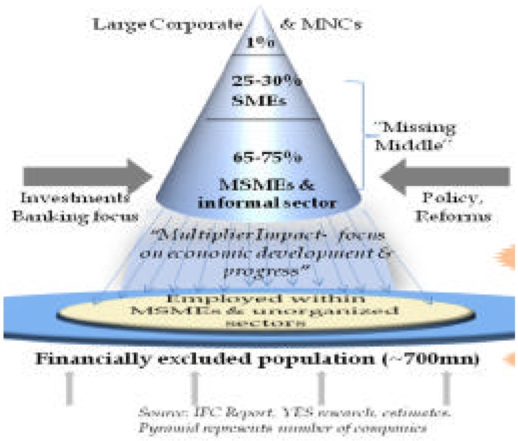
# Accelerating Financial Inclusion through MSMEs

**Rana Kapoor**
*Founder, Managing Director & CEO*
*Yes Bank Ltd.*

India is at the cusp of its pre-crisis growth trajectory, and is extremely well positioned for the next growth cycle. While there are short term escalating concerns on high inflation, systemic liquidity risks, global uncertainties and market fragilities, there is a broad consensus that India must continue to grow steadily, and should focus on making this growth sustainable and inclusive.

Over the last few years, the agenda of financial inclusion has become a national imperative with progressive initiatives being taken by the Government, various policy makers including RBI, private sector & financial institutions. While there is increasing awareness and consensus on the importance of financial inclusion, the same doesn't reflect around the "strategic processes to achieve" the objectives of financial inclusion. It is also important to appreciate that the objective of providing affordable access of suitable financial services to the financially excluded is driven by the broader agenda to **ensure economic development** of this class, and **their inclusion** is only a **means to an end** and **not the end in itself.**

While the current focus and efforts are predominantly on providing **banking services to the financially excluded**, this "**direct intervention of banking the unbanked**" through various models such as branchless banking, banking facilitator, banking correspondent, mobile technologies etc., is fraught with a significant challenges for the financial institutions such as high entry barriers and higher go-to-market & servicing costs, which hinder the rapid scale- up of the programs. The challenge gets further aggravated with general lack of awareness and trust amongst the financially excluded regarding the benefits of the banking system. Hence, reaching out to the over 700 million citizens across 6 lakh villages who don't have access to formal banking system is likely to be a "**Hanumanian**" task. In my opinion, while the various initiatives, including the foregoing models and implementation of UID are essential, by achieving financial inclusion (in spirit) through this mode would take the better part of the next 2-3 decades. To fast track the inclusion objectives, these initiatives need to be complemented with other alternatives that have multiplier effect on economic development and progress of the financially excluded.




I strongly believe that **"Unleashing the untapped potential of the MSME segment"** by improving the bankability and thereby the competitiveness of this large segmentcan prove to be one such effective multiplier intervention model. The significance and role of the MSME sector is certainly an established fact, as it is a key driver of innovations and productivity at the grassroots level and is the backbone of the modern day Indian economy.

This large segment, presently constituting around 26 million units, contributes 45% of industrial output, 40% of exports, employs 60 million people and creates 1.3 million jobs every year, and ensures balanced regional and socially inclusive growth. As has been highlighted in various national and international forums, a healthy and growing MSME sector has a direct multiplier effect on the economic growth, and is a pre-requisite for sustainable growth of any nation.

**<u>MSME: Key Challenges</u>**

- Lack of reliable data to develop and assess policy implications
- Access to finance, particularly during crisis times
- Access to technology, R&D infrastructure and skilled manpower
- Inability of entrepreneurs to articulate business plans
- Unwillingness of entrepreneurs to dilute holdings, preferring to be 'big fish in a little pond' rather than being a 'small to medium piece of a much larger pie'.
- Limited marketing expertise to access larger/ export markets
- Lack of enabling policy environment to handle insolvencies
- Systems procedures and controls need strengthening
- Limited historical financial information on the companies

Inspite of their immense contribution and crucial role, MSMEs have remained the **“Missing Middle”,** in the scenario of the Indian economy. The sector is largely informal, with merely 10% of the units registered, and 95% of the sector not having access to any kind of formal institutional credit. The unorganized nature of MSME sector has resulted in an increasing gap between needs, capacity and policy responses. Further, the recent financial crisis triggered in the advanced economies adversely impacted the sector and revealed deficiencies in MSME financing. As a result due to constrained liquidity, the credit supply to the MSME sector was affected significantly.

To fuel this high growth potential sector of the Indian economy, a concerted effort is required to effectively address the challenges being faced by MSMEs, by adopting innovative SME financing models, robust policy frameworks and knowledge driven financial solutions, supported by relevant stakeholders including Government, financial institutions and trade/ industry associations.

**Innovative Business Models for MSME Financing**

Typically, MSMEs have limited access to equity capital with most promoters commencing business with their personal/ family funds, and the commercial banks remain the main source of financing for MSMEs. However, considering the nature and characteristics of the industry, involving riskier borrowers, asymmetric information, higher working capital cycles, servicing repayment commitments particularly during adverse market conditions, low bargaining power for interest rates, lack of technology/ internal systems/ controls/ corporate governance, and inaccurate risk assessment frameworks, access to finance remains a key concern. This results in the ever increasing **complexity and financing gap for MSMEs**, leading to a potential loss to the national economy.

The traditional approach for MSME financing that was based on rigid credit assessment frameworks, limited delivery channels and hierarchical structure for decision making needs to be replaced with new flexible models for MSME financing, to ensure **agility** and achieve **cost efficiencies**.

New age banks are moving to a more **flatter, horizontal and functional structure,** to enable faster, time bound and objective decision making processes, while financing MSMEs. In my opinion, this flexible structure should be further complemented by technology to make the application, appraisal and sanctioning process faster for the enterprises.

