MSMES IN INDIA: ROLE OF FACTORING AS AN ALTERNATIVE SOURCE OF FUND.

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ABSTRACT

MSMEs in India have been contributing significantly to the GDP and the growth of MSMEs is considered to be quintessential to the growth of the Indian economy. Currently there are around 49 million MSMEs contributing 8% of the GDP.MSMEs have been at the center of policy initiatives for the government of India. Despite their high enthusiasm and inherent capabilities to grow, MSMEs in India are also facing a number of finance related problems. Although MSMEs are considered as priority sector for bank financing in India yet most of the MSMEs rely on the traditional sources of funding. The demand and supply gap in financing needs for MSMEs is projected at INR 16331 billion in the year 2016-17. Present study is an attempt to explore factoring as an alternative source of finance for managing the working capital gap by releasing the funds locked in overstretched receivables. Factoring as a financial product has been in existence in India for several decades, however penetration of factoring in India particularly in the MSME sector is abysmally low as compared to other developing countries. This study is an attempt to address some of key challenges faced by MSMEs in raising finance and intends to bring to fore the role of factoring in facilitating quick access to finance by turning accounts receivables into cash. This study has also highlighted various initiatives taken by Government of India to supplement the efforts of factoring industry in India with a view to assist MSMEs in working capital management and help them to scale up.

Keywords: MSME (Micro,Small and Medium Enterprises), Factoring.

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INTRODUCTION

MSME sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades .MSMEs not only play crucial role in providing large employment opportunities at comparatively lower capital cost than large industries but also help in industrialization of rural & backward areas, thereby, reducing regional imbalances, assuring more equitable distribution of national income and wealth. MSMEs are complementary to large industries as ancillary units and this sector contributes enormously to the socio-economic development of the country.

Table 1: Size and contribution of MSMEs in Indian Economy

- The Sector consists of 49 million units.
- The MSME Sector is the largest employment generator sector of the Indian economy. The labour to capital ratio is much higher than large industries. It provides employment to over 111 million persons creating one million jobs every year.
- The MSMEs develop a diverse range of products and services to meet the needs of the local markets, the global market and the national and international value chains. It produces more than 8,000 products ranging from machinery and equipment to apparels and to food products to furniture.
- About 55% of the enterprises are located in rural areas, thus offering a great potential for rural development and for reducing the strain on urban infrastructure,
- Geographical distribution of these enterprises is more hence promote balanced and equitable growth all over the country.
- It contributes about 8% to GDP
- It contributes 45% to the total manufacturing output.
- It accounts for 40% of the exports from the country.

Source: 1. MSME at a glance 2016, Ministry of Micro,Small and Medium Enterprises.

2. Laghu Udyog Samachar March,2016

The MSME sector has the potential to spread industrial growth across the country and can be a major partner in the process of inclusive growth. It has been acknowledged fact that the MSME sector can help realise the target of the proposed National Manufacturing Policy of raising the share of the manufacturing sector in GDP from 16% at present to 25% by the end of 2022.

Current MSME definition in India:

As Per Micro, Small & Medium Enterprises Development (MSMED) Act, 2006 the micro, small and medium enterprises are defined as below:

Table 2. Definition of MSME as per MSMED Act, 2006

Categories	Manufacturing (Investment in plant and machinery)	Services (Investment in equipments)
Micro	Does not exceed ₹ 25 lakh	Does not exceed ₹ 10 lakh
Small	More than ₹ 25 lakh but does not exceed ₹ 5 crore	More than ₹ 10 lakh but does not exceed ₹ 2 crore
Medium	More than ₹ 5 crore but does not exceed ₹ 10 crore	More than ₹ 2 crore but does not exceed ₹ 5 crore

BACKGROUND OF THE PROBLEM

According to the Report of the Task Force on MSME (Chairman:Shri.T.K.A.Nair,2010)set up by the Government of India, although Indian MSMEs are a diverse and heterogeneous group, they face some common problems related to finance such as lack of availability of adequate and timely credit, high cost of credit, collateral requirements etc. A substantial body of research has established that the SMEs face severe bank credit constraints, forcing them to also tap alternative financing sources, especially trade credit. However, alternative financing typically involves higher transaction costs as well as interest costs than bank finance. Since MSMEs are the engines of growth of our economy the issue of financing becomes an issue of vital importance. A recent survey of MSMEs by the Confederation of Indian Industry (CII) had identified 'delay in realization of receivables' as the most important challenge being faced by MSMEs. Delayed realization of receivables increases the working capital needs of MSMEs and strains their financial position. Mechanisms to leverage other sources such as factoring can potentially help MSMEs liquidate receivables faster, and possibly afford them an opportunity to leverage their creditworthiness to avail financing.

