

K C Chakrabarty: Empowering MSMEs for financial inclusion and growth – issues and strategies

Keynote address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the Central Bank of India SME Conclave, Mumbai, 20 December 2011.

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It is my pleasure to be here at this Conclave on the eve of the conclusion of Centenary Year Celebrations of Central Bank of India. As you all may be aware, Central Bank of India, which was established way back in 1911, has a glorious past and would be celebrating its Foundation Day on December 21, 2011. I take this opportunity to congratulate Shri Tanksale, CMD, Smt Iyer, ED, all employees and customers of the bank and all the other stakeholders on completing a remarkable hundred years of exemplary service to the nation. The bank was the realization of the dream of Shri Sorabji Pochkhanawala, a visionary, a philanthropist and a rare breed of people who richly deserve our tributes. It was the first commercial bank which was wholly owned and managed by Indians. Central Bank of India, over the years, has won the trust and confidence of its clients and it comes as no surprise then that it has become one of the most prominent banks in India. But more importantly, the bank had a rich tradition of promoting small and medium entrepreneurship and played a sterling role in the industrial development of the Bombay Presidency region. However, over a period of time, this zeal of promoting entrepreneurship development appeared to have dimmed a bit and, therefore, I am extremely happy that as their Centenary Year draws to a close, Central Bank of India is bringing the limelight back to SMEs and rededicating themselves to the cause. I congratulate Shri Tanksale for organizing this Conclave on “Empowering SMEs for Inclusive Growth-Strategies and Initiatives” in collaboration with a predominant industry association – the Small and Medium Business Development Chamber of India.

A. Importance of the MSME sector

Now, there is no need for me to overemphasize the role and importance of the micro, small and medium enterprises. You are all aware that in a developing economy, the MSMEs play a vital role and if India were to have a growth rate of 8–10 percent for the next couple of decades, it needs a strong micro, small and medium sector and for that micro entrepreneurs need to be nurtured. As per available statistics (4th Census of MSME Sector), this sector employs an estimated 59.7 million persons spread over 26.1 million enterprises. It is estimated that in terms of value, MSME sector accounts for about 45% of the manufacturing output and around 40% of the total export of the country. The MSMEs are the best vehicle for inclusive growth, to create local demand and consumption and also to fight with the global meltdown. Public policy has rightly accorded high priority to this sector in order to achieve balanced, sustainable, more equitable and inclusive growth in the country. A micro enterprise of today will be a big enterprise of tomorrow, and might well become a multinational enterprise eventually, if given the support in finance and capacity building. It is also an opportune time for putting more emphasis on MSMEs due to recession in many countries of the globe and rupee depreciation. The recession, while slowing down the global demand for goods and services, should not impact the sector, so adversely, as there is a huge demand

in the local markets which could be tapped and the depreciation of the rupee has improved their price competitiveness of exporting firms in the sector.

Sizeable growth in credit – yet MSMEs feel not enough is being done

The MSMEs primarily rely on bank finance for their operations and as such ensuring timely and adequate flow of credit to the sector has been an overriding public policy objective. Advances extended to the micro and small enterprises sector are treated as priority sector advances. Over the years there has been a significant increase in credit extended to this sector by the banks. As at the end of March 2011, the total outstanding credit provided by all Scheduled Commercial Banks (SCBs) to the MSE sector stood at Rs.4,575 billion as against Rs.3,622 billion in March 2010 registering an increase of 26.3%. Despite the increase in credit outstanding to the sector, the MSME borrowers feel that the lenders are not doing enough for the MSMEs and are catering more to the needs of the large corporate. Let me now focus on the major problems / challenges / issues faced by the MSMEs and, more specifically, the Micro and Small sector.

