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MSME FUNDING – OPPORTUNITIES & CHALLENGES

RESURGENT INDIA LIMITED

MESSAGE FROM MD/CEO, RESURGENT

Indian Economy reported robust growth during the period 2005-08. But the growth moderated on the back of the global economic crisis thus, proving that the global economic condition has its repercussions on the domestic economic outlook. The economy recovered during 2009-11, again to decline owing to weak global economic cues and other domestic factor.

Going ahead, Micro Small and Medium Enterprises (MSMEs) are considered to be the key for economic growth as it promotes equitable development. Over the years, this segment has been fuelling economic growth and has been a catalyst to industrialization of rural and backward areas, reducing regional imbalances and assuring more equitable distribution of national income and wealth. This segment is labor intensive and it contributes for generation of employment.

Despite being a catalyst to the economic development and being beneficial to the economy of the country in more than one ways, MSMEs still face numerous hindrances that are obstructing the growth of the segment. The primary problem faced by the sector is access to funds due to its high risk profile. Here in this research paper, we discuss about alternate avenues of fund raising at a minimal cost.

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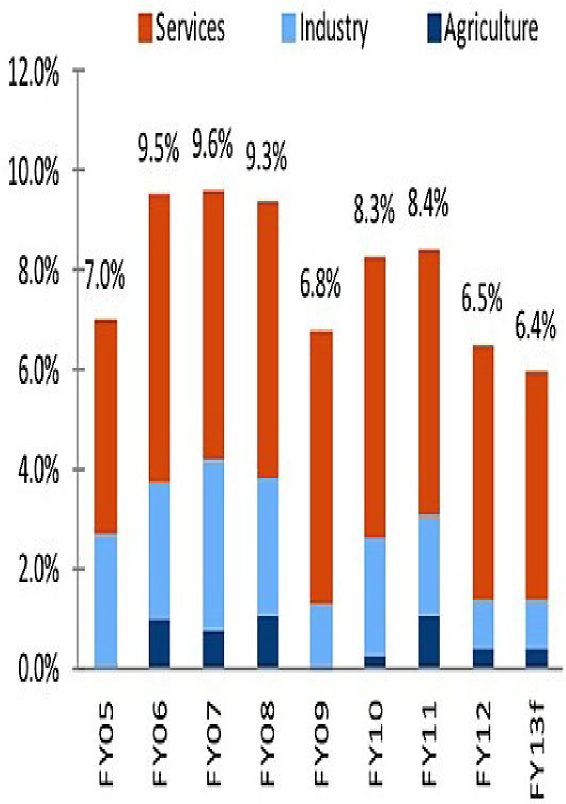
INDIA MACRO ECONOMIC OVERVIEW

The Indian economy after registering a robust growth of more than 9 per cent during the period 2005-08, moderated to a growth of 6.7 per cent in 2008-09 on the back of the global financial crisis. As a result of timely stimulus in fiscal and monetary space, the economy managed to recover quickly to a growth of 8.4 per cent in 2009-10 and 2010-11. Since then, however, the fragile global economic recovery and a number of domestic factors have led to a slowdown once again.

Moderated GDP Growth



The moderation in growth is primarily attributable to weakness in industry which registered a growth rate of only 3.5 per cent and manufacturing sector reported growth at 2.7 per cent and 1.9 per cent for the same period. In line with this, agriculture has also been weak in 2012-13, due to lower-than-normal rainfall, especially in the initial phases (months of June and July) of the south-west monsoon. Going ahead, service sector, after achieving double-digit growth continuously for five years and narrowly missing double digits in the sixth (between 2005-06 and 2010-11), the growth rate of the services sector also declined to 8.2 per cent in 2011-12 and 6.6 per cent in 2012-13.

The reason behind, economic slowdown despite a strong recovery from the global financial crisis is firstly, the boost to demand given by monetary and fiscal stimulus following the crisis was large. Additionally, consumption grew at an average of over 8 per cent annually between 2009-10 and 2011-12. The result was strong inflation and a powerful monetary response that also slowed consumption demand. Second, starting in 2011-12, corporate and infrastructure investment started slowing both as a result of investment bottlenecks as well as the tighter monetary policy. Thirdly, even as the economy slowed, it was hit by two additional shocks: a slowing global economy, weighed down by the crisis in the Euro area and uncertainties about fiscal policy in the United States, and a weak monsoon, at least in its initial phase.

The consequent slowdown, especially in 2012-13, has been across the board, with no sector of the economy remaining unaffected. Falling savings without a commensurate fall in aggregate investment have led to a widening current account deficit (CAD). Wholesale price index (WPI) inflation has been coming down in recent months. However, food inflation, after a brief slowdown, continues to be higher than overall inflation. Given the higher weightage to food in consumer price indices (CPI), CPI inflation has remained close to double digits. Another consequence of the slowdown has been lower-than-targeted tax and non-tax revenues. With the subsidies bill, particularly that of petroleum products, increasing, the danger that fiscal targets would be breached substantially became very real in the current year. The situation warranted urgent steps to reduce government spending so as to contain inflation. Also required were steps to facilitate Several measures announced in recent months are aimed at restoring the fiscal health of the government and shrinking the CAD as also improving the growth rate. With the global economy also likely to recover somewhat in 2013, these measures should help in improving the Indian economy's outlook for 2013-14.

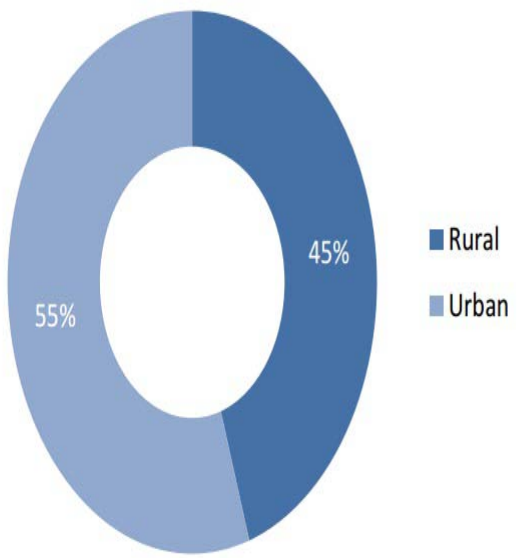
The long-term policy of the country is to achieve inclusive growth. The current developmental problem facing India is exacerbated by the changing demographic profile of the country. The number of unemployed will be a large number of which the proportion of the educated youth will be the largest. Therefore, the need for strong, accelerated economic growth is now much more acute than ever.

India’s economic growth has been led by the services sector in the last decade, particularly owing to the growth in Information Technology (IT) and Business Process Outsourcing (BPO) industries. The manufacturing sector’s importance has grown in the recent years with the advancement in its output. The sector offers huge potential for employment creation. Moreover, the importance of Micro, Small and Medium Enterprises (MSMEs) in the growth process is considered to be a key engine of economic growth in India in the years ahead.

MSME – INTRODUCTION

The Micro, Small and Medium Enterprises (MSMEs) play a pivotal role in the economic and social development of the country, often acting as a nursery of entrepreneurship. They also play a pivotal role in the development of the economy with their effective, efficient, flexible and innovative entrepreneurial spirit. The MSME sector has been a significant contributor to the country's with generating the highest employment growth as well as accounting for a major share of industrial production and exports.

Classification of MSMEs by location (%)



MSMEs across the globe are fuelling economic growth and are the key instruments for promoting equitable development. The primary attribute of the sector is its employment potential at low capital cost. The labor intensity of space is much higher than that of large enterprises. MSMEs account for about 90 per cent of total enterprises in most of the economies and are credited with generating the highest rates of employment growth and account for a major share of industrial production and exports. On the domestic front, MSMEs play an essential role in the overall industrial economy of the country. In recent years, the MSME sector has been consistent in registering a higher growth rate compared with the overall industrial sector. Further with qualities such as agility and dynamism, the sector has shown admirable innovativeness and adaptability to survive the recent economic downturn and recession.

