

A STUDY ON PROFITABILITY OF MSME LENDING BUSINESS FOR BANKS IN INDIA

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ABSTRACT

Micro Small and Medium enterprises play a very important role in India economy. MSMEs face several problems, non-availability of finance is an important challenge for MSMEs in India. Among MSMEs, micro unit face even more challenges as compared to medium and small enterprises. This research paper is a study on the profitability of MSME loans given by banks in India. The analyses conclude that the growth of MSMEs is higher than the growth of GDP and hence MSMEs are driving growth of the country; MSMEs are paying higher rate of interest and hence banks generate better interest income on these loans; and the NPAs in MSME accounts are lesser than the NPAs in large accounts. Hence the study concludes that lending to MSMEs by banks is more remunerative and is also helping the country increase its GDP growth and employment. Therefore, the banks should provide more loans to MSMEs by simplifying their processes.

KEYWORDS

MSME, Bank Loan, Non-performing Assets, Interest Margin.

1. INTRODUCTION TO MSMEs

The MSME sector is a vital sector of the Indian economy and has been a key contributor to economic growth over the last five decades. The sector fosters entrepreneurship and creates employment opportunities at relatively lower capital cost (second only to agriculture), thereby assisting in the overall development of the nation. MSMEs act as ancillary units and complement larger industries thereby promoting inclusive industrial development. MSMEs pervade various sectors of the economy by offering a wide array of goods and services to fulfil the demands of domestic and international marketplaces (GOI AR, 2019). Despite its importance and contribution to India's economy, the MSME sector experiences a substantial gap between the demand for finance and the supply of credit from formal financial sources. According to an IFC-Intellect report, the credit gap stood at Rs. 16.66 lakh crore in 2019. It is noteworthy that this gap only widened in the years past. Banks and financial institutions have set procedures, protocols and systems for extending credit to borrowers.

This paper evaluates the role of MSME sector and attempts to find out if giving loans to MSME sector is a profitable business for banks.

MSMEs play an important role in most economies across the globe, especially developing economies; they help in work formation and contribute towards worldwide economic growth. SMEs account for nearly 90% of business and over 50% of employment the world over. Formal SMEs contribute up to 40% of GDP in emerging markets. The figures would increase

significantly if informal SMEs are also considered. It is estimated that by the year 2030, nearly 600 million jobs would be needed to engage the increasing workforce across the globe. Thus, SME development assumes priority for several governments around the world. SMEs create close to 70% of jobs in emerging markets. However, obtaining adequate finance is a crucial hindrance to SME growth, especially in developing countries (World Bank Report).

Generally, SMEs are less likely to receive bank loans than larger organisations. These units depend on their own funds or financial help from family and friends to commence their enterprises. According to the IFC, nearly 65 million firms, or 40% of formal MSMEs in emerging countries face unmet annual funding requirement of almost \$5.2 trillion. This requirement is equal to nearly 1.4 times the existing loans and advances granted by banks to MSME world over. Nearly half of formal SMEs can't obtain formal credit; this gap widens if informal enterprises are considered (World Bank Report). For a country like India, MSMEs act as the backbone of the economy as the sector provides livelihood to millions of people. But again, for MSMEs, obtaining credit from the right source remains a major challenge.

2. MSMEs IN INDIA

MSMEs are part of a vital sector of the Indian economy as they contribute significantly to the country's GDP, exports, industrial output and job creation (RBI Circular, 2019). Over the past five decades, the Indian MSME segment has become more prominent and competitive. MSMEs generate substantial employment at lower capital costs (as compared to larger industries) and promote development of rural and underdeveloped areas, thus, the regional imbalance is reduced and national income and wealth are distributed more equitably. MSMEs complement larger industries and contribute towards more inclusive economic growth.

