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Enhancing Credit Flow for Accelerating the Recovery of MSMEs: Some Policy Lessons

Introduction

The Covid-19 pandemic severely affected business operations globally by disrupting supply chains and generating demand and supply shocks. Micro, small and medium enterprises (MSMEs), which constitute the bulk of enterprises in India and serve as the backbone of its economy sustaining the lives of millions of workers, were particularly hit badly. These firms are still struggling to revive. MSMEs are more vulnerable to such shocks in comparison to large firms, given their poor financial strength. Credit problem was one of the major challenges faced by the MSMEs during the pandemic. The high cost of credit or non-availability of credit is not new to the MSME sector in India. The pandemic has just aggravated the problem and highlighted the vulnerability of the sector once again. To address these challenges, the Government and the Reserve Bank of India (RBI) announced many initiatives including an emergency credit line guarantee scheme, loan moratorium, interest rate subvention, equity infusion for MSMEs, reclassification of MSMEs, etc. But the effectiveness of these initiatives was limited by the huge informality in the sector.

ISID has recently conducted a study to understand the criticality of the flow of funds for the growth of MSMEs, challenges faced by various stakeholders in enhancing credit flow to the sector, and suggest appropriate policy measures to ease access to formal credit, using both primary and secondary data. The secondary data sources comprised the Annual Reports of MSMEs, RBI, select Public Sector Banks, 67th and 73rd rounds surveys of unincorporated non-agricultural enterprises (excluding construction) conducted by the National Sample Survey Office (NSSO) in the years 2010-11 and 2015-16 respectively. The primary data were collected from a survey of key stakeholders viz. MSME owners, bank branches, and lead district managers (LDMs) located in Delhi and Uttar Pradesh using semi-structured questionnaires. Both qualitative and quantitative data were collected. A total of 52 branches of public sector banks and 9 lead district bank offices were surveyed besides 271 MSMEs primarily in Delhi and 6 districts of Uttar Pradesh (i.e. Agra, Allahabad, Gautam Buddh Nagar, Ghaziabad, Sant Ravidas Nagar, and Varanasi). Snowball sampling technique was applied to execute the survey at each industrial center to collect the data from MSME Owners. The key observations of the study are discussed below.

Declining Flow of Credit to the MSME Sector

Although credit flow to the MSME sector has increased over time in absolute terms, its share in non-food credit (NFC) and priority sector advances (PSA) has declined. As per RBI data, the share of MSMEs in NFC has declined from 48.51% in 2007-08 to 43.09% in 2017-18. Similarly, the share of MSMEs in PSA has reduced from 16.46% in 2007-08 to 14.31% in 2017-18 which indicates a declining preference for MSME lending by the scheduled commercial banks. Although a large fraction of small firms voluntarily excludes themselves from the financial market for taking a loan due to many reasons including personal and social values, our computation using NSSO data shows that percentage of MSMEs reporting non-availability of credit or high cost of credit as a severe problem has increased from 7.54% in 2010-11 to 8.34% in 2015-16. It indicates an increasing trend of credit problems in the MSME sector.

Access to credit is still a major constraint for the MSME sector

Evidence from a Primary Survey

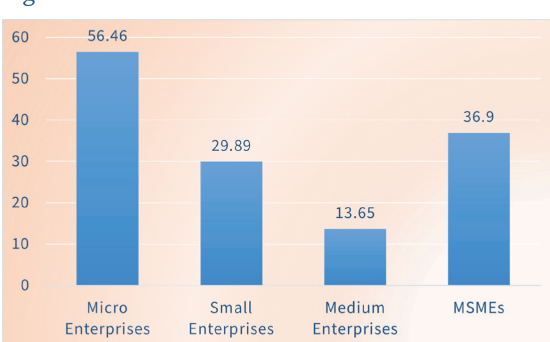
Rising Credit Problems for MSMEs

Analysis of our primary survey data collected in 2019 indicates that credit problems in MSMEs have further aggravated. Around 37% of sample firms faced credit problems (Figure 1). The credit problem faced by MSMEs in urban areas is more than 39% which is around 9% higher than that in rural areas. The incidence is much higher than what we observe from the analysis of 67th and 73rd rounds surveys of unincorporated non-agricultural enterprises (excluding construction) conducted by NSSO in 2010-11 and 2015-16 respectively, as discussed above. Although our sample size is small in comparison to the NSSO data, our findings highlight the increasing trend of credit problems in MSMEs which might have been aggravated due to policy shocks such as demonetization in 2016 and GST in 2017.

