S S Mundra: ABCD of MSME credit

Keynote address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at the 2nd CII National Conference on MSME Funding, New Delhi, 23 August 2016.

* * *

Assistance provided by Shri Jose Kattoor, Ms. Sudha Vishwanathan and Shri Sanjeev Prakash is gratefully acknowledged.

1. Thank you for inviting me to deliver the keynote address at this second edition of the Conference on MSME Funding. I compliment the CII for having chosen a very relevant theme for the Conference 'Propelling MSME Growth through Enhanced Financial Access and Support'. The theme lays emphasis on two crucial pillars that are pertinent for the sector i.e. enhancing financial access and ensuring adequate support to enable MSMEs to attain faster growth.

2. It is universally recognized that small businesses are the best vehicles for generate jobs. A IFC /Mckinsey Study has estimated worldwide MSME population at 420 to 510 million, of which 360 to 440 million alone, are in emerging markets. The report also estimates that the formal SMEs contribute up to 45 percent of total employment and up to 33 percent of national income (GDP) in emerging economies and these numbers could be significantly higher when informal SMEs are included. The Asia SME Finance Monitor 2014 published by the Asian Development Bank has estimated that 96% of all enterprises in the Asian region fall under the MSME category, absorb close to 2/3rd of the working force and contribute to about 42 % of GDP.

3. According to MSME Ministry's Annual Report for 2015-16, MSME sector in India today is a network of 51 million enterprises providing employment to 117.1 million persons and contributing 37.5 per cent of India's GDP[1]. The development of this sector is, therefore, crucial in generating significant levels of employment across the country, more so since we have a large young and educated population which is on lookout for employment.

MSME – significance beyond job creation

4. While job creation is certainly critical, small businesses play a far greater role than just providing employment. Let me state two key contributions of MSME sector here.

5. One, the MSME sector is a nursery for entrepreneurship and a school for innovation. Countless medium and large corporates in India have evolved out of being micro and small sometime in not so distant past. I am sure many in the audience here, who own fairly large businesses today, would have cut their teeth in business through the route of micro and small enterprises.

6. Secondly, MSME sector is crucial for the success of the national agenda of Financial Inclusion. Let me explain. Normally, when we talk about financial inclusion, we do so largely from the perspective of an individual or at best a household. However, to my mind, universal financial inclusion cannot be considered to have been achieved unless it is ensured that the micro and small businesses are financially included. Credits to these small family run or individual run entities from the formal financial channels would make these businesses sustainable and help them move out of poverty and propel them to a better quality of life.

7. The surmise that I am trying to drive at is that if this is the sector that is the bulwark for such critical developmental paradigms, there are compelling enough reasons for all stakeholders- be they the Associations, the Financial Institutions, the regulators or the Government, to put

[1] Annual Report, Ministry of MSME 2015–16.

all their might together in a convergent fashion so that the right environment is created to propel growth of MSMEs in our country.

8. For achieving this objective, there is a need to create an ecosystem which can facilitate handholding and nurturing of MSME units particularly at the nascent stages. Also, there is a need to eliminate a host of impediments – of permits, of inspections, of red tape and provide a set of enablers – skill development, infrastructure, markets, technology etc. However, of all the enablers, probably none is more important than Credit. The IFC/Mckinsey has estimated the credit gap for formal and informal MSMEs worldwide at around $ 3.9 trillion globally, of which $2.1 to 2.6 trillion is in emerging markets.

The ABCD of credit

9. As I said, credit is perhaps the most critical component for MSME entrepreneurs. Provision for Credit is essentially dependent on four pivotal issues which I would call ***"ABCD" of credit***. Let me take you through each of them and also explain what we are doing to iron out these issues.

a) The á of credit – access/availability

10. The 4th All India survey of MSMEs states that close to 90 per cent of MSMEs are dependent on informal sources, which by any standards is a worrisome figure. Since that survey, some headway must have been made in improving MSMEs' access to formal financial channels; however, it still remains a challenge. The public sector banks today have close to 3000 specialized branches which specialize in lending to MSME units. Private sector banks have built up products and processes, which enable quick disbursal of loans. Most banks have switched over to centralized credit sanctioning, which enables better turnaround time. Many others have increased the credit limits to the field level functionaries. While these steps have improved access, there is still a huge unmet demand for credit for MSMEs[2] (There is a total finance requirement of INR 32.5 trillion ($650 billion) in the MSME sector, which comprises of INR 26 trillion ($ 520 Billion) of debt demand and INR 6.5 trillion ($130 Billion) of equity demand).As per provisional data for period ended March 2016, total outstanding loan of the banking system to MSME sector stood at around 11.1 trillion rupees in 20.6 million loan accounts. Contrast this to the estimated need of INR 26 trillion and number of MSMEs at 51 million.

