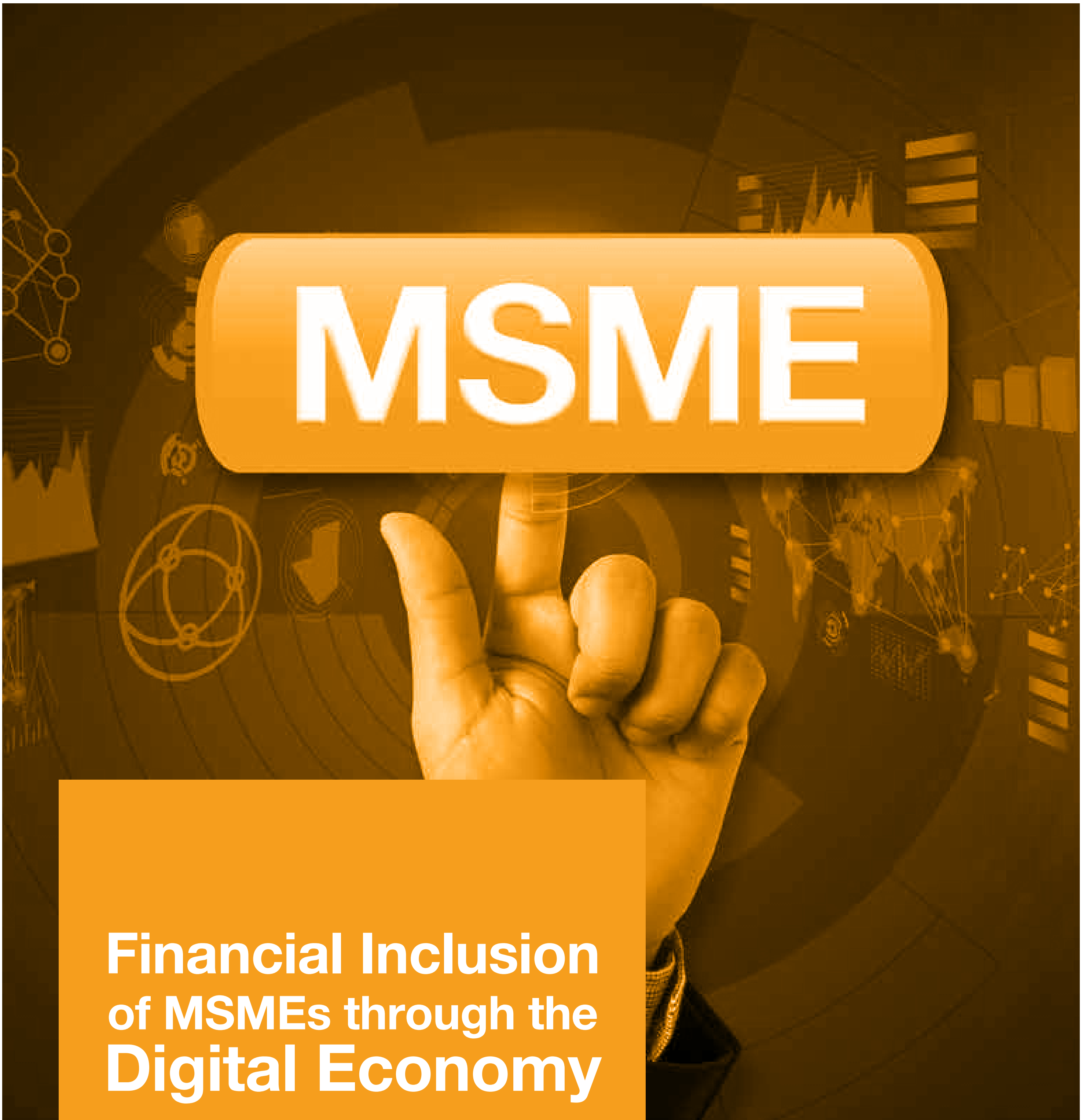

Financial Inclusion of MSMEs through the Digital Economy

December, 2016

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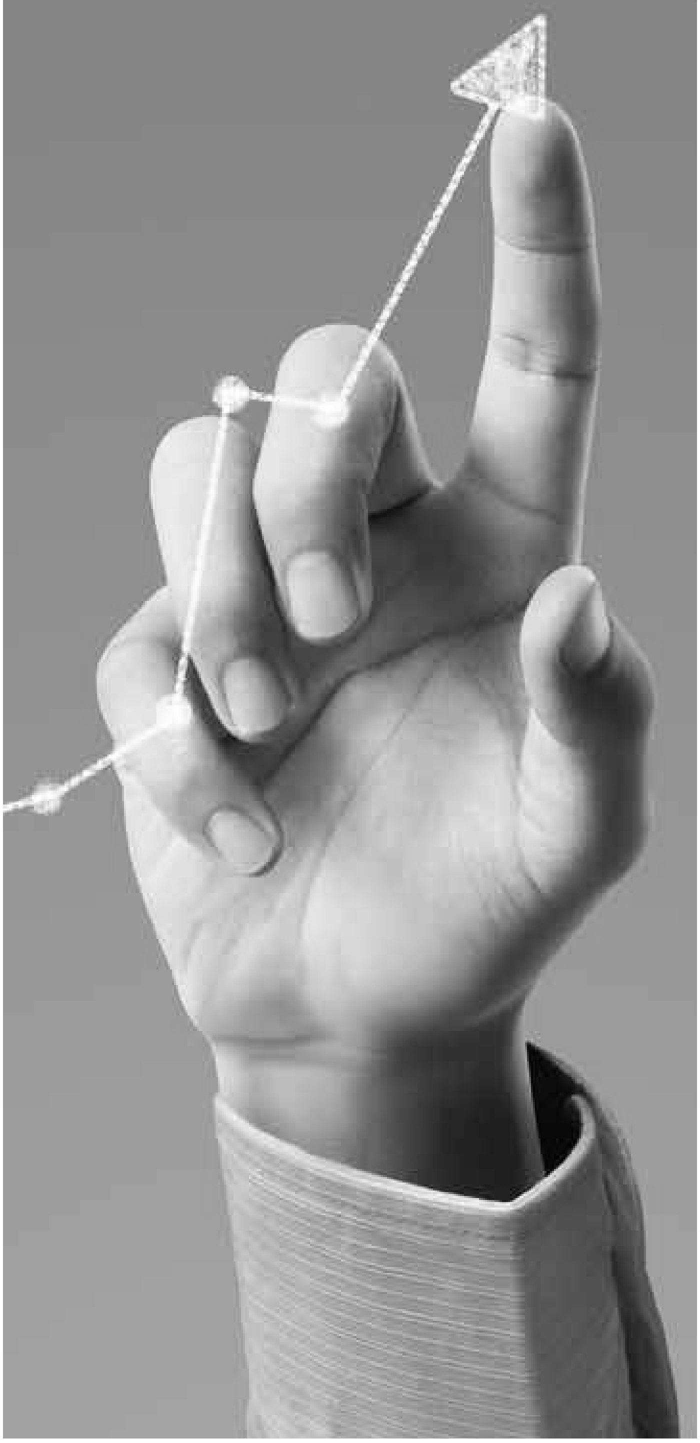

Executive Summary

Micro Small and Medium Enterprises (MSMEs) contribute about 37.5 percent to India's GDP, account for 40 percent of total exports and employ up to 10 crore people (GOI, 2015). Despite this, access to finance remains a systemic concern in the sector. The current demand for loans in the MSME sector is about INR 26 lakh crores, and only INR 11 lakh crores has been made available, that too from several informal channels of financing (RBI, 2016). Almost 87 per cent of MSMEs have no access to finance and merely 11 per cent have access to institutional lending (4th All India Census on MSMEs).

Even if they can access institutional credit, MSMEs tend to plan growth around capacity expansion and not productivity enhancement, whereas banks tend prefer to fund the latter given their risk management priorities. The higher risk profile associated with capacity additions in small firms coupled with low capitalization, fewer fixed assets and inadequate business plans leads to a loss in creditworthiness and the inability to access bank loans. Even the non-banking finance companies (NBFCs), which cannot take retail deposits, must lend at higher rates than banks, leading to loss in competitiveness of small firms. The firms instead access alternative informal sources of funds or worse, fall back to non-institutional sources like local moneylenders at higher borrowing costs.

There is growing recognition within the policy community that financial inclusion for MSMEs cannot be confined to opening of bank accounts, but must ensure access to the full range of "catalytic" financial services, including, but not limited to, savings, insurance, payments and credit.

