ADBI Working Paper Series

THE ROLE OF CREDIT RATING AGENCIES IN ADDRESSING GAPS IN MICRO AND SMALL ENTERPRISE FINANCING: THE CASE OF INDIA

Savita Shankar

No. 931
March 2019

Asian Development Bank Institute

Savita Shankar is an associate professor at the Keio Business School of Keio University in Yokohama, Japan.

In this publication, "$" refers to United States dollars.

Suggested citation:

Shankar, S. 2019. The Role of Credit Rating Agencies in Addressing Gaps in Micro and Small Enterprise Financing: The Case of India. ADBI Working Paper 931. Tokyo: Asian Development Bank Institute. Available: https://www.adb.org/publications/role-credit-rating-agencies-addressing-gaps-micro-small-enterprise-financing-india

Please contact the authors for information about this paper.

Email: savita.shankar@keio.jp

Asian Development Bank Institute
Kasumigaseki Building, 8th Floor
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

Abstract

This paper describes the common financing challenges faced by micro, small, and medium-sized enterprises (MSMEs) in India and some important measures taken to address them, with a focus on the credit rating scheme implemented in 2000. It examines the usefulness as well as the limitations of the scheme, drawing on interviews with rating agencies and MSMEs. The analysis indicates that with credit rating being an expensive exercise, the availability of government subsidies under the scheme has been an important factor in encouraging MSMEs to get themselves rated, thereby reducing information asymmetry with banks and enabling access to credit. Given the large number of unbanked MSMEs in the country, leveraging the data generated by MSME lending and credit rating in the country through the creation of a credit risk database is necessary. Lenders will then be able to tap into the collective data generated in order to make more informed credit decisions with regard to MSMEs without relying on subsidies.

Keywords: micro, small, and medium-sized enterprises, India, credit rating

JEL Classification: G21, G28, G38

Contents

1. INTRODUCTION

The Indian micro, small, and medium-sized enterprise (MSME) sector is estimated to comprise 63.38 million enterprises, employing an aggregate of around 111 million people (Ministry of MSMEs 2017–18). As MSMEs tend to be labor-intensive, this sector is especially important in India where the creation of job opportunities for the large workforce is an important policy objective. However, studies have shown that MSMEs in India face various constraints, the primary one being that of a lack of timely and adequate finance.

The inadequate financing of MSMEs is often attributed to the paucity of information regarding these entities. Many MSMEs lack financial records, credit histories, and collateral, the bases on which lenders make credit assessments. In their absence, lenders are unable to progress with their credit appraisals. Credit rating is one way to address these information asymmetries prevalent in the sector. In India, some policy initiatives have tried to encourage credit rating agencies to offer MSME ratings.

This paper analyzes the policy initiatives taken and examines the potential for using credit ratings to help address the gaps in financing micro and small enterprises in India, drawing on interviews with rating agencies and MSMEs.

The paper is organized as follows: The second section will provide background on the Indian MSME sector and its importance for the Indian economy; the third section describes the challenges that MSMEs face in accessing finance; the fourth section examines the developments with regard to the credit rating of MSMEs in India; the fifth section discusses the benefits and challenges of credit rating for MSMEs; the sixth section discusses the other policies being implemented to improve MSMEs' access to finance; and the final section develops policy recommendations.

2. MSME SECTOR IN INDIA AND ITS PLACE IN THE ECONOMY

In India, enterprises are classified as belonging to the MSME sector based on their investment in plant and machinery. In the manufacturing sector, enterprises with investment in plant and machinery of up to Rs 2.5 million (approximately $3,500[1]) are categorized as micro, those with Rs 2.5 million up to Rs 50 million ($0.7 million) as small, and those with Rs 50 million to Rs 100 million ($1.4 million) as medium-sized enterprises, respectively. In the services sector, the corresponding limits for investment in plant and machinery for micro, small, and medium-sized enterprises are up to Rs 1 million ($14,286), Rs 1 million up to Rs 20 million ($0.29 million), and Rs 20 million to Rs 50 million ($0.7 million). The reason for using investment as a benchmark to define MSMEs is that given the lack of records and documents prevalent among these enterprises, investment is relatively easier to measure and verify. These definitions were given in the MSME Act, 2006. A bill had been introduced in 2015, seeking to amend the Act and raise the investment limits for each of the categories to update the definitions after a decade to adjust for inflation during the period. While the bill was still pending in Parliament, in February 2018, the Indian cabinet approved a proposal to revise the definition of MSMEs to one based on annual revenue rather than on investment. The logic for this revision is

[1] An approximate exchange rate of Rs 70 to $1 has been assumed throughout the paper. The exchange rate has varied between Rs 65 and Rs 72 over the last 12 months, with the rate as of 23 September 2018 being Rs 72.70.

that in July 2017, the country had replaced multiple indirect taxes in the country with a single unified tax called the “Goods and Services Tax” (GST). The implementation of the GST required the creation of an information technology (IT) platform that could serve as an interface with taxpayers that could be shared by the central government and various state governments. This infrastructure was set up by the GST Network, a not-for-profit company in which the central government, state governments, and financial institutions hold stakes. Because of this IT infrastructure, the government is now able to ascertain the annual turnover of registered entities, making it possible to have a turnover-based definition. The MSME Act 2006 will now need to be amended to make the new definition effective. According to the new definition, enterprises with a sales turnover of up to Rs 50 million ($0.7 million) would be categorized as micro enterprises, while those with a turnover of between Rs 50 million and Rs 750 million ($10.7 million) would be called small enterprises, and those with a turnover of between Rs 750 million and Rs 2.5 billion ($35.7 million) would be considered medium-sized enterprises. The new definition is expected to make classification of enterprises into these categories more transparent and will eliminate the need for unnecessary inspections to this end (Prasad 2018).

