



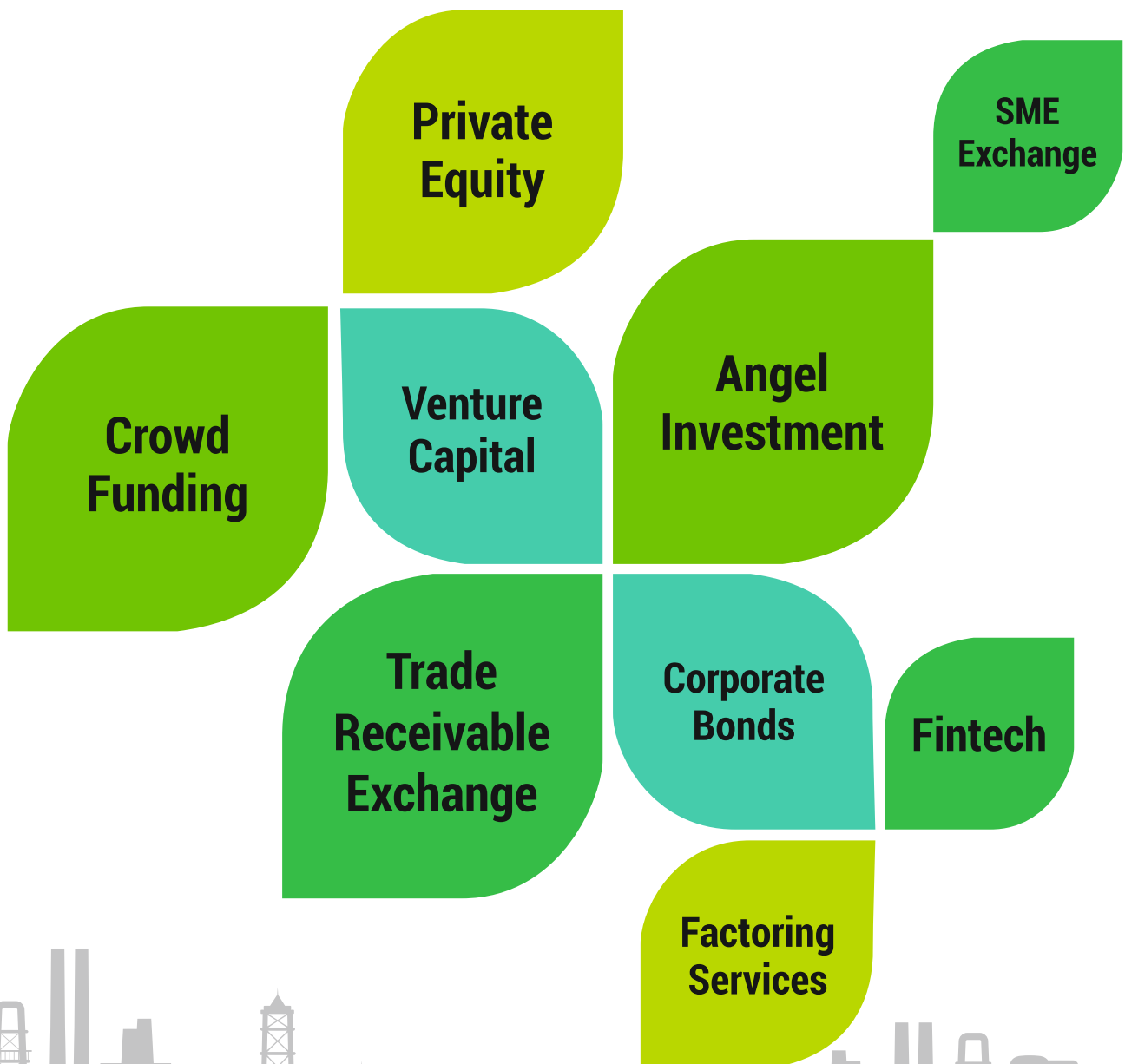
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MUMBAI

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M. Visvesvaraya Industrial Research and Development Centre



All India Association of Industries

Report on Evolving Sources of **FINANCE** for **MSMEs** in India





MVIRDC

M. Visvesvaraya Industrial Research and Development Centre



Bharat Ratna Sir M. Visvesvaraya

(15 September, 1860 - 14 April, 1962)

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Preface

India's economic growth in the last two decades owes its dynamism in no small measure to the vibrant micro, small and medium enterprises. The vitality of India's enterprises is visible in the jugaad or frugal innovation that they perform to stay competitive in the face of scarce capital, inadequate infrastructure facilities and lack of access to cutting-edge technologies. Across the country, millions of micro, small and medium enterprises have kept alive their age old mastery in manufacturing fine quality textile, leather, jewellery and other handicrafts, processed food, among others.

It is time we give the much-needed facelift to these enterprises by infusing capital and technology to maintain their competitive edge in this age of globalization and technological disruption.

India has a long history of policy intervention to boost credit to MSMEs, starting from the introduction of priority sector lending norms for banks in 1970s, to the launch of SIDBI in 1990s to the formation of credit guarantee trust in the year 2000 and further with the launch of the Pradhan Mantri Mudra Yojana in 2015.

Other policy initiatives taken in this regard are the setting up of state finance corporations, state industrial development corporations, Regional Rural Banks, Mudra Banks, among others. The advent of microfinance institutions opened a new model of funding to women entrepreneurs and micro enterprises through the concept of joint liability.

The launch of SME Exchange by India's leading stock exchanges, NSE and BSE, have enabled MSMEs to access equity finance from the capital market, which was earlier unimaginable for small enterprises because of stringent regulations and disclosure norms.

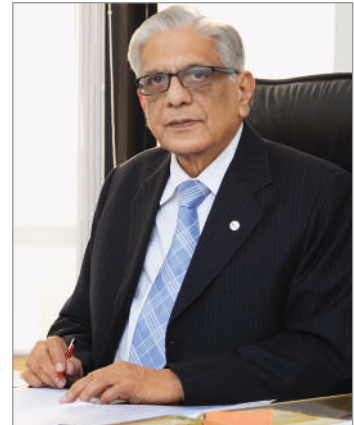
It is no doubt that these institutional measures have boosted flow of capital to MSMEs and reduced their dependence on exploitative informal sources such as money lenders. However, we still have a long way to go in bridging the credit gap of MSMEs as there is an unmet financial need of Rs. 20-25 trillion in this sector, according to an estimate by International Finance Corporation.

The dawn of the digital era has opened an unprecedented opportunity for MSMEs to access collateral free loans from fintech companies based on the track record of their digital payments. However, in order to capitalise this opportunity, MSMEs need to digitize their operations and make all their transactions digital. This will require concerted efforts by government, financial sector regulators and industry bodies to handhold local MSMEs in embracing digital technologies. There is also a need to promote flow of risk capital from private equity, venture capital investors to MSMEs.

India's march towards a USD 5 trillion economy by 2024 will get a fillip if we infuse fresh lease of life to the MSME sector by enhancing its access to capital and creating a world class mentoring ecosystem for the sector.

MVIRDC World Trade Center Mumbai has brought out this Report to serve as a useful knowledge resource for trade and industry stakeholders as well as academia. This Report offers an analytical overview of the institutional finance mechanism in India and how we can develop this ecosystem by exploring innovative ways of financing to this sector. We thank all the experts who contributed their valuable perspectives on the subject to this Report. This Report also contains the detailed proceedings of the Programme on 'Evolving Modes of Financing for MSMEs', which was held at WTC Mumbai on October 16, 2019. The key recommendations of distinguished speakers at this Programme have been compiled in the form of a white paper, which is included in this Report.

We are confident that the contents of this Report will serve as a useful guide for policy roadmap to strengthen the flow of credit to MSMEs.



Mr. Y. R. Warekar
Director General
MVIRDC World Trade
Center Mumbai

White Paper on Promoting Alternative Sources of Finance for MSMEs

Micro small and medium enterprises (MSMEs) are the key growth drivers of Indian economy as they account for 29% of India's GDP. It is imperative to enhance the scale of operation of these enterprises if India has to grow its GDP to USD 5 trillion by 2024. Timely access to credit at affordable cost is essential for MSMEs to expand operation and benefit from economies of scale. Micro enterprises, that account for almost 99% of all MSMEs, do not benefit from economies of scale because of small size of operation. Availability of finance will help these enterprises expand their operation and also upgrade their technologies to become globally competitive.

Employment in micro, small and medium enterprises (in lakhs)			
Type of Enterprise	No. of Enterprises	No. of Employment	Share in total Employment
Micro	630.52	1076.19	97.0%
Small	3.31	31.95	2.9%
Medium	0.05	1.75	0.2%
Total	633.88	1109.89	100%

Source: Annual Report 2018-19, Ministry of MSME, GoI

Imperatives for boosting credit to MSMEs

- 1. Promote Economic Growth:** MSMEs form almost a third of India's GDP and hence they are the key drivers of economic growth. Therefore, it is important to ensure long term sustainability and future expansion of their business by facilitating their timely access to institutional credit.
- 2. Protect Employment:** Micro enterprises account for 97% of total jobs in the MSME sector. In order to safeguard jobs in the micro enterprises, we need to make these businesses more sustainable by facilitating their access to finance. Also, by enabling access to finance, these enterprises will be able to expand their operations and increase job opportunities.
- 3. Formalisation of enterprises:** Access to institutional credit will force unorganized enterprises to adopt professional accounting and management practices. This will promote formalization of the economy and increase in tax base.

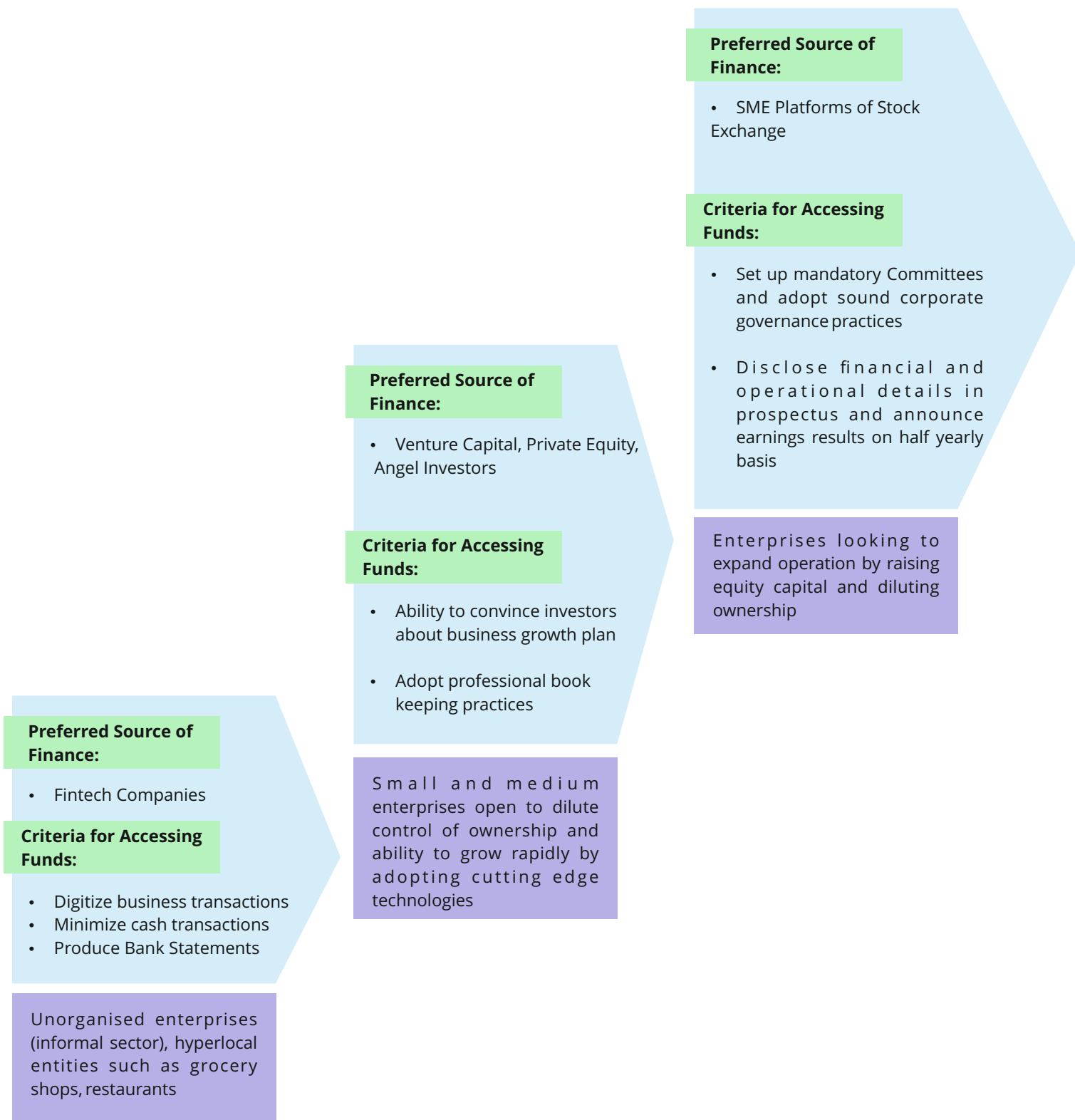
The Programme on 'Evolving Modes of MSME Financing', conducted by MVIRDC World Trade Center Mumbai on October 16, 2019, generated diverse perspectives on how to enhance flow of debt and equity capital to small enterprises. Speakers at the event shared their views on strategies to be adopted by MSMEs to access funds from a wide range of sources, viz. fintech companies, stock exchanges, factoring agencies, receivable discount exchanges and venture capital funds. The criteria for accessing funds vary from sources to sources. For instance, to access credit from fintech companies, SMEs need to have digitized their transactions. For accessing funds from stock exchanges and venture capital funds, SMEs need to have sound accounting and professional corporate governance practices. For discounting their trade invoices from receivable exchanges, SMEs need to supply their goods to only those corporate buyers that are registered with these exchanges.

The speakers at the programme emphasized on the need for industry associations, financial regulators and government agencies to create awareness about these criteria for accessing funds from various institutional sources.

The choice of funding source also depends on the purpose for accessing credit, scale and maturity of these enterprises. For instance, micro enterprises such as grocery shops, restaurants, logistics operators can digitize their operations and access cash credit from fintech companies. On the other hand, companies that are looking to upgrade their technologies and expand their scale of operation can access funds from venture capital funds and dedicated platforms of stock exchanges.

Scale of operation and maturity of the enterprise are also relevant factors that determine the choice of funding sources. The following diagram explains the appropriate sources of funding for different types of enterprises and the steps to be taken by these enterprises to fulfill the criteria for accessing credit from these sources.

