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A CHANGE IN BEHAVIOR OF BANKING SECTOR FOR MICRO FINANCE IN MSME

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Abstract

The setting of interest rates in the field of microfinance (MF) has been hotly debated for years. On the one hand, it is claimed that high interest rates are justified because of the elevated operating and processing costs of serving very small loans without collateral. Today India has just slowdown in unemployment. Through this research paper we have just disclosed the India banking structure change of Micro finance. In 2011 India launched a cap on MF interest rates of 26% for loans up to 50,000 rupees (US$1,124) and at that rate stagnation and reduced borrowing followed. To offset this, in April 2014, the Reserve Bank of India introduced a more flexible rate: cost of funds (at market rates) plus 10% for existing MFIs and cost of funds plus 12% for new MFIs. A recent study by CGAP (Consultative Group to Assist the Poor) analyzed interest rates in over 866 MFIs between 2004 and 2011, finding that most African countries have instituted interest rate caps to protect consumers, in some cases due to political and cultural pressures.

Key words: *Interest rate, micro finance, Banking structure, CGAP, micro finance institutions*.

Introduction

Microfinance is a source of financial service for entrepreneurs and small businesses that enables the poor to pull themselves out of poverty.For some, microfinance is a movement whose object is "a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers."[1] Many of those who promote microfinance generally believe that such access will help poor people out of poverty, including participants in the Microcredit Summit Campaign. Most commonly, it involves making small loans to the working poor in developing countries. These loans are usually less than $200 and are made by local organizations called microfinance institutions.

How Micro Finance Works

Credit refers to programs that primarily provide credit in tiny1 amounts for self-employment but also other financial and business services to very poor persons, mainly women. It reflects the fact that thousands of microfinance institutions of varying structure, degree of independence, and funding sources, including those partially or completely commercial in approach and ownership, now exist. These deliver and increasingly wide range of retail financial services to the poor. As well as credit and savings product, money transfers and insurance are being offered by more and more MFIs.

Poor people borrow they often rely on relatives or a local moneylender, whose interest rates can be very high. An analysis of 28 studies of informal money lending rates in 14 countries in Asia, Latin America and Africa concluded that 76 % of money lender rates exceed 10% a month, including 22% exceed 100% a month. Moneylenders usually charge higher rates to poorer borrowers than to less poor ones.

Current Scenario of change in behavior of banking sector for micro finance in MSME

This paper discusses issues relating to bank finance with regard to the first two classifications viz., Micro and Small among the MSMEs. It analyses the status and characteristics of MSEs, factors, both internal and external, affecting the flow of bank finance to this sector and lays down strategies for accelerating the pace of bank finance for its development.

Table:1. Classification of MSEs – Investment ceiling in Plant, Machinery/Equipment

Classification	Manufacturing	Services
Micro	Upto Rs 25 lakh	UptoRs 10 lakh
Small	Above Rs 25 lakh & up to Rs 5 crore	Above Rs 10 lakh & up to Rs 2 crore

Source: MSMED Act, 2006.

Status and Characteristics

i. Heterogeneity of MSE sector

The MSE sector in India is highly ***heterogeneous*** in terms of the size of the enterprises, location, variety of products and services, people employed, coverage of social sector, and leveraging information, communication and technology (ICT) in running their enterprises. Of the total number of MSMEs estimated at 214.38 lakh, as many as 214.35 lakh indicating that almost all the units were MSEs. These two categories of enterprises have contributed for employmentof 497.61 lakh people (Tables:2&3).

Table:2. Number of MSEs- Type-wise

Category (Number-lakh)	Regd	%	Unregd	%	Total
Total – MSMEs	**15.64**	**198.74**	**214.38**		
Micro	14.85	94.94	198.39	99.83	213.24
Small	0.76	4.89	0.35	0.17	1.11
Total – MSEs	**15.61**	**198.74**	**214.35**		

Source: MSME Annual Report, 2012-13

Table:3. MSEs- Employment-wise

Category (Number-lakh)	Regd	%	Unregd	Total
Micro	65.34	70.19	NA	
Small	23.43	25.17	NA	
Total	88.77	408.84	497.61	

Source: MSME Annual Report, 2012-13

ii. Industry-wise *distribution of enterprises*

Among various types of industries classified under the MSE sector, the top three positions were held by industries relating to manufacturing of food products (62.99 lakh), wearing apparels (35.91 lakh), and the textiles (35.91 lakh) sector. Among the services sector, the top three positions were held by the industries in sale and maintenance and repair of motor vehicles (30.03 lakh), education (27.26 lakh), and health and social work (16.07 lakh). Computer and related activities, a new entrant to this sector, were also found to be contributing significantly by providing employment to 10.52 lakh people (MSME Annual Report, 2012-13).

iii. *Ownership of enterprises – Social Group-wise*

Analysis of the MSE sector in terms of social group reveals that the enterprises owned by Scheduled Caste (SC), Scheduled Tribes (ST) formed just 13.59% of the total number of units in the country. The enterprises owned by OBCs showed a significantly higher level at 41.94% (Table:4). In the context of the national policy for supporting MSEs of those owned by such disadvantaged groups like SCs/STs/OBCs, low coverage of bank finance poses a challenge for banks.

