Sattva Knowledge Institute SKI perspective

DECODING IMPACT

FINANCIAL INCLUSION OF MSME

February 2023

Acknowledgements

Contributors

This podcast was arranged by the **Livelihoods Team** in Sattva Knowledge Institute and was hosted by **Rathish Balakrishnan.**

We would like to thank **Ms Bindu Ananth,** Chair, Co-founder and Managing Trustee, Dvara Holdings, for participating in this podcast and for contributing her valuable expertise, insights and time.

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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**.

Introduction: *From Sattva Knowledge Institute. This is Decoding Impact, the podcast where we apply systems thinking in conversation with extraordinary experts to understand what it truly takes to scale solutions in the social sector. Decoding Impact is hosted by Rathish Balakrishnan, a co-founder and managing partner at Sattva. Welcome to today's episode.*

Rathish Balakrishan (RB): [00:00:38] With the government's push towards Aatmanirbhar Bharat, India has signalled that micro, small and medium enterprises will drive employment opportunities in the country. By 2025, MSMEs are anticipated to account for 50% of the national GDP and 60% of exports. However, the reality today is that 90% of MSMEs remain micro enterprises instead of growing into small and large firms. As per the IFC report, ₹69.3 trillion is the assessed debt demand of MSMEs, out of which only 16% is formally financed debt demand. This forces firms to rely on borrowing from informal channels where interest rates could be twice the formal borrowing rate. In this podcast episode on the financial inclusion of MSMEs, we want to understand the challenges and potential solutions for the unique financing needs of MSMEs in India. We will deep-dive into major causes that prevent MSMEs from accessing affordable credit, along with understanding the opportunities that lie ahead for digital lending in India. To talk to us about this, Bindu Ananth has joined us today. She is the Chair of the Dvara Trust and has over 20 years of experience working on this topic. Bindu, thanks so much for joining us today.

Bindu Ananth (BA): [00:01:47] Thank you. Great to be here.

RB: [00:01:59] It's almost a truism to say that MSMEs are our growth engine and that they have to grow and access to finance is critical. And that always seems to be some obvious solutions to these problems. But I know that the nuances of these problems are a lot deeper. So I thought we could start by understanding the MSME landscape broadly today. How do we imagine this? How do we understand that? Understand the problems a lot more and then move down to the solutions that you think are there and where we are today and where we need to go. And finally, we'd love to close with your thoughts on where can philanthropy play a role. And the first question I have for you is on the mental model of an MSME itself. Because when I, and I've done this in a room and I ask people to close their eyes and then imagine an MSME So people are thinking of this startup entrepreneur who is based out of Koramangala, sitting in a coffee shop and building a startup, but it's far from true. So I'd love to have you share your expertise on who is an MSME, a micro enterprise, especially today, and what is our true mental model of these entrepreneurs. Because without understanding it, solving problems for them is going to be very difficult.

BA: [00:03:00] Thanks, Rathish. I think that's a fantastic starting point because often our solutions, like you said, are built around somewhat of a naive kind of model of the entrepreneur. So I think the first thing to put out there is the fact that most MSMEs are not entrepreneurs by choice, right? And that, again, goes against the grain of what many people think about this space. So if you just think about the numbers, you take the total workforce in India, take agriculture out, which is still declining but still pretty large about, I think, 43-45% of the workforce. You take that out and then MSMEs are then accounting for about 50% of the non-agrarian workforce. So that's a large number. And I think to your point, many committees that including the ones that I've been part of, we approach that as a good thing, as an achievement. But I think that's where we need to step back and think about what's really happening there. Because, you know, like you said, 90% of these are micro-enterprises or what we call single-person enterprises, own account enterprises, which means it's just me. I'm not employing anybody else. And I think there's a fair bit of literature that has looked into this. For example, I think Manish Sabharwal talks about the baby enterprises versus the dwarves, I think. Right. And the point there is all enterprises start small, but some are sort of structurally doomed to remain small, whereas for the others it's a starting point. I think again, Abhijit Banerjee, Esther Duflo, they have a recent paper that talks about this whole notion of reluctant entrepreneurs versus gung-ho entrepreneurs. I think that's what they call it. It's a similar idea that these all may look similar from the outside as tiny units, but the assumptions around how much they aspire to grow, how much risk are they willing to take, I think is very different across the spectrum.