Incidence across Size Classes of MSMEs

Among MSMEs, micro-enterprises face more problems than small enterprises, and similarly, small enterprises face more credit problems than medium enterprises *(Figure 1)*. It indicates that the size of the firm particularly in terms of investment negatively affects credit problems. Since loan amount for relatively larger firms is higher than that for smaller firms, banks also prefer larger firms in the MSME category for lending to meet the target of lending to priority sector advances which is in terms of percentage to their total advances. It also reduces banks' loan application processing costs for the MSME segment. Further, service enterprises face more credit problems than manufacturing enterprises irrespective of their size. Less prevalence of credit problems in manufacturing enterprises may be due to high investment in plant and machinery in comparison to service enterprises which enables them to have collateral security for getting a loan from banks.

Figure 1: Credit Problems and Size of Firm



Source: ISID Primary Survey.

Women-led MSMEs and younger firms face greater credit challenges

Women-led MSMEs Face Greater Challenges in Rural Areas

In general, female-owned firms face more credit problems than male-owned firms. But, interestingly, although female-owned rural firms face more credit problems than male-owned rural firms, there is not much difference in credit problems for male or female-owned firms in urban areas. Further, younger firms face more credit problems than older firms which indicates that credit problems in the firm may decline with the increase in its age.

Registration Status has no Impact on the Incidence of Credit Problems

Surprisingly, the registration status of a firm has no significant impact on the prevalence of credit problems in MSMEs. Both types of firms have a similar prevalence of credit problems. Possibly, it may be the reason for low registration and higher informality in the sector. Although commercial banks are an important source of business finance, MSMEs prefer informal sources for financing their business due to ease of access particularly the ability to get a loan when required, and no requirement of financial statements and collateral.

Low Success Rate of Loan Applications in Rural Areas

Around 70% of sample firms that apply for a loan get finance which indicates a significant improvement in formal lending to the MSME sector over time. However, rural areas have low success rate than urban areas in loan approval from banks. Firms that did not receive a loan from banks or that did not apply hinted at the high level of corruption in getting loans from banks. Though its verification was beyond the scope of the study, the blame for corruption on the bank officials in absence of appropriate financial documents can also not be ruled out.

Major constraints of Credit Flow to the MSME Sector

Poor Quality of Loan Applications and Poor Selection Mechanism under Schematic Lending

Applications received by bank branches under government schemes are routed through government agencies including District Industries Centers (DICs), Khadi and Village Industries Commission, Scheduled Caste Development Corporation, Scheduled Tribe Development Corporation, and Coir Board. After preliminary screening by government agencies, loan applications of borrowers are sent to bank branches mentioned in the application or nearby locations of enterprises. As per Bank officials, the majority of such loan applications are very poor. Entrepreneurs are often found to lack a viable business idea along with appropriate supporting documents. The success ratio of such applications is very low. Around 20% of such applications finally succeed to get a loan from bank branches.

Lack of Financial Literacy in Majority of Small Firm Owners

The majority of MSMEs, particularly micro-enterprises, do not maintain their accounts due to a lack of financial literacy. They are unable to submit the required documents needed along with loan applications. Lack of financial literacy affects the ability of MSMEs to get a loan from banks. It also affects the success of online loan application platforms such as psbloansin59minutes. Enhancing the financial literacy of MSMEs may help the banking system in the selection of suitable MSME borrowers.

The Reluctance of Bank Officials in Lending to MSMEs

The experiences of lead district officers indicate that some banks are reluctant in lending to the MSME sector. The main reason for bank officials' reluctant approach to lending to the MSME sector includes fear of staff accountability if a loan turns non-performing asset. The general perception about the sector is that advances to the MSME sector are not economically viable, even though it is collateral-free. There is always a fear about turning of an MSME loan account into a stressed loan account or non-performing asset (NPA). Among others, the main reasons for an MSME loan account turning bad include ill-intention of business entities for fund utilization, particularly under government schemes, poor post-sanction monitoring of accounts, business cycles, and economic shocks.

Variation in the Branch Wise Targets for MSME Lending

District coordinators of banks participate in the meetings held by the lead district bank and concerned forums. Bank-wise targets for lending are part of the district credit plan which also include priority sector lending. Each bank distributes such targets among its branches depending upon their locations and the credit support available at the branch. Therefore, there are huge variations in branch-wise targets. Some of the bank branches may not have any such targets which may affect lending to MSMEs having accounts in those branches.

