Special Study

on

Issues and Challenges in Access to Finance for MSMEs

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I. Executive Summary

Introduction: In the 56th meeting of the College Advisory Committee, the then Chairman, Shri S.S.Mundra suggested that CAB may conduct field studies and use the learnings to make the training programmes more effective. Accordingly, a qualitative exploratory study on the issues and challenges in financing MSMEs was carried out in the engineering clusters in Pune. The primary objective of this study was to identify and analyze the issues and challenges in financing MSMEs from the perspective of both the lenders and the entrepreneurs in Pune region with specific focus on engineering clusters. The study was conducted in two clusters viz., Sukhakarta General Engineering Cluster and Mahasainik Industrial Estate (MSIE), both located in Pimpri-Chinchwad Industrial Area, Pune. The study was conducted by interviewing the entrepreneurs of the clusters, bankers, and NBFC officials.

Choice of financial institutions by entrepreneurs: Interactions with entrepreneurs revealed their clear preference for loans from cooperative banks. The reasons cited by the entrepreneurs for the aforementioned preference include, (i) cooperative banks offered personalized attention and dedicated service to the micro and small entrepreneurs; and (ii) they were able to process their credit proposals in shorter time. Further, commercial banks appeared to be reluctant to lend to new entrepreneurs for want of past three years' income tax returns, financial statements, invoices, etc., even when they found the project/idea to be sound and commercially viable. Such entrepreneurs gravitated towards cooperative banks/credit societies and non-banks, in spite of higher interest rates.

Further, in the case of NBFCs, it was learnt that they approach customers and collect the required documents in one go. This enhanced customer experience. However, in the case of banks, customers had to make repeated visits to the branches for submission of the various documents. Most NBFCs rendered door-to-door service, which was greatly appreciated by customers as it enabled them to devote more time to their business operations rather than frequenting the branches of banks.

Loan Processing: The entrepreneurs reported that banks rejected loan proposals without making an entry in the Loan Proposal Tracking Systems in several cases and they accepted loan applications only when they saw a strong possibility of actually extending a loan. The entrepreneurs themselves were unaware of the option of the online portal for submitting loan applications and tracking the status. This highlighted the need for banks to sensitize their field level functionaries about desisting from outright rejection of loan applications, to ensure entering the loan proposal in the online portal, and to properly assess the viability of MSME proposals.

The entrepreneurs also reported the tendency of bankers to not communicate the reasons for rejection of loan proposals. However, they felt that such feedback is likely to help them to refine their business plans and proposals.

Complex documentation was reported as a major hurdle for entrepreneurs in accessing finance from banks. The entrepreneurs unanimously felt that for micro and small units, banks should devise simple application forms with minimum document requirements.

Under-financing: Instances of working capital underfinancing were also reported during the discussions with entrepreneurs in the clusters. Entrepreneurs narrated instances which indicated that banks provided less credit than required, thus forcing the entrepreneurs to meet the credit gap from NBFCs or even through informal sources (such as money lenders, credit societies or 'pat samstha').

Delay in payments to MSMEs: Despite the statutory stipulation that payments be made within 45 days by the corporate buyers to MSMEs, it was reported by MSMEs that they typically received payments from their buyers after 90 days. MSMEs were unaware about the statutory position. Even when they were made aware, they did not consider it prudent to press this issue as there was a risk of losing business from their corporate customers.

Bill discounting facility: Discussions with the entrepreneurs revealed that due to a mismatch between the credit period provided by their suppliers (of raw material) and credit period extended by MSMEs to their customers, a finance gap opens, which worked to their disadvantage. This gap was met through own funds/funds from other businesses rather than through bill discounting facility at banks. While a few entrepreneurs were aware of the bill discounting as an option to finance their invoices, none of them heard about the electronic bill discounting platform, TReDS, highlighting the need for cluster based financial literacy programmes by the various stakeholders.

Need for specialized branches: It was observed that MSME specialized branches of banks performed better than the normal branches in respect of dealing with applications, assessment of credit needs and credit delivery. They showed alacrity in dealing with the new entrepreneurs and seemed to possess entrepreneurial sensitivity. The branch manager's delegated powers for sanctioning loans were higher by about 25% in some MSME branches. This delegated power to MSME branches helped in avoiding unnecessary delay. In the case of NBFCs, despite their having centralized loan processing centers, turnaround time was actually shorter, due to reasons like focused attention, incentives to the field staff, etc.

Financial Awareness: Awareness about GoI/RBI policies relating to MSME and financial products offered by banks was rather low amongst the entrepreneurs. Many of the entrepreneurs were not aware of the following:

i. Banks are directed by RBI vide its circular that it shall not accept collateral security for loans less than ₹ 10 lakh;
ii. CGTMSE scheme, which envisages collateral free loans; and
iii. Alternative forms of financing such as P2P Lending, Venture Capital and Angel Finance

Up-skilling Human Resource: There appears to be no system of identifying the right person for the right job in so far as placement of bankers in MSME specialized branches was concerned. A few bankers indicated that they did not have the right skills set for appraisal of loan applications of MSMEs. They felt that it is necessary to post officials having right mindset for MSME lending.