OBJECTIVES OF THE STUDY

1. To identify key challenges faced by Indian MSMEs in raising finance.
2. To know how factoring helps MSMEs in financing receivables.

3. To provide an insight into the growth of factoring industry in India.
4. To assess government initiatives in the field of factoring.

KEY CHALLENGES IN FINANCE

1. **Funding Gap in MSMEs**

Lack of adequate and timely access to credit is one of the biggest challenges of Micro Small and Medium Enterprises sector in India.Different studies have indicated that only a small percentage of credit requirement of micro and small enterprises is met from institutional finance.Financial institutions,on their part,have not been able to meet the growing need for credit and other financial products to this sector and hence there remains a large gap in supply and demand of credit for the sector.

Table3.Financial Exclusion in MSME Sector

Source of finance	No. of enterprises(million)	% of units that have availed finance
institutional sources	1.4	5.16
non-institutional sources	0.5	2.05
Self finance	24.2	92.77
Finance through both	0.01	0.05
Total	26.1	100

Source: The Fourth Census of MSME sector, September 2009

The statistics compiled in the Fourth Census of MSME sector September 2009 revealed that only 5.18% of the units (both registered and unregistered) had availed of finance through institutional sources, 2.05% had finance from non-institutional sources the majority of units i.e. 92.77% had no finance or depended on self finance.

One of the studies conducted by the sub group on flow of Private Sector Investment(Table) for MSME Sector-Planning Commission of India estimates the total credit demand to be INR 37.6 trillion in 2016-17 with short term debt requirement is as high as 70% of the total demand .On the other side projected supply of credit in MSME sector is INR 21.2 trillion thereby a credit gap of INR 16.33 trillion (43%) indicating that a vast section of enterprises still remains unserved by the financial sector.

Table 4.Demand and Supply Estimates of MSME Credit (INR Trillion)

	Total Credit demand by MSMEs			Projected supply of credit flow to MSME sector			Credit Gap	
	Working Capital	Term Loan	Total demand	Working capital	Term loan	Total supply	Absolute terms	Credit gap as % of demand
2010-11	14.6	6.3	20.9	5.0	2.3	7.4	13.6	65%
2011-12	16.2	6.9	23.1	6.0	2.7	8.7	14.3	62%
2012-13	17.8	7.6	25.4	7.2	3.2	10.4	15.0	59%
2013-14	19.6	8.4	28.0	8.6	3.8	12.4	15.7	56%
2014-15	21.6	9.3	30.9	10.3	4.5	14.8	16.1	52%
2015-16	23.8	10.2	34.1	12.4	5.3	17.7	16.4	48%
2016-17	26.3	11.3	37.6	14.9	6.3	21.2	16.3	43%
Total	**140.0**	**60.0**	**200.0**	**64.4**	**28.2**	**92.6**	**107.4**	**54%**

Source: Report of the Sub-Group on flow of Private Sector investment for MSME Sector-Planning Commission of India

As per IFC advisory services the major reasons for creation of this gap are information asymmetry which exists in Indian SMEs, the family owned nature of Indian businesses, and lack of information regarding tapping the right kind and source of finance. Though the first two reasons are systemic, lack of information can be easily resolved with targeted efforts from financial institutions and government agencies.

Broadly, sources of funds for small businesses can be classified into –

(i) External sources like loans from banks, financial institutions & non-banking finance companies (NBFCs), loan from family & friends, loans raised from the unregulated market, venture capital/ private equity, factoring, trade credit, subsidies and government grant; and (ii) Internal sources like ancestral capital, personal fund including through sale of assets, retained earnings etc.

Traditionally, private funds from friends and family form the single largest source of finance to MSMEs in India. MSMEs in India also rely heavily on private money lenders and the unorganized financial sector for their requirements, where the terms of financing are unclear and interest rates are high. This small pool of funding providers often forces many potentially viable and growth focused MSMEs out of operation.

Banks have been making steady strides in order to bridge this gap. However the approach followed by banks to funding is very restrictive as the bankers do not feel secure about lending to this sector for number of reasons. As the borrowers of MSME sector are high risk borrowers due to lack of credit information about small enterprises, insufficient assets, low capital, vulnerability to market fluctuations and high mortality rates ,bankers ask for collateral support and also impose many conditions to lend. Therefore it is not always possible for an entrepreneur to satisfy all requirements and conditions which the Bank might pose. At a little higher cost of funds, a factoring company can well be the liquidity generator to scoot the SME growth engine.

