

Pulse

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MSME Greenfield Rating: A Tool For Improving Access To Credit For First Generation Entrepreneurs Through Credit Guarantee Scheme of CGTMSE

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Highlight

Micro, Small and Medium Enterprises (MSMEs) have increasingly become an important part of Indian economy whether in terms of their contribution of them in Gross Domestic Production (GDP), exports or in employment generation. However, a look at the constraints facing first time entrepreneurs in starting a new MSME, highlights the numerous challenges in the development of MSME sector in India.

One of the major challenges fresh entrepreneurs face is access to sufficient funds required for purposes like capital expenditure or working capital financing. Banks and financial institutions, traditionally, have been reluctant in extending large volumes of credit to small businesses given the higher credit risk involved along with lack of adequate collateral assets to cover their exposure. According to the Reserve Bank of India (RBI), as on March 2009 the total credit extended by the Scheduled Commercial Banks (SCBs) to MSMEs (both existing and new) was just about 11.4% of the total net banking credit. The study also reflected that only 7.23% of the MSMEs (both existing and new) in India have access to institutional and non-institutional funds which reflects that the majority of the MSMEs are either self financed or do not have access to external funding. Even amongst these, fresh start-ups are hardly entrusted with any form of credit.

To address the above issue, Government of India along with Small Industries Development Bank of India (SIDBI) established the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE). For new MSMEs who don't have sufficient collateral to give to banks and financial institutions the trust acts as a guarantor. Over the years the CGTS gained momentum and has witnessed extension of credit facilities to more than one lac MSMEs across India of various sizes. However, a deeper analysis into these figures of loan disbursement to MSME units indicates that majority (61%) of the loans were below Rupee one lac. This figure in itself undermines the impact of the scheme and calls into question its efficiency as the average loan amount seems insignificant to have any positive impact on development of MSME units. It seems that MLIs have consciously distributed lesser amount to larger number of MSMEs to eventually minimize the risk exposure.

For the scheme to achieve its objective of helping the first generation entrepreneurs in creating sustainable business platforms, a credit rating and limit fixation for new MSME units is required which acts as a risk assessment tool for lending institutions and builds greater confidence on their part in the proposals put forward by MSMEs. One way of doing so is by introducing the concept of MSME Greenfield Ratings. These ratings would not only provide the entrepreneurs suitable credentials which back his project, it would also enhance the comfort level of lenders to finance such projects. The framework will comprise a comprehensive assessment of the various risk factors like project specific risk, management risk, operational risk and financial risk and their impact on the viability of the business proposition.

Background

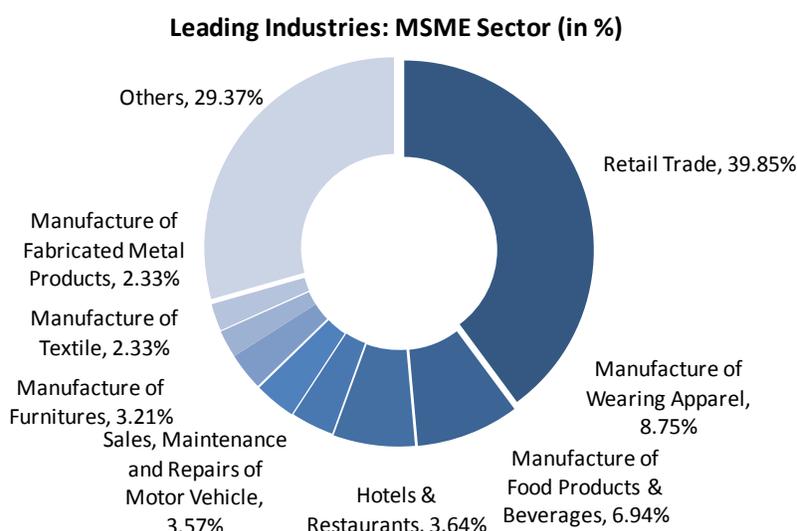
Significance of the Micro, Small & Medium Enterprises in Indian Economy

Micro, Small & Medium Enterprises (MSMEs) are very important for the development of any economy given their role in job creation and their ability to foster entrepreneurship. MSME units contribute significantly to the manufacturing output, employment generation and exports of India. It is estimated that the sector accounts for about 45% of the manufacturing output and 40% of the total exports of the country. For the year 2011-12 the sector is estimated to employ about 1,012.59 Lac persons in over 447.73 Lac units throughout the country. Further, this sector has consistently registered a higher growth rate (6.5% on gross output for financial year 2012-13) compared to the rest of the industrial sector. Following table summarizes the growth of the MSME sector over the past few years in India:

SL. No.	Year	Total Working Enterprises (in Lac)	Employment (in Lac)	Market Value of Fixed Assets (in Rs. Crore)	Gross Output (in Rs. Crore)
1	2007-08	377.37	842.23	917,437.46	1,435,179.26
2	2008-09	393.70	881.14	971,407.49	1,524,234.83
3	2009-10	410.82	922.19	1,029,331.46	1,619,355.53
4	2010-2011	428.77	965.69	1,094,893.42	1,721,553.42
5	2011-2012	447.73	1,012.59	1,176,939.36	1,834,332.05

Source: Annual report, Ministry of Micro, Small and Medium Enterprises, 2012-13

There are over 6000 products ranging from conventional to sophisticated items, which are being manufactured by the MSMEs in India. The contributions from different industries are mentioned below¹:

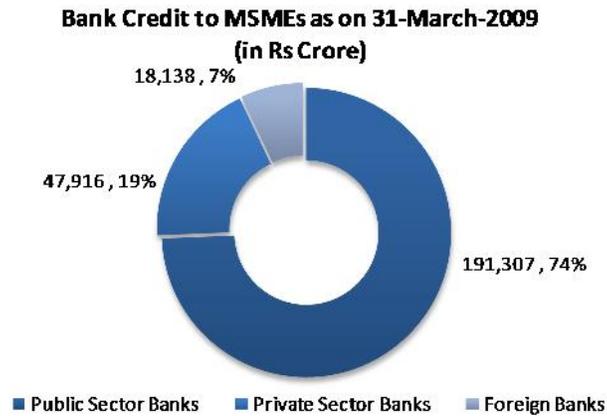


Source: Annual report, Ministry of Micro, Small and Medium Enterprises, 2012-13

¹ Manufacturing of fabricated metals excludes machinery and equipments and retail trade excludes trade in motor cycles and vehicles and repairs of personal and household goods

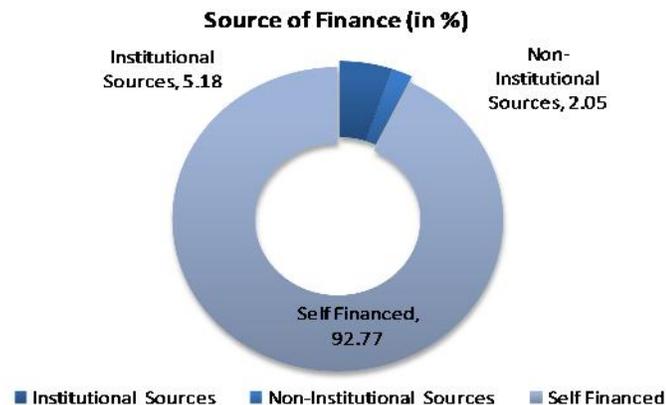
The Major Challenge for First Generation Entrepreneurs: Availability of Finance

The new business units within the MSMEs have generally been found to lack sources of adequate funds thus having to rely on external funding for various purposes, be it capital expenditure like purchase of land, building, plant or machinery or for working capital financing. The Indian government has taken several initiatives for ensuring availability of credit facilities to these MSMEs which has led to significant improvement in extension of credit facilities to such units.



Source: Reserve Bank of India

However, the initiative taken by the government seems inadequate as MSMEs still face significant challenges in getting bank funding particularly for starting up of new ventures. As on March 2009 the total credit exposure to all MSMEs (both existing and new) by all Scheduled Commercial Banks (SCBs) amounted to ` 2,57,361 Crore, which is just 11.4% of the total adjusted net banking credit. The banks and Financial Institutions (FIs) are reluctant in enhancing credit facility to the MSMEs, specifically to the new ones as they consider as high risk and which do not have adequate sufficient collateral or third party guarantee to cover the borrowing, which banks and FIs usually need to hedge the risk of default. As per the 4th census of MSMEs (2009) only 7.23% of the MSME units (both existing and new) in India have availed credit facilities from external sources (the figure is even lower for new business units within the MSME segment) including both Institutional and Non-Institutional lenders. The major chunk of the new MSMEs today are either self financed or without any access to external funding.



