Role of Microfinance Institutions (MFIs) in Financing Micro, Small & Medium Enterprises

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Abstract

SMEs all over the world play a strong role in national development. This is attributed to the massive employment it provides to the citizenry of the country where it exists. The financing of these ''goose'' which have being laying so many golden eggs has come under scrutiny by academics and practitioners. Finance for micro, small, and medium-sized enterprises (MSMEs) has been a concern for all stakeholders including entrepreneurs, financial institutions, and government organizations. The key objective of the study was to identify various challenges faced by MSMEs in sourcing of finance during different stages of their life cycle. The objective of this study was to investigate the role of financial institutions on the growth of small and medium enterprises and to give recommendations based on the problems. Despite the tremendous increase in number of SMEs, little research exists that examines role of financial institutions; banks and microfinance institutions; on the growth of small and medium enterprises in developing countries, especially India.

Keywords: MFIs, Micro, Small, Medium, Enterprises, Financing, Growth, Institutions

Introduction

Micro, small, and medium-sized enterprises (MSMEs) have gained increased attention in India in recent times, considering their strategic importance to the economy and the country. MSMEs play an important role in generating employment-48.8 million MSMEs in the country provide employment to 111.4 million people. MSMEs in the manufacturing sector alone produce more than 6,000 products and contribute 7.7% of the GDP of the country. Similarly, MSMEs in the services sector contribute 27.4% of the country's GDP.

Microfinance is a source of financial services for entrepreneurs and small businesses that do not have easy access to banking and related services. The main objective of microfinance is to assist the poor to overcome the poverty and thus help in economic development. Microfinance is not only giving micro credit but it includes wide range of services like insurance, savings, remittance and also non-financial services like training, counselling etc. Micro-Enterprises sector has been recognized as an important pillar of economic growth all over the world. The sector is characterized by low investment requirement and operational flexibility. Micro-Enterprises play a very important role in the development of country because of its innovative entrepreneurial spirit. In many developing economies including India, Small and medium enterprises (SMEs) plays a crucial role in employment creation and income generation. What are the key factors influencing Micro-Enterprise to become small than medium enterprise and hence large enterprises? It is Microfinance. Microfinance is an important tool to promote business development. Researches shows that in Bangladesh more than 15 million families are benefited from small loans and other financial products such as micro-savings and micro-insurance and about 40% of the overall reduction of rural poverty in recent years has been due to microfinance provided to Micro-Enterprises.

Small Industries Development Bank of India (SIDBI) set up on 2nd April 1990 under an Act of Indian Parliament, acts as the Principal Financial Institution for Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector as well as for co-ordination of functions of institutions engaged in similar activities.

The MSME sector, the focused business domain for SIDBI, has been an important pillar of the Indian Economy, contributing up to 33% in the country's Gross Value Added (GVA) as per FY 2014-15, with 51 million enterprises providing employment to over 117 million Indians. Over the years, SIDBI has been working towards the sustainable development of MSME sector, pioneering efforts that have manifested in creation of economic wealth, its distribution for an egalitarian society while preserving the ecological wealth of the country. These include the innovative Credit Plus model, where credit is supplemented with advisory and mentoring facilities to MSMEs. Some of SIDBI's other revolutionary initiatives include the MFI-led Microfinance movement in India that has nurtured and strengthened more than 100 MFIs and facilitated creation of SFBs, introducing a culture of energy efficient and sustainable finance for the MSME sector, introducing Venture Capital, Risk Capital, Reverse Factoring and other innovative facilities that have been later adopted by various public and private players in the country.

The Micro, Small and Medium Enterprise sector is crucial to India's economy. There are 29.8 million enterprises in various industries, employing 69 million people. The sector includes 2.2 million women-led enterprises (7.4 percent) and 15.4 million rural enterprises (51.8 percent). In all, the MSME sector accounts for 45 percent of Indian industrial output and 40 percent of exports. Although 94 percent of MSMEs are unregistered, the contribution of the sector to India's GDP has been growing consistently at 11.5 percent a year, which is higher than the overall GDP growth of 8 percent. Poor infrastructure and inadequate market linkages are key factors that have constrained growth of the sector. The lack of adequate and timely access to finance has been the biggest challenge. The financing needs of the sector depend on the size of operation, industry, customer segment, and stage of development. Financial institutions have limited their exposure to the sector due to a higher risk perception and limited access of MSMEs to immovable collateral.