The Indian MSME sector space is immensely heterogeneous with regards to the size of the enterprises, variety of products and services, and levels of technology. The sector not only plays a crucial role in providing employment opportunities at comparatively lower capital cost than large industries but also helps in industrialization of rural and backward areas, reducing regional imbalances and assuring more equitable distribution of national income and wealth. MSMEs complement large industries as ancillary units and contribute enormously to the socio economic development of the country.

Apart from providing the support to the large industries, MSMEs have played an important role in the development of States in terms of the employment generation. More than 55 per cent of these enterprises are located in six major States of the country, namely, Uttar Pradesh, Maharashtra, Tamil Nadu, West Bengal, Andhra Pradesh and Karnataka.

After realizing the importance of MSME sector, Government has taken various initiatives to boost the growth of the segment. Further, the key attributes of the sector such as, high contribution to domestic production, significant export earnings, low investment requirements, operational flexibility and many others have lead to tap opportunities in various industries.

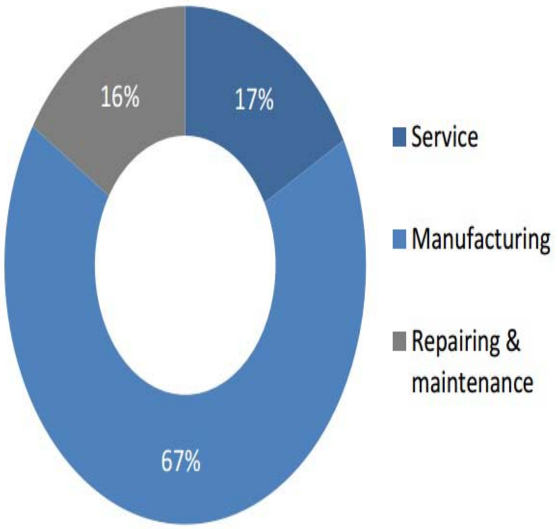
The MSME sector has slowly come into the limelight, with increased focus from the government and other government institutions, corporate bodies and banks. Policy based changes; investments into the sector; globalization and India's growth story have opened up several latent business opportunities for this sector.

Recent Initiatives by the government: As the Government recognised the importance of promoting the MSME sector in order to boost the overall growth of the economy, a Task Force under the Chairmanship of the Principal Secretary to the Prime Minister was constituted in 2009. The primary objective of the task force is to offer suggestions for the development and promotion of MSMEs in the country and recommend an agenda for immediate action to provide relief and incentives to the MSMEs, accompanied by institutional changes and detailing of programme to be achieved in a time bound manner. Further, it also recommends the setting up of appropriate legal and regulatory structures to create a conducive environment for entrepreneurship and growth of MSMEs in the country. The Task Force has laid emphasis on timely implementation of the recommendations and has set up a system for its continuous monitoring in the Prime Minister's Office. A Council on MSMEs under the chairmanship of Hon'ble Prime Minister has also been constituted to lay down the broad policy guidelines and review development of the MSME sector.

Measures from within the sector to lobby for favourable policies and increasing credit flow are convincing.

Further, the sector has also realized the necessity of technological and modernization initiatives. However, with economic liberalization and changes in the trade policy, MSMEs are now facing increased competition from foreign companies. Under intensive global competition, MSMEs are transforming to a new business environment with emergence of global supply chains. MSMEs form an integral part of almost every value chain and there is a symbiotic relationship between the large corporations and their relatively smaller sized suppliers. However, in a liberalized world, the relationships between the suppliers and buyers are undergoing dynamic changes with the dissolution of existing relationships and formation of new trade linkages that transcend the barriers of nationality and boundaries.

Classification of MSMEs by sector (%)



Even the domestic market is no more a protected zone in a controlled economy; the competitive pressures of a free market economy are catching up in India and the domestic market has been flooded with many low cost, reasonable quality, bulk produced products giving tough competition to MSMEs. With the opening up of the economy, MSMEs need to catch up with global standards in order to remain competitive and profitable.

To gain the competitive edge, enhance efficiency and manage communication, this sector is set to focus on Information and Communication Technology (ICT) enablement. Small scale industries face limited needs for ICT given their organization and restructuring themselves to accommodate these changes. Possibility of international trade has forced many to build an online presence. E-commerce and enterprise management solutions are also being considered by many.

The Government of India has developed key strategies to promote and support competitiveness in the MSME sector, thus leading to have a positive impact on the sector. The key attributes of the segment such as high contribution to domestic production, significant export earnings, low investment requirements, operational flexibility, location wise mobility, capacities to develop appropriate indigenous technology, import substitution, contribution towards defence production, technology-oriented industries, and competitiveness in domestic and export markets etc. help them tap opportunities in various sectors.

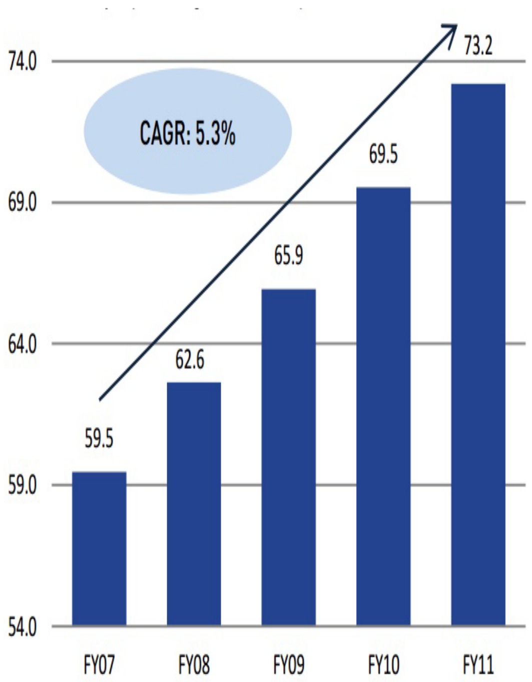
Some of the key announcements for MSMEs in the Union Budget, 2013 are:

- Start-ups and MSMEs can list on SME exchange without public offering but only after informing investors
- If an MSME grows into a larger enterprise, no tax for three years after its growth
- National Skill Development Corporation to train 5 crore people in current plan period
- To modernize power-loom sector through technology upgrade scheme for textile sector of Rs. 2,400 crore
- Youngsters who are skill trained to be given boost in employment and productivity; 10 lakh youth can be motivated in one year
- To allocate Rs. 1,000 crore to extend skills of youth
- With help of Ministry of Science &Technology, Centre has identified amazing innovations; will allocate Rs. 200 crore to scale them and make them available to people

MSMEs CONTRIBUTION TO ECONOMY

MSMEs have contributed significantly to the Indian economy, with more than 31 million units employing more than 73 million persons. Further, productivity of the MSME sector has been improving significantly with fixed investments and employment growing consistently over the past few years. This is a direct indication of the efforts focused on this sector to integrate the workforce with technological enhancements to increase production. Fixed investments in the MSME sector between FY07 and FY11 has grown at a CAGR of 11.48 per cent and employment has grown by more than 5 per cent (y-o-y). Further, between FY07 and FY11, the sector's total production grew at a CAGR of 11.5 per cent - reiterating the substantial contribution of the MSMEs to the Indian economy.

Employment Generation by MSMEs (millions)



Key highlights of the MSME Sector:

- MSMEs account for about 45 per cent of India's manufacturing output
- MSMEs accounts for about 40 per cent of India's total exports
- The sector employs more than 73 million people in more than 31 million units spread across the country
- MSMEs manufacture more than 6,000 products ranging from traditional to high tech items
- For FY11, total production coming from MSME sector was projected at Rs. 10,957.6 billion, an increase of more than 11 per cent over the previous year
- For FY12, the MSME sector is estimated to have an average credit off-take of Rs. 7.16 lacs for 32.2 million units.