The challenges in the financial inclusion of MSMEs identified by the Ministry of Finance (MSME Committee, 2015) centre on the lack of connectivity between beneficiary, institution and owner of capital.

Lack of information on beneficiaries hampers satisfactory credit risk assessment by formal and informal financial institutions. This leads to hesitation in providing financing and subsequent reliance on traditional sources of credit and a dissociation from the credit ecosystem. This cycle perpetuates exclusion. The nature of service-delivery is presently supply-driven with users of financial products seen as beneficiaries rather than economic actors. This attitude is furthered through the lack of robust last mile delivery platforms which can offer context-specific, tailored solutions rather than static, regulatory prescriptions.

Growth of the smallest businesses within the MSME sector is particularly constrained because of the credit gap. Research suggests that while 70 percent of micro-enterprises now have bank accounts (Janalakshmi, 2016), only 15 percent of their working capital needs are being met through institutional financing, 59 percent relied on promoter financing and 26 percent on supplier credit (Crisil, 2016). The lack of organized credit, effectively stunts the growth of the MSME sector and is a particularly compelling challenge in terms of creating equitable growth opportunities for all.

The Government has made efforts on financial inclusion across the board. For individuals, the Pradhan Mantri Jan Dhan Yojana (PMJDY) has opened over 24 crore accounts, enabling a first level of access to the financial system. Activation of these accounts will follow, through use of direct benefit transfer for social security and other schemes, and by increasing financial literacy. The challenges of deploying PMJDY, such as controlling account activation costs and overcoming technological barriers, can be better met by partnering with the fast evolving payments industry. These issues have been thrown in sharp relief because of the challenges faced by National Payment Corporation of India (NPCI) with providing PIN to the large number of recipients within the stipulated period, causing the cancellation of the guaranteed automatic insurance. Moreover, the Government's push to actualize e-KYC through Aadhar has been insufficiently realised.

Commendably, Prime Minister Modi launched the MUDRA Yojana in 2015, to develop and refinance all banks and microfinance institutions (NBFC and MFIs) in the business of lending to small business.

A slew of measures, discussed in this paper, can be undertaken to strengthen and supplement the initiatives of the Government:

It is known that Indian states with higher Internet penetration can be expected to grow faster, and by 1.08 percentage points for every 10 percent increase in the number of internet subscribers (ICRIER, 2012). A large part of these economic gains can be harnessed through sustained efforts in helping the MSME sector access the financial system digitally.

While initiatives such as the notification of Priority Sector Lending for MSMEs and MUDRA signal positive intent as far as inclusion is concerned, there is a lot more to be done from an ecosystem development standpoint to make sure that access to credit is based on the larger volume of data being made available through digitisation as well as greater market competition from 'asset light' models for disbursing credit

It is in national interest to allow all network partners to participate in this important government initiative in an open and level playing field within a defined regulatory framework which will help government leverage the capabilities and experience of private sector networks in working with governments internationally, to deliver successful financial inclusion programmes. For instance, global payment networks can provide the requisite outreach infrastructure for payment banks, including Indian Post Payments Bank, which are struggling to create a business model to monetize the Base of Pyramid (BoP) opportunities presented to them

Beyond product sophistication and policy convergence, financial literacy remains the final frontier of inclusion. Effecting behaviour change involves leveraging every form of outreach and partnership to make the features of the digital financial ecosystem common knowledge

To highlight related financial inclusion opportunities and challenges as experienced by Indian MSMEs in particular, the Confederation of All India traders (CAIT) organized a panel discussion through the Alliance for Digital Bharat (ADB) on 6th October, 2016. It is pertinent to note at the outset that most of CAIT's six crore members are MSMEs, ranging from hawkers to sole proprietors and differentiated merchant businesses, and therefore the stakeholder mix within it is as good an approximation of the business ecosystem in the country as possible. This paper begins by outlining some of the structural challenges faced by the business community and goes on to suggest a few ways to overcome them with a focus on the growing digital ecosystem.

Structural Challenges

The need to extend support to MSMEs is part of the RBI's financial inclusion agenda. The RBI has prescribed that Priority Sector Lending guidelines extend to include loans to MSMEs. It defines the problems in MSME lending as constituting of:

Access/Availability:

The need for MSME loans is significant. The adequacy of banking infrastructure, particularly across remote areas is suboptimal. The banking correspondent model, designed to reach the last mile has not been able to fill the infrastructural gap.