Table 5. Aggregate bank credit flow to Micro & Small and Medium Enterprises (Outstanding credit amount in Rs, Crore)

Year (last reporting Friday)	Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial banks
March 2012	5,33,279.29	1,24,725.66	23,300.71	6,81,305.66
March 2013	6,43,525.02 (20.7%)	1,82,247.82 (46.1%)	43,251.30 (85.6%)	8,69,024.14 (27.6%)
March 2014 (Provisional)	7,54,391.07 (17.2%)	2,46,025.76 (35.0%)	34,359.17 (-20.6%)	10,34,775.99 (19.1%)

Source: RBI

Note: Figures in brackets indicate year on year % growth/decline

As per data from RBI year on year % growth in aggregate bank credit flow to MSMEs has come down from 20.7% to 17.2% in case of Public sector banks,46.1% to 35% in case of private sector Bank,85.6% to -20.6% in case of foreign banks and 27.6% to 19.1% in case of Scheduled banks.

2. Sizeable NPAs

Table 6: Gross nonperforming assets (NPA) for Micro &Small Enterprises (Outstanding gross NPA amount in Rs. Crore& NPAs in percentages)

Year (last reporting Friday)	Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial banks
March 2012	24,272.44 (6.1%)	1,880.73 (1.7%)	159.83 (0.7%)	26,312.99 (5.0%)
March 2013	28,575.29 (5.7%)	2,506.44 (1.6%)	396.23 (1.3%)	31,477.96 (4.6%)
March 2014 (Provisional)	38,949.80 (6.3%)	3,021.63 (1.5%)	457.36 (1.5%)	42,428.79 (5.0%)

Source RBI

Note: Figures in brackets indicate NPA percentages

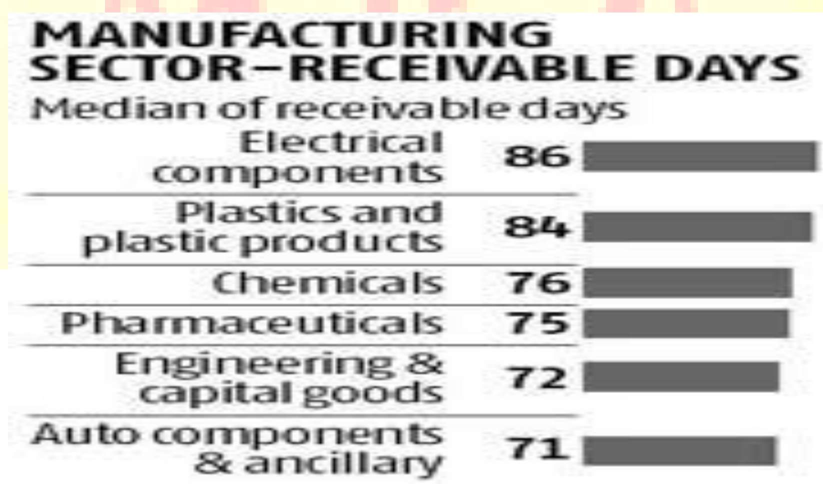
MSMEs have sizeable incidence of NPAs and this aspect needs to be addressed. This issue can be addressed by an efficient system of receivables factoring/discounting.

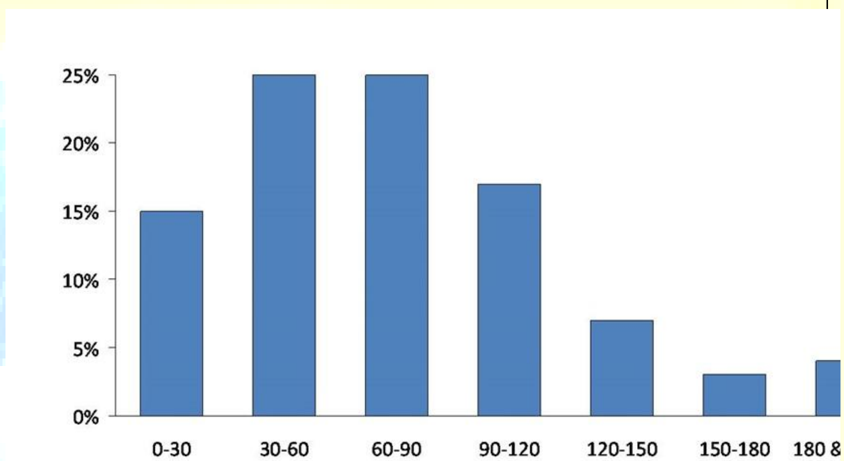
3. Delayed payment cycle

The delayed payment cycle by the large scale customers of SMEs have an adverse effect on their operational facets and fund recycling efforts. MSMEs face the problem of delayed payments from their buyers , which are mostly large corporates.This adversely impacts their working capital as well as their next cycle of production by affecting their ability to service existing debt. As per the provision of the MSME Act, the release of funds for the regulation of capital cycle is very necessary for maintaining the timely payment of stretched receivables to the MSMEs.