Based on the analysis of above findings, the followings major suggestions have been made by the study.

i. There is a need to focus on financial literacy programmes for the MSMEs entrepreneurs covering the various financial products, processes and institutions, preferably using a cluster approach.

ii. There is a need to encourage role of institutions such as NBFCs, co-operative banks, and small banks in lending to MSMEs.

iii. It is necessary for banks to understand the needs of entrepreneurs and provide the required handholding support to them, by setting up more specialized MSME branches with skilled manpower and right aptitude.

iv. Banks need to sensitize their field level functionaries to desist from rejecting applications outright without thorough analysis to ascertain the viability of the proposals.

v. Bank controllers need to ensure that the bank branches adhere to the extant regulatory guidelines, including acknowledging the loan applications and processing as per the prescribed time-norms.

vi. In respect of micro and small units, banks should devise simple application forms with minimum document requirements and the services of Certified Credit Counsellors can also be utilized for this purpose.

vii. Banks need to shift their focus to cash flow based lending rather than insisting only on the collateral security, by developing alternative methods of credit appraisal for at least the first time entrepreneurs.

viii. The study highlights the non-adherence of banks to the guidelines relating to CGTMSE. There is a need to ensure that banks do not accept collateral for loans up to ₹ 10 lakh.

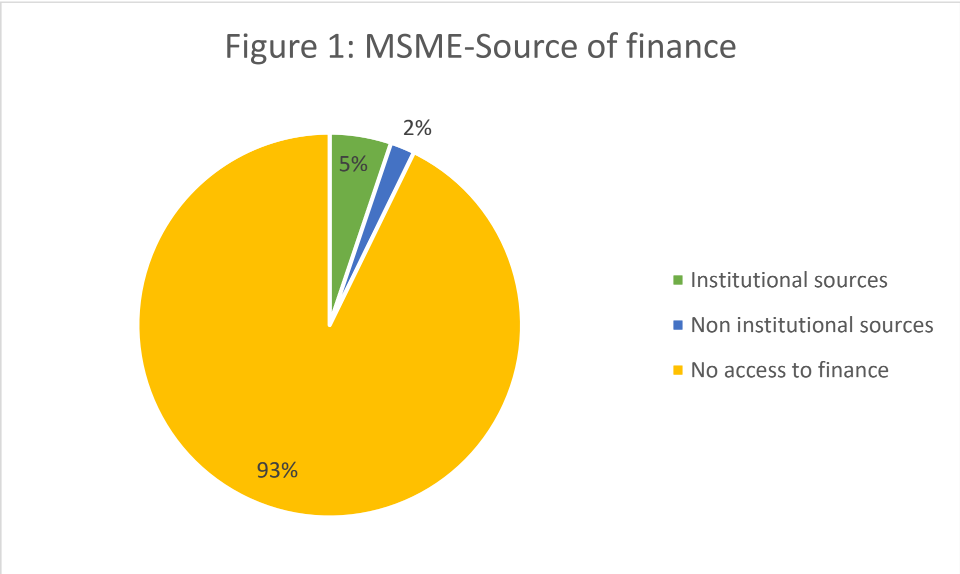
ix. The study findings highlighted the cases of under-financing by banks in several cases.

x. Trainings such as NAMCABs can go a long way in sensitizing branch managers and their field-level officers for a more positive mindset towards MSME lending.

xi. Awareness about CGTMSE, Small Finance Banks, Bill discounting facility (either through own bank, or through TReDS), need to be created by way of adequate credit counselling and financial literacy programs.

II. Introduction

The micro, small and medium enterprises (MSME) sector constitutes an important segment of the Indian economy. As per the estimates of Fourth All-India Census of MSMEs, the number of such enterprises is estimated to be about 26 million, providing employment to an estimated 60 million persons. The MSME sector is estimated to contribute about 45 per cent of the total manufactured output and nearly 40 per cent of the country's exports. While one end of the MSME spectrum comprises highly innovative and high-growth enterprises, more than 90 per cent of the MSMEs are small and unregistered, with a large number of them concentrated in the unorganized sector. The Census revealed that only 5.18 per cent of the units (both registered and unregistered) had availed of finance from institutional sources, 2.05 per cent units availed finance from non-institutional sources, and 92.77 per cent of the units had no access to external finance, i.e. they depended wholly on self-finance (Fig. 1).



Source: Fourth All-India Census of MSMEs

2. The above data suggests that the credit flow to MSMEs from the institutional sources may not be commensurate with the credit needs of the sector. Indian MSMEs, especially the micro and small enterprises, are a diverse and heterogeneous group but in a broad sense, they face a common set of problems. Lack of access to adequate and timely credit, limited market access, and lack of modern technology and quality control, to name a few, are problems which the sector is facing.

Industrial Scenario of Pune

3. Pune is the second largest city in the state of Maharashtra. The geographical area of Pune district comprises 5.09 per cent of the area of Maharashtra. The district is well connected by road, rail and air to all important cities in the country. The IT industry is developing very fast in and around Pune city. As per the MSME Development Institute, Mumbai[1], Pune had a total of 27,683 MSMEs as on July 2012. Out of total MSMEs, 78.6 per cent units were micro units, followed by 21 per cent in small and 0.4 per cent units in medium category.