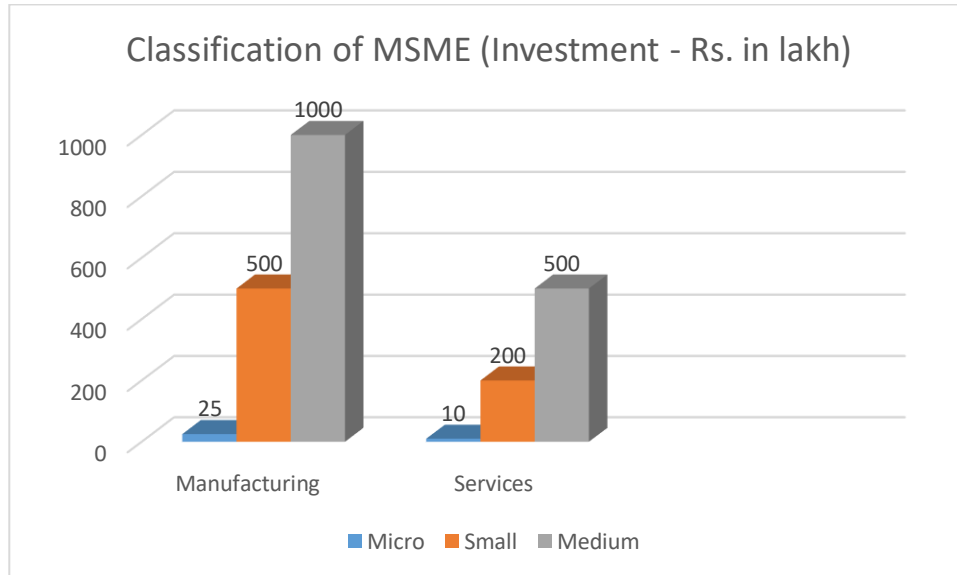


Figure 1. Classification of MSMEs

According to the MSMED Act, 2006, the Micro, Small and Medium Enterprises are defined on the basis of two components. First, their investment in plant and machinery for manufacturing units and secondly on the basis of investment in equipment or related infrastructure used by the enterprises to provide ready material to its consumers or markets (Jahanshahi et al., 2011). The investment limits in plant and machinery for units in the manufacturing segment are up to Rs.25 lakhs for micro-enterprises, Rs.25 lakhs to Rs.5 crores for small enterprises and Rs.5 crores to

Rs.10 crores for medium enterprises. While the investment limit in equipment for units in services sector is up to Rs.10 lakhs for micro-enterprises, Rs.10 lakhs to Rs.2 crores for small enterprises and Rs.2 crores to Rs.5 crores for medium enterprises (Kumar & Gugloth, 2012).

This definition has been revised and as per the new definition, an entity with investment up to Rs one crore and annual turnover of a maximum of Rs.5 crore will be termed as a Micro Enterprise, while those with investment up to Rs 10 crore and turnover upto Rs.50 crore will be classified as Small Enterprises and enterprises with investment up to Rs 50 crore and turnover upto Rs. 250 crore, will be termed as Medium Enterprises (GOI, 2020).



Category	Capital	Turnover
Micro	Rs 1 Crore	Rs 5 Crore
Small	Rs 10 Crore	Rs 50 Crore
Medium	Rs 50 Crore	Rs 250 Crore

Revised on June 01, 2020

Figure 2. Revised definition

The MSME sector in India consists of 360 lakh units employing over eight crore people; this sector produces 6,000 different products, contributing about 8% to national GDP; the sector contributes to nearly 45% of the total industrial production and 40% of exports from India (Suresh & Balanaga, 2015). The number of MSMEs is growing continuously, and as per the Ministry of MSME Annual Report 2018-19, the number of MSMEs stands at an estimated 633.88 lakh.

3. BANK FINANCE TO MSMEs

As per World Bank Group, getting adequate finance is a major challenge for SME and it (bank finance) has been cited as the second most difficult problem faced by SMEs, both in developed as well as developing countries. As compared to larger firms, SMEs face difficulties in obtaining loans from banks; SMEs rely on internal capital or money sourced from family and friends to commence business. As per IFC report, 650 lakh companies or 40% of formal MSMEs in emergent economies face unmet funding demand of around \$5.2 trillion, equivalent to nearly 1.4 times the current global amount of MSME loans. East Asia and the Pacific region accounted for the highest portion at 46% of the worldwide financial gap, led by Latin America and the Caribbean at 23% and Europe and Central Asia at 15%. The financial gap varies significantly from region to region. In particular, Latin America, Caribbean, Middle East and North African regions have the largest financial disparity relative to potential demand, which is estimated at 87% and 88% respectively. Almost half of all SMEs have no structured credit linkage. The funding disparity becomes greater when informal micro-units are considered (World Bank Report).