At present, some of the MSMEs are involved in acquiring companies abroad as part of the globalization process. Most of these units are ancillaries and are export oriented. The MSME sector has altered itself to cater to the needs of large local manufacturers and suppliers to global manufacturers like Auto Industry. Currently, the segment is getting involved in investment towards R&D in order to equip itself to be competitive globally. Going ahead, outsourcing from multinational companies has played a vital role in fuelling the growth of Indian MSMEs as world leaders in specified products. The competencies in labor-intensive manufacturing units, lower transport costs and lose labor policies of the small scale sector have led to major outsourcing in manufacturing and services.

MSMEs contribution to economy can be considered vital as it contributes to around 45-50 per cent of the country's export. Going ahead in terms of employment generation, it stands next only to agriculture. And in production, it accounts for around 40 per cent of gross manufacturing output.

MSME's Contribution to Exports: MSMEs have a crucial contribution in India's present export performance. The sector accounts for around 45-50 per cent of the country's export, of which direct exports from the sector account for nearly 35 per cent of total exports. Besides direct exports, it is estimated that small-scale industrial units contribute around 15 per cent to exports indirectly that takes place through merchant exporters, trading houses and export houses. They may also be in the form of export orders from large units or the production of parts and components for use for shown excellent growth rates in this decade. The product groups which dominate the exports comprises of sports goods, readymade garments, woolen garments and knitwear, plastic products, processed food and leather products. Further, MSMEs are re-orienting its export strategy towards the new trade regime being ushered in by the WTO.

Performance of this sector can be determined in terms of the following criteria:

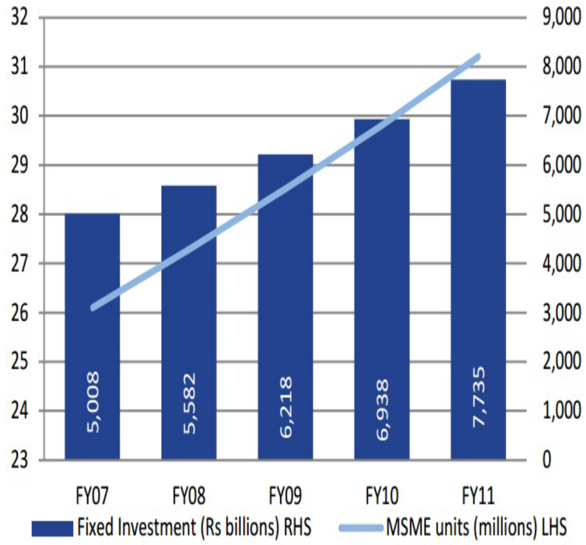
Employment Generation: MSME in India creates largest employment opportunities, next only to Agriculture. It has been estimated that a lakh rupee invested in fixed assets in the sector results in generating employment for four persons. Some of the interesting observations related to employment in MSMEs are related to generation of employment according to the industry. For instance, food products industry ranked first, followed by non-metallic mineral products and metal products. Additionally, Chemicals & chemical products, Machinery parts except Electrical parts, Wood products, Basic Metal Industries, Paper products & printing, Hosiery & garments, Repair services and Rubber & plastic products also contributed to generate employment.

Production: MSMEs play a crucial role in the growth of the country by accounting for 40 per cent of the gross manufacturing output. As per estimation, a lakh rupee of investment in fixed assets in the sector produces 4.62 lakh worth of goods or services with an approximate value addition of ten percentage points. The space has registered impressive growth over the past few years and the growth rate recorded during the various plan periods have been very impressive. Further, the transition period of the process of economic reforms was also affected for some period by adverse factors such as foreign exchange constraints, credit squeeze, demand recession, high interest rates, shortage of raw material etc. Further, when the performance of this sector is compared with the growth in the manufacturing and the industry sector as a whole, it instils confidence in the resilience of MSMEs.

Export Contribution: MSMEs plays a major role in India's export performance by accounting for 45-50 per cent of total exports. The surprising fact is that non-traditional products account for more than 95 per cent of the MSME exports. The exports from the segment have registered enormous growth during the last decade. Further, the growth in the segment has been mostly fuelled by the performance of garment, leather and gems and jewellery units.

Opportunities: MSMEs has performed outstandingly well and enabled the country to attain a wide measure of industrial growth and diversification. By its nature of being less capital intensive and more labor intensive, the sector has made significant contributions to employment generation and also to rural industrialization. This sector

MSME units and fixed investments



is ideally suited to build on the strengths of traditional skills and knowledge, by infusion of technologies, capital and innovative marketing practices.

The opportunities of growth in the MSME sector are extensive due to the following attributes, which makes it a more attractive investment option:

- Less Capital Intensive
- Extensive Promotion & Support by Government
- Reservation for Exclusive Manufacture by small scale sector
- Project Profiles
- Funding - Finance & Subsidies
- Machinery Procurement
- Raw Material Procurement
- Manpower Training
- Technical & Managerial skills
- Tooling & Testing support
- Reservation for Exclusive Purchase by Government
- Export Promotion
- Growth in demand in the domestic market size due to overall economic growth
- Increasing Export Potential for Indian products
- Growth in requirements for ancillary units due to the increase in number of green-field units coming up in the large scale sector.

Economic Indicators: MSME constitutes a very important segment of the Indian economy. MSME sector acts as a catalyst in upholding and encouraging the creation of the innovative spirit and entrepreneurship in the economy, thereby helping in laying the foundation for rapid industrial development. Moreover, the sector also boosts employment generation and balanced regional development. Globalization and liberalization of the Indian economy have also brought a host of opportunities for the industrial sector, particularly the MSME segment. MSMEs have responded to competition satisfactorily, further there is scope for increasing their export potential, domestic market share and developing them as serious players in the global value chain.

KEY HINDRANCES FACED BY MSME SECTOR

Despite being a sector of strategic importance, MSMEs in India faces numerous problems, thus moderating its growth. In order to overcome the hindrances faced, there is a need to establish a potential strategy in order to improve linkages and coordination between the Government, Industry and Academia.

MSMEs currently are taking limited initiatives in formulating growth strategies and also are following a reactive strategy, where it reacts according to current economic situation.

Despite the sector being strategically important for overall industrialization strategy and employment generation, as well as the opportunities that the Indian landscape presents, the MSME sector confronts several challenges. Constraints such as technological obsolescence and financing problems have been faced by the segment for a very long period now. Further, hindrances include high cost of credit, low access to new technology, poor adaptability to changing trends, lack of access to international markets, lack of skilled manpower, inadequate infrastructure facilities, including power, water, roads, etc., and regulatory issues related to taxation (state-central), labor laws, environmental issues etc. are also linked with its growth process.

There is a need to establish a potential strategy in order to improve linkages and coordination between the Government, Industry and Academia. There is also a need to develop alternate delivery channels through capacity building of the MSME Associations and the public-private partnerships in the institutional structure as also the schemes. Given the nature of the enterprises, there is a need to facilitate start-ups and evolve a time-bound exit mechanism.

Currently, MSME's are taking limited steps in formulating growth strategies and moving along with the pace of GDP. Besides, the sector also adopts a reactive strategy under which the sector reacts according to the current economic situation of the country. The productivity and growth becomes limited for the moment and growth falls back again. Therefore, the sector needs to adopt a proactive strategy approach where the government should prepare a medium to long term strategy to sustain themselves in the changing economic scenario and progress beyond the current GDP growth.

The primary challenge for the MSMEs is raising funds. Lack of funds has resulted in various other issues, thus obstructing the growth of the sector. Further, taking a note of this problem, Finance Minister has increased SIDBI's provision for refinancing incremental lending by banks to MSMEs out of the shortfall of banks on priority sector lending targets. Considering the problems being faced by handloom weavers, inability to repay debts to handloom weaver cooperative societies which have become financially unviable, FM has proposed to provide Rs. 3,000 crore to NABARD. This measure is expected to be benefited by 15,000 cooperative societies and about 3 lakh handloom weavers.

