Measuring Financial Inclusion in Urban India-a Cross-Sectional Examination of Financial Depth

A case study of Bangalore Urban District

JANA FOUNDATION

contents

Table of Figures

Table of Tables

ABBREVIATIONS

BUD	Bangalore Urban District
CCFS	Committee on Comprehensive Financial Services for Small Businesses and Low Income Households
C-GDP	Credit to GDP
DES	Department of Economics and Statistics
EC	Economic Census
IFC	International Finance Corporation
I T	Income Tax
MSME	Micro, Small and Medium Enterprises
MSE	Micro and Small Enterprises
ME	Micro Enterprises
NSSO	National Sample Survey Office
RBI	Reserve Bank of India
SIDBI	Small Industries Development Bank of India
UCB	Urban Cooperative Bank

CHAPTER 1

EXECUTIVE SUMMARY

70% of micro-enterprises have a bank account but only **5%** have access to term loans from banks and **1%** to working capital loans from banks

The Committee for Comprehensive Financial Services to Small Businesses and Low Income Households (CCFS) established under the Reserve Bank of India (RBI) envisions that every low income household and small business would have convenient access to credit from formally regulated lenders, taking into account the pricing and risk considerations underlying specific segments.

The mandate of the Committee is to undertake an assessment of all aspects of financial inclusion and propose a concrete way forward for financial inclusion by the year 2017. To this effect, a workshop under the aegis of the CCFS was organized in Bangalore on November 11th 2013 to examine the indicators used to measure financial inclusion. The workshop focused on introducing a third measure of financial inclusion in addition to the indicators currently used **(Box 1).**

Box 1: The indicators of financial inclusion can be broadly classified under 'breadth' indicators that measure number of deposit accounts with commercial banks per 1,000 adults and number of loan accounts with commercial banks per 1,000 adults and 'depth' measures that include deposit-GDP or credit-GDP ratios

The proposed third measure of financial inclusion disaggregates the credit to GDP (C-GDP) ratio by verticals- micro, small and medium enterprises in order to understand the main drivers of this indicator.

The main thrust of the workshop was to look at financial inclusion in the context of urban areas, where unlike a rural set up, most of the infrastructure and players needed to bridge the demand and supply gap are already present. In that sense, cracking the financial inclusion problem in urban India is a proximately realizable goal.

The workshop focused on Bangalore Urban District (BUD) as a case study. BUD provides an ideal setting to disaggregate the drivers of the C-GDP ratio by MSE verticals. The district is the largest contributor to Karnataka's economy and contributes 2% out of Karnataka's contribution to India's GDP of 6%. It is therefore expected that the overall C-GDP ratio of this economically robust district would be good, providing an ideal context to disaggregate this indicator.

The Credit to GDP Ratio is **146%** for Bangalore Urban as a whole. When broken by verticals, it is only **62%** for the Micro sector and **88%** for the MSE sector.

As expected, it was observed that the overall C-GDP ratio for BUD was 1.46, suggesting the district as a whole fared well on the measure of financial inclusion. However, upon disaggregation, the C-GDP ratio for the micro sector and MSE sector as a whole was found to be much lower: 0.62 and 0.88 respectively.

This exercise in BUD underscores the importance of adding a third measure of financial inclusion. The drivers of C-GDP ratio in BUD are mostly large enterprises and using the district level C-GDP ratio as an indicator to measure financial inclusion is likely to the true drivers of the measure.

Since the thrust of the workshop was primarily urban financial inclusion using BUD as a case study, Jana Foundation conducted a survey (henceforth Footprint Survey) for the purpose of the workshop focusing on key themes related to access to credit for micro-enterprises.

The survey itself was part of a larger census (henceforth Jana Census) undertaken by Jana Foundation in one area of Bangalore's Central Business Districts (CBD). The Jana Census revealed the presence of a large segment of enterprises that are vendors on streets or footpaths.

The observations from the Jana Census raises questions regarding the definition, classification and enumeration of micro-enterprises (MEs). When compared to the enterprise data from the official Economic Census (EC) of 2005-06 in BUD, the administrative data appears to underestimate the size of the ME sector and omits the enumeration of street vendors, a sizable percentage of enterprises in BUD.

The Jana survey provides an in depth understanding of access to credit issues for micro-enterprises. Saliently, it revealed that while a substantial percentage (~70%) of MEs had access to bank accounts, very few of them had access to credit for term loans (5.43%) and working capital (~1%).
The study found a large extent of informality among survey respondents. 87% of the respondents had never filed income tax returns,

High level of informality among micro-enterprises. ~**90%** with no income tax returns; **67%** with no books of accounts; **65%** with no form of enterprise registration

65% maintained no book of accounts and 63% of them had no enterprise registration of any form.

The lack of formalization can pose significant barriers to accessing formal sources of finance. Not surprisingly, a majority of respondents accessed informal sources of finance for their credit needs.

This raises the question of whether it is prudent for providers of credit to innovate and work around formalization barriers or if the policy focus should be on encouraging enterprises to formalize.[1]

One of the concerns that was raised during the workshop was the paucity of granular data related to financial inclusion that would enable the addition of a third measure of financial inclusion. Where data was not available, assumptions were made to calculate indicators or credit demand estimates. For example, the data from the lead bank of Bangalore included information only for the top six banks in the region. Similarly, GDP data at a district level is not available at a granular level for a number of industry sectors. One of the ways forward for policy that emerged during the workshop was to set up a dedicated cell in the RBI that would be the custodian of all data pertaining to financial inclusion.