11. An important piece of the problem is adequacy of banking outlets. Small entrepreneurs are spread across remote locations in the country where physical bank branches are not available. Also, the banking correspondent mechanism is yet to mature to a level where they can play a key role in credit disbursal. Second and perhaps a more import dimension is availability of credit at a time when it is required by the entrepreneur. Ability of small entrepreneurs to withstand life cycle shocks is extremely limited and hence availability of timely credit becomes critical for their survival. The formal financial system, due to a variety of reasons, which may include cumbersome procedures, lack of understanding of the business model, inability of the entrepreneur to meet the requirements of the banks etc., is unable to meet this immediate need of the entrepreneur.

b) "B"- banks and business

12. ***"B"*** in the "ABCD" paradigm of credit fundamentally refers to the information asymmetry between the two Bs – ***Banks and Business***.

The United States Agency for International Development (2009) defines a financially literate SME owner/manager as "someone who knows what are the most suitable financing and

---

[2] "Micro, Small and Medium Enterprise Finance in India", IFC, World Bank Group, November 2012.

financial management options for his/her business at the various growth stages of his/her business; knows where to obtain the most suitable products and services; and interacts with confidence with the suppliers of these products and services. He/she is familiar with the legal and regulatory framework and his/her rights and recourse options."

13. I don't think that majority of the MSME entrepreneurs in the country today meet the criterion. Financial literacy in the context of a MSME focuses on an individual's ability to translate financial literacy concepts to business needs. Financial literacy is essential for effective money management and low levels of financial literacy hinder the understanding of available financial products and services. MSE entrepreneurs are also constrained by lack of operational skills, accounting and finance acumen, business planning etc. which underscores a need for facilitation by banks/other agencies.

14. However, it is not a one way street. Large-scale retirements in banks in recent years have also adversely impacted the collective skill-sets available at the field level in understanding, appraising and monitoring the MSME loan portfolio. The poor underwriting skills leads to avoidable under or over financing, which can have a telling effect on the health of the MSME units, particularly in adverse life cycle situations.

c) "C"- collateral requirements

15. The formal financial institutions particularly banks consider lending to MSMEs as highly risky since the entrepreneurs often do not possess adequate collateral to support the credit. Very often, the loans are rejected, despite the project prima facie, being feasible. While there are several dispensations to tide over the problem, the credit culture has not matured enough to a level existing in developed economies where lending is done against the assets of the firm including its movable assets. This also necessitates that we build up strong financial infrastructure, which would support the banks in lending to these sectors without worries and using all types of assets available to secure the loan. It is also pertinent for banks to realise that though the loan to the individual entities in the sector may be riskier on a solo basis, overall on a portfolio level, these are less vulnerable than loans to corporate.

d) "D"- documentation

16. Many of the MSMEs, particularly the Micro units, do not have adequate documentation to match the rigours of a formal financial system. Absence of documentation drives the small entrepreneurs to informal sources that are willing to provide credit with minimum documentation. Further, a vast majority of the MSMEs are informal, which brings down the credit score of the entrepreneur and hinders the ability of the formal financial system to lend to them. Banks, on their part will need to leverage on modern technology algorithms and Big data so that they can differentiate between a good borrower and a not so good one even in the absence of conventional documentation.

17. Having analysed various impediments in finance to the sector let me dwell on some of the steps taken by RBI, Government of India and other Apex institutions in bridging these gaps.

(i) Access / availability

RBI has initiated several measures to improve the availability of banking services, especially in the rural and far-flung areas where access to formal finance is arduous.

18. ***New institutions:*** As you are aware, two new universal banks have started operations while in-principle approval has been granted to 10 entities to set up Small Finance Banks that would primarily focus on lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities. These small finance banks have been mandated to extend 75 per cent of its Adjusted Net Bank Credit (ANBC) to the sectors eligible for classification as priority sector lending (PSL) by the Reserve Bank. At least 50 per cent of its loan portfolio should constitute loans and advances of up to Rs. 25 lakh. Many of the SFBs have prior experience of working with small

businesses as MFIs/NBFCs and we believe that they will be able to bring in technology backed innovative last mile practices to serve their customers.