Further, the concern of increase in input costs has been affecting the competitiveness of MSME products in domestic as well as international market. Besides, it's difficult for MSMEs to pass on the extra cost to consumers due to which their margins decline, making production unviable.

Some of the most persisting constraints faced by the sector include poor/non-availability of loan finance; low levels of technology; inadequate physical and economic infrastructure; and a truncated policy of product reservation.

Loan Finance: The most dominant factor affecting the MSME sector has been access to loan finance, adequately and timely. This problem is persistent despite clear instructions from the Reserve Bank of India (RBI) and the Ministry of Finance to encourage flow of funds from the commercial banks to small enterprises. It is observed that, there are strong structural underpinnings to the inadequate flow: the organizational structure of banks, and processes within them, have taken them far from task orientation, and have created a specific bias against small loan portfolios. The ways of direction and supervision of banks by the RBI and an absence of performance-based incentive system for proactive bankers have all constricted easy flow of loan finance to small firms. The situation has been much more difficult for the tiny enterprise sector.

It is observed that, the problem faced by Indian finance system is that there is no transparency regarding the financial conditions of MSMEs. The reason for this may be that some enterprise owners themselves may not grasp their financial conditions well. This will result in hesitation from banks to give loan to small scale units. In fact, there is evidence to establish that a fairly significant proportion of loans given to small enterprises in the past have compounded the problem of non-performing assets (NPAs). Unless there is fairly detailed information on small firms, banks would hesitate to take risk. Hence, securing transparency of financial conditions, eventually, influences decisions on loan finance.

Recently, the Credit Guarantee System for MSMEs has been introduced by commercial and other financial institutions. For instance, under the Credit Guarantee Fund Trust for MSEs (CGTMSE) life insurance cover for the chief promoters of enterprises is guaranteed. Further, various industry associations have signed MoUs with commercial banks and other financial institutions to offer collateral security to upcoming entrepreneurs for their credit requirements. The CGTMSE will function under the monitoring of the SIDBI. Unless the credit guarantee system is strengthened and streamlined smaller units would continue to suffer neglect in accessing the much needed credit for both inception and expansion.

Sickness in MSME sector: Sickness has been one of the major problems affecting the MSME sector. Here the sickness refers to inability of the enterprise to repay the loan finance. Sickness in MSMEs has been growing from 13.98 per cent in 2001-02 to 14.47 per cent in 2006-07 and is expected to be around 17 per cent at present. Out of the units having loan outstanding with institutional sources like banks and financial institutes, sickness was about 14.08 per cent in the registered MSMEs. Sickness identified in terms of continuous decline in gross output was 13.01 per cent in the registered MSMEs.

The following yardstick is used to measure sickness of an enterprise-

(a) Delay in repayment of loan over one year,

(b) Decline in net worth by 50 per cent, and

(c) Decline in output in last three years

Combining the three yardsticks used to measure sickness, i.e. (a) delay in repayment of loan over one year, (b) decline in net worth by 50 per cent, and (c) decline in output in last three years, about 14.47 per cent of the units in the registered MSMEs were identified to be either sick or on the verge of converting into a sick unit. The cause of sickness can be largely contributed to lack of demand, shortage of working capital, marketing problems, and units becoming non-competitive, uneconomical and inefficient.

Symptoms of sickness:

- Lack of healthy movement of stocks and rising level of inventories.
- Frequent return of cheques issued by the party/inability of the party to promptly honor the bills drawn on them.
- Non Submission/Delayed Submission of stock statements/financial statements.

➢ Frequent return of cheques deposited/bills drawn by the party.

➢ Default in payment of interest charged to borrowal account and default in payment of term loan instalments.

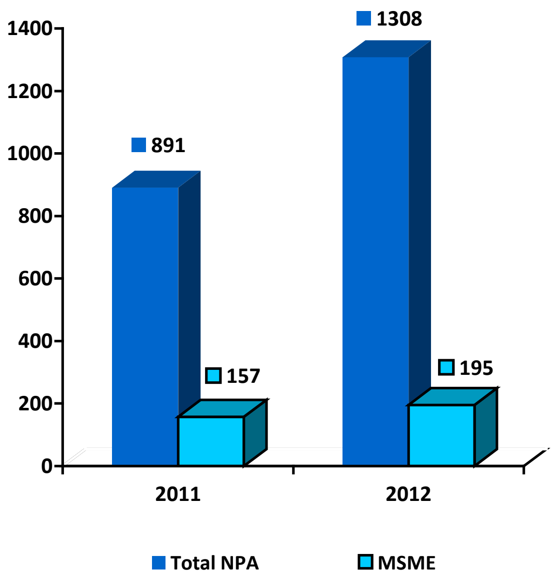
➢ Frequent request for granting of excess/enhancement of limits/adhoc limits without corresponding increase in sales.

➢ Low capacity utilization.

➢ Poor current ratio.

Non Performing Assets (NPA) in MSME: The main reason that is keeping commercial banks away from MSME lending is high transaction cost and NPAs thus leading to a perception of the MSME sector being non profitable for lending. For the Banking sector, the ever increasing level of NPAs has become a matter of concern and we are aware of its repercussions on the Indian economy. Eradication of this issue has been discussed on many platforms but so far strong actions on promoting a right platform, which identifies the bad accounts well in advance while resolving NPA properties faster with an idea of saving industries as well as helping the banking sector, has not been implemented strongly.

Total NPA Vs MSME NPA (in Rs. Billions)



Source: Reserve Bank of India's Report on Trend and Progress of Banking in India 2011-12

The common traits and role conflicts that have been observed in MSME are inability to evaluate, objectively the performance of the enterprise. The MSME owners are often blamed for their inability to network with other professionals in dealing with issues. They try to resolve issues which are not their forte and also inability to network amongst them with a view to moving up the value chain is hardly visible.

Tough competition is another reason attributed for the slow growth of MSMEs. Competition from foreign entities, limited budget for marketing, lack of market intelligence on the demand, non-availability of inputs at reasonable prices as well as equipment problems are significant issues.

The high rate of NPAs in small enterprises sector has created risk aversion among lenders, which has hindered increase in flow of credit to the sector. Further, a dynamic global economic scenario has offered various opportunities and challenges to the MSME sector in India. On the other hand, many opportunities have opened up for this sector to enhance productivity and look for new markets at national and international level. Besides, it has also put an obligation to upgrade their competencies to meet the competition as new products are launched at an incredible pace and are available worldwide in short time.

The performances of MSMEs are for some extent dependant on the physical and economic infrastructure available. Despite knowing the importance of the infrastructure for the performance, it remains a neglected area, thus affecting the potential of the sector.

Infrastructure: Much of the potential of small firms to grow and nurture innovativeness is shaped by the kind of infrastructure, both physical and economic, available and can be accessed at reasonable costs. Unfortunately, the consequences of infrastructural constraint faced by small firms remain one of the most neglected areas of enquiry. Moreover, the nature and implications of such infrastructural absence or inadequacy could be deeply varied as between small enterprises located in urban areas and those in rural and semi-urban areas.

The access to dependable supply of electricity emerged the most crucial issue blocking the rise of productivity and output of small firms. Similarly, poor transportation facilities, especially in rural and semi-urban areas have been cited as constraints encountered by small enterprises. Further, access to newer and larger markets has been severely restricted due to this. This crucial infrastructure includes improved roads, railways and port facilities. Along with generic infrastructural facilities that boost the local economy in general, there is need for enterprise specific infrastructure, i.e., provision of common effluent treatment plants (CETPs), well-developed industrial estates / parks, common testing / quality check facilities, etc. Even provision of potable water to small enterprises was considered an important infrastructure that could add to productivity rise.