In India, as per the latest IFC report (2018), the total addressable funds demand of the MSME sector is Rs. 36.7 trillion, out of which the formal sector is providing only Rs. 10.9 trillion as credit, leaving a viable gap of Rs. 25.8 trillion (USD 397 billion)! It is noteworthy to mention here that the total bank loans of all banks in India was at Rs. 97.10 trillion as on March 31, 2019 meaning that there is a scope and potential to add over 25% additional bank lending just by meeting the credit needs of MSME sector (RBI Trend & Progress Report 2019 – Table IV.1).

4. MEASURES TAKEN FOR THE AVAILABILITY OF CREDIT TO MSMEs

In order to improve loan availability to MSMEs, RBI has mandated bank-specific lending targets in relation to MSMEs. The RBI has directed all banks to lend 7.5% of total loans & advances (Adjusted Net Bank Credit) to micro units (RBI Master Direction 2018). RBI has been taking several other measures to provide timely support to MSMEs. On January 1, 2019, RBI advised banks to restructure existing stressed MSME loan accounts with amounts up to Rs. 25 crore without classifying these accounts as NPA (RBI MSME Circular, 2019). As per the suggestions of Prime Minister's Task Force on MSMEs, banks were to achieve a 20% year-on-year growth in terms of the amount of loans provided to micro & small enterprises, 10% increase in numbers of micro-unit account, and 60% of all loans to micro and small units as on March 31st of the last year should go to micro units (RBI Master Direction on MSME Lending, 2017). In order to address concerns about insufficient collateral, banks have been advised to extend security free loans whereby Credit Guarantee Fund Trust Scheme for Micro and Small Industries provides credit guarantee cover to Member Lending Institutions (MLIs) up to 75% of the default amount for loans up to Rs. 2 crore (Maini, 2019; CGTMSE, 2018). GOI has also established Micro Units Development and Refinance Agency Bank (MUDRA) for increasing access of finance to the micro sector. All these guidelines indicate that MSME sector is an important sector and both the RBI and the Govt. of India have been making efforts to increase bank lending to MSME sector.

5. MSME LENDING – IS IT A PROFITABLE BUSINESS FOR BANKS

As per the study by TransUnion CIBIL (2018), Return on Assets (ROA) with respect to loans in the MSME segment was calculated to be between 2% and 5%, which is much higher as compared to the average ROA in 2017-18 for efficient private sector banks (1.14%), and foreign banks (1.34%) (RBI Report on Trend & Progress, 2019). Also, NPAs in MSME loans are much lower as compared to loans to large corporates (source: TransUnion CIBIL Report, 2018). Hence, the rate of interest on loans to MSMEs is much higher than the rate at which loans are extended to large corporates and banks earn a higher interest (income) on MSME loans.