Sr. No.	Category	Number of enterprises (Cumulative since inception up to the end of reporting month July 2012)		
		Manufacturing	Service	Total
1	Micro	19907	1856	21763
2	Small	5045	773	5818
3	Medium	84	18	102
4	Total	25036	2647	27683

4. Pune is a hub of the auto industry, with presence of major automobile companies like Tata, Volkswagen, Mahindra, Bajaj and Mercedes Benz. Consequently, a large group of auto ancillaries catering to the auto majors is also present here. The Industrial township of Pimpri Chinchwad, has developed into a major automobile centre. It is estimated that over 4,000 MSME units[2] are

[1] http://dcmsme.gov.in/dips/IPS%20Pune%20New.pdf

[2] http://indianexpress.com/article/cities/pune/union-budget-2018-push-for-msme-sector-draws-mixed-reaction-5048437/ - *Union Budget 2018: Push for Micro Small and Medium Enterprise sector draws mixed reaction*

based in the industrial area of Pimpri Chinchwad, employing over four lakh people. Around 90 per cent of Small and Medium enterprises in the manufacturing sector in Pune are in the automobile sector

5. In the Union Budget for 2018-19, Government of India (GOI) has announced higher custom duty of 15 per cent (increased from 7 per cent) on auto components. The move is likely to help auto ancillary industries, as automobile companies may shift towards local procurement and reducing their dependence on imports.

III. Objectives of the Study

Keeping in view the issues being faced by MSMEs in general and the auto ancillaries industry in Pune region in particular, a study was conducted in two auto clusters viz., Sukhakarta General Engineering Cluster and Mahasainik Industrial Estate (MSIE), both located in Pimpri-Chinchwad industrial area of Pune during February 2018 with the following objectives.

Objectives of the study

1. To identify and critically analyze major issues and challenges in accessing bank finance for MSMEs from the perspective of entrepreneurs.
2. To identify the measures to overcome the constraints faced by the bankers in lending to MSMEs.

IV. Scope of the Study

There can be two perspectives in respect of the challenges in financing MSMEs, viz., perspective of entrepreneurs and of bankers. The information asymmetry that exists between MSMEs and lending institutions is known to be a significant barrier in financing MSMEs. Non-availability of reliable financial and legal information about the MSMEs, such as credit history, financial statements, total leverage of the company, etc. contributes to the information asymmetry. Non-adherence to accounting standards, scanty records of payment behavior are other sources of information asymmetry. Banks, therefore, find it hard to assess the viability and bankability of such enterprises. Further, it also results in risk getting overestimated as a result of which higher interest costs are factored while sanctioning loans. From the perspective of borrowers, there are many issues and challenges faced by them in accessing mainstream institutional credit, viz., delay in processing the loan applications, not adhering to the banks' internal and regulatory guidelines and lack of empathy on the part of banks towards to MSMEs borrowers. The study elicited responses from both entrepreneurs and bankers to understand their perspectives, the factors that shaped their perspectives and the possible expectations from both the sides to address such factors.

V. Methodology of the Study

As part of the study, data was collected from both primary and secondary sources. Primary data was collected by visiting the entrepreneurs and bankers in the two auto cluster in Pimpri-Chinchwad area of Pune district selected for the study. The information was gathered from entrepreneurs and bankers by interviewing and interacting with them. Questionnaires for the purpose of interacting with the entrepreneurs and bankers are attached as Annex 1 and 2 respectively. Secondary data was based on information published by RBI, NABARD, SIDBI, Ministry of MSME etc.

A brief of the Clusters taken up for the study

The Group visited the entrepreneurs in the following two clusters and the bankers working in the region in order to ascertain the challenges for MSMEs in accessing bank finance.

1. Sukhakarta General Engineering Cluster, Akurdi Chowk, Pimpri-Chinchwad, Pune
2. Mahasainik Industrial Estate (MSIE), Pimpri Industrial Area, Bhosari, Pune

Sukhakarta General Engineering Cluster is located on the outskirts of Pune, near Akurdi Chowk in Pimpri-Chinchwad. It is in the vicinity of some large automobile companies' factories (e.g. Bajaj Auto, Tata Motors, Mahindra Auto, Etc.). This industrial cluster houses a Common Facility Centre (CFC), with the following facilities:

a. Material Testing Lab, accredited by the NABL (National Accreditation Board for Testing and Calibration Laboratories)
b. 3D 5 Axis laser Cutting Machine
c. Horizontal Machining Centre
d. Turn-Mill Centre

e. Sliding Head
f. Coordinate Measuring Machine (CMM)

The total investment in plant and machinery is ₹ 25 crore, out of which Govt. of India has given a grant of ₹13 crore. The land has been taken on lease for a period of 15 years at market rates. There are 75 enterprises which are members of the cluster, but the facilities can be availed by other enterprises also.

Mahasainik Industrial Estate (MSIE) industrial/engineering cluster is located in Pimpri Industrial Area, Bhosari, on the outskirts of Pune. Membership of the cluster is limited to ex-servicemen, wife/son/daughter of defence personnel who died in service, ex-servicemen who suffered from disability/injury while in service, disabled ex-servicemen, or widows and children of ex-servicemen. Altogether, there are presently 30 enterprises which are members of the cluster.

The land (2.5 acres) has been taken on lease for a period of 15 years at market rates, i.e. the land has not been made available to the industrial estate at concessional rates. A flatted factory complex[3] has been made with three floors in all – ground floor (40 units), first floor (40 units) and second floor (40 units). The 'galas' (or individual units meant to house enterprises) range from area of 524 sq. ft. to 995 sq. ft. The plant and machinery (common facility) available at the estate are:

a. Lathe – VMC and CNC
b. Milling and Drilling Machines
c. Surface Grinding Machine
d. Cylindrical Grinding Machine
e. Power Press
f. Welding Machine

[3] Flatted Factory Complex refers to a structure in which the building consists of apartments which are optimized for running enterprises, mainly manufacturing enterprises. It is analogous to residential apartment blocks, with the difference that the individual apartments are meant to house enterprises. The insides of the apartments are designed differently to enable the installation of machinery, keeping of stock-in-process, etc.

g. Metrology and Metallurgy Equipment

Other common facilities in the cluster include: telecom centre, documentation centre, cyber centre, conference hall, exhibition centre, raw material storage facility, marketing outlet, first aid centre and canteen facility. There is also provision for a technicians' training centre and arrangement for stay of the trainees.