1| Refer Box 6- Closing Remarks of Dr. Nachiket Mor

Some of the other policy implications that emerged from the workshop are:

- Developing a new classification system for micro-enterprises that includes segments like street/footpath vendors and the tail end of the ME distribution.
- Focus on both the demand and supply side to improve access to finance. On the supply side, efforts include moving from a bank dominated approach to a more inclusive approach that accommodates other financial providers. On the demand side, policy focus should be on incentives to dismantle ME's reluctance to formalize.

The report is organized as follows.
Chapter 2 disaggregates the C-GDP ratio for BUD and chapter 3 elaborates findings from the Jana survey.

Box 2: Workshop Opening Remarks

Dr. Nachiket Mor (Chairman, CCFS) opened his remarks by outlining the mandate of the committee and the motivation for the workshop. He observed that India had already made a great deal of innovation in terms of institutional design required for financial inclusion. However he touched upon some areas of concern as to whether these institutions were performing the roles they were designed for and if the problem of financial exclusion was exacerbated by the lack of coordination among these institutions.

With respect to the measure of financial inclusion, Dr. Mor opined that at a district and sub-district level, while the overall financial depth might be quite high, the extent of 'verticalization' can be a matter of concern. Urban areas have a financial depth of close to 100% but this could well have been accounted by a small number of large firms.

Mr. R.K Dubey (CMD, Canara Bank) highlighted the important role played by MSME in poverty alleviation, economic growth and employment generation. Sharing lessons from the ground, he noted that KYC norms were a barrier to financial inclusion, especially for migrant populations. He also highlighted problems with the BC model and stated that the current remuneration paid to BCs was too low to retain them. He proposed the creation of a subsidiary of the bank exclusively for financial inclusion that would employ the BCs. He also recommended the government to be more proactive in the mobile banking arena, citing the success story of financial inclusion through mobile banking in Kenya.

Mr. Ramesh Ramanathan (Chairman of Jana Group and Member of CCFS) provided an overview of the enterprise economy in India. He expressed concern that the growth of enterprises in India has largely been fuelled by enterprises with less than ten employees. He highlighted the informal nature of employment in India noting that 350 million out of 450 million strong workforce in India lie outside the formal enterprise sector. Touching on the nature of financing, he observed that 90% of the enterprises in India are self-financed, up from 80% in 1998-99. He opined that while the credit to GDP is a good depth indicator, there was a need to extend it and look at the substructure of the economy. He expressed concern over the lack of availability of high quality data with respect to financial inclusion, especially with government sources. He noted that the current Economic Census itself could be missing enterprises like street enterprises and vendors, which make about 23% of all enterprises in Bangalore Urban District.

CHAPTER 2

Slicing the Depth of Financial Inclusion

This chapter focuses on disaggregating the C-GDP ratio for BUD. It provides a description of the credit supplied to the district, GDP at the district level and the method used to arrive at the C-GDP ratio by verticals.

Overview of the Enterprise Sector

In 2004-05, the Economic Census data pegged the number of Indian enterprises at 42 million, out of which about 40% of enterprises were urban. From the year 1998-99 to 2005-06, the number of enterprises grew by 11 million, 10 million of which came from enterprises with less than 5 employees. Accounting for an annual growth of 5%, the number of enterprises is expected to rise to about 65 million by year 2014. It is likely that micro-enterprises would account for the largest share of the growth in terms of numbers. Micro-enterprises are the bulwark of the Indian economy.

Another related characteristic of the Indian Enterprise sector is the informal nature of employment. India has a labor force of 450 million workers, of which only 100 million are employed in what is recognized as the enterprise sector. This leaves the majority of 350 million workers outside the ambit of the formal enterprise sector. The 1000 listed companies in India employ only 1% of the working population. Owing to the informal nature of most of India's enterprise sector, it is not surprising that 90% of enterprises are self-financed. Out of the 10% of the enterprises that do use external sources of financing, only 3.25% borrow from banks.

Bangalore Urban District, the focus of this report accounts for 15.8% of Karnataka state's population and 15.2% of the workforce. Bangalore also is the

largest contributor to not only the state's economy, accounting for 32% of the GSDP, it also accounts for 2% of India's GDP when Karnataka's contribution is 6%. The GDDP of BUD is 1, 28,168 Crores in current prices in 2013.

BUD has a robust MSME sector in terms of employment, accounting for 28% of the Karnataka's workforce. About 30% of all investments in the state's MSME flows to MSMEin BUD.

Box 3: Computation of GDP at a District Level

The paucity of granular data limits the computation of GDDP. The information in this box is intended to shed some light on the computation of GDP at a district level. As per the guidelines laid down by the Department of Economics and Statistics, GDDP is estimated using three approaches: Production, Income and Expenditure. Different approaches are used to calculate income from different sectors of the economy. For example, income from agriculture is calculated through the production approach while income from construction and forestry are calculated through the expenditure method.

The database for estimation of DDP is not satisfactory for any state. The methodology for estimates has been developed, discussed and debated but the process has not been attempted-owing to the poor quality of data. The Central Statistics Office follows a combination of the income and 'value-added' approach in estimating the GDP at the state level. The approach for various sectors is based on the availability of data. GDP of agricultural sector is estimated from the aggregate value of production for all the crops produced within a district in a given year. For the remaining sectors, a district level index has been developed using the production approach—allocated in proportion to the district wise workforce and relevant indicators. This index is then used to distribute the State GDP across the districts.

