

FINANCIAL INCLUSION OF MSME

August 2022



Acknowledgements

About the Authors

The primer has been written by **Prerit Shukla** with support from **Deshna Saraogi**.

Disclaimer

This report has been produced by a team from Sattva Consulting as a product for the Sattva Knowledge Institute (SKI). The authors take full responsibility for the contents and conclusions. Any participation of industry experts and affiliates who were consulted and acknowledged here, does not necessarily imply endorsement of the report's contents or conclusions. To quote this primer, please mention: Sattva Knowledge Institute, *Financial Inclusion of MSME*, August 2022. Use of the report's figures, tables or diagrams, must fully credit the respective copyright owner where indicated. Reproduction must be in original form with no adaptations or derivatives. For use of any images in the report please contact the respective copyright holders directly for permission.

This work is licensed under the Creative Commons Attribution-NonCommercial-ShareAlike 4.0 International License:

Attribution - You may give appropriate credit, provide a link to the license, indicate if any changes were made.

Non-Commercial - You may not use the material for commercial purposes.

Share A Like - If you remix, transform, or build upon the material, you must distribute your contributions under the same license as the original.



To view a copy of this license, visit <http://creativecommons.org/licenses/by-nc-sa/4.0/>

About Sattva Knowledge Institute

Sattva Knowledge Institute (SKI), established in 2022, is our official knowledge platform at Sattva. The SKI platform aims to guide investment decisions for impact, shedding light on urgent problems and high potential solutions, so that stakeholders can build greater awareness and a bias towards concerted action. Our focus is on offering solutions over symptoms, carefully curating strong evidence-based research, and engaging decision-makers actively with our insights. Overall, **SKI aims to shift intent and action toward greater impact by influencing leaders with knowledge**. All of our content proactively leverages the capabilities, experience and proprietary data from across Sattva.

Design: Cognitive Designs; cognitive.designs@gmail.com

CONTENTS

1	Executive Summary	04
2	MSME Landscape	06
3	Financing Challenges for MSMEs	11
4	Stakeholder Interventions to Finance MSMEs	15
5	Recommendations for Stakeholders	24
6	References	29

EXECUTIVE SUMMARY



Overview

Micro, Small and Medium Enterprises (MSMEs) are strategic assets for economic development and employment generation, but remain too small and informal to make an impact. Over 95% of Indian enterprises are classified as micro, leading to the curious 'missing middle' syndrome. One of the key factors inhibiting the scaling up of MSMEs is a lack of affordable finance. MSMEs face a credit gap of ₹69.3 trillion out of which only ₹36.7 trillion is addressable by formal financing.

Demand and Supply Financing Constraints

Both demand and supply constraints result in lack of financial inclusion of MSMEs. Demand-level constraints in the MSME ecosystem include delayed payments from buyers, inadequate formal records, and information asymmetry among MSMEs. Limited supply of formal financing by banks due to outdated underwriting process, unsuitable loan products and high transaction cost prohibit MSMEs from accessing credit at affordable rates.

Stakeholder Interventions

Multiple stakeholders are providing a range of financing options to MSMEs. Banks, non-banking financial companies (NBFCs) and microfinance institutions remain the main institutional credit providers. Digital lending through financial technology companies, or fintechs, is solving unique and sector-specific challenges. Through their platforms such as TReDS, government and regulatory bodies are enabling invoice discounting to address working capital needs of MSMEs.

Recommendations for Action

Despite interventions by ecosystem stakeholders, common challenges persist. To solve these challenges, three critical levers should be addressed: (1) **solving for delayed payments**, which requires greater uptake of TReDS and capacity-building of MSMEs; (2) banks and NBFCs need to increase their lending to MSMEs by **revamping their credit appraisal process and innovating loan products** for MSMEs and (3) **scaling up digital lending** is necessary for financial inclusion of micro and small enterprises by building trust in digital products through a phygital approach.



MSME LANDSCAPE



Micro, Small and Medium Enterprises (MSMEs) are strategic assets for economic development, but remain too small to make an impact.

MSMEs contribute significantly to the Indian economy.



30.27%

of India's **Gross Development Product** is contributed by MSMEs (IBEF 2021).



63.3 million

registered MSMEs in the country, growing at a compound annual growth rate of **18.5%** (MSME Annual Report 2022).



45% of industrial output and **40%** of the total exports are accounted for by MSMEs in India (IBEF 2021).



111 million people are employed in the sector, adding **1.3 million** jobs each year (MSME Annual Report 2022).

Criteria	Manufacturing		Services	
	Turnover	Investment	Turnover	Investment
Micro	< ₹5 Crore	< ₹25 Lakh	< ₹5 Crore	< ₹10 Lakh
Small	< ₹50 Crore	< ₹5 Crore	< ₹50 Crore	< ₹2 Crore
Medium	< ₹250 Crore	< ₹10 Crore	< ₹250 Crore	< ₹5 Crore