Literature Review and Framework

A number of studies have been conducted on microfinance and SMEs in China. China Microfinance Industry Assessment Report provided by the China Association of Microfinance gives the definition of microfinance in China, and examines the impacts of microfinance development at macro, meso, and micro levels, spanning over agricultural industry, financial markets, and social vulnerable groups such as women and farmers (He, Du, Bai, and Li, 2009). Many studies then have focused on each level specifically. Li (2006) concludes that microfinance has offered an effective finance method for the construction of new socialist rural regions and has won the support of agriculture and farmers. Dyar, Harduar, Koenig, and Reyes (2006) together examine the impact of microfinance on gender inequality in China and have discovered that there are many benefits to providing microfinance to women, despite lack of conclusive evidence on significantly reducing gender inequality. Microfinance allows women to enjoy greater economic power, better living quality, and stronger social and political empowerment. Park, Ren, and Wang, (2004) assess the potential role of microfinance for financial reform in China and suggest that China's financial reforms have yet to create an institutional space in which microfinance can operate, thrive, and expand. Therefore, expansion of microfinance will almost definitely have to await substantial further progress in creating a well-developed commercial, financial system. In the meantime, however, microfinance programs are competing with China's official financial institutions and levying pressure on the practice and reform of the rigid state-owned financial institutions.

As we can see, little research has found the connection between microfinance and the profitability of SMEs. We have seen the research conducted in Africa that aims to find the impact of microfinance on entrepreneurial development in Nigeria. However, countries in Africa are less developed. The impact of microfinance is not significant. The main contribution of this paper is to focus on China - the most fast-developing country - by using a primitively-designed survey and by collecting two waves of panel data in 2010-2011 to study the relationship between the profitability and the microfinance of small and medium enterprises. The paper shows that microfinance plays a crucial rule in the revenue and profit growth of SMEs. The paper also reveals that the SMEs with higher financial risk and lower level of productivity are more likely the firms seek to microfinance. Furthermore, the paper finds that firm characteristics including product innovation efforts and managerial and entrepreneurial attitudes are the keys that determine the likelihood of receiving the micro -financing.

Microfinance institutions in India

Microfinance organisation is not new to the financial market in India. Due to the overwhelming poverty in India, government gave special attention to the development of rural credit. Taking All India Rural Credit Survey report (1950) into account, it reconstructed the cooperative structure which included the partnership of state in cooperatives, establishment of Regional Rural Banks (RRB) and National Bank for Agriculture and Rural Development (NABARD). In India, Non-Government Organisations (NGOs) played a pivotal role in the development of micro financial service. Furthermore, microfinance industry in India has witnessed a fast-paced growth in last two decades. In 2009, the total number of microfinance institutions in India was around 150 (Tripathi, 2014).

Definition of microfinance institutions in India

Microfinance Services Regulation Bill of India, defines microfinance services as financial assistance to be provided to an eligible individual directly or by a group mechanism for:

An amount of maximum fifty thousand in aggregate per person for small and cottage enterprises, agricultural and allied activities (consumption purposes of the person is also included) orA maximum amount of one lakh fifty thousand in aggregate per person for the purpose of housing orSuch like the above amounts may be prescribed to a person for other purposes also.

The bill, in addition, explains microfinance institutions as the organization of individuals which includes the following if the establishment of the organization concentrates on the purpose of increasing microfinance services:

i. Registration of society under Societies Registration Act (1860).

ii. A creation of trust under Indian Trust Act (1880) or registered public trust under state enforced governing trust.

iii. A society registered under the Multi State Cooperative Societies Act (2002) which can be a cooperative society or a mutual benefit corporative etc (Singh, 2016).

