Evaluating Access to Finance Constraints for Micro, Small & Medium Enterprises in India

Marcia Parada
Aayush Sakya
Kathryn Seitz
Shwetha Shankar

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# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>LIST OF FIGURES</td>
<td>V</td>
</tr>
<tr>
<td>LIST OF TABLES</td>
<td>VI</td>
</tr>
<tr>
<td>LIST OF ABBREVIATIONS</td>
<td>VII</td>
</tr>
<tr>
<td>EXECUTIVE SUMMARY</td>
<td>VIII</td>
</tr>
<tr>
<td>1 INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>2 HISTORY AND BACKGROUND</td>
<td>3</td>
</tr>
<tr>
<td>2.1 Post-Independence</td>
<td>3</td>
</tr>
<tr>
<td>2.2 Early 1990s: Focus on MSMEs</td>
<td>3</td>
</tr>
<tr>
<td>2.3 Mid-2000s: Increasing Attention on MSMEs</td>
<td>3</td>
</tr>
<tr>
<td>3 METHODOLOGY</td>
<td>5</td>
</tr>
<tr>
<td>3.1 Phase 1: Analysis of the MSME Operating Environment</td>
<td>5</td>
</tr>
<tr>
<td>3.1.1 World Bank Enterprise Surveys data description: Micro Manufacturing</td>
<td>6</td>
</tr>
<tr>
<td>3.1.2 World Bank Enterprise Surveys data description: Retail Enterprises</td>
<td>6</td>
</tr>
<tr>
<td>3.1.3 World Bank Enterprise Surveys data description: IT and Communication Technology Enterprises</td>
<td>6</td>
</tr>
<tr>
<td>3.2 Phase 2: Focus on Access to Finance</td>
<td>7</td>
</tr>
<tr>
<td>3.2.1 World Bank Enterprise Survey data description: Manufacturing survey</td>
<td>8</td>
</tr>
<tr>
<td>3.3 Phase 3: Preparation of Recommendations</td>
<td>9</td>
</tr>
<tr>
<td>4 An Analysis of the MSME Operating Environment</td>
<td>10</td>
</tr>
<tr>
<td>4.1 Electricity</td>
<td>11</td>
</tr>
<tr>
<td>4.2 Corruption</td>
<td>11</td>
</tr>
<tr>
<td>4.3 Tax Rates and Tax Administration</td>
<td>12</td>
</tr>
<tr>
<td>4.4 Access to Finance</td>
<td>14</td>
</tr>
<tr>
<td>4.5 Reserve Bank of India Stakeholder Survey</td>
<td>15</td>
</tr>
<tr>
<td>5 Access to Finance</td>
<td>16</td>
</tr>
<tr>
<td>5.1 Literature Review: Importance of Access to Finance</td>
<td>16</td>
</tr>
<tr>
<td>5.2 Literature Review: Types of Financial Barriers Faced by MSMEs</td>
<td>17</td>
</tr>
<tr>
<td>5.2.1 Involuntary Exclusion</td>
<td>17</td>
</tr>
<tr>
<td>5.2.2 Voluntary Exclusion</td>
<td>17</td>
</tr>
<tr>
<td>5.2.3 Implications</td>
<td>17</td>
</tr>
<tr>
<td>5.3 National-level Survey Analysis of Access to Finance Barriers</td>
<td>18</td>
</tr>
<tr>
<td>5.3.1 Utilization of bank funding by size</td>
<td>18</td>
</tr>
<tr>
<td>5.3.2 Evidence of involuntary exclusion</td>
<td>18</td>
</tr>
<tr>
<td>5.3.3 Evidence of voluntary exclusion</td>
<td>20</td>
</tr>
<tr>
<td>5.4 State-level Survey Analysis of Access to Finance Barriers</td>
<td>22</td>
</tr>
<tr>
<td>5.4.1 State-level Findings from the Retail Services Survey</td>
<td>24</td>
</tr>
<tr>
<td>5.4.2 State-level Findings from the Manufacturing Survey</td>
<td>25</td>
</tr>
<tr>
<td>5.4.3 No Evidence of Differences in Finance Laws Across States</td>
<td>27</td>
</tr>
</tbody>
</table>
6 LENDING TO MICRO AND SMALL ENTERPRISES IN INDIA

6.1 Priority Sector Lending

6.2 Credit Provided to Micro, Small and Medium Enterprises

6.2.1 Public Sector Banks

6.2.2 Private Sector Banks

6.2.3 Foreign Banks

6.2.4 Urban Cooperative Banks

6.3 Microfinance Sector Lending

7 New Initiatives to Facilitate Access to Finance

7.1 Initiatives to Increase Directed Funds and Guarantees

7.1.1 Priority Lending Targets

7.1.2 Refinancing Funds

7.1.3 Credit Guarantees

7.1.4 SVCL (SIDBI Venture Capital Limited)

7.1.5 SME Finance and Development Project (SMEFDP)

7.2 Initiatives to Reduce Information Asymmetries

7.2.1 Credit Information Bureau India Limited (CIBIL)

7.2.2 Performance & Credit Rating Scheme

7.3 Initiatives to Reduce Transaction Costs

7.3.1 Cluster Financing

7.3.2 Online Business Registration

7.4 Initiatives to Enhance Bank Financial Flexibility

7.4.1 Interest Rate Deregulation

7.4.2 Collateral Registration & Recovery

7.4.3 India SME Asset Reconstruction Company (ISARC)

7.5 Initiatives Fail to Address MSME Voluntary Exclusion from Finance Problem

8 Recommendations

8.1 Framework

8.2 Alternatives and Recommended Programs

8.2.1 Banking Reform

8.2.2 Technical Assistance to Banks

8.2.3 Program Evaluation and Monitoring

8.2.4 Public Private Dialogue

9 Conclusion

10 Bibliography

11 Appendix 1: Structure of India’s Banking Sector

12 Appendix 2: Steps for Business Registration in India
List of Figures

Figure 1 The three phases of the methodology utilized in this report ............................................................. 5
Figure 2 Size of Micro Manufacturing dataset by workers .................................................................................. 6
Figure 3 Location of surveyed establishments in the Micro Manufacturing dataset ............................................. 6
Figure 4 Size of retail enterprises dataset by workers ...................................................................................... 7
Figure 5 Location of surveyed establishments in the retail enterprises dataset .................................................. 7
Figure 6 Size of IT and communications technology enterprises dataset by workers ........................................... 7
Figure 7 Size of manufacturing enterprises dataset (from the World Bank Enterprise surveys website) .......................................................... 8
Figure 8 List of barriers provided by the survey for ranking by severity by the respondent ... 10
Figure 9 Top six barriers to growth for SMEs from the World Bank Enterprise Survey data .11
Figure 10 Corruption as a constraint to growth, and the prevalence of informal gifts to ‘get things done’ ............................................................................................................................. 12
Figure 11 Tax rates and tax administration issues as a constraint to growth in India ................................. 13
Figure 12 Ranking of access to finance as a major or severe obstacle, by sector .............................. 14
Figure 13 Reasons for poor growth among MSMEs as cited by stakeholders in the RBI survey (listed in order of frequency of citation) ................................................................................................. 15
Figure 14 Source of finance for working capital ............................................................................................ 19
Figure 15 Source of finance for new investments .......................................................................................... 19
Figure 16 Bank interaction by firm size .............................................................................................................. 19
Figure 17 Reasons for loan rejection by sector ................................................................................................ 20
Figure 18 Annual purchases by firm size .......................................................................................................... 22
Figure 19 Average value of loan collateral (as a percent of loan value) ........................................................... 22
Figure 20 State-wise share of credit in India .................................................................................................... 23
Figure 21 Business with current loans from financial institutions by state ......................................................... 26
Figure 22 Firms reporting access to finance as a moderate to severe obstacle ................................................. 26
Figure 23 Firms that have their annual financial statement checked by an external auditor ............................ 27
Figure 24 Number of weeks required to approve an application from time of submission .................... 27
Figure 25 SCB lending to the MSE sector ........................................................................................................ 29
Figure 26 Share of SCB lending to MSEs ......................................................................................................... 30
Figure 27 Involuntary exclusion problems and initiatives .................................................................................. 32
Figure 28 Criteria used to rate recommendations ............................................................................................. 39
Figure 29 Structure of India’s banking sector .................................................................................................. 50
List of Tables

TABLE 1 DEFINITION OF SMEs (BASED ON INVESTMENT IN PLANT, PROPERTY, AND EQUIPMENT) .................. 1
TABLE 2 THE BURDEN OF TAX RATES IN INDIA: NUMBER OF PAYMENTS, MANAGEMENT TIME UTILIZED, AND PROFIT LOST ................................................................. 14
TABLE 3 REASONS FOR NOT TAKING OUT A LOAN ............................................................................. 20
TABLE 4 REASONS FOR NOT TAKING OUT A LOAN: A COMPARISON WITH CHINA AND RUSSIA ............. 21
TABLE 5 NUMBER OF FIRMS SAMPLED IN EACH STATE ..................................................................... 23
TABLE 6 IS ACCESS TO FINANCING AN OBSTACLE TO CURRENT OPERATIONS OF THIS STORE? ............ 24
TABLE 7 LENDING STATISTICS FOR FIRMS WITH A CURRENT LOAN OR LINE OF CREDIT .................. 24
TABLE 8 "WHAT WAS THE MAIN REASON THIS FIRM DID NOT APPLY FOR A LOAN?" ......................... 25
TABLE 9 FINANCIAL SOPHISTICATION OF FIRMS ACROSS STATES ................................................. 25
TABLE 10 PRIORITY SECTOR LENDING .......................................................................................... 28
TABLE 11 RATING OF RECOMMENDATIONS AGAINST CRITERIA ...................................................... 43
TABLE 12 STAKEHOLDERS OPERATING IN THE MSME CREDIT ACCESS SPACE .............................. 44
TABLE 13 CREDIT PROVIDED TO MSEs ......................................................................................... 50
List of Abbreviations

ANBC  Adjusted Net Bank Credit
CEOBE  Credit-equivalent Amount of Off-balance Sheet Exposures
CF  Credit Facility
CGTMSE  Credit Guarantee Fund Trust for Micro and Small Enterprises
CIBIL  Credit Information Bureau India Limited
CII  Confederation of Indian Industry
CRISIL  Credit Rating and Information Services of India
DFID  UK Department for International Development
FI  Financial Institutions
GoI  Government of India
IBA  Indian Bankers Association
ISARC  India SME Asset Reconstruction Company
ISTSL  India SME Technology Service Limited
MFI  Microfinance Institutions
MSE  Micro and Small Enterprises
MSME  Micro, Small and Medium Enterprises
MSMED  Micro, Small and Medium Enterprises Development Act
MMSME  Ministry of Micro, Small and Medium Enterprises
MoF  Ministry of Finance
MoU  Memorandum of Understanding
NABARD  The National Bank for Agriculture and Rural Development
NHB  National Housing Bank
NPA  Non-performing Assets
NPL  Non-performing Loans
NSIC  National Small Industry Company
NSSO  National Sample Survey Organization
PPE  Property, Plant and Equipment
RBI  Reserve Bank of India
RSF  Risk Sharing Facility
SCB  Scheduled Commercial Banks
SIDBI  Small Industries Development Bank of India
SGF  SME Growth Fund
SMEFDP  SME Finance and Development Project
SMERA  SME Rating Agency of India Limited
SSI  Ministry of Small Scale Industries
SVCL  Small Industries Development Bank of India Venture Capital Limited
TBSE  Technology Bureau of Small Enterprises
UNIDO  UN Industrial Development Organization
Executive Summary

What is the purpose of our study?
The purpose of our study is to evaluate barriers faced by Micro, Small, and Medium enterprises (MSMEs) in India in accessing finance and achieving sustainable growth. This study was undertaken to assist the Asia Foundation in creating programs aimed at promoting growth among Indian MSMEs by improving their access to finance.

How did we collect the data and analyze the findings?
We analyzed firm-level survey data from the World Bank’s Enterprise Survey to understand the key constraints to growth faced by firms in India. Additionally, we used the same survey data to focus more deeply on the barriers MSMEs faced in accessing finance. We also analyzed data on bank lending to MSMEs obtained from the Reserve Bank of India. Alongside the data analysis, we conducted qualitative research of government policies aimed at ameliorating barriers to MSME operation. Finally, we developed a set of criteria with which we rated our proposed program recommendations.

What are our major findings from the data analysis?
Taken as a whole, access to finance is the most severe concern for MSMEs in India. However there are some differences regarding how different types of firms rate access to finance as an obstacle. 38 percent of micro-manufacturing firms report it as the most severe obstacle to operations, compared to only 6 percent of IT firms.

Other obstacles identified as a major concern by MSMEs are poor delivery of electricity, corruption and high tax rates and onerous tax administration.