Appropriate Sources of Finance for Different Types of MSMEs



Factoring institutions play an important role in meeting the working capital needs of MSMEs by discounting the trade receivables of these enterprises. However, growth of the factoring industry is hindered by several challenges. Mr. Pankaj Gupta, Senior Vice President, SBI Global Factors mentioned the following difficulties faced by factoring institutions.

Non-acceptance of Notice of Assignment by debtors and unwillingness of larger corporate buyers to commit themselves to any obligation to a third party, say a factor.

1. Non-availability of trade credit insurance.
2. Reluctance on the part of banks to share credit information reports or charge on securities.
3. Progressively converging regulatory regime but higher cost of funds as compared to banks.
4. Non-acceptance of names of willful defaulters by CIBIL from NBFC-Factor.
5. Non-availability of enablers like Debt Recovery Tribunals (DRTs) to NBFCs-Factor for expediting recovery.

Distinguished speakers highlighted the role of MSMEs, government departments, industry associations, financial institutions and regulators in creating a favourable environment for enhancing flow of institutional credit to MSMEs. Some of the suggestions offered by the speakers, in this regard, are as follows:

Measures to be taken by MSMEs

1. Delineation of ownership and management: MSMEs need to separate ownership and management of their enterprises. Management of the business must be handed over to professionals. This will create confidence among financial institutions and investors about the business practice of the organisation.

2. Adopt professional bookkeeping practice: MSMEs must hire professionals for accounts and audit to adopt standard bookkeeping practices. Sound bookkeeping practices will create confidence in the transparency and financial integrity of the enterprise among prospective investors and lenders.

3. Third party credit rating: MSMEs need to hire a recognized credit rating agency to rate the credit worthiness of their business entity. Banks and other financial institutions consider the credit rating of the enterprise before sanctioning loans and credit lines. MSMEs can reduce their cost of funding if they get high credit rating based on their financial performance and balance sheet.

4. Maintain credit lines: Currently, bank credit is a major source of funding for MSMEs. Given the importance of bank credit for day-to-day operations of MSMEs, it is strongly advisable that MSMEs maintain credit lines, instead of cancelling unutilized/ undrawn credit lines, on account of commitment fees.

Measures to be taken by industry and government

1. Create awareness about factoring service: Factoring is a supply chain finance that eliminates stress on the working capital condition of an enterprise. Government of India, in association with local industry associations, must hold knowledge sessions about factoring in every district to create awareness about this alternative mode of finance. Such knowledge sessions must generate awareness about the advantages of factoring service and procedure to access this service.

2. Promote mandatory use of factoring service: Government of India needs to introduce regulation for mandatory use of factoring services by companies that deal in receivables. We need to follow the footsteps of European countries that have introduced similar regulation. At a time, when bank credit to MSMEs is declining, there is a need to promote alternative sources of funding such as factoring services for MSMEs.

3. Promote Cluster financing: Given the information asymmetry and scope for improvement in delivery of information on more real time basis, the due diligence for MSME proposals, more often, takes longer time than the time taken for due diligence of large corporates, which are high rated and which have sufficient information and data in the public domain. As sometimes the size and the risk of such MSME proposals does not meet the bank's criteria, such MSMEs, along with trade

associations, can explore cluster financing, where there is suitable risk sharing mechanism, especially for the common infrastructure, which facilitates trade.

Measures to Support Factoring Industry

1. Trade Credit Insurance: NBFC Factors should be allowed to buy trade credit insurance. Availability of Credit Insurance to factors would make it easier to innovate products and services to facilitate imports on open account terms by Indian importers-thus helping them cut costs on opening Letters of Credit.

2. Credit Guarantee Fund: Credit Guarantee Fund Scheme of National Credit Guarantee Trustee Company Ltd (NCGTC) for Factoring was announced in 2015 but it is yet to be made operational. Implementation of Credit Guarantee Fund Scheme of National Credit Guarantee Trustee Company Ltd (NCGTC) for factoring should be expedited. This will help Factors reach out to smaller entities among the MSMEs, which meet their financial requirements from informal sources.

3. Amend Factoring Regulation Act: Corporate Debtors are reluctant to accept the assignment of receivables in favour of an NBFC Factor, when factoring facility is availed by MSMEs. Government must amend Factoring Regulation Act 2011 to make a PSU/Government/Corporate Buyer compulsorily accept assignment of receivables made in favour of Factors. This will help ease reluctance on the part of large corporate houses.

4. Amend RDDBFI Act: Currently, NBFCs are not allowed to use Debt Recovery Tribunals (DRTs) for recovery of their dues. The Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act 1993 must be amended in order to make DRTs applicable to systematically important NBFCs. This will help expedite the recovery process through legal framework.

5. Second charge or sub-servient charge to factors to be ceded by banks without demur: Generally, banks are reluctant to cede second charge or sub-servient charge on current assets in favour of factoring companies. By ceding second charge, banks can help factoring companies secure a part of their exposure to clients. Reserve Bank of India may issue an advisory to banks to cede subservient charge on current assets in favour of factoring companies. Also, banks may be directed to share credit information with the factoring companies like sending banks opinion report as regards the conduct of account (if the clients have sanctioned working capital limits from the banks) and the copies of their sanction letters, without undue delays.

6. Wilful Defaulters' List: India's leading credit information bureau CIBIL has stopped accepting the names of defaulters of factoring companies in its wilful defaulters list. If CIBIL accepts and publishes the names of defaulters of factoring companies on its website, it would help the factoring companies in their recovery efforts, as the clients may be persuaded to settle their overdues to avoid being publicized as a wilful defaulter in public domain. Reserve Bank of India may issue advisory to CIBIL to accept the names of the defaulters of factoring companies in their list of wilful defaulters.

List of NBFC Factors registered with RBI as of Sep 2019		
S No	Name of the company	Regional Office
1	Canbank Factors Limited	Bengaluru
2	IFCI Factors Ltd.	New Delhi
3	Bibby Financial Services (India) Pvt. Ltd.	New Delhi
4	SBI Global Factors Ltd. [Formerly: Global Trade Finance Limited]	Mumbai
5	India Factoring & Finance Solutions Pvt Ltd	Mumbai
6	Siemens Factoring Private Limited	Mumbai
7	Pinnacle Capital Solutions Private Limited	Patna

Major Components of Assets and Liabilities of NBFC Factors (as of Sept. 2018)			
Liability (Rs. Billion)		Asset (Rs. Billion)	
Borrowings	18	Loans and Advances	31
Other Liabilities	20	Other Assets	7
Total Liabilities	38	Total Assets	38

Source: Reserve Bank of India

Programme on 'Evolving Modes of MSME Financing'

Panel Session on 'Encouraging Alternative Modes of MSME Financing'

MVIRDC World Trade Center Mumbai organised a Programme on 'Evolving Modes of MSME Financing' on October 16, 2019 at WTC Mumbai. The first panel session of the programme was themed 'Encouraging Alternative Modes of MSME Financing'. The session was addressed by experts from fintech enterprises, stock exchange and angel investment network and it was moderated by Mr. Jaikrishnan G, Director, Financial Services, KPMG Advisory Services. Distinguished speakers highlighted emerging avenues for MSME financing from capital market, angel investors and fintech lenders.



(from left to right): Mr. Jaikrishnan G, Director, Financial Services, Management Consulting, KPMG Advisory Services, Ms. Rachana Bhusari, Vice President-SME, National Stock Exchange India, Mr. G. Ramachandran, Director, Keiretsu Forum, Mr. Arun Nayyar, CEO, NeoGrowth Credit, Mr. Y.R. Warkerkar, Director General, MVIRDC World Trade Center Mumbai

Welcome Address



Mr. Y.R. Warkerkar Director General, MVIRDC World Trade Center Mumbai

Mr. Y.R. Warkerkar delivered welcome address for the programme by outlining the objective of the event and stressing on the importance of access to institutional finance for growth of MSMEs. He said, "Promoting the MSME sector is a key objective of MVIRDC World Trade Center Mumbai and its activities are geared to promoting the cause of the MSME sector. The topic of today's programme assumes great significance as finance is the lifeline of any business activity."

He further remarked, "India is a land of abundant entrepreneurial talent. The country is home to more than 6 crore MSMEs which together contribute almost a third to the country's GDP. Timely access to credit at a reasonable cost is a pre-requisite to the effective functioning of MSME enterprises and ensuring the viability of the MSME sector."

Mr. Warkerkar pointed out, "traditional institutions such as banks and NBFCs have been the major sources of funds for MSMEs. However, there is a dire need to promote alternative sources of funding as the MSME sector is stifled due to unmet credit need of Rs. 20-25 lakh crore, according to International Finance Corporation."

He concluded the remarks by saying, "This programme will discuss how emerging channels of finance can meet this credit gap of the MSMEs. The distinguished speakers of this programme represent some of the emerging sectors of finance such as fintech companies, receivable discounting exchanges, SME platforms of stock exchanges among others. I believe the programme will create ample awareness on how MSMEs can benefit from these emerging sources of funding."



Mr. Jaikrishnan G, Director, Financial Services, Management Consulting, KPMG Advisory Services

Mr. Jaikrishnan set the tone for the session by highlighting the importance of financing for MSMEs. He said, "Access to long term capital is essential for small businesses to scale up their operations. In India, it takes fairly long time for small enterprises to become large because of lack of access to institutional credit."

He said availability of finance at reasonable cost is very important for our MSMEs to compete in the global market. Although banks and non banking finance companies (NBFCs) are the major sources of funding for MSMEs, recent years have witnessed emergence of alternative sources of finance. However, in rural areas, MSMEs continue to be dependent on informal sources such as families, friends, money lenders and chit funds, Mr. Jaikrishnan informed.

Speaking about alternative sources of funding for MSMEs, he said, "Fintech companies are offering unsecured loans to small enterprises based on their ability to generate steady flow of income, which can be traced by their digital transaction history. Therefore, the criteria of modern day financing has shifted from asset based financing to cash flow based funding."



Ms. Rachana Bhusari, Vice President-SME, National Stock Exchange India

Ms. Bhusari shared information about SME platform of National Stock Exchange and suggested MSMEs to raise equity capital by listing on this platform. She said, "National Stock Exchange's SME platform - Emerge offers an alternate funding mechanism to small and medium enterprises wherein they raise funds by tapping the capital markets instead of only relying on bank funding, venture capital or private equity."

The platform also provides an option to these companies to migrate to the main board of the stock exchange. Currently, more than 200 companies have raised funds through this platform and these companies represent diverse industry base such as media and entertainment, manufacturing, textiles, engineering, finance, chemicals, agriculture, food processing and construction etc. We conduct awareness sessions across the various Industry clusters and have witnessed encouraging response from the entrepreneurs towards this platform."

Ms. Bhusari concluded her remarks by reaffirming the commitment of her organisation to facilitate equity financing for SMEs. She said, "NSE is committed to continue engaging quality small and medium businesses, helping them access equity capital through our Emerge platform to guide them to robust business growth path."

Ms. Bhusari suggested MSMEs looking to list on the Emerge Platform to follow strict corporate governance standards. She said, "It is mandatory for small enterprises looking to list on the NSE Emerge Platform to form mandatory committees, follow strict corporate governance practices and disclose relevant information in the Draft Red Herring Prospectus (DRHP)."



Mr. G. Ramachandran, Director, Keiretsu Forum

Mr. Ramachandran shared his perspectives on the difficulty faced by MSMEs in raising equity capital, especially risk capital from angel investors, private equity and venture capital funds. He remarked, "MSMEs are the heart and soul of India and they are the key growth drivers of the economy. However, they are considered as poor cousins of big companies and they have difficulty raising capital because of high risk perception."

Mr. Ramachandran pointed out that while MSMEs face difficulty in accessing capital, technology-enabled start-up companies are able to raise capital from venture capital funds despite making huge losses. Technology-enabled start-up enterprises identify themselves with the new age digital economy and their businesses command huge valuation because of perception of strong growth potential.

Mr. Ramachandran suggested MSMEs to reorient their business strategies by adopting cutting edge technologies so that their enterprises are also identified as high growth businesses similar to start-up companies.

Mr. Ramachandran expressed hope that MSMEs will be successful in raising capital from venture capital funds if they adopt cutting edge digital technologies.



Mr. Arun Nayar, CEO, NeoGrowth Credit

Mr. Nayar explained how fintech companies have enhanced access to collateral-free loans for MSMEs in India. He said, "Fintech companies are offering credit to small groceries, pharmacies, restaurants and other small business units by examining the revenue realized by these entities from credit card and debit card payments of their customers. Fintech lenders offer loans to small businesses based on their expected cash flows rather than based on their balance sheet."

Mr. Nayar explained how availability of online data reduces information asymmetry and risk perception among fintech companies towards MSMEs. He said, "Fintech companies rely on data on credit card and debit card sales, GST returns, net banking transactions to assess the creditworthiness of MSMEs. This data enables fintech companies to understand the cash flow and revenue potential of MSMEs, based on which they take lending decisions to these enterprises. Lack of such data is the major barrier in enhancing flow of institutional credit to MSMEs as these enterprises largely transact in cash. Therefore, there is a need for MSMEs to shift from cash transactions to digital transactions to leave a credible digital database."

Sharing information about his organisation, Mr. Nayar said, "NeoGrowth Credit is a digital lending company that has been meeting the credit needs of small merchants for the last five years. Since inception, the company has built a loan book of Rs. 1,200 crore by catering to around 30,000 business entities. The company offers collateral-free loans to consumer facing retail businesses such as restaurants, café, apparel showrooms etc. NeoGrowth is a technology-driven company that assesses the bank statements of its potential borrowers in 10 seconds and also examines the credit card and debit card payments received by the borrowers from their clients in the last six months. The company has automated loan repayment mechanism and so the borrowers need not issue cheque or visit the branch of the company to repay her loan. The company recovers the debt on daily basis from the borrower. NeoGrowth Credit recovers its loans by deducting a certain amount from the credit card or debt card payment made by the clients to the borrower."



Panel Discussion on Accessing Trade Finance

The theme of the second panel session of the programme was 'Accessing Trade Finance'. The session generated thought provoking perspectives on supply chain finance from experts representing EXIM Bank, rating agency and factoring companies. Distinguished speakers shared their perspectives on the advantage of debt financing over equity financing for MSMEs and suggested policy measures to promote credit to these enterprises. The session was moderated by Mr. Suman Chowdhury, President – Rating Operations, Acuité Ratings & Research Limited.



(from Left to Right): Mr. Suman Chowdhury, President – Rating Operations, Acuité Ratings & Research Limited Mr. T. D. Sivakumar, General Manager, Corporate Banking Group, EXIM Bank of India, Mr. Abhijeet Angane, Senior Vice President and Regional Head - West – Relationship, India Factoring and Finance Solutions, Mr. Anil Velde, Joint Director, MVIWDC World Trade Center Mumbai



Mr. Suman Chowdhury, President – Rating Operations, Acuité Ratings & Research Limited

Mr. Chowdhury set the tone for the session by sharing an overview of the recent developments in MSME financing in India. He said, "Easy access to finance has been a persistent challenge for Indian MSMEs. It has been estimated that the total funding requirement of this sector in India is USD 520 billion (Rs. 36.4 lakh crore), with only 50% of it being met from the formal financial sector. RBI data indicates that direct bank credit to SME sector has grown by 7.3% over the last 5 year period; while NBFCs were a major source of funding for SMEs in this period, there have been headwinds of late due to the credits events in that sector."