The issue of high costs of acquisition, servicing and monitoring the MSMEs, can be addressed through **innovative products** that are more suitable for such enterprises. Standardized products are being replaced by structured products such as receivable financing, cash flow based lending, asset securitization, guarantees, advisory services etc to provide a comprehensive solution to the MSME customers. Financial institutions should look at creative MSME financing models that can be implemented successfully in other economies, for their suitability in the Indian context. For instance, Japan has a framework for issuing bonds to family and friends to mitigate constraints faced by MSMEs. This reduces the operational hassles and simplifies the procedure, making it easier for MSMEs to raise funds.

The **Cluster based approach**, with support from local/ national trade associations, MSME development centres, and state promotional agencies, can prove beneficial for companies as well as for the development of the local area. There are several towns such as Coimbatore, Ludhiana, Guntur, Surat, etc. that witnessed rapid urbanization with establishment of local clusters. With forward and backward linkages of these clusters, the local communities around these areas also benefitted significantly. Further, clusters also provide a true understanding of the sector and companies to banks, and they are in a better position to take credit view and prudential decisions while extending banking facilities to these companies. Countries like Taiwan, Hong Kong, and Italy have demonstrated that a cluster based approach can be effective to compete in export markets. Working through industry-based clusters, MSME exporters in these countries have created competitive niches in world markets.

The rigid risk assessment models, that are largely dependent on the financial statements provided by the company, need to be replaced by new techniques to **distinguish between high-risk and low-risk MSME borrowers**. There exists a huge opportunity to bring the large number of MSME units under the formal banking system, through a more flexible and intelligence based credit appraisal methodology for MSMEs with specialist Relationship and Credit Managers.

Further, with the evolution of integrated technology platforms, banks should continuously work towards developing alternate channels including internet, ATMs, mobile, POS etc. This can result in significant reduction in costs and improve TAT’s substantially. Strategic tie ups with technology partners, such as use of mobile based solutions, can offer numerous opportunities for developing synergistic models.

**Policy Frameworks and Strategic Initiatives**

Appreciating the concerns of the MSME sector, the Government has taken number of progressive steps to develop a conducive environment for development of these enterprises. Focused steps were taken by the Government in response to the global crisis, including for refinance facilities, special window to augment credit flow to MSMEs, directing PSUs for timely payments to MSMEs, enhanced credit guarantees etc. As the economy tides over the financial crisis, a healthy business ecosystem should be created for MSMEs, based on market principles.

Industrial infrastructure, specifically for MSMEs remains inadequate, and has been repeatedly highlighted through various industry forums. Targeted investments are required to be made to create affordable industrial areas, industrial parks, technology incubators, with integrated infrastructure facilities, under MSME cluster programmes. "OVOP – One Village One Product" and "OTOP – One Tambon One Product" programs from Japan and Thailand respectively, have catalyzed development of industries unique to their regions, and have cultivated them to national/ globally accepted levels with strong geographic appellation, traceability and evolving trustmarks.

Rating of companies in the MSME sector can play a key role in channelizing finance to these companies, by providing benchmarks and improving transparency. Independent agency ratings for MSMEs, based on high standards of analytical capability, can provide greater confidence to lenders, and consequently broaden the range of financial resources available to MSMEs. Further, research work should be encouraged to improve credit information on MSMEs, by building MSME credit histories and developing credit scoring products.

Suitable policy frameworks should be devised to align the investors from public, private, PE funds, and other institutions, which approach MSMEs for financing with diverse set of offerings and expectations. With increased co-ordination among the participants within the MSME investment value chain, genuine needs of MSMEs can be addressed in a seamless manner.

A positive initiative towards improving the existing policy, legal and regulatory framework is the World Bank led multi agency project on financing and development of MSMEs in India that is currently being implemented by SIDBI. The Project aims at making MSME lending an attractive and viable financing option, and also facilitate increased turnover and employment in the sector, by strengthening the credit information system, credit rating, credit scoring, structuring of innovative products, capacity building of the participating banks, policy and regulatory issues and promotion of market oriented business development services for the sector.

**Knowledge Driven Solutions**

Most of the MSMEs are run by entrepreneurs who are adept in technical knowledge, but lack the financial, legal or managerial expertise, and are unaware of the financing options and Government schemes available to scale up their enterprises. To address this, banks should develop knowledge**/ advisory based approach** towards MSME financing, to drive **viability based funding rather than collateral based lending** to MSMEs, and to assist promoters for optimal use of capital. As technology and information sharing continue to improve, this approach will become even more cost effective and attractive to investors.

At YES BANK, we have made conscious efforts towards this and Knowledge Banking is one of our key pillars through which we focus on the MSME sector, with the objective of creating a knowledge-based platform for MSMEs, that enables **sharing of global best practices, analysing industry and sector trends, and applauding successes** in the diverse MSME universe of India. As part of our Knowledge-driven approach, YES BANK engages with industry forums such as **CII**, **FICCI**, **ASSOCHAM**, **PHDCCI**, among others, on various initiatives. YES BANK has developed significant knowledge capital through in-depth domain expertise in the sunrise sectors of the Indian economy. This has been amplified through exemplary knowledge reports that capture the upcoming trends and financing solutions for companies operating in these industries.

**Conclusion**

Against the backdrop of the need for sustainable and inclusive growth,, MSMEs present a huge opportunity to accelerate the ongoing inclusion initiatives. The associated socio-economic benefits with the growth of MSME segment, particularly in the Indian context, justify a case of focused coherent approach towards the growth of this segment. Financial institutions need to partner with MSMEs on their transformation path to emerge as the Future Businesses of India.