

MSME Finance: From Credit Delivery to 'Responsible Banking'

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ISED Small Enterprise Observatory
Jointly with
ISED Centre for Enterprise Development

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Preface

The mainstream theory and practice of banking in India focus on the business activities of a commercial bank. Credit delivery is the core business of commercial banks. The modern concept of 'business finance', however, is strongly anchored on the principle of 'social responsibility'. 'Responsible banking' means getting involved in sustainable and durable projects that are of value to society by offering customers simple and straightforward services and products. This is a new terrain of financial-real sector interface that matters significantly, under a situation where the economy is in turmoil.

Under the India MSME Communication Programme(IMCP), the Observatory, in co operation with the various Knowledge Centres of the Institute, makes a rigorous analysis of the latest currents in the MSME constituency, leading to a unique 'Development Report'. This study is a spill-over of this exercise of Development Reporting on micro, small and medium enterprises (MSMEs) at the ISED.

While the team of the Observatory did a meticulous job under the guidance and support of the Project Leaders, individual members of the Team, including the editors and the Associates, have made their special contribution in specific thematic areas. While this title is significant in the present context of the Indian economy , and of the MSME developments in specific, I hope it will contribute to wider discussions in the subject area.

As this title come out as a joint output of the Observatory and the ISED Centre for Financial Education & Research, the Institute wishes to thank, without fail, the pains and efforts of the authors, and all who have supported it through inputs and suggestions. ISED has taken best efforts to ensure the quality and reliability of this paper. However, for the findings and views, the authors alone are responsible.



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Abstract

The mainstream theory and practice of banking in India focus on the business activities of a commercial bank. Credit delivery is the core business of commercial banks. The modern concept of ‘business finance’, however, is strongly anchored on the principle of ‘social responsibility’. ‘Responsible banking’ means getting involved in sustainable and durable projects that are of value to society by offering customers simple and straightforward services and products. This is a new terrain of financial-real sector interface that matters significantly, under a situation where the economy is in turmoil.

Key Words: MSME, finance, India, responsible banking.

1.0. Introduction

The mainstream theory and practice of banking in India focus on the business activities of a commercial bank. It is one where most people do their banking. Commercial banks make money by providing and earning interest from loans; customer deposits provide banks with the capital to make these loans. Credit delivery is the core business of commercial banks. The borrowers are allowed to draw funds from the account to the extent of the value of inventories and receivables less stipulated margin within the maximum permissible credit limit granted by the bank. Value of the inventory is taken at cost price or market price, whichever is lower. This is a typical model of banking, associated with the typical concept of a capitalist system that assumes free and unhindered play of the market forces. The modern concept of business finance, however, is strongly anchored on the principle of social responsibility. While the concept of social responsibility is validated by the modern principles of welfare economics, the business case attached to it has been increasingly recognized by modern management science. Doing ‘responsible banking’ means getting involved in sustainable and durable projects that are of value to society. In practice, it means offering customers simple and straightforward services and products, which again, means new business opportunities for financial institutions. MSME finance is a terrain where this financial-real sector interface matters significantly. More importantly, under a situation where the economy is in turmoil, this matters most from the point of view of policy and strategies. The purpose

of the following discussion is to grapple with the dynamics of MSME finance in the context of the on-going Pandemic.

2.0. Key Financial Sector Issue Today

Following the outbreak of the Pandemic, both the Government of India and RBI have come out with several relief measures for the MSME sector. During the reporting year, such measures continued in various forms. The Reserve Bank of India announced a series of measures to offset the economic impact of the second wave of the pandemic on MSMEs. In order to incentivize credit flow to these enterprises, the scheduled commercial banks were allowed to deduct credit disbursed to new borrowers from their net demand and time liabilities (NDTL) for calculation purposes, wide the RBI guidelines of February 2021. To further incentivize financial inclusion, this exemption currently available for exposures up to Rs.25 lakhs and for credit disbursed up to the fortnight ending October 01, 2021, was extended till December 2021. The restructuring under this framework invoked up to September 30, 2021, and will have to be implemented 90 days after invocation. The RBI circular of June 25, 2021 follows up the new definition of MSMEs announced by the Government of India. In view of the above amendment, the previous circular and norms therein were modified by the RBI.