Commenting on government steps to ease funding condition to the sector, Mr. Chowdhury said, "The government and RBI have taken a few initiatives in the current year to address these funding challenges which include bank outreach programmes, partial credit guarantee for loan securitization as well as co-lending schemes of banks and NBFCs. Acuité believes that with the emergence of the new age digital fintech platforms, funding to the MSME sector particularly trade finance will witness a boost over the next 2-3 years."

Sharing more information about challenges in MSME financing, Mr. Chowdhury said, "There has been a significant decline in the Credit Ratio i.e. upgrade to downgrade ratio for Acuité Ratings to 1.14 times in FY19 from 1.88 times in FY18. Clearly, the lower proportion of upgrades to downgrades which is expected to continue in FY20, partly reflects the challenges in the MSME sector such as higher working capital requirements due to delayed customer payments, increased funding challenges and the visible signs of a growth slowdown from the second half of Fy19."

Mr. Chowdhury concluded his remarks by raising hope that the funding to the sector will improve in future because of a slew of measures taken by Reserve Bank of India and Government. He said, “Acuité Ratings believes that there is a conscious effort from the government to step up funding to the MSME sector. Public sector banks have seen significant capital infusion to the extent of Rs. 70,000 crore in the current year which will help them to step up lending to the sector or to refinance NBFCs that lend to the sector.” He further added, “With the growth slowdown and a modest inflation regime, RBI has not only cut rates by 135 bps in the current calendar but is also trying to ensure that such rate cuts are effectively transmitted. We therefore expect to see a significant change in the funding environment both in terms of availability and interest rates over the near term.”



Mr. T. D. Sivakumar, General Manager, Corporate Banking Group, EXIM Bank of India

Mr. Sivakumar explained the various sources of financing for MSMEs and suggested these enterprises to avail of emerging sources of funding. He said, “Currently, bank credit is a major source of funding for MSMEs. However, in recent years, many fintech companies have emerged to provide credit to MSMEs on flexible repayment terms. For instance, fintech companies offer cash advances to restaurants, shop keepers and other merchants with the option to repay the amount on daily installment.” Another emerging source of funding mentioned by Mr. Sivakumar is the P2P lending, which is a crowdsourcing platform that brings together individual borrowers and lenders (or investors). So far, Reserve Bank of India has given licenses to 19 entities for launching P2P lending platforms.

Speaking about sources of trade credit for MSMEs, he mentioned about factoring services for financing trade receivables or invoices. He said, “Reserve Bank of India introduced the framework for financing trade receivables of MSMEs in 2014. Trade Receivables Discounting System (TReDS) is an institutional mechanism to enable financing of trade receivables of MSMEs from corporate and other buyers through multiple financiers. Currently, India has three exchanges, viz. Invoicemart, RXIL and M1xchange, that facilitate discounting of trade receivables of MSMEs.”

“These three exchanges have financed Rs. 9000 crore worth invoices so far and around 5,000 MSMEs have benefitted from this. We need to create awareness about this platform to more and more MSMEs so that they can access trade finance under this mechanism.” Mr. Sivakumar informed that the small ticket size of MSME loans makes bank lending to this sector unviable. Therefore, he called for cluster financing, where the credit demand of 10 or more MSME units is aggregated by an industry association for bulk financing by banks and other financial institutions. He said the credit guarantee and risk sharing mechanism for such cluster financing must be evolved by the industry and financial institutions.

Mr. Sivakumar concluded his remarks by explaining the role of EXIM Bank in financing India’s exports. He said, “EXIM Bank offers Lines of Credit to overseas governments and domestic factoring companies.” He also informed that EXIM Bank has signed an agreement with United Nations Development Programme (UNDP) for capacity building of MSMEs in north eastern states. The agreement aims to promote exports, employment and livelihood opportunities in north eastern states given their huge endowment of natural resources and hydropower.



Mr. Pankaj Gupta, Senior Vice President and Chief Finance and Risk Officer, SBI Global Factors

Mr. Gupta began his address by explaining the basic concepts of factoring and how it can benefit MSMEs. He also clarified the benefits of using factoring services over other modes of credit. He explained, “Factoring is a form of supply chain finance and it involves three parties, viz. buyer, seller and factoring agency. Factoring is funding of Account Receivables against their Assignment in favour of a ‘Factor’, on “with” or “without” recourse basis. Factoring transfers risk from seller (especially MSMEs) to relatively stronger corporate buyers, thereby offering, a less-risky option for funding sale of goods and services.”

Explaining the benefits of factoring, Mr. Gupta said, “MSMEs can avoid liquidity stress by availing factoring services. Factoring is not linked to collateral security and it helps MSMEs reduce ‘Operating Cycle’, resulting in higher production, sales, and profit. By availing factoring services, MSMEs are spared the hassle of following up with corporate buyers for payment.”

Mr. Gupta concluded his remarks by sharing some of the challenges that impede the development of factoring sector in India. He said, "Factoring has not taken off in a big way in India because of various reasons; some of the reasons are: 1. Large corporate buyers do not acknowledge Factors as party to the dealings with their suppliers, 2. Factoring is expensive as compared to bank finance, 3. Factors don't have access to any cheaper source of funding, 4. Factors do not have any faster recovery mechanism for their dues in case of delinquency, 5. Banks view Factors as their competitors, and are unwilling to share securities/ credit information, 6. Factors are not allowed to avail of Trade Credit Insurance for covering risk of default by debtors etc."





Mr. Abhijeet Angane, Senior Vice President and Regional Head - West – Relationship, India Factoring And Finance Solutions


Mr. Angane explained the key features of export factoring and suggested all exporters to avail of the service of factoring agencies. He informed that exporters can get immediate funding against their export invoices from appropriate factoring companies in India. The factoring company in India will in turn collect the payment from the foreign importer through the correspondent factor in the country of the importer.


He said, "By availing export factoring services, exporters need not spend time and efforts in chasing overdue bills with importers. Factoring is an off-balance sheet funding and hence it will not appear as debt in the balance sheet of the MSME exporters. The risk of foreign importer's payment default is covered by the correspondent factor in the country of the importer."


Export Factoring Advantages to You..


- 


Improves his cash flow – immediate funding upon presentation of invoices
- 

Client need not spend time on chasing overdue debts – collections are done by our Correspondent
- 


No Languages / time zone issues with foreign debtors – collections are done by our correspondents
- 

No losses due to Bad debts – Correspondent cover / insure Buyer's Credit Risk
- 

Fully unsecured Facility – Client free to pledge his securities to Bank
- 

Balance Sheet ratios improves – Factoring is Off Balance Sheet for Client
- 

Improves Commercial competitiveness – higher credit terms does not affect the Client
- 

Self Liquidating Finance – Financing is recovered from payments made by the buyer
- 

Client can concentrate on his core business

Release of Handbook

During the programme, MVIWDC World Trade Center Mumbai released a Handbook on 'Evolving Sources of Finance for MSMEs in India'. This Handbook highlights recent trends in the institutional flow of credit to MSMEs based on meticulous analysis of secondary data. The Handbook also carries thought provoking perspectives on alternative sources of funding from industry leaders, rating agencies, consultancy organizations and academicians.

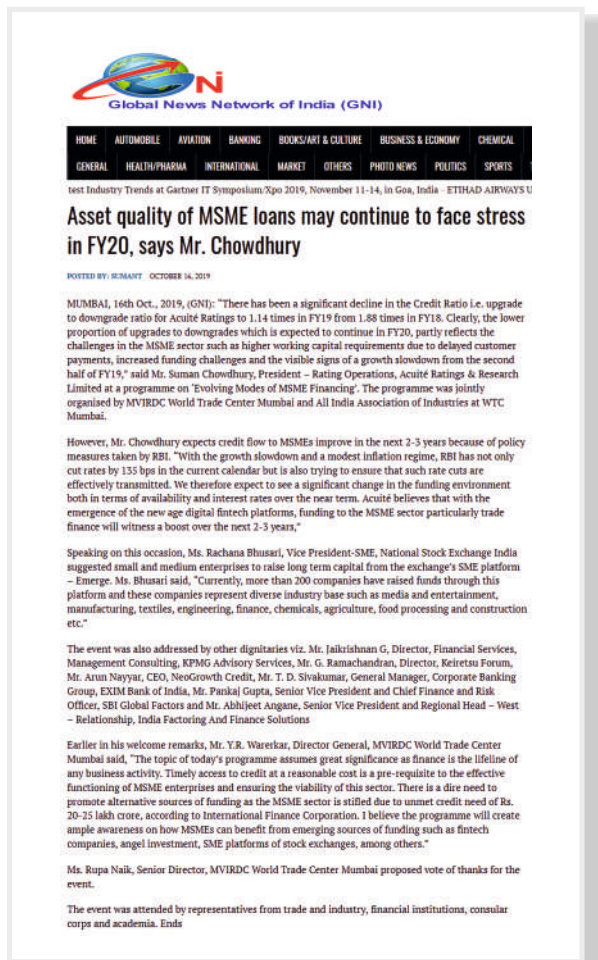


Distinguished delegates releasing Handbook on 'Evolving Sources of Finance for MSMEs in India' at an interactive programme on this subject at WTC Mumbai. (From left to right): Mr. Pankaj Gupta, Senior Vice President and Chief Finance and Risk Officer, SBI Global Factors, Mr. T. D. Sivakumar, General Manager, Corporate Banking Group, EXIM Bank of India, Mr. Jaikrishnan G, Director, Financial Services, Management Consulting, KPMG Advisory Services, Ms. Rachana Bhusari, Vice President-SME, National Stock Exchange India, Mr. G. Ramachandran, Director, Keiretsu Forum, Mr. Arun Nayyar, CEO, NeoGrowth Credit, Mr. Y.R. Warerkar, Director General, MVIWDC World Trade Center Mumbai, Mr. Suman Chowdhury, President – Rating Operations, Acuité Ratings & Research Limited, Mr. Abhijeet Angane, Senior Vice President and Regional Head - West – Relationship, India Factoring And Finance Solutions

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Asset quality of MSME loans may continue to face stress in FY20, says Mr. Chowdhury

POSTED BY: **IRMAANT** | OCTOBER 14, 2019

MUMBAI, 16th Oct., 2019, (GNI): "There has been a significant decline in the Credit Ratio i.e. upgrade to downgrade ratio for Acuité Ratings to 1.14 times in FY19 from 1.88 times in FY18. Clearly, the lower proportion of upgrades to downgrades which is expected to continue in FY20, partly reflects the challenges in the MSME sector such as higher working capital requirements due to delayed customer payments, increased funding challenges and the visible signs of a growth slowdown from the second half of FY19," said Mr. Suman Chowdhury, President – Rating Operations, Acuité Ratings & Research Limited at a programme on 'Evolving Modes of MSME Financing'. The programme was jointly organised by MVIRDC World Trade Center Mumbai and All India Association of Industries at WTC Mumbai.

However, Mr. Chowdhury expects credit flow to MSMEs improve in the next 2-3 years because of policy measures taken by RBI. "With the growth slowdown and a modest inflation regime, RBI has not only cut rates by 135 bps in the current calendar but is also trying to ensure that such rate cuts are effectively transmitted. We therefore expect to see a significant change in the funding environment both in terms of availability and interest rates over the near term. Acuité believes that with the emergence of the new age digital fintech platforms, funding to the MSME sector particularly trade finance will witness a boost over the next 2-3 years."

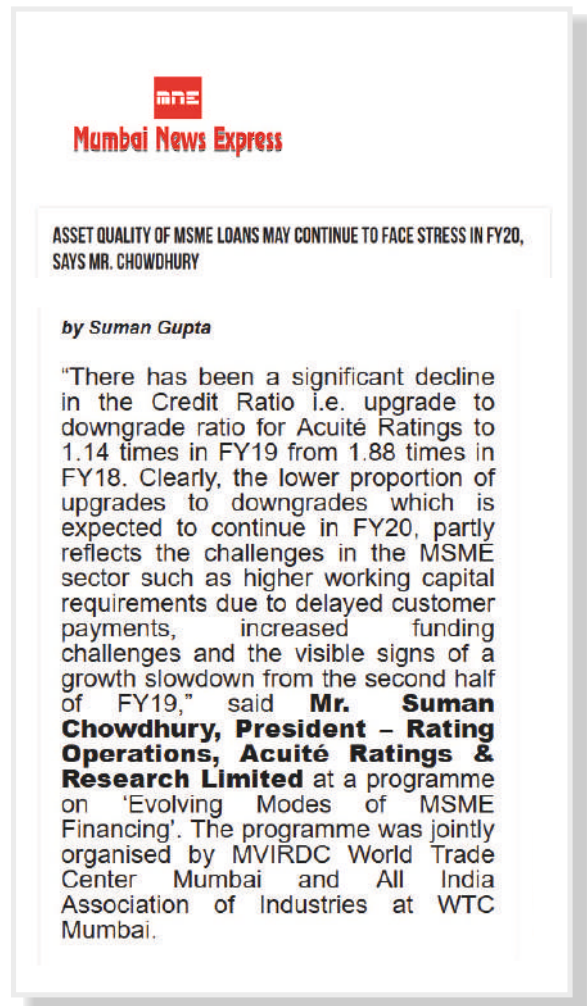
Speaking on this occasion, Ms. Rachana Bhusari, Vice President-SME, National Stock Exchange India suggested small and medium enterprises to raise long term capital from the exchange's SME platform – Emerge. Ms. Bhusari said, "currently, more than 200 companies have raised funds through this platform and these companies represent diverse industry base such as media and entertainment, manufacturing, textiles, engineering, finance, chemicals, agriculture, food processing and construction etc."

The event was also addressed by other dignitaries viz. Mr. Jaikrishnan G, Director, Financial Services, Management Consulting, KPMG Advisory Services, Mr. G. Ramachandran, Director, Keiretsu Forum, Mr. Arun Nayyar, CEO, NeoGrowth Credit, Mr. T. D. Sivakumar, General Manager, Corporate Banking Group, EXIM Bank of India, Mr. Pankaj Gupta, Senior Vice President and Chief Finance and Risk Officer, SBI Global Factors and Mr. Abhijeet Angane, Senior Vice President and Regional Head – West – Relationship, India Factoring And Finance Solutions

Earlier in his welcome remarks, Mr. Y.R. Warekar, Director General, MVIRDC World Trade Center Mumbai said, "The topic of today's programme assumes great significance as finance is the lifeline of any business activity. Timely access to credit at a reasonable cost is a pre-requisite to the effective functioning of MSME enterprises and ensuring the viability of this sector. There is a dire need to promote alternative sources of funding as the MSME sector is stifled due to unmet credit need of Rs. 20-25 lakh crore, according to International Finance Corporation. I believe the programme will create ample awareness on how MSMEs can benefit from emerging sources of funding such as fintech companies, angel investment, SME platforms of stock exchanges, among others."

