S S Mundra: Financing MSMEs: Banks & FinTechs - competition, collaboration or competitive collaboration?

Inaugural address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at the NAMCABS Seminar organized by College of Agricultural Banking, Mumbai, 20 February 2017.

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1. Mr. Simon Bell, Global lead, SME Finance, World Bank Group; Smt. Surekha Marandi, Executive Director, Reserve Bank of India; Shri P. K. Panda, Principal, College of Agricultural Banking(CAB); Chairmen/CEOs of various banks present here; other senior officers from the banking sector; my colleagues from RBI; ladies and gentlemen! At the outset, let me congratulate CAB for organising this Seminar on the theme of “Coping with the challenges of Financial Technology Innovations in MSME Financing”. I particularly take this opportunity to welcome Mr. Simon Bell to India and thank him profusely for consenting to address the participants this morning.

2. I think the seminar theme is very topical especially in the backdrop of a public policy push towards digitisation of finance in all its manifestations. MSME sector, which accounts for more than half of the world’s gross domestic product (GDP) and employs almost two-thirds of the global work force, is virtually the backbone of the global economy. Hence, the sector needs to benefit from the fintech innovations to keep the global growth engine chugging along.

3. The seminar theme precludes the discussion on ***‘whether’*** and ***‘how’*** financial technology innovations can be employed for financing of MSMEs and takes it as a given. Certainly to a large extent, financial technology (or FinTech[1]) innovations have permeated across the entire Financial Services Value Chain. So, whether it is wholesale banking, wholesale payments, retail and commercial banking, customer relationship or payment services, FinTech finds applications across the spectrum. What we are set to discuss today is, thus, only a segment of this value chain i.e. use of fintech for financing of MSMEs. Nevertheless, the challenges of financial technology innovations in Finance would be generally common to the entire value chain.

4. In the context of MSME Financing, I have been asked to speak on the topic ***‘A new business model for the next decade: collaboration with the fintech companies’***. All of you would agree that technology has been in use in banking and more generally in the sphere of finance for quite some time now -whether it is use of computers for book-keeping, products like credit and debit cards or use of ATM for delivery of services etc., all were fintech innovations in their time. But when we talk of fintech in today’s context, we generally mean innovations which have enabled Big Data Analytics, Algorithmic trading and applications of Block Chain Technology and their variants. In my address today, I intend to focus on the financial technology innovations and emerging collaboration opportunities for the banks with Fintech players for MSME financing.

Financial technology innovations in MSME financing

5. With around 51.1 million units throughout the geographical expanse of the country, MSMEs contribute around 8% of GDP, 40% of the total exports and around 45% of the manufacturing output[2]. They are also estimated to provide employment to around 120 million persons in the country. Moreover these figures may not be capturing contribution of MSMEs in services sector fully. As per the International Financial Corporation (IFC), a ‘funding gap’ of $ 2.1 to 2.6 trillion exists for all formal and informal MSMEs in emerging markets alone, which is equivalent to 30 to 36 per cent of current outstanding MSME credit. SME lending being a hugely underserved market is a major opportunity for FinTech Start-ups to build and scale up sustainable businesses by offering services such as credit underwriting, marketplace lending, etc.

6. Given the huge business potential the number of FinTech companies in the MSME Financing space has been growing rapidly. FinTech companies are improving access to finance for SMEs by giving loans themselves, connecting SMEs to banks and financial institutions (Marketplace Model) (e.g. Lendingkart, smelending.com, etc.) or becoming financial product aggregators (e.g. BankBazaar, bookmyforex.com, PolicyBazaar, FundsIndia.com, etc).

7. The fintech companies have leveraged on growing technological advances and pervasiveness of smartphones and have targeted niches in SME lending to bridge the funding gap for small businesses with innovative and flexible credit products. Potentially, the MSME borrowers can apply online in minutes, select desired repayment terms and receive funds in their bank accounts within 2-3 days with minimal hassle. There are few documentation requirements, very quick turnaround time and flexible loan sizes and tenors. That the P2P lenders can become a significant source of finance for the small borrowers is evident from the UK example where the P2P lending represents about 14% of the new lending to the SMEs.[3] A NESTA survey in the UK suggests that around 55–60% of peer-to-peer business borrowers were either refused bank credit or they had not approached banks considering they were not credit worthy enough. Though, corresponding data is not available for India, I believe the position in respect of refusal of credit to potential borrowers may be more acute. FinTech lending companies and the market place based lending, thus, have an underlying potential to emerge as an alternative source of finance for the small businesses. Considering the need to strike a balance between regulation of these entities even while preserving their ability to innovate, RBI is currently consulting on approach to regulate the P2P lending.