B. Major problems / challenges / issues faced by the sector

Access to credit

Notwithstanding the increase in credit outstanding to the sector, access to adequate and timely credit at a reasonable cost is a critical problem faced by this sector. The statistics compiled in the Fourth Census of MSME sector September 2009, revealed that only 5.18% of the units (both registered and unregistered) had availed of finance through institutional sources, 2.05% had finance from non-institutional sources; the majority of units i.e. 92.77% had no finance or depended on self-finance. Thus, the extent of financial exclusion in the sector is very high. But, this is not entirely unexpected because if one looks at the financial exclusion in our country in general, then MSMEs cannot remain unaffected by it. But there is a need to bridge this gap through enabling policies and the Government of India (GoI) needs to play a catalytic role to cater to the needs of this sector.

First time entrepreneurs

The MSE borrowers, especially new generation entrepreneurs, do not have collaterals to offer to avail of bank finance. It is generally observed that collateral security provides comfort to the lenders as it ensures commitment of the borrower to the project and is also available to them for recovery in the event of failure of the enterprise.

Infrastructure

In the present global environment, the MSMEs and more specifically the micro and small enterprises (MSEs) have to be competitive to survive and thrive. To ensure competitiveness of the MSEs, it is essential that the availability of infrastructure, technology and skilled manpower are in tune with the global trends. MSEs are either located in industrial estates set up many decades ago, or have come up in an unorganized manner in rural areas. The state of infrastructure including power, water, roads, etc. in such areas is inadequate and unreliable. Further, the MSE sector in India, with some exceptions, is characterized by low technology levels, which acts as a handicap in the emerging global market. Although India has the advantage of a large pool of human resources, the industry continues to face deficit in manpower with the right skill sets for specific areas like, manufacturing, service, marketing, etc. The HR problem is further exacerbated by the low retention rate.

Access to alternate sources of capital

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. For this purpose, removing fiscal/regulatory impediments to use such funds by the MSMEs should be considered on priority. Access to equity capital is a genuine problem. At present, there is almost negligible flow of equity capital into this sector. Absence of equity capital may pose a serious challenge to development of knowledge-based industries, particularly those that are sought to be promoted by the first-generation entrepreneurs with the requisite expertise and knowledge. There is a demand for a dedicated Exchange for MSMEs.

Delayed realization of receivables

Considerable delay in settlement of dues/payment of bills by the large-scale buyers to the MSMEs units adversely affected the recycling of funds and business operation of MSME units. Though the Government has enacted the Delayed Payments Act, 1998 many of the MSME units are reluctant to pursue cases against major buyers. After the enactment of the Micro, Small and Medium Enterprises Development (MSMED) Act 2006, the existing provisions of the Interest on Delayed Payment Act, 1998 to Small Scale and Ancillary Industrial Undertakings, have been strengthened. The banks have been advised to sanction separate sub-limits within the overall limits sanctioned to the corporate borrowers for meeting payment obligations in respect of purchases from MSME sector. Necessary instructions have been issued by banks to their branches to monitor the position of payment by corporates to MSME and wherever found necessary, persuade the corporate to release the same on priority basis.

Sickness of units

Growing incidence of sickness of the sector is yet another area of concern. When the sickness prolongs it leads to the closure of units and unemployment. The mortality of the MSE units is high. This has wider implications including locking of funds of the lending institutions, loss of scarce material resources and loss of employment. As on March 2011, the number of units identified as potentially viable as a percentage to total sick MSE units is around 8. The units placed under nursing as a proportion to the total number of sick units stood at 5.22%. The causes of sickness are both internal and external. The major causes are limited financial resources, lack of organisational, financial and management skills and expertise, non-availability of power supply shortage of raw materials, marketing difficulties, delayed and inadequate credit, obsolete technology, inadequate infrastructure, etc.

Exit policy for MSMEs

An exit route for non-viable units is necessary to manage sickness. Worldwide, MSMEs are credited with high level of innovation and creativity, which also leads to higher level of failures. Keeping this in view, most of the countries have put in place mechanisms to handle insolvencies and bankruptcies. The present mechanism available in India for MSMEs is archaic. Business failure in India is viewed as a stigma, which adversely impacts individual creativity and development in the country. The existing legislations may have to be toned up so as to provide for efficient liquidation of non-viable businesses.