Micro enterprises form the largest share in the segment

For every 100 enterprises, India has



95
Micro enterprises



04
Small enterprises



01
Medium enterprise

In comparison, developed countries feature



50
Micro enterprises



40
Small-Medium enterprises



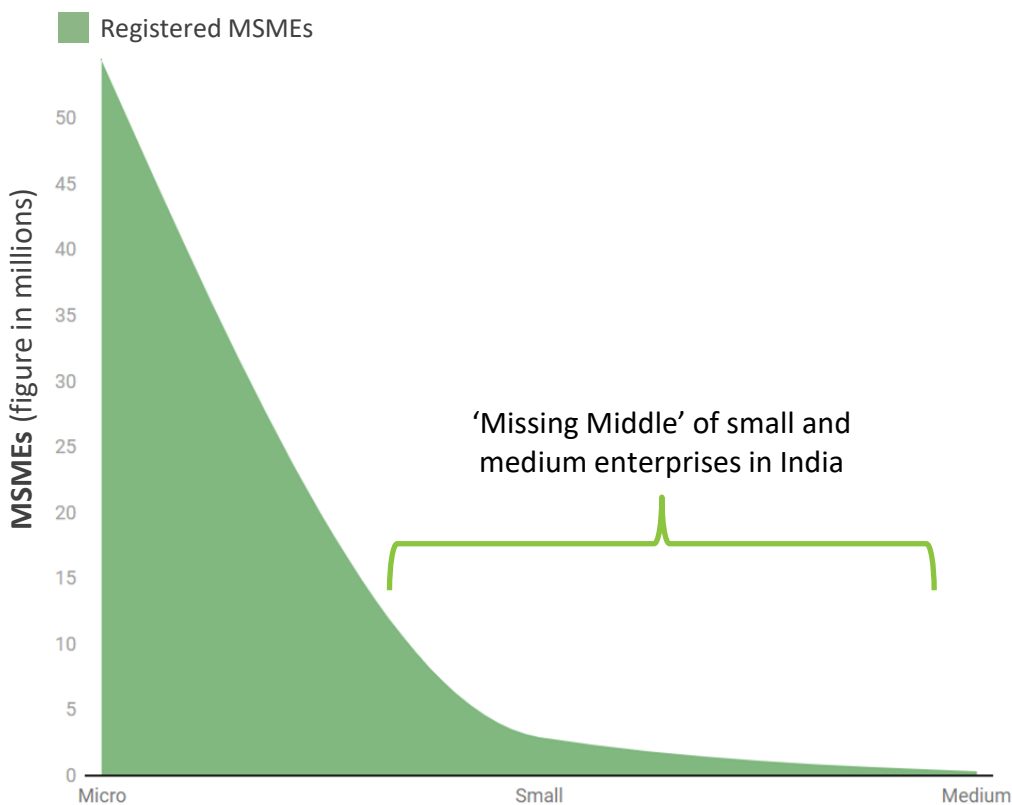
10
Large enterprises



India is unable to realise the potential of MSMEs due to the 'missing middle' syndrome.



>95% of MSMEs are micro-enterprises in India (MSME Annual Report 2022).



Widespread informality among India's small businesses

Informality precludes small businesses from accessing government schemes and borrowing at viable interest rates.

Majority of India's 63 million firms are informal; **fewer than 20%** are registered for GST.

Only 15% are registered on Udyam, the MSME registration platform.



Employment generation is limited in the micro enterprises

<5% of India's firms create more than **5 jobs** each.

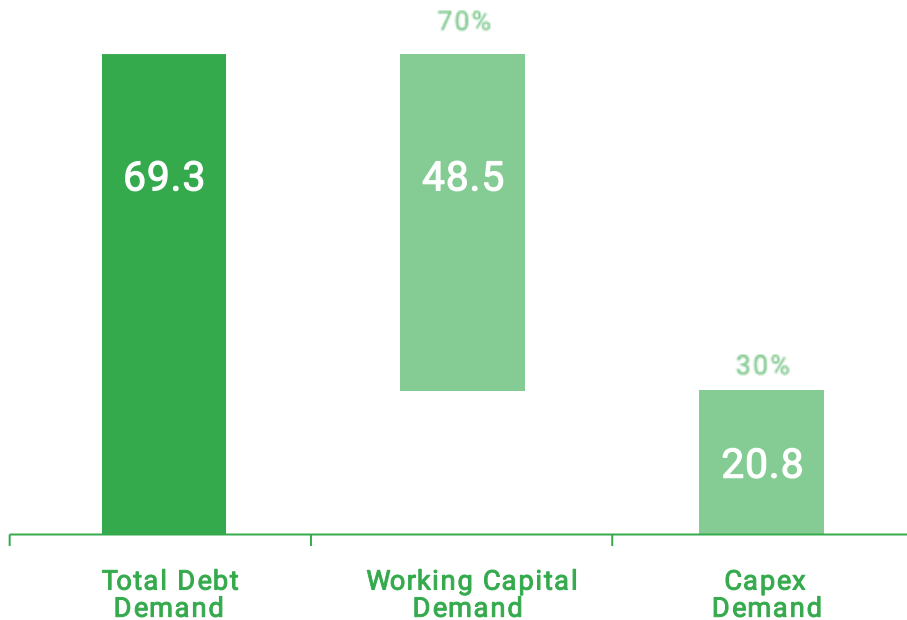
<2% of India's firms create more than **10 jobs** each.

In comparison, among OECD nations, firms with more than 10 employees make up **40% to 95%** of the enterprise landscape (GAME 2021).

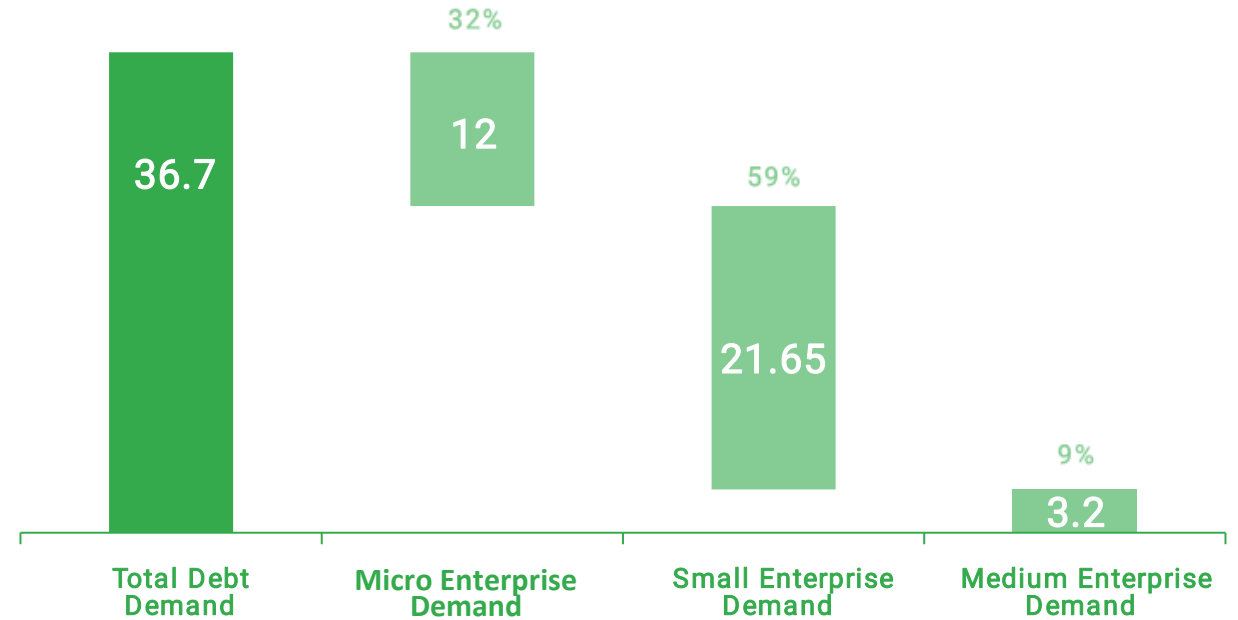


It is estimated that the total supply of debt to the MSME sector is ₹ 69.3 trillion (IFC 2018).