Self Help Group (SHG)

Self Help Group is a type of formal or informal group consisting of small entrepreneurs with similar kind of socio-economic backgrounds. Such individuals temporarily come together and generate a common fund to meet the emergency needs of their business. These groups are generally non-profit organizations. The group assumes the responsibility of debt recovery. The advantage of this micro-lending system is that there is no need for collateral. Interest rates are also generally low and fixed especially for women (Chowdhury, 2013; Business Standard, 2017). In addition various tie-ups of banks with SHGs have been implemented for the hope of better financial inclusion in rural areas (Jayadev & Rao, 2012).

One of the most important ones is NABARD SHG linkage program where many self-help groups can borrow credit from bank once they successfully present a track record of regular repayments of their borrowers. It has been very successful especially in

Andhra Pradesh, Tamil Nadu, Kerala and Karnataka and during the year of 2005-06. These states received approximately 60% of SGH linkage credit (Taruna and Yadav, 2016).

Flow of Finance to the MSME Sector

This study shows that of the overall finance demand of INR 32.5 trillion ($650 billion), 78 percent, or INR 25.5 trillion ($510 billion) is either self-financed or from informal sources. Formal sources cater to only 22 percent or INR 7 trillion ($140 billion) of the total MSME debt financing. Within the formal financial sector, banks account for nearly 85 percent of debt supply to the MSME sector, with Scheduled Commercial Banks comprising INR 5.9 Trillion (USD 118 Billion). Non-Banking Finance Companies and smaller banks such as Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and government financial institutions (including State Financial Corporation and State Industrial Development Corporations) constitute the rest of the formal MSME debt flow.