Problems related to access to finance stems from two different sources. The first concerns involuntary exclusion, wherein banks discriminate against small borrowers because of higher transaction costs and information asymmetry. Secondly, MSMEs may not access finance because of voluntary exclusion. In this case, firms choose not to pursue formal financing for a variety of reasons, including the availability of informal lending sources or the lack of a desire to grow. We found evidence of both involuntary and voluntary exclusion in the case of MSMEs in India.

Based on our state-level analysis of access to finance, there is considerable variation across states in lending to small enterprises. However, these differences are not a result of differences in financial laws across states. In India, relevant banking laws are promulgated at the national level. Thus, the wide disparities between states result from factors such as their respective bureaucratic effectiveness, degree of legal protection, and progress with economic development initiatives.
What are our major findings from the review of government initiatives?
One main policy that affects financing to MSMEs is the priority sector lending requirement. Banks have to provide 32 to 40 percent of their loan portfolio to priority sectors, which include agriculture, MSMEs, education, and other targeted sectors. We found that all types of banks meet the priority sector requirements set by the government.

Since 2005, multiple programs have been initiated to assist in increasing funding for smaller borrowers. Most of these initiatives address the involuntary exclusion of MSMEs from accessing finance. The government initiatives to increase credit to the MSME sector have four primary objectives: increase directed funds and guarantees, reduce information asymmetries, reduce transaction costs, and increase bank financial flexibility.

Since the policy initiatives are relatively new, it is difficult to assess their success at this point in time.

What are our recommendations?
We recommend that the Asia Foundation address issues stemming from both voluntary and involuntary exclusion with regards to access to finance. This can be achieved through the implementation of the following initiatives:

Program Evaluation and Monitoring
Various arms of the national government have launched measures to address the issue of access to finance in the MSME sector. Unfortunately, there is no single entity that systematically monitors progress on this front. We believe that the Asia Foundation could work with stakeholders in the MSME sector to conduct ex-post analysis of government reforms and publish them regularly. This measure would address involuntary exclusion of small businesses in accessing finance.

Public Private Dialogue
We also recommend the use of a public-private dialogue framework to address voluntary exclusion of businesses. By launching dialogues between various stakeholders—including government agencies, banks, and small businesses at the national or local level—the Asia Foundation could provide a forum for these entities to hold discussions on various topics. Agenda items for such forums could include information sharing, business registration, training sessions on improving business skills, and dialogue between micro finance institutions.
1 Introduction

Growth and development of Micro, Small, and Medium Sized Enterprises (MSMEs) in India is a major priority given the crucial role that these enterprises play in the country’s industrial economy. One rupee of investment in fixed assets in the MSME sector, for example, produces an estimated 4.6 rupees of goods and services with an incremental 10 percent in value addition.\(^1\) According to the Ministry of MSMEs, over 12.8 million MSMEs collectively employ about 31 million people, produce 39 percent of India’s manufacturing output, and make up 95 percent of all industrial units. Their output accounts for approximately 33 percent of total exports and 50 percent of total manufacturing exports.\(^2\) As with other emerging countries, the MSME sector has become an important driver for employment in India. According to the Small Enterprise Finance Centre at the Institute of Financial Management and Research in Chennai, India, the MSME sector is the second largest sector of employment in India, behind agriculture, and makes up about 45 percent of industrial employment.

The Indian government defines MSMEs based on their total investment in plant, property, and equipment (PPE) as shown in Table 1. This definition was refined by the Micro, Small, and Medium Enterprises Development (MSMED) Act of 2006.

<table>
<thead>
<tr>
<th>Enterprises</th>
<th>Manufacturing Sector</th>
<th>Services sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>Less than Rs. 25 lakh ((&lt;\text{US}$54,000))</td>
<td>Less than Rs. 10 lakh ((&lt;\text{US}$21,500))</td>
</tr>
<tr>
<td>Small</td>
<td>Between Rs. 25 lakh and Rs. 5 crore (US$54,000 - US$1.07m)</td>
<td>Between Rs. 10 lakh and Rs. 2 crore (US$21,500 - US$430,000)</td>
</tr>
<tr>
<td>Medium</td>
<td>Between Rs. 5 crore and Rs. 10 crore (US$1.07m - $2.1m)</td>
<td>Between Rs. 5 crore and Rs. 10 crore (US$430,000 - $1.07m)</td>
</tr>
</tbody>
</table>

Given the crucial role that MSMEs play in the Indian economy and labor market, the Asia Foundation (TAF) seeks to better understand the environment in which these enterprises operate. In doing so, TAF is specifically interested in barriers that MSMEs face in accessing finance and policies created by the Reserve Bank of India (RBI) and the Ministry of Finance (MoF) in order to facilitate access to finance for the MSME sector. Finally, the Foundation hopes to identify areas in which it might undertake future initiatives and find potential partners for programs to promote sustainable growth among MSMEs.

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\(^3\) US dollar figures based on average 2009 conversion rate of Rs 46.59 to $1. Sourced from: Ministry of Micro Small and Medium Enterprises, Government of India.
As such, the above topics form the crux of this report. The following section outlines a brief history and background of general regulatory policies towards MSMEs. Section three offers a detailed description of the methodology used in this report. The fourth section discusses the top four obstacles to growth faced by MSMEs in India. Then, an in-depth analysis on the ‘access to finance’ obstacle follows in section five. Sections six and seven discuss the current regulatory framework surrounding financing for MSMEs and the key stakeholders that participate in the regulatory process. Finally, we conclude with a discussion of potential programs for the Asia Foundation’s operations in India and offer two recommended courses of action.
2 History and Background

2.1 Post-Independence
India’s economy grew slowly for more than thirty years following its independence in 1947 due to tight government control and adherence to socialist policies. In the late 1970s, the Janata Party came to power and enacted a series of economic reforms that paved the way for further liberalization and higher growth throughout the next decade. India’s economy grew at a much faster pace until problems arose beginning in the late 1980’s and culminating in 1991 with a severe external debt crisis. Yet rather than defaulting on foreign debt obligations, Indian leaders responded by embarking on a new period of economic liberalization marked by significant changes in the country's development strategy and increasing integration into the world economy.

2.2 Early 1990s: Focus on MSMEs
Within this context, the government also turned its attention toward the growth potential and economic importance of smaller enterprises. Parliament created the Small Industries Development Bank of India (SIDBI) in 1990 as the main financial institution to promote, finance, and develop small-scale industry. Today, according to SIDBI’s annual report, it provides direct financing to the MSME sector and operates two funds of Rs 2,000 crore ($430 million) each to focus on “risk capital financing” and enhancing the MSME sector’s refinancing capabilities.

In 1991, the government created the Ministry of Small Scale Industries (SSI) and provided direct assistance to the MSME sector by giving smaller enterprises priority production rights to a list of about 4,000 goods and services over larger firms. In keeping with the country’s progression towards more liberal economic policies, this protection has been gradually phased out. As of March 2005, the list contains only 506 goods/services.

2.3 Mid-2000s: Increasing Attention on MSMEs
Government focus on MSMEs intensified with the passage of the Micro Small and Medium Enterprises Development (MSMED) Act in 2006. This Act introduced the concept of ‘enterprise’ – which expanded on ‘industries’ to include both manufacturing and service entities – and defined MSMEs based on their total investment in plant, property, and equipment.

The 2006 Act also created the Ministry of Micro, Small, and Medium Enterprises (MMSME), which coordinates policy and regulation affecting MSMEs, and included provisions for:
• Preferences to MSMEs in government procurement activities
• Mechanisms to assist with delayed payment problems
• A scheme to help MSMEs with business closures

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• Specific funds to promote, develop, and enhance MSME competitiveness.\textsuperscript{7}

The government has also worked to promote MSMEs by improving credit availability via higher loan limits and facilitating cooperation amongst MSMEs.\textsuperscript{8} Cluster development programs encourage MSMEs to physically locate themselves near each other in order to increase collective bargaining power, take advantage of infrastructure and technology upgrades, and avoid fragmentation. Such policies have translated into growth for both small and medium sized firms and the economy as a whole.

\textsuperscript{7} 11\textsuperscript{th} Five Year Plan (2008)
\textsuperscript{8} “Growth Opportunities for Indian SMEs” (2008)
3 Methodology
This project was primarily exploratory in nature and was conducted in three phases. The initial phase focused on a macro-level analysis of the MSME operating environment. The second phase drilled deeper into the issues faced by MSMEs in accessing finance and examined regulatory initiatives to encourage greater access to credit. In the final phase, we developed a set of recommendations based on our analysis in phases one and two. This section explains the methodologies and sources used as well as data constraints.

![Figure 1 The three phases of the methodology utilized in this report](image)

3.1 Phase 1: Analysis of the MSME operating environment

In order to indentify key obstacles to growth faced by MSMEs in India, we first analyzed firm-level survey data from the World Bank’s Enterprise Surveys. Next, we conducted qualitative research on government policy aimed at ameliorating barriers to MSME operation.

The World Bank’s Enterprise Surveys are firm-level surveys conducted in many countries and in different industrial sectors within a country. Within India, the surveys used stratified random sampling to obtain a representative sample of private sector businesses and collected responses in person from managing directors, HR staff, accountants, and other key staff in each enterprise. The sample covered registered businesses and includes firms of all sizes.
In this phase, we used datasets from 2006 and from the three available sector surveys for India: micro-sized manufacturing enterprises, retail services firms, and information technology and communications services firms. We used employee size as the criterion to determine firm size rather than property, plant, and equipment figures because they were not available. The World Bank also defines firm size within the surveys based on employee numbers. A description of the datasets follows.

### 3.1.1 World Bank Enterprise Surveys data description: Micro Manufacturing

The micro manufacturing dataset surveys 1,549 enterprises, which are all quite small in size. This survey classifies three sizes of firms: household (1 worker), micro (1-5 workers), and small (6-10 workers). Figure 2 shows the breakdown by size, and Figure 3 shows the geographical distribution of enterprises in the dataset.

#### Figure 2 Size of Micro Manufacturing dataset by workers

![Size of Micro Manufacturing dataset by workers](image)

#### Figure 3 Location of surveyed establishments in the Micro Manufacturing dataset

![Location of surveyed establishments in the Micro Manufacturing dataset](image)

### 3.1.2 World Bank Enterprise Surveys data description: Retail Enterprises

The retail enterprises dataset includes 1,948 enterprises, the majority of which are sole proprietorships with private ownership. As in the micro manufacturing dataset, the number of workers determines the size of the enterprise. Small enterprises form an overwhelming majority of businesses surveyed, making up 96 percent of all respondents (see Figure 4). The geographical spread of retail enterprises surveyed is more varied than in the micro manufacturing survey and covers most Indian states. Figure 5 shows the regional breakdown of firms in the dataset.

### 3.1.3 World Bank Enterprise Surveys data description: IT and Communication Technology Enterprises

The IT and Communication Technology dataset includes only 360 enterprises. Here too, the number of workers determines the size of the enterprise, with small enterprises defined as 1-19 workers, medium enterprises 20-99 workers and large over 100 employees. The breakdown is shown in Figure 6.

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9 Data obtained from the World Bank India Micro Manufacturing Enterprise Surveys 2006

10 Ibid
From these three datasets, we determined the top four pressing issues faced by MSMEs in India as outlined in section 4. We also focused on understanding the importance of MSMEs to the Indian economy and researching regulatory initiatives designed by the Reserve Bank of India and the MoF to benefit MSMEs. This research supports the data analysis as described above.

### 3.2 Phase 2: Focus on Access to Finance

From the four most severe obstacles to operations for MSMEs, we focused in on access to finance for two primary reasons. Firstly, firms identified access to finance as serious barrier to MSME growth. Secondly, the Asia Foundation is particularly interested in working to improve credit access for MSMEs in India.

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11 Data obtained from the World Bank India Retail Services Enterprise Surveys 2006
12 Ibid
13 Data obtained from the World Bank India IT and Communications Technology Enterprise Surveys 2006
In order to fully understand access to finance constraints, we conducted a literature review to understand the importance of finance for MSMEs and further analyzed the datasets described in sections 3.1.1, 3.1.2, and 3.1.3 with a particular focus on access to finance issues at the national and state levels.

The Asia Foundation was interested in examining a diverse sample of states in terms of geography, bureaucratic structure, and economic progress and proposed six states for our sub-national data analysis: Bihar, Gujarat, Karnataka, Madhya Pradesh (MP), Maharashtra, and Tamil Nadu (TN). For the state-level analysis, we used the retail services dataset (described in section 3.1.2) as well as another dataset from the Enterprise Survey covering all manufacturing enterprises. This dataset is described in section 3.2.1. The reason for these particular datasets for the state level analysis was because these were the only datasets that had a strong level of detail at state level.

Finally, in order to contextualize the analysis conducted in phase 2, we also looked at actual bank lending figures for MSMEs with data obtained from the Reserve Bank of India. Finally, we conducted a detailed review of regulations and initiatives taken both by the Government of India and other organizations such as the World Bank.