Ms. Rupa Naik, Senior Director, MVIRDC World Trade Center Mumbai proposed vote of thanks for the event.

The event was attended by representatives from trade and industry, financial institutions, consular corps and academia. Ends



Mumbai News Express

ASSET QUALITY OF MSME LOANS MAY CONTINUE TO FACE STRESS IN FY20, SAYS MR. CHOWDHURY

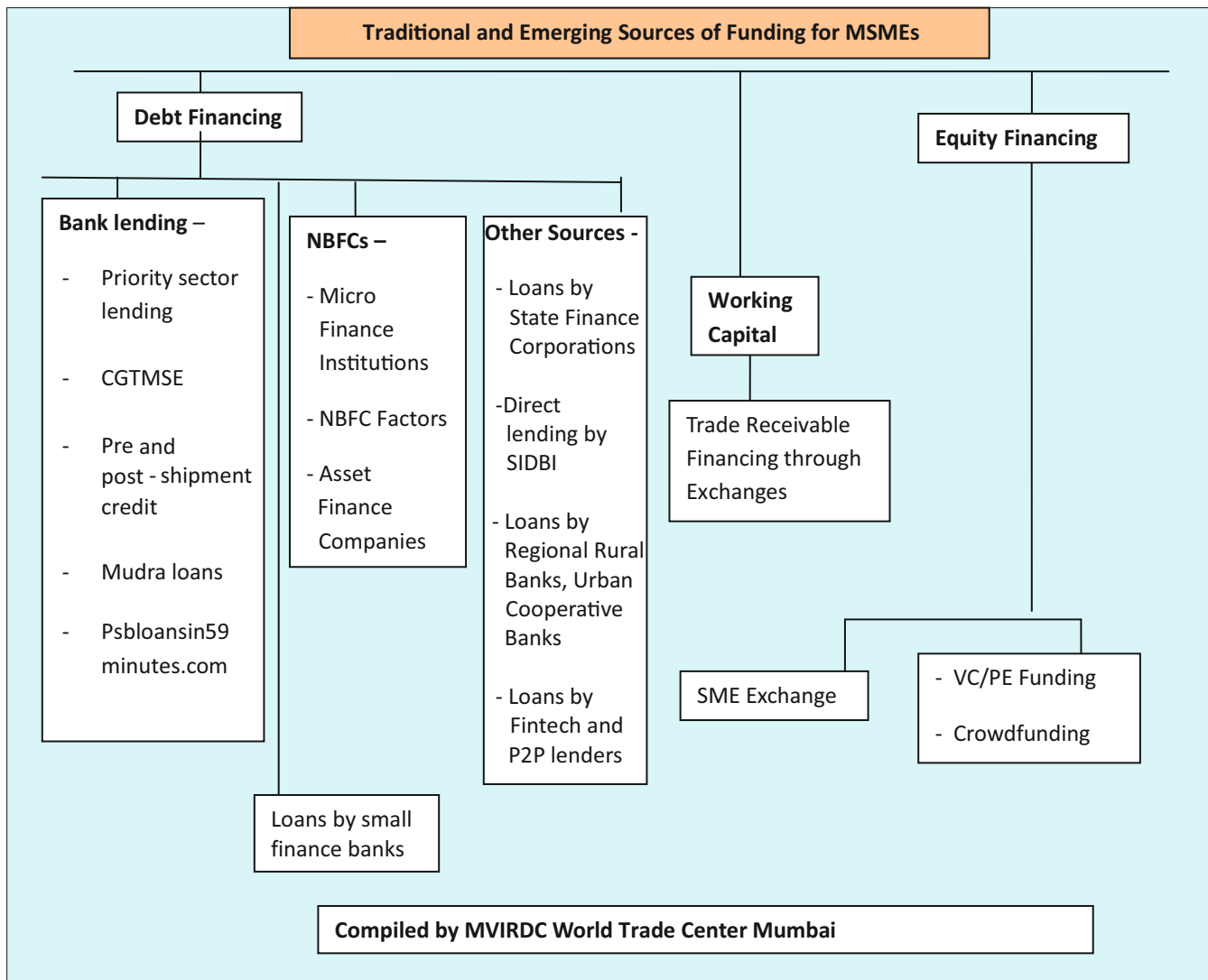
by **Suman Gupta**

"There has been a significant decline in the Credit Ratio i.e. upgrade to downgrade ratio for Acuité Ratings to 1.14 times in FY19 from 1.88 times in FY18. Clearly, the lower proportion of upgrades to downgrades which is expected to continue in FY20, partly reflects the challenges in the MSME sector such as higher working capital requirements due to delayed customer payments, increased funding challenges and the visible signs of a growth slowdown from the second half of FY19," said **Mr. Suman Chowdhury, President – Rating Operations, Acuité Ratings & Research Limited** at a programme on 'Evolving Modes of MSME Financing'. The programme was jointly organised by MVIRDC World Trade Center Mumbai and All India Association of Industries at WTC Mumbai.

MSME Financing in India An Overview

Micro, small and medium enterprises (MSMEs) are the pillars of Indian economy as they account for 29%ⁱ of GDP, more than 20%ⁱⁱ of total employment and 48%ⁱⁱⁱ of total exports. If India has to attain its objective of almost doubling its GDP to USD 5 trillion in the next few years, the role of MSMEs assumes profound significance. Supposing that the share of MSMEs in GDP remains the same as today, the size of the MSME sector will be USD 1.5 trillion when India's GDP touches USD 5 trillion.

As the size of the MSME sector grows, so will the demand for finance from this sector. According to a report by International Finance Corporation (IFC) released in 2018, the estimated demand for finance from the MSME sector is Rs. 87 trillion, of which demand for debt capital is pegged at Rs. 69 trillion and demand for equity capital is estimated at Rs. 18 trillion. This estimated demand also includes capital requirement of sick units, newly established micro enterprises and unorganised units with lack of professional book keeping practices. Financial institutions hesitate to cater to these enterprises because of high risk perception. The report finds that of the Rs. 69 trillion demand for debt capital by the MSME sector, only Rs. 37 trillion can be viably met by formal sources such as banks and NBFCs. Therefore, this estimated demand has to be met by both formal and informal sources such as money lenders, chit funds, families, friends etc. The available sources of finance for the MSME sector are depicted in the following figure.



Although banks and NBFCs can viably meet Rs. 37 trillion worth of demand for credit from the MSME sector, their overall credit exposure to this sector stands at Rs. 17 trillion^v as of March 2019. Thus, there is an estimated shortfall of Rs. 20-25 trillion in credit availability for this sector^v. This gap is expected to widen as the size of the economy and the MSME sector expands in the years to come, unless alternative sources of funding emerges.

Government of India and state governments have time and again introduced various schemes to bridge the credit gap in the MSME sector. The following table illustrates some of the schemes of the Ministry of MSME to address funding gap in this sector.

Key Schemes of Ministry of MSME, Government of India, to Promote Institutional Finance to the Sector	
Credit Linked Capital Subsidy Scheme	Under this scheme, government offers capital subsidy upto 15% to micro and small enterprises that are accessing institutional finance for upgrading their technologies
CGTMSE	Under this scheme, the government offers guarantee to micro and small enterprises accessing credit upto Rs. 2 crore from eligible banks and financial institutions
Interest Subvention	Under this scheme, government offers 2% interest subvention for all GST registered MSMEs, on fresh or incremental loans. Under certain conditions, exporters are eligible for increase in interest rebate from 3% to 5%
Prime Minister's Employment Generation Programme (PMEGP)	Under this scheme, the government offers margin money or subsidy to individual entrepreneurs and other beneficiaries for accessing loans from eligible financial institutions. The scheme is applicable for projects costing up to Rs.25 lakhs (for manufacturing units) and Rs.10 lakhs (for service units)
Interest Subsidy Eligibility Certificate (ISEC) Scheme	Under this scheme, government subsidises interest cost for loans to Khadi and Polyvastra institutions
Coir Udyami Yojana*	Under this scheme, the government provides credit linked subsidy to intended beneficiaries for setting up coir units
National SC/ST Hub	Under this scheme, government offers 25% capital subsidy to micro and small enterprises in the SC-ST category for technology upgradation
Compiled by MVIRDC World Trade Center Mumbai	
*Coir Udyami Yojana has been subsumed under PMEGP in 2018-19	

Challenges of Micro Enterprises

Although these government schemes have improved flow of institutional credit to MSMEs, micro and small enterprises continue to face difficulty in accessing formal sources of finance. These enterprises are unable to access formal sources of credit because of absence of prior credit history, inability to provide collateral, lack of professional bookkeeping practices, among other reasons. These enterprises fall in sectors such as handicrafts, repair and servicing, jewellery, food processing, brick kilns, restaurants, printing and publishing, among others.

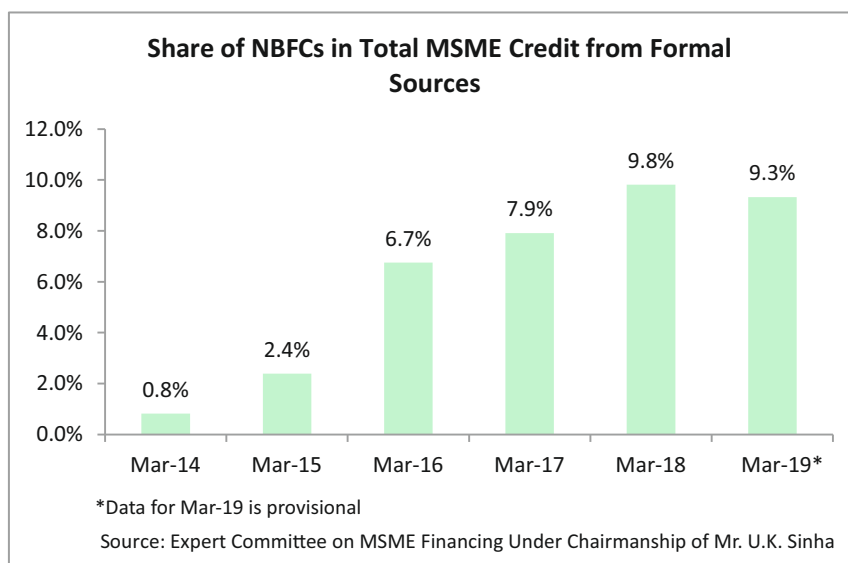
Most of these enterprises fall in the informal segment as they have not registered themselves under the MSME Act of 2006 or under the simplified Udyog Aadhar Memorandum (UAM) scheme. As a result, most of the enterprises in this segment depend on informal sources such as family, friends, moneylenders, chit funds etc. Studies conducted by International Finance Corporation (IFC) in 2018 show that of the total unmet credit need of Rs. 25.8 trillion, micro and small enterprises together have an unmet need of Rs. 24.8 trillion, with the remaining Rs. 1.0 trillion demand coming from medium enterprises.

Challenges Faced by Micro Enterprises in Accessing Formal Sources of Financing
Nature of Transaction: Micro enterprises deal in cash and hence it is difficult to verify the volume of their business, their payment records to their suppliers etc. This creates an element of trust deficit among lenders and hence they do not come forward to offer credit.
Traditional Book Keeping Practices: Micro enterprises do not follow professional bookkeeping practices and hence it is difficult to ascertain their assets and liabilities. Lenders from the formal sector need information on the financial health of the enterprises to assess their creditworthiness.
Lack of Collateral: Lenders demand collateral to secure their exposure to micro enterprises on account of the high-risk perception in lending to this sector. However, micro enterprises, especially in the services sector, do not have tangible assets to pledge against loans.
Unregistered business: Micro enterprises operate in the informal sector without registering themselves under the MSME Act. In order to evade taxes and administrative regulations, they do not register themselves with the income tax authority, labour bureau and sectoral regulators such as FSSAI. Also, their total revenue will be less than Rs. 40 lakh and hence they do not register themselves with the GST authority. However, financial institutions need documents such as PAN Card, income tax returns and bank statements to assess the credentials of borrowers.

Credit Gap in the MSME sector	
Micro Enterprises	Rs. 8 trillion
Small Enterprises	Rs. 16.8 trillion
Medium Enterprises	Rs. 1 trillion
Total Credit Gap	Rs. 25.8 trillion
Source: IFC Report November 2018	

Traditional Sources of Finance

Scheduled Commercial Banks and non banking finance companies (NBFCs) are the major traditional sources of funding (in the formal sector) to MSMEs. The outstanding credit to the MSME sector from these two sources stood at Rs. 17.3 trillion as of March 2019. Between them, banks have a lion share of more than 90% in total credit to MSME sector. The considerable presence of banks in MSME lending is understandable given that banks are subject to the priority sector lending norms of the RBI. Under the priority sector lending norms, scheduled commercial banks have to offer at least 7.5% of their adjusted net credit to micro enterprises. Banks that are unable to meet this target can fulfill it by financing NBFC micro finance institutions (MFIs) for on-lending to MSME sector. The share of NBFCs in total credit to MSMEs is growing in recent years, as can be seen from the following chart.