MSME Finance Demand Flowchart

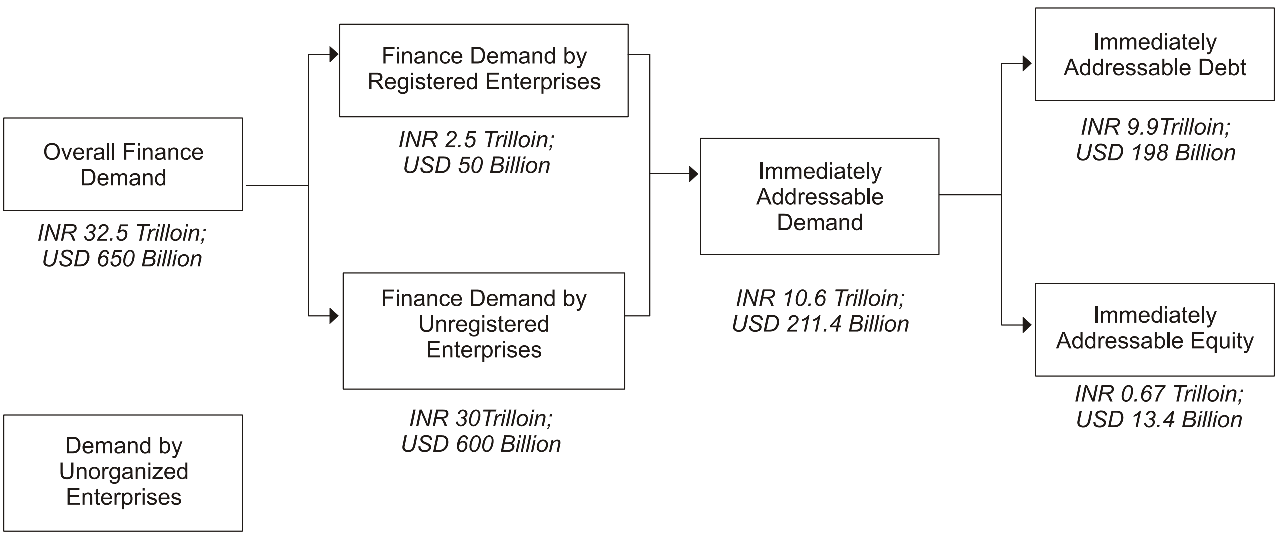

Figure 1 MSME Finance Demand Flowchart

Within the informal financial sector non-institutional sources include family, friends, and family business, while institutional sources comprise moneylenders and chit funds. MSME Finance Gap in the Sector Despite the increase in financing to MSMEs in recent years, there is still a considerable institutional finance gap of INR 20.9 trillion ($418 billion). After exclusions in the debt demand (62 percent of the overall demand) and the equity demand (from MSMEs that are structured as proprietorship or partnership), there is still a demand-supply gap of INR 3.57 trillion ($ 71.4 billion), which formal financial institutions can viably finance in the near term.

Overall Finance Gap in MSME Sector)in INR Trillion)*

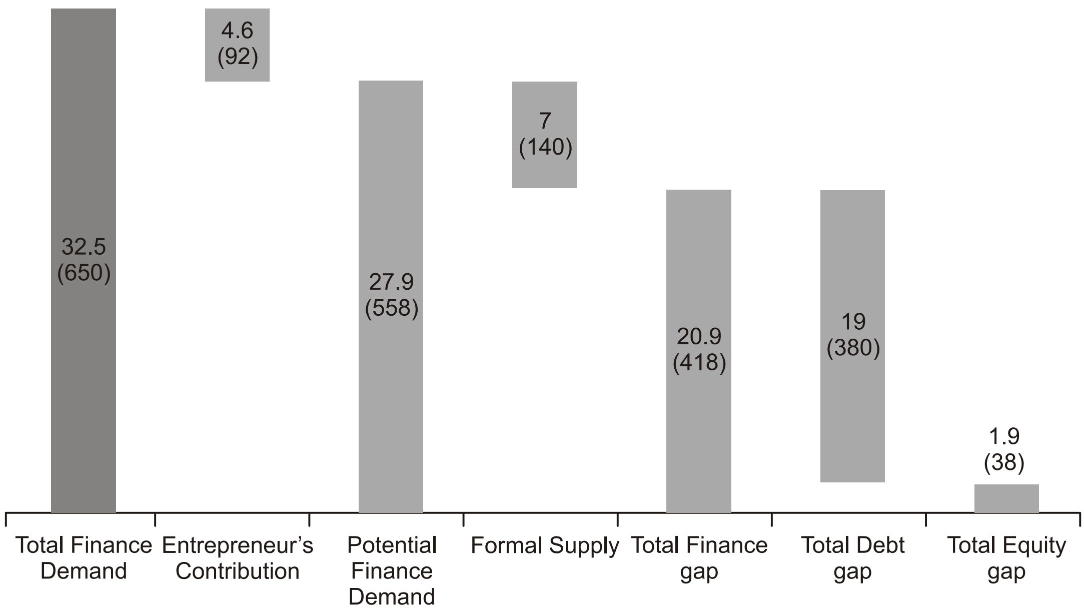

Figure 2 Overall Finance Gap in MSME Sector

This is the demand-supply gap for approximately 11.3 million enterprises. While a large number of these already receive some form of formal finance, they are significantly underserved with only 40-70 percent of their demand currently being met. With appropriate policy interventions and support to the MSME sector, a considerable part of the currently excluded demand can be made financially viable for the formal financial sector. Of the viable and addressable demand-supply gap, the debt gap is INR 2.93 trillion ($58.6 billion) and the equity gap is INR 0.64 trillion ($12.8 billion). The micro, small, and medium enterprise segments respectively account for INR 2.25 trillion ($45 billion), INR 0.5 trillion ($10 billion) and INR 0.18 trillion ($3.6 billion), of the debt gap that is viable and can be addressed by financial institutions in the near term. Micro and small enterprises together account for 97 percent of the viable debt gap and can be addressed by financial institutions in the near term. Available data and primary interviews indicate that medium enterprises in India are relatively well financed. The equity gap in the sector is a combined result of demand-side challenges such as the legal structures of enterprises, as well as supply-side gaps, such as a lack of investment funds focused on MSMEs. The equity requirements for the MSME sector are concentrated in the growth-stage enterprises (~70 percent).

