Financing Micro, Small, and Medium Enterprises in Indian Industry

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INTRODUCTION

During the last five decades, the micro, small and medium enterprises (MSME) in the Indian economy has emerged as a dynamic and vibrant segment having a significant contribution towards employment generation and entrepreneurship formation. In addition, these enterprises play a crucial role in making the growth of the economy more inclusive by reducing regional disparity. During 2012-17, the MSME sector in India accounted for almost 38 per cent of GDP. The sector has grown approximately at a rate of 28.02 per cent and 26.42 per cent in terms of estimated number of enterprises and employment respectively during the period 2001-02 to 2006-07. Within the MSME sector, services constitute 80 per cent and manufacturing constitutes the remaining 20 per cent (Annual Report, Ministry of MSME, 2014-15).

Despite being an important contributor towards the national output and employment of the economy, the issue of timely and adequate availability of credit has been recognised as one of the major impediments to the growth of the sector in recent times. Recognising the problem of credit constraint faced by MSMEs, a slew of initiatives has been undertaken to make the financial system architecture of the sector more conducive for growth. However, the issue of credit availability to small firms became more important after the recent financial crisis which caused further slowdown in credit flow from formal banking system to the small firms.

Across the world, countries have followed different strategies to solve the issue of information asymmetry and credit rationing in the small value loan market. However, adoption of these strategies primarily depends on the financial and legal system of the country. Typically, countries with advanced capital markets and strong legal and enforcement system use credit scoring, factoring, and leasing as alternative techniques to solve the issue of information asymmetry in small business loan segment (Berger and Udell 2006). However, due to weak enforcement, these strategies have limited effectiveness in developing countries. As a result, small firms in developing countries face larger credit constraints compared with countries which have well-developed financial systems. The existing literature on small firm financing discusses the issues and challenges from a cross-country perspective. There is a lack of detailed research on implications of country specific factors and financial system on small firm financing. The present essay aims to fill this gap by analysing the extent and nature of credit constraint faced by small firms in India.

The existing literature on small firm financing often analyses issues using the cross-country data. There are very few studies to understand the problems or complexities associated with small firm financing in the context of India. Further, deployment of technology assumes a key role in solving some of the structural issues embedded in the financial system of developing countries hindering credit flow to small businesses. At the same time, use of technology in the lending of small businesses raises important issues related to regulatory and policy responses to the online credit markets. So far, there is no comprehensive

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study of these issues in the literature. The present chapter aims to fill this gap. The objective of the present chapter is to analyse the financial system of India in the context of lending to small firms and to what extent use of technology can solve the problem of lack of access to credit to small firms in India.

The chapter is organised as follows: The next section (Section 2) provides a brief of theoretical foundation and literature review on the financing of small firms around the world. Section 2 is further divided into two sub-sections focusing on the existing lending technologies in the context of small firm financing around the world and the how infusion of technology in financial market may change the landscape. Section 3 delineates the present status of credit flow to the MSME sector from the formal banking system. The section also discusses the issues and challenges involved in providing finance to the small businesses through the banking system in India. Section 4 describes in detail the present state of technology in the small business credit market in India. Section 5 concludes the study with observations and policy implications.

BACKGROUND AND LITERATURE REVIEW

Worldwide, access to finance has been a major challenge for small enterprises (Beck and Demirguc-Kunt 2006). The information asymmetry in the small business lending market can take the form of i) ex-ante screening of projects (adverse selection) or ii) ex-post monitoring of loan contracts (moral hazard). In the presence of information asymmetry, there exists an interest rate which maximizes expected return to the bank and beyond which, increasing the interest rate as a response to meeting credit demand could attract more risky borrowers resulting in a lower profit for the bank. As a result, banks prefer to ration credit in such a situation.

Lending Technologies in the Context of Small Firm Financing: Relationship-Based vs. Arm's-Length Systems

Worldwide, the financial systems can be classified into two broad categories; i) bank-based system as observed in the case of Germany and Japan ii) capital market based system as the one in UK and US. Typically financial institutions in an arm's length system rely on hard information in the form of financial system statements for loan disbursement as well as loan pricing. On the other hand, in a relationship-based system, the length of the relationship between a financial institution and borrower determines key terms of loan contract (Peterson and Rajan 1995).

Suggesting that the causality runs from finance to growth, Rajan and Zingles (2001) establishes the theoretical underpinning of the interdependence between the financial system and industrial structure. According to the study, the relative growth of industries is largely influenced by financial system structure of the country. Industries which require a higher amount of external financing will thrive in countries with developed financial systems. Similarly, countries with advanced financial system cater to the needs of young and innovative firms well which at a later stage, fuels the wave of creative destruction as alluded by Schumpeter (1911). Also, the study highlights the role of collateral in mitigating information asymmetry problems in developing countries. Accordingly, as the capital market of a country develops, equity financed industries tend to grow faster and use less fixed capital. This theory also establishes the link between equity market development and innovation. As innovation is typically an intangible asset, the growth of innovation-led industries requires the development of equity market to efficiently process soft assets like innovation. According to Wurgler (2000), countries with well-developed financial systems will invest more in growing industries while countries with the underdeveloped financial system will focus on declining industries.