

MSME Funding: The Road Ahead



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It's common knowledge that the Micro, Small, and Medium Enterprise (MSME) sector is one of the critical engines fuelling the growth of India's economy. Besides providing intermediate supplies and invaluable services to large original equipment manufacturers, MSMEs generate employment, improve purchasing power, accelerate growth, and infuse a spirit of innovation and entrepreneurship.

ROLE OF MSMEs



29%

Contribution
to GDP



114 million

Indians employed
in MSME sector



93%

Contribution to the
Labour Force

However, they are also the most stressed and vulnerable sector across economies worldwide. India's MSME sector is constantly underfunded, under-supported, and overexposed to market risks and volatility. While the industry has been hard-pressed for capital before the coronavirus pandemic, the cash crunch and the consequent impact of nationwide lockdowns has squeezed the small businesses at the bottom of the pyramid the most.

Access to finance has been one of the crucial limiting factors that hinder the stability and growth of small businesses. While banks, NBFCs, and financial services institutions have been working tirelessly over the years to widen the financing ambit to include small businesses, MSME funding comes with several challenges.

Key Challenges in MSME funding

- **High-risk category**

One of the biggest challenges lenders face with MSME funding is the high risk associated with such lending. MSMEs that are still in their growing stages are vulnerable and highly susceptible to market volatility.

Additionally, MSMEs supplying to large corporations often experience severe working capital crunch due to long payment cycles that raise the question of their ability to service loans on time. Moreover, this sector has limitations on assets to offer as collateral, restricting the possible financing alternatives.

- **Financial reporting and compliance**

In India, small businesses still have a long way to go when it comes to formal financial reporting and compliance. Due to this, financiers have less information to review in their underwriting process, making credit assessment and taking calls on repayment ability difficult.

- **Poor credit history**

Given the continuous pressure on MSME's working capital, it is no wonder that a higher number of borrowers in this category default on repayments. Such misses get a bad reputation and ruin lenders' risk appetite to take on additional leverage in this sector.

- **High costs to serve**

Given the lack of formal reporting, small businesses require more paperwork and in-person follow-up, making it costlier for lenders to serve such clients. Additionally, given that their loan requirements might be small amounts for top lenders, the cost to serve puts a heavy burden on the margins making it less viable for financiers to extend services to this segment.

But these challenges are diminishing as financiers embrace technology and transform lending.

Role of technology in funding MSMEs

1. Digitisation of trade data

One of the biggest challenges of MSME funding was the lack of visibility and verified data sources on business performance. With the advent of GST and increased digital adoption, financiers today have access to data like never before.

Data indicating turnover growth over the years, timely repayment of past loans, meeting other payment obligations like utilities, supplier payments, and salaries on time can help lenders do thorough due diligence and accurate credit assessments.

2. Automation of lending processes

The other significant hurdle in MSME financing is the high amount of resources, effort, and time financiers had to invest in the document collection, credit assessment, loan sanctioning, and collections. The high cost to serve businesses with lower loan values discouraged several financial institutions from going down this path.

However, digitisation of lending has led to automating several processes from onboarding to collections while minimising manual intervention. A few ways digitisation has transformed lending illustrated below -

- o Technological advancements today allow borrowers to self-onboard by uploading relevant KYC details.
- o Employing Optical Character Recognition (OCR) helps systems read documents uploaded as images and enable automated data verification.
- o API integrations with Aadhar, PAN, and the Ministry of Corporate Affairs (MCA), to name a few, help financiers authenticate data in real-time.
- o Scorecard engines backed by self-learning AI and ML algorithms have helped streamline the credit assessment process requiring credit managers to intervene only in case of exceptions and stipulate sanction conditions.
- o Automation and disbursement APIs have helped ensure the funds are disbursed to small businesses within hours of sanction.

Moreover, automation and standardisation of processes help lenders keep costs under control as documentation is digital. Overheads such as document handling costs, transportation fees, and courier charges are removed, drastically reducing the cost per customer.

3. Enhanced risk prediction

Technology plays a pivotal role in building early warning systems that alert financiers of potential defaults. NPAs are nothing short of cancer to the health and vitality of any financial services institution. And, the biggest challenge to lend to MSMEs have been the imminent risk of such loans becoming bad debts given the susceptibility of small businesses to market risks.