While state governments are primarily responsible for the promotion and development of MSMEs, at the national level, the Ministry of MSMEs is responsible for overseeing the growth of MSMEs through initiatives designed to help them become competitive and to assist them in scaling up. The Ministry was formed after the enactment of the MSME Development Act in 2006. Under the Ministry, the National Small Industries Corporation (NSIC) specifically focuses on assisting micro and small enterprises by providing integrated support services such as marketing, technology, finance, and other services. A single-member committee, comprising Prabhat Kumar, former Cabinet Secretary, was set up to help formulate a national MSME policy. The committee submitted its report in January 2017 and is said to have recommended setting up a national authority to coordinate policies relating to MSMEs.

The number of MSMEs in the country was estimated to be 63.38 million according to the last census conducted by the MSME ministry in 2006–07, of which only 6% were registered enterprises and the remaining 94% were unregistered. Registered enterprises file business information such as investment, the number of employees, and the nature of operations with District Industries Centers of the state or union territory that they are in, while unregistered enterprises do not do so. This shows that even basic information regarding the majority of MSMEs in the country was missing. Another important aspect of the MSME group is that 95% of the enterprises fell into the “micro” category while 4.8% fell into the “small” category and the remaining 0.2% were classified as “medium.” This shows that MSMEs in India are predominantly very small in scale. MSMEs are however, spread across rural and urban areas with 52% in rural areas as per the last census. With respect to sector of operation, 71% of MSMEs were in the services sector, with the rest being in the manufacturing sector. Among registered MSMEs, the main areas of operation were wearing apparel; grain mill products, starches, and prepared animal feeds; repair of personal and household goods; metal products; and furniture. Among unregistered MSMEs, the main areas of operation were retail sale of food, beverages, and tobacco, and retail trade and manufacture of wearing apparel and tobacco. Not surprisingly, nearly 95% of MSMEs were organized as proprietorships.

The MSME sector has an important place in the Indian economy. According to the Ministry of MSME’s 2017–18 report, it employed 111 million people, which is approximately 21% (KPMG 2016) of the overall employment in the country. Over 20% of the enterprises were female owned and according to the last census in 2006–07, 18% of employees in this sector were female. The sector also contributed 28.8% to the country's GDP (Ministry of MSMEs 2017–18 annual report). The estimated contribution of the sector to the country's exports was 45% (ibid.). According to the census conducted in 2006–07, the sector's share in the services sector GDP was 24.6% and its share in the manufacturing output of the country was 33.4%. The contribution of the sector to GDP is low when compared to the average in a number of other countries in Asia. In the ADB's Asia SME Finance Monitor 2014, the average contribution of the sector to GDP for the countries studied was 42%.

In addition to the above factors, MSMEs are important because they have the potential to promote employment in rural areas, thereby reducing the need for urban migration. Moreover, many MSMEs focus on traditional skills and the use of local resources.

3. CHALLENGES IN ACCESS TO FINANCE FOR MSMES IN INDIA

A unique feature of MSMEs in India is that almost 93% do not access any outside funding while a little more than 5% use institutional finance and 2% use noninstitutional finance. Even among registered MSMEs, only 11% access institutional finance (Ministry of MSMEs 2009).

The main problem faced by MSMEs in accessing institutional finance is their lack of collateral, which makes it hard for them to offer any security for bank loans (IFC 2012). Another significant problem is that often they do not have credit histories either. This makes lending to them a risky proposition for banks. A very detailed loan appraisal of an MSME could reduce the risk of lending but could lead to very high transaction costs. Given the small unit value of typical MSME loans, such a high transaction cost could make lending to MSMEs unviable.

Credit scoring models have been routinely used in developed countries to reduce the time and cost of lending to small businesses. However, such models need to be specifically developed in the Indian context using historical data on lending to MSMEs. In the absence of collateral and credit histories, past data could be used to obtain credit insights that could help evaluate loan requests made by MSMEs. Using such models could be a good way to ensure speedy appraisal of loan requests from MSMEs at a reasonable cost. However, developing reliable and robust models would require access to a large volume of historical data. As MSME financing has been a neglected area for a long time, such vast amounts of historical data on MSMEs in India are not currently available on a consolidated basis. Some banks in India have developed their own models based on the available data (Joshi 2014).