VI. Observations of the Study

The information collected during the exploratory study is presented from the perspectives of a) Entrepreneur and b) banks and other lending institutions as under:

A. Entrepreneurs' Perspective

i. Access to different financial institutions in the clusters

It was observed that entrepreneurs in the clusters studied had access to a variety of financial institutions operating in the vicinity. These included commercial banks, cooperative banks, Non-Banking Financial Companies (NBFCs) and cooperative societies. A number of NBFCs had a very strong presence in the region thus complementing the commercial banks and cooperative banks, especially in lending for machinery and equipment needs of the entrepreneurs.

Small finance banks were not present in the region and many entrepreneurs were either unaware or reluctant to bank with them. They were comfortable with the idea of working with nationalized banks or cooperative banks but did not want to experiment with the new differentiated banks. Other forms of financing such as P2P Lending, Venture Capital or Angel Finance were not evident. This might have prevented innovative enterprise ideas from getting finance when banks' risk appetites prevented them from financing certain projects.

ii. Entrepreneurs' preference for financial institutions

In addition to cost of loans, two other key factors that determine entrepreneurs' choice of financial service providers in the clusters were; (i) **ease of operation and (ii) quality of service**. It was observed that many entrepreneurs preferred cooperative banks to other mainstream financial service providers like public and private sector banks because of ease of access i.e., proximity to their units.

Further, the cooperative banks offered dedicated relationship managers for MSME entrepreneurs which resulted in quicker processing, limited paperwork and personalized services to the entrepreneurs.

NBFCs followed the practice of collecting all required documents from the entrepreneurs in one go. This led to great ease and enhanced customer experience. On the other hand, in the case of commercial banks, the customers were sometimes required to approach banks multiple times for submission of the various documents. Most NBFCs rendered door-to-door service, which enabled customers to devote their time and energy to business operations rather than frequenting bank branches.

iii. First time entrepreneurs – challenges in financial access

Interactions with a few new entrepreneurs in the clusters revealed the enormous challenges faced by them in accessing bank finance, irrespective of the fact that their vision and ideas were commercially viable and credit-worthy. In fact, such entrepreneurs avoided approaching banks as they were not in a position to provide collateral and furnish relevant documents demanded by banks. Those who had tried to get bank loans stated that the banks were invariably insisting on collateral security for even loans as small as ₹ 5 lakh and that banks asked them to submit other documents like three years' audited balance sheets and income tax returns. As most new entrepreneurs did not have collateral or the financial documents demanded by banks, their loan applications were not accepted. They had, therefore, obtained costlier loans from informal sources to continue their entrepreneurship ventures.

Case Study

One of the specific cases which was studied was about a firm which was in the business of manufacturing precision engineering equipment. The entrepreneur wanted to acquire machinery (for making precision tools) costing around ₹8 lakh but banks demanded collateral security and 35% margin money. Further, banks insisted for income tax returns for the last three years. The entrepreneur could not comply with the above requirements since his enterprise was recently established. He also needed working capital facility of ₹ 2 lakh. However, CC facility was not sanctioned by the banks. Since its inception, the firm routed all its transactions through a Public Sector Bank, still the entrepreneur could not avail any loan from the bank. Incidentally, this entrepreneur was not aware of the facility of online submission of loan application or any form of seeking institutional finance other than approaching his bank branch.

In another case, a firm which was into plastic and rubber moulding work was in need of ₹ 22 Lakh for purchasing machinery. The firm's banker did not sanction the loan for want of documents like income tax returns for the past 3 years, which the firm could not produce since it was a new firm. The entrepreneur was not aware of any other means of institutional finance or the bills discounting system.

iv. Cost of credit

Rate of interest: Interactions with the entrepreneurs reconfirmed an established view that availability of timely credit at an affordable cost is a critical requirement for the survival of MSMEs. As regards cost of credit, most banks were charging approximately 11%, while institutions like NBFCs charged around 13%. Further, many NBFCs gave 1% discount to borrowers if all their instalments were paid on time, effectively bringing them at par with the banks. Interestingly, leading asset financing NBFCs, which are active in the area, charged lower interest rates (on an average, 1% lower than cooperative banks). In fact, only NBFCs had extended loans for the purchase of land. Entrepreneurs who were unable to get loans from formal sources ended up availing finance from informal sources but this raised their cost of borrowing to over 20% and also made them vulnerable to strong-arm recovery tactics if they defaulted.

Impact of interest rate on profit margin: Another observation was that many vendors supplied components under contracted prices to the corporate customers, but they had to bear the brunt of volatility in raw material prices. Resultantly, several units did only job work using the raw materials supplied by the corporates, to avoid the volatility in the raw material.