C. Initiatives by government of India / Reserve Bank of India

Recognizing the important role played by MSMEs in economic development and its sizeable contribution to employment and GDP, and realizing that financial access is critical for MSMEs growth and development, Government and Reserve Bank of India are taking the

lead in supporting initiatives that improve access to finance. While at the broader level, financial inclusion makes growth broad based and sustainable by progressively encompassing the hitherto excluded population, and has become a national priority, at the more narrower level, since the level of financial exclusion is very high in this sector, drive to universal financial access, including SME finance, is no longer a policy choice but a compulsion. The Reserve Bank of India has intensified a number of measures and endorsed quantitative access targets over the last year to further financial inclusion. Let me very briefly touch upon a few of them.

With an objective of ensuring uniform progress in provision of banking services in all parts of the country, banks were advised to draw up a roadmap to provide banking services through a banking outlet in every unbanked village having a population of over 2,000 by March 2012. The Reserve Bank advised banks that such banking services need not necessarily be extended through a brick and mortar branch but could be provided also through any of the various forms of Information and Communication Technology (ICT) – based models, including Business Correspondents (BCs). A total of about 74,000 such unbanked villages have been identified and allotted to various banks through State Level Bankers Committees (SLBCs). As at the end of September 2011, as reported by the State Level Bankers' Committees of various states/Union Territories, banking outlets have been opened in 42,079 villages across the various States in the country. This comprises of 1127 branches, 39998 business correspondents and 954 other modes like rural ATMs, mobile vans etc.

To ensure enhanced credit flow to the sector, in terms of the recommendations of the Prime Minister's Task Force on Micro, Small and Medium Enterprises (MSMEs) (Chairman: Shri T.K.A.Nair, Principal Secretary, Government of India) constituted by the Government of India, banks were advised to achieve a 20 per cent year-on-year growth in credit to micro and small enterprises; the allocation of 60% of the MSE advances to the micro enterprises is to be achieved in stages viz. 50% in the year 2010–11, 55% in the year 2011–12 and 60% in the year 2012–13 and achieve a 10% annual growth in number of micro enterprise accounts. The Reserve Bank is closely monitoring the achievement of targets by banks on a quarterly basis. The matter is followed up with the laggard banks to know their constraints and impress upon them the need to devise strategies to gear up the credit mechanism for the sector.

Further, based on the recommendations of the Working Group (Chairman: Shri V.K. Sharma, Executive Director, RBI) constituted by the Reserve Bank of India to review the Credit Guarantee Scheme (CGS) of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), the limit for collateral free loans to the MSE has been increased from the present level of Rs. 5 lakh to Rs.10 lakh and it has been made mandatory for banks. The Working Group has also made recommendations regarding increase in the extent of guarantee cover, absorption of guarantee fees for the collateral free loans by CGTMSE subject to certain conditions, simplification of procedure for filing claims with CGTMSE and increasing awareness about the scheme. CGTMSE, which is implementing agency for Credit Guarantee Scheme, has been advised to expedite implementation of the recommendations. The implementation of the Recommendations of the Working Group should result in enhanced usage of the Guarantee Scheme and facilitate increase in quality and quantity of credit to the presently included, as well as excluded, MSEs, leading eventually to sustainable inclusive growth.

All Scheduled Commercial Banks have also been advised on May 4, 2009, to review and put in place MSE Loan policy, Restructuring / rehabilitation policy and Non-discretionary One Time Settlement Scheme for recovery of non-performing loans duly approved by their Board of Directors. Banks were advised in December 2009 to give wide publicity to the Non-discretionary One Time Settlement Scheme for recovery of non-performing loans for the MSE sector by placing it on their bank's web-site and through other possible modes of dissemination.

On the issue of alternate sources of credit, dedicated Exchange for MSMEs, marketing, technology up-gradation and infrastructure, the PM's Task Force has examined the issues and has made several recommendations to address the bottlenecks. The implementation of the recommendations in a time bound manner are being monitored by the GOI.

