The study is primarily based on qualitative literature survey method. It facilitates in depth analysis of the issues related to financing constraints for the budding entrepreneurs and the MSMEs. Extensive review of the literature provided useful insight about the major constraints and bottlenecks that the MSMESs are facing today in availing credit facilities from banks and other financial institutions. The study is based on secondary data, which has been collected from various MSME Annual Reports, International Finance Corporation Report on MSME Finance in India, and SIDBI Annual Reports.

Demand in the MSME Sector

There is a total finance requirement of INR 32.5 trillion in the MSME sector, which comprises of INR 26 trillion of debt demand and INR 6.5 trillion of equity demand. Thus, after excluding (a) sick enterprises, (b) new enterprises (those with less than a year in operation), (c) Enterprises rejected by financial institutions (d) micro enterprises that prefer finance from the informal sector, the viable and addressable debt demand is estimated to be INR 9.9 trillion, which is 38 percent of the total debt demand.

The viable and addressable equity demand is estimated to be INR 0.67 trillion, after excluding: (a) entrepreneurs' equity contribution to enterprises estimated at INR 4.6 trillion and, (b) equity demand from micro and small enterprises that are structured as proprietorship or partnership, and are unable to absorb equity from external sources. The second is estimated to be worth INR 1.23 trillion.

Flow of Finance to the MSME Sector

Overall finance demand of INR 32.5 trillion, 78 percent, or INR 25.5 trillion is either self-financed or from informal sources. Formal sources cater to only 22 percent or INR 7 trillion of the total MSME debt financing. Within the formal financial sector, banks account for nearly 85 percent of debt supply to the MSME sector, with Scheduled Commercial Banks comprising INR 5.9 Trillion. Non-Banking Finance Companies and smaller banks such as Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and government financial institutions (including State Financial Corporation and State Industrial Development Corporations) constitute the rest of the formal MSME debt flow.

MSME Finance Gap in the Sector

Despite the increase in financing to MSMEs in recent years, there is still a considerable institutional finance gap of INR 20.9 trillion. After exclusions in the debt demand (62 percent of the overall demand) and the equity demand (from MSMEs that are structured as proprietorship or partnership), there is still a demand-supply gap of INR 3.57 trillion, which formal financial institutions can viably finance in the near term. This is the demand-supply gap for approximately 11.3 million enterprises. While a large number of these already receive some form of formal finance, they are significantly underserved with only 40-70 percent of their demand currently being met.

With appropriate policy interventions and support to the MSME sector, a considerable part of the currently excluded demand can be made financially viable for the formal financial sector. Of the viable and addressable demand-supply gap, the debt gap is INR 2.93 trillion and the equity gap is INR 0.64 trillion. The micro, small, and medium enterprise segments respectively account for INR 2.25 trillion, INR 0.5 trillion and INR 0.18 trillion, of the debt gap that is viable and can be addressed by financial institutions in the near term.

Micro and small enterprises together account for 97 percent of the viable debt gap and can be addressed by financial institutions in the near term. Available data indicates that medium enterprises in India are relatively well financed. The equity gap in the sector is a combined result of demand-side challenges such as the legal structures of enterprises, as well as supply-side gaps, such as a lack of investment funds focused on MSMEs. Table-2 reflects the overall finance gap in the MSME Sector and Figure-1 gives a diagrammatic representation of the overall finance gap in the MSME sector.

Problems Faced by MSMEs

Before analyzing the various causes, it is worthwhile to discuss in brief the criteria for identification of sickness. A unit may be considered sick if it has incurred cash loss for one year and in the judgement of the bank it is likely to continue to incur cash losses for the current year as well as the following year and the unit has an imbalance in its financial structure such as current ratio of less than 1:1 and worsening debt equity ratio. The other features of sickness may be:

- Continuous default in meeting for consecutive half yearly instalments of interest of Principal of Institutional loans.
- Continuous cash loss for a period or two years of continued erosion in the net worth by 50 percent or more.
- Mounting arrears on account of statutory or other liabilities for period of one or two years.

Despite of the importance of the MSMEs in Indian economic growth, the sector is facing challenges and does not get the required support from the concerned Government Departments, Banks, Financial Institutions and Corporates which is proving to be a hurdle in the growth path of the MSMEs. The list of the problems that are faced by existing/new companies in SME sector are as under:

1. Absence of adequate and timely banking finance
2. Limited capital and knowledge
3. Non-availability of suitable technology
4. Low production capacity
5. Ineffective marketing strategy
6. Constraints on modernisation & expansions
7. Non availability of skilled labour at affordable cost
8. Follow up with various government agencies to resolve problems due to lack of man power and knowledge etc.