Banks and Businesses:

Financial management and the regulatory ecosystem around it can be challenging for MSMEs owing to capacity constraints. Financial literacy is a big gap, along with skills like accounting, which can be addressed through digitisation.

Collateral:

Loan applications by MSMEs are often rejected by formal institutions due to lack of collateral. Alternatives to collateral based loans for MSMEs are already being developed.

Documentation:

MSMEs often do not have adequate documentation to match the needs of formal finance. This excludes them from accessing financial services.

Bank lending to MSMEs in India is virtually stagnant. As per the RBI, commercial bank credit to the non-food sector has been reduced to 8.2 percent year on year growth as of August 2016; a stark comparison to its peak of over 38 percent in 2005-06. Stakeholders at the conference discussed that the lack of growth in credit towards retail trade over the last six months is cause for worry, with only a 1.2 percent growth in August over the credit given out in March.

Moreover, MSMEs have seen negative year on year growth of credit.

The challenges of credit extend beyond the subdued growth trajectory. There is a lack of support infrastructure, and timely disbursement of credit is also a challenge. There is an urgent need to think outside of the conventional credit discourse that is fixated on prescriptive, heavily regulated means to financial inclusion.

While capital markets represent the clear alternative to bank lending, MSMEs are not well placed to avail of liquidity through them. This is because raising money through capital markets involves high transaction costs in the form of compliance and listing requirements, as well as other challenging legal and regulatory prescriptions. Thus, capital market participation has been the preserve of larger firms globally. However, following from international trends, SME exchanges are also becoming relevant in India, which offers some hope. The Bombay Stock Exchange's (BSE) SME Exchange has already seen close to 140 listings and is expected to see up to 30 more Initial Public Offerings (IPOs) within the year. Stakeholders suggest that awareness among MSMEs, of such institutional channels, and fiscal benefits such as exemption from long term capital gains tax remains low.

Despite efforts, MSMEs are also unable to fully leverage financial inclusion schemes run by government, such as Priority Sector Lending, owing to several structural challenges. Approximately 90 percent of the MSME sector is informal, and fear of audit, penalties, large taxes, keeps businesses away from formal institutions. Many MSMEs don't have the required documents relating to accounts, transaction and income and many struggle with delayed payments in the supply chains within which they participate. While the MSME Act has prescribed a maximum limit of 40 days for receipt of payments, the average time for receipt of payments is around 70 days (Crisil, 2015) – this hampers timely deployment of working capital and the ability to service debt.

The challenge of unavailable credit history is also compounded by lack of skilled risk assessment staff in banks, few credit ratings of small businesses and limited uptake of alternative risk assessment frameworks. Thus, loans against property constitute most of the lending by banks to MSMEs, wherein properties of owners, proprietors, and partners are mortgaged with the bank. The lack of collateral is a major reason why 70 percent of MSMEs, i.e. those with turnover of less than INR 25 lakhs, and receive credit from formal sources (Ministry of Finance, 2015).

Recognizing this impediment, the Basel Committee on Banking Supervision has recently floated a Consultative Document providing guidance for effective banking supervision to institutions relevant to financial inclusion. This gives credence to business models which use alternate credit scoring and screening techniques such as non-financial data and big data analytics. While being a potentially disruptive step in the direction of risk management, businesses remain wary of the safety of digital transactions. Issues like server downtime, interrupted transactions owing to low quality of telecommunications services, sharing of personal information, and recent ATM frauds exacerbate the perceived challenges among small businesses. These behavioural and infrastructural challenges will encumber the fast uptake of new technologies like NPCI's new interface Unified Payments Interface (UPI) – despite record rates of proliferation of smart-phones at 2.5 crore units sold quarterly in the country. And finally, as was concluded by stakeholders at the conference, at the heart of the gap in access to credit is lack of information and awareness. Most MSMEs do not have information about the products available to them and dissemination of information on BoP products is also low. As last mile outreach by financial institutions and civil society is limited – there is no continuity in engagement between banks/NBFCs/MFIs and users.

This discontinuity is significant since the inclusion of B2B flows in the digitization mandate can be an effective means of on-boarding a large number MSMEs. The inherently networked nature of business-related flows- maintenance, repair, procurement of office supplies, equipment, technology, temporary employment, couriers, events, support services- can spread awareness about products quickly. They can also exert a combination of persuasive-coercive influences on late adopters of technology and plug leakages at various levels.