Out of the ₹69.3 trillion, nearly **70% is the working capital demand** of MSMEs, implying low cash flows to run business operations.



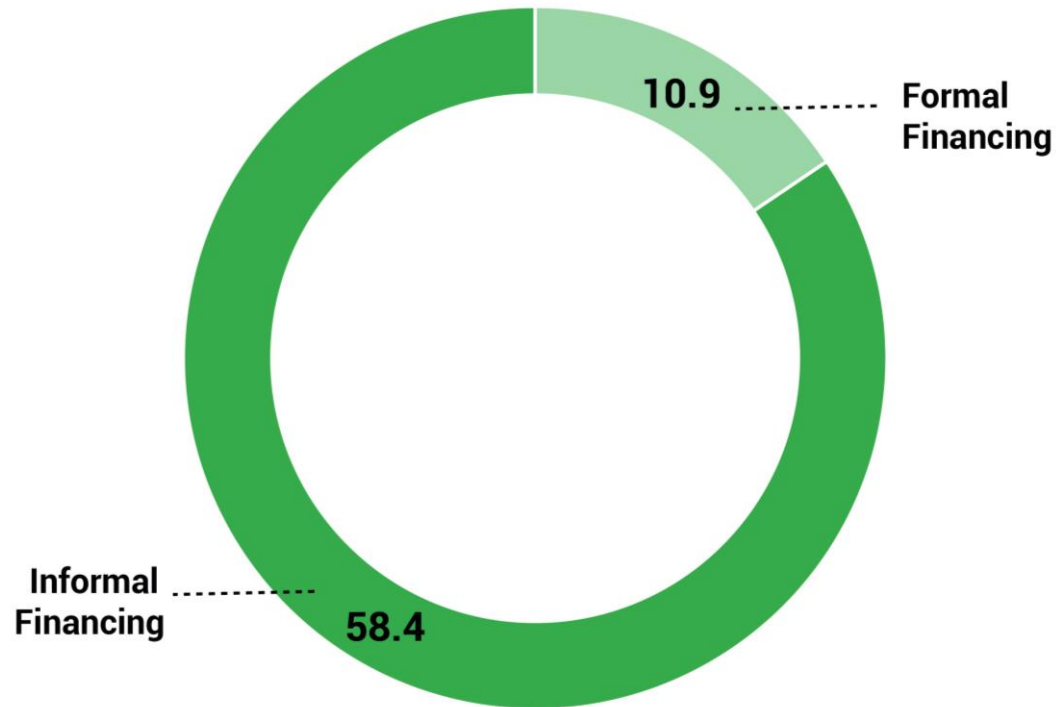
Out of the ₹69.3 trillion, **₹36.7 trillion** can be addressed by formal financing, with micro and small enterprises accounting for the largest share in addressable debt demand.



Lack of access to affordable finance is a key bottleneck in scaling up micro enterprises.

More than 80% of MSMEs have no access to formal financing (IFC 2018).

Distribution of formal and informal financing to MSMEs (in millions)



Entrepreneurs are dependent on informal credit sources.

Personal resources are the most preferred option for MSMEs to meet financial requirements.

80% Entrepreneurs did not avail any loan or financial service from banks or non-banking financial institutions (NBFIs) (IFC 2020).

Borrowing cost is the single biggest reason for dependency on personal finance.

99% Majority of informal lending comes from unregistered chit-funds such as moneylenders (IFC 2018).

Informal lenders cater to unregistered micro-enterprises that do not have formalised processes in place.

38% Annualised interest rates on informal borrowing is at least twice that of formal borrowing (SIDBI 2018).

FINANCING CHALLENGES OF MSMES



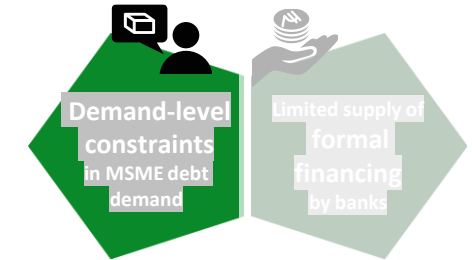
Both demand and supply constraints result in a lack of adequate credit for MSMEs.

Gaps in credit access to MSMEs



D & S - Demand and Supply

Demand-level Challenges: Constraints in the MSME ecosystem result in limited access to formal finance.



1

Delayed payments from buyers

- Payments are delayed because of a power asymmetry between small suppliers and large buyers.
- Total outstanding payments from buyers at **Rs 15 trillion** (GAME 2022).
- **80%** of the annual delayed payments amount is owed to Micro and Small Enterprises.
- Less than **1%** of registered MSMEs use Trade Receivables Discounting System (TReDS) and MSME Samadhaan platforms.

2

Inadequate formal records

- Low formalisation among MSMEs leads to inadequate documentation.
- **~50%** of micro-enterprise loan applications get rejected due to a lack of basic 'know your customer' (KYC) norms (GAME 2021).
- Only **9 million** of the 63 million MSMEs are ranked on CIBIL MSME Rank (GAME 2021).
- Early-stage small enterprises are unable to take loans without collateral.

3

Information asymmetry amongst MSMEs

- **Limited awareness** among micro-entrepreneurs about financial schemes and loan processes.
- Personal factors like degrees of financial literacy and industry experience limit access to credit.
- Existing relationships with loan providers lead to reliance on informal lending.
- Interest rates on informal borrowing are at least **twice** that of formal borrowing (SIDBI 2018).



