Finance and Development : The MSME Story

ISED Discussion Paper

by
ISED Small Enterprise Observatory
jointly with
ISED Centre for Financial Education and Research

Institute of Small Enterprises and Development

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This monograph forms part of the '*ISED Discussion Paper*' series of the Institute. Brought out by ISED Small Enterprise Observatory (ISED-SEO), the Institute's knowledge platform, titles under this Series are meant to offer a platform for discussion on some of the latest developments in the economy and society. The contents of this document may be used for debates and discussions, as also for preparation of course materials, but with due acknowledgement only.

Preface

Finance is undoubtedly a necessary, but not a sufficient condition for MSME sustainability. India has pioneered several experiments in ensuring credit in an inclusive manner. While these social aspects of finance are crucial, it is important to note that, there are several non finance aspects that are critical and pressing in ensuring sustainability of these enterprises.

The purpose of this Discussion Paper is to bring to light some of the least discussed aspects of MSME finance. It is also meant to initiate a wider discussion on the subject, so that it may contribute to alternative policies and strategies.

In India, public policy is reflected through recommendations of various expert committees,as also official pronouncements.. However, finance on the one hand, and non financial services on the other, proceed rather as parallel systems. It is on top of such a dual system that institutional platforms attempt to offer solutions. The broad basing of micro lending is an important step to forward. But it needs to be supported by an effective knowledge system that can address the challenges of MSME development in the country.

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Cochin
February 23, 2017 P.M.Mathew

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Abstract

Finance is undoubtedly a necessary, but not a sufficient condition for MSME sustainability. India has pioneered several experiments in ensuring credit in an inclusive manner. While these social aspects of finance are crucial, it is important to note that, there are several non finance aspects that are critical and pressing in ensuring sustainability of these enterprises. Despite recommendations of various expert committees, as also official pronouncements relating to MSME finance, there still lacks an integrated approach involving credit and non-credit interventions.. It is on top of such a dual system that institutional platforms attempt to offer solutions. The broad basing of micro lending, especially through the new scheme MUDRA, is an important step to forward. But effective knowledge system that can address the challenges of MSME development in the country is a critical gap today. Credit Guarantee systems and Business Development Services need a fresh look, and needs reforms.

Key words: MSME Finance, Credit Delivery, Credit Guarantee, Broad basing of credit, Enterprise life cycle

1.0. Introduction

In the MSME development agenda, finance has a crucial role as a key facilitator of the real economy. 'India MSME Report' series, over the past several years, has brought to the limelight some major facets of finance for micro, small and medium enterprises. Though with the hegemony of public sector banks, the institutional structure catering to MSME finance in India, has undergone some significant changes during the past two decades. Even with such changes, the emerging challenges and needs are rather unprecedented. If the financial system of the country fails in this mission, their very existence is likely to be questioned. The following pages are devoted essentially to a review of the trend and progress of banking in India in relation to their engagement with the MSME sector of the country. It also examines some of the key emerging issues in the area of MSME finance.

2.0. SME Financing: Comparitive Scene

SMEs, worldwide, consider limited access to finance their greatest obstacle to growth. While some parts of the world are recovering faster from the financial crisis than others, the overall picture for SME finance remains cloudy. The crisis has made banks world-wide more cautious in lending, and regulators understandably more concerned about risk management and sound credit underwriting processes. Even in countries where SME shares of total credit increased, this was more due to decreased credit to larger firms, which found alternative sources of financing in difficult markets Many central banks, world-wide, are increasing their activities in SME credit markets, through both direct capital injections into the banking system and indirectly through guarantee funds and other risk sharing instruments. The financial crisis has increased resources for such initiatives. The Central Bank of Korea, which has channelled low-cost funds to banks for SME lending through its "aggregate credit ceiling" policy since March 1994, has substantially raised its ceiling level since the financial crisis. There is an active debate going on in Europe on this topic as, despite significant new capital invested in similar measures, SMEs still report deteriorating credit conditions. The debate, relevant to all financial markets, is about broadening the range of financing instruments available for long-term credit, including credit for SMEs. Alternatives may enable better responses to the diverse needs of the SME sector, and reduce vulnerability to credit shocks.

2.1. Global Trend

The world economy is now growing at the lowest rate since the onset of the global financial crisis in 2008-09. Companies of all sizes encounter significant policy uncertainties and regulatory burdens that constrain their business activities in markets. Achieving the G20's additional 2% growth scenario by 2018 will only be possible through governments' commitment to enable private sector led growth and entrepreneurship. This calls for internationally consistent and evidence-based policies that support the competitiveness of these economies and thereby contribute to more robust, sustainable, and inclusive growth. Such policies matter for companies of all sizes, and in particular for the many small- and medium sized enterprises (SMEs) that operate in our economies. By participating in global value chains (GVCs), SMEs play a fundamental role in supporting world trade and investment, while at the same time enhancing their productivity and innovative potential. GVCs proffer the opportunity to see how trade, employment, economic growth, employment policies and financial regulations interact and ultimately impact the economy.