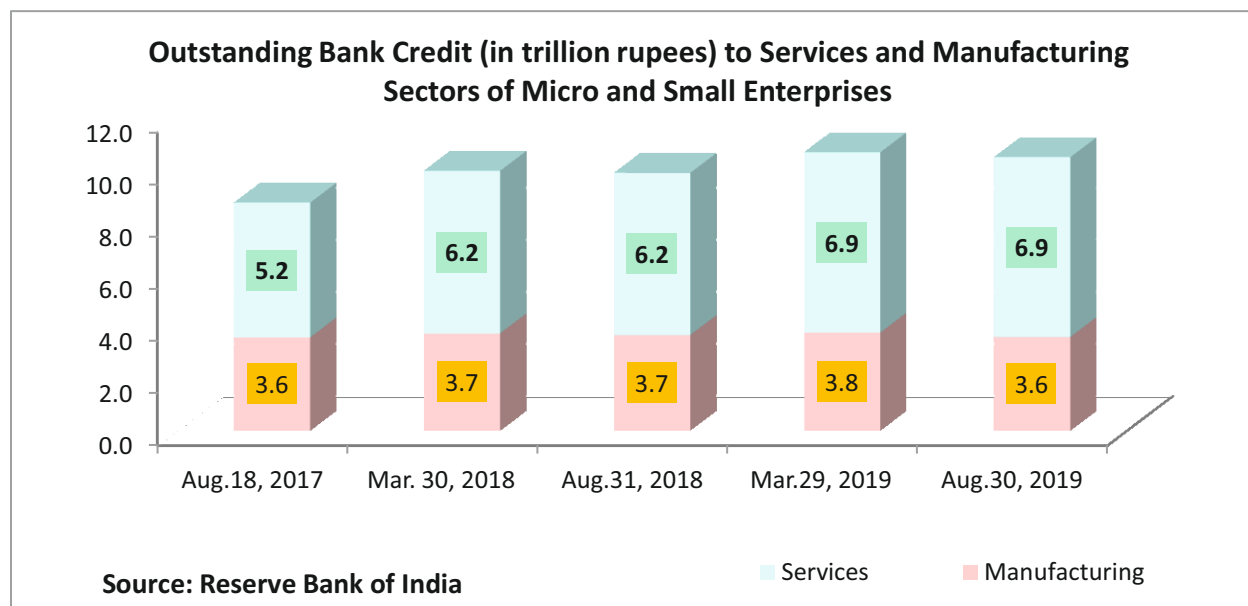


NBFCs such as micro finance institutions and equipment finance companies are in a better position to cater to the financial needs of micro enterprises because of their geographical reach. Generally, the ticket size of loans to micro enterprises is small and NBFCs find it profitable to cater to this segment because of their local presence and small size of operation. Therefore, commercial banks that are unable to meet their priority sector lending targets buy MSME loans from NBFCs to meet such targets. It is also observed that the loan applications of MSMEs are processed faster by NBFCs than by banks because of the varying risk assessment procedures adopted by both entities. As can be seen from the following table, the turnaround time taken to process MSME loans is 18 days in case of NBFCs, compared to 31 days in case of public sector banks and 29 in case of private banks. Another reason for the shorter turnaround time may be that the documentation procedure for loan application with NBFCs may be less stringent than with commercial banks.

Turnaround Time for Lending to MSMEs (in days)			
Lenders	2016	2017	2018
NBFCs	24	19	18
Public Sector Banks	41	35	31
Private Sector Banks	32	29	29

Source: Report of the Expert Committee on Micro, Small and Medium Enterprises, RBI, June 25, 2019

It is noteworthy that manufacturing sector has a less share in the bank credit to micro and small enterprises. This can be understood from the fact that manufacturing sector accounts for 31% of the total MSMEs, while the remaining 69% comprise of MSMEs engaged in service sectors. Of the total bank credit to micro and small enterprises, manufacturing sector accounts for hardly 35% as of August 2019. Service is the high growth segment for bank credit to these enterprises. As can be seen from the following graph, outstanding bank credit to service oriented micro and small enterprises grew from Rs. 5.2 trillion in 2017 to Rs. 6.9 trillion in 2019. The corresponding figure for manufacturing enterprises remained stagnant at Rs. 3.6 trillion during this period.



Other Traditional Sources

Apart from scheduled commercial banks and NBFCs, traditional sources of finance for MSMEs include Regional Rural Banks, Urban Cooperative Banks and government-owned entities such as SIDBI, State Finance Corporations and State Industrial Development Corporations. Urban Cooperative Banks and Regional Rural Banks were set up widely across the country to meet the credit needs of small businesses and farmers. These banks together account for 6% of the overall banking credit to MSMEs. Government-owned financial institution such as SIDBI and State Financial Corporations contribute minuscule (0.3%) to the total bank credit to MSMEs.

SIDBI was originally set up as a refinance institution for facilitating on-lending to MSME sector. However, in the course of time, the institution has been involved in direct lending and venture capital. SIDBI has also been instrumental in setting up a rating agency (Acuite Ratings & Research), an Asset Reconstruction Company (ISARC), a Trustee Company (STCL), besides other initiatives.

Emerging Sources of Finance

India is a rapidly digitising society where more and more financial transactions are happening through digital mode. India currently has around 500 million internet users. With the spread of digital literacy digital infrastructure and decline in cost of data, the number of internet users, especially through smartphones, is set to grow in the days to come. Also, the introduction of UPI and mobile banking facilities will reduce cash transactions in the society. The wide geographical reach of e-commerce websites such as Flipkart and Amazon will convince more and more offline sellers to register themselves on these online platforms. Such a rapidly digitising society creates a valuable set of data that can be used by financial institutions to assess the creditworthiness of borrowers. For instance, a financial institution can assess the creditworthiness of an online seller based on the number of orders she receives through various ecommerce platforms in a month, revenue generated through these orders and digital payments made by the seller to raw material vendors, creditors, employees etc. This will enable lenders to offer credit based on the assessment of the future cash flows of the enterprise, rather than based on collateral or tangible asset. This marks a remarkable shift in credit underwriting criteria from balance sheet or collateral-based standards to cashflow-based ones.

Thus, online data is a potential tool to understand the business model of micro enterprises that generally lack collateral or tangible assets. Countries such as China, USA and some of the African nations have witnessed rapid growth in fintech companies that meet the credit needs of micro enterprises based on their digital track record.

The following table illustrates the emerging lending platforms or players that use digital technologies in their operations:

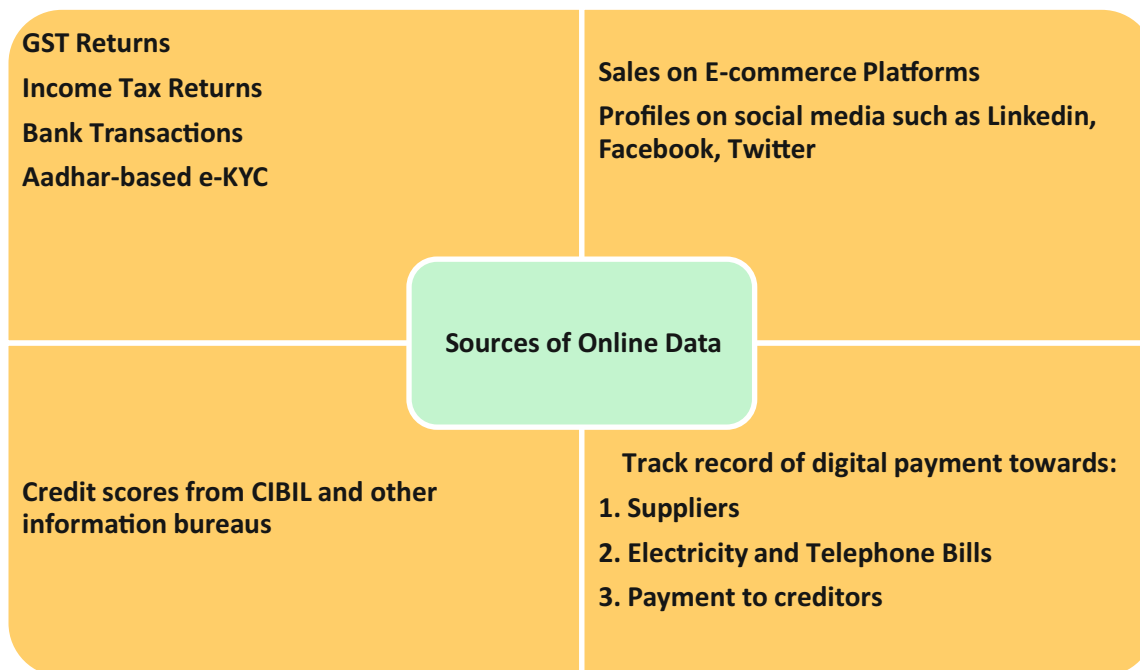
Emerging Players/Platforms for MSME Financing	
Fintech Lenders	These lenders pool funds from various classes of investors and lend them to borrowers based on innovative credit assessment. Creditworthiness of borrowers is assessed based on their digital transaction history by deploying artificial intelligence and machine learning technologies.
Trade Receivables Discounting System (TReDS)	This is an electronic platform that enables MSME sellers to convert their invoices or bills of exchange into cash at a competitive discount rate through an auction mechanism. MSME sellers, corporate buyers and financial institutions (banks and non banks) are the major players in the TReDS platform. Here, the participating financial institution funds the MSME sellers by discounting their invoices or bills of exchange drawn on corporate buyers. Currently there are three electronic receivable trading exchanges that are in operation in India.

Emerging Players/Platforms for MSME Financing	
Peer to Peer (P2P) Lending Platforms	These platforms are online marketplaces that bring together creditors and borrowers. These platforms are mere intermediaries between actual lenders and borrowers and they do not lend of their own. There are 19 P2P lenders registered with RBI as of August 31, 2019.
Payment Banks	Payment Banks are those entities that accept demand deposits and offer payment or remittance services to small businesses and individuals. RBI gave license to seven entities to launch payment bank service. Out of them, six are under operation. These banks are not allowed to undertake lending operations. However, these banks can refer their depositors to universal banks and other lending institutions for availing the latter’s loan products.
<p>Note:</p> <p>Small Finance Banks (SFBs) is another new category of players who focus largely on lending to micro and small enterprises. Today, there are 10 SFBs active in this segment. As of March 2018, 31% of their total advances has gone to MSME sector. However, they have not been included in this list of emerging players as nine of these entities were already operating as NBFCs before applying for SFB license with RBI.</p> <p>Compiled by MVIRDC World Trade Center Mumbai</p>	

Advantages of Emerging Platforms/Players

Asset Light Model	Innovative Risk Assessment	Innovative Repayment
<ul style="list-style-type: none"> •These emerging players operate through online platforms, thereby obviating the need for physical branches. They also operate with less manpower and physical assets •Therefore, these platforms can serve customers located in any geographical area with minimal operating cost 	<ul style="list-style-type: none"> •These emerging players assess the creditworthiness of borrowers based on their estimated cashflows or digital payment history, rather than based on traditional parameters such as balance sheet or tangible assets •Therefore, micro enterprises that do not have collateral can access funding based on the strength of their receivables or sound digital payment history •Such an innovative risk assessment model ensures paperless loan application and it also reduces time taken to sanction loans 	<ul style="list-style-type: none"> •Digital lending platforms offers innovative repayment terms to borrowers •For instance, a seller on an ecommerce platform can choose to make daily instalments to repay her loan. The daily instalment can be fixed as a percentage of her daily sales through the ecommerce website •This approach reduces instances of loan defaults by imposing appropriate discipline on repayment

Data Sources Used by Digital Platforms to Assess Creditworthiness of Borrowers



Recommendations

India is home to more than 63 million micro, small and medium enterprises, with 58% of them located in rural areas. Most of these enterprises lag behind in digital adoption, whether it is having a company website, registering their products or services on an e-commerce platform, having an app for their products or accepting UPI (unified payment interface) and similar digital payment mechanisms from MSMEs. Absence of an online footprint will be a great disabler for them in this age of digital finance. In fact, many enterprises wish to stay out of the digital economy and prefer to deal in cash transactions so that they remain in the informal sector thereby evading tax and regulatory burden. In this context, we propose the following recommendations for policy actions to promote institutional credit to MSMEs.

- **Formalisation of MSMEs:** Therefore, Government of India and state governments must work together to encourage the formalisation of MSMEs by improving ease of doing business and by creating awareness about the benefits of coming under the formal sector. Such awareness campaigns must send the message that the cost of formalisation for MSMEs will be less than the potential gains arising from it. A major benefit of coming under the formal sector is that the enterprise can avail of all the benefits of government schemes. In order to access institutional sources of credit, borrowers need to be registered under MSME Act or they should have filed Udyog Aadhar Memorandum (UAM), which is a self-declared online registration process. The local industry associations, jointly with District Industries Centre (DIC) must create awareness about UAM and encourage informal enterprises to register through UAM.
- **Digitisation of Payments:** Digitising their payment and other transactions will leave useful data for fintech companies to assess the creditworthiness of MSMEs and thereby increase their access to collateral free loans. Therefore, Government of India and RBI must conduct knowledge sessions on digitising the operations of MSMEs in different districts. The local industry associations can partner with RBI, the central and state governments in this initiative. The central government is planning to set up Enterprise Development Centre (EDC) at the district level for skill development and incubation and skill development of MSMEs. These EDCs can partner with local associations in the district to conduct knowledge sessions on digitisation for MSMEs.

- **Professional Bookkeeping Practices:** Micro enterprises do not follow professional practices in maintaining their books of accounts. Therefore, financial institutions hesitate to offer loans to these enterprises in the absence of credible financial statements. India's financial sector regulators such as RBI, SEBI, IRDA have jointly established National Centre for Financial Education (NCFE) to educate masses on financial matters. NCFE has created a handbook for micro entrepreneurs that explains business planning, managing finance of the business, building customer relationship and other basic elements of entrepreneurship. This handbook must be disseminated across industry associations in every district and printed in vernacular languages for ease of reading among micro entrepreneurs.

Apart from the above measures, the government must implement the recommendations of the Expert Committee on MSMEs under the Chairmanship of Mr. U.K. Sinha, which submitted its report to RBI in June 2019. Some of the salient recommendations of the committee are as follows:

Key Recommendations of Mr. U.K. Sinha Committee
<p><u>Delegated legislations to resolve insolvency:</u> A sound bankruptcy resolution mechanism is needed to create confidence among lenders about the legal remedies for recovering loans from insolvent enterprises. Given that micro enterprises are different from large companies in terms of access to resources, technology and professional management practices, insolvency of such enterprises must be treated differently from those of large companies. The extant Insolvency and Bankruptcy Code 2016 provides for a differentiated regime for insolvency/bankruptcy of firms, proprietary firms and individuals. The government is considering to bring out delegated legislation or rules to provide for out-of-court assistance to MSMEs such as mediation, debt counselling, financial education, or the appointment of a trustee. The introduction of such legislation must be expedited and it must be effectively implemented.</p>
<p><u>Enhance role of SIDBI:</u> SIDBI, being one of the leading development banking institution in the world, must create new products for raising finance by MSMEs and it must also be a market maker of such new products. SIDBI must also enter into partnerships with other financial institutions and enhance their capacity to cater to the unmet credit needs of MSMEs.</p>
<p><u>'Unique Enterprise Identifier':</u> Government must develop a Unique Enterprise Identifier for authenticating the identity of MSMEs for multiple purposes such as regulatory licenses, registration with public sector procurement agencies, registration with tax authorities and also for registering with NSIC and other government departments to claim fiscal benefits. Such a Unique Enterprise Identifier will improve ease of access to finance for MSMEs by allowing paperless KYC verification across all financial institutions, whether it is micro finance institutions, TReDS platform, banks or any other institution.</p>
<p><u>Encourage private funding for Cluster Development programmes:</u> There are more than 650 clusters across various districts in India. Many clusters are struggling to upgrade common infrastructure because of lack of access to finance. SIDBI must promote flow of private capital through corporate bonds, venture capital and other avenues in these clusters.</p>
<p><u>Introduction of E-Liens:</u> Cash flow based lending to MSMEs can be enhanced by introducing E-Liens, which enables lenders to recover loans electronically by creating a lien on the incoming cash flows of borrowers. E-Lien can be introduced through a set of interlocking Digital Public Infrastructure. By introducing E-Liens, financial institutions can process loan application of MSMEs faster and reduce their hassles involved in recovering loans.</p>

ⁱReport of the Expert Committee on MSMEs under the Chairmanship of Mr. U.K. Sinha

ⁱⁱMVIRDC Estimate

ⁱⁱⁱGovernment of India Press Release dated 22-July-2019

^{iv}Report of the Expert Committee on MSMEs under the Chairmanship of Mr. U.K. Sinha

^vReport of the Expert Committee on MSMEs under the Chairmanship of Mr. U.K. Sinha

^{vi}International Finance Corporation (IFC) Report on Financing India's MSMEs, November 2018

^{vii}International Finance Corporation (IFC) Report on Financing India's MSMEs, November 2018

Evolving Modes of MSME Financing An Overview

MSMEs are considered the backbone of the Indian economy. However, the MSME sector faces a major problem in terms of getting adequate credit for expansion of business activities. MSME financing is mainly restricted to bank financing in India where again it is the large organizations that get a preferential treatment. Due to the limited options available for financing, the cost of MSME financing goes up such as in the form of high interest rates. This deters the growth process of MSMEs.