A major hurdle for MSME financing is the information opacity prevalent in the sector as many of the units do not have complete accounting records, audited financial statements, or well-articulated business plans. This makes credit assessment by potential lenders very difficult. Lenders may need to help the enterprises put together these documents, which may again increase transaction costs, especially relative to the small ticket nature of such loans.

Even when accounting records and financial statements are available, MSMEs sometimes have trouble accessing institutional finance. This is because volatility and risk levels are considered to be higher in the MSME sector than among large corporates as often MSMEs are dependent on very few partners and contracts, especially as suppliers to larger companies. For instance, when there was a crisis at Maruti Suzuki India Ltd.,[2] the company itself did not default but several MSMEs that were dependent on its business defaulted on their bank payments due to liquidity problems. These MSMEs therefore were classified as NPLs by their banks, though later they paid back their dues (Singh 2017).

NPL rates among MSME loans have been on the rise. For the micro sector[3], the rate has gone up from 7.9% in March 2016 to 8.8% in 2018 while for the SME sector[4] it has gone up from 9.8% to 11.2% during the same period (TransUnion CIBIL 2017; TransUnion CIBIL-SIDBI 2018. This is reflective in some ways of the trend of increasing overall NPL levels experienced by banks in India with levels increasing from 7.6% in March 2016 to 11.6% in March 2018 (RBI Financial Stability reports 2016, 2017, 2018). As already seen, the NPL rates in the MSME sector have typically been higher than overall NPL levels in the past, though more recently we see that the levels in the SME sector are comparable to the overall rates because of the spike in NPL levels among large corporate borrowers. In the case of the micro sector, the NPL rates are at present lower than the overall NPL rate.

It is also found that even when MSMEs do access loans, the interest rates on these loans are frequently higher than those on loans availed by larger corporates. This is because when lending norms and models applied to large enterprises are applied to MSMEs, the ratings obtained by MSMEs are lower, resulting in higher interest rates being applied to loans availed by them. Besides their lack of collateral, MSMEs face other disadvantages that reduce their rating. For instance, MSMEs often lack bargaining power with suppliers and customers, resulting in their having unfavorable working capital terms that are a strain on their liquidity.

A 2012 study on MSMEs in India by the International Finance Corporation (IFC) estimated the overall demand for finance by MSMEs to be around Rs 32.5 trillion ($0.5 trillion), comprising a debt demand of Rs 26 trillion and an equity demand of Rs 6.5 trillion. After excluding enterprises that are in difficult situations, enterprises that have been operating for less than a year, enterprises that have been rejected by financial institutions, and enterprises that prefer informal sources of finance, the study estimates the viable debt demand in the sector to be Rs 9.9 trillion. Of the financing available to MSMEs, only 22% is catered to by formal sources of finance, with the balance coming from self-finance or informal finance. A proportion of 85% of formal financing comes from banks. Informal sources of finance include friends, family, moneylenders, and rotating savings and credit associations (ROSCAs or “chit funds” as they are locally known). The viable equity demand is estimated to be Rs 0.67 trillion by excluding entrepreneurs’ equity contributions and equity demand from proprietorships and partnerships, as these legal forms do not allow outside capital to be accepted. Considering the available supply, the study estimates the gap between the demand and supply of funding for MSMEs to be around Rs 3.57 trillion, affecting around 11.3 million enterprises. A proportion of 97% of the viable debt gap comes from micro and small enterprises.

---

[2] One of India’s leading passenger vehicle companies, Maruti Suzuki India Limited is a subsidiary of Suzuki Motor Corporation of Japan. Until 2007, it was known as Maruti Udyog Limited and was a joint venture between Suzuki, Japan, and the Government of India.

[3] In the case of lending by commercial banks, the micro sector refers to loans below Rs 10 million.

[4] In the case of lending by commercial banks, the SME sector refers to loans between Rs 10 million and Rs 250 million.

4. DEVELOPMENTS WITH REGARD TO CREDIT RATING FOR MSMES

4.1 Specialized Credit Rating Agency

While several credit rating agencies were in existence in India, their main focus was on large corporates and hence the need for a rating agency focused on MSMEs was felt. Moreover, it was also felt that rating MSMEs called for a different approach from the standard approach adopted when rating large corporates. Hence, the need for a specialized credit rating agency was felt, and in 2005, SMERA—a joint venture between the Small Industries Development Bank of India, Dun and Bradstreet,[5] and some commercial banks—was set up for rating micro, small, and medium-sized enterprises. SMERA had completed 50,000 MSME ratings by February 2018. In May 2018, SMERA changed its name to Acuité Ratings & Research Limited to position itself as a full-service rating agency with a diverse client base, as SME ratings accounted for less than 50% of its turnover.

4.2 Performance and Credit Rating Scheme

In 2004–05, a scheme entitled the Performance and Credit Rating Scheme (PCRS) was announced in order to enable registered micro and small enterprises to obtain credit ratings. The rationale for the scheme was that credit ratings would enable such enterprises to obtain cheaper and faster financing from banks. The PCRS scheme was formulated in consultation with various stakeholders such as small industries associations, the Indian Banks' Association, and some leading rating agencies (CRISIL, ICRA, Dun & Bradstreet, and ONICRA). The central bank, the Reserve Bank of India (RBI), issued circulars encouraging banks to use such ratings to enhance their lending to such enterprises.