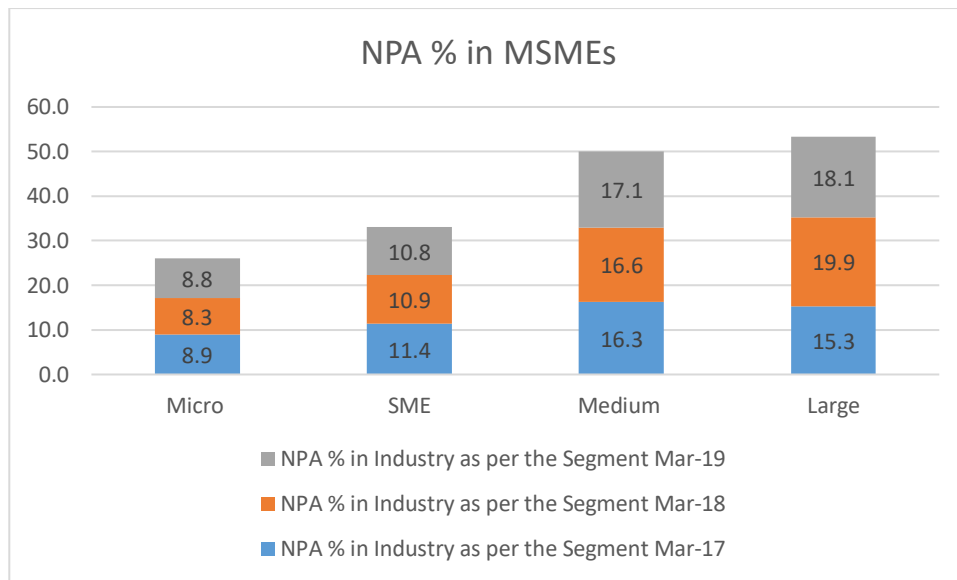


Figure 1.3. NPA percentage in MSMEs Source: TransUnion CIBIL Report, 2018

Figure 4 shows the percentage of NPAs as on March 31, 2017 in Micro sector was 8.9%, in SME 11.4%, 16.3% in Medium and 15.3% in large units. Similarly, NPAs as on March 31 2018 & 2019 were highest in large units (19.9% and 18.1%) and lowest in Micro units (8.3% and 8.8%). The NPAs in the year 2018 and 2019 are gradually increasing as the size of the units is increasing. Hence, it can be concluded that extending loans to Micro and SMEs are more profitable than lending to other segments.

6. PAST TREND OF BANK LENDING TO MSME SECTOR

As per data published in RBI Trend and Progress Report 2019 (Table IV.14: Sector-wise Deployment of Bank Credit), total credit extended by commercial banks in India grew by 10.4% and was at Rs. 83.99 trillion as on March 31, 2017, which increased to Rs. 95.19 trillion as on March 31, 2018, registering a growth of 13.3 per cent. Growth during September 2018 - September 2019 was 8.9 per cent. During the same period, the increase in MSE credit was only 8.8% in 2017-18, and 4.8% in 2018-19; negative growth of 0.4% was witnessed during September 2018 - September 2019. Figure 5 shows that the growth of MSE credit was far lesser than the overall credit growth of the banking sector during September 2017 – September 2020.

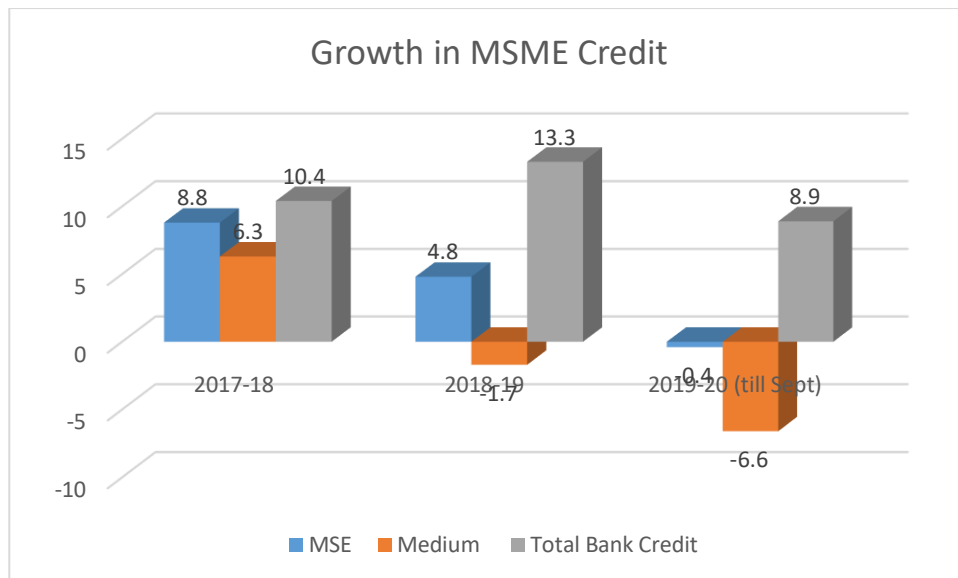


Figure 1.4. Growth in MSME credit (Source: RBI Annual Report 2019, table IV.14)

7. CONTRIBUTION OF MSMEs TO GDP

The growth in the contribution of MSMEs in Gross Value Added (GVA) of the country in 2015-16 was 8.65% and 9.44% in the year 2016-17; however, there was negative growth in credit extended by banks to MSEs in 2015-16 (-2.3%) and 2016-17 (-0.5%).