Onerous Requirements: Another problem reported by the entrepreneurs about borrowing from banks was the onerous requirements imposed by them on entrepreneurs. In one case, the borrower who took a loan of ₹80 lakh had to give ₹ 1 crore worth of property as collateral. And in addition, expenses for creating mortgage to the tune of ₹30,000/- was recovered by the bank. These requirements are perceived as onerous by entrepreneurs and appeared to be an important factor driving them towards non-institutional sources of finance.

v. Adequacy of credit

Under-financing: Instances of working capital underfinancing were also reported during the discussions with the entrepreneurs in the clusters. There were a few cases where the entrepreneurs revealed that banks had a tendency to provide less credit than required thus forcing the entrepreneurs to meet the financing gap from NBFCs or even from informal sources.

A classic case noticed during the study was about an entrepreneur dealing in laser cutting solutions for the past 17 years, a type of service availed by industrial customers. He was quite well established with an annual turnover of ₹ 35 crore, of which ₹7-8 crore came from exports to countries such as USA and Argentina. His major customers were Tata Motors. Hyundai, JCB, Suzlon, etc. He had installed a laser cutting machines unit, with an investment of around ₹7-8 crore. For working capital purposes, he had initially taken CC facility from a public sector bank. For a CC limit of ₹ 75-80 lakh, he had to keep property (flat) worth ₹1 crore as collateral. The bank did not inform him about or offer him the CGTMSE facility, which could have given some relief to him. Dissatisfied with the quality of service, he switched to a co-operative bank. As his level of activity grew further, he needed additional working capital limit and as his bank could not meet the requirement, he obtained personal loan from an NBFC at 18% rate of interest to meet the shortfall in working capital.

vi. Delayed payments

Delayed payments have been a grave concern for MSMEs in managing their cash flows. In terms of Section 15 read with section 16 of MSMED Act, 2006, the buyers are required to make their payment within a maximum period of 45 days and in case of failure to make payment, the buyer is liable to pay compound interest, with monthly rests, to the supplier on that amount from the appointed day or, as the case maybe, from the date immediately following the date agreed upon, at three times of the bank rate notified by RBI. MSMEs informed during the study that they received payments from their buyers after 90 days. MSMEs were unaware about the aforesaid legal provision. Delay in payments affects cash flow to MSMEs and also negatively impacts their ability to process other orders. Even after they were made aware, they did not think it prudent to exercise this option as there was a risk of losing business opportunities from the large corporates.

vii. Collateral Requirement

RBI has mandated banks not to take collateral security in the case of loans up to ₹10 lakh extended to MSE units. However, the banks located in the cluster reportedly insisted on collateral security. While interacting with one of the public sector banks, it was observed that due to high NPA level, they were not keen on extending fresh loans nor they were keen on extending collateral free loans to MSMEs. On the other hand, instead of insisting on collaterals, NBFCs used alternate methods of credit appraisal. For example, amongst various parameters, they awarded higher credit scoring for parameters like experience of the promoter, promoters understanding of the market, presence of assured market, etc., and the NBFCs took the first work order as a guarantee for the loan. In some start-ups, the NBFCs relied on the credentials of the partners of promoters. Thus, with the help of innovative methods of credit appraisal ably supported by a strong monitoring mechanism, they were successful in creating a niche for themselves. Borrowers who were denied a loan from banks due to non-availability of collateral were able to obtain loan from NBFCs.

viii. Awareness of Entrepreneurs regarding financial products

The awareness of the entrepreneurs interviewed about MSME policies and relevant financing products was rather low. Many of the entrepreneurs were not aware of the fact that banks were mandated not to insist on collateral security for loans less than ₹ 10 lakh. Awareness about CGTMSE scheme was also low in the clusters.

Though the discussions revealed an adverse mismatch between the credit period provided by raw material suppliers and credit period extended by MSMEs to their customers, it was observed that the entrepreneurs were meeting the gap by way of own funds/funds from other businesses instead of availing the bill discounting facility. While a few of them were aware of bill discounting as an option to finance their invoices, none of them have heard about the electronic bill discounting platform, TReDS, which could have been very beneficial to meet the financing requirements of entrepreneurs in the clusters.

ix. Specialised MSME branches

The study revealed that the MSME specialised branches of banks performed better than the normal branches in respect of dealing with applications, assessment of credit needs and credit delivery norms. They showed alacrity in dealing with the new entrepreneurs and seemed to possess entrepreneurial sensitivity. It was observed that the presence of specialized MSME branches in the clusters helped in addressing the concerns of MSME borrowers.

However, it was observed that the perspective and experience of these specialised MSME branches was not being shared with MSME entrepreneurs in a significant way on issues such as financial products and options for MSMEs, CGTMSE, different aspects of efficiently running small enterprises, etc.

B. Lenders' Perspective

i. Sourcing of MSME Customers

Banks and other financial institutions in the cluster used Agents and Channel Partners for sourcing the customers. These agents work on commission-basis and they could simultaneously work for many other banks/FIs. However, underwriting/assessment was being done internally by the staff of banks/FIs, who were mostly Chartered Accountants. Some of the customers were also acquired through balance transfer from other banks/NBFCs by offering competitive interest rates. While sourcing of loans, public sector banks had an advantage in the sector as its interest rates were very competitive in the market. Another reason is that many customers had to submit Bank Guarantees (BGs) to their large corporate buyers[4] and BGs from PSB were preferred by those corporates.

