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E - JOURNAL OF FRTL @ IIM CALCUTTA

September 2024. Volume 12. Issue 2

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

FRTL

Financial Research & Trading Laboratory

A suburban perspective on MSME loans in India: Bridging the gap in lending with Private Sector Banks

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1. Introduction

Despite plethora of schemes and policies adopted by various financial institutions, banks and non-banking financial institutions are unable to penetrate suburban cities of India optimally (RBI, 2008; Demirgüç-Kunt, 2018; Kamath, 2007; Bhandari and Tripathi, 2015). In rural areas or semi-urban areas, there is a propensity to rely on public sector banks for individual as well as micro, small and medium enterprises (MSME) banking services. Private sector banks are not able to tap this market which is plagued by unorganized lenders (Sharma, 2011; RBI, 2008; NABARD, 2021). Through a pilot study, we explore the landscape of MSME loans through the lens of borrowers, weighing the offerings of private sector banks as the lenders. We explain the landscape of business loans for small and young enterprises, highlighting its growth potential in tier-II and tier-III cities of India.

Using a semi-structured questionnaire, we conduct a pilot survey of MSME borrowers across the suburbs of Gwalior, Coimbatore, Bhubaneswar and Bulandshahar to identify industry clusters, where increased focus and outreach by private sector banks may translate to discovering hidden patterns, leading to responsible lending across various industries operating in suburban India. We underscore that banks need to focus more on emerging businesses even though they may have less number of employees or might have been incorporated fairly recently. We discuss gaps in working capital financing of small businesses and how they perceive the banking sector may address them. We further find a growing preference amongst new businesses in textile/apparel, manufacturing, automobile retailer, pharmaceutical companies and agriculture industries to associate with private banks. Finally, we discuss the role of MSME financing in achieving Viksit Bharat 2047.

1.1 Business Loan Groups

India has a diverse financial sector continuously expanding, both in terms of established financial services and new entrants in digital financial services. The Financial Stability Report of RBI, released in June 2024,

states the resilience of the Indian financial sector, with an average Capital-to-risk-weighted assets ratio of 16.8 per cent for Indian (Scheduled) Commercial banks. The report mentions a decline in the banks' gross net performing assets to 2.8 per cent in March 2024, as opposed to 3.9 per cent in March 2023 (RBI, 2024).

Apart from commercial banks, insurance firms, non-bank financial companies, cooperatives, pension funds, mutual funds, and other smaller financial enterprises comprise the sector. However, commercial banks dominate India's financial industry, accounting for more than 64 per cent of total assets held by the financial system (IBEF, 2024). Within the various strategic business units of commercial banks, the least explored are the business loan groups or BLG. Business loans are provided to enterprises who are dealing in manufacturing, trading or service industry and are registered under MSME scheme of the Government of India. Under this scheme, businesses can take loan of maximum of Rs.2 crores. Interestingly, there is no capping with respect to the minimum amount of loan available in this category. It is a credit facility given to businesses for managing their working capital needs. Enterprises thus end-up with small ticket loans of Rs. 10,000 to Rs.15,000, in line with the collateral-free credit guarantee scheme ensured under the Credit Guarantee Fund for Micro and SmalI Enterprises, by Government of India (Ministry of Micro, Small & Medium Enterprises, 2024). The purpose of BLG is to cater to the financial needs of the business and assist the business with various credit facilities. Distinct from the offering of MUDRA (Micro Units Development and Refinance Agency Limited) Loans, under Pradhan Mantri Mudra Yojana, BLG is a direct offering of scheduled commercial banks and may not have any interest subsidy or subvention (MUDRA, 2024).
Complemented by the current push towards digital banking, present ecosystem of BLG focuses on better banking services combined with value-added offerings for small and medium enterprises. BLG mainly focuses on MSME that require loans for a wide range of secured and unsecured business loans such as working capital finance, term loans, GST business loans, instant overdraft (Insta OD), etc. (*see Figure.1*)