So I think that's the first, to me, important starting point to recognise that not all of these six crore firms and eleven crore people are necessarily driven by growth. I give you an example from one of our clients in Dvara KGFS who in one of these branch visits I had the chance of meeting and she is one of these, what you call *parotta* masters in Tamil Nadu, right. Which means she's right at the high end of the skill meter in terms of *parotta* making. And her story was very much one of forced entrepreneurship. Her husband, who was the only working member in the family, he died and she was left, you know, not knowing what to do, young kids. So she couldn't go out to do agriculture or agricultural labour, which is what most people in her situation would do. And so she said, listen, what do I know how to do? I know how to make *parotta*, let me set up a small stall. Now, you know, as financiers, we love her, we love her story. But the fact is she doesn't really want to or cannot go beyond the single stall that operates for 3 to 4 hours a day. So I think that's the large number, which then I think poses a real challenge to us to think about, you know, where do we go from here. If this is a bit of a transitional state for households who are exiting, let's say, from agriculture, we know that there is and there will be a large exodus from agriculture given declining productivity. There are no great jobs to be had. Separate long conversation for us, but there is this big bulge. I think of micro-enterprises that are a byproduct, I think, of this kind of faultline. So no doubt there is a subsection that's the baby, not the dwarf that has the promise of high growth, high productivity. But policy often does a pretty bad job of distinguishing the two. In fact, in many cases, we end up heavily favouring the dwarves and sort of incentivising them to stay small. So I think that's a really important starting point. So even when you talk about financing, etc., there's a real question about even if supply were there and lots of problems on the supply side, we'll get into that. But in some sense, it's got to meet an enterprise who's thinking about growth. If not, you are just, you know, pushing money where there is no need for it.

RB: [00:07:55] I want to share some personal experiences and also unpack this at two levels, which are a little more fundamental. One, I remember I was in Ahmedabad once and I was doing I was just trying to understand this MSME group. And I remember walking to this place where there was an MSME, which is an apparel setup. Five women were working inside, so they were job creation. This *masterji* was working with a white shirt, white pant, no shoes, coming in. And I asked him and there was a car that was just passing by and asked him, “who was that?” And he said, “that's an export order. They want to do something.” And I said, “Are you going to take it?” He said, “I'm not going to pick it up.” I said, “Why? It must be a big deal.” He said, “Yes, it is a big deal, but that means I have to take more loans, their cash flow is going to be a problem. I don't want to grow beyond these five women.”

So there's a necessary choice that a lot of these people have made, even the ones that have created jobs, to say, listen, this is all I want to do. This is the right point at which my appetite for risk meets my need for money to my family's well-being. And that's where I'm going to stay. And that for me is I mean, as an entrepreneur myself, I realize that it's not an easy thing to be an entrepreneur. The amount of risk that you have to take things you're always playing the table stakes in some sense, right? So the stakes are high, and you probably want to say what level of stakes I want to take. And it seems like sometimes in philanthropy or policy, we want people to take the risk, but we don't understand the downsides they carry and we can't take that away. So just that was one observation. I'd love to have you share some thoughts on that. The second question I had was, if you had to put a percentage and I know it's not going to be scientific of all the MSMEs and if you say these are the babies and these are the dwarves, what percentage of them do you think are actually babies that they actually want to grow?

BA: [00:09:39] I mean, if I had to just take a wild guess and again, based on nothing here, but I would imagine it's a number less than 5%. And this is just, I think, the nature of entrepreneurship, for all the reasons that we talked about, how many people have the capacity and the desire to take risk, expand. And it's not something about people. It's also the support structure you have for a lot of women. For example, it's just that the dice is loaded. So I think for all of those reasons, the babies with the potential to become six-footers are probably a small number. But again, I mean, not to say that therefore do nothing. I think it's just about being more nuanced. For example, I often sit in a lot of discussions where we're talking about how do we bring more VC-equivalent risk capital to micro-enterprises. That's the problem because you see so much of this capital is chasing the entrepreneurs in Koramangala, and we need that to go to the *parotta* master in Thanjavur. But that right there inherently is kind of a difficult superimposition because the question again is, does that enterprise want to take that kind of risk? Do they have the ability to grow in scale in the way that the VC instrument is used to? Right.

So I think being smarter about who these enterprises are, how they may be segmented, I think also is then the first step to getting better policy, better financial services design, which of course is where most of my work and passion is. But you've got to know your customer, right? You can't approach them with a financial product that's just fundamentally unsuited to who they are or their aspirations for the business. So I think super important theme. And again, this topic you brought up about informality and you see so many efforts by governments at the state and centre level to push registration of some type. I mean, countries all over the world have been doing this for decades and there's very little evidence to show that formality is desired or indeed helps. I think India is proceeding in somewhat of an interesting way by also bringing in a lot of visibility in terms of transactions. So we'll talk about some of those platforms and innovations later. But the traditional efforts around registration of businesses, etc. have really not worked at all. Which again goes back to informality, may not be, as they say in Bangalore. Maybe not the bug, maybe it's the feature. And it's not like people are just waiting to change that status.