AI-based risk prediction models can help financiers monitor trends across borrower's business performance, cash flow position, behavioural patterns, and other critical data points and raise timely red flags to report anomalies, if any. Armed with such technology, financiers can be prompt on their collections and lend to MSMEs with confidence.

Government initiatives

Besides technology, the impetus from the Government to enhance financial inclusion in the last decade has been noteworthy.

The Ministry of MSME and SIDBI has jointly established the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) to extend downside protection to lenders through a Credit Guarantee.

In addition, the Pradhan Mantri Mudra Yojana scheme launched in 2015 with a corpus of Rs 20,000 crore, and a credit guarantee corpus of Rs 3,000 crore empowers financiers to lend smaller amounts to SMEs.

The Micro Units Development and Refinance Agency Ltd (MUDRA) provides refinance support to the Banks, NBFCs, or MFIs that lend to micro units up to Rs. 10 lakh per borrower. Additionally, the Micro Credit Scheme Mudra offers business loans up to Rs 1 Lakh through Micro Finance Institutions (MFIs) to self-help groups, joint liability groups and individuals to develop a microenterprise and promote small business activities.

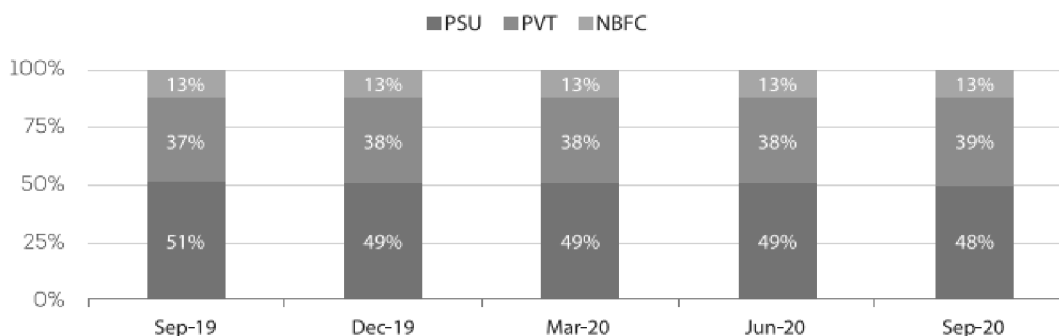
In May '20, following the first wave of coronavirus, the Government announced the Aatmanirbhar Bharat initiative that created a fund of funds to support equity infusion to MSMEs, subordinate debt options for stressed MSMEs,

revision of MSME definition to extend benefits to more small businesses, and provisions for clearing MSME dues in 45 days. Additionally, the Government offered a guaranteed emergency credit line to MSMEs under the Emergency Credit Line Guarantee Scheme (ECLGS). The scheme provides a credit guarantee to financiers on MSME lending of up to ₹3 lakh crores or 31st Oct, whichever is reached earlier.

These schemes, paired with the thrust towards formalisation of the industry by enforcing GST and e-invoicing, can go a long way in widening the reach of traditional financing to small businesses.

Share of NBFCs in MSME lending

Public Sector Banks have been frontrunners in MSME lending. A recent study by TransUnion CIBIL in February 2021 shows NBFCs share towards MSME lending at 13% in the last two years.



Source: MSME Pulse report by TransUnion CIBIL & SIDBI

However, the trend is gradually shifting as Private Sector Banks, NBFCs, and FinTech companies compete for larger MSME Lending market share. NBFCs have continued to tailor their offerings and credit policies to suit the workings of small businesses in the last decade. This expertise combined with technology-backed low-cost distribution models, broad market reach, and well-established presence beyond tier 1 cities makes NBFCs a suited funding partner for MSMEs.

Role of NBFCs in MSME lending

While the importance of MSME lending cannot be overstated, the road ahead post the pandemic is critical in sustaining small businesses.

NBFCs play a vital role in enabling small businesses with timely access to affordable credit. With minimal paperwork, flexible credit policies, higher adoption of technology and automation, NBFCs offer MSMEs a faster turnaround and convenient access to capital.

The need of the hour is for NBFCs to truly partner with MSMEs in their growth to unlock their true potential and contribute towards the collective vision of building a self-reliant India.