### 3.2.1 World Bank Enterprise Survey data description: Manufacturing survey

The Manufacturing enterprises dataset surveys 2,286 enterprises.

Figure 7 shows the breakdown of this dataset by firm size as provided by the World Bank.

Figure 7 Size of Manufacturing enterprises dataset (From the World Bank Enterprise Surveys website)

Because of missing employee size responses, it is more difficult to determine firm size in this particular dataset. Thus, in order to extract only the observations from micro, small, or medium firms, we use PPE figures. Because not all firms provided PPE data, we only use observations for which firms provided this information. While this may cause bias in the analysis, we only analyze responses from questions wherein response averages are approximately equal between firms without PPE figures and firms that did provide this information. This is not an ideal solution, but the resulting conclusions do correspond with those described in the literature on Indian MSMEs.
3.3 Phase 3: Preparation of recommendations
Based on findings from our quantitative and qualitative analysis described above, we proposed several alternatives and recommendations for the Asia Foundation. These were assessed and then ranked using five different criteria. These were: existing expertise of TAF, long term impact of the alternative, willingness of stakeholders, cost of implementation, and ease of implementation. Finally, we compiled a set of stakeholders that operate in the MSME credit access space, as requested by the Asia Foundation.
4 An Analysis of the MSME Operating Environment

In order to gain an understanding of the key barriers to growth that MSMEs face in their daily operations, we analyzed survey data from a range of industries in the manufacturing and the retail sectors.\footnote{14} The three surveys asked firms to rank an exhaustive list of issues according to their severity, in the event that the issue was an obstacle to operations. The lists of factors are similar across the surveys, and Figure 8 provides an example from the manufacturing survey.

Figure 8 List of barriers provided by the survey for ranking by severity by the respondent\footnote{16}

<table>
<thead>
<tr>
<th>Severe Obstacle</th>
<th>Codes</th>
<th>No obstacle</th>
<th>Degrees of obstacle</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Telecommunications</td>
<td>R11_5aA</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>B. Electricity</td>
<td>R11_5aB</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>C. Transportation</td>
<td>R11_5aC</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>D. Access to Land</td>
<td>R11_5aD</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>E. High taxes</td>
<td>R11_5aE</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>F. Tax administration</td>
<td>R11_5aF</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>G. Customs and Trade Regulations</td>
<td>R11_5aG</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>H. Labor Regulations</td>
<td>R11_5aH</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>I. Skills and Education of Available Workers</td>
<td>R11_5aI</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>J. Business Licensing and Operating Permits</td>
<td>R11_5aJ</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>K. Access to Financing (e.g. collateral)</td>
<td>R11_5aK</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>L. Cost of Financing (e.g. interest rates)</td>
<td>R11_5aL</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>M. Economic and Regulatory Policy Uncertainty</td>
<td>R11_5aM</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>N. Macroeconomic Instability (inflation, exchange rate)</td>
<td>R11_5aN</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>O. Corruption</td>
<td>R11_5aO</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>P. Crime, theft and disorder</td>
<td>R11_5aP</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>Q. Anti-competitive or informal practices</td>
<td>R11_5aQ</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>R. Regulation specific to your industry</td>
<td>R11_5aR</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>S. Legal system/conflict resolution</td>
<td>R11_5aS</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>T. Access to Foreign Technology</td>
<td>R11_5aT</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>U. Other (please specify)</td>
<td>R11_5ax</td>
<td>0</td>
<td>1 2 3 4</td>
</tr>
</tbody>
</table>

Figure 9 shows the top six barriers to growth across the three datasets; the percentages represent firm that ranked each barrier as a major or very severe obstacle. We only examined the top four barriers—access to finance, electricity delivery, corruption and tax rates—in-depth since these were the most severe and most relevant to the Asia Foundation’s existing operations and interests. The following section provides a brief analysis of electricity delivery, corruption, and tax rates. Access to finance is introduced in this section, but a detailed description follows in section 5.

\footnote{14} As mentioned in the previous section, the survey data is from the World Bank’s Enterprise Surveys. The surveys utilized are the Micro Manufacturing, IT and Communications (manufacturing sector) and Retail Services (services sector) surveys.

\footnote{15} Sourced from the Enterprise Surveys Manufacturing Questionnaire, 2006.
4.1 Electricity
In all three surveys, firms cite poor delivery of electricity as a major concern. In fact, electricity ranked as either the first or second most pressing concern for all sectors. Firms experience an average of 20 to 40 hours of power outages per month across the three sectors, with average power outages lasting between two to five hours.

The lack of a reliable power supply impacts the three sectors we examined differently. While more retail services firms reported electricity delivery as a significant barrier, micro manufacturing firms are affected most severely and lose an average of 11.4 percent of sales annually due to power outages. Retail services claim that 3.5 percent of sales are affected by a disruption in electrical supply. Since firms in the retail and micro manufacturing sector are smaller, less than 40 percent of them are able to purchase or rent a generator to use during blackouts.

4.2 Corruption
Corruption appears to be an obstacle to operations for all enterprises regardless of size. 30 percent of medium enterprises in India cite corruption as a major constraint to operations compared to 25 percent of large enterprises and 23 percent of small firms (Figure 10).

---

Data obtained from the World Bank India Enterprise Surveys of Micro Manufacturing, IT and Communications, and Retail Services Enterprises (2006)
When looking at specific sectors, IT and tech firms claim corruption to be their number one obstacle to operations—23 percent of enterprises said it was a major obstacle. Interestingly, even though 38 percent of micro manufacturing firms report corruption as a major obstacle, they ranked it as only their seventh most severe obstacle. This is indicative of the severity of the other obstacles for micro manufacturing firms. Firms usually have to make informal payments or gifts to government official inspectors to “get things done” with regard to customs, taxes, licenses, regulations, and services. 43 percent of manufacturing firms claim a gift is expected of them costing 0.3 percent of annual sales or Rs. 5,645 (note: some respondents provided the informal payments as a percentage of sales while others quoted the absolute value instead). In comparison, 40 percent of retail services pay gifts at a cost of 3.8 percent of annual sales or Rs. 5,185. 32 percent of IT firms provided informal payments at a cost of 5 percent of the value of their projects.

### 4.3 Tax rates and tax administration

High tax rates and problems with tax administration, which includes all activities related to the filing of taxes, are significant barriers to Indian enterprises. Figure 11 shows that over 35 percent of medium enterprises and 26 percent of small enterprises in India consider high tax rates to be a major constraint. 29 percent of medium enterprises and 18 percent of small enterprises identify tax administration issues as a constraint.

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17 Data obtained from the World Bank India Enterprise Surveys of Micro Manufacturing, IT and Communications, and Retail Services Enterprises (2006)
The tax burden faced by Indian enterprises is exceptionally high according to the World Bank Doing Business India Report.\(^\text{18}\) Average tax payments and employee contributions reached a peak of 81 percent of firm profits in 2006 and currently stand at around 69 percent of firm profits. These figures vary significantly across cities and states based on variations in the tax regimes at the local and state levels. The Indian government has implemented a number of initiatives aimed at reducing the high tax burden in recent years. Between 2005 and 2008, the government standardized VAT rates across all states and progressively reduced the central sales tax from 4 percent to 2 percent of income. Further tasks on the government’s reform agenda in this area include introducing a centralized goods and services tax (GST) rate and the currently pending abolishment of the central sales tax.

Tax administration procedures are also onerous in India. A representative medium sized firm must make 59 annual tax payments, which consumes 271 hours of management’s time throughout the year. The number of tax payments and the ease of filing taxes also differ across cities and states. India far exceeds the South Asian average of 37 yearly payments.\(^\text{19}\) Furthermore, the extent to which an enterprise suffers from tax administration issues depends on several factors, including existing policy in the city where the firms’ current operations are based, administrative efficiency within the tax offices, the use of tax software, and the skills and awareness of the entrepreneur (see Table 2).

The government has initiated administrative reforms to simplify tax administration procedures and pursued a strategy of computerization to create online tax filing systems. The number of tax returns filed online in 2008 increased by 250 percent over the previous year.\(^\text{20}\)

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\(^{19}\) Ibid

\(^{20}\) Ibid
Table 2 The burden of tax rates in India: number of payments, management time utilized, and profit lost

<table>
<thead>
<tr>
<th>Tax or mandatory contribution</th>
<th>Payments (number)</th>
<th>Time (hours)</th>
<th>Statutory tax rate</th>
<th>Tax base</th>
<th>Tax rate (% profit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate income tax</td>
<td>1</td>
<td>47</td>
<td>34.00%</td>
<td>taxable profits</td>
<td>22.1</td>
</tr>
<tr>
<td>Central Sales Tax</td>
<td>12</td>
<td>128</td>
<td>2%</td>
<td>purchase price</td>
<td>17.1</td>
</tr>
<tr>
<td>Social security contributions</td>
<td>12</td>
<td>96</td>
<td>12%</td>
<td>gross salaries</td>
<td>13.5</td>
</tr>
<tr>
<td>Employer’s state insurance contribution</td>
<td>12</td>
<td>-</td>
<td>4.75%</td>
<td>gross salaries</td>
<td>4.6</td>
</tr>
<tr>
<td>Property tax</td>
<td>1</td>
<td>-</td>
<td>10%</td>
<td>assessed value</td>
<td>2.3</td>
</tr>
<tr>
<td>Dividend tax</td>
<td>1</td>
<td>-</td>
<td>14%</td>
<td>dividend distributions</td>
<td>3</td>
</tr>
<tr>
<td>Fuel tax</td>
<td>1</td>
<td>-</td>
<td>6% + Rs. 3.25 per litar</td>
<td>fuel consumption</td>
<td>0.4</td>
</tr>
<tr>
<td>Fringe Benefit Tax</td>
<td>4</td>
<td>-</td>
<td>30%</td>
<td>value of specified corporate expenses (usually 20%)</td>
<td>0.3</td>
</tr>
<tr>
<td>Tax on insurance contracts</td>
<td>1</td>
<td>-</td>
<td>12%</td>
<td>insurance premium</td>
<td>0.3</td>
</tr>
<tr>
<td>Vehicle tax (pollution tax)</td>
<td>1</td>
<td>-</td>
<td>fixed fee (Rs 50)</td>
<td>per vehicle in use</td>
<td>0</td>
</tr>
<tr>
<td>Tax on interest</td>
<td>0</td>
<td>-</td>
<td>20%</td>
<td>interest income</td>
<td></td>
</tr>
<tr>
<td>State VAT</td>
<td>12</td>
<td>-</td>
<td>12.50%</td>
<td>value added on all federal taxes including the surcharge</td>
<td></td>
</tr>
<tr>
<td>Education cess</td>
<td>0</td>
<td>-</td>
<td>3.00%</td>
<td>the surcharge</td>
<td></td>
</tr>
<tr>
<td>Income surcharge</td>
<td>0</td>
<td>-</td>
<td>10%</td>
<td>on all federal taxes</td>
<td></td>
</tr>
<tr>
<td>CENVAT (Excise Duty)</td>
<td>1</td>
<td>-</td>
<td>14.42%</td>
<td>value added on all federal taxes including the surcharge</td>
<td></td>
</tr>
<tr>
<td>Secondary &amp; Higher education cess</td>
<td>0</td>
<td>-</td>
<td>1%</td>
<td>the surcharge</td>
<td></td>
</tr>
<tr>
<td><strong>Totals:</strong></td>
<td><strong>59</strong></td>
<td><strong>271</strong></td>
<td></td>
<td><strong>64.7</strong></td>
<td></td>
</tr>
</tbody>
</table>

4.4 Access to Finance

Access to finance includes the availability, cost, wait time, term and size of a loan, and the procedures and collateral required to get a loan. Problems with consistent access to finance at fair prices appear to adversely affect MSMEs in India.

Figure 12 shows that a large number of micro manufacturers—which represent the smallest firms out of the three datasets—rank access to finance as a major or very severe obstacle. As described below, capital shortages and the lack of long-term financing opportunities often prevent these firms from realizing their full potential for growth. At the same time, small firms sometimes elect not to utilize the banking sector to finance their operations or expansion. Since the remainder of our report focuses on access to finance constraints, the next section provides a more detailed analysis of this barrier.

Figure 12 Ranking of access to finance as a major or severe obstacle, by sector

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4.5 Reserve Bank of India Stakeholder Survey

In mid 2007, a working group was commissioned by the Reserve Bank of India to determine different stakeholder views on the impediments in the growth of the MSME sector. A survey was conducted among commercial banks, MSME/industry associations, state governments, and entrepreneurship development institutes to obtain initial feedback, which was later complimented by extensive discussions with entrepreneurs and MSME associations. This is an example of one of the many public/private/civil society dialogues that the RBI has initiated in an effort to obtain feedback from across the board on the issues affecting MSME growth. The questionnaire took the form of an open-ended 10-question survey, and we have included the stakeholder responses to the question “what are the major reasons responsible for poor growth [for MSMEs]?” in Figure 13.