Product Reservation: This rather long-standing and unusual policy of reserving certain products to be exclusively produced by the small scale sector has come to be interpreted as a bottleneck to productive efficiency of the small enterprises. The initiative seems to have lost its original purpose of creating local employment using locally available resources within a ‘protective’ policy framework. Observing the effect of this highly

Product Reservation is a unique policy reserving certain products to be exclusively produced by the small scale sector. However, initiative has lost its purpose of creating local employment using locally available resources within a 'protective' policy framework.

controversial policy, it has been pointed out that issue of technical inefficiency of products manufactured under reserved category as compared to the non-reserved products take centre stage. Studies have also referred to the impracticality and even irrelevance of the policy of reservation. Due to the emergence of new economic order which demanded more competitive sector, de-reservation was initiated and by February 2008 it has come down drastically low to only 35 items and in February 2010 it has come down to only 20 items. Non-MSME units can still manufacture these items, provided they undertake 50 per cent export obligations. Large organizations can, market these goods as there are no restrictions or regulations for the same. This poses further challenges for MSMEs which produce these reserved items.

Further, some of the standard issues raised comprises of frequent changes in the products listed were not always justified and supposed to have been influenced by extreneous reasons; a careless approach to the policy marked its broad-basing, as surveys found that producers engaged in manufacturing 'reserved' items had no clue about the policy; certain items continued to be produced by the medium and large scale firms as they had been doing so prior to the specific products were reserved; and the quality of reserved products was often not satisfactory.

Another very significant aspect that cannot be ignored is the woefully inadequate quality of the financials of such units and total lack of governance even its simplest form. The balance sheet, profit and loss accounts are made without disclosing the real state of affairs. This could be on account of the fact that such entrepreneurs cannot have access to highly proficient account staff or the sheer unwillingness to disclose the correct picture.

This leads to a situation where on the one hand the balance sheet etc. does not support bank lending beyond a particular level and on the other hand the same factor does not inspire any confidence for raising funds through the SME Exchange.

Ultimately in case someone in this sector is not getting access to funds somewhere the promoter would have to accept the blame on him for preparing inadequate financials.

To summarize the main issues of the segment can be noted as below:

- Credit Guarantee Scheme is not performing as expected. There has been falling credit to SSI during the post-reform period and high incidence of NPAs in SSI lending.
- The small-scale industry in India needs to upgrade technologies on a continuous basis to remain competitive.
- The number of industries becoming sick is substantially high and hence working on their rehabilitation is very challenging as the schemes do not seem to be very helpful.
- The exports scene is very exciting though huge potential is still unexplored.
- Reservation for SSI has not proved to of advantage to them and hence the process of de-reserving them has been aptly introduced by the Government.
- Difficulties in marketing the products have always been a major problem for the small manufacturers.

MSME FUNDING - NEED FOR ALTERNATIVE FINANCING

Finance is life blood of any enterprise. But Indian MSMEs, have always suffered the deficiency of this life blood, despite India having one of the most extensive banking network in the world.

Finance is the lifeline of any enterprise. India has one of most extensive banking networks in the world. Despite, a considerable expansion of the banking infrastructure during the recent years, the provision of finance to grass-root level businesses, scattered across the nation, still remains an enormous challenge. Going ahead, it is also observed that Indian MSMEs have limited access to finance. Majority of the MSMEs operates on the funds of its promoters, thus limiting its growth. The limited or non-availability of institutional finance at affordable terms is also hindering innovation in the Indian MSMEs. In India, the preferred mode of finance is either self or other sources. This further complicates the situation, as with these sources an enterprise cannot challenge the increasing competition. On account of globalization; MSMEs are beginning to opt for other specialized financial services and options.

The Government has been trying to tackle the problems faced by MSMEs and also have established several committees and study groups along with the Reserve Bank of India and Small Industries Development Bank of India (SIDBI) to study the problems faced by MSMEs

The Government has taken various initiatives from time to time to address the problems faced by the MSME sector. It has set up numerous, organizations, boards, corporations and training centres have been set up to provide technological, entrepreneurial, managerial and financial assistance to these units. Likewise, several committees and study groups set up by the Government, the Reserve Bank of India and Small Industries Development Bank of India (SIDBI) have studied the problems faced by MSMEs and suggested various measures to address these issues. This have significantly contributed and set up a favourable environment for setting up and nurturing small industrial units. However, high incidence of sickness and subdued credit off-take in this sector indicates that the results have not been as desired. This necessitates a paradigm shift in the approach of banks towards the segment. In this background, there is, thus, a need for formulating of a new business model for financing the MSMEs.

The traditional approach to MSME financing which is based on rigid credit appraisal systems that revolve around financials, single delivery channel, involvement of various hierarchies in processing and decision making, limited focus on cross selling opportunities, difficult and inflexible system of accessing transaction history, limited and pre-structured credit products, etc. has to be replaced with a new business model for financing MSMEs.

SIBDI is the principal financial institution for the promotion, financing and development of industry in the MSME sector in the country. SIDBI also provides appropriate support in the form of promotional and developmental services. In order to improve the credit flow to the MSME sector, it has tied-up with public sector banks in the country. With these tie-ups, it has covered 150 MSME clusters, out of the total 388 clusters identified across the country.

SIDBI is the front runner in promoting, financing and development of industry in the MSME sector in the country.

Change in Scenario

Banks today are slowly but surely adopting a more progressive and forward looking outlook. With the assistance of better technology, risk prediction and management strategies and tools, as well as the sheer number of positive MSME growth stories, banks are extending a strong lending hand to MSMEs.

Banks today have changed their attitude towards MSME, on the back of success stories. Thus banks are ready to cater to the full needs of the sector.

Banks are considering the recommendations made by the Ganguly Committee and the government directive to adopt a full-service approach to cater to the diverse needs of the MSME sector. This may be attained by extending banking services to recognized MSME clusters and by adopting the 4-C approach: Customer Focus, Cost Control, Cross-Selling and Containing Risk.

In its broadest definition, the banking sector includes commercial and investment banks, leasing companies, microfinance institutions (MFIs), and other related institutions. MFIs have emerged to serve the smallest of these enterprises, while banking institutions have typically concentrated on large corporations. MSMEs fall between these two markets where there is a financing gap.

However, the attitude has changed after the SSI segment was redefined in 2006, categorizing it into manufacturing and service segments under micro, small and medium industries. As a result, MSME banking started to grow as an industry. Banks thus began to turn their attention towards this untapped market. This resulted as ray of hope for MSMEs in the financing arena and banks are demonstrating that the MSME segment can be served profitably, provided it is properly understood. But banks alone cannot be the saviour of the MSME sector. They too need a strong system to lean upon. RBI must ease the lending and NPA accounting norms for banks who lend to the MSME sector. Such strong directives and support would have a very positive impact on the morale of the MSMEs.

Everybody knows about formal sources of finance such as bank, but very little is known about the alternative sources of finance for MSMEs, even though they constitute the predominant form of financing for such entities. Here we will discuss about the various alternative financing options and discusses how bringing these into a market system through financial intermediaries holds great promise for the millions of small and mid-size businesses in our country. This may result in decrease of the cost of capital for such businesses while simultaneously creating a credit history for them, thereby, making it easier for them to access cheaper bank finance. Amongst other alternative options, the paper discusses how financing of trade credit, for instance, can be an important source of financing for Indian MSMEs. If the receivables owed to the MSMEs by large firms could be securitized, it would result in both deepening and broadening of Indian credit markets. This would not only result in MSMEs accessing additional finance for its working capital recruitment, but also provide institutional investors additional investment avenues. Other alternative finance options such as securitization of MSME credit, supply chain financing, factoring, accessing equity capital from SME Exchange/ Portal, venture/ risk capital, cash flow based financing, etc. which can also play a catalytic role in improving access to funding for MSME are also discussed.

