



An analytical Review on the mechanism and implementation of Priority Sector Lending to MSMEs

Rashmi Sarda, North Lakhimpur, Assam

Orcid id: 0000-0002-9759-3361

DOI: 10.48047/ecb/2023.12.si4.1482

ABSTRACT

A plethora of researches are available worldwide relating directly and indirectly to Priority Sector Lending practices. The term ‘directed credit’ has been used extensively in international context to denote what in India is referred to as Priority Sector Lending. The works of some scholars have been reviewed systematically in order to draw inferences on the emergence, developments, rationale and status of Priority Sector Lending in India. Amongst the categories under norms of priority sector lending, advances to MSMEs is the concern of the present study. Hence, literatures related to credit disbursement to micro, small and medium enterprises are taken into consideration. Also, studies related to the criticisms made on the grounds of creation of Non Performing Assets, high transaction costs, lower profitability of banks which discourages present scenario of Priority Sector Lending have been reviewed. Thus an attempt has been made in the present chapter to get insights into the extant literature pertaining to Priority sector lending to MSMEs.

Key Words: MSMEs, Priority Sector Lending, India

INTRODUCTION

A plethora of researches are available worldwide relating directly and indirectly to Priority Sector Lending practices. The term ‘directed credit’ has been used extensively in international context to denote what in India is referred to as Priority Sector Lending. The works of some scholars have been reviewed systematically in order to draw inferences on the emergence, developments, rationale and status of Priority Sector Lending in India. Amongst the categories under norms of priority sector lending, advances to MSMEs is the concern of the present study. Hence, literatures related to credit disbursement to micro, small and medium enterprises are taken into consideration. Also, studies related to the criticisms made on the grounds of creation of Non Performing Assets, high transaction costs, lower profitability of banks which discourages present scenario of Priority Sector Lending have been reviewed.

Thus an attempt has been made in the present chapter to get insights into the extant literature pertaining to Priority sector lending to MSMEs.

Micro, Small and Medium Enterprises (MSMEs): Potential & Progress

Ayyagari, Beck & Kunt (2007) presented comprehensive statistics on the contribution of SME sector to total employment in manufacturing and to GDP across a broad spectrum of countries. The data revealed a significant variation in the size and economic activity of the

SME sector across countries, there are few SMEs in many transition economies and the SMEs constitutes most of the private sector in the developing countries.

Raju (2008) attempted to find how the global and national policy development affected the small industry in India. He closely examined the main provisions of the Micro, Small and Medium enterprises Act, 2006 and the present scenario of growth and development of small and medium enterprises in India. Due to the opening up of the economy in 1991 with globalization, economic liberalization and dilution of sector specific protective measures the Small and medium enterprises felt intense competition from the international market. In order to survive and make sustainable contribution to the national income, employment and exports there is need for financial infrastructure to be broadened and adequate inflow of credit to the sector be ensured taking into consideration the growing investment demand, including the requirements of technological transformation.

Das (2012) undertook a study to analyze the prospects of entrepreneurship development in small and medium enterprises in Assam. Besides government initiatives and NGOs engaged in the work of training youths and encouraging them to take up entrepreneurial activities, the role of SHGs in providing momentum to entrepreneurship development in the state was commendable. The majority of entrepreneurs were found to be micro entrepreneurs as most of the people of the state lives in the rural areas and under economic hardship. There has been ample scope in the areas of fish hatchery, automobile and electronic goods repairing, tailoring, bamboo based industry, bricks industry, food processing industry, etc.

Das (2014) analyzed the status and growth of Micro and Small Enterprises (MSEs) of Assam in North Eastern economy. The study found MSE sector to be the fastest growing sector in Assam in terms of output, investment, number of units and employment generation. If employment generation and investment pattern is concerned Micro enterprises are providing highest employment opportunities and small enterprises shows highest investment per month as compared to micro and medium enterprises. The study conducted on data from Annual reports of MSME, Government of India revealed that there has been an unequal growth of the number of enterprises, production value, employment and investment in Assam. Lack of institutional support, lack of adequate finance, inadequate and irregular supply of raw materials, technological obsolescence, and lack of infrastructural facilities, lack of marketing knowledge and lack of motivation to entrepreneurship were some of the identified problems by the author which have resulted in the retarded growth of MSE sector in Assam.

Institutional credit to MSMEs

Cziraky, Tisma & Pisarovic (2005) investigated possible reasons for low loan approval rate that occurred in Croatia in spite of interest rate subsidization and sufficient supply of loan funds in governmental SME loan programme. Hypotheses about consistency in the loan approval decisions and lending preferences were tested using Correlation and ANOVA analysis. The study concluded that amongst all SME loan applications, banks preferred smaller firms requesting for smaller loans. Individual banks differ in criteria in their loan-size preferences and no positive correlation exists between banks size and its loan size preference.