From the survey, we find that banks see marketing problems, inadequate infrastructure, and obsolete technology as the major obstacles to growth for MSMEs. In addition to inadequate marketing capabilities, MSME associations consider that delayed and inadequate finance, delay in government clearances, and high cost of funds are the major reasons for MSME’s lackluster growth. Directors of industry share the same concerns as banks and RRBs regarding the lack of infrastructure. They also find that delayed and inadequate finance is a problem to growth. On the other hand, entrepreneurship development institutes believe MSME growth challenges stem from a lack of managerial competence and a lack of awareness of services available for these firms.

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Figure 13 Reasons for poor growth among MSMEs as cited by stakeholders in the RBI survey (Listed in order of frequency of citation)\(^{22}\)

**Most Common**
- Inadequate marketing capability
- Lack of infrastructure
- Delayed and inadequate finance
- Lack of managerial competence

**Common**
- Obsolete technology
- Tough competition
- High cost of funds
- Delay in government approval

**Least Common**
- Delay in realization of receivables
- Creation of awareness

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5 Access to Finance

After considering the four major obstacles to growth and operations faced by MSMEs, access to finance stands out for both its severity and its potential to be alleviated by government policy and collaboration with stakeholders. Based on these practical considerations and the Asia Foundation’s existing expertise in regulatory reform and local economic development programs, the second half of this report focuses primarily on financing constraints to MSME operations.

5.1 Literature Review: Importance of Access to Finance

Before proceeding with more in-depth data analysis, we sought to understand whether or not increased access to finance is important for smaller-sized firms and if so, why. According to both theoretical and empirical literature, greater access to formal financial services is quite important, especially for small firms, for several reasons.

To begin with, an organized financial system more efficiently allocates capital than individuals. Information asymmetries and transaction costs emerge when individual borrowing and lending decisions must be made.23 Such frictions exist in almost all financial markets and have been shown to more adversely affect micro and small firms. In fact, financing constraints have been shown to reduce firm growth by 6 percent for large firms and 10 percent for small firms.24 Well-functioning financial systems are desirable because they help mitigate the costs of these frictions and ensure that worthy borrowers can access capital.

Moreover, there are proven firm-level benefits of increased access to finance. Since budding entrepreneurs often lack the funds to self-finance a business, bank loans help them to capitalize on innovation. Formal bank financing is also empirically linked to firm growth and a larger firm size, which typically results in greater efficiency, as firms are able to take advantage of economies of scale.25 Finally, firms that cannot access bank-lending keep more cash on hand in order to finance their working capital needs or purchase fixed assets—and this puts them at a greater risk of making bad investment decisions due to loosened cost controls.26 Access to bank financing effectively reduces the retained earnings requirements for these small firms, which in turn, will protect them from bad decision making practices within the firm.

As these firm-level benefits aggregate across an economy, increased access to finance has been linked to greater competition and diversification at the national level. Because small firms typically have the most to gain from improved access to finance, it is also linked with greater income equality in countries.27 Such benefits have important implications for government policy. Namely, governments should build sound financial institutions, encourage competition, and establish regulation that ensures appropriate incentives and broader access to finance, especially for MSMEs.

24 Beck, Demirguc-Kunt, and Maksimovic (2005)
25 Ibid
26 Jensen (1998) and Stultz (1990)
27 Demirguc-Kunt, et al. (2008)
5.2 Literature Review: Types of Financial Barriers Faced by MSMEs

In order to better inform the analysis that follows, it is important to understand what kinds of problems small firms face in accessing finance. There is a key distinction between firms that cannot access finance—because it is too costly or unavailable to them—and firms that simply choose not to turn to banks for loans. These two rather different kinds of exclusion from financial services can be thought of as involuntary and voluntary.\(^{28}\)

5.2.1 Involuntary Exclusion

Involuntary exclusion occurs because the prices, terms, and conditions of formal financial services are unfavorable to small borrowers. Banks, for example, often discriminate against small borrowers due to their perceived riskiness, do not offer products that meet the needs of poorer customers, charge prohibitively high fees to such borrowers, and have unreasonable contractual requirements. Many smaller borrowers are not registered or have poor financial statement records—or none at all—so banks are unable to correctly evaluate the risk they pose. Banks may also be unaware of government schemes that exist to encourage greater lending to small enterprises, exacerbating the involuntary exclusion problem. Small borrowers, in turn, may decide not to utilize financial institutions—not because they truly have no need—but because the perceived and real costs of obtaining bank financing outweigh the benefits.

5.2.2 Voluntary Exclusion

On the other hand, small firms might voluntarily exclude themselves from formal banking services due to their own financial illiteracy. These borrowers may be unaware of the benefits associated with obtaining external financing because of educational problems and marketing failures on the part of banks. Moreover, firms might report that they have no need for a loan because they possess internal funds or can access banking services indirectly through friends or family. Micro and small sized firms may choose not to prioritize business growth and development based on their own limitations in managing such expansion.

5.2.3 Implications

Of course, some of the firms in each category of exclusion are likely to be economically uncompetitive, so policies geared at keeping them afloat would in fact interfere with market forces. Yet, in addition to the findings discussed above regarding firm-level benefits of access to finance, a study conducted on bank lending in India concluded that there is “definite evidence of very substantial under-lending” within the Indian banking system.\(^{29}\) This study found that an increase of Rs. 1,000 crore in lending was linked to a 2.7 percent increase in profit, all else equal. Moreover, Indian bank lending patterns indicate that firms lack credit because “banks seem remarkably reluctant to make fresh lending decisions.”\(^{30}\) According to their research, banks did not alter their nominal lending amounts from year to year for two-thirds of borrowers, despite rising inflation. Another study on lending in India takes these findings even further by pointing to the particular vulnerability of smaller firms: “there are strong structural underpinnings to the

\(^{28}\) Ibid
\(^{29}\) Banerjee, Cole, and Duflo (2003)
\(^{30}\) Ibid
inadequate flow [of finance]: the organizational structure of banks, and processes within them, have taken them far from task orientation, and have created a specific bias against small loan portfolios."

While these findings point to problems of involuntary exclusion, the linkage between increased lending and higher profits also has implications for those borrowers voluntarily excluding themselves from the banking system. Essentially, regardless of the type of exclusion, borrowers are likely missing out on potential growth opportunities.

5.3 National-level Survey Analysis of Access to Finance Barriers

Because the type of exclusion matters for our ultimate policy recommendations, this section utilizes the framework outlined above in order to better understand the financing problems faced by MSMEs in India based on data from the 2006 World Enterprise Surveys. It distinguishes between voluntary and involuntary exclusion where possible.

5.3.1 Utilization of bank funding by size

In order to meet working capital needs or make new fixed asset purchases, micro and small enterprises tend to rely more on internal funds and retained earnings than on loans from banks. This contrasts with medium and larger sized firms, which are more likely to use banks to meet their financing demands (see Figure 14, Figure 15, and Figure 16).

Overall, micro and small firms are also less likely to have a current loan from a financial institution than larger firms; approximately 35 percent of micro or small firms have an existing loan compared to more than 55 percent of medium sized firms.

It is difficult to say what factors lead to these outcomes, but inefficiencies certainly result from underutilization of external financing.

5.3.2 Evidence of involuntary exclusion

Access to finance appears to be a greater burden for smaller firms. As explained in section 4.4, more small firms (17 percent) identify access to finance as a major constraint to operations compared to medium (13.5 percent) or large firms (10.5 percent).32 Micro manufacturing enterprises, in particular, overwhelmingly report access to finance as their most severe obstacle to operations (Figure 12). Moreover half of all respondents in the National Sample Survey Organization (NSSO) reported that they experienced “an acute shortage of capital.”33

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32 Size is based on number of employees: small (5-19), medium (20-99), and large (more than 100)
Retail and tech business likely face even more pressing barriers to growth, such as lack of electricity or corruption, whereas micro manufacturing firms seem to have a harder time proving that they are worthy borrowers. This is likely due to the informal and often less sophisticated nature of smaller firms. It is possible to get a sense of financial sophistication based on a firm’s willingness to use external auditors to verify their financial statements, which also indicates that they keep such records in the first place. While about 95 percent of small and medium firms had their statements audited, just over 80 percent of micro firms used an auditor. This fact also helps
explain why micro manufacturers have more trouble taking out loans. Figure 17 illustrates that banks overwhelmingly reject loan applications from micro manufacturers due to “insufficient documentation.” A poor informational environment can force the use of collateral as a guarantee for loans rather than assessments of the quality and feasibility of investment projects or the credit history of the firm. Thus, the lack of adequate collateral also works against small firms.

Figure 17 Reasons for loan rejection by sector

5.3.3 Evidence of voluntary exclusion
According to the retail services survey, 92 percent of respondents—or 1,788 firms—did not take out a loan in the past year (2005-6). When asked why they did not take out a loan, the vast majority of these firms (77 percent) report “no need for a loan” despite being presented with a range of other response options. For IT and tech sector firms, the percentage reporting “no need for a loan” jumps up to 94 percent. As shown in Table 3, only a small percentage of these firms cited reasons that point to involuntary exclusion, such as unfavorable interest rates, collateral requirements, or application procedures.

Table 3 Reasons for not taking out a loan\textsuperscript{35}

<table>
<thead>
<tr>
<th>What was the main reason the firm did not apply for a loan?</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>No need for a loan</td>
<td>77</td>
</tr>
<tr>
<td>Application procedures are complex</td>
<td>7</td>
</tr>
<tr>
<td>Interest rates are not favorable</td>
<td>7</td>
</tr>
<tr>
<td>Did not think it would be approved</td>
<td>3</td>
</tr>
<tr>
<td>Collateral requirements are unattainable</td>
<td>3</td>
</tr>
<tr>
<td>Size and maturity of loan are insufficient</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
</tr>
</tbody>
</table>

\textsuperscript{35} From the Retail Services Survey, World Bank Enterprise Surveys (2006)
These results do not tell us why the firm had no need for a loan—an important piece of information in assessing whether or not to take action in order to promote firm growth. In other words, firms that simply do not want to grow because they lack profitable projects are different from firms that might otherwise want to grow if they had the expertise required to manage their own expansion or understood the benefits of formal financing. Nonetheless, this finding remains significant in the context of other large, developing nations. As shown in Table 4, more Indian firms report that they do not need a loan than firms in China or Russia. This points to the possibility that Indian firms are less likely to have adequate information about bank lending—and the application or cost barriers involved with obtaining loans—than their peers in other countries. Ultimately, further understanding is needed in this area as we elaborate on in the recommendation section.

Table 4 Reasons for not taking out a loan: a comparison with China and Russia

<table>
<thead>
<tr>
<th>Why did the firm not apply for a loan?</th>
<th>India (%)</th>
<th>China (%)</th>
<th>Russia (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does not need a loan</td>
<td>80</td>
<td>69</td>
<td>60</td>
</tr>
<tr>
<td>Collateral requirements are too strict</td>
<td>18</td>
<td>26</td>
<td>25</td>
</tr>
<tr>
<td>Interest rates are too high</td>
<td>17</td>
<td>17</td>
<td>35</td>
</tr>
<tr>
<td>Application procedures are too burdensome</td>
<td>16</td>
<td>27</td>
<td>23</td>
</tr>
<tr>
<td>Does not think it would be approved</td>
<td>n/a</td>
<td>22</td>
<td>2</td>
</tr>
<tr>
<td>It is necessary to make informal payments</td>
<td>n/a</td>
<td>11</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>7</td>
<td>n/a</td>
<td>3</td>
</tr>
</tbody>
</table>

Data on whether or not firms have potentially profitable investment ideas that they are unable to take advantage of due to limited credit access would be helpful for our analysis. Instead, we can examine their purchasing histories to get a sense of firms’ propensity to grow. As shown in Figure 18, small firms are far less likely than their larger counterparts to make fixed asset or land purchases.

Finally, the collateral requirements for loans differ only slightly between small and large firms. In fact, loans granted to small firms were less likely to require collateral (70 percent) than those extended to large firms (79 percent) probably due to government schemes that encourage banks to give collateral-free loans to MSMEs. On average, banks require collateral equaling 127 percent of the loan amount from small firms versus 121 percent from large firms (Figure 19). This surprisingly small difference may indicate that small firms that are approved for loans share similar risk profiles with medium and large sized firms with loans. The rejection rates of loan applications from different sized firms would allow us to rule out approval-bias, but these statistics are unavailable.

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36 Reproduced from Demirguc-Kunt, et al. (2008). Multiple responses were allowed in this particular survey, so the percentages do not add up to 100.
Thus, the data indicates that SMEs may voluntarily exclude themselves from formal banking services. These findings have important policy implications and point to the necessity of increasing both access to and understanding of the benefits of formal, external financing to micro and small enterprises in India.