Despite the global challenges, SMEs cannot seize opportunities in world markets without access to the financial services they require to compete, grow, and add value in and across our economies. Access to credit is one of the key cylinders of the global economy that is underperforming and holding back growth. Governments and the private sector must work together to strengthen the participation and financing of SMEs in the global value chains. The OECD Conference, (BIAC-B-20) that identified G20 priorities for enhancing Business Access to Global Value Chains and Financing SMEs, has influenced global thinking. By recognizing the fundamental role that SMEs play in adding value to products and services along global value chains (GVCs), the event examined the interlinkages and 'common denominators' across all B20 recommendations (spanning trade, investment, employment, entrepreneurship, financing, and more) to develop a truly holistic understanding of the financing of SMEs and the markets in which they compete.

The key questions that emerged globally in 2015 were as follows: Are objectives for financial stability, economic growth, and returns on investment, sufficiently aligned in order to sustainably support our economies and societies? And therefore what are the recommendations needed to achieve a sustainable balance? The G20 Leaders, at their Summit in Antalya in November 2015, made three overarching recommendations as follows:

1. Focus on coordination, consultation, and impact assessment.
2. Raise SME access to finance and skills through an integrated approach.
3. Maximize the sharing of information through digital platforms.

SMEs, as in 2016, have a key role to play for a sustainable recovery. As the world economy grapples with these numerous challenges, governments increasingly look to SMEs as a key driver of sustained and inclusive growth. The importance of SMEs to growth, innovation, job creation and social cohesion cannot be overstated. Across OECD countries, SMEs typically account for more than half of business sector activity and around two-thirds of employment. In emerging economies, SMEs deliver on average more than 40% of GDP and 50% of employment. Young, small firms, in particular, contribute disproportionately to creating jobs. Yet, business dynamics have been slowing in most OECD economies and there are signs of lagging productivity in the SME sector, particularly in micro- and small firms. Raising investment and productivity levels in SMEs is crucial to strengthen the recovery and ensure growth patterns have solid foundations. It is also key in order to help small businesses tap into global markets, particularly through participation and upgrading in global value chains. At the same time, the productive investment and financing needed to underpin economic growth are hampered by fragmentations in and across corporate and financial sectors (OECD, 2016b).

While SME finance, as in 2016, is reported to be recovering, the outlook is uncertain. While access to finance alone is not a sufficient condition for small firms to innovate, upgrade, become more productive and participate in global markets, it is one of the keys to unlocking their potential. The 2016 edition of the *OECD Scoreboard on Financing SMEs and Entrepreneurs* shows that, after several years of serious difficulties, SME access to credit appears to have turned the corner. The outstanding stock of SME loans in 2014 surpassed 2013 levels in a large number of countries, including some of the countries whose SME lending was most affected by the economic and financial crisis. For example, credit to SMEs expanded by more than 2% in 2014 in Greece. In Chile, Colombia and Turkey, the annual growth in SME lending surpassed 10%.

On the other hand, progress has been uneven. In Spain, despite a robust expansion of 8.5% between 2013 and 2014, new lending to SMEs stood at only 36% of its pre-crisis level. In the United Kingdom, net lending, the difference between new lending and repayments, only turned positive in the first quarter of 2015, after a continuous decline since 2008. Credit conditions for SMEs, which tightened significantly in the years after the crisis, are gradually improving, as a consequence of the unprecedented monetary easing in many parts of the world. Yet, conditions remain much tighter for SMEs than for large enterprises, with rising or persistently high interest rate spreads in most countries (OECD, 2016c).

Despite recent improvements, SME financing will remain fragile in the medium term. The downside risks in the macro-economic outlook may reverse recent gains, and bank deleveraging will continue to impact SME lending disproportionately, especially in countries where the banking system is burdened by high levels of non-performing loans.

Implementation of Basel II and III norms for the banks pause some unintended negative impacts on access to finance for creditworthy enterprises. While, in principle, the 2019 timetable should give banks plenty of time to adjust to the new rules, and minimize negative impact on willingness to lend to SMEs, more recent work by OECD suggests that European banks already are adjusting their capital positions, shedding higher risk-weighted assets in favour of government bonds, mortgages and inter-bank lending. Similar movements in emerging markets, where SMEs have virtually no alternatives to banks for formal debt financing, could reverse what small gains are being made to fill the SME