About 99 per cent of Indian enterprises belong to the MSME sector. A disruption in their sources of borrowing disrupts the entire business cycle owing to the contagion effect. It also leads to a slowdown in the economy. MSMEs are further suffering owing to the systemic weaknesses in the economy such as lack of basic infrastructure facilities and delays in getting approvals from various authorities.

The government is encouraging alternative modes of credit for the MSME sector such as digital financing platforms which are backed by technology-based loan evaluation parameters that automate the application process and accept paperless documentation. These platforms also make the entire process transparent. Thus, with improved digital footprint of MSMEs, the inefficiencies of the informal money lending system are getting eliminated.

The MSME sector is also moving from collateral-backed to cash flow-based borrowing methods wherein MSMEs do not have to mortgage their assets for taking loans. Rather, it is their digitized transactions and GST payment history that act as proof of their creditworthiness. However, there is also a need to encourage other alternative modes of MSME financing such as SME exchanges, venture capital, angel investors, crowd funding platforms, MFIs, NBFCs and factoring services. Similarly, the government should improve the effective implementation of schemes such as CGTMSE and MUDRA that aim at easing the funding requirements of MSMEs.

In this regard, it is noteworthy to consider the recent recommendations for MSME financing by the Expert Committee on Micro, Small and Medium Enterprises, formed under the Chairmanship of Shri U. K. Sinha. Some of the recommendations of the committee are:

- SIDBI should help deepen credit markets for MSMEs in underserved districts and regions by handholding private lenders such as NBFCs and MFIs for increasing their presence and reach, working with local level bankers, differential pricing for refinance, awareness programmes, etc.
- SIDBI, as a nodal agency, should ideally play the role of a facilitator to create a platform wherein various Venture Capital Funds can participate and in turn create multiplier effect for providing Equity Support to MSMEs. For this it has to help popularize/spread awareness of new ways of investing (modified term sheets for instance).
- Increase the limit for non-collateralised loans to Rs. 20 lakh, this would address a significant proportion of MSEs' needs. Revision in loan limit sanctioned under MUDRA to Rs. 20 lakh from Rs. 10 lakh.

In order to bring our MSMEs at par with those across the world, we need public, as well as, private participation in financing MSMEs. The following tables highlight the key industries to which MSMEs in India belong. By adopting technology and through digitization, these MSMEs can have better access to the evolving alternative sources of finance mentioned above.

UAM filed by MSMEs: Key Industries

The Ministry of Micro, Small & Medium Enterprises, Government of India, in September 2015 notified that every MSME unit shall file Udyog Aadhaar Memorandum (UAM), which replaces the filing of Entrepreneurs' Memorandum (EM part-I & II) with the respective States/UTs. As per recent data available on the Udyog Aadhaar website, manufacture of food products, manufacture of textiles, manufacture of fabricated metal products, except machinery and equipment, manufacture of chemicals and chemical products, civil engineering, among others, dominate the manufacturing activities of MSMEs. The following tables highlight the top 10 manufacturing industries wherein UAM have been filed by MSMEs.

Top 10 Manufacturing Industries in terms of UAM filed by Micro Organisations		
Industry	No. of Micro Organisations	Share in Total (%)
Manufacture of food products	5,90,500	15
Manufacture of textiles	4,44,598	12
Other manufacturing	3,99,846	10
Crop and animal production, hunting and related service activities	3,64,403	10
Manufacture of wearing apparel	2,90,461	8
Manufacture of fabricated metal products, except machinery and equipment	1,68,876	4
Manufacture of machinery and equipment n.e.c.	1,16,084	3
Repair and installation of machinery and equipment	1,07,055	3
Specialized construction activities	98,132	3
Manufacture of chemicals and chemical products	95,267	2
Total No. of Micro Manufacturing Organisations that have filed UAM	3,817,670	100

Source: <https://udyogaadhaar.gov.in>, MVIRDC WTC Mumbai Inhouse Analysis

Top 10 Manufacturing Industries in terms of UAM filed by Small Organisations		
Industry	No. of Small Organisations	Share in Total (%)
Manufacture of food products	72,169	11
Manufacture of textiles	68,901	10
Other manufacturing	53,177	8
Manufacture of fabricated metal products, except machinery and equipment	42,330	6
Manufacture of rubber and plastics products	37,485	6
Manufacture of machinery and equipment n.e.c.	37,180	6
Civil Engineering	27,840	4
Specialized construction activities	25,058	4
Manufacture of wearing apparel	22,432	3
Manufacture of other non-metallic mineral products	21,730	3
Total No. of Small Manufacturing Organisations that have filed UAM	658,716	100

Source: <https://udyogaadhaar.gov.in>, MVIRDC WTC Mumbai Inhouse Analysis

Top 10 Manufacturing Industries in terms of UAM filed by Medium Organisations		
Industry	No. of Medium Organisations	Share in Total (%)
Manufacture of food products	4,039	14
Manufacture of textiles	3,117	10
Other manufacturing	2,714	9
Manufacture of rubber and plastics products	1,924	6
Manufacture of fabricated metal products, except machinery and equipment	1,482	5
Manufacture of basic metals	1,372	5
Manufacture of chemicals and chemical products	1,328	4
Civil Engineering	1,178	4
Manufacture of machinery and equipment n.e.c.	1,162	4
Manufacture of other non-metallic mineral products	980	3
Total No. of Medium Manufacturing Organisations that have filed UAM	29,917	100

Source: <https://udyogaadhaar.gov.in>, MVIRDC WTC Mumbai Inhouse Analysis

Similarly, other personal service activities, food and beverage service activities, retail and wholesale trade, except for motor vehicles and motor cycles, computer programming, consultancy and related activities, other professional, scientific and technical activities, among others, dominate the service industries in MSMEs. The following tables highlight the top 10 service industries wherein UAM have been filed by MSMEs.

Top 10 Service Industries in terms of UAM filed by Micro Organisations		
Industry	No. of Micro Organisations	Share in Total (%)
Other personal service activities	5,44,851	13
Retail trade, except of motor vehicles and motorcycles	5,37,822	13
Food and beverage service activities	4,76,878	11
Other professional, scientific and technical activities	2,27,743	5
Computer programming, consultancy and related activities	1,79,661	4
Repair of computers and personal and household goods	1,72,023	4
Travel agency, tour operator and other reservation service activities	1,57,071	4
Other financial activities	1,48,176	4
Office administrative, office support and other business support activities	1,45,208	3
Wholesale trade, except of motor vehicles and motorcycles	1,34,124	3
Total No. of Micro Service Organisations that have filed UAM	4,159,029	100

Source: <https://udyogaadhaar.gov.in>, MVIRDC WTC Mumbai Inhouse Analysis

Top 10 Service Industries in terms of UAM filed by Small Organisations		
Industry	No. of Small Organisations	Share in Total (%)
Land transport and transport via pipelines	43,873	9
Food and beverage service activities	42,340	8
Other professional, scientific and technical activities	33,562	7
Other personal service activities	30,687	6
Computer programming, consultancy and related activities	25,430	5
Warehousing and support activities for transportation	24,482	5
Rental and leasing activities	21,228	4
Office administrative, office support and other business support activities	20,003	4
Services to buildings and landscape activities	19,134	4
Wholesale trade, except of motor vehicles and motorcycles	19,005	4
Total No. of Small Service Organisations that have filed UAM	505,683	100

Source: <https://udyogaadhaar.gov.in>, MVIRDC WTC Mumbai Inhouse Analysis

Top 10 Service Industries in terms of UAM filed by Medium Organisations		
Industry	No. of Medium Organisations	Share in Total (%)
Warehousing and support activities for transportation	1,907	11
Food and beverage service activities	1,396	8
Computer programming, consultancy and related activities	1,116	6
Land transport and transport via pipelines	1,108	6
Other professional, scientific and technical activities	1,056	6
Accommodation	1,011	6
Human health activities	923	5
Other personal service activities	736	4
Office administrative, office support and other business support activities	684	4
Information service activities	659	4
Total No. of Medium Service Organisations that have filed UAM	17,781	100

Source: <https://udyogaadhaar.gov.in>, MVIRDC WTC Mumbai Inhouse Analysis

Technology Adoption: The Way Forward

In order to attract the evolving modes of MSME financing mentioned above, MSMEs need to shed their traditional ways of doing business and adopt latest technology to make their ideas promising and saleable. Online grocery stores such as Big Basket, Grofers and Godrej Nature's Basket, cab aggregators such as Ola and Uber, ecommerce websites such as Flipkart and Snapdeal, and online travel portals such as MakeMyTrip and Oyo are examples of startups that have been successful in attracting private equity and act as technology platforms which benefit MSMEs that are listed on these platforms.

Adopting technology can help MSMEs in the sectors mentioned in the tables above reduce cost and mitigate risks in business operations. Getting listed on online platforms, filing GST returns and transacting digitally enables MSMEs leave a digital footprint that not only brings in transparency, but also brings these MSMEs in the formal sector net, thereby reducing their cost of borrowing. As these MSMEs gain competitiveness, they can further tap the equity market for getting cheaper finance.

As the majority of Indian enterprises fall in the micro enterprises segment, they do not call for huge amounts of capital (fixed as well as working). The evolving modes of finance can, therefore, easily cater to their financing needs as through increased digitization, the genuine borrowers can be segregated from the non-worthy ones. With increased penetration of these newer modes of finance, Indian MSMEs will be able to augment their scale of operations, thereby achieving economies of scale that can enhance their reach in the domestic as well as global markets.

While MSME financing has so far been a major challenge in India, the times to come offer a major paradigm shift in the attitudes of financiers with increased technology penetration. MSMEs should encash this window of opportunity in order to meet their business aspirations and set themselves on a high-growth trajectory.

Attracting Risk Capital

MSMEs must also enhance their equity capital base by attracting funding from angel investors, venture capital and private equity funds. The investors from these funds will provide not only capital but also strategic guidance to MSMEs on sound management practices and adoption of cutting edge technologies. Accessing funds from large private equity or venture capital investors will enhance the enterprise value and creditworthiness of MSMEs. This will also increase their chances of accessing credit from banks, NBFCs and other sources at a reasonable interest rate. The following table illustrates some of the benefits of accessing equity capital from these investors.

Benefits of Accessing Private Equity (PE) and Venture Capital (VC) Funds
1. MSMEs accessing equity capital from reputed PE and VCs can enhance their capital base so that they can use this capital for upgrading their technologies.
2. Accessing risk capital will reduce their dependence on informal sources of funding such as families, friends, relatives and other sources such as moneylenders who are potentially exploitative.
3. Inducting professional investors such as PEs and VCs will help MSMEs adopt best management and book keeping practices.
4. Accessing risk capital will enhance their creditworthiness and improve access to loans at reasonable interest rates.
5. Accessing equity capital will provide an opportunity for MSMEs to enhance their scale of operations and thereby benefit from scale economies
6. This will enhance their competitiveness in the global market and thereby promote their exports

Articles

from Experts and Industry Leaders

Finance and Financing of MSMEs in India: Emerging Trends

By Dr. P.M. Mathew, Director, Institute of Small Enterprises and Development*

While giving the final touches of the twenty-second volume of the India MSME Report today, it occurs to me that finance stands out as the largest single MSME problem of the year. The picture of the Indian economy, painted by the recent Annual Report of the Reserve Bank of India, as also the Report of the U.K. Sinha Committee which came out in July this year, highlights the need for innovative solutions to the problem of MSME finance. The key challenges of India's MSME journey, as in 2019, are seven-fold: 1) the generational change in business start-up; 2) stalled growth at the bottom of the enterprise pyramid; 3) subcontracting stalemate; 4) finance and financing; 5) manufacturing stalemate; 6) falling business confidence; and 7) labour redundancy; amidst unemployment.

Why finance stands out as a unique problem? Besides being a cross-cutting theme, it is a critical common factor for decision making under a crisis situation. In order to manage a crisis, decision making is vital. Some decisions are urgent; others need to be postponed. Positive decisions imply demand for finance; postponed decision impacts output, and hence, act as a bar on supply of finance. Delayed payments enhances the volume of working capital available to the parent company; whereas, it curtails the supply of working capital of the vendor. MSMEs account for more than 45% of the total manufacturing output in India and over 40% per cent of the country's exports. MSMEs in the manufacturing sector contribute around 8% to the national GDP, apart from generating almost 70% of the total employment opportunities. But such priorities have often been outdone by the credit-gap. The credit gap is significant, and the most recent survey by IFC-Intellicap pegs it at about Rs 25 trillion. According to a recent report by International Financial Corporation (IFC), small businesses in developing economies need more than USD 2 trillion to fulfil their working and growth capital requirements. The World Bank estimates a credit demand-supply gap of USD 380 billion in India alone. Commercial banks consider MSMEs a risky lending proposition. A large percentage of Indian MSMEs do not maintain a consolidated record of their financial data such as tax returns filings, P&L, and transactions. With institutional lenders having little to no visibility into MSME finances, their underwriting mechanisms fail to accurately gauge the creditworthiness of potential borrowers. Moreover, since small businesses often don't own substantial physical assets, traditional BFSI players are unable to offset the risk to capital, and end up rejecting most MSME loan requests.

Excessive documentation requirements, as well as the time taken for the loan to be finally approved under the conventional loan application process, also puts a lot of prospective MSME borrowers off. Most MSMEs operate as part of a forward supply chain; products and services are delivered immediately, with the payment taking anywhere between 30 and 90 days to be cleared. Such businesses don't have a large capital corpus, to begin with, and operate on very fine financial margins, making it necessary for them to have immediate and urgent access to working capital to meet their day-to-day expenses, such as paying staff salaries, suppliers, and utility bills. Conventional working capital loans can take up to several weeks to get approved and disbursed.