Some Other Problems of MSME Sector

1. Lack of credit from banks- The MSME`S are presently facing the problems of credit from the banks. The banks are not providing the adequate amount of loan to the MSME`S. The loan providing process of the banks is very long and formalistic. The owners of the MSME`S has to produce different types of documents to prove their worthiness. The banks are providing on an average 50% total capital employed in fixed assets. The cost of credit is also high.

2. Competition from multinational companies- In present era of globalization, the MSME`S are facing the great from the international manufacturing companies who are proving quality goods at cheapest price. Therefore, it is very difficult to compete with the multinational companies.

3. Poor infrastructure- Though, MSME`S are developing so rapidly but their infrastructure is very poor. With poor infrastructure, their production capacity is very low while production cost is very high.

4. Unavailability of raw material and other inputs- For MSME's required raw material skilled work force and other inputs, which are not available in the market. Due to unavailability of these essentials, it is very difficult to produce the products at affordable prices.

5. Lack of advanced technology- The owners of MSME`S are not aware of advanced technologies of production. Their methodology of production is outdated. The owners are using older method in the field of fabricated metal and textile.

6. Lack of distribution of marketing channels- The MSME`S are not adopting the innovative channels of marketing. Their advertisement and sales promotion are comparatively weaker than the multinational companies are. The ineffective advertisement and poor marketing channels leads to a very poor selling.

Problems faced by Banks in Lending to MSMEs

- Most of the MSMEs work in unorganized sector. Therefore they do not maintain proper accounts. This hinders banks in lending credit to MSMEs.
- Banks consider MSME projects risky. Therefore banks prefer not to lend money more than their priority sector lending obligations.
- Banks generally require collateral security for MSME lending which becomes a big hurdle for MSMEs in securing credit from banks.
- Banks mostly do not finance new ideas. They like to stick with its regular customers.
- New entrepreneurs face problems in securing credit from banks because of the lack of credit history.
- Bureaucracy in lending procedure becomes a big hurdle for public sector banks in MSMEs financing.

Financial Constraints Faced by MSMEs

In the first Technical Note, focus was on detailed overview of Micro, Small and Medium Enterprises (MSMEs) in India. Present technical note talks about constraints and scope to MSME growth with particular focus on Missing Middle enterprises in India.

The MSME sector faces several barriers to their growth and to realizing their full potential. These key barriers of the sector have been highlighted in the report of Prime Minister Taskforce on MSME, 2010, these include:

- Lack of availability of adequate and timely credit
- High cost of credit
- Collateral requirements
- Limited access to equity capital
- Problems in supply to government departments and agencies
- Procurement of raw materials at a competitive cost
- Problems of storage, designing, packaging and product display

- Lack of access to global markets
- Inadequate infrastructure facilities, including power, water, roads, etc.
- Low technology levels and lack of access to modern technology
- Lack of skilled manpower for manufacturing, services, marketing, etc.
- Multiplicity of labour laws and complicated procedures associated with compliance of such laws
- Absence of a suitable mechanism which enables the quick revival of viable sick enterprises and allows unviable entities to close down speedily
- Issues relating to taxation

While the above list provides key barriers for MSME growth in general, these constraints play out more severely for microenterprises, particularly access to finance. In order to understand the constraints faced by microenterprises particularly related to financing, it is first necessary to understand the key characteristics of microenterprise units, these are discussed below:

- Microenterprise units are very small. Large proportions of them operate out of houses or small rented premises
- Most of the units are unregistered and are unorganized
- Most of the units do not have bank account. Usually owner of the enterprise has bank account in his/her name
- Financial transactions are primarily in cash
- Most of the units do not maintain any formal accounts so ascertaining their financial performance is difficult
- Units have low level of mechanization and often use obsolete technologies
- Most of the units are vulnerable to even minor income shocks
- Most of the units prefer to avoid registration and other regulatory compliances to avoid compliance related costs, taxes and scrutiny attached to compliances
- Most units have poor working conditions for labour, lack social security for labour and may also involve child labour

There are number of financial and non-financial constraints plaguing the MSME sector. However, financial exclusion that too of the microenterprises in particular, is the most critical one. It is also the focus of this Knowledge Series.