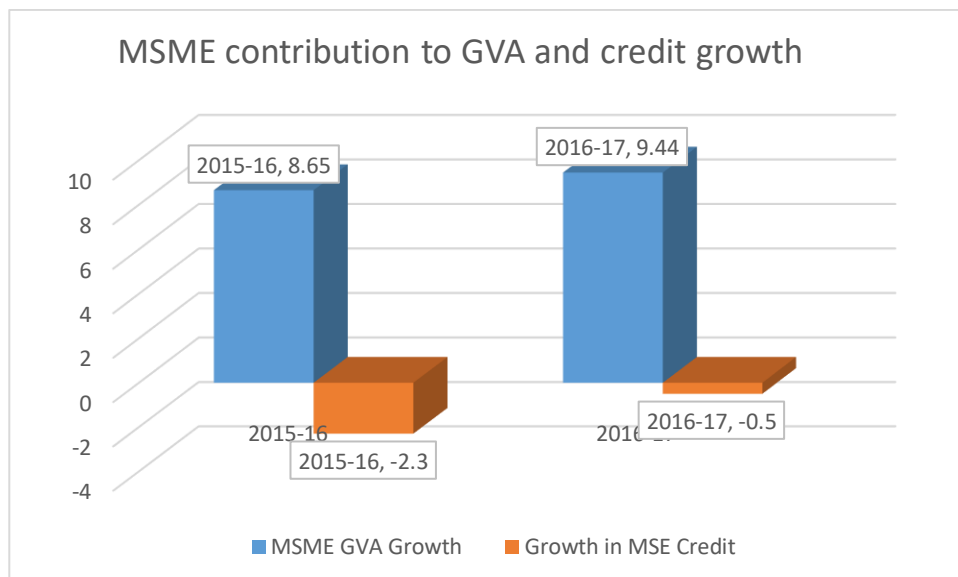


Figure 1.5. MSME contribution to GVA and credit growth (Source: Central Statistics Office (CSO), MSME Annual Report and RBI Report on Trend and Progress, 2017 - Table V.20: Sectoral Deployment of Gross Bank Credit)

Hence, the overall credit of banks is increasing, but the loan to MSE is not growing at the same pace; the share of MSMEs in GVA is increasing; however, the credit to MSEs is registering negative growth, then it is evident that the MSME sector is not getting a proportionate loan from the banking sector.

8. CONCLUSION

MSMEs play a very important role in the Indian economy. While MSMEs have an unmet demand for credit, on the other hand, banks are not able to increase their lending because of higher NPAs in large accounts. As per the Financial Stability Report of RBI (June 2017), credit growth during the half-year ended March 2017 was 4.4% and surplus liquidity in the system was about Rs 4 lakh crore. The surplus liquidity in March 2020 was Rs. 3.16 lakh crore (TOI, 2020) and a huge ocean of opportunity in the form of the credit gap in the MSME sector remained untapped (IFC 2012; IFC 2018). MSMEs are approaching the informal sector (non-bank players such as money-lenders) for their credit needs; and these loans are being repaid as the business of MSMEs is growing which is evident from the fact that the contribution of MSMEs to GVA is growing year after year. The problem, therefore, is twofold - unmet credit needs of the MSME sector and surplus funds available with the banking sector in India. If banks start lending to MSME sector, the unmet need of the sector will get fulfilled and at the same time, the surplus liquidity available with the banking sector will get utilised, thereby the banks will be able to generate higher ROA. It is therefore concluded that lending to MSME is a profitable business for banks.

9. ASSUMPTIONS AND LIMITATIONS OF THE STUDY

Notwithstanding the fact that the study has its contributions to existing body of knowledge, it has certain limitations. The study is based on secondary data available in public domain and hence is not based on primary data being collected in fields. The study is based on the assumption that the secondary data available in public domain is reliable and hence conclusions are made based on the secondary data. Any change in the data might lead to variation in the findings of the study, which is a limitation of the study. Some of the old data has been presented in the report in order to highlight the fact that the MSMEs have been facing credit constraints and it's not a recent phenomenon; banks are not providing timely credit to MSMEs despite the fact that the units are sustainable and are growing year after year.

10. FUTURE RESEARCH DIRECTION

MSME sector is a growing sector and hence future studies can be conducted on the ways and means through which the credit to this sector can be provided by banking sector at easy terms. Such a study will help not only MSMEs, but also the banking sector and the GDP of the country. Readers will be curious to take cue from such research, which will bring more relevant antecedents to the current body of literature.

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