The scheme was implemented by the National Small Industries Corporation (NSIC), a body under the Ministry of MSMEs. According to the scheme, micro and small enterprises could obtain a 75% reimbursement of the rating fees charged by credit rating agencies for their first credit rating. As there were variations in the fees charged by different credit rating agencies, ceilings for the reimbursement from the NSIC were set that were linked to the turnover of the enterprises as mentioned in Annex 1. The scheme specified that only credit rating agencies registered with the Securities and Exchange Board of India and empaneled with the RBI as external credit assessment institutions were authorized to obtain reimbursements under the scheme. Enterprises were given the option of choosing any agency meeting the above criteria. The scheme has been in existence since 2004–05, though the amount budgeted under it showed wide variations depending on the fiscal pressures prevalent each year. In the financial year 2017–18, no amount was budgeted for the scheme and it was virtually at a standstill. However, the budget for 2018–19 has a small provision for the scheme.

While SMERA was promoted in order to cater to the needs of MSMEs, when the NSIC scheme was formulated, it was decided to include the other major credit rating agencies too in the scheme in view of the large number of MSMEs in the country and to give the enterprises more choice. As a result of the PCRS scheme, many of the large credit rating agencies soon set up MSME divisions to focus on the sector.

[5] A US-based multinational company that provides data and credit information services.

Besides setting up focused teams to rate MSMEs, the need for a customized model to rate them was also felt. This is because the standard rating models used to rate large corporates tend to be inherently biased against MSMEs as they have some weaknesses arising from their small scale of operations, lower value of assets, and weaker bargaining power. Hence the NSIC, in consultation with the credit rating agencies, developed an eight-point rating scale specifically for MSMEs, so that such enterprises could be compared to their peers and not to large corporates. Like standard rating models, the model developed takes into account business, financial, operational, and management risks but it gives higher weightage to the operating capability of the enterprise and lower weightage to financial strength.

Site visits and interviews with the owners are an essential part of MSME ratings. The financial records of the enterprises are scrutinized in detail and stock audits are conducted to ascertain the quality of record keeping. If there are gaps in past financial records, these are corrected. As rating agencies require audited accounts for at least three previous years, if these are not available, the promoters need to draw up the accounts based on invoices and get the accounts audited.

As one of the main objectives of the PCRS scheme is to reduce the information asymmetry prevailing in the MSME sector and to shorten the time required by banks to complete loan appraisals of MSMEs, the rating reports about MSMEs are more detailed than those of large corporates. The reports are typically six to seven pages long and provide detailed information on the enterprise's operations including the exact location using GPS coordinates.

The NSIC has appointed independent researchers from time to time to study the impact of the PCRS scheme on micro and small enterprises. The very first such study was conducted just one year after the scheme was launched and found that the enterprises that obtained a credit rating under the scheme were able to receive higher amounts of credit and at lower rates of interest (Mohapatra 2012). A second study was conducted in 2010 and found that besides the access to more and cheaper finance, rated enterprises were able to make gains in operational efficiency as a result of the feedback obtained through the rating process (ibid.). A later study showed that companies with a relatively higher turnover were more likely to obtain ratings and nearly half of the rated companies were exporting their products. The most recent study was conducted in 2012 and additionally found that after the rating, more than half of the enterprises studied improved their record keeping and strengthened their organizational systems and policies (ibid).

After May 2017, the PCRS scheme was specified to be open only to micro and small enterprises with a sales turnover of at least Rs 10 million ($0.14 million), when a bank or nonbanking financial company (NBFC) requires it. With limited funding and budget constraints, it appears that the Ministry of MSMEs has sharpened the focus of the scheme. Credit rating exercises for MSMEs are typically expensive to carry out, as they involve site visits and interviews with promoters of the enterprise, as well as extensive audits and record checking. In the case of MSMEs, sometimes financial records have gaps and inaccuracies that need to be corrected as part of the rating exercise. Hence ratings are more viable when the enterprise (and consequently its funding requirement) is of a reasonable size. In view of the funding constraints, the Ministry has also sought to limit its use to cases where the utility of the credit rating is more certain, such as in cases where banks or NBFCs have explicitly suggested that the MSME obtains the rating.

5. BENEFITS OF CREDIT RATING OF MSMES

From the systemic viewpoint, credit rating serves the important purpose of reducing the information asymmetry regarding MSMEs. More specifically, as the credit rating report has detailed information on the operations of the enterprise, its strengths as well as the risks that it is exposed to, it serves as a good reference document for bankers. Although banks do their own appraisal before sanctioning a loan, the time required for appraisal by the bank can be reduced due to the availability of key information in the credit rating report. Hence the turnaround time on the loan request of the MSME is considerably shorter.