Canovas & Solano (2010) analyzed the relationship between banks and SMEs in the continental European bank-based system. SMEs which are maintaining longer relationship with banks had enhanced access to loans, also at the same time they are bearing higher cost

for their debts. Firms which are maintaining two bank relationships are availing cheapest debts as it establishes a limit for the degree of concentration of banks relationships. The results shows the existence of trust between firm and bank improves access to financing and reduces the borrowing costs whereas it increases the likelihood that guarantees will have to be provided. Consequently, relationship based on trust seemed to be a better strategy to improve SMEs finance than the establishment of longer or more concentrated relationship.

Bohra (2017) examined the financing pattern of small business enterprises and traders in Guwahati. The study was conducted on the manufacturing sector and the service sector and the data were analyzed and presented through factor analysis, regression and ANOVA. To identify different sources of finance available for small businesses and the difficulties in acquiring finance by small businesses were the main objectives of the study.

Priority Sector Lending Schemes

Kohli (1997) attempts to examine the theory and empirical evidence on directed credit programmes, reviews the Indian experience and draws some policy conclusions for the Indian financial sector through a comparison of policy implementation in East Asia and India. The discussion is confined to the case for direct lending to small scale enterprises only. After examining the existing evidence on the costs and benefits of priority sector lending in India, the author argues that the credit policy in this regard needs to be re-appraised and geared towards more specific objectives which could be defined locally on the basis of a bank-industry exchange that could guide the banks as to which firms or industries are to be financed. It also suggested for an introduction of periodic review of targeted firms and industries, designing a sharply focused credit policy with incentives structured to reduce moral hazard and ensure good performance and streamlining of the monitoring and supervision functions of banks.

Burgess, Wong & Pande (2005) pointed that within the low-income countries, the rural poor were most likely to be excluded from the banking sector. Government regulations of the banking sector in India played a key role in directing bank credit towards the poor, also the state-led branch expansion into rural unbanked locations reduced poverty across Indian states. The paper summarizes the state-level data and the household data during the years of the social banking programs (1969-2000) which reflected that bank borrowing among rural labour households was higher in states that show more rapid rural branch expansion. In addition, the emphasis on directed bank lending towards sectors deemed as “priority sectors” which included agriculture and small scale industries and within these sectors to individuals belonging to “weaker sections” of society contributed to its success in reaching the poor. However, the authors ended with the question that the Indian state invested substantial resources in the development of a state banking sector in order to reduce poverty but whether such reduction at the same level could have been possible at lower cost through some other intervention in credit markets (i.e. microfinance) or in a different sector (i.e. land reforms).

Kulkarni (2007) in her study identified the widening of credit gap (i.e. gap between demand for and supply of bank credit to SSIs) over the years. In this backdrop, various issues related to this credit gap had been studied. The study aims to identify the relationship between growth of the SSI sector and supply of bank credit during the recent past and to assess the progress made in implementing the recommendations of the expert committee or study

groups, and also to examine various constraints associated with the credit supply. Five surveys were conducted which includes survey of entrepreneurs, survey of branch managers, survey of sick units under rehabilitation, survey of chiefs of SMEs in banks and financial institutions and a study of successful entrepreneurs. The survey so conducted brings out the conclusion that despite SSI sector's unique contribution to nation's economy in terms of creation of employment, foreign exchange earnings, reduction in regional disparities, etc, the supply of institutional credit to this sector is too less and often delayed. Efforts of banks in providing finance to SSI sector needs to be strengthened as this sector has many other expectations from banks.

Consequences of schemes

Mensah (2004) analyzed the effectiveness of various schemes, initiatives and funding mechanisms for facilitating access of SMEs in Ghana to loan and equity finance. In Ghana, banks were found not paying attention to the development of SMEs. The government should open the dialogue and create instruments together with the banks to promote the financial aspects of successful SME development.

Zechinni & Ventura (2009) evaluated the impact of public credit guarantees to SMEs in increasing credit availability and reducing borrowing costs without compromising their financial sustainability. Performance of SMEs that benefitted from Italy's guarantee instruments was compared and extensive econometric tests had been carried out to confirm the presence of a casual relationship between the public guarantee and the higher debt leverage of guaranteed firms as well as their lower debt cost.

Canales & Nanda (2012) made an empirical analysis based on a comprehensive loan-level panel data set on SME loans in Mexico covering the period 2002-2006. It was found that decentralized banks, where branch managers have greater autonomy over lending decisions, give larger loans to small firms and those with "soft information". Decentralized banks has an advantage in small-business lending relative to the centralized decision making structure in large banks, since much of the information used in lending to small businesses may be "soft". The paper on the one hand, is related to studies examining how competition in the banking industry impacts credit constraints of small startups and on the other, it is related to studies examining how bank structure affects lending outcomes. In tying together these two literatures, the findings of the paper also explains why entrepreneurship increased significantly following the cross-state banking deregulations from the late 1970s. It is found that decentralized banks are more responsive to their own competitive environment and they are more likely to expand credit when faced with competition but also cherry pick customers and restrict credit when they have market power.