Access to capital for MSMEs is indeed severely constrained which has been recognized even by the Prime Minister Taskforce on MSME. However, this constraint is particularly acute for the microenterprises. Having understood the key characteristics of typical microenterprises in the previous section, it is now much easier for us to appreciate the financial constraints that such units face.

Conclusion

MSMEs play a pivotal role in our economy. From time to time, Government and Reserve Bank of India (RBI) have implemented several policies to improve the flow of credit to the MSME Sector. Whether we talk about priority sector lending or collateral free loans, the bitter reality is that, still it’s a cumbersome process for MSMEs to avail credit facilities from the Banks or other financial institutions.

Today, there is a total finance requirement of INR 32.5 trillion by the MSME sector in India but out of this, government is hardly able to meet the demand of INR 12 trillion. There is still a finance gap of approximately 20 trillion for the MSME sector. The gap is huge for the government to fill.

Banks also face several problems at their end while granting loans to the MSME sector. As most of MSMEs work in the unorganized sector, so they do not maintain any proper accounts or balance sheets. Without the presence of proper balance sheets, Banks find it really difficult to lend credit to MSMEs. Banks do not have that much of trust on newly setup enterprises or the start-ups. They consider MSME projects risky and are scared of NPAs while granting credit to start ups. So, Banks generally lend only the prescribed amount to this sector as mentioned under priority sector lending obligations.

Another major problem that MSMEs face in accessing credit from banks is absence of collateral security. Banks generally require collateral security for MSME lending and it becomes a big hurdle for MSMEs in securing credit from banks. The budding entrepreneurs are unable to avail credit from banks because of the absence of credit history.

MSMEs also face the problem of incompetent management. The owner/manager generally does not have all the skills required to manage a firm efficiently. Non availability of skilled man power is another major issue that hinders the growth of MSME sector.

Apart from this, MSMEs face several other problems such as problem of marketing their products. Once the product is ready, it becomes imperative for the owner/manager to sell it into the market. Generally, MSMEs are unable to make use of proper intermediaries for the marketing of their products.

To sum it up, it can be concluded that MSMEs face several obstacles and hindrances in accessing finance from the banks and other financial institutions. Though a lot of efforts have already been made by the government to make the flow of credit easy to this sector but still a lot of work needs to be done to meet the actual finance requirements of the MSME sector in India.

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Table-1
Classification of Industries in MSME Act 2006

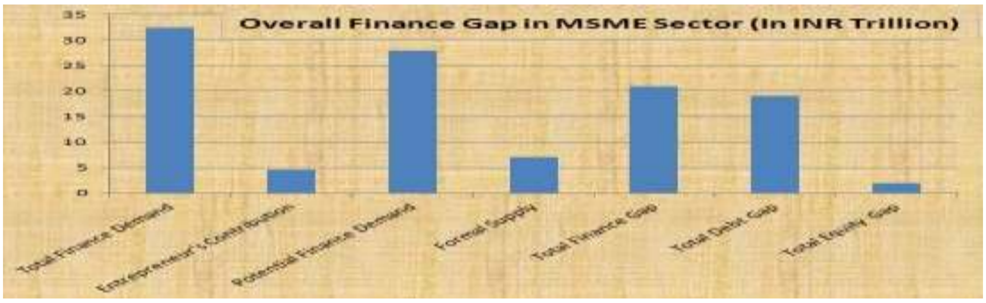
Particulars	Investment in Plant & Machineries in case of Manufacturing Enterprises	Investment in Equipment in case of Service Sector Enterprises
Micro Enterprises	Up to Rs. 25/- lacs	Up to Rs.10/- lacs
Small Enterprises	Above Rs. 25/- lacs and up to Rs.500/- lacs	Above Rs.10/- lacs and up to Rs.200/- lacs
Medium Enterprises	Above Rs.500/- lacs and up to Rs.1000/- lacs	Above Rs.200/- lacs and up to Rs.500/- lacs

Source: Compiled from MSME Annual Report (2012)

Table-2

	(In INR Trillion)
Total Finance Demand	32.5
Entrepreneur's Contribution	4.6
Potential Finance Demand	27.9
Formal Supply	7
Total Finance Gap	20.9
Total Debt Gap	19
Total Equity Gap	1.9

Overall Finance Gap in MSME Sector
Source: Compiled from MSME Census, RBI Reports, SIDBI Reports, IFC Intellecap Analysis



Source: Compiled from MSME Census, RBI Reports, SIDBI Reports, IFC Intellecap Analysis

Figure-1
Overall Finance Gap in MSME Sector