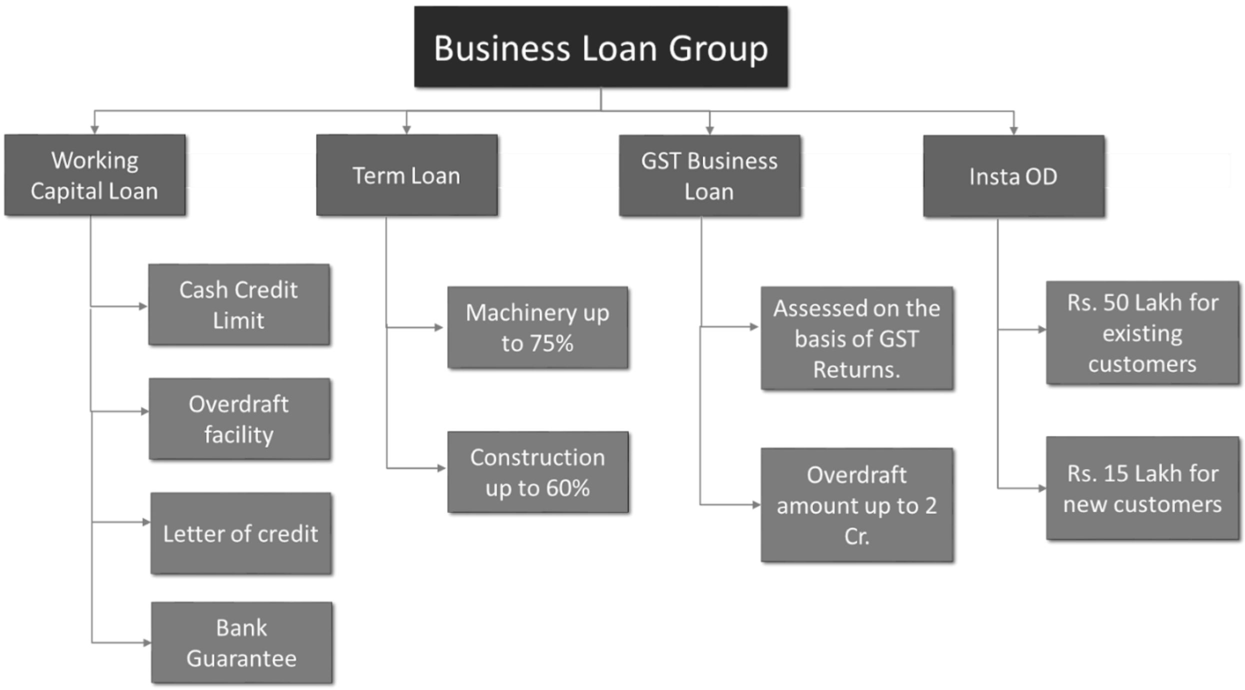

Figure.1. Business Loan Groups and offerings

We discuss the present landscape of business loans from the perspective of micro, small and medium enterprises in tier-II and tier-III cities of India. Broadly, there are four criteria on which the bank provides loan namely the classification of the business based on its offering of services and products; for how long the business is in the market i.e. the age of the business; the turnover that the business has over the last three years as shown in the profit and loss statement and balance sheet of the business; and whether the quantum of profit of business. After understanding the process of eleven private and public sector scheduled commercial banks in India, we note that the eligibility for business loan is heavily reliant on *"hard scoring*" creditworthiness, in terms of CIBIL (Credit Information Bureau India Limited) score, size of the organization and various measures of profitability. While CIBIL score for an MSME may range from 300 to 900 point, a minimum of 700 or above points are required for loan eligibility of MSME (IIFL, 2024). Thus, for a new business it becomes increasingly difficult to access credit in the form of short-term unsecured loans. We thus explore various factors, from the borrowers' perspective, based on which banks can sanction the loan in untapped markets.