Acharya (2015) evaluated the efficacy of Indian Credit Guarantee Schemes for MSMEs in terms of increase in credit flow, creation of employment, increase in turnover of the MSMEs and the impact on probability of default of the loans. The survey of the entrepreneurs revealed that the most important factor hindering setting up of an enterprise is market linkage followed by bank credit. Unavailability of collateral security and the cumbersome application process were the major impediments in the issue of bank credit. The survey of the bankers revealed that intervention of credit guarantee schemes had facilitated flow of credit to MSME sector.

Dave (2016) presented the trends of priority sector lending of State Bank of India, Canara bank, Punjab National Bank, Bank of India and Bank of Baroda for five years from 2011-12 to 2014-15. He analyzed the data using Ratio-analysis in percentage as an accounting tool and F-test and one-way ANOVA as tools of statistics. He concluded that that the lending activity towards priority sector by the entire selected banks are following the norms for advances to priority sector on an average nearer one fourth to one third of their total advances during the research period. In order to boost up the economy the banks have to increase their lending activity towards priority sector as these sectors are the key segments of the development of the economy.

Thingo (2016) critically studied into the problems of MSMEs in Nagaland by carrying out a comparative analysis of policies for MSMEs in Nagaland with the other Northeastern states. The differences were found with regard to incentives schemes offered by each state wherein the comparative analysis was carried out on the basis of type of scheme, period applicable for and rate of subsidy ceiling. The study also revealed that problems such as difficulty in raising capital, demands from informal groups, dishonest handling of subsidies, inadequate power supply, unavailability of equipments, lack of skilled labour were some of the major problems affecting the MSMEs in Nagaland.

CONCLUSION

All the studies conducted so far on priority sector lending or directed credit and advances to MSMEs worldwide show mix results about the impact of priority sector lending scheme. The beneficiaries are positively affected whereas there is a great negative impact on the banking authorities. There is a significant change in the living of millions of poor people which has become possible due to strict targets laid under the priority sector lending norms. But the same has deteriorated the profitability of banks and increased the non-performing assets of banks miserably. Development discourse premises that development of MSMEs is crucial to overall economic and social growth in India as well as in North East region. Extant literature shows that to improve the status of MSMEs, bank lending to MSMEs needs to be improved. Mere fulfilling targets is not enough.

References

- Acharya, S.S. (2015). *Evaluation of the efficacy of the Indian Credit Guarantee Scheme for MSMEs* (Doctoral dissertation, KIIT University, Bhubaneswar, India).
- Ayyagari, M., Beck, T. & Kunt, A.D. (2007). "Small and Medium Enterprises across the Globe", *Small Business Economics*, 29 (4), 415-434.
- Bohra, P. (2017). *Financing pattern of small business enterprises and traders in Guwahati city* (Guwahati University, Assam, India).
- Burgess, R., Wong, G. & Pande, R. (2005). "Banking for the Poor: Evidence from India", *Journal of the European Economic Association*, 3(2/3), 268-278.
- Canovas, G. H. & Solano, P.M. (2010). "Relationship Lending and SME Financing in the continental European bank-based system", *Small Business Economics*, 34(4), 465-482.
- Canales, R. & Nanda, R. (2012). "A darker side to decentralized banks: Market Power and Credit Rationing in SME lending", *Journal of Financial Economics*, 105, 353-366.

- Cziraky, D. & Tisma, S. & Pisarovic, A. (2005). "Determinants of the low SME loan approval rate in Croatia", *Small Business Economics*, 25(4), 347-372.
- Das, B. M. (2012). *Prospect of entrepreneurship development in Small and Medium enterprises in Assam with special reference to Nalbari district* (Doctoral Dissertation, Guwahati University, Assam, India).
- Das, B. M. (2012). *Prospect of entrepreneurship development in Small and Medium enterprises in Assam with special reference to Nalbari district* (Doctoral Dissertation, Guwahati University, Assam, India).
- Dave, Dr. K.S. (2016). "A study of Priority Sector Lending for Selected Public Sector Banks of India", *International Journal of Research and Analytical Reviews*. 3(3), 84-86.
- Kohli, R. (1997). "Directed Credit and Financial Reforms", *Economic and Political Weekly*, 32(42), 2667-2669+2671-2673.
- Kulkarni, S.S. (2007). *Strengthening of Credit flow to SSI Sector in India- New Approaches* (Doctoral dissertation, University of Pune, India).
- Mensah, S. (2004, March). "A review of SME financing schemes in Ghana", Paper presented at the UNIDO Regional Workshop of Financing Small and Medium scale Enterprises, Accra, Ghana.
- Raju, Dr. K. D., (2008). "Small and Medium Enterprises (SMEs) in India: Past, Present and Future", PHDCCI Working Paper. Retrieved from: <https://ssrn.com/abstract=1080505> or <http://dx.doi.org/10.2139/ssrn.1080505>
- Thingo, C. (2016). *MSMEs in Nagaland: A critical study into their problem and prospects* (Doctoral Dissertation, Tezpur University, Assam, India).
- Zechinni, S. & Ventura, M. (2009). "The impact on Public Guarantees on credit to SMEs", *Small business Economics*, 32(2), 191-206.