D. Role of banks and industry associations in empowering MSMEs

Role of banks

There has been a burst of entrepreneurship across the country, spanning rural, semi-urban and urban areas. This has to be nurtured and financed. It is only through growth of enterprises across all sizes that competition will be fostered. As I mentioned in the beginning, a micro entrepreneur of today will become a small entrepreneur and then a big entrepreneur of tomorrow, and might eventually well become a multinational enterprise if given the comfort of financial support and capacity building. There will be failures and successes. Despite the risk, financing of first time entrepreneurs is a must for financial inclusion and growth. Banks will therefore, have to tone up their risk assessment and risk management capacities and provide for these failures as part of their risk management.

Banks have to recognise the vast potential that exists in responsible lending to the MSE segment. The banks must deliver on their voluntary commitments enshrined in their Code of Commitment to their MSE borrowers. Banks have, no doubt, through the Code of Bank's Commitment to MSEs, voluntarily committed to their MSE customers to provide easy, speedy and transparent access to banking services in their day-to-day operation. In the last Standing Advisory Committee meeting held on July 5, 2011, it was decided that the SCBs should understand the problem of the sector and devise strategies to gear up their credit mechanism structure so as to achieve the prescribed target of lending to the sector by the PM's Task Force. Sensitivity on the issue to be developed at various hierarchical levels, such as, discussion of the issue in the Board meetings, management level meetings once in three months. Branch manager's conference on financing to the micro sector to be held and the local NGOs, KVIC could be involved so as to appreciate the problems of the sector and flagging major issues to remove constraints/ bottlenecks in financing. The performance of branch managers in dealing with the sector should be made a criterion in their performance appraisal.

With increasing competition, introduction of new products and stringent regulatory environment, the role of banks needs to change from mere lenders to partners in business. There is a need for greater participation of banks in the affairs of their constituents by convergence of credit services and non credit services. The bank's staff should be trained and sensitised through customised training programmes to meet the diverse needs of MSEs such as knowledge of markets, both domestic and global, use of technology, etc. Banks should be actively providing advisory and planning services and in fact hand-holding their clients through the setting-up stage and such services should be extended to all regardless of the size of their turnover. The banks should not only provide differentiated products for MSMEs, but also provide counseling & guidance to new and established businesses, marketing support etc. In short, all banks, in fact, may develop innovative mechanism to provide not only finance and banking services to their MSME customers but also non credit related services to them under one roof at reasonable charges.

For creating transparency and wider dissemination of services provided by banks for their MSME clients, it was decided in the 12th Standing Advisory Committee on MSMEs that all SCBs should set up a SME Portal on their website, where they could put in all information/products of their bank for their MSE clients, as well as information on awareness programs etc organized by them. I am sure Central Bank of India and other banks would have taken a step in that direction.

In order to expedite sanction and disbursement of loan to MSMEs a single window concept could be provided by Central Bank of India, if not already done. Loan facility to small units, say Micro enterprises, should be sanctioned at the level of the branch. A Centralised Credit Processing Cell (CPC) for MSMEs could be introduced. These Cells may be utilized for single point appraisal, sanction, documentation, renewal and enhancement. The arrangement is expected to help in reduction in delay and multiple queries, utilization of the available talent in an optimal fashion besides building reliable MIS, developing fair practices and easier tracking. Initially, the CPCs may be set up at each Regional Office of the banks and subsequently in the recognized clusters. In case of micro and small enterprises simplified procedure of loan application/ sanction should be followed, score based lending be done up to Rs 2 crores, working capital limits be given by projected turnover method, and term loans be sanctioned as recommended above to prevent the burden of data collection, project report/ projections preparation for MSMEs. The disposal of applications should be done in a time bound manner, which should be within the overall time limit prescribed by RBI. All banks should tap the available technology and set up Central Registration of Loan Applications. The same set up can be used by the borrower for tracking of the status of application on the internet on the basis of the receipt issued to him. The borrower may also be provided option of tracking his application over telephone on the toll-free helpline. The same technological setup may also be used for making online applications. Online applications may be popularized and publicized by all branches.