Apart from the conventional ways of financing an enterprise there are various alternative options to finance a business. These alternative or unconventional ways of financing offer a wide range of choice for the promoter to raise fund for his business and also offers a range of options to choose from.

Need for Alternate financing:
Notwithstanding the policy support to MSMEs and increase in bank credit to this sector in recent years, access to adequate credit at a reasonable cost is still a critical problem for the sector. The credit flow to MSMEs through institutional sources is not commensurate with the economic activity undertaken by MSMEs. As per the statistics, it’s known that small businesses generally depend on multiple sources of financing ranging from new internal sources, viz., personal funds and funds from

friends, to external sources, both formal and informal, which include financing from banks, NBFCS, venture capital funds, trade credit, factoring etc. Choice of alternative financing sources is determined by the growth stage of the enterprise, the quantum of funds received, the maturity of the financial market and the policy environment. Therefore, alternative sources of finance can be very important for MSMEs.

Alternative financing sources:

Securitization of Trade Credit *is an arrangement where receivables of an enterprise could be packaged as a securitized asset, thus helping MSMEs reduce their investment in working capital and their need for finance significantly.*

Securitization of Trade Credit: Trade credit is an important source of financing for MSMEs, as they sell on credit to their large customers and then wait for long periods for payment. If these receivables (trade credit) could be packaged as a securitized asset, which would essentially be a commercial paper with the credit rating of the large firm, it could help MSMEs reduce their investment in working capital and their need for finance significantly. The credit worthiness of a typical MSME would also improve, qualifying it for greater bank funding. Though the securitization process which is similar to factoring, could be more cost-effective than bank funding, factoring, and letters of credit.

Securitization of MSME Credit *refers to packaging of MSME credit into loan pools or securitized assets and sold to interested parties I exchange of funds.*

Securitization of MSME Credit: Likewise, MSME credit could be packaged in the form of loan pools or securitized assets and sold to investors interested in such an asset class. The MSME loans which had very nominal share of 2 per cent in securitization during 2010-11 have emerged as one of the key loan categories to be securitized accounting for almost 11 per cent of total assets securitized in the asset backed security (ABS) pool during 2011-12, indicating growing investor and issuer interest in this asset class.

If institutions utilize their expertise to systematically build this asset class backed by a strong underwriting framework and market it to a larger investor franchise then such transactions would enable small business lenders to access capital markets at a reasonable cost and boost funding to MSMEs. Securitization helps in creating a secondary market for MSME loans in India and if properly applied this technique can become a replicable tool that can enhance access to finance for MSMEs. The new guidelines for securitization of standard assets issued by Reserve Bank of India in July 2012 are also expected to go a long way in the creation of a true securitization market in India as they have incorporated several safeguards to enhance the quality of pass through certificates issued in a securitization transaction.

Factoring to Tackle Delayed Realization of Receivables *is an arrangement that helps an enterprise to tackle the problem of delayed realization of receivables by institutionally factoring their receivables and thus providing alternative source of financing.*

Factoring to Tackle Delayed Realization of Receivables: Considerable delay in settlement of dues/payment of bills by the large-scale buyers to the MSMEs units adversely affects the recycling of funds and business operation of MSME units. Further, timely payments from customers will help MSMEs in reducing their working capital requirements leading to lower interest costs, improved profitability and a positive impact on the long-term health and sustainability of India's MSME sector. A study of 5000 MSMEs by CRISIL shows that high quantum of receivables is an endemic problem across industry/ sectors and geographies in the MSME space. Smaller MSMEs, perhaps due to their lower bargaining power, are in an unfavourable position with weaker receivable positions. CRISIL estimates that timely payments from large customers will help MSMEs reduce interest costs, and improve profitability by around 15 per cent and have a positive impact on the long-term health and sustainability of India's MSME sector. It is, therefore, critical that small enterprises receive payments on a timely basis from customers or alternatively they are able to raise liquidity against their receivables.

The above problem of delayed realization of receivables can be institutionally tackled by factoring which provides liquidity to MSMEs against their receivables and can be an alternative source of working capital. Factoring is a flexible alternative to traditional forms of funding. When a client makes a sale, delivers the product or service and generates an invoice, the factor buys the right to collect on that invoice and releases funds, usually 80-90 per cent of the invoice value to the client. Factoring as a financial services product is superior to the conventional bank finance in terms of it being an easy and fast method of turning accounts receivables into cash, offering funding up to 90 per cent of the invoice value, not restrained by geographical limits, non requirement of collateral security, offering value-added services in the form of sales ledger administration, collection and credit protection, credit screening-cum-credit monitoring and early detection and warning of customer service problems.

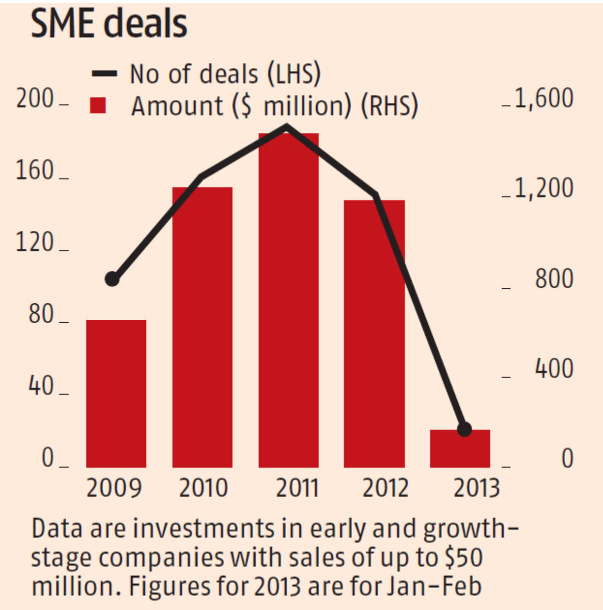
Across the world, factoring is a preferred route of accessing working capital for MSMEs and even larger organizations. Some banks and financial institutions in India have already launched factoring services for MSMEs. As a result of this procedure, MSMEs attain liquidity against their receivables from customers and is regarded as a cash management tool. Factoring would also help improve MSME financing and is a major step towards full-fledged securitization. The Indian factoring market is currently pegged at around Rs. 25000 crore. Factoring as a service is seeing significant demand from MSMEs in line with global trends.

__Angel funds/Venture Capital Funds__ is an alternative source of financing generally used by high-growth potential and start-up MSMEs. The enterprise opts for such kind of financing when it need funds to expand or break into new markets and grow faster.

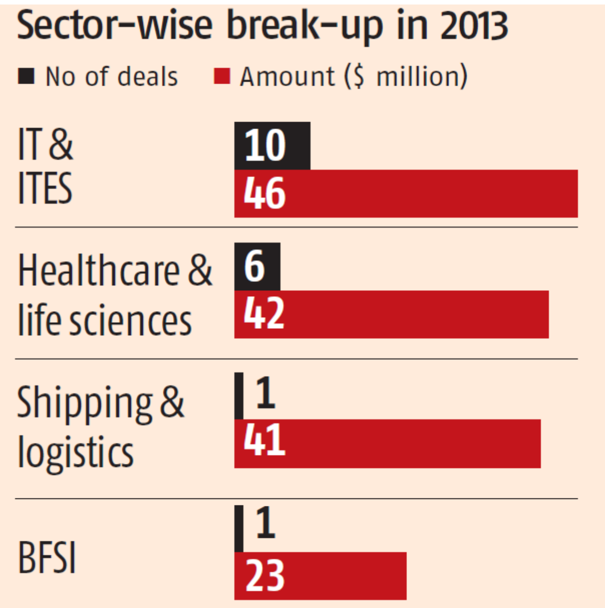
Angel Funds / Venture Capital Funds: Venture/ Risk capital is often a more appropriate financing instrument for high-growth potential and start-up MSMEs. However, the ability of MSMEs (especially those involving innovations and new technologies) to access alternative sources of capital like angel funds/risk capital needs to be enhanced considerably. Although the sector commonly uses traditional debt, this type of financing is often not accessible for fast growth and start-up firms. During their initial phase, firms need finance to study, assess and develop an initial concept (seed phase) or for product development and initial marketing (start up phase). At this stage, firms may be in the process of being set up or may exist, but have yet to sell their product or service commercially. High-growth firms usually develop an idea, concept or product that requires an incubation period before generating revenues and profits.