Supply-level Challenges: Traditional finance does not meet the unique financing needs of MSMEs.



1

Outdated underwriting process

- Traditional financial sources underwrite MSMEs based on parameters like **CIBIL score, past three years' income**, tax returns, financial statements, and collateral (Mugunthan et al 2018).
- These techniques are based on standardised documentation, which several MSMEs are unable to furnish.
- Reliance on past performance of the enterprise limit borrowing opportunities for new-to-credit customers.

2

Unsuitable loan products

- Credit offerings by banks are misaligned with the needs and capabilities of MSMEs.
- Loan products are inflexible in tenure and **payment structure**.
- Repayment is structured as equal monthly installments (EMI), even though many micro-enterprises prefer to repay in weekly installments.
- Loan sanctioning process is **complicated and long**, with a waiting period of more than 20 days (IFC 2020).

3

High transaction cost

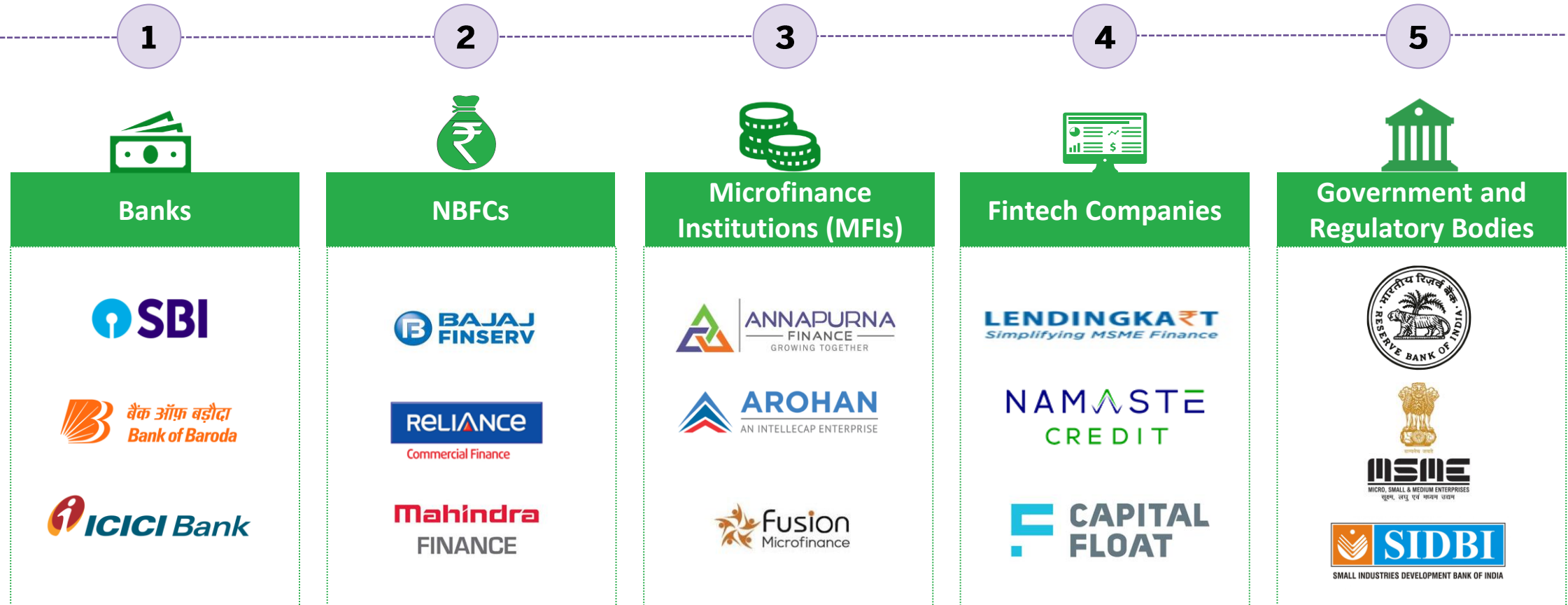
- High customer acquisition cost **for low ticket size loans (<₹10 lakhs)** among MSMEs (GAME 2021).
- Risk-averse nature of banks with strict lending policies to the NBFC sector.
- MSMEs are a **high-risk segment** for banks due to increasing non-performing assets (NPAs) in the sector.
- Lower margins for banks due to small ticket size, and high cost of due diligence and collections.



STAKEHOLDER INTERVENTIONS TO FINANCE MSMES



Multiple players including banks, NBFCs, governments and fintech companies are a part of the MSME financing ecosystem.



Banks, NBFCs and MFIs are the main institutional credit providers to MSMEs.










1

2

3

4

5

Parameter	Banks	NBFCs (including fintech lenders)	MFIs
 Function/Definition	Banks (both private and public sectors) form the backbone of the formal credit given to MSMEs.	NBFCs provide loan to MSMEs on much simpler and flexible terms than banks.	MFIs provide microcredit to specific MSME segments like rural women and small entrepreneurs who otherwise would have no other access to financial services.
 Contribution to MSME sector*	 ₹ 18.4 trillion (SIDBI 2022)	 ₹ 2.7 trillion (SIDBI 2022)	 ₹ 2.8 trillion (MFIN 2022)
 Target Segment	Medium enterprises	Small and medium enterprises	Microenterprises
 Interest Rates* (Paisabazaar 2022)	6%-16%	15%-24%	18%-26%
 Range of Loan Amount* (Bankbazaar 2022)	₹250,000 and above	₹10 million and above	₹5000 to ₹30,000
 Loan Process	Banks assess creditworthiness based on financial statements, past years' income and collateral.	NBFCs also factor alternative credit assessment processes like looking at cash flows, other than immovable collateral.	MFIs provide loans on simpler terms without a physical asset for collateral.

* Indicative figures

Over the last decade, banks and NBFCs have been collaborating with **fintech companies** to enable digital lending for MSMEs.



Digital lending is the process of availing credit online. The credit is applied for, disbursed, and managed through digital channels. Lenders use digitised data to make credit decisions and build intelligent customer engagement (Accion 2018).

Digital lending can provide unique and sector-specific solutions to finance MSMEs.