Lack of adequate capacity is the key feature, as regards micro, small and medium enterprises are concerned. In order to equip the MSMEs with the capacity to manage their businesses effectively and efficiently comprehensive guidance and training on setting up new units as well as providing continuous education on different aspects of successful management of existing business enterprises must be provided. While the Rural Self Employment Training Institutes (RSETIs) are working in this direction there is a need to examine the impact of RSETIs. A scheme for utilizing NGOs to provide training services to tiny micro enterprises could be encouraged. Entrepreneurship development is important in view of its visible impact on wealth creation and employment generation. To facilitate and encourage this, skill building has been impressed upon by the Prime Minister's Task Force for MSMEs. Enterprise Development Centres (EDC) should be set up by the Central/State Governments with incubators to provide training not just for setting up of new units but also to provide continuing education on different aspects like product design, packaging, technology upgradation, financial management and marketing.

Role of associations

All SLBC Convenor banks have been to review their institutional arrangements for delivering credit to the MSME sector, especially in 388 clusters identified by United Nations Industrial Development Organisation (UNIDO) spread over 21 states in various parts of the country. The Central Bank of India has presence in 47 clusters identified by UNIDO and these branches have been designated as Specialised MSME Branch. The MSME Associations/Chambers may bring to the notice of SLBC Convenor banks clusters where banking facilities are not available so that the same could be addressed. Specific issues concerning the sector where banks could play a role should also be brought to the notice of the SLBC Convenor bank and the Empowered Committee on MSMEs by the Industry Associations for appropriate measures to be taken to solve the issues.

As any other sickness, the need for timely treatment after identification of sickness cannot be overemphasized in MSMEs. For viable units, timely and effective rehabilitation by way of renegotiations of terms of loans, induction of fresh dose of funds, business restructuring, change of management etc. may become necessary. The process should not only be quick, efficient, cheap and fair to all stakeholders but also acceptable to and implementable by all, with necessary monitoring arrangements for implementation of the same. In case the unit is not found viable, recovery of the dues of lenders through a fair, efficient and swift legal

mechanism should be the focus. The senior-level representatives of MSME Associations in each State are members of the Empowered Committee set up by RBI at each of its Regional Offices, of which the SLBC convenor, representatives of banks having predominant share in SME financing in the State, SIDBI, Director of Industries of the State Government etc. are also members. MSME Associations need to use this Forum not only for removing bottlenecks in the smooth flow of credit to the sector but also for reviewing the accessibility of bank finance to more and more MSMEs but also highlight gaps if any in the attitude and skills at the bank branch level. As it is observed that rehabilitation of sick micro, small and medium enterprises could not be taken up due to non-availability of promoters' contribution in a large number of cases, we have recommended to the GOI to set up a Rehabilitation Fund for rehabilitation of sick MSME enterprises.

The Industry Associations have often been representing on the delayed payments from large corporates. While banks have been advised to allocate a sub-limit in respect of large borrower accounts, for making payments to the MSE units against purchases from them but it is not possible for banks to force the large buyers to utilize the limit for making payments. This problem could be institutionally tackled by factoring. In the recent meeting of the Standing Advisory Committee to review credit flow to this sector, it was urged upon the Industry Associations to bring forward exemplary cases where big corporates have defaulted in making payments to MSE suppliers so that appropriate action, under the Act, could be taken by the Government of India.

The MSME Associations and Chambers of Commerce have an important role to play in stepping up credit to this segment. Asymmetry of information and lack of transparency and reliability of data has been a major concern for organizations dealing with MSMEs world over. The Association need to therefore, proactively engage themselves in organising workshops and training programmes for their members to enlighten them about cash flow cycles, various financial products, accounting practices, etc. In this regard, I would urge upon the other MSME Associations, Chambers of Commerce etc. to collaborate, in the same manner with banks, NIBM or any other training institute in the area of banking and finance, basic accountancy and information technology for MSMEs.