19. I***ncreased branch penetration/ Specialized branches:*** RBI has advised banks to set up 'brick and mortar' branches in villages with population of more than 5000 in a phased manner. Coupled with a more mature Banking Correspondent mechanism, this would give considerable fillip in meeting the banking needs of the MSMEs particularly in rural areas. Besides, creating presence of physical branch, there is also a need to have large number of bank officials with appropriate skill sets and knowledge to handle the life cycle needs of the small businesses. Already, Public Sector banks have established specialized MSME branches in every district to cater to the needs of the small businesses. We are already working towards improving the skill sets and entrepreneurial sensitivity of the field level functionaries.

20. ***P2P lending:*** *New* players have entered the MSME lending landscape in form of P2P companies. These entities use an online platform to match lenders with borrowers to provide unsecured loans and mostly for receivables financing. P2P lending has great potential as an alternative form of low-cost finance as it can reach to the needy where formal sources are unable to reach or unwilling to lend. RBI has been mindful of a need to regulate these entities without stifling their ability to innovate and is currently in the process of issuing final guidelines on P2P lending.

21. ***Policy intervention for Life Cycle Issues:*** We have advised the banks to keep a provision for additional credit limits (Standby Credit Facility for term loans and an additional provision within the overall working capital limits) in order to provide timely financial support to Micro and Small enterprises facing financial difficulties during their lifecycle. Banks have also been advised to carry out mid-term review of regular working capital limits and fix up timelines for credit decisions. I am happy to say that most banks have put in place similar provisions in the last one year or so.

22. ***Co-origination of loans:*** While several steps have been taken to address the problems related to accessibility, there are certain structural problems which would take their own sweet time in getting sorted out. One of this is the issue of reaching the last mile. Much as we have encouraged the banks to establish brick and mortar branches across remote villages, we must be conscious that they would always be driven by viability assessments/ cost considerations. One possible solution for this problem could be convergence of efforts between banks on one hand and the NBFCs, MFIs on the other, who have "feet on the ground" in such locations, better understanding of the local conditions and business viability, better knowledge about the credit worthiness of individuals, their repayment capabilities etc. Could we envisage a framework for ***co-origination of loans by banks and the NBFCs/MFIs with risk participation***? While it would ensure skin in the game for both parties, it would benefit the entrepreneurs in terms of cost of credit, which on account of blending could be substantially lower. This could probably be the most ideal structure to serve the micro enterprises who are the most deprived in terms of availability of credit.

(ii) Banks and business

23. Let me now turn my focus to steps for bridging the information asymmetry between the banks and the businesses. As I mentioned earlier, this is not a one-way street. Not only are the small entrepreneurs often ignorant about banking products and practices, several bankers have little understanding of the lifecycle credit needs of small businesses. Towards covering this base, RBI has started a capacity building initiative called the National Mission for Capacity Building of Bankers for financing MSME Sector (NAMCABS) in a mission mode. The field level functionaries must appreciate the importance of two critical pillars of financing MSME sector viz., timeliness and adequacy of credit. I am happy to state that close to 3300 officials of the banks have undergone this programme in the last one year.

24. ***Credit Counsellors:*** For bridging the information asymmetry on the MSME borrowers side, RBI is initiating a process for putting in place a framework for accreditation of credit counsellors who are expected to serve as facilitators and enablers for micro and small entrepreneurs. Since

MSMEs are typically enterprises with little credit histories and with inadequate expertise in preparing financial statements, credit counsellors will assist the borrowers in preparing their project reports and also help banks make better informed credit decisions.

25. ***Revival and Rehabilitation of MSMEs:*** Another key step in the direction of supporting the firms in distress is the issuance of guidelines on the Framework on Revival and Rehabilitation of MSMEs, which provides an institutionalized framework for rehabilitation of enterprises which are potentially viable, but are under temporary duress. The Framework provides for a structured mechanism, which could be triggered either by the banker or by the entrepreneur at the first signs of stress. The problem resolution is scaled up to a committee with a time bound schedule. I see this as a very powerful tool and urge upon the bankers to get this process rolling at the earliest.