5.4 State-level Survey Analysis of Access to Finance Barriers

In order to fully understand the financing landscape within India, we also analyzed data from the retail services and manufacturing (not to be confused with micro manufacturing) surveys at the state-level and found considerable variation across the chosen sample. As outlined in the methodology section, the Asia Foundation was interested in examining a diverse sample of states in terms of geography, bureaucratic structure, and economic progress and initially proposed six states: Bihar, Gujarat, Karnataka, Madhya Pradesh (MP), Maharashtra, and Tamil Nadu (TN). Figure 20 shows RBI data on differences across the six states in their share of overall lending as well as their share of credit given to small enterprises. As you can see from this figure, banks in Maharashtra and TN extend a disproportionately large share of credit overall and credit to small enterprises while banks in MP and Bihar underperform in these two areas.

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37 Sub-national data were not available for the micro manufacturing or IT and tech surveys.
38 Since India has 28 states, each state would have about 3.6 percent of the credit market under a scenario of equal distribution.
Table 5 provides summary statistics on the breakdown of firms across states in the two surveys. In the retail services survey, Bihar and MP were combined because only one city in Bihar (Patna) was included. For the manufacturing survey, Jharkhand was used in place of Bihar based on data availability, primarily because of the similarities in operating environment between the two states. Because of these differences as well as discrepancies between the two survey questionnaires, the results of our analysis are presented separately.

<table>
<thead>
<tr>
<th>State</th>
<th>No. of firms in retail services survey</th>
<th>No. of firms in manufacturing survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bihar/MP</td>
<td>160</td>
<td>N/A—see below for MP</td>
</tr>
<tr>
<td>Gujarat</td>
<td>175</td>
<td>178</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>N/A</td>
<td>187</td>
</tr>
<tr>
<td>Karnataka</td>
<td>188</td>
<td>203</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>286</td>
<td>194</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>161</td>
<td>194</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>See above, combined with Bihar</td>
<td>123</td>
</tr>
</tbody>
</table>

Only 32 firms were surveyed in Bihar compared to 187 firms in Jharkhand. Jharkhand state carved out of Bihar in the year 2000.
5.4.1 State-level Findings from the Retail Services Survey

The composition of small, medium and large firms was nearly identical across states in the retail services survey with small firms accounting for 93 percent (or greater) of the enterprises surveyed in each state.\footnote{These size delineations are determined by number of workers: a small firm has 1-19 workers, medium 20-99, and large over 100}

5.4.1.1 Evidence of Involuntary and Voluntary Exclusion

Responses to a question on the severity of access to finance obstacles for firms varied considerably across states but not necessarily in keeping with the RBI lending statistics shown above. Given the fact that TN, for example, has more than three times the assumed average share of credit to small enterprises—which would be 3.6 percent since there are 28 states in India—it was somewhat surprising that 15 percent of firms in TN ranked access to finance as a ‘very severe’ or ‘major’ obstacle (see Table 6).

*Table 6 Is access to financing an obstacle to current operations of this store?*

<table>
<thead>
<tr>
<th>State</th>
<th>Percent of firms listing access to finance as a ‘very severe’ or ‘major’ obstacle</th>
<th>Percent of firms that said access to finance is ‘no obstacle’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Karnataka</td>
<td>21</td>
<td>44</td>
</tr>
<tr>
<td>Bihar/MP</td>
<td>20</td>
<td>34</td>
</tr>
<tr>
<td>TN</td>
<td>15</td>
<td>45</td>
</tr>
<tr>
<td>Gujarat</td>
<td>10</td>
<td>75</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>8</td>
<td>45</td>
</tr>
</tbody>
</table>

Actual lending figures also look quite different across states. Firms in Bihar/MP received a significantly higher average loan amount than any other state—Rs. 724,900 crore compared to the next highest state of Gujarat at Rs. 687,400. The average duration of loans to firms in TN (68 months) was more than double the duration offered to firms in Maharashtra at 32 months as shown in Table 7.

*Table 7 Lending statistics for firms with a current loan or line of credit*

<table>
<thead>
<tr>
<th>State</th>
<th>Percent with loans</th>
<th>Average amount (Rs.)</th>
<th>Average duration (months)</th>
<th>Percent requiring collateral</th>
<th>No. from private banks</th>
<th>No. from state banks</th>
<th>No. from non-bank institution</th>
<th>No. from ‘other’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Karnataka</td>
<td>20%</td>
<td>329,850</td>
<td>48</td>
<td>87%</td>
<td>10</td>
<td>22</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Bihar/MP</td>
<td>16%</td>
<td>724,900</td>
<td>51</td>
<td>72%</td>
<td>3</td>
<td>16</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>13%</td>
<td>557,420</td>
<td>32</td>
<td>53%</td>
<td>21</td>
<td>16</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>TN</td>
<td>9%</td>
<td>543,700</td>
<td>68</td>
<td>60%</td>
<td>2</td>
<td>10</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Gujarat</td>
<td>9%</td>
<td>687,400</td>
<td>34</td>
<td>50%</td>
<td>7</td>
<td>4</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

Finally, Table 8 shows wide variation in evidence of voluntary versus involuntary exclusion based on the question: if this store did not apply for a line of credit or loan in the last year, what was the main reason? Firms in Gujarat, for example, are much more likely to cite unfavorable interest rates, complex application procedures, or unattainable collateral than firms in any other
state. In contrast, 85 percent of Maharashtra firms said they have no need for a loan and a mere 0.4 percent said they did not think the loan would be approved. These discrepancies make clear that the recommendations offered in the final section of this report must be tailored to the specifics of each state—or districts—problems with financial exclusion. Table 9 shows additional statistics on the financial sophistication of firms across states.

### Table 8 "What was the main reason this firm did not apply for a loan?"

<table>
<thead>
<tr>
<th>State</th>
<th>No Need</th>
<th>Unfavorable interest rate</th>
<th>Didn’t think it would be approved</th>
<th>Complex application procedures</th>
<th>Unattainable collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maharashtra</td>
<td>85%</td>
<td>7%</td>
<td>0.4%</td>
<td>5%</td>
<td>2%</td>
</tr>
<tr>
<td>Gujarat</td>
<td>84%</td>
<td>6%</td>
<td>4%</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td>TN</td>
<td>76%</td>
<td>7%</td>
<td>7%</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>Bihar/MP</td>
<td>73%</td>
<td>3%</td>
<td>8%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Karnataka</td>
<td>61%</td>
<td>15%</td>
<td>3%</td>
<td>10%</td>
<td>9%</td>
</tr>
</tbody>
</table>

### Table 9 Financial sophistication of firms across states

<table>
<thead>
<tr>
<th>State</th>
<th>Percent of firms that applied for new loans in 2005-6</th>
<th>Percent of firms that used an external auditor to verify financial statements</th>
<th>Percent of firms with current and/or savings account</th>
<th>Percent of firms that made a fixed asset purchase in 2005-6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Karnataka</td>
<td>11</td>
<td>56</td>
<td>67</td>
<td>13</td>
</tr>
<tr>
<td>Bihar/MP</td>
<td>11</td>
<td>28</td>
<td>66</td>
<td>16</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>8</td>
<td>45</td>
<td>78</td>
<td>18</td>
</tr>
<tr>
<td>TN</td>
<td>8</td>
<td>40</td>
<td>64</td>
<td>27</td>
</tr>
<tr>
<td>Gujarat</td>
<td>6</td>
<td>21</td>
<td>57</td>
<td>13</td>
</tr>
</tbody>
</table>

### 5.4.2 State-level Findings from the Manufacturing Survey

Firms across the country appear to rely heavily on internal funds or retained earnings in order to finance both working capital and new investments. However, there was considerable variation in the degree to which firms rely on internal funds versus bank lending across states. Businesses operating in Tamil Nadu, Karnataka, and Gujarat, for instance, obtain a greater percentage of their total working capital from banks, while businesses in Jharkhand and Madhya Pradesh rely on bank lending far less. For new investments, the situation looks much the same. Moreover, firms in Jharkhand are least likely to have a current loan from a financial institution whereas firms in Tamil Nadu are the most likely to have an outstanding loan.
Perception of access to finance as a moderate to severe obstacle to growth varies across states, indicating that problems of involuntary exclusion are also somewhat variable (see Figure 22). Only 6 percent of firms in Karnataka report that accessing finance is a moderate to severe obstacle, while 30 percent to 45 percent of firms operating in the other states report the same. This is especially intriguing since just over 20 percent of all firms in Karnataka have a loan.

5.4.2.1 Evidence of Involuntary and Voluntary Exclusion
There is some indication to show that firms are largely voluntarily excluding themselves from financial services. When firms without a current loan were asked the reason for not taking out a loan, a vast majority reported that they have no need for a loan. This phenomenon appears consistently across all the states analyzed.

However, even if the vast majority of firms are voluntarily excluding themselves from financial services, there is some evidence that the unpreparedness of firms may be a debilitating factor should the firm require a loan. For example, the percentage of firms with certified financial statements by external auditors does mirror the percentage of firms that currently have a loan by state (see Figure 23).
Furthermore, the amount of time required to disburse a loan differs across states. States with better investment climates such as Gujarat and Maharashtra take approximately 5 to 6 weeks to approve a bank application, while applications made by firms in states with poor investment climates such as Jharkhand and Madhya Pradesh take 8 weeks or more (see Figure 24).

5.4.3 No Evidence of Differences in Finance Laws Across States
In an attempt to explain these state-level findings, we searched for discrepancies in rules, regulations, and laws pertaining to financing between states. In India, relevant banking laws are promulgated at the national level. Thus, the wide disparities between states result from factors such as their respective bureaucratic effectiveness, degree of legal protection, and progress with economic development initiatives rather than differences in sub national laws.
6 Lending to Micro and Small Enterprises in India

Micro and small enterprises (MSEs) can access finance through a couple of different channels within India’s banking system. The major source of financing for these enterprises is the scheduled commercial banks (SCB) segment, which consists of 27 public banks, 40 private banks, and 33 foreign banks. Urban cooperative banks are also an active player serving the sector. More recently, microfinance institutions have entered the market to finance microentrepreneurs, albeit at much smaller volumes.

Small borrowers certainly face problems obtaining financing in India, but government policies targeting MSMEs and national lending statistics reveal considerable improvement in the availability of credit for small firms. As noted in the RBI’s most recent report on banking, the government is focused on assisting micro and small enterprises in order to create employment, achieve greater regional dispersal of industries, and promote entrepreneurship.

6.1 Priority Sector Lending

One of the main government policies affecting the delivery of credit to micro and small enterprises is the priority lending guidelines set for banks. To ensure that credit is channeled to vulnerable sectors of the economy, the RBI revised the priority sector lending guidelines in 2007. Loans to more vulnerable borrowers might not be attractive for banks from a profitability point of view, yet they are necessary as these borrowers play an important role in economic development. As part of the policy, domestic banks and foreign banks have to extend 40 percent and 32 percent respectively of the adjusted net bank credit (ANBC)—or the credit-equivalent amount of off-balance sheet exposures (CEOBE), whichever is higher—to the priority sectors. SCB loans going towards agriculture, MSMEs, microcredit, education, and housing fall under priority sector loans. SCBs who fail to achieve priority-lending targets must contribute the remaining balances to the government-run MSME Refinance Fund and the MSE Risk Capital Fund.

As of March 31, 2009, public sector banks had 42.5 percent of their ANBC allocated to the priority sector compared to 46.8 percent and 34.3 percent for private sector banks and foreign banks, respectively (see Table 10). This shows that the domestic private sector has been able to meet priority sector lending targets set by the government. In fact, they outperform public sector banks in meeting these targets.

Table 10 Priority Sector Lending

<table>
<thead>
<tr>
<th>(In Rs. Crore)</th>
<th>Public Sector Banks</th>
<th>Private Sector Banks</th>
<th>Foreign Banks</th>
<th>Urban Cooperative banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Priority Sector Advances</td>
<td>7,20,083 (42.5%)</td>
<td>1,90,207 (46.8%)</td>
<td>55,483 (34.3%)</td>
<td>55,248 (56.4%)</td>
</tr>
</tbody>
</table>

42 Report on Trend and Progress of Banking in India 2008-2009, Reserve Bank of India.
43 Note: Numbers in parenthesis represent the percentage of ANBC.
6.2 Credit Provided to Micro, Small and Medium Enterprises

The SCB segment has significantly increased lending towards micro and small enterprises (MSEs) in the last few years in both absolute terms and as a percentage of ANBC (see Figure 25 below) and Table 13 in the appendix for more details. Lending from private banks has grown the fastest, nearly increasing five-fold from 2006 to 2009. Moreover, the share of credit provided to MSEs compared to total bank lending nearly doubled from 6.7 percent in 2006 to 11.6 percent in 2008.

6.2.1 Public Sector Banks

The principal source of institutional credit for MSEs is public sector banks (see Figure 26). As of March 31, 2009, credit outstanding to the MSE sector from public sector banks was Rs. 191,307 crore or 11.3 percent of ANBC. Advances to manufacturing enterprises and service enterprises totaled Rs. 131,177 crore and Rs. 54,449 crore respectively, constituting 67 percent and 29 percent of total public bank MSE loans. Public sector banks have been building a network of specialized MSME bank branches to facilitate the flow of credit to the sector. As of March 31, 2009, they had a total of 869 specialized MSE branches throughout India.