RB: [00:12:27] And I think at some point I know this is a larger conversation we'll probably come back to it. To understand what is the state of equilibrium for the Indian sector. We are going to be largely I mean, if you assume that we're going to be largely informal, given where we are, that a large share of this is going to be small and we're not going to have this consolidation of large-scale players. How do you design systems that work for them? You know, if you know that this is the ideal state. Because I remember and I'm taking a tangential example, retail giving in India is largely informal for philanthropy. 91% of the money goes to religion and to maids and cooks. There's always a discussion from people saying, how can we make that informal money formal? Maybe it's never going to happen. Maybe we'll always give to religion and to maids and cooks. If you accept that, the way you think about solutions is going to be very different. And I think that the point you made about how do we then create a taxonomy to talk about MSMEs, I'm making this on the fly, but I can imagine at least three types, one, the *parotta* maker who's not going to create jobs, but it's going to run a business but still has maybe not an opportunity spectrum, but a risk spectrum. Something can go wrong. They need the access to cash to be able to do this. And then there is going to be the small job creators like the *masterji* that I talked about, five jobs, ten jobs. They're never going to become Vimal or something like that. And then there are going to be the babies that are going to be six foot tall. Even just creating a taxonomy to talk about these, I think will be very, very helpful.

BA: [00:13:53] Absolutely right. Because the taxonomy we have today is in terms of things like cutting turnover and investments, etc. But it doesn't give you the psychometrics, if you will, behind the entrepreneur and the business. And I think getting more nuanced about that also means that we can channel resources differently, structure policy differently. So I think for a number of reasons, that would be a good start. Even though what you were talking about is the second type, the 5% textile. Remember, that also is a big rarity. Most, 90%, are the single person *parotta* maker. So even the move to more, in our definitions, "small" is already big progress, whereas we are actually saddled with a very large and growing number of micro. And how to get more micro to small, I don't think it's a function necessarily of just financing. It's about just, you know, becoming clearer about who are these individuals, entrepreneurs and what do they want.

RB: [00:15:13] I want to talk about access to finance. I know as an entrepreneur there was a space at Sattva as well where I had to check my bank account thrice a day because unless we get the money, we were not going to run. We were not going to run another week, you know, and I don't think anything kills enterprise like cash, which is literally cash flow and not just how much revenue I'm making, etc., which is why I think everybody intuitively understands access to finance. But access to finance is often understood as access to credit, which is how can I give you loans to run your business better? What is the access to or the cash problem of the msme? How do we understand that better?

BA: [00:15:49] Yeah, so I think lots of issues, big, big set of things to unpack. But I think you're right. I mean, in some sense there is a whole lifecycle to financing, right? When you start your enterprise, when you have really just the idea, whether it's a *parotta* stall or a chip making unit, whatever it is, it's really just an idea. And at that point, just by definition, you're not creditworthy because I think often people miss this. But you know, debt has to be pretty robust. That cannot come in when the enterprise is still discovering itself or figuring out where revenue will come from, because at least theoretically, debt is backed by deposits of banks. And you and I don't want to take the risks that our deposits are not safe because the bank went on a merry spree, lending to small businesses. So, you know, debt needs a certain level of stability. That's just the nature of the beast. So I think even something as basic as that gets missed in conversations in which we're pushing lenders to take more risk, but if lenders start doing that, we have all sorts of other problems, right? So I think then it really becomes before an enterprise is ready for credit and that can be as small as a ₹10,000 loan. But even before that, there is that in-between period where it has to be some form of own capital. Now, that's a problem for poor households because there's not a lot of own capital, right? So that's where the chicken and egg is. If I have, you know, wealth inherited from my family or if I just, you know, exited my first enterprise and I have cash in the bank, it makes that initial period so much easier, relative to that journey. But we've got to solve for that. And I think that's fair. For example, many of our customers I see in the rural context, they use gold. You often don't associate that with early-stage capital, but you know, if you have your jewellery to pawn, no questions asked, right? Because it's like hard collateral. That's the cash that people are using at very early stages or like you said, borrowing from friends and family and informal, in that sense, lenders. And one of the things I've learned in my 20 years of financing is that you cannot - and it's not even clear that you should want to - take out the informal lending ecosystem. In our work through Dvara KGFS, we’ve observed this carefully over a period of time. And we find that, of course, as formal financing comes in, there is a large take-up, people shift quite a bit, but every customer of ours still has a little bit of that. In a way, it's a bit of a safety net, right, to say if this large lender disappears, I will still have to go back to my own other mechanisms. And the point that informal is even now able to do things that formal lenders like us cannot do. So I want some emergency cash in the middle of the night. You know, my credit bureau, because of the last two years of COVID, the credit record seems to have been impaired. The informal lenders care about that. He has other ways to enforce the loan. Right. So I think that's going to be that enduring role and the 0 to 1 stage of the enterprise will, I think, continue to be funded by some of these. And that's where the drive of the individual, the networks, the ability to use other collateral that's available to them will continue to matter. We should debate this more, but I don't see how we can get in formal risk capital at that early stage of the enterprise. Right. That's just a tough problem to crack.