Customer Onboarding

1

- User applies for a loan through a digital lending platform.
- Digital lending ensures a quick registration process and approval process through e-KYC.



Credit Appraisal

2

- App uses an algorithm to arrive at a credit score.
- Digital underwriting is more granular and complete, enabling detailed insights into borrowers' behaviour (BCG 2020).



Customised Loan Products

3

- Digital lenders aggregate a large volume of small loans based on user preferences.
- Flexible repayment options are offered, based on the business cycles of MSMEs.



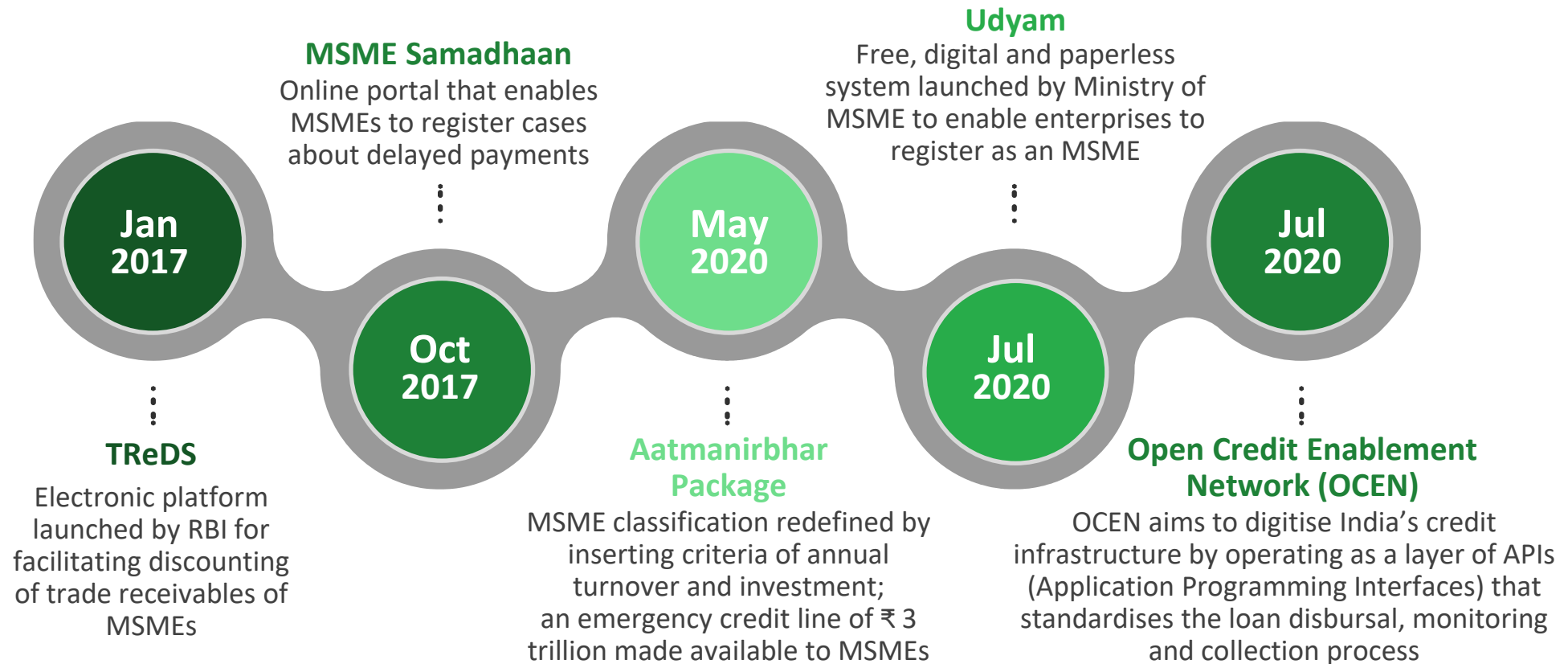
Loan Repayment

4

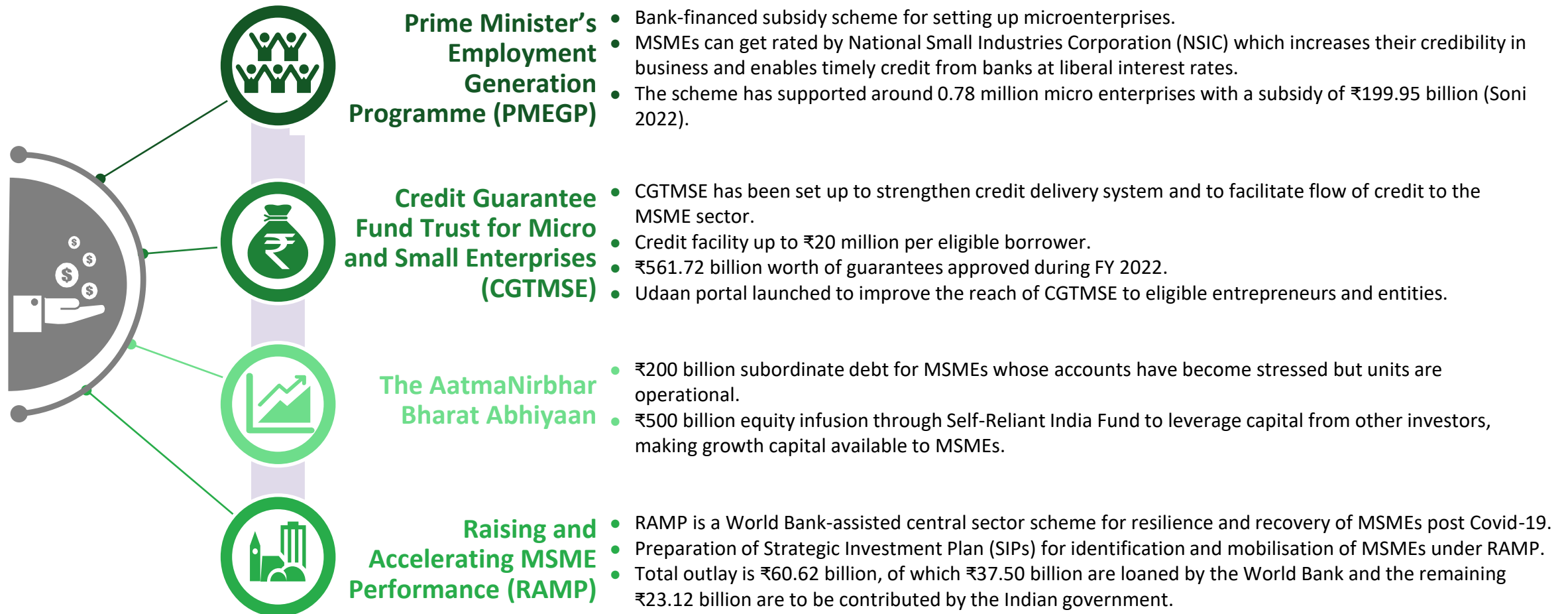
- User repays the amount in the agreed number of instalments.
- Efficiency in collections leads to lower default rates.