Way Forward

To address many of the challenges cited above, the Government started MUDRA, which promises to process loans in a timely fashion without a guarantor/collateral and with simple documents for loans up-to INR 10 lakhs. However, stakeholders suggested that there are challenges with the MUDRA model as well; that have led to lower than expected results. MUDRA's primary mandate is to "fund the unfunded", but only a small number of borrowers have been found to be first time borrowers (MicroSave, 2016). Banks perceive MUDRA loans as having high risk and low return potential, and have been careful to only extend loans to pre-selected customers identified as reliable. Outreach and awareness has been limited. Concomitantly, MUDRA users have only received 83 percent of the credit demanded. Further, of the 143 institutions under MUDRA, only 43 percent are refinanced per Government data.

The absence of 'Middle India' in the inclusion discourse is a larger, unaddressed issue. Meeting the credit and financing needs of this section of the Indian populace, distinct from middle-class India, is critical for completing the loop on financial inclusion. At present this segment saves only 7.7 percent of household income and just 12.7 percent of loan-seekers have managed to acquire credit (Hedrick-Wong, 2016). The formalization of this economic group should supplement the subsidy-driven inclusion programme of the poorer segments as one of the key objectives of the inclusion agenda.

Much of the current MUDRA landscape is reminiscent of the structural challenges discussed previously. Therefore, stakeholders agreed that a holistic and harmonised approach should be adopted by government, financial institutions, technology companies and MSMEs to improve the efficacy of the ecosystem. And technology can play a central role in achieving such alignment. The following suggestions derive from this:

Financial Awareness and Literacy

There is need for a comprehensive outreach strategy which includes information camps in media dark areas, television, radio and newspaper advisories and banking agents who can hand hold MSMEs through the process of understanding and accessing institutional credit. Beyond awareness, targeted financial literacy programmes are needed to enable small businesses to harness the benefits of the financial system including capital markets. Businesses should be equipped to understand the products available to them, the implication for choosing one product over another, and the processes of accessing each product.

Financial awareness and literacy are naturally complemented by digital literacy. India finds itself in unique circumstances wherein it is perhaps the only country in the world where lakhs are becoming digitally literate in some form, despite not availing of formal education. This category of technology users is “keypad literate” before learning to write with a pen. Moreover, many mobile phone users now have access to cheap ‘smart phones’ that can become conduits for targeted financial awareness and literacy outreach. In this context, the role of the private sector innovators is critical. For instance, the plethora of applications being developed on top of the existing UPI infrastructure, can potentially help in leapfrogging over traditional infrastructural limitations such as lack of rural bank branches or limited time windows for conducting transactions. Informational applications such as those that constitute the “India Stack” (a set of Application Programming Interfaces managed by a not for profit coalition called iSpirit) are also going to enhance user engagement with the financial system through intuitive interfaces. Given the potential of the UPI in revolutionizing the mandate for financial inclusion, there is a need to open the platform to all forms of electronic payment options. This will not only enhance user experience, but enable people to enjoy the benefits of interoperability. With access to a myriad of payment options, consumers can seamlessly transfer credit without being locked into using a particular platform and also not lock out people who want to transfer credit to them.

Additionally, the RBI has mandated that banking correspondents (BCs) will conduct functions like opening of accounts, helping with withdrawals and deposits, yet the business model is currently unviable as incentives to BCs are not enough to keep them in the market. Course modules disseminated in regional languages can help bridge some of the extant information gap.

Incentives to Digital Onboarding

There is incumbent need for Government to actively develop incentives for MSMEs to embrace the digital financial system. Although three out four merchants acknowledge that accepting digital payments would accelerate sales, other potential benefits such as improved recordkeeping, better control on finances and brand-building, have not been sufficiently highlighted (Incite, 2015).

Ancillary products which can be packaged with a core payment terminal can better capture the many benefits of digital payments:

Potential use cases include invoicing, billing and collections, sales tracking, inventory and stock control, customer engagement and retention, campaign management and rewards

Providing alternatives to bank financing and insurance, to boost cash flow, meet working capital requirements and protect from unforeseen stoppages and disruptions

Other potential linkages can be made with e-commerce platforms and on-demand services

Since many MSMEs are individual-only businesses, personal financial planning, wallets and new insurance models can also be incorporated (McKinsey Global Institute, 2016)

The wide diffusion of Near Field Communications (NFC) devices, mobile PoS, Bharat Bill Payment System and PayGov can enhance the acceptability of digital as a means of interaction with participants in an economy. For instance, companies in developing countries like Kenya and Mexico, already leverage data from digital payments to create risk profiles and arrange for financing from lenders with the appropriate risk appetite. Although these would require significant regulatory oversight, a phased deployment could address the credit gap as well as popularise digital payments.