Poor Monitoring of MSME Lending

In terms of monitoring of MSME lending, almost all branch managers mentioned that there is no direct monitoring of MSME lending by any government agencies with branches. Further, the lead district bank, the nodal agency for the coordination between banks and government authorities for the implementation of various government schemes meant for enhancing institutional credit flow, does not have any direct interface with any of the Government departments/agencies in monitoring the performance of lending to the MSME sector by banks. At the lead district office, there is no system for calling information about MSME lending from an individual bank branch. The Lead District Manager (LDM) office of the lead district bank gets quarterly information about

Majority of MSME owners lack financial literacy the priority sector lending which includes MSMEs lending among others from the State Level Banker's Committee (SLBC) portal.

Further, the Director of MSME - Development Institute (MSME-DI) is an invitee to the District Consultative Committee (DCC)/District Level Review Committee (DLRC) meeting in the district, where MSME clusters are located, to discuss issues concerning MSMEs. It was revealed by bank officials that in the DCC/DLRC meeting, which discusses and reviews the 'District Credit Plan' and priority sector lending in the district, monitoring of MSME lending is not discussed as a separate agenda item. Therefore, MSME lending as such does not receive focused attention for monitoring with the same intensity. Thus, there is a need for a specific monitoring mechanism for lending to the MSME sector within the set-up of the lead district office.

LDMs of some districts also informed that on many occasions, these meetings are just a formality to follow the mandatory guidelines of the RBI. Being a junior officer to DGM/AGM in the bank staff hierarchy, LDM is not in a position to influence the bank's priorities for lending. However, being a coordinating office between banks and government agencies, it pursues banks for lending under various government schemes in the district.

Poor Coordination between Government Agencies, Business Associations, and Bank Personnel

Around two-thirds of branch managers who interacted during the study expressed their dissatisfaction with branch lending under the MSME segment and suggested the need for better coordination between government agencies, business associations, and bank personnel in terms of designing lending schemes for the MSME sector and their implementations.

Shortage of Skilled Staff at Banks

Most of the branch managers indicated that their branches lack staff, particularly skilled staff. The existing staff is hard-pressed with a high workload. It increases loan application processing time. The majority of bank officials informed that loan processing time is more than two weeks. The actual time depends upon the availability of required documents and the amount of the loan. The steps involved in this process include proper checking of due diligence, address verification, interview of a loan applicant, pre-sanction visit, and inspection of the enterprise site. In general, loan processing time in private banks is less than that in public sector banks due to their separate loan processing cells and the engagement of more staff for the purpose. Firm owners also suggested reducing the loan processing time and number of branch visits. However, a shortage of staff also affects the post-disbursement monitoring of loan accounts. It was suggested by almost all branch managers to increase the staff particularly skilled staff at the branch level. A branch manager with adequate field staff can also gather correct information about the demand gap of particular products/services in the market and properly assess the business viability of the firm before sanctioning the loan.

Bias against the New Customers

Given the high workload, less skilled staff, and fear of accountability on decisions if a loan account turns NPA, branch managers give some preference to existing customers instead of new customers in approving loan applications. It is mainly because branch managers have prior information about the financial behavior of their old customers. Thus, many new and needy customers fail to get a loan from the public sector banks.

Poor Awareness about Government Schemes

The awareness and utilization of select government schemes related to access to finance including Prime Minister's Employment Generation Programme (PMEGP), Pradhan Mantri MUDRA Yojana (PMMY), Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), Trade Receivables Discounting System (TReDS), and MSME59 (psbloansin59minutes.com - a digital lending

Shortage of skilled staff in banks affects loan application processing and lending to MSMEs platform for MSMEs providing in-principle sanctioning of a loan in 59 minutes) were assessed. It has been observed that there is a low level of awareness about different government schemes meant for easing access to finance and growth of MSMEs except in the case of PMMY *(Table 1)*. However, the utilization of this scheme for getting funds from banks is low like other schemes. In general, less than 5% of firms who were aware of the scheme availed of its benefits. It also indicates a mismatch between the financial needs of business entities and credit schemes designed for easing access to finance for MSMEs.

Table 1: Awareness of Select Government Schemes

Government Schemes	*Firms Having Awareness About Scheme * (percent)*	*Firm Received Benefits under Scheme ** (percent)*
PMEGP	35.79	5.15
PMMY	96.31	1.53
CGTMSE	12.18	0
TReDS	10.33	21.43
MSME59	18.45	4

Source: ISID Primary Survey.
Note: * Percentage of Total Firms under Study;
** Percentage of Firms having Awareness.

High Informality

The majority of the business entities in the MSME segment are informal. They don't register and thus lack the required documents needed for loan applications from the banks. It affects their ability to get a loan from banks and supports from the various government agencies at the time of need.