2. Challenges in SME Financing

We note that there is a lack of empirical evidence on the antecedents and outcomes of MSME financing specific to suburban India. However, while probing the overarching challenges in MSME financing across emerging markets, we note that it has dual aspects of credit supply and demand issues. An MSME may have a profitable business idea but it may struggle to access sufficient external financing to implement them. On the other hand, an MSME might in itself be not creditworthy, and thus may require access to financing. In these circumstances, creditors will no longer provide credit and further downgrade credit score until lending is sponsored to recover incurred losses. The macroeconomic scenario also can make it hard to finance small and medium-sized firms. For example, if the economy is credit deficit, banks can also additionally discover it to be more worthwhile or much less volatile to finance established larger firms than to lend to the smaller private sector firms. This may further increase the minimum credit score required by MSME to procure funds. Most enterprise property, in particular for small and medium-sized businesses, are constant property (along with equipment and receivables). However, banks are commonly hesitant to just accept those property as collateral because of insufficient felony and regulatory regimes, specifically in emerging markets like India. In this scenario, banks decide on actual property such as land as collateral due to transparency and easy of evaluation as well as reduced likelihood to be the situation of possession disputes (Abraham & Schmukler, 2017). Extent literature notes that bootstrapping with personal savings, friend and family is often used for running early level businesses. It is well-documented that businesses choose public sector banks to elevate their capital, with minimal collateral. MSME's preferred choice are public banks for working capital financing and collateral financing where as private banks and NBFCs are preferred for short-term loans. A shift towards private sectors banks is occasional and may be attributed to elevated monetary call or an elevated capacity of the enterprise to pay back with a better credit score at a certain level. Cooperative banks also emerge as a conventional channel for MSME for short-term loans and collateral financing (Singh & Wasdani, 2016). Due to their modest size, MSMEs regularly battle to reap economies of scale and fail to gain from marketplace opportunities that require moderate to high capital expenditure. In addition, their limited scale of operations makes it hard to internalize offerings such as market research, technological innovation and information, which reduces productivity. However, their limited scale of operations may translate into higher agility and flexibility. (Sinha, 2012). We note that MSME financing has been analyzed from a supply (banks') perspective, but it is limited to discussing loan size or other quantitative indicators. There is limited understanding about how banks' practice responsible lending, i.e. providing loans to MSME with fair assessment of their repayment capacity without any financial strain (Buteau et al., 2022). In the present context of sustainable development goals, responsible lending may also translate to sustainable banking practices. (Rajput et al., 2023). We underscore the lack of existing research in the following five categories, which may open room for discussion in any work involving MSME financing, i.e. (a) MSME personality, (b) MSME business and/or industry viability, (c) MSME knowledge and competence, (d) MSME financial situation, and e) expertise in preparing documentation and loan applications. In addition, we try to provide examples of issues to be discussed in each area based on works from the literature. (Junaid, 2011).

3. A Suburban Perspective of Business Loans to MSME

We constitute a pilot survey of 45 registered MSME across the suburbs of Gwalior, Coimbatore, Bhubaneswar and Bulandshahar. The wide demographic spread across four semi-urban locations in north, south, east and central India aims to ascertain heterogeneity of perspectives. The participants belong to fourteen different sectors including, fast moving consumer goods (FMCG), textile and apparel, electronics and electrical, agriculture, healthcare and pharmacy, jewellery, automobile ancillaries, construction, confectionery, stationery, furniture and small-scale participants of service sector. Our instrument comprises of a semi-structured questionnaire, recording details of name, industry/sector, number of employees, bank partner, choice of banking products and services. During the in-depth interview, we discuss two important queries; (i) What are the issues/ concerns about the present MSME corporate banking services? and (ii) What are the products/ services desired in MSME banking which may be of interest?

We note that the CASA (Current Account / Savings Account), online payments including, Immediate Payment Service (IMPS), National Electronic Funds Transfer (NEFT), Real-Time Gross Settlement (RTGS) and mobile banking followed by term loans are some of the most preferred products of SME. More than 50% of the participants feel that the interest rate and processing fees are higher in private sector banks. But MSME have the perspective that private sector banks provide loans in a lesser time as compared to public sector banks, though they may require collateral of the value of 100% or more of the loan amount. MSME participants perceived that unsecured loans or the requirement of collateral depends on their CIBIL score. On further enquiry, we note that there is lack of knowledge about the exact measure and frequency of updation of CIBIL score amongst MSME.