External credit ratings can also be used by banks to determine the risk weights for their exposures as per the RBI's April 2007 guidelines regarding implementation of the capital adequacy framework under Basel II. If the borrower is rated by one of the rating agencies registered with the Securities and Exchange Board of India (SEBI) and the rating is within the top three notches, i.e., AAA, AA, or A, then the risk weight assigned to the loan provided by the bank is 20%, 30%, and 50%, respectively. When the risk weight is less than 100%, it reduces the capital that the bank needs to set aside for the loan. A part of this saving can be passed on to the borrower by way of a lower interest rate. Hence the availability of a credit rating not only shortens the bank loan appraisal process, it also enables the bank to give the borrower a more favorable interest rate on the loan. Based on interviews with some credit rating agency representatives and MSMEs that have been rated, the reduction in interest rate that is possible as a result of a credit rating in the top three notches is found to range between 25 and 75 basis points.

The use of credit ratings by banks, though, is subject to some caveats. Banks are not allowed to cherry-pick among ratings provided by different rating agencies. Moreover, they should use the same agency consistently for each type of claim (RBI Master Circular Basle III Capital Regulations 2013).

Credit ratings not only improve the bargaining power of MSMEs with banks, they also put them in a stronger position while negotiating terms with suppliers. This is because MSMEs can demonstrate their standing to the suppliers by sharing the report of an independent third party (the credit rating agency) with the supplier. By publishing their ratings on their websites and in their bulletins, MSMEs can build credibility and hope to gain wider recognition.

Another advantage of credit ratings under the PCRS scheme is that they have resulted in a database on MSMEs. This is because all requests for credit ratings by MSMEs are required to be entered in a portal[6]. This portal hence serves as a database on MSMEs with details of their products, capacities, and locations. Effective 1 April 2015, under the Public Procurement Policy for Micro and Small Enterprises, Order 2012 mandates Central Public-Sector Undertakings, Central Government Ministries and Departments to procure a minimum of 20% of their products and services from micro and small enterprises. However, in the past, these organizations sometimes could not meet this target due to a lack of information regarding the micro and small enterprises that provided the good or service that they required. By using the database, they can try to access information regarding possible suppliers from the micro and small enterprise segment. The database is also referred to by banks and other businesses to identify MSMEs for business development purposes.

The credit rating has other intangible benefits too. One is that enterprises are able to obtain feedback through the rating process on their strengths and weaknesses. They are

[6] www.msmedatabank.in.

also able to benchmark themselves with other MSMEs when they obtain their ratings. They can also track their progress over time by looking at the variation in their credit ratings.

The main challenge with the credit rating of MSMEs in India is that many of the ratings were requested by MSMEs because of the availability of the subsidy under the PCRS scheme. As the availability of subsidies tends to depend on the fiscal situation in any given year, this makes the scheme unstable and volatile. As mentioned earlier, while the scheme has been in existence since 2004–05, the budgeted amounts for it have varied widely over the years. In fact, in the financial year 2017–18, no amount was budgeted for the scheme and it was virtually at a standstill. However, the budget for 2018–19 has a small provision for the scheme. The reduction in subsidy in recent years has resulted in some credit rating agencies downsizing their MSME-dedicated infrastructure and manpower.

Yet another challenge is that while the subsidy is available for only the first rating for an MSME, renewals of the rating were only carried out by a minority of enterprises. A 2012 study on the PCRS scheme commissioned by the NSIC found that only 32% of the contacted enterprises had renewed their rating in the last three years. Interviews with credit rating agency officials indicate that the percentage of renewals among MSMEs that have availed themselves of subsidies for credit ratings may be even lower at 20%.

Another area of concern is that while interest rate reductions on bank loans are generally among the main benefits of credit rating for MSMEs, there are a few examples of MSMEs that have been unable to negotiate interest rate reductions despite having high ratings.

6. OTHER POLICY INITIATIVES TO HELP MSMES ACCESS FINANCE

6.1 Credit Guarantee Scheme

Under the Credit Guarantee Fund Scheme, launched in 2000, guarantee cover is provided for collateral-free loans given by banks and financial institutions. The corpus for the fund was contributed by the government of India and SIDBI at a ratio of 4:1 and stood at around Rs 25 billion as of 31 May 2017. This scheme is discussed in detail in another chapter.

6.2 MUDRA Bank Initiative

To address the need for funding for micro, small, and medium-sized enterprises, in April 2015, the Micro Units Development and Refinance Agency (MUDRA) Bank, a public sector financial institution, was launched with funding of Rs 200 billion for on-lending and Rs 30 billion for provision of credit guarantees. MUDRA Bank is a subsidiary of the Small Industries Development Bank of India (SIDBI), the apex bank for the development of small industries in the country. The apex bank has assisted many MFIs, though going forward it plans to mainly act as a market maker for small industries and focus on providing venture capital for start-ups (Nayak 2015). MUDRA Bank is to provide refinance to last mile [7] providers of finance for micro and small enterprise loans. Commercial banks, regional rural banks, cooperative banks,

[7] The term “last mile provider” refers to the entity that ultimately interfaces with the customer as opposed to other entities that merely act as financial intermediaries in the process of financial service delivery to unbanked populations.