6.2.2 Private Sector Banks

Credit outstanding to the MSE sector by private sector banks totaled Rs. 47,916 crore or 11.8 percent of ANBC as of March 31, 2009. Loans to manufacturing enterprises and services enterprises amounted to Rs. 17,625 crore and Rs. 26,363 crore respectively, representing 37 percent and 55 percent of total private bank MSE loans, respectively.

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44 Report on Trend and Progress of Banking in India 2008-2009, Reserve Bank of India.
45 Note: Figures for 2006 represent SSI, not MSME. All SCBs is the sum of public, private and foreign bank loans and does not include urban cooperative banks.
6.2.3 Foreign Banks
The total credit provided to the SME sector by foreign banks was Rs. 18,383 crore or 11.2 percent of ANBC for the same period. It is nevertheless worth noting that foreign banks face various restrictions for operations in India, including being limited to opening up only 18 branches per year.

6.2.4 Urban Cooperative Banks
As of March 31, 2009, urban cooperative banks had a total of Rs. 21,283 crore in loans outstanding to MSE sector or 21.7 percent of their ANBC.

![Figure 26 Share of SCB Lending to MSEs](image)

6.3 Microfinance Sector Lending
There has been a recent surge in microfinance institutions (MFIs) serving the Indian poor, which includes micro entrepreneurs, over the last few years. Since MFIs are non-regulated institutions and do not require registration, it is impossible to obtain the number of MFIs currently operating in India. Some observers estimate that there may be around 800 institutions providing micro-credit services in India.\(^\text{46}\) According to MIX Market, 123 MFIs in India reported having an aggregate of Rs. 9,753 crore ($2.1 billion) in outstanding loans to 16 million active borrowers as of year-end 2008.\(^\text{47}\)

As of March 31, 2009, the banking sector had a total of Rs. 5,009 crore ($1.08 billion) in loans outstanding to 1,915 MFIs in India, who then on-lend to self-help groups (SHGs). These amounts are still very nominal when compared to bank MSME lending, and MFI financial products are not very sophisticated.

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\(^{46}\) Ghate (2006)
\(^{47}\) MIX Market is the leading information provider of MFI data.
7 New Initiatives to Facilitate Access to Finance

As evidenced by the lending statistics provided in the previous section, the government has paid increasing attention to micro and small enterprises through the adoption of policies aimed at increasing lending to these firms. In 2005, the finance minister set a minimum target of 20 percent annual growth in credit to MSEs for public sector banks and encouraged them to set higher targets. Since then, the government—the RBI in particular—has initiated multiple initiatives, many linked to funding that assists smaller borrowers and target the weakest loan candidates within this group. Additionally, it has commissioned several working groups to engage MSME stakeholders at the national level to create new initiatives that facilitate access to finance.

Most of these initiatives were enacted following the MSME Development Act of 2006. Even though these initiatives look great on paper, we are not able to say much about how effective they are in improving access to finance, as they are still very recent. Additionally, all of these initiatives address the problem of enterprise involuntary exclusion from finance, yet none of them address the voluntary exclusion problem that we identified in the analysis section earlier.

In order to synthesize the large number of current initiatives, we have grouped them into four different categories that attempt to solve the four different problems regarding involuntary exclusion from finance (see Figure 27). This categorization is critical in order to understand how each problem is being addressed and which problems need more attention. The first category of initiatives increases directed funds and guarantees towards the MSME sector in an effort to address the problem of insufficient funds. If the problem is one of underlending because of information asymmetries, the second category attempts to reduce these information asymmetries by sharing borrower credit information between different parties. This enables banks to better assess an enterprise’s risk. High bank transaction costs from lending to small enterprises is another major reason why these firms are involuntarily excluded from finance. The third category of initiatives attempts to reduce these transaction costs in order to increase a small enterprise’s chances of securing a loan with a bank. And finally, discrimination against smaller borrowers as a result of inflexible government policies is alleviated by the current initiatives in the fourth category that enhance a bank’s financial flexibility.

Figure 27: Involuntary Exclusion Problems and Initiatives

<table>
<thead>
<tr>
<th>Problem</th>
<th>Initiative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insufficient Funds</td>
<td>Increase Directed Funds</td>
</tr>
<tr>
<td>Information Asymmetries</td>
<td>Reduce Information Asymmetries</td>
</tr>
<tr>
<td>Transaction Costs</td>
<td>Reduce Transaction Costs</td>
</tr>
<tr>
<td>Inflexible Government Policies</td>
<td>Enhance Bank Financial Flexibility</td>
</tr>
</tbody>
</table>

7.1 Initiatives to Increase Directed Funds and Guarantees

7.1.1 Priority Lending Targets
The main program that increases funds towards the MSME sector is the priority sector guidelines program discussed in Section 6.1 above.

7.1.2 Refinancing Funds
In June 2008, the RBI created two funds of Rs. 2,000 crore each within SIDBI for risk capital financing for MSEs and to enhance MSME refinancing capabilities. The money for these funds has come from penalties imposed on SCBs that fail to meet their priority lending sector targets. Moreover, these funds ambitiously seek to achieve 30 percent growth in the MSME loan portfolio, focus on underserved states, and achieve 40 percent growth in microfinance lending. In response to the global financial crisis, SIDBI received Rs. 7,000 crore more for the refinancing fund from the RBI in December 2008 to be put towards enhancing credit delivery to the sector.

7.1.3 Credit Guarantees
Several credit guarantee schemes exist to ensure the availability of bank financing without collateral or third party guarantees. As noted by the RBI, this type of assistance is extremely important for first-time entrepreneurs hoping to set up operations. SIDBI’s Credit Guarantee Scheme provides financial and deferred payment guarantees to its MSME customers. As of March 2008, SIDBI had already extended Rs. 2,700 crore in guarantees for over 97,200 proposals.49

SIDBI has also partnered with the Government of India (GoI)—specifically with the Ministry of Micro, Small, and Medium Enterprises—to create the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE). This fund encourages lending institutions to emphasize the firm’s project viability and extend credit based on primary assets rather than secondary collateral. In doing so, the CGTMSE covers collateral-free loans up to Rs. 1 crore to new and

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existing MSEs and also provides rehabilitation assistance to the lender should factors beyond management’s control cause it to become sick. Notably, CGTMSE has already implemented GoI recommendations for reduced guarantee fees (lowering them from 1.5 percent to 1.0 percent) and annual service fees (from .75 percent to .50 percent for loans under Rs. 5 lakh).\(^{50}\) Unfortunately, this fund has not been very successful thus far, so the RBI has created a working group to review CGTMSE and propose ways to simply the procedures required for an MSE to obtain coverage.

### 7.1.4 SVCL (SIDBI Venture Capital Limited)

SVCL is a subsidiary of SIDBI incorporated in 1999. The government owned venture capitalist fund aims to invest in smaller enterprises in the technology and SME sectors that may be overlooked by other VCs because of their higher perceived risk. The fund allocated for technology (The National Venture Fund of Software and Information or NSFIT) had a cumulative capital of Rupees 1 billion as of 2009 from SIDBI, Ministry of Technology, and the Government of India. It funds small-scale units in the IT sector. The SME Growth Firm (SGF) is the major arm of the unit with a targeted corpus of Rupees 5 billion funded by SIDBI in association with other government and state owned banks. As of March 31, 2008, NSFIT had disbursed only Rs. 84.4 crore and SGF had allocated Rs. 234 crore to 23 proposals.\(^{51}\)

### 7.1.5 SME Finance and Development Project (SMEFDP)\(^{52}\)

The SMEFDP between the World Bank, SIDBI, and the UK’s Department for International Development (DfID) began in April 2005. This project is focused on increasing financing opportunities and business development services available to the SME sector in India in order to promote growth, competitiveness, and employment of the sector. In order to achieve these objectives, the World Bank operates two main programs—a credit facility (CF) and a risk sharing facility (RSF)—and the DfID runs the technical assistance (TA) component of the project.

As of June 2008, the World Bank had allocated $115 million worth of credit to 927 SMEs in 10 states for an average loan amount of Rs. 55 lakh and average tenor of five years. It spent the remaining $5 million of its original $120 million total on the risk sharing facility, which was implemented through the CGTMSE (see above). The CF project was considered a huge success according to the bank’s performance analysis metrics, which included growth in volume of lending to SMEs, growth in the volume of term loans to SMEs, and reduction in non-performing loans (NPL). Participating bank branches witnessed a decline in their NPL ratios from 12 percent in December 2004 to just under 2 percent in March 2008. This improvement is attributed to synergies from the technical assistance component of the project as well as increased efforts by the participating banks to monitor and improve asset quality.

The DfID provided $37 million in assistance to banks to improve their credit appraisal mechanisms and created a commercial credit bureau and an SME rating agency (see more on this below). Additionally, this component of the project has initiated pilot interventions to provide business development services in three clusters: Alappuzha (which produces coir fibers), Kanpur

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\(^{50}\) Ibid

\(^{51}\) Ibid

\(^{52}\) See SIDBI Annual Report (2007-08) and Report No. 47963-IN on SMEFDP from the World Bank.
Based on the success of the initial phase of SMEFDP, the World Bank has signed an agreement with SIDBI and GoI to extend additional financing of $400 million. This money will be allocated in order to increase the geographical coverage of the project, improve access to loans for smaller MSMEs—known as ‘downscaling’—and expand the number of longer term loans offered to MSMEs. Of the total amount, $380 million will be allocated to the CF and $10 million to the RSF with an expected closing date of June 30, 2012.

### 7.2 Initiatives to Reduce Information Asymmetries

#### 7.2.1 Credit Information Bureau India Limited (CIBIL)

Multi-country empirical studies conducted by the World Bank have shown that the establishment of public credit registries improves the access of credit to borrowers without increasing the risk to banks. Credit registries also reduce the risk to banks for a particular level of credit access. Another study found that having access to positive information about clients in Argentina reduced default rate of banks from 3.9 percent to 2.9 percent. Other studies have shown that smaller and medium sized banks benefit more from public credit registries than larger banks.

Not surprisingly, incumbent banks are reluctant to share information on clients’ repayment records. Recognizing that better credit information sharing can directly increase the amount of financing for MSMEs by reducing the risk and costs arising from information asymmetries, the Credit Information Bureau of India Limited (CIBIL) was created in 2004 as a public-private partnership. As India’s first credit information bureau, CIBIL is mandated with compiling the credit history of commercial and consumer borrowers. Currently, it has credit histories on 135 million trades between individuals and businesses. Even though this is a very important step in creating a center that stores all credit information and shares it with parties in need, CIBIL’s immediate challenge is to collect the data, including that of SMEs. In order to compile this data, banks would need to share all their information on SMEs with CIBIL. The problem is that most Indian banks do not have the necessary credit information on SMEs in a format that can easily be transferred to CIBIL. The 2010 World Bank Doing Business Report for India shows that only 10.2 percent of adults are included in the public or private registry. As a result, as part of the SMEFDP, the World Bank is providing assistance to SIDBI and the participating commercial banks to verify and collate historic data on SMEs in a transferable format, which would then be made available to CIBIL. It is also building the capacity of CIBIL so that it can provide SME credit histories and develop credit-scoring products. To ensure credit information sharing, the World Bank technical assistance to banks is being made conditional upon recipient banks sharing their credit information with SIBIL.

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56 Press Trust of India (2009)
7.2.2 Performance & Credit Rating Scheme

The need for a performance and credit rating mechanism for MSMEs was highlighted in the Union Budget of 2004-2005. As a result, a program to rate SSIs was formulated in consultation with various stakeholders, including Small Industries Associations, the Indian Banks’ Association (IBA), and various rating agencies (Credit Rating and Information Services of India (CRISIL), ICRA, Dun & Bradstreet (D&B) and Onicra). The National Small Industry Corporation (NSIC) was appointed as the nodal agency for the implementation of this policy through its various branches/offices located in the country.\(^{57}\) As part of the program, credit rating agencies have come up with individual methodologies to rate these small enterprises. Most of the rating agencies combine an evaluation of the performance and credit worthiness of the enterprise and include parameters that measure operational, financial, business, and management risks. In turn, MSMEs have the liberty to select any of the rating agencies empanelled under the rating scheme. Even though each enterprise is responsible for paying the special SSI rating fee set by each credit rating agency, the Ministry of MSME subsidizes 75 percent of the fee charged.

The credit rating scheme benefits all of the stakeholders involved. The Ministry of MSME funds a solid initiative to strengthen the sector by creating awareness amongst MSMEs about the strengths and weaknesses of their existing operations and provides them an opportunity to enhance their organizational strengths. The ratings provide an independent, third party opinion on the capabilities and credit-worthiness of MSMEs, facilitating banks and vendors/buyers in capability and capacity assessment of MSMEs. This allows banks and financial institutions to better manage their risk and extend more credit to the MSMEs because they are now able to assess credit worthiness more accurately.