Credit Supply in Bangalore Urban District

According to data provided by Canara Bank, the lead bank for Bangalore, the total outstanding credit from all banks for BUD is Rupees 2, 01, 981 Crores. Over the past five years, BUD has witnessed a compounded annual growth rate of 8%. During the same period, deposits have grown by 24% and advances have recorded a growth rate of 20%.

With respect to the MSME sector, RBI guidelines mandate that banks should ensure a minimum increase of 10% annually in the number of accounts under micro-enterprises. Also, lending to the MSE sector is mandated to grow 20% annually, with 60% of all MSME lending channeled to micro-enterprises.

However, in reality, the industry average of advances made to micro-enterprises in BUD remains at 40% and the growth rates of disbursements to MSME has witnessed a 10% since 2008-09.

The low penetration of the formal banking sector with respect to MSE lending was shared by all participants in the workshop. In spite of several support schemes supporting MSE lending by banks, several constraints preventing access to finance by the MSE sector were highlighted. Among these are the unorganized nature of MSEs, poor record keeping and low financial literacy.

The Credit to GDP Ratio is **146%** for Bangalore Urban as a whole. When broken by verticals, it is only **62%** for the Micro sector and **88%** for the MSE sector.

Slicing the Credit to GDP ratio in BUD

The Credit to GDP ratio measures outstanding bank credit to Gross Domestic Product and indicates the extent to which banks lend relative to the size of the economy. This is a very useful measure that helps understand financial inclusion at a macro level. For example, the Credit to GDP ratio for Maharashtra is 116% and is similar to those of Tamil-Nadu and Karnataka. On the other hand, the ratio for the North Eastern states and Bihar is under 16%. At a glance one can therefore conclude that Maharashtra, Tamil Nadu and Karnataka are more financially included when compared to Bihar or other North Eastern states.

While the measure depicts financial inclusion at a macro level, it sheds no light on the substructure of the economy. Rather, it may serve to mask the real drivers of financial inclusion in states or districts where the ratio is high. Looking at a credit-GDP ratio greater than 100%, it is possible to wrongly conclude that a state or district fares well on financial inclusion.

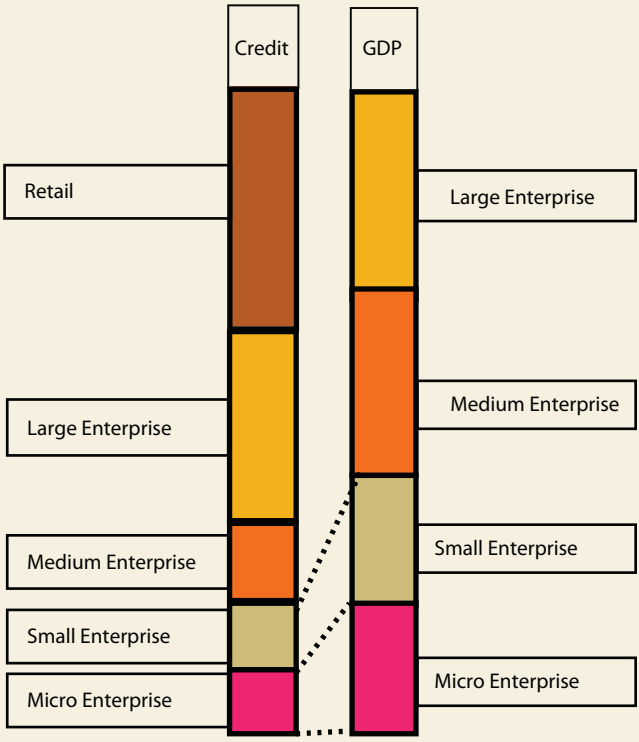


Figure 1: Illustration of Credit and GDP Break-up

It is therefore crucial to slice this depth by verticals- by micro, small and medium enterprises to shed light on who the drivers of the credit to GDP ratio are. It may well be that micro and small enterprises contribute to a significant share of GDP but get relatively little bank credit.

The following section slices the credit to GDP ratio using available data for Bangalore Urban District and uses assumptions where granular data is not available. One of the challenges with slicing the depth ratio by verticals for Bangalore Urban is the paucity of data at a more granular level. Credit data is available only for the top six banks in Bangalore and GDP data is not available at a district level.

Credit to GDP Ratio for Micro and Small Enterprises:

Credit to GDP for Bangalore Urban: In 2013, the Gross District Domestic Product (GDDP) for Bangalore Urban in current prices is Rupees 1, 28,168 Crores[3]. The level of outstanding credit for all banks in Bangalore Urban, accounting for 1608 branches is Rupees 2, 01,981 Crores.[4] The credit to GDP ratio for Bangalore on the whole is therefore 146%. Unsurprisingly, this shows the district as a whole fares well on the depth indicator.

Credit to GDP for MSE in Bangalore Urban: The ratio is brink down for the micro and small enterprise sectors as follows. The total outstanding credit from the top six banks in 2013 to the MSME sector is Rupees 9,899 Crores. This accounts for about 70% of the total credit extended to the MSME sector.[5] Therefore the total credit disbursed to the MSME sector in Bangalore Urban district is about Rupees 14,141 Crores. According to the lead bank data, the proportion of credit disbursed to the micro and small enterprise sectors is 25.15% and 45%, bringing the outstanding credit disbursed to these sectors Rupees 3,557 Crores and Rupees 6,361 Crores Respectively.