nonbanking financial companies, and microfinance institutions are eligible to obtain refinance for loans under three categories: up to Rs 50,000, Rs 50,000 to Rs 0.5 million, and Rs 0.5 million to Rs 1 million. The three categories are expected to cater to microenterprises at different stages of development, though 60% of MUDRA Bank's funding is earmarked to cater to the first category. The loans are meant to be for nonfarm income-generating activities. It is expected that the availability of funding through MUDRA Bank will bring down the average cost of funds for the lending institution and consequently the interest rate charged to borrowers. Interest rate caps have also been stipulated for different types of lenders. For example, in the case of NBFC-MFIs there is a cap on margins of 10% for MFIs with loan portfolios larger than Rs 1 billion and 12% for smaller MFIs with loan portfolios lower than Rs 1 billion or 2.75 times the average base rate of five major commercial banks, whichever is lower. In the case of banks, the RBI has also put a cap on the interest rate at the base rate or marginal cost of funds-based lending rate (MCLR) for loans to micro units. Similarly, regional rural banks and cooperatives can only charge up to 3.50% over and above the MUDRA refinance rate to the ultimate borrower. In the case of NBFCs, the RBI has also stipulated an interest cap of 6% over and above the MUDRA refinance rate when lending to the MUDRA segment.

6.3 Start-Up India

In January 2016, the Start-up India initiative was launched by the government of India with the objective of creating an enabling ecosystem for start-ups in the country. The scheme defined start-ups as enterprises less than seven years old with an annual turnover lower than Rs 250 million ($3.8 million) since incorporation. The initiative aims to address three aspects of the start-up ecosystem: simplification and hand-holding, funding support and incentives, and industry-academia partnerships and incubation. To provide funding support for start-ups, the scheme envisages setting up a fund with an initial corpus of Rs 25 billion ($384 million) and a total corpus of Rs 100 billion after four years. The fund will act as a fund of funds, investing through venture capital funds registered with the Securities and Exchange Board of India (SEBI).

6.4 Stand-Up India

Initiated in April 2016, Stand-up India is an initiative of SIDBI to help women and members of scheduled castes and tribes set up enterprises by facilitating the availability of financing to them. The objective of the scheme is to encourage branches of scheduled commercial banks to provide loans ranging between Rs 1 million and Rs 10 million for greenfield enterprises[8] promoted by women or members of scheduled castes and tribes. The loans can cover up to 75% of the project cost and can be in the form of a composite loan including term loan and working capital. The borrower is expected to contribute a minimum of 10% of the project cost. The rate of interest is required to be the lowest possible for the rating subject category to a maximum of 3% over the base rate plus tenor premium. In addition to financing, hand-holding services can also be accessed by these enterprises via a portal set up for the scheme.

[8] Refers to the first-time venture of the beneficiary in the manufacturing, services, or trading sector.

6.5 Other New Sources of Loans for Micro and Small Enterprises

While many banks and NBFCs cater to medium-sized enterprises, micro finance institutions (MFIs) are an important source of funds for loans up to Rs 0.1 million ($1,429) for micro enterprises. The segment in between the two has fewer financing options (Shankar 2016). To expand the range of funding available to such enterprises, in 2015, a commercial bank license was given to one MFI, Bandhan, and small finance bank licenses were given to ten entities (eight of them MFIs). Small banks must lend at least 50% of the loan portfolio to loans and advances of a value of up to Rs 2.5 million ($35,714). There are also some NBFCs that cater to niche segments within the micro and small sector. For example, there are NBFCs that focus on the financing of commercial vehicles, both new and pre-owned. They usually operate through a dense network of branches with credit officers who are responsible for the entire transaction from identifying customers, valuing the commercial vehicle, and financing it to handling the collection of principal and interest. These executives meet the customer at least every month. Electronica Finance is an NBFC that focuses on financing asset acquisition by the missing middle. Appraisal is based on field visits, interviews with promoters, and checking of records and cash transactions. The financial data provided by the firm are cross-checked with income tax returns and value-added tax returns (Manickaraj 2010). As loans are only provided for the purchase of equipment, disbursement of the loan is made directly to the equipment supplier. The downpayment of 25% is collected up front from the customer and the NBFC pays the amount in full to the supplier.

Digital lending initiatives are also on the rise to cater to small and micro enterprises. With data from the GST portal expected to be available as well as data from the digital platform for discounting of trade receivables (Trade Receivables Discounting Systems or TReDS), several digital lending start-ups are hoping to expand their operations.

6.6 Initiatives to Reduce Information Asymmetry regarding MSMEs

Besides the availability of more information on MSMEs as a result of the GST data and TReDs data, the Ministry of MSMEs has launched an initiative to launch an MSME databank. This is an attempt to get an online census of the MSMEs in the economy. The databank attempts to capture information on turnover, investment, number of employees, products and services, credit rating, joint ventures, technology transfers, and import and export of machinery. It is mandatory for MSMEs availing themselves of government assistance schemes to register their details on the databank.