Table 7: literature survey on delayed payment cycle

Research report	Findings
A CRISIL study on 5000 SMEs released in December 2010.	• High quantum of receivables is an endemic problem across industry sectors and geographies in the SME space. • SMEs can enhance profits by at least 15 per cent if they receive payments on time from their large corporate customers.
CRISIL report based on the analysis made	• SMEs with large corporate customers have receivables of 90 to 120 days of sales on their balance sheets, as against 45

on debtor-collection period of 1,400 MSMEs in the service sector in 2012-13.	days stipulated by the Micro, Small, and Medium Enterprises Development (MSMED) Act. • The report stipulated that the development of MSMEs were affected by the deferred collection of the cash. It also mentioned that due to inadequate cash flow, the overall growth of MSMEs is being impeded, as it influences the trivial operations .
CRISIL report on the debtor-collection period of 2,400 micro, small, and medium enterprises (MSMEs) in the manufacturing sector in 2012-13.	• The results indicate that receivables are stretched the most for electrical components and equipment and plastic and plastic product MSMEs, followed by enterprises in the chemicals, pharmaceuticals, engineering and capital goods, and auto-component industries. • To manage their tight liquidity position, these MSMEs depend on borrowing from banks and other sources, which erodes their profitability by increasing their interest burden. Thus, timely payment to MSMEs, as per the provision of the MSMED Act, remains essential to release funds tied up in the  working capital cycle.

IFC world Bank Group Enterprise Finance in India A Research Study on Needs, Gaps and Way Forward (November, 2012)	• Over 60% of SMEs in India today receive payment from customers only after 60 days or longer. • 35% of SMEs receive payment only after **90 days** or longer: **Debtor days in Small & Medium Enterprise segment,** *% of enterprises (N = 5,000)*  Source: IFC/Intellecap MSME Finance Report It is almost a cliché in business in India that no one pays on time. But while larger corporations may have the scale and sophistication to mitigate the adverse effects of these cycles, small and medium enterprises chronically struggle to manage cash flow in these situations.

FACTORING AS AN ALTERNATIVE SOURCE OF FUNDS

Factoring is one of the upcoming sources of finance for SMEs in India. A company growing on a daily basis with new customers added regularly have chances of ending up with huge invoices. Given MSMEs funding restrictions many businesses are looking for alternative source of finance like factoring. Factoring is a flexible alternative to traditional forms of funding.

What Is Factoring?

Factoring is a form of receivables finance whereby a business sells or assigns its accounts receivables (i.e. invoices) to a finance company (a factor) at a discount in exchange for immediate money with which to finance continued business. (SME World article dated Sep2011 http://www.smeworld.org/story/money/factoring-alternative-source-of-wc.php) When a client makes a sale, delivers the product or service and generates an invoice, the factor buys the right to collect on that invoice and releases funds, usually 80-90% of the invoice value to the client. Factoring as a financial services product is superior to the conventional bank finance in terms of it being an easy and fast method of turning accounts receivables into cash, offering funding up to 90% of the invoice value, not restrained by geographical limits, non requirement of collateral security, offering value-added services in the form of sales ledger administration, collection and credit protection, credit screening-cum-credit monitoring and early detection and warning of customer service problems. All over the world, factoring is a preferred route of accessing working capital for SMEs and even larger organisations.

Advantage of factoring

- **Improved liquidity:** Factoring is capable of providing SMEs with the liquidity needed against their receivables and can be efficient alternate source of working capital. Delay in settlement of dues / payment of bills by the large-scale buyers to the SMEs units adversely affects the recycling of funds and business operation of SME units. Timely payments from customers will help SMEs in reducing their working capital requirements
- **Improved profitability:** CRISIL estimates that timely payments from large customers will help SMEs reduce interest costs, improve profitability and have a positive impact on the long-term health and sustainability of India’s SME sector.
- **Lesser constraints as compared to bank finance:** It is much preferred and superior product than bank finance on account of its superior conversion time of receivables into cash, absence of geographical restraints, non requirement collateral security etc .