Digital lending platforms help to utilise technology and to create unique customised loan products. Fintech lending solutions offer ecosystem-based lending. MSMEs are invariably keyed into bigger supply chains, whether as suppliers or customers. Digital lending platforms are now partnering with large corporate organisations to use the data that exists within these supply chains. Doing so, not only enables them to more accurately underwrite MSME borrowers, but also deliver highly-customised financing solutions at their point of need.

India is a hotbed for financial technology, or FinTech innovation. FinTech is an amalgamation of finance and technology and is fast paving a new way for the future of the financial world. Beyond an enabler, they are a driving engine of the modern economy. FinTech includes companies involved in payments, insurance, investing, credit and lending, and blockchain, to name just a few. The top FinTech companies in the world each may command valuations in the billions of dollars, with the U.S. and China leading the list. The financial world is undergoing a technological revolution in such a way that, it is only a matter of time when everything around us will have FinTech as its focal point. Since ecosystem-based loans can be availed as an integral part of the financial transaction itself, MSMEs are motivated to access consumer credit. This increased credit appetite will, in turn, drive business growth, both within the MSME sector and along the supply chain, whilst also stimulating economic activity on a much larger scale.

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How Trade Financing Can be the Secret Weapon of Indian MSMEs

By Mr. Pushkar Mukewar, Co-founder and Co-CEO, Drip Capital

At a time when banks are reeling under pressure to clean up balance sheets, leading them to opt for 'safe' credit lending, the worst-hit victims of the credit crunch are once again the core of India's economy-- MSMEs.

Even Non-Banking Financial Corporations (NBFCs) are unable to provide the requisite liquidity needed to sustain the explosive growth of India's mid-sized companies. Major events like the NPA crisis and the PNB scam have created a strong sense of uncertainty across the Indian financial and trade ecosystems.

Companies need capital to run and Indian trade, comprising of both intra-regional and cross-border trade, needs uninterrupted working capital. Given the inability of banks and NBFCs to service this need, alternative sources of finance have emerged to meet the unmet credit demand of MSMEs.

Leveraging technology to ease lending solutions for the MSME sector, these alternative sources of financing are increasingly taken centerstage in the Indian trade ecosystem.

The rise of alternatives

Given its rapid proliferation and easy availability, alternate finance seems like the definite road ahead for India's fast-growing MSMEs. Alternative financing options have sprung up across multiple sectors, geared towards making working capital availability simpler.

Trade financing is one of the most rapidly growing sectors among these. Several trade finance services and options have become popular, including factoring or debtor financing, public equity via a prospective listing, private equity or venture capital, and micro loans among others.

Emerging fintech companies recognize the win-win opportunity in working with and for the MSMEs in India. They are using deep tech to develop solutions for Indian traders to reach out to the global trade community. This technological revolution is happening swiftly, with consumers acceptance and comfort also rapidly rising. Several Indian companies are developing and leveraging technology from Silicon Valley and bringing it to India to benefit local businesses here. This "reverse migration" is a sign of the changing times, as more and more fintech firms explore innovative means to strengthen and assist existing local businesses.

To facilitate MSMEs, fintech companies like Drip Capital are exploring ways to bridge the international trade funding gap by providing easy finance to Indian exporters with rapid approvals and minimal documentation, as opposed to the tedious and red-tape-heavy legacy processes traditionally followed in the country, boosted by the use of technology and data.

A key factor behind the rise in popularity of these firms is that their clients have complete transparency about the funds they receive. Through these firms, SMEs can monitor trade cycle transparently while trusting the financier, who serves as a catalyst for swift growth in a highly competitive business environment. Tools such as automated risk assessment allow the fintech firms to provide easy access to finance, while eliminating the hassle of paperwork and bureaucracy and creating a seamless borrowing experience for clients.

Golden Times for Fintech

India has one of the most advanced financial payments infrastructure in the world at this moment. Bolstered by our Hon'ble Prime Minister Narendra Modi-led government's efforts to push Indian citizens to adopt digital payments, digital lending has made rapid inroads in the otherwise tradition-bound MSME sector of the country.

Even with the massive investments in infrastructure being undertaken today, the first task for many fintech companies remains making online processes easy for MSMEs. Particularly in the Indian context, medium and small businesses are not

very adept with the latest technological tools, are often afraid to trust online transactions, and constantly fear online theft. As such, it is important that fintech firms tackle this cultural shift head-on, and the positive signs of change are already visible.

Additionally, as Indian MSMEs expand their connections and presence in overseas trade, fintech companies are helping them get bigger orders and higher volumes seamlessly. For example, a transformational change from hard paper invoicing to more transparent e-receipts that exporters can now furnish to financiers and ensure payments from importers is a key product of the fintech revolution.

MSMEs who otherwise work on forward contracts and are often thirsty for liquidity can now consolidate their market reach via active use of advanced analytics and market-insight tools provided by fintech organizations to stay ahead of the curve.

The Road Ahead

As India whistles past its former rank in the Ease of Doing Business Index to 77th in a 190-country list accessed by the World Bank, the world is taking interest in the lucrative opportunities offered by the country's diverse assets and products.

Indian MSMEs are quite aware of this increased interest, but their growth has been hampered primarily by lack of knowledge and access to finance. However, the rise of fintech in the Indian ecosystem is slowly but surely resolving this gap, helping the MSME community look beyond the banks and NBFCs to adopt a safer, more transparent route to enable their business.

Thus, in the short term, the central challenge faced by alternate sources of lending will remain widespread awareness. Once adoption of new-age technology-driven digital lending platforms becomes more commonplace, the impeccable business acumen of India's MSME community will undoubtedly get further wings. For this, testimonials of successful trade by existing clients, as well as support from policymakers and traditional players, will play a big role.

The Indian government has made boosting trade a central priority. The integration of several government agencies into an online system and the upgrading of port equipment and infrastructure are key steps already taken in this regard. Ultimately, it is up to the MSME ecosystem to capitalize on the opportunities being generated by the government's increased support.



Partnering with a fintech business equipped with a global team and perspective will also be key for growth. Opting for a tech-driven partner who offers an easy platform to avail credit as well as monitor growth is a key method for growth and development. An integrated fintech company with a global network can help Indian companies reach out to more potential buyers and grow business without worrying about the capital.

In the long term, opportunities for digital lending and trade finance to help the Indian MSMEs will continue to grow.

However, global trade disruptions in the form of trade wars and other geopolitical and socioeconomic tensions could become a potential concern.

Amid political uncertainty, fintech companies with a multinational and global presence will be ideally positioned to keep driving impact and growth in international trade. Working with such firms will give MSMEs the freedom and assurance to keep growing their business without undue concerns about the availability of credit and other facilities.

In a nutshell, the Indian MSME sector – touted to play a significant role in ensuring India's dominant position in international trade – must look at alternate sources of finance for their business requirements by partnering with technology-led platforms. Doing so could help the contribution of MSMEs towards India's GDP jump from the current 31% to nearly 50%, a welcome development as India chases its goal of becoming a USD 5 trillion economy.

Leveraging Digital Technologies to Promote Credit for SMEs

By Mr. Arun Nayyar, Chief Executive Officer, NeoGrowth Credit

There are around 60 million micro, small and medium-size enterprises (MSMEs) operating in India today, contributing around 30% to India's GDP and employing more than 111 million people.¹ But a major barrier to their growth has been the ease of getting credit – today, around 40% of total MSME credit demand is still served by informal sources of credit. As per the IFC Report 2018, the huge financing gap is pegged at Rs 45 lakh crore out of which 40% will be served by informal credit, 25% through personal loans and only about one-fifth of the total credit demand will be fulfilled by formal credit.²

The lack of credit availability not only hinders the MSME growth potential, but it also limits their choice of lender and bargaining power. This is where a new era of lending has dawned. With technology at their disposal and a new business model based on creating ease of business, alternate finance companies have taken this challenge head-on. Their goal is to serve the small and medium businesses of this country without having to make things further difficult when all they need is just credit.

Now, this previously unaddressed sector is at the center of attention for alternate finance companies and new-age lenders such as NeoGrowth are leapfrogging traditional banks in reaching the target market and providing faster credit, almost real-time in some cases. Sensing their superior abilities to address the market in a holistic yet efficient manner, banks are beginning to partner with such lenders now to boost the spread of their loan portfolio. The models of such collaborations include partnerships for lead generation, customer acquisition, richer data for underwriting and for smarter portfolio monitoring.

Hence, MSME digital lending has the potential to reach Rs 6-7 lakh crore in annual disbursements by 2023.³ The major factors leading this growth are the fast pace of digitization, API-based data availability to help credit scoring and the increased receptivity to digital lending by the small and medium businesses.

The key reason behind this growth is superior formalization of small businesses which has happened in India in the last five years. From the goods and services tax which brought a lot of untraceable businesses into the formal system to the digitization revolution which put trails on cash flows, lenders now experience more comfort in making a credit decision to even asset light SMEs if they can see these footprints.

Cost of data has fallen by 95% in the last three years in the country leading to a smartphone proliferation. Currently, 85% of MSMEs have smartphones. Some of the models of credit assessment involve credit scoring through traditional models but pairing it with collected data from the phones and triangulating it with social media activity of the entrepreneur/entity to arrive at a better credit decision.

For instance, digital lending players like NeoGrowth address the challenge by underwriting based on the digital payments data which gives a good measure of the intensity of business throughput as well as allows for automated and daily repayment through POS machines itself. This enables businesses with a low asset base or inadequate credit history to avail timely funds.

The main driver for a rational credit decision is data. So far, traditional lenders like banks and legacy NBFCs were only focusing on credit bureau data to assess the financial health of a company/entrepreneur seeking a business loan.

However, the paradigm has changed now with government and other firms stepping in to provide alternate sources of data. Verified bank account data is available, KYC is simpler and financial data and legal data also is readily available through online and other sources.

Several niche fintech firms have emerged focusing specifically on enabling easy access to various kinds of data for the industry. Further, RBI's new initiative of NBFC - Account Aggregator will enable sharing of digitally verified banking data in machine readable format with lenders by a touch of the button which would reduce paper handling and drastically reduce loan application processing time.

New-age lending involves integrating all this data with more robust sources such as GST returns which reduce loan processing time and enhance customer experience across all touchpoints. For instance, in 2017, the number of MSMEs with some form of formal government registration grew by 5% and by 14% amongst MSMEs with annual turnover between Rs 10 lakh – Rs 1 crore. At the same time, more than 47% of MSMEs have adopted digital tools for business processes, payments, and online sales.⁴

This revolution could boost the MSME digital lending annual disbursements to reach INR 6-7 lakh crore by 2023. Digital payments have helped the cause in a crucial way. E-commerce companies or retail stores can simply use their transaction data gathered through Point-of-Sale terminals to help the lender verify their cashflows and health of the business.

This is where the government's digital payment push has helped a lot. Digital payment transactions have jumped two to five times above expected levels turning this growth into a leapfrog more than 2 years in the curve with the entry of global giants like WhatsApp and Google. With small ticket merchant payments shifting to these platforms, it's easier for an entrepreneur to provide cashflow summary to a lender for availing a business loan.

Through this mode, they can obtain easy funding for a period ranging between 12 to 36 months at competitive rates. Meanwhile, new-age NBFCs are also aiming for a share in this market by bringing in high-end algorithms to quickly sift through eligible borrowers and funds are disbursed quickly – in less than 3 days in most cases. The major factors driving this immense potential are:

- MSMEs with annual revenue between INR 10 L and INR 1 Cr are rapidly formalizing and digitizing
- The growing API-based data availability has fundamentally transformed every step of the credit value chain
- The increased receptivity to digital lending by MSMEs indicates the large scale of the potential market

This is not all. The social impact of such lending is also immense. By lending to first generation entrepreneurs who may be new-to-credit, digital MSME lenders are creating a strong positive social movement by normalizing formal credit and bringing people into this fold. At the same time, availing short sachet-sized loans through these lenders can help people build admirable credit scores with traditional bureaus which will only improve their long-term financing credentials.

This is a big step forward for the government's financial inclusion agenda as the next step for financial inclusion after providing people with bank accounts is to provide them with credit to show them the ease and transparency of formal credit. Moneylenders can charge up to 90% of annualized interest from SMEs looking for funds urgently. Meanwhile, the new-age lending platforms provide far more competitive interest rates and allow entrepreneurs to ditch the moneylender in the favor of ease, transparency and business efficiency.

Moreover, such businesses are furthering financial inclusion by an increasing focus on lending to small and medium businesses in Tier II & Tier III cities. With continuous thrust of measures by the Government for the MSMEs and NBFCs, growing acceptance of digital modes of payments, further opening up of GST returns data combined with payments and digital trails, SME lending could galvanize India's economy and provide it the much-needed competitiveness and vibrancy that one would come to expect from one of the fastest developing economies of the world.

¹<https://economictimes.indiatimes.com/small-biz/sme-sector/vision-is-to-increase-msmes-contribution-to-gdp-to-50-nitin-gadkari/articleshow/69978436.cms?from=mdr>

²https://www.intellecap.com/wp-content/uploads/2019/04/Financing-Indias-MSMEs-Estimation-of-Debt-Requirement-of-MSMEs-in_India.pdf

³<https://economictimes.indiatimes.com/small-biz/sme-sector/digital-lending-to-msmes-poised-for-major-growth-in-india-omidyar-bcg-report/articleshow/66735018.cms?from=mdr>

⁴https://www.omidyar.com/sites/default/files/file_archive/18-11-21_Report_Credit_Disrupted_Digital_FINAL.pdf

Securing the Unsecured – Evolving Lending Models in SME Finance

By Mr. G Jaikrishnan, Director, KPMG in India

Bassanio was perhaps the first borrower in history who managed to obtain a loan in a non-traditional format. Remember the infamous Shylock from “Merchant of Venice”? Shylock could not have underwritten Bassanio on the merit of any collateral; Antonio’s guarantee was also not passing Shylock’s credit assessment. They finally figured out an alternative which gave comfort to all involved in the transaction: the Lender, the Borrower (although he was not very comfortable in pledging his friend’s pound of flesh) and the Guarantor (who was very confident in his ships returning in time to avoid occurrence of a default).

Since then, lending has evolved to include more refined alternatives. Imagine if we had only traditional sources of lending. In simple terms, traditional sources can only afford to lend against valuable collateral securities at a loan to value ratio between 50 – 75%. The value itself is determined by existing market conditions and a reflection of the assets’ potential realizable value. It is also well understood that asset creation is not always funded by lenders - rather income generation is funded by lenders. Assets are created out of surplus income generated by the wealthy. By this logic, majority of our country’s assets are owned by wealthy and established businessmen. However, many of these assets are not available to be pledged. If the traditional method was to be followed, the total credit which India could offer its small and medium enterprises would be a miniscule amount of the total available left-over assets worthy of underwriting.