The Dominance of Herd Mentality in Micro and Small Entrepreneurs

Another important aspect highlighted by the branch managers about the entrepreneurial orientation of the firm owners was the herd mentality of the majority of micro and small entrepreneurs. People copy the successful enterprises in their locality without proper assessment of the demand gap for a particular product or service. It reduces the business viability of not only the new firm entering into the market but also the other firms by reducing the expected profit of the new firm and making all similar firms normal profit-earning firms or just surviving firms in the future. Possibly, it may be the reason for the low growth of micro and small firms or their graduation into sick firms over time. It also increases the possibility of MSMEs' loans converting into a stressed loan or NPA.

District Industries Centres should be developed as a nodal agency for entrepreneurial activities in the district

Key Policy Lessons

The observations derived from the perspectives of key stakeholders infer that the credit problems of MSMEs are multi-dimensional. The existing policies need redesigning considering the constraints and limitations of all key stakeholders. We propose the following policy suggestions to improve credit flow in the MSME sector.

Enhancing the Role of District Industries Centres

DIC should be developed as a nodal agency for the entrepreneurial activities in the district. As a nodal agency, it should act as a centre for entrepreneurial training, firm registration, and processing of applications under government support schemes. Further, there is also a need for drastic improvement in the mechanism of selection of beneficiaries by DIC under schematic lending. DIC should consider application only after evaluating the entrepreneurial orientation of firm owners. There should be a regular interface between DIC, banks, and other stakeholders.

DIC should provide appropriate training to entrepreneurs for enhancing their financial literacy, awareness about government schemes, and regulations. There should be a mechanism to send messages to MSMEs on monthly/quarterly intervals about government schemes, regulations, and forthcoming events, exhibitions, and meets. There should be a designated help desk for this purpose. There should be an online or app-based mechanism to take feedback about DIC activities from business entities. In case of dissatisfaction, concerns should be addressed by the appropriate authorities. DICs may engage academic institutions (i.e. colleges, universities, and institutes) of the region for enhancing understanding of the changing need for MSMEs through research studies. Field visits by the students and the preparation of a report on certain issues can be part of the curriculum of different courses.

Empowering the Lead District Bank Offices

The LDM Office should be developed as a nodal agency to monitor banks' lending to the MSME sector. LDM should have an appropriate position in the hierarchy of bank staff so that it may influence the bank's lending priorities if required. The LDM should formulate a mechanism whereby the district co-ordinator of each bank provides branch-wise performance under MSME lending to the LDM office on monthly basis. A specially designed and designated portal for 'MSME lending information' can serve the purpose more effectively. The LDM office should publish a monthly/quarterly report on credit flow to the MSME sector and distribute it among all key stakeholders.

Effective Reviews of MSME Lending

DCC/DLRC should continue to act as a reviewing authority for MSME lending in the district. However, lending under MSME should be taken as a separate agenda item of the DCC/DLRC meeting. Along with bank-wise progress in MSME lending, branch-wise progress should also be discussed in the DCC/DLRC meetings. The district coordinator of each bank should attend the meetings. If required, a suitable direction may be given to the respective district co-ordinator of the bank for achieving the required progress under MSME lending of the bank and also at the branch level. In the District Credit Plan, the target of MSME lending with break-up of micro, small and medium enterprises should be given and it should be documented to evaluate the performance of banks and bank branches in each district. Further, the target under schematic lending (e.g. MUDRA with the break-up of Shishu, Kishore, Tarun, Start-up India, and Stand-up India) should be part of the 'District Credit Plan'. In the case, if it is decided by the individual banks beyond the District Credit Plan for any reason, the Lead District Office should collect these targets from the respective bank's district coordinator. Monitoring mechanism of lending under the schemes should focus on the performance/achievement of the target under individual categories *viz.* micro, small, and medium enterprises. Progress vis-a-vis the target should be monitored for each branch of the respective bank in the DCC meeting. It will help to ensure uniformity in lending and remove regional/area-specific imbalances if there are any.

A Separate Loan Processing Cell in Each Bank with Adequate Skilled Staff

There should be a separate cell for loan processing in each bank. It will help in the reduction of accountability fear among bank staff if a loan account turns NPA. The primary work of bank branches should be to generate loan demand, ensure timely disbursement of loans, and follow up after loan disbursement. Adequate skilled staff should be placed in each branch and credit assessment cell.