Gap by Geography & Type of Enterprise

An overview of the MSMEs spread across the country indicates that although the Low-Income States [12] (LIS) have 32.6 percent of India's total MSMEs, the viable debt gap is disproportionately high at INR 1.93 trillion ($38.6 billion) or ~66 percent of the country's total. On the other hand, only ~3 percent MSMEs are based in the North-Eastern States, accounting for a viable debt gap of INR 0.09 trillion ($1.8 billion). The rest of India accounts for the remaining ~65 percent of MSMEs, with a viable and addressable debt-supply gap of INR 0.9 trillion ($18.2 billion) or ~31 percent. Across India, there are significantly more service sector enterprises than manufacturing units (~ 71 percent versus a 29 percent split respectively).

However, manufacturing enterprises are more capital-intensive with longer working capital cycles, and consequently have higher working capital requirements. Therefore, nearly 60 percent of the demand for finance arises from the manufacturing sector.

The share of the debt gap in the manufacturing sector is also considerably higher at 73 percent of the total gap.

Enabling Environment for Growth of Finance in the MSME Sector

The three main pillars of the enabling environment analysed in the study are: (a) legal and regulatory framework (b) government support (c) financial infrastructure support. MSMEs function in a highly competitive environment and require an enabling environment to sustain growth. Well-rounded fiscal support, a strong policy framework, and incentives promoting innovation by financial institutions can significantly increase the penetration of formal financial services to the MSME sector.

Schematic of Key Elements of the Enabling Environment

Growth of MSME and MSME Finance

Legal and Regulatory Framework

- Legal and Regulatory Framework to define the sector - MSMED Act. 2016
- Financial regulations to bolster duppy of finance - SARFAESI 2002, Credit information companies (Regulation) Act 2005
- Inclusion of Micro, and Small Enterprises (MSE) in purview of Priority Sector Lending (PSL)
- Master Circulars on Mending to MSME

Government Support

- Policies to Facilitate multi-pronges sipport-skill, development marker linkage, technology adoption and infrastructure
- Promotion of cluster development
- Financial support through apex sector bodies like SIDBI
- Funding support to credit guatantee schemes to enhance unsecured financing
- Financial sipport to increase penetration og credit rating

Financial Infrastructure Support

- Credit bureaus to track credit history of enterprises
- Collateral registry for immovable assets
- Credit rating agencies
- Asset reconstruction companies
- Small and Medium (SME) Stock Exchange to facilitate primary and secondary transaction for SME securities

Figure 3 Schematic of Key Elements of the Enabling Environment

Conclusion

Small businesses in India need access to funding for their businesses to flourish on a sustainable basis. Although, small businesses promote the development of an economy, it has not been given adequate recognition that corresponds with intensity of its contribution. It is noteworthy to state that both financial and non-financial services provided by microfinance banks and institutions have greatly assisted small businesses in India and have enhanced the distribution of business skills and the sharing of innovative ideas. The implication of this study is that, micro-financing significantly promotes businesses by reducing the resource gap for small businesses. Micro-financing has a huge potential for increasing the performance of small businesses through the frequent contributions in micro-financing and provision of non-financial services.

An attempt has been made in this study to understand the role of Microfinance on the growth and development of Micro-Enterprises. The paper assessed Micro-Enterprises owners who have received credits from Micro Finance Institutions. It is observed that 57.6% of respondents are satisfied or very satisfied with the products offered by Microfinance Institutions. The findings also revealed that most of the respondents in this study reported that their business had expanded and their income and physical assets had increased significantly as a result of having taken microfinance loans. Findings showed that Microfinance lead to increase of business sales, business profits and business physical assets. Except increased of capital structure has no direct relation to microfinance access. All these, were observed to be statistically significant. Statistically, there seems enough evidence to prove that Micro-Enterprises that received loan from Microfinance Institutions succeeded than those that did not receive.

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