Asset financing NBFCs acquired customers primarily in two ways. The loans were either sourced by sales team in the field or they financed the MSMEs who procured machinery from original equipment manufacturers (OEMs) for their business purposes. In this approach, the NBFCs had a holistic expertise of the market by working closely with the manufacturers of these machineries and the buyer MSMEs. Illustratively, health care market was a part of Siemens ecosystem and the Siemens Financial Services (SFS) knew every OEMs in this field and approached them for financing their MSME buyers. NBFCs tracked each and every asset financed by them. Some of the important factors considered by them were are under.

i. Who are the suppliers?

ii. What is the value addition being done by the borrower?

iii. What is the position on technological obsolescence of the asset?

iv. What is the level of technical capacity required to handle the assets?

In case a customer was unrealistic and applied for more than required credit, NBFCs analysed the actual requirement and guided the borrower to understand his/her actual requirement and advised suitably. These NBFCs approached the customers as partners in business and closely worked with them to understand their needs and requirements. While banks insisted on collateral security, NBFCs rather based their credit decisions on whether the MSMEs had the potential to generate cash flows and repay the loans.

ii. Appraisal of loans

The banks, while considering the loan proposals relied on the project proposals, the prospects of sales and revenue generation, and the bank's own knowledge

[4] Most customers were vendors of marquee names such as Tata Motors, Mahindra and Bosch, etc.

about the activity through a study of the market. However, emphasis remained focussed on the availability of adequate security. In a few cases, it was also observed that loans were given on the basis of cash flows of the business. For example, in the case of an ex-serviceman who set up a pets' park at Wagholi on the outskirts of Pune, the equipment installed at the facility was taken as the primary security for the loan. Given the unusual nature of the business, it was very unlikely that the equipment could be sold at a good price in case the account turned NPA. However, what helped the bank to decide was the prospects of revenue generation, the business model, the level of knowledge and commitment of the entrepreneur.

It was observed that one of the banks took initiative in dealing with loan processing by having a tie-up with a few non-profit agencies in Pune for guidance and handholding of MSME entrepreneurs. However, these NGOs did not have pan-India presence, which was a limitation for enterprises outside Pune region.

In the absence of financial information, the NBFCs relied on their understanding of the nature of the business and the character of the potential borrower. They followed a scorecard model which used both qualitative and quantitative data family income, years in business, household assets, regularity in payments for public utilities, etc. As most of these NBFCs did asset-based lending, they focused on end-use monitoring. They assessed feasibility and viability of the loan, revenue generation potential as a mechanism of calculating debt server capability of customers.

iii. Higher delegated powers for MSME branch managers

The branch manager's delegated powers were higher in several MSME specialised branches, by about 25%, compared to officers in similar grade in non-SME branches. This delegation of power in favour of MSME branches helped in reducing the turnaround time and unnecessary delay. On the other hand, the banks which did not have such delegated power referred the loan proposals beyond a particular threshold to a central unit for processing, which resulted in delay in some cases.

Though the NBFCs had a centralized loan processing centres, they were operating with less turnaround time due to reasons like focused attention, suitable incentives to the field staff, etc.

iv. Challenges in CGTMSE coverage

As per the CGTMSE scheme, lending institution were required to closely monitor the borrower accounts. The banks informed that their branches meticulously followed the time-lines for various steps as stipulated by CGTMSE and received the first tranche (75%) of the guaranteed amount on time. However, this amount had to be parked by them in Suspense Account and could not be adjusted against the outstanding in the defaulting account till the concerned legal case reached conclusion. Banks expressed their concern that though the amount was received, the same remained unutilised till the final conclusion of the legal case.

Though NBFCs were now eligible for coverage under CGTMSE scheme, the awareness about the scheme was much lower and hence the customers of NBFCs were unable to derive benefit of collateral free loans.

v. NPAs and its impact on lending by banks

In case of a few banks operating in the cluster, a high incidence of NPAs had a negative impact on fresh lending. The branch level officials concentrated on recovery and not enough on sourcing new customers. As the threshold level of risk acceptance went up, only a few proposals were sanctioned.

VII. Limitations of the Study

The study was carried out on the basis of qualitative exploratory interview method, which has its own inherent limitations. The study was carried out in only engineering clusters in Pune region and hence the findings may not be generalized for all MSMEs.

VIII. Findings

1. While interviewing the entrepreneurs, it was observed that almost 90% of the entrepreneurs in the cluster had financing relationship with cooperative banks even though a commercial bank branch was closer to their units. The key reasons stated by them were that the cooperative banks offered personalised attention and dedicated service to the entrepreneurs running small enterprises and were able to process their credit demands in shorter time and their location was close to where the MSMEs were based, indicating ease of banking.

2. First time entrepreneurs found it challenging to access finance from commercial banks. Banks were reluctant to lend to new entrepreneurs for want of past three years income tax returns, balance sheet, invoice, etc., irrespective of whether the project/idea was commercially viable or not. Such entrepreneurs gravitated towards cooperative banks/credit societies and non-banks, where processes were reportedly easier and processing was faster, despite higher interest rates in most cases.

3. The branch managers working in SME specialized branches of PSBs were delegated with higher powers resulting in significantly less processing time in loan processing. This coupled with relatively lower interest rates of PSBs created a feel-good factor to some entrepreneurs dealing with such specialized MSME branches.

4. The entrepreneurs informed that the banks accepted the loan application only if they were comfortable in sanctioning the loan. The entrepreneurs were not aware of the option of an online portal for submitting applications, where the question of not accepting the application does not arise.

5. The entrepreneurs also complained that the bankers did not communicate the reasons for rejections of their applications and if the bankers did so, it would have helped the MSMEs to rework on the application and resubmit.