An enterprise basically looks for venture capital to provide them with the financing they need to expand or break into new markets and grow faster. Further, Government of India, in terms of the recommendations of the PM's Task Force on MSMEs, is already looking at removing the fiscal/regulatory impediments to the use of such funds by the sector. Venture/ Risk capital funding is ideal for newly emerging ventures like bio-tech, food processing, IT, pharmaceutical and other knowledge based sectors. Creation of venture capital funds to meet the equity requirements of these units in the initial phase of their working in the knowledge sector including BPO, KPO, Life sciences, on-line business, technology-enabled design and manufacturing as well as in emerging areas of nano-technology and environmental technology would go a long way to help such industries.

Angel investors are investors who typically invest their own funds, unlike venture capitalists, who manage the pooled money of others in a professionally-managed fund are increasingly becoming another alternative source of funding for MSMEs in India.



Private Equity Funding: Private Equity (PE) investment provides another source of raising capital for MSMEs. PE funds have been investing in Indian firms since 1990s. These financial enterprises are typically focused on funding a company early, adding value to them and making an exit at a later stage. They are stable sources of capital and tend to have an investment horizon of 3-5 years looking at a multiple return on their investment. PE investors not only bring capital but also expertise and experience and expertise from established businesses and from the global markets. They expose their portfolio companies to best in class practices and work extensively to see that they are implemented into the organizations that they are funding. They also work extensively with their portfolio companies and encourage management to undertake operational improvements in case of any strategic opportunities such as mergers, acquisitions and joint ventures. The Planning Commission recently released a preliminary approach paper regarding its 12th five-year plan (2012-2017). A key focus area in the plan is to promote equity investment in MSMEs by constituting a Working Group devoted to the concept.



Owing to the high valuations at which the investments were made in 2007 and 2008, a number of portfolio investments of PE funds are currently not 'in the money' and with the relative fall in Indian rupee, exits have been becoming even less attractive.

Private equity investments in India's MSME sector fell to US$151 million in January-February 2013, implying a decline of 51 per cent compared to similar period last year.

In the last four years, 2011 was the best year for the sector, attracting US$1,478 million in PE flows across 188 deals, compared to US$1,246 million across 159 deals in

2010 and US$642 million across 103 deals in 2009. In 2012, the sector attracted investments totalling US$1,184 million across 151 deals - a fall of 19 per cent over 2011.

Mezzanine Financing: Business owners need finance in order to invest but they want to retain control of their business and not give up valuable equity. For MSMEs the financing options are limited and private equity investors are usually interested in larger companies, while business angel investors are more active in start-ups. Furthermore, conventional bank lending is often not available for projects that could be classified as speculative. That's where mezzanine finance comes in. Mezzanine finance is a fairly well-known type of funding, which sits between traditional bank debt and equity and it is exactly what many MSMEs need.

Mezzanine Financing is a financial instrument that possesses the attributes of both the debt and equity. Further, in the hierarchy of creditors, mezzanine debt is subordinate to senior debt but ranks higher than equity.

Mezzanine debt refers to hybrid financial instruments that possess characteristics of both debt and equity. It lies somewhere in the midst of debt and equity on the risk-return spectrum. In the hierarchy of creditors, mezzanine debt is subordinate to senior debt but ranks higher than equity. Mezzanine debt is also called subordinated debt or second mortgage. Commensurate with their subjugated position in the claim over the assets of a corporation which is tantamount to the assumption of relatively higher risks, mezzanine financers typically demand a higher rate of return as compared to debt providers but lower than that required by equity investors. Mezzanine finance typically is a structured debt-like instrument, earning high yields, through a combination of cash coupon and terminal yield and/or equity-linked components, such as warrants and optionally convertibles.

Although the position of mezzanine finance lies along the continuum between traditional debt and equity, the exact extent of its commonality with either is nebulous at best. This is because mezzanine debt instruments are primarily of the over-the counter (OTC) type, i.e., they are privately negotiated contracts between private parties.

Mezzanine financing can be a very effective tool in aiding sales development and creating jobs, but a common question is how it impacts the internal structure of a business? This is the major issue between MSMEs and equity investors.

Current status in India

Due to its effectiveness in the developed economies, mezzanine financing has evinced considerable interest in India. However mezzanine financing is available to the upper strata of the companies and not available to MSMEs other than certain high interest lending done by cooperative banks with second charge on assets. A working Group was constituted under Dr K.C.Chakraborty to improve flow of credit to MSME segment including developing markets for alternative sources of funding. The group in its recommendations has suggested the necessity to develop markets for alternative sources of funding like mezzanine financing with appropriate financial tools. Subsequently, SIDBI has taken the lead through SIDBI Foundation for Risk Capital and has started providing mezzanine financing to existing, profitable MSMEs.

Mezzanine funding has a great potential in India and will become more prominent. This kind of funding allows flexibility to the borrower and provides greater security of capital due to downside protection structures and equity like returns on the upside.

In order to solve the problem of accessing equity capital from stock exchanges, major stock exchanges of India, National Stock Exchange (NSE) and Bombay Stock Exchange have set up an exclusive platform for MSMEs to access institutional and retail capital.

Access to Equity Capital through SME Exchanges: Access to equity capital from the stock market is a genuine problem for MSMEs. Till a few years ago, there was negligible flow of equity capital into this sector. Absence of equity capital poses a serious challenge to the development of knowledge-based industries, particularly those promoted by the first-generation entrepreneurs with the requisite expertise and knowledge. Further, for efficient capital structure decisions, an optimal mix of equity and debt is very important. Keeping this in mind, the Report of the Task Force on MSME Chairman (Shri. T.K.A. Nair, 2010) had recommended the setting up of a dedicated Stock Exchange/Platform for MSMEs to access institutional and retail capital. This would also facilitate greater financial inclusion in the country. Following this, SEBI laid down the regulatory framework for the SME Exchanges with relaxed listing conditions and accorded approval to BSE and NSE to launch an SME Exchange in September 2011 and October 2011 respectively. Successful examples of SME Exchanges across the World include AIM (London), Canada (TSXV), Hong Kong (GEM), Japan (Mothers), Korea (KOSDAQ) and US (NASDAQ).

In March 2012, both BSE and NSE launched their SME exchange platforms to enable MSMEs to raise funds and get listed as public entities. BCB Finance Ltd. was the first Indian SME to get listed on the BSE SME Exchange. This was an event of immense significance for MSMEs as they have a huge listing potential but mostly had debt-financing options. The launch of SME exchanges will play an important role in growth of MSMEs and the need of the hour is to improve the awareness among MSMEs about equity capital, stock markets and funding options, other than banks. The capital markets can play a crucial role in helping MSMEs improve their visibility and raise capital for their growth and expansion, offering an effective way to improve financial inclusion. They can also offer investors opportunities to invest in growing businesses at an early stage. Since its launch in March 2012, 13 companies have listed with BSE SME exchange, and BSE is negotiating with other companies for listing. BSE’s rival NSE has also followed suit and launched its own SME platform called 'Emerge' with the proposed listing of Chennai-based SME Thejo Engineering. A vibrant equity market for MSMEs would also provide an added incentive for private equity and venture capital investments by providing an exit option for them. Listing on exchanges will also offer MSMEs an opportunity to offer equity ownership to their employees, thereby, increasing their commitment to their company and working for its future success.