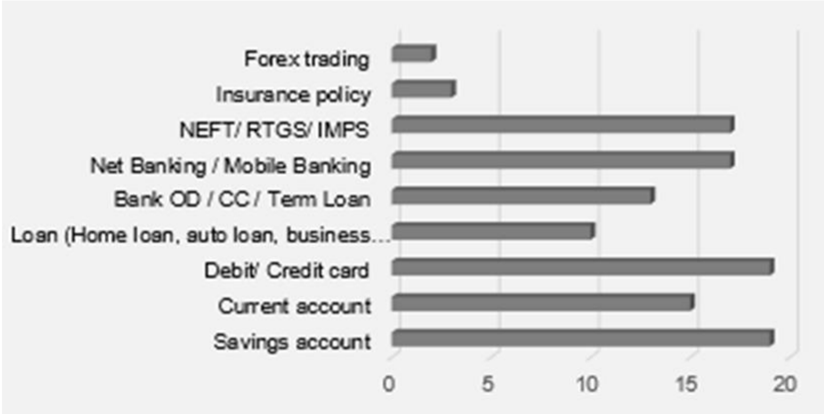

Figure.2: Product and service preference of SME for corporate banking

We note that younger firms are more willing to change their banking preferences. They may opt for higher interest rates for ease of access and quality of services of BLG products. While probing into the issues and concerns about the present MSME corporate banking services, we note that irrespective of age, size and sector, suburban MSME perceives that banks usually target businesses who have more number of employees as they are large enough to repay the debt. Regarding desired services in BLG, private sector banks are mostly preferred by textile and apparel, automobile retailer and agriculture industries for overdraft and lending, citing collateral free loans. This offering in BLG is mostly to industries who have fixed assets and cannot be availed by confectionaries or service sector participants. We note that majority of the participants are not aware about the distinct offerings of BLG as their promotions and advertisements fail to address the digital divide.

4. Bridging the gap with private sector banks

There exists a wide gap in the awareness followed by the understanding of credit-enhancement schemes for MSME. This unawareness is magnified by strong negative perceptions about credit eligibility under BLG. This gap is further under-examined in the suburban context. We note a deterrence in MSME participants in approaching government sector banks, though they are clearly the most preferred amongst older MSME, i.e. those existing for more than 10 years. Though at higher interest rates, with minimum of three years of turnover, profit and loss statement and books of account required to establish eligibility for BLG products and services, private sector banks are emerging as the alternate source of short term financing. The emphasis needs to be on marketplace facilitation and simplicity of doing business for micro, small and medium-sized firms.

As a nodal institution, we underscore the role of the ministry of micro, small and medium enterprises, government of India, to act as a facilitator for constructing systems in which diverse assignment of capital is possible at a dynamic price range. Such systems can be fostered with state sponsored Fintech (financial technologies) participation, thereby having a multiplier impact for responsible lending and imparting awareness to MSME. While we have witnessed an emergence of peer-to-peer lending, government-led platforms are absent in the space.

Referring to the recommendations of Reserve Bank of India's (RBI) MSME Expert Committee recommendations[10] issued in the year 2019, we have progressed towards access to credit and digitalization, though regional contexts, like suburban perspectives are yet to be addressed for their idiosyncrasies. The committee had recommended an authorities-backed Fund of Funds (FoF) for structured MSME financing, though both access and usage of it needs empirical assessment. Comparing to the most recent roadmap of *Viksit Bharat 2047*, MSME financing has taken the center stage (Press Information Bureau, 2024). We underscore the need for special focus on the Indian suburban geography. With a proposed corpus of up to Rs. 50,000 crore equity infusion through Self Reliant India Fund for providing growth capital to the deserving and eligible units of MSME sector, the plan for outreach is yet to be paved while addressing the rural, urban and suburban divide.

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