6. Complex documentation was reported as a major hurdle for entrepreneurs accessing the banking facilities.

7. RBI mandate to banks to not accept collateral security in the case of loans up to ₹10 lakh extended to units in the micro and small segments was reportedly not being adhered to in a few cases. The entrepreneurs informed that banks were insisting on collateral security for loans as small as ₹ 5 lakh. In the absence of collateral and other documents like three years audited balance sheet, income tax returns, etc., these entrepreneurs had to rely on money lenders to start their first entrepreneurial venture.

8. Delayed payments was reported as a grave concern for MSMEs in managing their cash flows. Though there is a statutory requirement for payments to MSMEs within 45 days, MSMEs informed during the study that they received payment from their buyers after 90 days. MSMEs were unaware about this statutory requirement. Even when they were made aware, they did not consider it prudent to exercise this option as there was a risk perception of losing business opportunities from the large corporates.

9. Some of the bankers indicated that due to high levels of NPA, their focus was more on recovery than on-boarding new customers.

10. Small Finance Banks were yet to make their presence felt in the industrial MSME segments in the Pune region. However, NBFCs had strong presence, particularly in term-lending for machinery and equipment. NBFCs also provided unsecured business loans which could be used for working capital or any other business purposes.

11. MSMEs in this area were facing constraints in obtaining adequate finance, particularly in terms of their ability to convert their trade receivables into liquid funds. There was a lack of awareness regarding the beneficial financial products, which banks could offer to meet their financing needs. One such product was bill discounting. Although bill discounting was not currently a popular product in this cluster, there is great potential for this product as it would enable MSMEs to effectively manage their cash flows. It was also

observed that neither the MSMEs nor the bankers in the region were aware about the TReDS platforms[5].

12. It was observed that the means of financing other than bank loans or NBFC loans, such as P2P lending, crowd funding, venture capital or angel finance were not evident. This prevented innovative enterprise ideas from getting finance when banks' risk appetites might have prevented them from financing certain projects. Further, awareness about P2P platforms[6], which provide a bidding platform that helps in rate discovery of individual loans, was not observed.

13. The entrepreneurs in the cluster were generally unaware of CGTMSE. It was informed that the banks had insisted on collateral security and did not give any information about the role of Credit Guarantee Schemes in facilitating collateral free credit to the MSMEs. As regards reliance on collateral security, banks appeared to have been over-reliant on the same, thus missing out on good opportunities in lending to MSMEs in the competition with NBFCs as the latter were able to extend credit based on primary security and alternate credit appraisal methods.

14. The NPAs of NBFCs were very low (less than 2%) as they reportedly had more robust alternate credit appraisal systems suited for the MSMEs and strong monitoring mechanism. They were also reportedly better able to identify the potential will-full defaulters.

15. Banks were hampered by the lack of knowledge about the nature of the cluster/industry/sector and the challenges faced by MSMEs during different

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[5] The scheme for setting up and operating the institutional mechanism for facilitating the financing of trade receivables of MSMEs from corporate buyers through multiple financiers will be known as Trade Receivables Discounting System (TReDS).The TReDS will facilitate the discounting of both invoices as well as bills of exchange. Further, as the underlying entities are the same (MSMEs and corporate buyers) the TReDS could deal with both receivables factoring as well as reverse factoring so that higher transaction volumes come into the system and facilitate in better pricing. RXIL, Invoicemart etc. are some of the platforms which are licensed to discount bills.

[6] It is a P2P lending marketplace where creditworthy borrowers and lenders are aggregated. *Faircent* empowers the borrower by having a transparent rate discovery model and enables them to reduce interest rate through a unique reverse auction model.

stages of their life cycle. NBFCs seemed to have a better understanding about the industry/cluster and their life cycle needs.

16. Bankers informed that small businesses, when making profit, parked the funds in purchasing land and property rather than using them to augment their business. The lack of business acumen coupled with poor book keeping and accounting habits placed them in a vulnerable position while securing credit from banks.

17. A few bankers indicated that they did not have the right skills set for appraisal of loan applications by the MSMEs. Recruitment of right kind of staff for right jobs, their training, posting, mind-set and staff accountability are important issues highlighted by them.

18. To ensure timely credit, which is a critical element in MSME financing, bankers felt that it was necessary to ensure that banks put in place efficient processes and equip MSME lending function with skilled and adequate manpower to reduce the processing time.

IX. Suggestions

1. The study highlights the substantial need to focus on financial literacy for the MSMEs entrepreneurs covering the various financial products, processes and institutions, CGTMSE and other market instruments such as TReDS. The credit counselling scheme operationalized by SIDBI may be utilised to create the necessary awareness.

2. The study highlights the role of institutions such as NBFCs, co-operative banks, and small banks in lending to MSMEs due to their faster and customer oriented processes, thus suggesting the need to encourage their role in lending to MSMEs.

3. It is important that the banks understand the entrepreneur's business and guide the entrepreneur to ensure that the MSMEs are not stressed. It is also important that a realistic assessment is made regarding MSMEs' eligibility for loans and communicate their realistic concerns. Therefore, it is necessary for the banks to understand the needs of entrepreneurs and provide the required handholding support to them. This function could be ably performed by setting up more specialized MSME branches with skilled manpower.

4. It may be necessary for banks to sensitize their field level functionaries to desist from rejecting applications outright without thorough analysis to ascertain the viability of the activities proposed by the entrepreneurs. The study findings highlight the need for ensuring that the bank branches adhere to the extant regulatory guidelines, including acknowledging the loan applications and processing as per the prescribed time-norms. Controllers of banks need to be sensitized to undertake this function effectively.