Moving beyond Collateral based Lending

The expansion of the digital finance ecosystem will present many opportunities and challenges. A development to watch will be the evolution of the Trade Receivables Discounting System (TReDS). This platform will enable supplier financing in which MSMEs across the country can sell their credit-worthy accounts receivable at a discount (generally equal to interest plus service fees) and receive immediate cash from the buyer (typically banks and NBFCs). This will help MSMEs tackle challenges relating to lack of working capital and common delays in supply chain payments. A digital platform/exchange to enable 'factoring' is currently being set up through a joint venture between the National Stock Exchange Strategic Investment Corporation Limited (NSICL), Small Industries Development Bank of India, Axis Bank and Mynd Solutions.

Touching an annual turnover of around INR 31,000 crore, factoring volumes in India are very low, at around a hundredth of the size of the Chinese market. While the setting up of the above mentioned platform will address part of this lack of volume, a large amount of groundwork needs to be done by government and other stakeholders for raising awareness within MSMEs. Given that retail sector is well-integrated with its supply chain back-end, targeted dissemination of information through merchants may prove to be an effective means to enhancing the factor market in India.

Peer to peer (P2P) based lending is also growing in India – and new companies (NBFCs) are entering this space to plug the funding gap for MSMEs. Although the RBI is in the process of prescribing precise rules, innovators have promoted the use online platforms to match lenders with borrowers to provide unsecured loans. It is imperative that the regulator continues to balance consumer protection concerns with access linked goals. This innovative model, reduces traditional barriers to capital and can open lending for a lot of small businesses. Most such platforms are online, which simplifies engagement and transactions. Linking these with the Unified Payments Interface and credit bureaus would also promote horizontal usage and enrichment of credit histories.

Overall, as transactions and businesses are digitized and with the growth of e-commerce, it is possible to move beyond collateral and use business data to service loans to MSMEs, particularly those within the merchant community (owing to a degree of standardisation in basic bookkeeping). Notably, ecommerce firms in China have begun to distribute credit cards to merchants based on transaction histories. In India, a few leading players are also in the process of making available short working capital loans to merchants, based on the transaction history of the merchants. Transaction histories can also enable the financial sector to better assess risk profiles and provide loans and equity to previously unfunded MSMEs. Such equity financing and credit guarantee schemes are currently hamstrung by a lack of awareness, information and flexibility of financing options. The move away from collateral based financing to cash flow based financing will also diminish the large interest rate spread between credit available through formal channels and informal channels.

Private Sector Competition

Last year, the volume of electronic clearing surpassed that of paper clearing, owing in large part to the increasing role of the private sector in creating solutions for users. The market capitalisation of large state owned banks is also witnessing a long term downward trend, indicating that a competitive private sector is emerging. The government will always play a key role in developing the backend infrastructure. However, front-end products and service delivery, must be unencumbered by government intervention to the extent possible. As the digital financial market develops, India is also bound to grapple with competition issues around interoperability, regulatory coordination and data sharing. The Government would do well to reflect on international experiences and best practices in this regard, and to delineate clearly, the role of various financial market regulators with respect to digital products and services.

Tailor Made Credit Services

The Government should consider reducing the MSME credit gap by ensuring that the regulatory framework recognises that risk assessments, products, repayment rules, interest rates are increasingly going to be tailored per individuals and businesses rather than be based on certain pre-ordained formulas. Technology will enable such dynamic assessments, particularly as more data become available through online transactions and the eventual advent of the Goods and Services Tax.

Reimagining MUDRA

While it is still early days for MUDRA bank, it is important to draw lessons from existing evaluations and feedback. There is need to incentivise banks to reach out to customers and increase MUDRA loans, especially to first time borrowers. Transaction histories from PMJDY accounts can be used to identify potential MUDRA customers, as the segment for both schemes is likely to be similar (MicroSave, 2016). It may also be possible to enrol BCs to conduct risk assessments for MUDRA loans, and inform MSMEs on innovative new products.