On the GDP side, the contribution of the MSE sector to GDP is 8.72%.[6] Assuming this percentage holds true for Bangalore Urban and further assuming that the proportion of micro and small enterprises to

gross output in urban areas is 51.2% and 48.4% respectively, the contribution of micro sector to GDP is Rupees 5,721 Crores and the contribution of the small enterprise sector to GDP is Rupees 5,452 Crores.[7]

The Credit to GDP Ratios are highlighted in the table below:

	Total Outstanding Credit (Crores of Rupees)	GDP Contribution (Crores of Rupees)	Credit to GDP Ratio
Bangalore Urban	2,01,981.00	1,28,168.00	1.46
Micro Sector	3,557.14	5,721.10	0.62
Small Sector	6,361.43	5452.90	1.16
MSE Sector	9,918.57	11174.00	0.88

From the table it can be seen that though the credit to GDP ratio of Bangalore is 1.46, the credit to GDP ratio of micro is 0.62 and the MSE sector overall is 0.88. This verticalization exercise for Bangalore Urban District demonstrates the necessity to disaggregate the credit to GDP ratio by micro and small enterprise verticals and unmask the asymmetries underlying its structure.

3| DES Data
4| Source: Lead Bank, Bangalore (Canara Bank)
5| Source: Lead Bank, Bangalore (Canara Bank)
6| Press release, Ministry of MSME: http://pib.nic.in/newsite/erelease.aspx?relid=82860
7| MSME Report

Box 4: Workshop Presentations with Data for Estimating C-GDP Ratio.
Mr. Karupasamy (Executive Director of RBI), highlighted the role played by Urban Co-operative Banks (UCB) in MSME lending in BUD. He stated that the UCBs constituted 3.8% of the total banking system in terms of advances made. He stated that Karnataka had the largest number of UCBs in the country and all districts in the state had UCBs, but their penetration remained poor. Outlining the structure of UCBs, he noted that these banks were self-financed- they could accept deposits from the general public but lending could be made only to members. With respect to problems faced by the UCBs, he noted that governance issues continued to hinder the growth of the sector. He also noted that the UCBs' conservative attitude and technological backwardness were concerns.

Mr. S.S Bhat (General Manager for Financial Inclusion, Canara Bank Bangalore), represented the Lead Bank of BUD. He noted that the mandate of Canara Bank as a lead bank did not include the metropolitan region, only peripheral areas. He noted a limitation of the Crisil Inclusix Index, stating that it did not capture the asymmetry of banking locations- BUD might have a large number of banks but they might all be concentrated in one location. Presenting data for BUD, he stated that the total advances made to the district was 2,01,981 crores. He presented data for the six largest banks in BUD and the advances they made to the MSME sector. He noted that Canara Bank runs 53 self-employment training institutes to encourage entrepreneurship.

Mr. K Sathianandan (General Manager, SIDBI) outlined the role SIDBI played in the development of the MSME sector, pointing out that there had been a decline in credit lending to MSME over the previous financial year. He stated that the level of advances made by SIDBI to MSME in Karnataka totaled Rs. 65, 953 crores as of March 2013.

Mr. Narasimha Phani (Directorate of Economics and Statistics) presented data pertaining to the GDDP of BUD. He presented the methodology used to calculate GDDP and estimated it at 1, 28, 168 Crores. He highlighted Bangalore's contribution to the GDP of Karnataka and India but noted that there was paucity of granular data which limits the estimation of GGDP at a district level.

Mr. T. Baskaran (Deputy Director General, NSSO) presented data pertaining to BUD's contribution to state and national GDP. He also provided highlights of the data from Annual Survey of Industries, noting that 53% of Karnataka's factories are located in Bangalore. With respect to MSME, he noted that the sector employs 23 lakh people in Karnataka and enterprises in BUD employ 28% of all employment provided by MSME in Karnataka.

CHAPTER 3

Micro-Entrepreneur Study in Janalakshmi's Footprint

The workshop used Bangalore Urban District as a case study to understand aspects of financial inclusion for micro-enterprises in an urban context. Jana Foundation conducted the Footprint Survey of micro-enterprises to get a deeper understanding of the following: 1) current credit access for M.Es 2) future credit needs and 3) barriers related to access to finance.

Current credit access addressed questions related to use of bank accounts and sources of credit used for term loans and working capital. Future credit needs addressed business plans of M.Es over the next two years, how they planned to finance them and the size of loans that they would need to fulfill these needs. Barriers to finance addressed questions related to formalization. This included the absence of book of accounts, income tax returns and other paper work essential to obtain credit.

Footprint Census

The Footprint Survey was conducted in the footprint of one of Janalakshmi's branches located in Bangalore city's Central Business Districts (CBD). The survey itself was part of a larger Footprint Census conducted by Janalakshmi that spatially maps the entire 31sqkm area around the S.R Nagar branch. The census covered all enterprises excluding large franchises, shopping malls and large retail chains. It included street vendors, both stationary and mobile. The number of enterprises in the 31sqkm was 13,177 (Refer Box 5).

Sampling

The Jana Census area was divided into 104 grids, each covering approximately 0.3 sqkm. Using spatial maps from the Jana Census, the areas were segregated by density yielding areas with dense concentration of enterprises, moderate concentration and areas that were sparsely populated with enterprises. The areas were then proportionally sampled based on density to arrive at a random sample of 1019 enterprises.