Since the scheme was put in place in 2005, CRISIL has rated 657 SMEs. SME Rating Agency of India Limited (SMERA)\(^ {58}\)—a joint initiative by SIDBI, D&B, CIBIL and several leading banks in the country—has rated 3,800 SMEs. These numbers are still very small when compared to the 13 million MSMEs in India today.

However, many SSIs are unable to be rated by these agencies as they lack the main requirements for service: 1) SSI registration certificate 2) last 3 years of audited financials and 3) tax statements. As a result, the enterprises most likely to be rated are medium enterprises with more established operations. Even though we believe this to be a meaningful effort to allow better access to credit and credit terms for SSIs at the higher end of sophistication, this effort does not address the needs of the younger and less sophisticated enterprises. Rating the entire SME sector is obviously not a feasible goal and not one we recommend as not even developed countries rate most of their SMEs. Instead, we believe that business registration, bookkeeping, and credit registry efforts are a much more needed and feasible approach to tackling MSMEs problem of accessing credit.

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57 Available at http://www.nsic.co.in/creditrating.asp.
58 SMERA is the country’s first rating agency that focuses primarily on the Indian SME segment.
7.3 Initiatives to Reduce Transaction Costs

7.3.1 Cluster financing

As part of its initiative to increase credit to MSMEs, the RBI has also promoted cluster-based financing, especially for 388 clusters in 21 states as identified by the UN Industrial Development Organization (UNIDO).\(^5^9\) Clustering is the geographic concentration of similar businesses (i.e. producers and suppliers) and is used for many reasons. Firms may be able to take advantage of reduced transaction costs for financing, promote collaboration and innovation, or simply find it easier to gain access to electricity by locating near other similar firms. SIDBI has already reached out to 480 clusters—266 micro or artisan clusters and 214 SME clusters—through 73 of its branches. In November 2007, SIDBI signed a Memorandum of Understanding (MoU) with a special purpose vehicle to facilitate projects where MSMEs are incentivized to implement energy savings initiatives.\(^6^0\)

7.3.2 Online Business Registration

The importance of business registration lies in the ability of a formalized business to access business services, finance, or even government grants or subsidies, thereby increasing productivity. In India, this allows SMEs to access the credit guarantee schemes, priority sector lending, capital subsidies, reduced customs duty, power tariff subsidies and exemptions under tax laws\(^6^1\). Furthermore, in a cross-country study conducted by the World Bank and the IFC, the ease of business registration has a direct correlation with the number of SMEs per 1000 inhabitants.

In order to facilitate business registration and reduce firm transaction costs, the Indian government introduced the MCA21 initiative in 2006. This project made electronic registration of companies possible and thus eliminated the need for physically filing forms at the office of the Registrar of Companies (RoC). However, despite the introduction of this online filing system, there still remain many subsequent procedures that add to the delay and paperwork required to register a business in India. Tellingly, India ranks at number 169 out of 183 economies in the World Bank’s Doing Business survey 2010 for ‘starting a business’. This includes all the various procedures required to register a business (a small size company) in India. There are 13 procedures in total, which on average take 30 days to complete. The cost of starting and registering a business in India is 66.1% of GDP per capita and the minimum capital required to register the business is 210.9% of GDP per capita.\(^6^2\)

7.4 Initiatives to Enhance Bank Financial Flexibility

7.4.1 Interest Rate Deregulation

Interest rate ceilings are considered a rather blunt tool to increase access to financing for underserved enterprises. The purported goal of such ceilings is to prevent borrowers from paying unreasonably high interest rates. Instead, such policies typically push borrowers to use

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\(^{59}\) Report on Trend and Progress of Banking in India 2008-2009, Reserve Bank of India.

\(^{60}\) SIDBI Annual Report (2007-08).

\(^{61}\) Information sourced from the Government of India’s Business Knowledge Resource Online.

\(^{62}\) From the Doing Business in India 2010, a World Bank Report.
unscrupulous and predatory lenders. A more effective approach would allow lenders to set interest rates provided that the borrower understands the terms of contract.

The RBI is taking bold steps in removing interest rate ceilings. Starting in April 2010, the central bank is planning to rescind laws that currently provide commercial loans at lower interest rates.\textsuperscript{63} This enhances a bank’s financial flexibility as it is now able to cover the sector at higher interest rates that covers its costs. This improves a small firm’s chances of obtaining a loan, albeit at a higher interest rate. While interest rate controls may be abolished, it is difficult to say if the authorities will resort to using “de facto ceilings” – informal interest rate ceilings that may not codified into law but are applied through political pressure.

\subsection*{7.4.2 Collateral Registration & Recovery}

In a study, Pande and Udry showed that land titling has a very limited impact on improving credit access in countries with less developed credit markets.\textsuperscript{64} Pande and Udry also suggest that enforcement of land repossession contracts is more important than property rights in facilitating transactions between lenders and borrowers.

Strengthening the Debt Recovery Tribunal in India may be the best path to ensure contract enforcement in the financial sector. A study found that establishment of such institutions reduced delinquency by 3 to 11 percent.\textsuperscript{65} Interest rates in areas where such tribunals were instituted were lower by 1.4 to 2 percentage points.

The working group set up to re-invigorate the SME sector understands this as an important step in ensuring access of finance to the sector. To redress the weakness in this recovery infrastructure, it proposes that the disposal of suits by the tribunal should be time bound. It also recommends adding more staff to the tribunal to facilitate this process.

It is not the case that collateral registration is unhelpful in improving access to finance, but it is futile if there is no mechanism to enforce contracts. As explained above, the Indian government has been trying to make improvements on this front. According to the Law Commission of India, in the 1980s, nearly 40 percent of the pending debt recovery cases had been pending for more than 8 years.\textsuperscript{66} After reforms in 1998, the Dispute Resolution Tribunal (DRT) was established and the length of resolution period has been reduced significantly. According to one estimate, cases filed in DRTs were resolved in 2 years compared to 6-7 years taken by the civil courts to resolve such cases.\textsuperscript{67}

\subsection*{7.4.3 India SME Asset Reconstruction Company (ISARC)}

The India SME Asset Reconstruction Company (ISARC) was established in 2009 to acquire, manage and recover illiquid or non-performing assets (NPAs) from banks and financial institutions lending to the MSME sector. This process relieves the banking system of the burden of NPAs and allows them to focus on their core function of financing and development of new

\begin{itemize}
  \item Press Trust of India (2010)
  \item Pande and Udry (2006)
  \item Visaria (2006)
  \item Visaria (2006)
  \item Quoted in Lilienfeld-Toal (2009)
  \item Visaria (2009)
\end{itemize}
business opportunities to strengthen the economy. ISARC was initiated by SIDBI in conjunction with 10 public sector banks, 2 state financial corporations, and a technical consultancy organization that felt the need for an institution that would unlock idle non-performing assets to facilitate greater and easier flow of credit from the banking sector to the MSMEs.

7.5 Initiatives Fail to Address MSME Voluntary Exclusion from Finance Problem

All the current stakeholder and government efforts described above address involuntary exclusion from finance issues but fail to address the problems resulting in MSME voluntary exclusion from finance. In the next section, we will propose alternatives and recommendations that both address voluntary exclusion and supplement the current efforts aimed at reducing involuntary exclusion from finance.
8 Recommendations
We constructed a set of primary recommendations and alternatives based on our findings and research in phases one and two. This section outlines the criteria used to evaluate possible alternatives and provides a description of our top recommendations for the Asia Foundation.

8.1 Framework
In order to provide the Asia Foundation with effective recommendations, we used several criteria to evaluate potential initiatives. First and foremost, we assessed project feasibility from the Asia Foundation’s perspective based on its existing expertise and programs, both within India and overseas. Next, our assessment turned to the degree of immediate versus long-term impact for potential projects. Under this criterion, we favored initiatives that are likely to achieve long-term gains to the MSME sector rather than quick fixes. Then we considered if there would be willing stakeholders who would participate in the projects to work on the objective of improving access to finance for MSMEs. In doing so, we carefully examined the availability of local partners for the Asia Foundation to work with in addition to stakeholder dynamics (see Table 13 for a list of major stakeholders). And finally, we evaluated the cost and ease of operationalizing potential recommendations.

Figure 28 Criteria used to rate recommendations
8.2 Alternatives and Recommended Programs

In the process of formulating our recommendations, we considered four possible proposals and assessed these based on the five criteria outlined above. We begin briefly with the two alternatives that did not meet our primary criteria—existing Asia Foundation expertise—and then offer a detailed description of our two recommendations to the Asia Foundation: program evaluation and monitoring and public-private dialogue.

8.2.1 Banking Reform

One alternative involved encouraging less government intervention and more competition in the banking sector. Theoretically, this would increase the number and diversity of lending products available to MSMEs. Yet we ultimately decided against pursuing this option further without more conclusive evidence that micro and small enterprises would actually benefit from increased competition. Competition could also have the adverse effect of crowding smaller firms out of the lending markets. Moreover, lending by private sector banks to small enterprises is already growing rapidly, and changes to the banking sector that are too drastic could shock the entire economy, effectively depressing overall (and MSME sector) growth.

There were also other reasons why banking reform was not a feasible option. The Asia Foundation does not have any expertise in the national banking sector, and it is unlikely that the Reserve Bank of India would welcome the Asia Foundation’s assistance in this regard.

8.2.2 Technical Assistance to Banks

We also considered programs aimed at increasing bank lending to MSMEs and small and micro enterprises in particular. Because of the success of the World Bank program in increasing the number of longer-term loans provided to small and micro enterprises, we contemplated the Asia Foundation’s possible involvement in a hands-on lending initiative. From our perspective, the World Bank partnership program is so beneficial because it encourages institutional learning among banks that are able to experience the gains that come with lending to micro and small enterprises (i.e. reduced NPL ratios) rather than just hear about them. While there is certainly more room for guaranteed pilot lending programs in India—as evidenced by the additional $400 million in funds secured by the World Bank to continue its efforts—the Asia Foundation would need a large amount of capital and on-the-ground monitoring expertise to replicate the Bank’s success. If the Asia Foundation does ultimately want to facilitate a lending program such as this one, it should look to work with SIDBI and the GoI in order to secure guarantees in the event of loan defaults. Providing technical assistance meets the criteria of having a positive impact in increasing access to finance to MSMEs and in finding willing stakeholders to partner with. However, the lack of existing expertise and the prohibitive costs are major hurdles that seem insurmountable at this juncture.

8.2.3 Program Evaluation and Monitoring

Over the last couple of years, the Indian government and SIDBI, in particular, have enacted a laundry list of programs designed to improve formal lending opportunities for MSMEs. Large sums of money have already been disbursed and more funding for these programs is readily available. As the government pushes ahead with more funds, guarantees, and rehabilitation
programs, it should reflect on its achievements and shortcomings to date. Now it is time to assess whether these changes are having the intended impact, especially in increasing financial access to the MSME sector. From this exercise, important lessons can be learned on how to most efficiently achieve the objective of increased MSME sector growth in India as well as other countries similarly struggling to foster small business development. Beyond this, the government will learn how to more effectively monitor its future programs and promote policies that best sustain long-term growth. Further, a program of this nature is also geographically scalable; the focus may be local or national.

Based on the government’s willingness to solicit outsider help in this matter, the Asia Foundation could have a role to play in evaluating current benchmarks, goal-setting practices, and coordination across various bureaus and initiatives. This last step is key since considerable overlap appears between the programs discussed above. Moreover, a multitude of reports contain progress updates and statistics on the MSME sector. For our research alone, we accessed numerous RBI documents, SIDBI annual reports, the Union Budget, reports from the Ministry of MSMES, the National Manufacturing Competitiveness Council, and individual websites for information on the schemes and initiatives identified above. In order to improve access to information for government bureaus, banks, and businesses themselves, we suggest that these stakeholders come together to produce one annual, official report evaluating MSME sector growth and policies. Such a document should be distributed to small business associations and registered MSMEs, and efforts should be made for the information to reach unregistered businesses as well.

While the specific form of the Asia Foundation’s evaluation efforts will depend on local dynamics, personalities, and receptiveness to outside help, its Regulatory Impact Assessment (RIA) program in Indonesia may provide a workable model for India. By evaluating the ex-post need for and costs and benefits of government initiatives to assist MSMEs, a RIA-like program might help improve the regulatory environment faced by MSMEs along with firm-level growth. While the RIA program in Indonesia is conducted at the local level, we believe that the Asia Foundation could apply the same framework to assess the impact of policies carried out by the RBI and SIDBI either in some local regions or across the country. The cost of such a program would depend on the scale at which it is implemented.