Role of MSMEs

MSEs too, on their part, should understand that banks are responsible to their depositors and shareholders and, therefore, they, i.e. the MSEs, as customers of bank credit, have certain obligations to fulfill by way of repaying bank loans, maintaining proper books of accounts, submitting information correctly and more importantly sharing information about financial problems when these arise so that they can work together with the bank in resolving these. On the cost of credit, while interest rates have been deregulated by Reserve Bank of India, my message to the MSME sector is that as interest costs are a very small fraction of their operating costs, only approximately 4%, do not ask for low interest rates from the banking sector, and instead ask for credit at competitive rates. Credit has to be self-liquidating on a viable project and has a cost.

In fact, what the small entrepreneurs need to focus on are four typical mistakes entrepreneurs make as rightly pointed out by Peter F. Drucker in his book "*Managing in the Next Society*". Many new businesses start out with high promise but suddenly run into trouble after a year or two. There are typical mistakes entrepreneurs make and all are foreseeable and avoidable. Firstly, majority of successful new inventions or products do not succeed in the market for which they were originally designed. So one has to keep options open and not be dogmatic about pushing a product in a market for which initially designed or targeted. Success may lie elsewhere. Secondly, entrepreneurs believe that profit is what matters most in a new enterprise. But profit is secondary. It is the cash flow that matters. A business that grows fast devours cash. Constant investments have to be made to just keep even. Thirdly, when a business grows, it is necessary to create a management team. Young entrepreneurs often cannot afford to bring in an external management team. So, it is necessary to identify

the core competencies of the people working with you. This planning should take place well in advance. Lastly, when the business is a success the entrepreneur needs to ask what the business needs at this stage and whether he is concentrating on the right things. As successful entrepreneurs, they have gained experience and wisdom from their mistakes and going forward, it is necessary to ensure that the same mistakes are not repeated.

E. Need for financial infrastructure

Establishing a solid financial infrastructure (credit registries/ bureaus, collateral, and insolvency regimes) should be a priority in the financial development agenda, as it can lower the costs and risks to financial institutions of serving MSMEs. Bankruptcy regimes regulate the efficient exiting of the market, and make the resolution of multiple creditors' conflicting claims more orderly, resulting in more extensive opportunities for recovery by both the bankrupt entity and its creditors. Stronger creditor rights improve access to finance. Stronger creditor rights tend to have a higher number of loan accounts per adult population and also higher rates of private credit to GDP.

There is a need for adequate and reliable credit information mechanism, such as an MSME credit bureau, that serves the needs of both the MSMEs' and the potential lenders'. Transparency shall facilitate them in obtaining finances, getting favourable contracts and improving their business prospects. A World Bank report stated that a good credit information infrastructure can contribute significantly towards assisting MSMEs' access to capital. The report further highlighted that small firms with access to credit bureaus have a 40% chance of obtaining a loan, whereas firms without access to credit bureaus have only a 28% chance of receiving a loan. Therefore, significant opportunities exist to increase lending activities to MSMEs with the establishment of MSME credit bureaus. A sound financial information infrastructure should improve transparency and disclosure for MSMEs in a cost-effective way, and help MSMEs build a credit history, which is critical in helping to address both challenges of information asymmetry and cost to serve. Setting of Credit Information Companies has already been approved by Reserve Bank of India.

F. Conclusion

The recent past has been a challenging time for the banking sector in India. You, along with the entrepreneurs, have coped well with these challenges and have emerged stronger from a difficult phase. While the banking sector has responded well so far, there are several challenges that lie ahead. Our banking system needs to equip itself to deal with emerging challenges and be prepared to cash in on the opportunities unleashed by higher growth. In dealing with the needs of small and medium enterprises, banks have to look for new delivery mechanisms. They must economise on transaction costs and provide better access to the currently under-served. To serve new rural credit needs, innovative channels for credit delivery will have to be found. The proud history of your bank should inspire you to seek greater heights of professional glory. In the end, I once again congratulate Central Bank of India and the SME Chamber in jointly organizing this Conclave. I also convey my best wishes to every employee and entrepreneur customer of your bank on the eve of the conclusion of your Centenary Year, to your customers and well-wishers, and wish you a great future of growth and development. You have had a glorious hundred years. You now have a great opportunity. May the next hundred be even better!