While the first credit bureau in the country was set up by TransUnion CIBIL in 2000, there are now four such bureaus that help individuals create a credit history. Many MSME owners avail themselves of loans based on their personal credit histories and use the loans for their enterprises as many of them are sole proprietorships or partnerships. Data from credit bureaus, combined with income data and transaction data (now available from application programming interface-based data aggregators like Yodlee and Perfios), could be put together by lenders trying to assess the debt repayment capacity of MSME owners (Ramachandran 2018).

In 2017, TransUnion CIBIL introduced a credit risk ranking for MSMEs that ranks MSMEs on the chances of their defaulting over the next 12 months. Using algorithms based on the data that banks enter into their systems, a rank between 1 and 10 is assigned to MSMEs, with 1 representing the rank for the least risky MSME.

7. CONCLUSIONS AND POLICY RECOMMENDATIONS

There are three aspects that need to be addressed with regard to MSME financing.

The first relates to the supply of funds to the sector. Several steps have been taken by the government to make more funding available to the sector. The setting up of MUDRA Bank makes more funds available to the last mile providers. The number of last mile providers has also increased with the setting up of new banks, including small finance banks, which have a special focus on the sector. Moreover, market-led sources of funding such as specialized NBFCs and digital lending platforms have also emerged.

However, availability of funds does not guarantee that loans will be made to the MSME sector. As lenders need to be able to make sound assessments of borrowers, there is a need to reduce the information asymmetry in the sector. This is the second important aspect of MSME lending. It is here that credit rating plays an important role. However, since credit rating is an expensive exercise, government subsidies have been used to encourage its use in India. The availability of budgetary funds tends to vary depending on other pressures, and as a result, usage of credit ratings by MSMEs tends to be volatile too. As many MSMEs that are getting rated for the first time have no idea about the kind of rating they are likely to obtain, they are reluctant to go in for credit ratings in the absence of a subsidy. Given the large number of unbanked MSMEs in the country, funding for the PCRS needs to be sustained. As in the past the funding for the scheme has t been sporadic, the role of credit rating in terms of access to funds for MSMEs is limited and is likely to remain so. Besides the credit rating scheme, the growth of services providing credit information on individuals and attempts to provide MSME ranks based on credit history are also useful. Most importantly, the availability of GST data, TReDs data, and transaction data is likely to be very useful to potential lenders for verifying and cross-checking details provided by MSME owners.

The third aspect that is important for MSME finance is reducing the cost of loans to these entities. Reasonably priced loans support the viability of MSMEs. While increasing the supply of funds and reducing information asymmetry could be useful, schemes such as the Credit Guarantee Scheme could also help in reducing the risk levels and costs of financing.

On a long-term basis, to get the benefit of the government-supported credit rating and credit guarantee schemes, the information generated should be utilized to build a large credit risk data set that could enable the use of credit scoring models that have a lower unit cost. Currently, some banks have their own in-house models developed with the data available to them. Building up a credit risk database focused on the MSME sector to which lenders submit financial statements as well as default data could be extremely useful for developing statistical credit scoring models.

Such a model based on data from all MSME lenders is likely to be much more robust than individual bank models. Availability of such a model could greatly reduce the appraisal time and cost for MSME loans as well as reducing risk levels. Moreover, the models used will improve with time as more and more data are added. A similar database with SME data being shared by members in an anonymous form has been found to be useful in Japan (Kuwahara et al. 2016). The database was set up specifically to encourage bank lending to SMEs. The costs of setting up the model need to be borne by potential users and subscribers.

This initiative would be distinct from the MSME databank initiative that the government is pursuing. The latter is useful in developing a census of MSMEs; however, building up a credit risk database would be useful in helping lenders make risk assessments. MSMEs are a heterogeneous and large group, so such a database can help in understanding the various subsegments in the group. The database should utilize data generated by the implementation of the Goods and Services Tax, data available at credit bureaus, and data available with banks and credit rating agencies. Mandatory reporting as required in the case of credit bureaus will help in building up the database. The use of analytics will help in developing scoring models for MSME lending specific to each subsegment. The database could also help in developing differential pricing for credit guarantees.

While availability and cost of financing of MSME loans is very important, financial literacy of MSME owners is important to enable them to make informed financial decisions. Only 24% of adults are financially literate in India according to the Global Financial Literacy Survey (Standard & Poor 2005). The government of India and the RBI need to design and implement a financial literacy strategy that will target adults and MSMEs, helping them make informed decisions. This could include a wide array of measures, such as financial education in national education curricula, dedicated training and workshops for MSMEs, and the launch of applications and a website to promote financial education (with videos, calculators, and games) based on the model of the Australian website MoneySmart (OECD 2012).

There have been several positive developments that augur well for MSME financing in recent times. The development of an MSME-focused credit risk database that will help in developing credit scoring models and widespread and systematic promotion of financial literacy efforts for MSME owners are the next steps that will greatly help the MSME sector to take full advantage of these positive developments.

REFERENCES

Asian Development Bank. 2014. *Asia SME Finance Monitor 2014.* https://www.adb.org/publications/asia-sme-finance-monitor-2014.