8. As I said earlier, the fintech firms are powered by technologies that harness big data analytics & machine learning and use a mix of traditional and non-traditional methods to assess the credit worthiness of individuals and SMEs. These firms are also willing to lend to small businesses that might not have collateral, significant revenues or years of experience. Many of the fintech firms abroad employ unorthodox techniques, including psychometric tests to run checks on their borrowers, determine their social media reputation and do rigorous due diligence before lending. This provides an inherent advantage to them over the traditional lenders in gauging the creditworthiness of the potential borrower/business.

9. With the combination of data and analytics, it is possible now to do credit risk analysis online, complete loan appraisal and disbursal faster. A key reason why algorithm-based automated lending by FinTech firms is possible today, unlike say 5-7 years ago, is the availability of reliable data on potential borrowers. On the back of strong growth in internet penetration and mobile density, e-commerce and smartphone-based services have created a huge amount of data on individuals and small businesses. The availability of records from credit bureaus, utility and credit card bill payments etc., has enabled the FinTech firms to sift through large volume of available information and gather specific data on potential borrowers. As more and more data is getting digitized, the cost and effort involved in assessing the creditworthiness of SMEs would decline significantly. The borrowers can give their 'consent' to a FinTech lender or to a bank to use their digital footprint for sanctioning a loan. This is already evident in the pre-approved loans that are being offered to retail borrowers.

Why are we talking about bank's collaboration with Fintech companies?

10. Fintech companies as we have seen are disrupting every facet of the traditional financial services business and have emerged as a challenge to the banking system. According to a PwC 2016 Global Fintech Survey report, up to 28% of the banking and payments business are at risk by 2020. The imminent competition to banks' business comes from the new breed of fintech companies having capacities to address specific pain-points of financial customers such as remittance, credit, savings, etc. The report adds that MSME banking is likely to be the fourth largest sector to be disrupted by Fintech in the next 5 years after consumer banking, payments, and investment/wealth management. Another study[4] done by Citi researchers predicted that the

fintech revolution will wipe out nearly a third of all the employees at traditional banks in the next 10 years. This prediction is essentially about the lack of growth and loss of business over time, though it may be difficult at this juncture to accurately gauge the possibility of any particular benefit or risk materialising in the fintech universe.

11. In view of the above challenges that the fintech companies may present, it seems to make business sense for the brick and mortar banks to collaborate with the more efficient and agile fintech players. The banks would need to assess the likely impact of disruption and re-orient their business models. As the incumbents, they may need to leverage their comparative advantage to improve their customer relationships, change their internal processes, mindset, and internal structures. Some banks have already adopted the ways of the fintech companies by employing technology for making credit-decisions in a limited way. Many have started using credit scoring models for retail and SME borrowers. What still eludes them is the nimble-footedness of the fintech players, which alienates the potential borrowers.

12. Fintech firms are good at innovative skills and mindsets supported by the regulatory freedom presently available to be innovative, to leverage Big Data and to be nimble in responding to market changes. However, as this segment grows in size, they would sure be coming under equivalent regulatory framework. Moreover, majority of them are venture capital supported entities, which can't exactly substitute a wide capital base. This is where the banks could capitalise on the fintech ecosystem. The banks could as well leverage big data, data analytics, SME friendly applications, etc., in effectively lending to MSME segment while remaining compliant with extant KYC norms and appraisal & monitoring principles and reduce their intermediation and compliance costs. Whether to do so inhouse or through a collaboration is a business judgement that individual banks need to make.