Today, Indian Micro, Small and Medium Enterprises (MSMEs), driven by a strong entrepreneurial culture, can operate with limited capital and infrastructure- but, only in semi-urban and rural areas. This may be less attractive to larger organizations. On the other hand, growth beyond a point is now hard to come by due to multiple factors. Limited growth opportunities are mirrored in the fact that the microfinance sector, with its 630.52 lakh estimated enterprises, accounts for more than 99% of total estimated number of MSMEs.

(Micro Enterprise loans are smaller ticket sizes and can’t grow beyond the exposure limits specified by regulators. Larger portion of the overall MSMEs pertain to this segment, thus posing a scalability challenge).

History has proven that it would have been worth lending multiple times between 1981 and 1991 to today’s IT consulting majors for their requirements. These were the early days when groups of youngsters were running small shops from their homes; although they capitalized their savings, they had to struggle for funds. If only bankers then had the ability to predict these companies’ growth – companies which are now India’s most valued enterprises. On the flipside, one could also argue that there are many others who did not make the cut. How could a banker have differentiated? How does a banker cherry pick? What is this non-conventional wisdom that could prove so powerful in the hands of a financier? The answer lies in alternative lending models that are powered by the use of data and knowledge.

India today has witnessed data explosion unlike any other economy over the past 10 years. With over 60 crores internet subscribers, India is one of the biggest telecom markets. However, India’s telecom growth has remained skewed towards urban regions which have a tele-density of almost four times that of rural areas. With lower cost of data and competition amongst telecom operators, rural internet penetration is expected to witness a higher growth. With roughly 50% of MSMEs situated in rural areas, digital infrastructure is expected to be a key growth driver in digital lending to MSMEs.

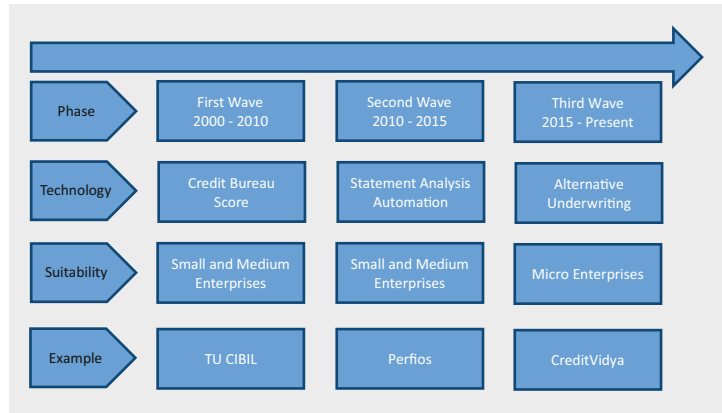
Credit Supply to MSMEs:

The credit supply to MSMEs has grown in the past few years. The overall lending by banks and NBFCs to MSMEs has grown at a CAGR of 22.5% from 2016 to 2018. Credit supply to both the segments of MSME (that is, the individual and the entity) has grown at 28.5% and 18.7% respectively. As of March’19, the total on-balance sheet commercial lending exposure in India stood at INR 64.1 Lakh Crores with the Micro and Small segments constituting around 24.9% of commercial credit outstanding. Micro and SME Loans have shown a Y-o-Y growth of 19.8% and 15.6% respectively during year ended March 2019, while the MID segment has grown by 5.5%

An important aspect of this growth in credit to MSMEs is the rise of unsecured lending to SMEs. Liquid income assessments and flow-based lending has emerged as the models adopted by banks and NBFC's to augment smaller ticket lending. There is lesser reliance on traditional documentation and valuation processes. It is now an accepted fact that the one who possesses considerable immovable properties, need not necessarily be the more credit worthy borrower. Lenders have developed systems and analytical capabilities, to simulate and create customer personas based on qualitative aspects and data points that were not consumed by them traditionally.

Credit Analytics

Credit analysis and underwriting is one of the most critical steps in the loan lifecycle. There are various players in the ecosystem that leverage technology to offer underwriting solutions to financial institutions. The chart below illustrates the evolution of credit solution providers over the years.



Developing Ecosystem Enablers

Today, Aadhar has enabled instant and seamless authentication process, thus enabling financing of transactions on the go. Despite privacy and data security concerns, unique identification and authentication continue to be essential prerequisites for entering into valid contracts. Hopefully, the regulator and authorities will find appropriate means to address concerns raised by all stakeholders and make this mechanism work for the larger good of society, especially for the SME community. Once the apprehensions are addressed appropriately, this enabler will greatly help in evolving multiple alternative lending models and market place models.

Coming to Goods and Services Tax, the Goods and Services Network (GSTN) is touted to be a big data treasure for financiers. Given the mammoth size of data it offers, the GSTN can certainly provide useful insights for financiers to develop models that can give them better visibility about the borrower business models. By adding advanced data science innovations and predictive algorithms, these data sets could prove to be the magic ingredient needed to identify many potential unicorns early in their life.

Also, mobile penetration and the government's thrust for cashless transactions are generating terabytes of new data points every minute. New age analytics companies are viewing these opportunities as potential business models and we are now having living examples of many data enterprises adding value to the MSME lending ecosystem.

Deeper Knowledge of Borrower Ecosystem

With the use of data encryption and distributed ledger technology, digital contracts are fast becoming a reality today. As the use of digital becomes more universal, the need to be transparent in pricing and margins will further rise. This will give room for safe and more secured data sharing arrangements between the financiers and borrowers. To further the lender's knowledge, the borrower ecosystem will also strengthen the financier's ability to foresee risks associated with the credit decision and accordingly design the terms in the lending contract. As lenders develop deeper specialization in sectors, this process could become more seamless. Insight-driven knowledge is the new way of securing a lending portfolio. Financiers would need to invest in creating better knowledge systems and insights about the borrowers and their ecosystem to remain secure.

To sum up, alternate lending models like bill discounting, warehouse receipts and dynamic working capital limits are picking up pace. Point of Sale (POS) linked financing models and subscription models are already transforming SME financing. With the advent of newer innovations and digital models every day, the economy is looking brighter and the future good - considering the immense potential for growth. Deeper knowledge of borrower business models and predictive capabilities within this ecosystem will go a long way in helping alternative financing models mature faster than we anticipate.

Alternative Financing for Indian MSMEs

Important Building Block for a USD 5 trillion economy

By Mr. Suman Chowdhury, President – Rating Operations, Acuité Ratings & Research Limited

There is no denying the fact that a sustainable growth of the MSME sector is the key to a healthy expansion of the domestic economy.

Nearly 60 million MSMEs account for more than 29% of Indian GDP and employ over 110 million people, contributing to almost 45% of all manufacturing output (although such estimates vary widely). IFC data interestingly, reveals that there are as many as 23.9 MSMEs in India for every 1000 people; whereas in China, there are 7.7 MSMEs for every 1000 people and the industry is mostly concentrated in the large scale segment. Despite such a large population of MSMEs, financing requirements of these enterprises often remains unmet.

Data collated by Acuité Ratings suggests that the debt requirement of Indian MSMEs is in the vicinity of \$520 billion (Rs. 36.4 trillion) and in the short term, only 38% of it can be sustainably met by the formal financial sector. The latest data from RBI highlights that the outstanding loans from the banking sector to micro and small enterprises categorised as priority sector stands only at Rs. 10.48 trillion with a modest growth of 7.3% over the last 5-year period (2014-2019). If one includes the indirect financing of SMEs through NBFCs and the miscellaneous lending to SMEs not included in priority sector, it will be in the range of Rs. 16.0- 18.0 trillion. Clearly, there is a large funding gap of over 50% which remains unmet or at best, met through the unorganized sources at very high interest rates. This has particularly impacted the micro-enterprises to a large extent where the funding gap is as large as 80%.

The other important aspect in MSME financing is that most of the discussion around this subject centres around debt while equity is expected to be contributed only by the promoters. The lack of access to long term funds mainly equity has been a key reason for the higher vulnerability of the sector to economic downturns and liquidity squeeze. While the government facilitated the launch of SME listing platforms in both NSE and BSE in 2012, only 400 SMEs have been listed so far, given the challenges in particular on compliance requirements. It is therefore imperative that alternative financing for MSMEs in India go beyond traditional sources such as banks, NBFCs and public equity markets.

The Origins of Alternative Financing for Indian MSMEs

During early 1980s, Government of India brought the Technology Policy Statement to commercialize technology and foster a technological revolution in the country. For giving a boost to the scheme, alternative investment funds could invest in technology-oriented sectors in the late 1980s. The success story and the scalability of Indian Information Technology (IT) sector in the 1990s and thereafter highlights the contribution of these funds, especially venture capital, who were instrumental in nurturing the nascent industry.

While this success of Indian information technology sector is well known, the role of the alternate investment funds is far from over since still exists a huge potential in the economy in the context of the emergence of new technologies and new business models. The investment opportunity in the Indian MSME space is huge and largely untapped as the country aspires to become a USD 5 trillion economy by market size over the next five years. With a sustainable and robust growth in per-capita income, India's consumption led story is the second most attractive, after China, for foreign alternative funds in the Asian region. Interestingly, the venture capital (VC) funds raised to GDP share in India has scaled up substantially from 0.04% to 0.50% in a relatively short span of time between FY14 and FY18.

Fund Sources in VCs Largely Foreign; Access to Large Corporate Surpluses Necessary

The foreign participation in alternative investments is estimated to account for more than 70% of the total corpus. Clearly, there is a significant scope for an increase in domestic contribution from HNIs, family offices, corporate surpluses and also separate corpuses from financial institutions. We reckon that higher domestic investors' participation can actually encourage more foreign investments and would validate the large growth prospects of Indian MSMEs, which are starved of sustainable and affordable growth capital.

Ironically, domestic participation in this space cannot be attributed to a lack of funds. Acuité's research indicates that large corporates in India carry significant cash reserves; it is estimated that liquid surpluses of large corporates, having net worth of more than Rs. 5,000 Cr have increased by 30% on average over the past three years.

Understandably, the capex cycle along with return on investments in the private sector has slowed down substantially in recent years, leading to accumulation of cash surpluses for meeting future requirements including overseas deployment. A part of such cash reserves from the corporate sector or from family offices (if distributed through dividends) can find its way to MSMEs through VC funds.

The Concept of Corporate Venture Capitalists and Relevance for MSMEs

Furthermore, it is observed that corporate partnership in venture capital deals in India is weak. It is only limited to 5% in India as compared to a healthy proportion (12-15%) seen in prominent countries such as US, European Union member countries and China. In the latter, the concept of Corporate Venture Capital (CVC) is prominent and corporations take pride in such engagements with a strategy to diversify their exposures and help build new business models or brands in this digital age.

The deployment of the available corporate surpluses in MSMEs through VC funds can be a win-win situation for the stakeholders. It can not only provide higher return on capital for the corporate shareholders but can also be seen as an integral part of their corporate social responsibility (CSR) initiatives while also addressing the funding gap challenge in the MSME segment.

Additionally, the MSME eco-system in India is in dire need of professional experts and technocrats from the large corporate space. Corporates may not only be strategic investors through VCs but can also mould and guide investee MSMEs owners. As India aspires to be self-sufficient in high tech yet critical industries such as defense (avionics, turbo-fan technology as well as self-defense suites) and telecommunications, there lies an immense opportunity for alternate investment financing and a collaboration between the large corporate and the MSME segments. The transfer of technology and other related requirements is creating entire value chains in various sectors, spawning a vast array of specialized MSMEs, needing requisite financing and mentoring.

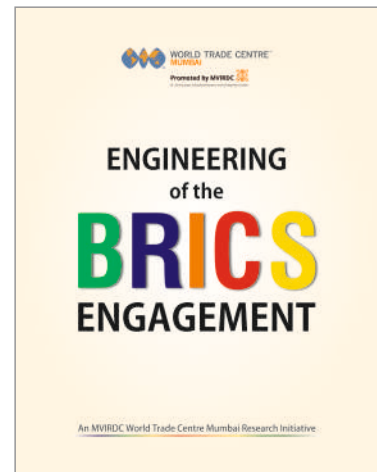
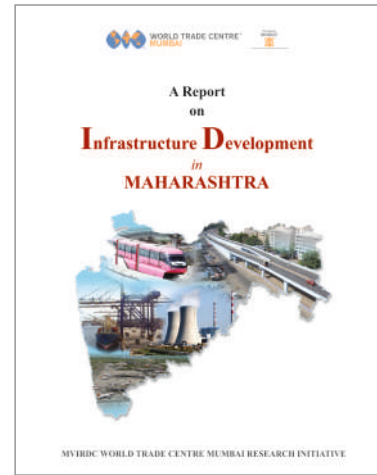
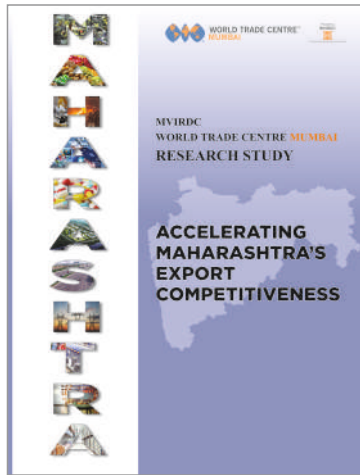
Better access to trade finance for MSMEs need of the hour

Needless to say, MSMEs have larger working capital cycles as their bargaining power is limited. They are not in a position to stretch their creditors while typically their large customers stretch their receivables. Most of these enterprises don't get adequate working capital support from banks who seek higher collateral security; further, unsecured borrowings from NBFCs are highly expensive. It is in this context that the availability of trade finance through services like factoring and bill discounting from non-banks assume significance. There is a clear need to increase the penetration of factoring services among Indian MSMEs. Given that the latter contributes to around 40% of Indian exports, overseas trade finance mechanisms also need to be strengthened. The credit concerns of the factoring and the bill discounting players can be addressed through better quality of information in SME grading reports (where Acuité is a significant player through its SMERA brand) and also through credit insurance.

Floation of the Bharat MSME Fund

In the context of the large funding gap in the MSME space, the idea of a "Bharat MSME Fund" can also be actively considered. While a few public financial institutions such as SIDBI do raise bonds from the market to finance its direct and indirect financing to MSMEs, a specialized asset management company can be set up either as a subsidiary of these institutions or as an independent entity which can mobilise funds from the public or even institutions and deploy them in either debt or equity of MSMEs and start-ups identified as having sustainable business models. The government may consider providing tax incentives for such investments to attract the much needed funds. Given the long term prospects of the MSME sector, the returns of such a fund can be healthy. However, the management of such a fund needs to be undertaken by an independent professional team that has extensive experience in the MSME sector.

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