(iii) The difficult 'C's -credit and collateral

26. The issue of finding the right balance in securing a loan without pushing the borrower to informal sector has been a bugbear for the banking system. This is sought to be addressed through creation and development of right institutional structures. Let me delve upon some of these efforts:

27. ***Movable Asset Registry***[3]: Movable assets, as opposed to fixed assets such as land or buildings, often account for most of the capital stock of private firms and comprise an especially large share for micro, small and medium-size enterprises. Hence, movable assets are the main type of securities that firms can pledge to obtain bank financing. I am happy to state that CERSAI, in active coordination with Government of India and Reserve Bank has established the movable asset registry, which when mature would have a multiplier effect in lending to the sector.

28. ***TReDS:*** In order to solve the problem of delayed payment to MSMEs, RBI has licensed three entities for operating the Trade Receivables Discounting System (TReDS). The system would facilitate the financing of trade receivables of MSME enterprises from corporate and other buyers, including government departments and public sector undertakings (PSUs) through multiple financiers. The objective is to create Electronic Bill Factoring Exchanges which could electronically accept and settle bills so that MSMEs could encash their receivables without delay. It is expected that the TReDS will commence operations within this current fiscal. It would be important that the use of TReDS is made mandatory for, to begin with corporate and PSUs and later for the Government departments. I would urge the Chambers and the MSME Ministry to proactively examine this aspect as success of TReDS initiative can be a game changer for the sector.

29. ***Utility of the Credit Guarantee Scheme:*** Realizing the problems of small borrowers in posting collaterals, RBI has asked the banks not to insist on collateral in case of loans up to Rs 10 lakh extended to units in the MSE sector. Also, Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) has been set up to encourage the Member Lending Institutions to extend credit based on the viability of the proposal rather than insisting on security or surety. Based on practical experience however, I tend to believe that these provisions have not led to desired outcomes. Let me elaborate.

30. On one hand, the guideline on collateral-free loans has led banks to at times devise ways of denying credit to the MSMEs borrowers, while on the other extreme, the provision for credit guarantee has potential to cause deterioration in quality of credit appraisal and due diligence, consequently straining the resources of the CGTMSE. Clearly, both outcomes are undesirable. I would rather advocate that borrower is compensated by way of a better pricing in loan for the availability of collateral. Further, ***I would also like to see the CGTMSE to evolve a***

[3] http://blogs.worldbank.org/allaboutfinance/does-introduction-movable-collateral-registries-increase-firms-access-finance.

framework for making the pricing risk-based rather than having a uniform risk premium related to the past performance and quality of individual portfolios. Eventually, this activity should also move to an open market system.

(iv) The cumbersome "D"- documentation

31. The absence of credit history and the need for documentation often pushes the micro entrepreneur away from conventional banking channels to the more informal sectors. This has to be addressed through a constant process of simplification of procedures and more importantly by leveraging technology.

32. ***Udyami Mitra portal*** set up by SIDBI leverages IT architecture of Stand-Up Mitra portal and aims at instilling ease of access to MSMEs' financial and non-financial service needs. The Portal, as a virtual market place endeavours to provide 'End to End' solutions not only for credit delivery but also for the host of credit-plus services by way of hand holding support, application tracking, multiple interface with stakeholders (i.e. banks, service providers, applicants).We could see development of more such technological interfaces in the coming days making it easier for MSME entrepreneurs to borrow from the banking system. RBI is committed to support such initiatives with appropriate safeguards and consumer protection measures.

33. ***Role of Associations:*** The entrepreneur and Industry bodies have a significant role to play in linking, maintaining and sustaining the borrower-banker relationship. This could be in handholding, enabling and capacity building of the new entrepreneurs. As you are aware, the BCSBI has formulated a Code of Bank's Commitment to Micro and Small Enterprises for voluntary adherence by the banks. The industry associations must also spread awareness about various facilities available/guidelines issued by the regulators to bridge the information asymmetry.

Conclusion

34. Let me conclude by going back to the theme of propelling growth of MSMEs. In using the term 'propel' you have underlined the sense of urgency that is required in this area. Our demographics compel us to push forward this agenda and make quantum jumps so that entrepreneur can start and drive businesses without worrying about finance. We are committed to this paradigm shift and the slew of measures that are being taken by the RBI, other apex institutions and stakeholders signify this. I call upon CII and other industry bodies to also join this effort as enablers.

Thank you!