INDIAN FACTORING MARKET

The Indian factoring market is still at a nascent stage. As per the Annual Review in 2014 by Factors Chain International (FCI), a global network of factoring companies worldwide, the turnover of India is only €5240 million out of which international factoring is €240 million, which is nearly half of the turnover of Singapore and not even 2% of China's turnover. There are nearly 12 factoring companies in India with Canbank factors and SBI Global Factors being two of the oldest. The worldwide factoring volume is € 2230477 millions. In US there are 110 factoring companies with a total turnover of €83,739 million .Even a small country like Taiwan has 21 factoring companies with a market of €73000 million

Table 8 Factoring Industry in India

Total No. of Factoring companies in India:	12
Total size of business volume	€5240(out of this international factoring is €240)
India's share in total factoring business of world	Less than 1% of the total volumes generated in the world
India's share in total factoring business of Asia	Only 2.2%.
Turnover growth	Merely.03% in 2013 from 2007

Source: Annual review 2014, FCI

GOVERNMENT INITIATIVES:

1. **The Factoring Regulation Act 2011** which came into force in February, 2012, regulates factoring business in India and provided the much-needed legal framework for factoring in India. This act aims to promote the concept of factoring,to make it more organized and to provide clarity on the process of assignment, rights and obligations of parties to contract for assignment of receivables.

Salient features of the Factoring Act, 2011:

a) Assignment of debts under factoring being exempted from stamp duty(Amendment to the Indian Stamp Act 1899, by inserting Section 8D) The amendment has reduced transaction costs(in form of high rates of stamp duty) for factoring arrangements.

b) Every factor to register the particulars of every transaction of assignment of receivables in its favour with a central registry set up under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI Act). A centralized database was aimed at reducing frauds and facilitating factors to verify whether a certain set of receivables had already been assigned in favour of a third party.

2. **Credit Guarantee Fund for Factoring for MSME units:** In December 2014, the Government approved a Credit Guarantee Fund for Factoring for MSME units with a corpus of RS, 550 crore. The National Credit Guarantee Trustee Company (NCGTC) will manage the Fund for guaranteeing. It is a financial arrangement for suppliers by making factored debts upto a maximum of 50%.The National Credit Guarantee Trustee Company Ltd. is a private limited company incorporated under the Companies Act 2013 in March 2014. NCGTC facilitates access to financing through the guarantee schemes under its management.

3. **Penal provisions for delayed payment to Small Scale and Ancillary Industrial Undertakings:** Under the Amendment Act, 1998 of Interest on Delayed Payment to Small Scale and Ancillary Industrial Undertakings, penal provisions have been incorporated to take care of delayed payments to MSME units. After the enactment of the Micro, Small and Medium Enterprises Development (MSMED), Act 2006, the existing provisions of the Interest on Delayed Payment Act, 1998 to Small Scale and Ancillary Industrial Undertakings, have been strengthened.

4. **Trade Receivables Discounting System (TReDS):**The RBI has notified guidelines for Trade Receivables Discounting System (TReDS). The scheme is for setting up and operating the institutional mechanism to facilitate the financing of trade receivables of micro, small and medium enterprises (MSMEs) from corporate and other buyers, including government departments and public sector undertakings (PSUs) through multiple financiers. The intention is

to facilitate electronic Bill Factoring Exchanges in the country, which could electronically accept and auction MSME bills so that MSMEs could be paid promptly. TReDS will allow SMEs to post their receivables on the system and get them financed. This will not only give them greater access to finance but may also generate more discipline on corporates.In November 2015, RBI gave "in-principle" approval to three companies to set up and operate the TReDS. The three companies include a joint venture between NSE Strategic Investment Corporation Limited & SIDBI, Axis Bank and Mynd Solutions.

5. **Factors as a new category of non-banking financial company (NBFC):**In addition to the launch of TReDS, the RBI has introduced factors as a new category of non-banking financial company (NBFC). It has also simplified the eligibility criteria with regard to principal business – the NBFC Factor needs to ensure that financial assets in the factoring business constitute at least 50 per cent of its total assets, and that its income derived from factoring business is not less than 50 per cent of its gross income, as against 75 per cent previously. RBI rulings mean factors can now also access credit information from credit bureaus.

These steps, along with the improved economic sentiment, should help drive factoring industry development and change the face of conventional working capital finance in the country.

CONCLUSION

It is very much evident from the study that MSME sector, plays a very critical role in the Indian economy in terms of employment generation, exports and economic development.As per available statistics in the study, there is a need to carefully nurture and support this sector financially. Factoring as an alternative source of finance would help improve SME financing and is a major step towards receivables management which is a crucial issue in MSMEs due to overstretched accounts receivables.Initiatives undertaken by Government of India to support factoring industry in India are appreciable and it is hoped that with the support of Government factoring can prove to be a successful cash management tool and help in building a robust and resilient MSME sector.

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