Source: Fourth MSME Census (September, 2009)

Improving Availability of Credit for First Generation Entrepreneurs through Credit Guarantee Scheme of CGTMSE

To address the issue of unavailability of collateral by the first generation entrepreneurs the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) was established in 2000-2001 by the Government of India (GoI) in collaboration with Small Industries Development Bank of India (SIDBI). The Trust stands as a guarantor to MSMEs and provides guarantee to the MLIs to facilitate hassle free credit facility to the MSMEs. As on 31 December 2013, there are 131 registered MLIs with CGTMSE² which includes Public Sector Banks, Private Sector Banks, Regional Rural Banks (RRB), Foreign Banks and Financial Institutions (FIs). These MLIs in turn extend credit facilities to the MSMEs. The extent of guarantee cover provided by the CGTMSE is given in the table below:

Borrower Category	Maximum extent of Guarantee where credit facility is		
	upto Rs.5 Lac	above Rs 5 Lac upto Rs 50 Lac	above Rs 50 Lac upto Rs 100 Lac
Micro Enterprises	85% of the amount in default subject to a maximum of Rs 4.25 Lac	75% of the amount in default subject to maximum of Rs 37.50 Lac	Rs 37.50 Lac plus 50% of amount in default above Rs.50 Lac subject to overall ceiling of Rs 62.50 Lac
Women entrepreneurs/ Units located in North East Region (including Sikkim) other than credit facility upto Rs 5 Lac to micro enterprises	80% of the amount in default subject to a maximum of Rs 40 Lac		Rs 40 Lac plus 50% of amount in default above Rs 50 Lac subject to overall ceiling of Rs 65 Lac
All other category of borrowers	75% of the amount in default subject to maximum of Rs 37.50 Lac		Rs 37.50 Lac plus 50% of amount in default above Rs 50 Lac subject to overall ceiling of Rs 62.50 Lac ³

The loans are extended for a period of five years or a block of five years. The details of fees and annual service charges are mentioned in the table below:

Credit facility	Fees and Annual Charges (% of loan)		
	Upfront one time guarantee fee		Annual Service Fee
	North East Region (including Sikkim)	Others	
Upto Rs 5 Lac	0.75%	1.00%	0.50%
Above Rs 5 Lac to Rs 50 Lac	0.75%	1.50%	0.75%
Above Rs 50 Lac to Rs 100 Lac	1.50%	1.50%	0.75% ⁴

The CGTMSE will cover the credit facility extended to the MSMEs maximum to the tune of Rs 50 Lac in case of RRBs and FIs and of Rs 100 Lac in case of Scheduled Commercial Banks (SCBs) and few selected FIs in form of both term loan and working capital loan after an agreement with the CGTMSE.

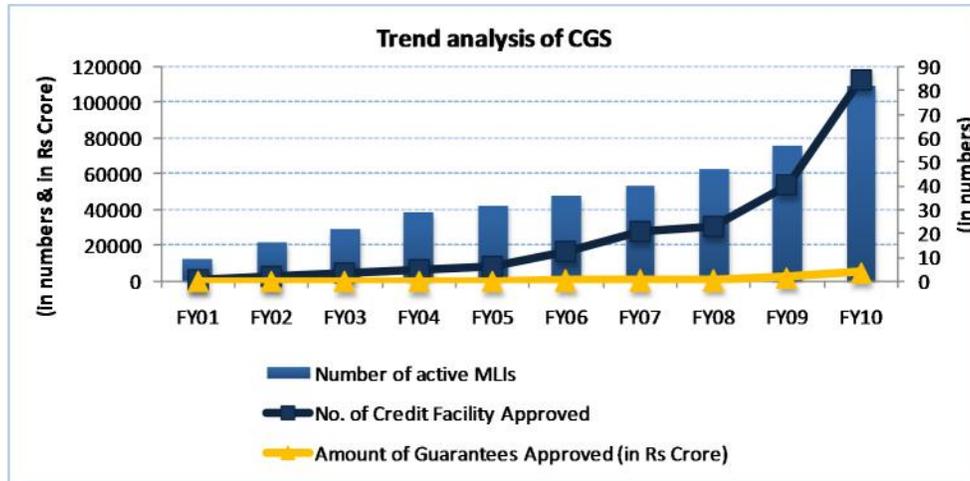
² http://www.cgtmse.in/List_Of_MLIs.aspx

³ Report of the Working Group to Review the Credit Guarantee Scheme of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)

⁴ Report of the Working Group to Review the Credit Guarantee Scheme of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)