The government has pushed for several interventions to address the financing needs of MSMEs.



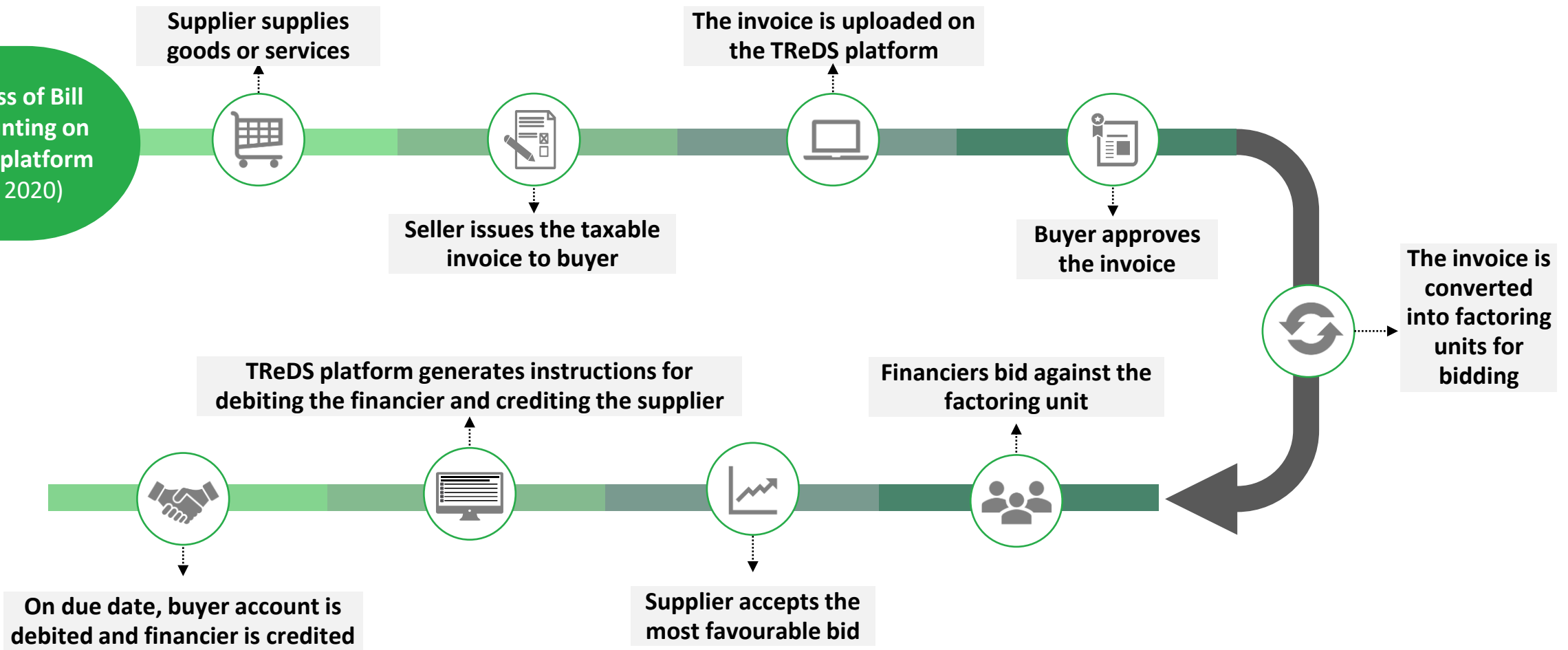
Government schemes are strengthening the credit outflow to the MSME sector.



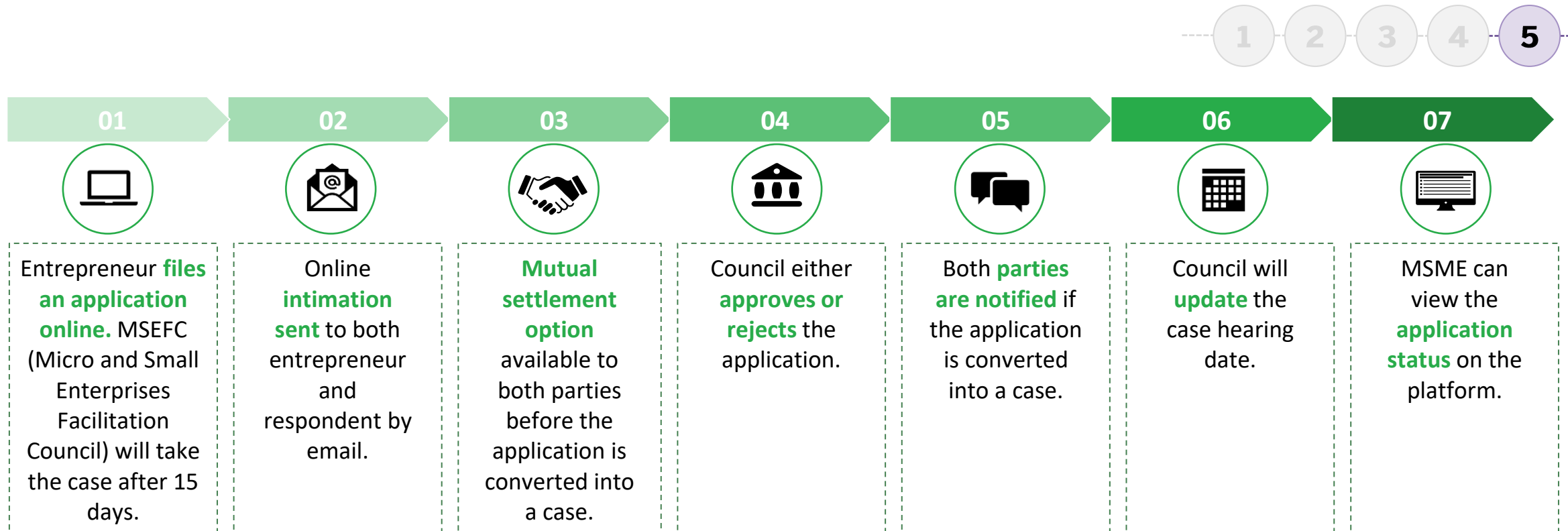
The flagship TReDS platform brings together MSMEs, financiers and corporate buyers to facilitate settlement of invoices.