Description of survey data

The description of enterprises is presented in the sections below:

Type of enterprise

The top six occupations and their composition are presented in Table 1 below:

FOOTPRINT SURVEY			
Occupation Type	NIC Code	%	Cum %
Retail Food/Beverages-Specialized	5220	41.71	41.71
Other Special Retail	5239	10.50	52.21
Retail Food Non-Specialized	5211	9.62	61.83
Textiles/Footwear/Clothing	5232	8.44	70.26
Cigarette/Beedi Manufacture	1600	7.07	77.33
Motor Vehicle Repair	5020	2.94	80.27

Table 1: Type of Enterprises

As Table 1 shows, three of the top six enterprises in the sample engage in retail trade. The top six enterprises types also account for nearly 80% of all enterprises in the sample.

Table 2 in the Appendix compares the distribution of enterprises in the Footprint Survey with the Economic Census data 2005-06 for the same wards that are covered in the Footprint Survey. It is observed that in the survey data, the vendors of food and beverages accounts for 41.71% of enterprises whereas in the EC data this accounts for only 14.4%. The Footprint Survey covers street vendors, which the Economic Census data does not.

From Table 2, it can also be seen that three out of the top five enterprise types in the survey match

the top three enterprise types in the Economic Census 2005-06 for the whole of BUD.

The type of enterprises in the Footprint Survey account for 51% of the type of enterprises found in the Economic Census data.

Enterprise Size

# of employees	Percentage	Cumulative %
0	53.74	53.74
1	26.06	79.80
2	13.62	93.42
3	2.61	96.03
4	2.61	98.65
5	0.99	99.64
6	0.36	100.00

Table 3: Enterprise Size- Number of Employees

The sample is predominantly made up of enterprises with two or lesser employees, accounting for over 90% of the enterprises. All enterprises in the sample have less than six employees.

Comparing this with the Economic Census data, it is seen that about 92% of the enterprises in Bangalore Urban district have less than six employees.

Legal Form

98.2% of the Footprint Sample consists of proprietary enterprises (Figure 2). Proprietary enterprises account for 84.21% of all enterprises in the Bangalore Urban Economic Census data. The higher representation of proprietary enterprises in the footprint sample data is because of the sampling strategy that excluded large retail franchises, government offices, NGOs etc. that are covered by the Economic Census.

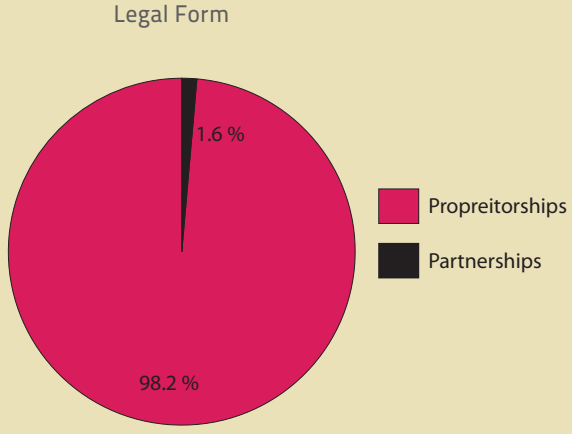
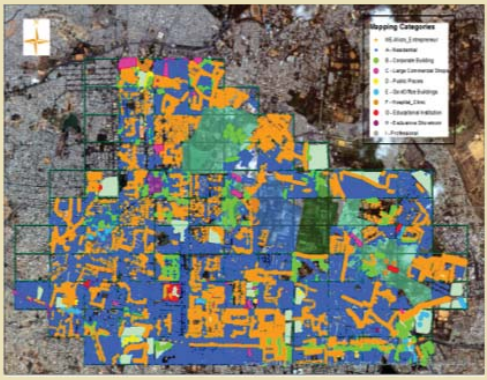


Figure 2: Footprint Survey Description- Legal Form

From Table 3 and Figure 2, it is observed that the dominant type of enterprises both in the Footprint Sample and the Economic Census are small proprietary enterprise.

Box 5: Is the Economic Census Capturing all Micro-Enterprises?
The Economic Census pegs the total number of enterprises at 2,56,643 in Bangalore Urban District in year 2005-06. If an annual growth rate of 5% is assumed, the total number of enterprises in Bangalore Urban in the year 2013 is estimated to be 3,79,179 units.



The map above illustrates the spatial distribution of micro-enterprises in the S.R Nagar branch found in the Jana Footprint Census. The total area under consideration is 31 square kilometers and this was found to have 13,177 micro-enterprises. The density on average is therefore 425 units per square kilometer. If an assumption is made that within Bangalore's municipal boundaries (750 square kilometers), the density of micro-enterprises is 80% of that in the central business district (CBD); and further that the remaining urban areas (1440 square kilometers) have 50% of the density of CBD, the number of enterprises in Bangalore can be estimated to be 5,61,085 units. The type of units found in the Footprint Survey maps only to 50% of the type of enterprises found in the Economic Census data, raising the question of whether there are a close to a million micro-enterprises in Bangalore Urban district.

Most notably, one of the segments excluded from the Economic Census enumeration are footpath vendors or vendors without permanent premises. This forms a substantial portion of the Footprint Survey data (24.5%).

The Economic Census data therefore likely underestimates the size and estimates of credit demand of micro-enterprises.