International Finance Corporation (IFC). 2012. *Micro, Small and Medium Finance in India: A Research Study on Needs, Gaps and Way Forward.* www.ifc.org/wps/wcm/connect/4760ee004ec65f44a165bd45b400a808/MSME+Report-03-01-2013.pdf?MOD=AJPERES.

Joshi, Deepali Pant.2014. Credit Scoring. *rbi.org.* https://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1042.

KPMG. 2016. *The New Wave Indian MSME.* https://assets.kpmg.com/content/dam/kpmg/pdf/2016/03/The-new-wave-Indian-MSME.pdf.

Kuwahara, S., Yoshino, N., Sagara, M. and Taghizadeh-Hesary, F. 2016. Role of Credit Risk Database in Developing SMEs in Japan: Ideas for Asia. In *SMEs in Developing Asia*, ADBI: Tokyo 297−323.

Manickaraj, M. 2010. Electronica Finance Limited: Designing the Future of Micro, Small, and Medium Enterprises. *Vikalpa,* 35 (30). 117–127.

Ministry of Micro, Small and Medium Enterprises. 2009. *Quick Results. 4th All India Census of MSMEs 2006−07.* www.dcmsme.gov.in. http://www.dcmsme.gov.in/publications/Final%20Report%20of%20Fourth%20All%20India%20Census%20of%20MSME%20Unregistered%20Sector%202006-07.pdf.

———. 2015. *Public Procurement Policy 2012.* http://dcmsme.gov.in/Public-Procurement-Policy-15.pdf.

———. 2016. *Performance and Credit Rating Scheme for MSMEs − Guidelines.* http://www.nsic.co.in/pdfs/Rev_gd23052016.PDF.

———. *Annual Report 2017−18.* https://msme.gov.in/sites/default/files/MSME-AR-2017-18-Eng.pdf.

Mohapatra, Ambuj. 2012. *Study of the Performance and Credit Rating Scheme for Micro and Small Enterprises.* www.nsic.co.in. http://www.nsic.co.in/pdfs/STUDY/srcr2012.pdf.

Nayak, G. 2015. We see ourselves as a strong market maker for MSME ecosystem: Sidbi MD, Kshatrapati Shivaji. Interview with Small Industries Development Bank of India managing director. *Economic Times.* 23 October. http://economictimes.indiatimes.com/opinion/interviews/We-see-ourselves-as-a-strong-market-maker-for-MSME-ecosystem-Sidbi-MD-Kshatrapati-Shivaji/articleshow/49498919.cms.

OECD. 2012. *OECD/INFE High-Level Principles on National Strategies for Financial Education*. http://www.oecd.org/daf/fin/financial-education/OECD-INFE-Principles-National-Strategies-Financial-Education.pdf.

Prasad Gireesh Chandra. 2018. *Government Redefines MSMEs Based on Annual Revenue.* Livemint Newspaper, February 8.

Ramachandran, Narayan. 2018. *Crediting India's Credit Information Companies.* Livemint Newspaper, April 2. https://www.livemint.com/Opinion/KpoLsdCeou5NUV1mDjmVUN/Crediting-Indias-credit-information-companies.html.

Reserve Bank of India. 2007. *Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework.* https://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=3464.

———. 2013. *Master Circular on Basle III Capital Regulations.* https://rbidocs.rbi.org.in/rdocs/content/pdfs/58BS300685FL.pdf.

———. 2015. *Financial Institutions: Soundness and Resilience.* https://rbi.org.in/scripts/PublicationReportDetails.aspx?ID=831.

———. 2016. *Financial Institutions: Soundness and Resilience.* https://rbi.org.in/scripts/PublicationReportDetails.aspx?ID=861.

———. 2017. *Financial Institutions: Soundness and Resilience.* https://rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=887.

———. 2018. *Financial Institutions: Soundness and Resilience.* https://rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=902.

———. 2016—17. *Report on Trend and Progress of Banking in India.* https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP20161778B7539711F14E088A31D52351BF6440.PDF.

Shankar, Savita. 2016. *Bridging the Missing Middle between Micro Finance and Small and Medium-Sized Enterprise Finance in South Asia.* https://www.adb.org/sites/default/files/publication/189390/adbi-wp587.pdf

Singh, Sugandh. 2017. The Bad Boy among Banks' NPAs. *Entrepreneur India Magazine.* https://www.entrepreneur.co.

Standard & Poor. 2015. Global Financial Literacy Survey. http://gflec.org/wp-content/uploads/2015/11/3313-Finlit_Report_FINAL-5.11.16.pdf?x87657.

TransUnion CIBIL. 2017. *TransUnion CIBIL Launches CIBIL MSME Rank.* https://www.transunioncibil.com/press-release/transunion-cibil-launches-cibil-msme-rank.

TransUnion CIBIL-SIDBI. 2018. *MSME Pulse June 2018.* https://www.transunioncibil.com/resources/tucibil/doc/insights/reports/report-msme-pulse-June-2018.pdf.