- 1
- 2
- 3
- 4
- 5

Process of Bill Discounting on TReDS platform (RBI 2020)



MSMEs can track the status of delayed payment complaints through **MSME Samadhaan portal**.



Impact of MSME Samadhaan since its launch in 2017 (MSME Samadhaan website)

12015

Applications filed by MSEs

19027

Cases disposed by the MSEFC Council

₹34.77 BILLION

Amount involved in disposed cases



Regulators like SIDBI provide multiple forms of concessional financing to MSMEs.

1

2

3

4

5

1

Institutional Credit

- Institutional finance to lending institutions such as banks, NBFCs and MFIs for onward lending to MSMEs.
- Equity investment and resource support to facilitate development of small finance banks.

3

Credit Score

- CIBIL-like score for MSMEs called Fit Score under development (Khetarpal 2022).
- Credit score based on GST data, income tax returns and bank account details.



2

Direct Loans

- Short-term loans to MSME to execute urgent loan orders (SIDBI 2022).
- PRAYAAS scheme to bring down the cost of credit to borrowers at the bottom of the pyramid.
- Financial assistance to micro-enterprises for capital expenditure or working capital requirements.

4

Invoice Financing

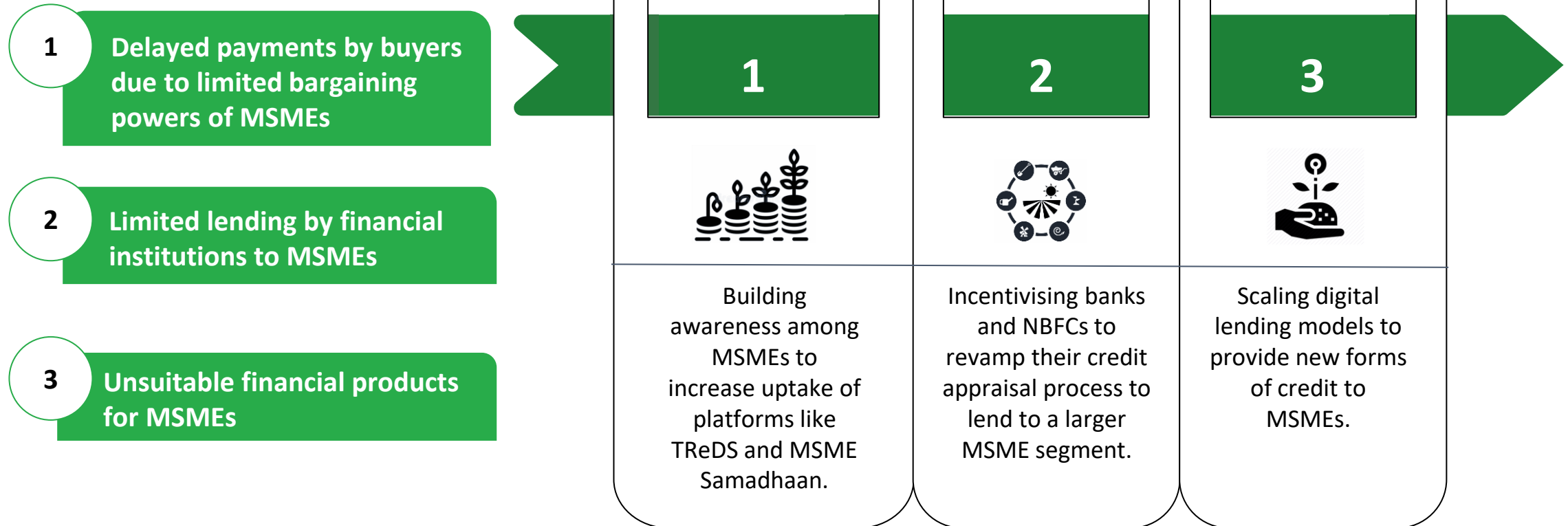
- Testing GST Sahay app with banks for invoice-based financing (Khetarpal 2022).
- MSMEs can use unpaid invoices to get quick working capital loans.



RECOMMENDATIONS FOR STAKEHOLDERS



Addressing common challenges involves solving issues with delayed payments, incentivising financial institutions and scaling up digital lending.



Targeted interventions from the government can solve the problem of delayed payments to the MSMEs.

1

Increase adoption of TReDS platform



- Government should increase enthusiasm among buyers by reducing the turnover threshold for mandatory onboarding onto TReDS from **₹5 billion to ₹2.5 billion**.
- MSMEs from Tier 3 cities and district headquarters need to be onboarded to increase the adoption of the platform (GAME 2021).
- All **Public Sector Undertakings** (Maharatnas and Navratnas) should be mandated to transact on TReDS.

Prompt payments to MSMEs



- **Timely payments** by buyers ensuring a 45-day limit on the payment cycle can unlock **working capital of ₹38 trillion for micro enterprises and ₹32 trillion for small enterprises** (GAME 2021).
- **MSEFC** can ensure faster resolution of payment disputes by enabling the entry of online dispute resolution service providers.

Build capacity and awareness



- The government can collaborate with philanthropy and industry associations to ensure **targeted training**, to increase the uptake of digital platforms like TReDs.
- Encourage MSMEs to use digital invoice creation to initiate the next wave of **digitisation among MSMEs**.