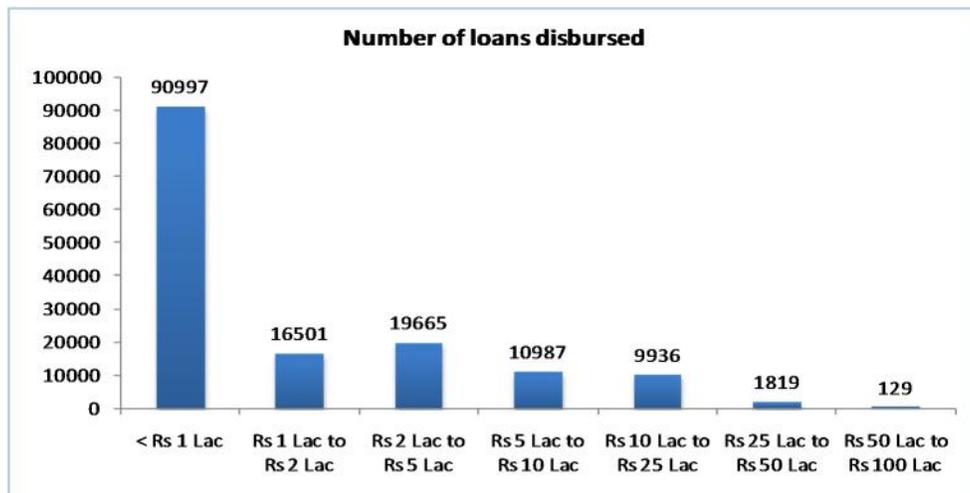
Risk Averse Nature of MLIs Undermining The Impact of The Scheme

As per Reserve Bank of India report on CGTMSE as on 31 January 2010 there are 110 registered MLIs (which have grown to 131 as on 31 December 2013) out of which 82 MLIs have availed the CGS facility. Graph below depicts the growth of the CGS scheme since its inception.



Source: CGTMSE (as on 31 January 2010)

As depicted in the above graph the scheme has shown a significant growth over the years from 2000 till 2010. With just 9 MLIs in the beginning year (FY01) the MLIs approved 951 proposals and extended facility of Rs 6.06 Crore. And as on 31 January 2010 there are 82 MLIs who have extended credit facility to more than one Lac MSMEs (both existing and new) to the tune of Rs 5110.09 Crore for FY10 (estimated). However, it is surprising to know that the average credit facility extended to each MSME still remains below Rs 5 Lac. The graph below show the loan size wise segregation of credit facility extended to the MSMEs.



Source: 9th annual report CGTMSE

As per the above mentioned graph the number of MSMEs availed less than Rs 1 Lac is the highest. Further with the increase in the loan amount the number of loans disbursed has shown a declining trend. As per the 9th annual report CGTMSE only 129 MSMEs received more than Rs 50 Lac.



Although the number of MSMEs availing credit facility looks the highest in smaller amount (i.e. below Rs 1 Lac) there may be multiple reasons for the same as the amount seems to be significantly low to make any impact on the businesses (let alone the startup business, the amount is too low to make any impact for existing businesses)

One of the reasons of the spread may be the risk averse nature of the MLIs which may have resulted in rejection of higher amount loan proposals or under financing of proposals and diversification of the guarantee to a large pool of MSMEs to lower the risk exposure and hence undermining the impact of the scheme itself.

Analysis

MSME Green Field Ratings for First Generation Entrepreneurs

The intent of introducing credit ratings under the CGTMSE scheme is to get more MSME (specifically the new ones) included under the ambit of the scheme. There are a number of credit viable (having lower risk) but not bankable projects that are rejected by the bankers even under the CGTMSE scheme. These are largely third generation entrepreneurs who are unable to prove their credibility and thus are considered non-bankable by the banking institutions. A green field rating and credit limit fixation by a credible third party agency that focuses on the viability of the proposed business proposition is a tool that can help the entrepreneur get the desired backing for this project and produce a case in front of the banking institutions. This will not only help the entrepreneur present his case better but also make him aware of the various risks involved at the very start of the project further reducing the chances of business failure. On the other hand banks will be able to understand the proposals better through an independent third party view thus will be more likely to extend the facility to the entrepreneur. Other than banks the rating report can be used as a valuable tool that helps investors, financial institutions, vendors and other market participants in taking informed investment and funding decisions.

Credit Rating and Credit Limit Fixation framework for Greenfield projects

The framework will comprise a comprehensive assessment of the various risk factors impacting the viability of the business proposition. It is an independent, third party assessment providing a clear indication of the likelihood of viability of the project in the given market scenario. The risk parameters that must be covered under the framework are as follows:

- **Project specific Risks:** This is a combination of demand risk, market risk and feasibility of the business model keeping in view the operating environment.
- **Management Risk:** Management risk evaluation provides an indication on the management's quality, integrity and project management expertise. Various parameters like educational qualification, professional experience, previous track record in implementing projects of similar size and nature, networking ability, fundraising ability and tie ups with customer and suppliers are considered under this assessment.
- **Operational Risk:** This will be a measure of the risk associated with the functional day to day and long term functional aspects of running the business.
- **Financial Risk:** Evaluating financial risk comprises of evaluating the projected financial to evaluate the performance of the project, financial flexibilities associated with the promoters and any likely provision for credit enhancements.

The rating and periodic surveillance system if introduced can prove to be a corner stone in the development of credit worthy but non-bankable entrepreneurs.

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