Access to Credit

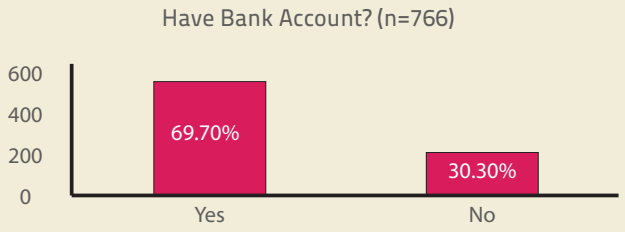


Figure 3: Footprint Survey- Bank Accounts

70% of micro-enterprises have a bank account but only **5%** have access to term loans from banks and **1%** to working capital loans from banks

As seen from Figure 3, a large proportion of respondents have a bank account.

However, as illustrated in Figure 4 and Figure 5, the percentage of respondents who actually have access to credit from banks is considerably low. The percentage of respondents who reported accessing public or private banks for term loans was 5%. The percentage of respondents who reported accessing public banks for working capital was 0.5%. None of the respondents reported accessing private banks for working capital needs.

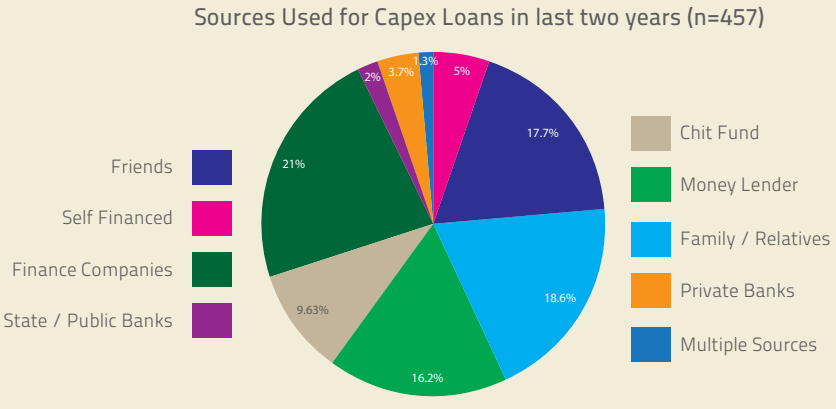


Figure 4: Footprint Survey- Sources for Capex Loans

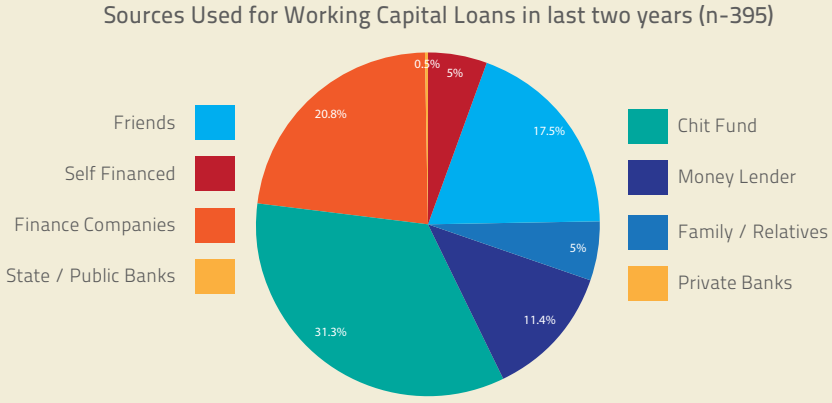


Figure 5: Footprint Survey- Sources for Working Capital Loans

The estimated credit demand for micro-enterprises in BUD is Rupees **18,907** Crores

Future Credit Needs

Over three quarters of respondents reported plans to expand existing businesses or start new businesses in the next two years. Of these, 90% had plans to take loans from external sources.

33.5% reported they preferred public sector banks and 10% stated a preference for loans from private banks. These show a considerably higher percentage of respondents preferring banks compared to the percentage of respondents who actually accessed these source in the past.

Over two years, the average credit requirement for micro-enterprises in the sample was Rupees 4,39, 911. Using the projected number of micro-enterprises from the Footprint Census (Refer Box 4), the total number of micro-enterprises requiring credit over the next two years is 4,20,813.

Therefore, the total estimated credit demand for all micro-enterprises in Bangalore Urban District is Rupees 18,907 Crores.

Barriers: Formalization

Compared to the percentage of respondents who actually accessed banks for term loans and working capital credit in the past, a greater share of respondents reported that they preferred these sources for future business plans.

This suggests that there are barriers that prevent access to credit from formal sources like banks. One of the hypothesized barriers to accessing formal sources of credit is the lack of formalization in micro-enterprises. This implies that micro-enterprises often operate in the informal or unorganized sector and lack documents and clear titles that are usually required to access loans from formal sources. The following figures highlight the lack of formalization in micro-enterprises:

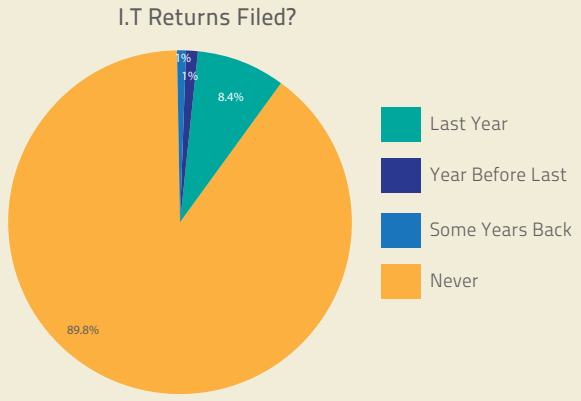


Figure 6: Footprint Survey: Formalization- I.T Returns Filed

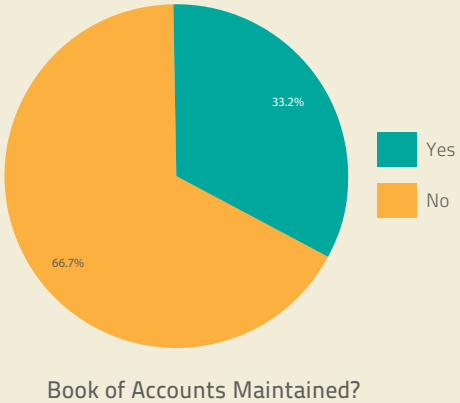


Figure 7: Footprint Survey Formalization: Book of Accounts Maintained

Similarly, about 65% of micro-enterprises have no form of enterprise registration.

In conclusion, the micro-entrepreneur footprints study highlights the following:

- There is a flourishing micro-enterprise sector in BUD with significant credit needs and most likely not captured by the Economic Census.
- A large percentage of micro-entrepreneurs use informal sources of credit despite having bank accounts.
- A significant share of respondents report preferring loans from public and private banks.
- Micro-enterprises have low levels of formalization evidenced by lack of records, books of accounts or income tax returns.

Implications for Policy

Micro and small enterprises will remain the bulwark of the Indian economy. A look at India's enterprises reveals not only the dominance of MSE as an enterprise structure, but also an expansive informal sector in which these enterprises dwell. To underscore the pervasiveness of the informal sector, the formal sector accounts for the employment of only 100 million individuals, leaving the remaining 350 million of India's working age population outside the sphere of what is considered the enterprise economy.

The RBI instituted the Committee for Financial Inclusion for Small Businesses and Low Income Households to assess all aspects of financial inclusion and propose a concrete way forward for financial inclusion by the year 2017. To this effect, a workshop under the aegis of the CCFS was organized in Bangalore on November 11th 2013 to examine the indicators used to measure financial inclusion. The workshop focused on introducing a third measure of financial inclusion in addition to the indicators currently used.

A study of Bangalore Urban district's enterprise economy underscored the necessity to add a third measure of financial inclusion that disaggregates the depth measure. The overall good C-GDP ratio of Bangalore Urban was 1.46, an overall good indication of financial inclusion. However, when this measure was disaggregated by verticals, the ratio was much lower for micro and MSE sector- 0.62 and 0.88 respectively.

The Census of micro-enterprises conducted in Bangalore by Jana Foundation highlighted concerns with how micro enterprises were enumerated in Economic Census. The Jana Census estimates the number of micro-enterprises in BUD at 5,61,085. However, the Economic Census data estimate is

3,79,179 enterprises, underestimating the number of micro-enterprises in BUD. This was largely due to the exclusion of street vendors who form a substantial percentage of enterprises in urban areas. There is therefore a need for a new classification system of nano, micro and small enterprises (NSME) that covers street vendors and the tail end of micro-enterprises.

The survey of MSE in Janalakshmi's footprint further revealed that the low C-GDP ratio for ME was despite the large demand for credit (Rs. 18,907 Crores) from the micro sector. This underscores the importance of adding a third indicator of financial inclusion that disaggregates the C-GDP ratio in a state or district by verticals.

High level of informality among micro-enterprises. ~**90%** with no income tax returns; **67%** with no books of accounts; **65%** with no form of enterprise registration

The study found a large extent of informality among survey respondents. 90% of the respondents never filed income taxes, 67% maintained no book of accounts and 65% had no enterprise registration of any form.

The lack of formalization can pose significant barriers to accessing formal sources of finance. Not surprisingly, a majority of respondents accessed informal sources of finance for their credit needs. This raises the question of whether it is prudent for providers of credit to innovate and work around formalization barriers or if the policy focus should be on encouraging enterprises to formalize.

These observations imply that there are large gaps in the demand for and supply of credit to the MSE sector and that these gaps are largely structural. Policy efforts will have to be both demand and supply side. Supply side efforts include policy and regulatory changes. For example, the RBI's current approach which is bank dominated will need to accommodate other players in the financial inclusion space. On the demand side, incentives need to be provided to NSMEs to dismantle their reluctance to formalize. Local governments could play an important role in the development of this sector through the powers bestowed on them through the Shops and Establishments Act. The boxes below highlight policy implications further.

Box 6: Concluding remarks from Mr. Ramesh Ramanathan (Chairman, Jana Group)

In his concluding remarks, Mr. Ramesh Ramanathan, Chairman of the Jana Group observed that the institutional form needs to change from a 'Bank-only' to a 'Bank-and' model. He also noted that the ease-of-doing-business metrics need to be extended to the micro and small enterprises as well. He outlined three possible steps and recommendations for taking the agenda of the workshop forward:

1) Completing the study of MSEs in Bangalore Urban and calculation of the financial inclusion metric for Bangalore
2) He recommended that the CCFS report address policy issues like institutional agnosticism, addition of the disaggregated depth metric as a measure of financial inclusion as well as addressing demand side challenges like formalization.
3) He also recommended the creation of a cell within the RBI who will be the custodians of granular data on financial inclusion. Policy decisions and initiatives in future would be driven by data.