Table:4. Ownership of Enterprises – Social Group-wise

Category	**Regd**	**Unregd**	**Both**
	%		
Sch Caste (SC)	7.6	7.84	7.83
Sch Tribe (ST)	2.87	5.89	5.76
Other Backward Classes (OBC)	38.28	42.11	41.94
Others	51.26	43.21	43.56
Not recorded	0	0.95	0.9

Source: MSME Annual Report, 2012-13

iv. Banks' concerns in lending to MSEs

The Fourth Census of MSME sector revealed that only 5.18% of the units had availed of finance through institutional sources. While 2.05% had finance from non-institutional sources, the majority of units i.e. 92.77%, had no finance or depended on self-finance[2].

There are concerns that banks face while lending to smaller enterprises. Credit information about a small enterprise is not as easily available, as it is for a larger firm, and it is not cost effective for the lender to collect information on all small enterprises. Nor have the small enterprises adequate collaterals to offer. The lenders, therefore, either refrain from lending or load the cost of information asymmetry into the lending rates. Another important factor is that risk assessment of smaller enterprises requires a separate set of tools as against the conventional tools, the absence of which is likely to dissuade banks from such lending[3].

v. Priority Sector Lending and *MSEs*

There is no sub-target fixed for MSE lending for banks though it forms part of priority sector lending, which means that even if a bank does not make any lending under MSE segment, it can fully achieve all priority sector stipulations by lending to other priority sector segments.

vi. Usage of Credit Guarantee Scheme for MSEs

The Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) set up in 2000 operates a Credit Guarantee Scheme (CGS) which guarantees grant of collateral free and /or third party guarantee-free-credit facilities to MSEs by Member Lending Institutions (MLIs).

Although the CGS is in operation since 2000-01, out of total number of MSE accounts of 21,80,036 with the banks, the accounts covered under the CGS were just 57,552 (31 March, 2009) which constituted only 2.64% of total accounts. Further, only about 10% accounts representing collateral free bank loans up to Rs 25 lakh were covered under the CGS[4].

The Working Group on MSEs set by the RBI in 2009 reviewed the working of the CGS and suggested measures to enhance its usage by banks. However, as observed above, a number of challenges in implementation of CGS such as poor coverage of loans under CGS, low settlement rate by the agency to banks etc., still remain unresolved.

vii. Areas of divergence in guidelines

The Bank of Baroda had undertaken a study of its select branches in Kerala in financing MSE sector and implementation of guidelines of CGTMSE and RBI concerning this sector[5]. The study analysed various aspects governing financing of MSE sector by banks. These are classified in the following matrix (Table:5)

Table:5. Divergence in Guidelines of CGTMSE and RBI

Guidelines	CGTMSE	RBI
Maximum amount of collateral free loan.	Rs 100 lakh	Rs 10 lakh
Mandatory nature of lending.	Non mandatory	Mandatory
Quickness of sanction.	Delayed	Quick
Reason for delay.	Sanction needs approval from CGTMSE before disbursement	No delay, since sanction is at bank level
Cost to borrower	Borrower to bear guarantee fee. For MEs up to ` 10 lakh is borne by CGTMSE.	No additional charges both toMSEs

Recovery of dues in case of default	i. Lock in period of 18 months 1. Initiation of legal proceedings to claim guarantee above ` 50,000/- iii. Guarantee to be invoked within one year (now 2 year) of account classifying as NPA. iv. Final claim be paid by the Trust to the MLIs after three years of obtaining of decree of recovery.	i. No such lock in period 1. Legal action to the discretion of bank iii. No such condition iv. No such condition.

Source: BOB study report

The study concluded that divergence in guidelines issued by CGTMSE and RBI had contributed to poor growth of CGTMSE lending in Bank of Baroda, in Kerala. This is another challenge banks would be facing in financing MSEs.

Strategy

As mentioned above, the MSE sector is heterogeneous in character and so, one size fits all approach of providing one standard bank product or a set of financial products would not address the issues being faced by the sector. So, it is attempted to look at the sector slightly moving away from the conventional bank finance approach being followed by banks under the extant guidelines of the RBI.