While SMEs constitute a significant market segment for the financial institutions around the world, the ongoing Pandemic has created unprecedented stress in this constituency. While the objective situation is

globally recognized today, the key question relates to the strategic approach to move forward: whether to have a 'fire-fighting' approach, or to develop a 'business case' from such an objective situation. The former is essentially a problem-solving approach; the latter seeks to explore and justify an alternative strategy, with a concrete project, programme, or portfolio. Do we have the outline of such a 'business case' around an alternative strategy? This is the question that the development community in general, and the development finance practitioners in specific, needs to discuss today.

The objective situation today needs to be examined and discussed essentially in relation to the relationship between the real sector and the financial sector, in terms of their convergence and conflicts.

2.1. Rigidities in the Credit Market

The MSME crisis today is a "scissors crisis"; it acts both from supply side and demand side. On the demand side, the sector's pre-existing liquidity crisis has been aggravated on account of the Pandemic-related disruptions and fall in revenue. Unlike in the case of the usual business cycles, disruption in economic activity under a Pandemic is of a long-term nature. Therefore, the usual logic of the market does not help the MSMEs to come out of the crisis spontaneously. On the supply side, economic disruptions have penetrated into the cash-flow cycle of the MSMEs. The lenders have a tendency to drastically reduce their credit exposure to the sector. Immense working capital stress is the natural outcome.

2.2. Macroeconomic Dimensions

The MSME liquidity impact today is on 33 percent of manufacturing output and an annual job figure of 1.3 millions every year. Hence, considering the characteristic 'enterprise atomism' of MSMEs, the above liquidity problem is reflective of a huge liquidity stress in the Indian economy. Hence, beyond an MSME problem, it is largely a macro economic problem. Therefore, the magnitude of the problem needs to be examined on the basis of available evidences.

3.0. Policy Response

The contingency created by the Pandemic, primarily,

demand maintaining the *status quo*. For this, the SME sector now desperately wants survival support. The recently announced Rs 3.75 lakh crore packages have made an earnest attempt to address the capital crunch of the sector. Announcements like Rs 3 lakh crore collateral free automatic loans, Rs 20,000 crore subordinate debt for stressed MSMEs, Rs 50,000 crore of equity infusion for MSMEs through a fund of funds, etc. are expected to offer some liquidity support. However, there are also criticisms that these benefits do not percolate.

The Union government has announced the strategy of "vocal for local", against this historical context. As such, it falls broadly on lines of the "Critical Minimum Effort" and the "Big Push" thesis, as advocated by classical development economists. It demands the 'collective resilience' of SMEs. This 'collective resilience' is important for the interests of financial institutions as well, because the SME 'business case' of these institutions is built upon a collective volume of business, rather than an individual volume. It, therefore, makes the financial institutions active stakeholders in an MSME resurgence agenda. In a nutshell, such MSME resurgence is central to the revitalization of the financial sector as a whole. How can this collective resilience be achieved? This is the first problem at hand. In this mission, what can be the role of the financial institutions?" More of the same thing" or something new?

This is time for a stress test for the MSMEs. The inherent strength of the SME economy demands a check on the following: a) depth of the formal credit system, and the prevailing overall credit gap. (Almost 90 per cent of the SMEs do not have access to formal credit); b) the flow constraints/glut in the credit market (conventional channels of credit are turning increasingly risk-averse); and c) presence of alternative windows (NBFCs are fighting their own liquidity issues today).

4.0. Search for a Strategic Approach

A strategic approach in the context of the Pandemic requires two major steps: a) crisis management/contingency strategies; and b) identification of policy level and institutional gaps and bottlenecks for developing 'business case', for an alternative strategy. The first step has already been crossed,