In future the MSME sector will continue to be one of the catalysts of growth for the country’s economy, and presents a significant business opportunity for both banks and alternative finance providers. The extent of financial exclusion in MSMEs is high and notwithstanding the increase in credit outstanding in recent years, access to adequate and timely credit from the banking system is still a critical problem being faced by this sector. Alternative sources of finance can, therefore, step in and assist MSMEs in their growth and development. In recent years, a plethora of alternative finance options have emerged and have proven to be an important source of financing for Indian MSMEs. The alternative financing avenues discussed above truly have the potential to bridge the financing gap for MSMEs from banks. Access to finance is essential for improving MSMEs competitiveness, as MSMEs have to invest in new technologies, skills and innovation. On their part, the MSMEs should be responsible borrowers, should use the finance in a judicious manner and take advantage of the business opportunities both within and outside the country. They should improve their governance and risk management practices, maintain proper books of accounts, submit correct information to banks and all authorities, and make their operations more efficient and productive to get easier access to finance from banks and other investors. This way the MSME sector would become more competitive and efficient and contribute further to the economic development of our country.

MSME FUNDING - CHALLENGES

The present situation does not offer enough opportunities for the MSMEs to raise low cost funds. However, the Government is taking proactive measures to guarantee better access to credit. Despite this, banks are reluctant to lend to MSMEs as a result of high risk profile of the segment.

The present domestic market conditions do not provide enough opportunities for the MSME sector for raising low cost funds. To improve the flow of credit there is a need to provide low cost finance to the MSME sector, which has limited working capital and is dependent exclusively on finance from public sector banks. The cost of credit in the Indian MSME sector is higher than its international peers. A transparent credit rating system, simplification/reduction in documentation for accessing finance, providing interest rate subvention to the MSME sector must be taken into consideration in order to maintain the growth of the MSME sector.

The Government is taking proactive measures to ensure better access to credit. Bank lending to the sector will grow at a rate of 20 per cent on a year-on-year (y-o-y) basis, along with 10 per cent annual growth in number of micro enterprise accounts, with 60 per cent of the share of MSME credit directed towards micro enterprises. These and various other measures ensure that credit flow to the sector, especially micro and small enterprises, is adequate.

In spite of these measures banks are reluctant to lend to MSMEs due to their higher risk profile owing to zero collateral or their limited years of operations. Indian firms raised about 47 per cent of their total funding from internal sources, 19 per cent from banks and financial institutions (FIs), and 5 per cent from capital markets. The remaining 29 per cent came from alternative sources. When it comes to MSME, only 15 per cent of funding came from internal sources, 25 per cent from banks and FIs, and 10 per cent from capital markets. Around 50 per cent of the funding has been sourced through alternative funding sources including friends and family, trade credit etc. These alternative sources are far more expensive and are dependent on prevailing market conditions and are rarely a guaranteed source. This clearly implies that MSMEs face very high interest cost due to the lack of availability of adequate credit.

The reasons that are keeping banks away from financing MSMEs are the high transaction cost and NPA. These factors have made commercial banks to perceive that lending to MSME sector is non profitable lending. One of the reasons attributed for low profits by public sector banks is lending to priority sector at lower rates of interest. But as per the studies in other countries, lending to this sector is a lucrative banking activity.

There are a number of issues in lending to the MSME sector, which banks generally face. The key issues among them are –

Information Asymmetry: Accurate information about the borrower is a critical input for decision-making by banks in the lending process. Where information asymmetry (a situation where business owners or managers know more about the prospects for, and risks facing their business than their lenders) exists, lenders may respond by increasing lending margins to levels in excess of that which the inherent risks would require. However, the sheer ticket size of MSME lending makes it unviable for banks to invest in development of information systems about MSME borrowers. In such situations, banks may also curtail the extent of lending even when MSMEs are willing to pay a fair risk adjusted cost of capital. The implication of raising interest rates and/or curtailing lending is that banks will not be able to finance as many projects as otherwise would have been the case.

Granularity: This is a situation where the risk grading system at banks does not have the requisite capability to discriminate between good and bad risks. This will lead to tightening of credit terms, or an increase in prices, or both. From the borrower's perspective, this leads to an outcome where the bank is over-pricing good risks and under-pricing bad risks. The fact that most banks in India have not developed adequate expertise in MSME lending risk assessment exercises leads to the problem of granularity when it comes to MSME lending.

Pecking order Theory: This theory flows from the above mentioned issues that make MSME lending highly difficult for banks. Under this hypothesis, the sector which faces a cost of lending that is above the true risk-adjusted cost will have incentives to seek out alternative sources of funding. Evidence suggests that in such situations MSMEs prefer to utilize retained earnings instead of raising loans from banks.

Moral Hazard: Even when loans are made to MSMEs, it may so happen that the owners of these MSMEs take higher risks than they otherwise would without lending support from the banks. One reason for this situation is that the owner of the firm benefits fully from any additional returns but does not suffer disproportionately if the firm is liquidated. This is referred to as the moral hazard problem, which can be viewed as creating a situation of over-investment. The moral hazard problem may thus lead to MSME lending turning bad in a short period of time, a situation that all banks would like to avoid.

Switching Costs: MSMEs may find it harder to switch banks, when countered with any issue. It is a known fact that the smaller the business, the more significant the switching costs are likely to be and, therefore, it is less likely that the benefits of switching outweigh the costs involved. This situation results in MSME lending becoming a seller’s market, which may not be attractive to MSME borrowers.

CONCLUSION AND SUGGESTIONS

In order to ensure that the above issues do not stand between MSMEs and Bank Finance, the following steps could be taken as remedial measures:

Collateral: Existence of collateral that can be offered to banks by MSMEs could be one effective way of mitigating risk. Banks could, therefore, look at collateral when pursuing the question of MSME lending. It can also be stated that a borrower's willingness to accept a collateralized loan contract offering lower interest (relative to unsecured loans) will be inversely related to its default risk. However, not all MSMEs would be able to offer collateral to banks. .

Relationships: The length of the relationship between a bank and its MSME customers is also an important factor in reducing information asymmetry, as an established relationship helps to create economies of scale in information production. A relationship between a MSME and a bank of considerable duration allows the bank to build up a good picture of the MSME, the industry within which it operates and the calibre of the people running the business. The closer the relationship, the better are the signals received by the bank regarding managerial attributes and business prospects.

Quality of Information: MSMEs are required to provide accurate and qualitative information to the banks for them to undertake a reliable risk assessment. Accurate risk assessments obviously rely upon good information regarding the MSME and its prospects. Hence, it is suggested that banks should make efforts to encourage MSMEs to improve the quality of information provided.

Customer Consideration: The MSME market is somewhat different as compared to the corporate market. The corporate customers generally have a wide range of financing options to choose from and are not as dependent on bank financing as is the case with MSMEs. The extent to which MSMEs can take necessary steps, with the aid of public initiatives, to easily switch to another bank is another factor that can influence the level of competitive pressure on banks in the case of MSME lending.

Going ahead, it is well recognized that unlike in many developed countries, Indian MSMEs do not currently have access to a well funded ecosystem. India, therefore, needs a properly designed and adequately resourced financing regime. It will need to be a combination of many different routes. However, it will need to be based on Indian realities and the reality of the Indian MSME sector.

Merely creation of greater number of financing bodies is not the solution. The systems, rules, procedures, and practices governing the granting of capital, monitoring, will need to be thought through carefully. This, in turn, will require a multi-dimensional and multi-departmental approach, where human capital, expertise, financing, legal regimes, all need to be changed to suit the requirements of India's new MSMEs. These will not be dependent on government largesse and subsidies, but on the entrepreneurs ability to harness all available technologies and resources.

Already with government support, and also newer private initiatives, such an ecosystem is emerging. The government needs to catalyze these activities by removing the bottlenecks that prevent the market for risk capital from evolving.

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