At present, banks finance MSEs using conventional finance products such as composite loans (combining working capital and investment credit), separate term loans and working capital loans for large size MSEs.

Under conventional financing, investment credit to an MSE is provided by way of a term loan with an appropriate rate of interest charged on the loan amount sanctioned. For example, if a loan of Rs 50,000 is issued to an MSE carrying an interest of about 15% to be repaid over period of 4 years, the principal compounded with interest would reach a level of Rs 77,240 at the end of the stipulated period. In other words, the borrower would be required to pay an interest of Rs 27,240 on a loan of Rs 50,000 which would be more than 50% of the principal amount borrowed by it from the bank. Though, with the interest rate compounded increase the loan burden of the borrower considerably, it will be less than the interest rate charged by the informal system. However, compounding of interest has its own demerits.

The power of compound interest will result in unpaid loans leaving the lender and the borrower in distress. The result is a vicious cycle that sets up a domino effect of defaulters. Compounding interest grows so fast and the borrower would not be able to pay his bank dues making the economy to pay the price. So, charging interest may not be a solution for financing MSEs at least for those disadvantaged (SC/ST/OBCs) and those at the lower end of the spectrum.

According to experts in finance, conventional finance creates artificial money supply not being backed by real assets leading to high inflation, rich becoming richer. So, what is the solution available for financing such assets of MSEs which are run by those who do not have means to offer even collaterals, particularly the enterprises set up by SC/ST/OBCs. Therefore, the strategy proposed will be a combination of providing investment finance by way of 'finance lease' in lieu of term loan and /or using 'participative financing'. In addition, an outline on the idea of introduction of 'Referral Programmes for MSE customers' is also given in the paper.

Introduce Referral Programmes

'Referral Programmes' are popular among a number of new generation industries, particularly the IT sector. On similar lines, banks may consider introducing 'Referral Programmes' for getting new MSE customers. They can use their existing customers running an MSE as 'Referral Ambassadors' by providing suitable incentives/ rewards to them.

Running an incentive programme to reward such 'ambassadors for referrals' is a time tested method of dramatically increasing 'word of mouth' (WOM) success. The referral/ reward structure taps into an innate desire to help others. Such programmes present a lot of room for creativity in the structure, cost and development of referral incentives.

In developing a suitable reward structure for referral ambassadors, banks should keep in view that the incentive should be enough to interest the customers to participate and it should not erase the profit of the new revenue generated. So, the first step in determining the 'optimum incentive value cost' is to analyse the 'Customer Lifetime Value' (CLV) and 'Customer Acquisition Cost' (CAC). These two concepts are extremely important for banks looking to get a good ROI on their marketing investment[6]. Rewards can be either monetary or non-monetary or a combination of both.

The idea of introducing referral programmes among banks for promoting MSEs needs policy support from the RBI. Hence, details and modalities of a suitable incentive/reward structure have not been attempted in this paper.

Conclusion:

Access to financial services has been proven to be a powerful tool to help fight poverty.

The impact is greatest especially for the poor people when they have access to a broad range of financial services with which they can invest in income generating and asset building activities to meet basic needs such as health, education and nutrition. The ability to manage assets helps poor people to gain control of their own future and make greater contribution to national development. India like any other developing country is saddled with the problem of rural-urban migration, mass illiteracy, poor infrastructural facilities, poverty and low access to formal financial services. This requires a vibrant micro finance initiative aimed at expanding the financial infrastructure of the country to meet the financial requirements of the Micro, Small and Medium Enterprises (MSMES) as well as the need of the rural and urban poor. For the country's economically active poor to rise above their current poverty level, the micro finance banks must be seen to be up and doing as this is the only way they can achieve their mandate and true purpose of their existence.

To date, the objective of microenterprise development has driven much of the microfinance field. While microenterprises are an important source of income for many poor households, they are only one part of their overall livelihood systems. Microfinance is more than credit, and as shown in this research, microfinance can play an important role beyond enterprise development in supporting the livelihoods of the poor. The concept of livelihood is a broader concept than that of enterprise development. It considers a mix of resources, activities, and capabilities that enable individuals and households to pursue their economic goals. In reality, resources within households are fungible, and it is important to recognise that clients will use microfinance services for a variety of purposes. Clients use microfinance not only to invest in enterprises, but also to build household assets, smooth income, and help manage their cash flow. By providing chunks of money when it is needed, microfinance can help clients reduce their vulnerability, expand their options, and graduate from a reactive mode of survival to a proactive climb out of poverty.

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