A Separate Desk and Designated Officer for MSMEs in Each Bank Branch

Based on the business volume and potentially available, there could be a separate desk for MSMEs in the branch. So that a designated branch officer can give sufficient time to interact with MSME customers. The officer can be a designated as Relationship Manager for dealing with MSMEs. The behaviour of branch officials towards its customers should be supportive. It will make them feel comfortable and encourage them to use various financial services to the maximum. There should be a mechanism for taking feedback from customers on their purpose of visit, the number of visits, time spend in the bank, and experience with bank officials after each visit to the branch.

> *Each bank should have a separate loan processing cell to assess the business proposals on time*

In case of any dissatisfaction, the concern of customers should be addressed by the appropriate authorities. It may enhance the trust between customers and bank officials.

Encouraging Online Loan Applications

Online loan application portals like psbloansin59minutes.com should be encouraged. Decisions on loan applications on approval/rejection, processing, and loan disbursement should be taken timely, without delay. Further, all banks may consider introducing a designated online platform for loan application under any scheme so that one entrepreneur cannot apply for a loan for the same proposal from more than one bank simultaneously. This platform may also contain information about the timely repayment behaviour of the firm so that the financial behaviour of the applicant could be assessed for the next application. It should also be linked with the credit score system.

Timely Processing of Loan Applications

There is a need to improve the turnaround time for financing MSMEs at the operation level. At the branch level, a day in a week or fortnight should be fixed when any delay in loan processing is shared with applicants and a report about it should be submitted to the higher authority of the bank for monitoring purposes.

Increasing Awareness about Lending Schemes

There should be a display in each branch about MSME schemes with their brief descriptions. So that customers are made aware of the scheme. It may generate interest among customers in schemes and help the bank in generating loan demand. MSME scheme camp as part of the outreach programme may be held regularly.

Encouraging Online Payments for Business Transactions

Bank does give preference to its old customers for financial support. It should encourage business entities to open their business account even before applying for any loan. The bank should also encourage business entities for online payments for their business transactions. It may help banks to analyze the cash flow of firms for assessing their loan application and capabilities to carry the business if required.

Online loan applications should be encouraged

Promoting Risk Sharing Banking for MSMEs

Risk-sharing banking on various dimensions may be promoted for MSMEs. Venture capital schemes should be encouraged even for small players. Facilities such as crowd/society funding could be outlined and introduced for MSMEs. Coverage of CGTMSE may be broadened to include all MSMEs and the amount of coverage may be enhanced.

Designing MSME Lending Scheme after Wider Consultations

Government agencies should design MSMEs lending schemes in consultations with key stakeholders' *viz.* bank officials, government departments working for MSMEs, research institutions working on MSMEs, and business associations. After the launching of a scheme, there should be an aggressive campaign to enhance awareness about schemes among MSMEs.

Effective Support for Loan Recovery by the Government Agencies

Government agencies in coordination with the banks should not only monitor the credit flow to MSMEs under specific schemes but also help the banks in loan recovery if any loan becomes NPA. A scheme can be developed for the recovery of banks' dues on the lines of the Public Money (Recovery of dues) Act as available in the state of Uttar Pradesh and many other states.

Incentivising Timely Loan Repayment by MSMEs

If MSMEs take financial assistance under any government scheme/loan from the bank, they should be encouraged to repay it on time. Apart from improvement in the Credit Information Bureau (India) Limited (CIBIL) score, there should be some monetary incentives for timely repayment. The government may introduce an incentive for timely repayment for MSMEs as it is in the case of the Kisan Credit Card (KCC) for farmers. If a business entity fails to repay the loan on time, Government may consider providing support for additional funding in one way or another, so that the business entity can find a chance to revive its business activities.

Encouraging Registration of Business Entities

Registration of business entities should be encouraged. In terms of incentives, registered firms must get a significant advantage over unregistered firms. DIC should play a key role in the registration of business entities. There should be a division at DIC for proper training and support to the owners of MSMEs. MSMEs should be encouraged to maintain proper documents/ financial statements of their business activities, even if they don't require any government support/credit support from banks. Further, as part of educating entrepreneurs, they should be made to understand and be convinced of the impact, if a loan account turns NPA, particularly in the case of schematic lending.

Concluding Remarks

ISID's interactions with LDM, branch managers, business entities, and government officials have provided a comprehensive understanding of the challenges faced by bank officials in lending to the MSME sector and small firms in availing loans from banks. To improve the credit flow to MSMEs, multi-pronged strategies involving all key stakeholders – banks, firms, and government institutions are required. Academic/research institutions may also be engaged in getting regular feedback about challenges faced by MSMEs, assessing the effectiveness of policies, and enhancing awareness of entrepreneurs through research activities.

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