13. Despite some inherent advantages that the fintech players enjoy, it is not a one way street for them. The fintech companies do not have a big client base of their own and without the expertise to navigate the regulations and licensing discipline of the finance industry; they can't go very far on their own. A major strength that traditional banks possess is a reputation for trustworthiness built over several decades. The banks have capital and can weather intense competition. They also have the benefit of experience and tried-and-tested infrastructure alongside specific financial knowledge of risk management, local regulations and compliance. In fact, banks' on-the-ground market and customer knowledge and pre-existing client base can be of immense value to fintech projects. In a nutshell, banks and fintech firms have different comparative advantages and a strategic collaborative partnership between the two would liberate them to focus on their respective core competencies and contribute to the innovation process.

14. Let me now highlight few recent tech-enabled initiatives which have been blessed by RBI for promoting accessibility of finance to the MSME sector.

Some RBI initiatives

15. RBI has initiated measures to expand the reach of banking services for unbanked population, regulating an efficient electronic payment system and providing alternative options to the MSME sector. Before I conclude let me focus on couple of recent tech-based initiatives launched by the RBI for benefit of the MSME ecosystem.

(i) ***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 objective is to create Electronic Bill Factoring Exchanges which could electronically accept and settle bills so that MSMEs could encash their receivables without delay. 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. It is expected that the TReDS will commence operations within this current fiscal.

(ii) An ***Udyami Mitra portal*** has been set up to leverage IT architecture of Stand-Up Mitra portal which 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).

(iii) ***Payment Banks/ Small Finance Banks (SFBs)***: Following the issuance of differentiated banking licenses, a number of such entities have become/ will shortly become operational. These banks will have the advantage of embracing state of art technology from beginning. Payment banks can't lend directly but can be distributors of the credit products, while SFBs would predominantly be in MSME space. This throws open meaningful oppurtunities for emergence of two-way/ three-way alliances between legacy bankers/ new banking entrants & fintech companies in the area of MSME financing. Key would be who develops a clear vision & moves fast.

Conclusion

16. Let me utilise the presence of the bank CEOs and in-charges of MSME divisions to draw their attention to the need for focussing separately on 'micro' customers from amongst the MSME segment. Micro entities comprise a very 'niche' segment as these are mostly individual or family run businesses having very unique credit needs. As they generally lack adequate documentation, they fail to receive credit from the formal financial system. An estimate suggests that at present almost 93% of such units are outside the formal credit system. I think this segment, including the small enterprises, can benefit immensely from the collaboration between banks and the fintech players whereby their other payment records can form a basis for working their credit worthiness.

17. A related aspect I want to highlight is that the smaller players in the MSME segment typically dealt in cash despite having a bank account. Thanks however to the withdrawal of the SBNs recently, most of them have begun to route their transactions through their bank accounts. It opens up a huge opportunity for the banks to employ data mining techniques and utilize the outcomes to assess credit needs of the small entrepreneurs. Needless to add that such exercise has to be supplemented with financial literacy efforts – for ensuring that borrowers utilize the credit for productive purpose & also don't retreat to cash dealings.

18. In fact, my vision of a fin-tech enabled banking system is one in which a micro entrepreneur receives an online bank credit early in the morning, which she utilizes for buying her wares from the wholesale market, sells them during the day, receives payment from customers in electronic form (mobile money), pays back the bank loan at the end of the day and gets the surplus credited to her linked savings account. Part of this saving when pooled, automatically moves to some micro investment/ pension products. I strongly feel that a harmonious collaboration between fintech firms and the banks can quickly help realize this vision.

19. Let me conclude by reiterating that the age of FinTechs is here and for the incumbent banks there is no time to lose. The banks that do not quickly convert in to a new-age digital bank run the risk of becoming history. They would need to tap the requisite talent and create an environment where such talent can innovate and be agile. The banks must view the success of fintech ecosystem as an opportunity and not as a threat.

I once again thank CAB for inviting me here and wish the Conference all success.

Thank you!

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[1] Financial Stability Board defines FinTech as technology-enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets

and institutions and the provision of financial services.

2 msme.gov.in/sites/default/files/Background%20Note%20-%20UAM_0.pdf

3 “The Promise of FinTech-Something new under the Sun?”- Speech delivered by Mark Carney, Governor, Bank of England at Deutsche Bundesbank G20 Conference in Wiesbaden.

4 svicenter.com/how-big-banks-are-embracing-the-fintech-revolution-and-more-news