Except for the ease of implementation, this alternative meets all other criteria that we are considering. Implementation is an issue that we are concerned with here because a systematic evaluation of government policies would require a large team of economists to monitor banking sector reforms and assess the impact it has on the flow of finance to MSMEs. Additionally, to provide a thorough assessment, such a report would have to be launched at regular intervals, perhaps every two years.

8.2.4 Public Private Dialogue
The Asia Foundation should work with stakeholders to address the issue of voluntary exclusion from finance. As we have discussed, voluntary exclusion arises when borrowers seek not to pursue formal means of finance. The Asia Foundation could launch a series of public-private dialogues that would address this issue.
A public-private dialogue would essentially bring together stakeholders from various organizations such as owners of small businesses, business organizations, banks, and local government to share information and discuss effective means to increase access to finance in the MSME sector. The Asia Foundation has launched similar dialogues in a variety of sector in different countries to support open and inclusive governance. A similar framework could be used to address the issues that have been raised here. The following subsections outline the key agenda points to be discussed in the public private dialogue.

8.2.4.1 Business Registration

Registering a business in India is both time-consuming and costly. As outlined in Appendix 4, businesses have to complete 13 steps in the registration process that take 60 to 70 days and cost Rs. 25,000. For small family-owned retail shops or manufacturing entrepreneurs, the costs of registration can act as a deterrent since owners have limited resources and experience with such procedures. They may also fail to realize that not registering now could cost them in the long run. Registered businesses are far more likely to have the financial statements and documentation required to access bank financing. Based on our research, this is a key area where current government initiatives fall short and additional work is needed to improve both the procedural ease and understanding amongst small businesses that registration is important.

A public-private dialogue on educating small businesses on the importance of business registration has enormous potential to bring together government bureaus, banks, and businesses to work together to resolve this issue. Having banks participate should maximize the gains of these educational initiatives since banks can interact directly with unregistered borrowers and can disseminate information after the dialogues take place. Such a dialogue may also serve to impress upon rural banks the existence of a variety of government initiatives to support their lending to MSMEs.

8.2.4.2 Increase Information Flows

An important agenda that can be addressed within this framework includes discussions on sharing of information between MSMEs, banks, and the government. It is critical that the government bodies such as SIDBI and SMERA understand the needs of the clients that they seek to serve. Simply informing small business the benefits of registering will not make them more likely to do so. The government would have to understand why MSMEs currently choose to operate in the informal economy. This is perhaps because entering the formal economy has many other costs such as payment of taxes, the need to bribe government officials to operate a business and so on. Unless there is a platform to have a discussion on these issues, policies enacted at the top will not have the intended impact.

A dialogue on sharing information could also help private banks to understand the need of their clients and allow businesses to understand the procedures that they would have to meet to borrow from banks. During these dialogues sessions, banks could be prompted to discuss how they make decisions on loan approvals. Similarly, MSMEs could explain their concerns regarding borrowing. A dialogue of this nature would essentially help businesses learn how they can be better customers and allow banks to understand how they can better serve the need of their clients.
Finally, increased information sharing may lead to a deeper understanding of the reasons why firms voluntarily exclude themselves from access to finance.

8.2.4.3 Improving Business Skills
A lack of managerial capability is one of the reasons why MSMEs choose not to expand their business operations. Consequently, they are also less likely to borrow funds because of a lack of business skills. The public-private dialogue can help gather resources for training programs that will aid MSMEs in acquiring these business skills.

8.2.4.4 Dialogue Between Micro-Finance Institutions
Microfinance institutions serve as an important and increasing source of capital for micro entrepreneurs who cannot access credit at formal banking institutions. To date, there are various MFI models in place in India and around the world. Some merely provide credit, while others offer additional financial services such as savings and insurance products. Some MFIs even extend training and capacity-building services for their borrowers. MFIs can use this forum to share their experiences with the different existing MFI models. These dialogues will identify the best products and practices catered specifically to micro and small business needs. Additionally, these MFIs may serve as fertile ground to enact the business registration assistance programs that disseminate information on the benefits of registration.

As Table 11 outlines, the public-private dialogue meets all the criteria that we have considered. The Asia Foundation has the expertise to launch such a program and it would not be difficult to find willing stakeholders to participate in such a program. (A possible selection of stakeholders is provided in Table 12). A public-private dialogue held in particular local regions would also be less costly to implement and much easier to operationalize than some of the national level reforms that we have considered. Finally, it is the only measure that addresses the issue of voluntary exclusion, which is a key obstacle in achieving greater flow of access to finance to MSMEs. The impact of any public-private dialogue would be incremental, as it would only affect a small proportion of the MSME sector. However, the programs are scalable and multiple non-governmental organizations can work together to expand this operation.

<table>
<thead>
<tr>
<th></th>
<th>Public-Private Dialogue</th>
<th>Program Evaluation</th>
<th>Banking Sector Reform</th>
<th>Technical Assistance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Expertise</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Stakeholders</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Long Term Impact</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Cost</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Ease of Implementation</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Table 12 Stakeholders operating in the MSME credit access space

<table>
<thead>
<tr>
<th>Gov. Bureaus</th>
<th>Domestic Agencies</th>
<th>Banks</th>
<th>Industry Associations</th>
<th>SME Associations</th>
<th>Int’l Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>RBI</td>
<td>SIDBI</td>
<td>Banker’s Industry Association</td>
<td>Federation of Indian Chambers of Comm. &amp; Industry (FICCI)</td>
<td>Indian Industries Association</td>
<td>World Bank / IFC</td>
</tr>
<tr>
<td>Ministry of MSME</td>
<td>NABARD</td>
<td>ICICI</td>
<td>Assoc. Chambers of Comm. &amp; Industry of India (ASSOCHAM)</td>
<td>Federation of Indian MSMEs</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>Ministry of Technology</td>
<td>National Small Industry Corp.</td>
<td>Urban State Coops.</td>
<td>PHD Chamber of Commerce &amp; Industry</td>
<td></td>
<td>UK’s Dept. of Development</td>
</tr>
<tr>
<td>Ministry of Finance</td>
<td></td>
<td></td>
<td>Confederation of Indian Industry</td>
<td></td>
<td>UNIDO</td>
</tr>
</tbody>
</table>
9 Conclusion

Increasing access to finance for MSMEs is important to improving overall economic growth in India. There is evidence that small businesses in India are not currently able to grow to their full potential because the flow of financing to these enterprises is restricted. The restriction stems from both involuntary and voluntary exclusion. On the one hand, banks in India discriminate against MSMEs because of high transaction costs and information asymmetry. On the other hand, smaller businesses themselves are less likely to borrow from banks primarily because they do not seek financial loans.

Since the government has launched a raft of programs in recent years, we suggest that the Asia Foundation work with MSME organization to set up bi-annual reports to measure the successes of the financial measures taken by the national government. An ex-post analysis of government policies is critical to address the problem of involuntary exclusion from formal financing faced by MSMEs. In addition, the Asia Foundation could also launch public-private dialogues to address a variety of issues that would educate potential borrowers about the existence of available of government programs, increase the flow of information between banks and borrowers, and help improve the skills of small and medium business owners operating in India.
Bibliography


Appendix 1: Structure of India’s Banking Sector

The Indian financial system is composed of a large number of financial institutions with diverse operations under the regulation of the central bank, the Reserve Bank of India (RBI) (see Figure 29). Public, private and foreign banks together hold 95 percent of the total system’s loan advances. The State Bank of India and other public sector banks alone extend 71 percent of the loans compared to 18 percent and 6 percent for private and foreign banks respectively. This statistic demonstrates the dominance of the government in India’s banking sector. Regional rural banks, urban cooperative banks, and state cooperative comprise the remaining 5 percent of scheduled bank lending.

Other financial institutions exist to complement banks by providing a wide range of financial services. “Financial Institutions” (FI) such as the National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), and the National Housing Bank (NHB) are considered India’s main refinancing institutions. NABARD provides refinance to lending institutions operating in rural areas, including credit cooperatives and regional rural banks. SIDBI has a mandate to promote, finance, and develop MSMEs and coordinate with institutions involved in these activities. It provides direct credit to MSMEs through its 100 branches in all major industrial clusters in India. Additionally, it also provides refinancing to lending institutions to enhance credit to small industries. Apart from providing finance and refinance for MSMEs, SIDBI has taken many proactive measures to assist MSMEs, including setting up subsidiaries to provide support services for venture capital, credit guarantee, credit rating, and technology services initiatives, among others. Non-bank financial companies (NBFCs) are a heterogeneous group of institutions performing financial intermediation in a variety of ways, like accepting deposits, making loans and leasing.

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69 Report on Trend and Progress of Banking in India 2008-2009, Reserve Bank of India
70 A public sector bank is one that is 51 percent or more government-owned.
Figure 29 Structure of India's Banking Sector

Table 13 Credit Provided to MSEs

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Banks (in Rs. Crore)</th>
<th>Private Banks (in Rs. Crore)</th>
<th>Foreign Banks (in Rs. Crore)</th>
<th>Urban Coops. (in Rs. Crore)</th>
<th>All SCBs (in Rs. Crore)</th>
<th>Growth Rate</th>
<th>MSME Credit/ANBC</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>82,434</td>
<td>10,421</td>
<td>8,430</td>
<td>n/a</td>
<td>101,285</td>
<td>n/a</td>
<td>6.7%</td>
</tr>
<tr>
<td>2007</td>
<td>102,550</td>
<td>13,136</td>
<td>11,637</td>
<td>n/a</td>
<td>127,323</td>
<td>26%</td>
<td>7.2%</td>
</tr>
<tr>
<td>2008</td>
<td>151,137</td>
<td>46,912</td>
<td>15,489</td>
<td>n/a</td>
<td>213,538</td>
<td>68%</td>
<td>11.6%</td>
</tr>
<tr>
<td>2009 projected</td>
<td>191,307 (11.3%)</td>
<td>47,916 (11.8%)</td>
<td>18,383 (11.2%)</td>
<td>21,283 (21.7%)</td>
<td>257,606</td>
<td>21%</td>
<td>11.4%</td>
</tr>
</tbody>
</table>

71 Percent figures represent the share of total Indian banking system outstanding loans for each scheduled bank category.
### Appendix 2: Steps for Business Registration in India

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Time to complete</th>
<th>Cost to complete</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Obtain director identification number (DIN) online</td>
<td>1 day</td>
<td>Rs. 100</td>
</tr>
<tr>
<td>2 Obtain digital signature certificate online</td>
<td>1-6 days</td>
<td>Rs. 400 to Rs. 2650</td>
</tr>
<tr>
<td>3 Reserve the company name with the Registrar of Companies (ROC) online</td>
<td>2-3 days</td>
<td>Rs. 500</td>
</tr>
<tr>
<td>4 Stamp the company documents either at the Superintendent or an authorized bank</td>
<td>1 day</td>
<td>Rs. 200 (for MOA) + Rs. 1000 (for AOA) for every Rs. 500,000/- or part thereof + Rs. 100 (stamp paper for declaration Form 1)</td>
</tr>
<tr>
<td>5 Present the required documents along with the registration fee to the Registrar of Companies to get the certificate of incorporation</td>
<td>3-7 days</td>
<td>Rs. 15,823</td>
</tr>
<tr>
<td>6 Make a seal</td>
<td>1 day</td>
<td>Rs. 350</td>
</tr>
<tr>
<td>7 Visit an authorized franchise or agent appointed by National Securities Depository Services Limited (NSDL) or Unit Trust of India (UTI) Investors Services Ltd to obtain a Permanent Account Number (PAN)</td>
<td>7 days</td>
<td>Rs. 66 for Fee and Rs. 5 for Application Form, (if not downloaded)</td>
</tr>
<tr>
<td>*8 Obtain a tax account number for income taxes deducted at source from the Assessing Office in the Mumbai Income Tax Department</td>
<td>7 days, simultaneous with Procedure 7</td>
<td>Rs. 55</td>
</tr>
<tr>
<td>*9 Register with Office of Inspector, Mumbai Shops and Establishment Act</td>
<td>2 days, simultaneous with procedure 8</td>
<td>Rs. 1,500 + 3 times registration fee for Trade Refuse Charges</td>
</tr>
<tr>
<td>*10 Register for VAT before the Sales Tax Officer of the ward in which the company is located</td>
<td>12 days, simultaneous with procedure 9</td>
<td>Rs. 5000 (Registration Fee) + Rs. 100 (Stamp Duty)</td>
</tr>
<tr>
<td>*11 Register for profession tax</td>
<td>2 days, simultaneous with procedure 10</td>
<td>no charge</td>
</tr>
<tr>
<td>*12 Register with Employees’ Provident Fund Organization</td>
<td>12 days, simultaneous with procedure 10</td>
<td>no charge</td>
</tr>
<tr>
<td>*13 Register for medical insurance (ESIC)</td>
<td>9 day, simultaneous with procedure 10</td>
<td>no charge</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>60-70 days</strong></td>
<td><strong>Rs. 25,194—27,500+</strong></td>
</tr>
</tbody>
</table>

*Takes place simultaneously with another procedure*