Proactive steps by banks and NBFCs are necessary to increase lending to the MSME sector.

2

Incentivise banks to lend to NBFCs



- Large public sector banks should lend to smaller NBFCs to finance new-to-credit customers.
- **Co-lending models** between banks and NBFCs can lead to better risk sharing by extending credit lines to a larger MSME segment (GAME 2021).

Revamp credit appraisal process



- Banks and NBFCs should use alternative methods to assess repaying capacity (IFC 2018).
- Instead of relying on financial statements, lenders should **underwrite on the basis of surrogate data** like banking transactions, utility payments, and GST.

Innovate loan products



- Financiers need to create **customised financial products** for MSMEs.
- Sector-specific loan products can be developed based on the credit needs of the industry.

Innovative financing models



- Philanthropy and multilateral organisations should provide **partial guarantees or first loss cover to NBFCs**. This will increase risk appetite and reduce the cost of capital.
- Returnable grants can be used by philanthropic organisations to help build a credit footprint for new-to-credit customers (GAME 2021).

Directed interventions for different MSME segments can ensure ease of financial inclusion in the digital lending process.

3

Onboard micro enterprises



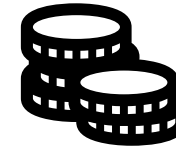
- Government and fintech players need to initiate a **behavioural shift** towards digital economy.
- Access to bank accounts and frequent usage of online transactions can create a digital trail for micro-enterprises.
- Philanthropy and NGOs can facilitate digitisation and upskilling of new-to-credit customers.

Increase digital comfort



- Provide **phygital support**, combining digital experiences with physical assistance.
- Fintechs should **build trust and experience** in digital finance through demonstrable use cases.
- Develop simple and intuitive design to drive adoption and usage by target customers.

Regulate digital lending



- RBI should mitigate fraud risks and strengthen **consumer data protection**, especially for vulnerable groups.
- Mandate fintech companies to educate users about loan features and maintain high levels of transparency.

Collaborate with philanthropy



- Blended finance products can be developed to de-risk investment by fintech companies in the MSME segment.
- Philanthropy should invest in **innovative digital products** that encourage underrepresented groups to use financial products.
- Provision of **catalytic capital** to develop programmes can enable experiential models of learning for first-time users.

REFERENCES



1. Accion Insights 2018, [Demystifying Digital Lending](#), Accion Global Advisory Solutions, Cambridge.
2. Bankbazaar 2022, [‘Top Microfinance Institutions in India and How they Work?’](#) viewed 26 August 2022.
3. College of Agricultural Banking 2018, [Special Study on Issues and Challenges in Access to Finance for MSMEs](#), Reserve Bank of India and CAB, Pune.
4. [Credit Guarantee Fund Trust for Micro and Small Enterprises](#) 2022, MoMSME, Delhi, viewed 2 September 2022.
5. Dvara Research 2020, [State of Digital Lending towards MSMEs in India](#), Dvara Research, Chennai.
6. Global Alliance for Mass Entrepreneurship 2021, [The Mass Entrepreneurship Manifesto 2020-21](#), GAME.
7. Global Alliance for Mass Entrepreneurship 2022, [Unlocking the full potential of India’s MSMEs through prompt payments](#), GAME, B&D and ONI.
8. India Brand Equity Foundation 2021, [‘MSME Sector- Imperative to Lift Indian Economy’](#), IBEF, 30 December 2021, viewed 29 August 2022.
9. Intellectap 2018, [Financing India’s MSMEs- Estimation of Debt Requirement of MSMEs in India](#), IFC and Intellectap
10. International Finance Corporation 2016, [Financial Inclusion for Women owned MSMEs](#), IFC and the Government of Japan.
11. International Finance Corporation 2018, [‘Financing India’s MSMEs- Estimation of Debt Requirement of MSMEs in India’](#), IFC, Intellectap.
12. Kheterpal, S 2022, [‘FE Exclusive: SIDBI to launch invoice-based financing app GST Sahay for MSMEs, opens it to banks and NBFCs’](#), Financial Express, 29 July 2022, viewed 29 August 2022.
13. Mansur, R 2019, [‘The Missing Middle India has 95 micro businesses for Every 5 Small Medium and Large Enterprises’](#), YourStory, 1 January 2019, updated 5 September 2019, viewed 29 August 2022.
14. Microfinance Institutions Network India 2022, [‘Annual Report 2021-22’](#), MFIN India, India.
15. Ministry of Micro, Small and Medium Enterprises 2022, [Annual Report 2021-22](#), MoMSME, Delhi.
16. Ministry of Micro, Small and Medium Enterprises 2022, [MSME SAMADHAN- Delayed Payment Monitoring System](#), MoMSME, New Delhi, viewed 29 August 2022.
17. Omidyar Network 2020, [Credit Disrupted- Digital MSME Lending in India](#), Omidyar Network and BCG.
18. Paisa Bazaar 2022., [‘MSME Loan’](#) viewed 26 August 2022.
19. [Prime Minister Employment Generation Programme](#) 2022, MoMSME, Delhi, viewed 2 September 2022.
20. Reserve Bank of India 2020, [Frequently Asked Questions- TReDS](#), viewed 29 August 2022.
21. Reserve Bank of India 2021, [Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps](#), RBI, New Delhi.
22. Sattva Consulting 2022, [Enabling Financial Inclusion Through Digital Platforms](#), Sattva Consulting, Bangalore.
23. Small Industries Development Bank of India 2019, [Study on Informal Sector Lending Practices in India Final Report](#), SIDBI, Lucknow.
24. Small Industries Development Bank of India 2022, [Direct Loans](#), SIDBI, Lucknow, viewed 29 August 2022.
25. Small Industries Development Bank of India 2022, [MSME Report August 2022](#) SIDBI, India.
26. Soni, S 2022, [‘Govt extends PMEGP scheme for five more years with ₹ 13.5k crore outlay’](#), Financial Express, updated 30 May 2022, viewed 2 September 2022.
27. [‘What is RAMP scheme’](#) 2022, Business Standard, March 2022, viewed 2 September 2022.