Box 7: Concluding remarks from Dr. Nachiket Mor (Chairman CCFS)

Dr. Mor summarized the proceedings of the workshop with the following observations. On the demand side, he noted that formalization of SME would be a difficult challenge as there was likely a large 'metal overhead' amongst enterprise owners operating in the informal sector to formalize. On the supply side, he noted that lessons from around the world suggest local community banks did well in servicing the needs of SME. He noted however that governance would be challenge with community based banks. He suggested that an alternate route would be to strengthen existing agent based models like the Pygmy Bank model proposed by Canara Bank. He remarked that the weakness in the NBFC-MFI sector stems from the absence of full service institutions- most of these institutions specialize in the delivery of particular types of credit that are characterized by high frequencies and small amounts. Dr. Mor opined that the use of credit bureaus was a good path to move forward but there were regulatory gaps that needed to be addressed. For example, he noted that Urban Co-operative Banks and Regional Rural Banks were not required to report to credit bureaus, leaving out many products like the Kisan Credit Cards from the ambit of credit bureaus. He also suggested that development of better second hand markets could provide an answer to lack of collateral as a barrier to accessing credit.

Appendix

Footprint Survey				EC Data: Jana Census Wards (2005-06)				EC Data: Full Bangalore Urban (2005-06)			
Type of Enterprise	NIC Code	%	%	Type of Enterprise	NIC Code	%	%	Type of Enterprise	NIC Code	%	%
Retail sale of food, beverages and tobacco in specialized stores	5220	41.71	41.71	Retail sale of food, beverages and tobacco in specialized stores	5220	14.42	14.42	Retail sale of food, beverages and tobacco in specialized stores	5220	15.34	46.97
Other retail sale in specialized stores	5239	10.50	52.21	Other business activities	7499	6.65	21.07	Other retail sale in specialized stores	5239	5.99	63.59
Retail sale in non-specialized stores with food	5211	9.62	61.83	Other retail sale in specialized stores	5239	4.93	26	Retail sale of textiles, clothing, footwear and leather goods [incl	5232	5.47	54.3
Retail sale of textiles, clothing, footwear and leather goods	5232	8.44	70.26	Maintenance and repair of motor vehicles	5020	4.12	30.12	Other business activities	7499	4.67	88.74
Manufacture of tobacco products	1600	7.07	77.33	Retail sale of textiles, clothing, footwear and leather goods	5232	3.78	33.9	Finishing of textile excluding khadi/handloom	1712	2.89	7.03
Maintenance and repair of motor vehicles	5020	2.94	80.27	Sale, maintenance and repair of motorcycles and related parts and accessories	5040	3.15	37.05	Restaurants, bars and canteens	5520	2.43	71.34
Retail sale of household appliances, articles and equipment	5233	2.94	83.22	Finishing of textile excluding khadi/handloom	1712	3.09	40.14	Retail sale in non-specialized stores with food, beverages or tobacco predominating	5211	2.41	30.39
Other business activities	7499	2.75	85.97	Other non-store retail sale [including network marketing]	5259	2.94	43.08	Retail sale of household appliances, articles and equipment	5233	2.21	56.5
Other service activities	9309	2.45	88.42	Sale of motor vehicle parts and accessories	5030	2.72	45.8	Telecommunications	6420	2.12	76.4
Washing and (dry-) cleaning of textile and fur produts	9301	1.57	89.99	Hotels; camping sites etc.	5510	2.49	48.29	Hotels; camping sites and other provision of short-stay	5510	2.00	68.91

Table 2: Distribution of Type of Enterprises (NIC Codes)

Workshop Agenda and List of Speakers

Role	Time	Speaker, Organization	Brief Description
	12.30-1.30	Lunch	
	1.30-1.40	Dr. Nachiket Mor, Central Board Member, RBI	Introduction and Context
	1.40-1.50	Mr. R. K. Dubey, CMD, Canara Bank	Opening Remarks
	1.50-2.00	Mr. Ramesh Ramanathan, Jana Group	Defining the Problem
Overview of Bangalore's economy	2.00-2.15	Mr. Narasimha Pani, Directorate of Economics and Statistics, Government of Karnataka	Bangalore Urban, district-wise GDP- trend lines, composition
	2.15-2.30	Mr. T. Baskaran, National Sample Survey Office	Structure of Bangalore Urban enterprise economy and trends
Supply Side	2.30-2.45	Mr. S. S. Bhat, Canara Bank	Credit flows in Bangalore Urban- change in the last 10 years and break-up
	2.45-3.00	Mr. K. Sathianandan, Small Industries Development Bank of India	Credit with respect to Bangalore Urban MSMEs
	3.00-3.15	Mr. Karuppasamy, Urban Co-operative Banks	Credit of Urban Co-operative Banks in Bangalore's urban districts
	3.15-3.30	Tea	
Data	3.30-3.45	Mr. Shyam Sundar, Ministry of MSME	Definitions and available data on verticals
	4.30-4.40	Mr. Arbind Singh, National Association of Street Vendors of India	Economic Contribution and Credit Needs
	4.40-4.50	Dr. Gayatri Ramnath, Jana Foundation	Survey results from MSE for Bangalore Urban Location
	4.50-5.00	Mr. Ramesh Ramanathan, Jana Group	Vertical Challenges of Financial Depth Measurements- Size and Causality Possibilities
	5.00-5.20	Open Discussion	Open Discussion
Closing Remarks	5.20-5.40	Dr. Nachiket Mor, Central Board Member, RBI	Way forward
	5.40-6.00	High tea	

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