5. In respect of micro and small units, the banks should devise simple application forms with minimum document requirements. The check list of documents required should be invariably supplied to the applicants so that they are not made to visit the branch multiple times. Services of Certified Credit Counsellors can also be utilized for this purpose.

6. It is necessary for banks to concentrate on the genuine business proposals by assessing the cash flows rather than insisting only on the collateral

security. After all, repayment of loan is going to be out of the inflows generated from business activity of the borrower and not the security. Banks may, therefore, develop effective alternative methods of credit appraisal for at least the first time entrepreneurs, who are not in a position to offer collaterals.

7. The study highlights the non-adherence of banks to the guidelines relating to CGTMSE. There is a need to ensure that banks do not accept collateral for loans up to ₹ 10 lakh.

8. The study findings highlighted the cases of under-financing by banks in several cases thereby forcing the entrepreneurs to approach informal sources for the credit gap. This highlights the need for banks to ensure adequate credit support to MSMEs as per their business requirement.

9. The need for banks to change their perspective from that of being just a lender to that of being a strategic business partner has also been highlighted by the study. They need to establish long-term relationships with those MSMEs that have the potential to be successful.

10. The need for banks to adopt a positive attitude towards first time entrepreneurs was also highlighted, without being prejudiced by the incidences of NPAs in MSME advances elsewhere.

11. MSME entrepreneurs sometimes fail to get access to bank finance due to failed communication between bankers and themselves. Training such as NAMCABs can go a long way in sensitizing branch managers and their field-level officers for a more positive mindset towards MSME lending. To this effect, it may be advantageous to continue with the NAMCABS programmes being organized by RBI for the banking fraternity in industrial pockets all over the country.

12. Awareness about CGTMSE, Small Finance Banks, Bill discounting facility (either through own bank, or through TReDS), need to be created by way of adequate credit counselling and financial literacy programs.

Annex 1

Exploratory Study - Questionnaire For Entrepreneurs						
No	**Queries**	**Details**				
1	**Name of the Unit**					
2	**Year of Establishment/Registration**					
3	**Form of Organization**☐ Sole Prop. ☐ Family Owned Bus. ☐ Partnership ☐LLP ☐Company ☐Others					
4	**Address of Enterprise**					
5	**Type of Activity**	☐Service ☐ Manufacturing				
6	**Investment in Plant and Machinery** ☐Up to 25 Lakhs ☐ > 25 Lakhs to 5 Crore ☐ > 5 Crore to 10 Crore					
7	**Financing Profile (in Lakhs of rupees)**					
	I. Sources of funds/investment	**Banks**	**NBFCs**	**Other institutional**	**Informal Sources**	
	Amount					
	II. Type of financing	**Banks**	**NBFCs**	**Other institutional**	**Informal Sources**	
i)	**Working Capital (Amount in Rs. Lakhs)**					
	a) Requested by the Unit					
	b) Sanctioned					
	c) Time taken for Sanction					
	d) Reasons for lesser sanction, if any					
ii)	**Term Loan (Amount in Rs. Lakhs)**					
	a) Requested by unit					
	b) Sanctioned					
	c) Time taken for Sanction					
	d) Reasons for lesser sanction, if any					
iii)	Non Fund based facilities					

iv)	Any other financial facilities					
	a) TREDS					
	b) Others					
8	**Security**					
i)	**Primary Security offered**					
ii)	**Collateral Security offered**					
iii)	**Credit Guarantee availed**					
9	**Any Govt Subsidy availed**					
	Whether registered on Udyog Aadhaar					
	Whether registered on Udyamimitra					
10	**Raw material**					
	a) Holding period for raw material					
	b) Stock in progress					
	c) Credit period given by supplier					
11	**Finished Goods**					
	a) Holding period of finished goods					
	b) outstanding amount payable					
12	**Operations**					
	a) What operations are undertaken					
	b) What is the time taken for process					
	c) How much time the goods are in process					
13	**Sales**					
	a) Customer profile					
	b) Credit period given to buyers					
	c) Account receivables					

Annex 2

Exploratory Study - Questionnaire For Bankers		
No	**Queries**	**Details**
1	**Name of the Unit financed**	
2	**Form of Organization**☐ Sole Prop. ☐ Family Owned Bus. ☐ Partnership ☐LLP ☐Company ☐Others	
3	**Address of Enterprise**	
4	**Type of Activity**	☐Service ☐ Manufacturing
5	**Investment in Plant and Machinery** ☐Up to 25 Lakhs ☐ > 25 Lakhs to 5 Crore ☐ > 5 Crore to 10 Crore	
6	**Financing Profile (in millions of rupees)**	
i)	**Working Capital (Amount in Rs. Million)**	
	a) Requested by the Unit	
	b) Sanctioned	
	c) Time taken for Sanction	
	d) Reasons for lesser/delayed sanction, if any	
ii)	**Term Loan (Amount in Rs. Million)**	
	a) Requested by unit	
	b) Sanctioned	
	c) Time taken for Sanction	
	d) Reasons for lesser/delayed sanction, if any	
iii)	Any adhoc/standby credit facility extended to the unit	
iii)	**Primary Security offered**	
iv)	**Collateral Security offered**	
v)	**Credit Guarantee availed**	
vi)	**Other financial facilities offered**	
7	**Whether online portal has been provided as per PM Task Force recommendations - Master Direction- July 24, 2017**	