

Upscaling Micro & Small Enterprise Financing: Fixing the Missing Middle Impasse

The Indian MSME sector is an important pillar of the country as it drives its economic growth. It constitutes of around 30 million units, creates employment for about 70 million, manufactures more than 6000 products, and contributing about 45% to manufacturing output and about 40% of exports, directly and indirectly. This sector even assumes greater importance now as the country moves towards a faster and inclusive growth agenda.

Acknowledging the significance of the sector's contribution to the job market, GDP and fostering entrepreneurship and innovation, numerous initiatives by the current government have been in the limelight. To increase the output of the manufacturing sector by 12-14% per annum and develop its share of GDP to 25% by 2025, the government has plans to make financial and technical support more accessible.

Status of Microenterprises

The Fourth Annual Census on MSME categorizes microenterprises as Registered and Unregistered. Among all the enterprises in the MSME sector, microenterprises make almost 95% in registered category and 99.82% in the unregistered category. The unregistered category is the majority, within which the rural enterprises are lagging behind in registering their enterprises. This may be due to both lack of information and unwillingness of entrepreneurs, as they don't want to reveal details about their enterprises to avoid tax and regulatory process (State of Financial Inclusion of Microenterprises: Missing Middle, GIZ, New Delhi, p.12).

Microenterprises also contribute to the major share of employment generated in the MSME sector. Since the unregistered segment is mostly comprised of microenterprises, the employment share in this segment is more than 99%.

Changing Business Environment

The advancement in technology is opening newer channels for businesses across several sectors. This is particularly true for B2B and e-commerce firms in the sector. With enterprises in India hyped to be a \$25.8 billion market for emerging technologies by 2020, the rise of B2B ecommerce is a trend that will certainly gain more momentum. Microenterprises have also experienced several shocks in the past few years. Though it's foreseen that the implementation of GST will help solve problems in the current taxation system, its initial glitches and adaptation challenges have slowed down the sectoral growth. Those who will survive the effects of policies like demonetisation are more likely to witness a smoother course ahead.

The reforms in the start-up space have also been relatively slow. The implementation of the Public procurement policy, Pradhan Mantri Mudra Yojana, Make in India and Skill India has not yielded significant impact yet. Other than above, the major consistent need is to improve financial and technical support to this sector.

Institutional arrangements also pose hurdles to financing microenterprises. Since microenterprises fall in the 'missing middle' category that does not come under the purview of formal financial institutions, they have always found it difficult to meet their working capital requirement.

The Need to Improve Credit Flows to Microenterprises

A major constraint in the growth of micro Enterprises has been the non-availability of easy finance. It's a commonly known fact that they do not find favour with traditional banks when it comes to lending courtesy, lack of experience, absence of collaterals and infrastructure, poor financials and small ticket size.

Key Facts

1. Among the formal financial institutions, commercial banks constitute the largest source of financial assistance for the MSME sector at about 87% as of 31st March 2011. The outstanding MSE credit by SCBs recorded a strong growth of 34% in FY 2011 on a strong base of 3,62,291 crore INR as of 31st March 2010. (PwC, 2013)
2. Micro enterprises have credit gap to the tune of 73%, as estimated by the National Commission on Enterprises in the Unorganised Sector (NCEUS) by the end of March 2012
3. Estimation: the numbers of unorganized micro enterprises are 70 million with an average credit off-take of 1.23 lakh per enterprise.
4. Commercial banks are the largest source of formal financial assistance to MSME sector and its share is about 87% as on end March 2011. Of these assistances, 70% of the total loans to MSME sector can be classified as working capital loans and 30% as term loans. These estimates are as per 11th five-year plan estimate. (Kar & Prasad, 2015)
5. Close to 45 to 55% of the formal SMEs (11-17 million) in the emerging markets do not have access to formal institutional loans or overdrafts despite a need for one.
6. The finance gap is far bigger when considering the micro and informal enterprises; 65-72% of all MSMEs (240-315 million) in emerging markets lack access to credit. Some studies about SMEs in India have reported that as high as 93% of their financing needs are met by internal and informal sources. (McKinsey and Company, 2013)¹
7. With demonetization and GST, the Government has revised its focus towards the MSME sector. An easier business environment is leading to historic opportunities for our entrepreneurs, particularly for the MSME sector, bringing more prosperity.²
8. Today India is also plagued by a huge demand-supply gap in credit to individual MSMEs. Estimates peg the gap at about \$46 Bn (INR 3 Tn).³

Current Trends in Lending

Given the technological upgradation and development of online tools, several financial institutions are now making it more convenient for the Micro enterprises to receive loans. The last couple of years have experienced a surge in NBFCs with special focus on offering customised loan products through quick and easy online platforms. Also with the creation of alternative lending companies to analyse credit worthiness of the sellers using data analytics and other screening methods like sales and digital records, the speed of loan disbursal has improved commendably.

¹ https://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=938

² <https://www.entrepreneur.com/article/304074>

³ <https://inc42.com/resources/cashless-digital-india/>