RB: [00:19:50] Right. I want to flesh this further out, which is that there is a 0 to 1 and there are probably other life stages where the needs are going to be different. But I'm going to ask a meta question, which is something I always grapple with. Government wants, or the economy needs more entrepreneurs to thrive, and hence there's interest creating MUDRA schemes and pushing cash to the bank, etc., expecting that more entrepreneurs take loans. But I think the larger meta question is, who is supposed to carry the risk, right, in this entire piece? Like you said, we don't want the banks to carry the risk. We also don't want the government to carry the risk completely and do write-offs because that's going to be irresponsible financial behaviour, which means that you probably have the wrong people come in. We probably want the entrepreneur to carry the risk, but there is only so much an entrepreneur can carry. So is there a larger meta question around, while the greater good is in having more entrepreneurs, the big question is who's carrying the downside here? And how do we look at that? Because philanthropy cannot carry the risk. I mean, it's catalytic capital. It's very small. It's not even big money. And I don't know if there are global precedents to this as well, where, you know, essentially the State carries that risk and saying, hey, listen, I will take this along. But how does that work?

BA: [00:21:02] Yeah, I would say the first part of it is we have to understand and slice these risks better, right? So at a very high level, if you think about small business, let's say there are idiosyncratic risks or shocks, which is to say, I set up this *parotta* stall, but I ended up picking a crappy location where there's no footfall and therefore it's just, you know, I didn't have good judgment around where to set up my shop. So revenues are low. I need to shift it near a bus stand, something like that. Or, you know, I fall unwell, I'm not able to operate it. So those are very specific to the individual. And then there are what one might think of as more systematic shocks, you know, COVID or flooding in Bangalore as it's been happening in the last two weeks, a bunch of roadside vendors, etc. have been severely affected. So at least in theory to your question, systematic risk should be treated differently. They are amenable to be underwritten, to be insured. So one of the recommendations we made to the Tamil Nadu government in a committee that was created last year, sort of thinking about post COVID, etc, is to say that we can't expect most businesses, particularly micro-small businesses, to be able to absorb this magnitude of risks. I mean, they're just going to shut shop and it's going to show up on lender balance sheets essentially. But also, their lives and livelihoods are destroyed. Why don't we think about pretty targeted, for example, catastrophic insurance that is specific for MSMEs, which covers events such as natural disasters, you know, epidemics, big supply chain disconnects that happen as a function of global trade, nothing that they can control, but in some sense, they are sitting ducks for. So I think that's one way to think about it, to slice it and think about who most efficiently can bear those risks. Governments certainly should be part of the conversation. The problem today is government is bearing risks that are also idiosyncratic. So when a government through whatever body gives a credit guarantee. And most of these guarantees are, by the way, pretty generous, like 80% of the loan is guaranteed. They are effectively also picking up a lot of idiosyncratic shocks, whereas, I mean, just resources are limited. That's just the reality. We'd much rather see those resources being used to protect against some of these larger shocks. And the rest of it, well, that's the nature of being entrepreneurial. You've got to manage. If you have terrible business judgment, well, perhaps you shouldn't be in business, but you shouldn't suffer because, you know, a flood suddenly washed out your entire premises. So I think those interactions are very important. And like you said, currently that small entrepreneur is left holding the can, which is also, by the way, very similar in farming. And the small farmer who's bearing the risk of a big rainfall failure, not the lender, because I'm still going to collect from you and because my depositors expect me to do that. So we're not getting enough, and we'll talk a lot more about product design. I think that's a big part of the question. Product design has, in this space (finance for small businesses), been just disappointing and I think there's so much more potential with digital with, you know, also sort of combining insurance and credit so that you're also absorbing some of that risk away from the person who is least equipped to be holding the can. Right? So I think, role of government, longer topic, but today I feel like they are all over the place rather than being a lot more sharp about what is the risk that we truly can meaningfully take away.

RB: [00:25:19] So let's come back to the point you made, which is that the lifecycle stage, the 0 to 1 stage is the first stage where I have this idea of what I want to do. I have zero validation. I can't go to a bank at this moment to be able to do this. And as you rightly said, half the time I'm probably transacting my social capital to get financial capital by telling my friends that, hey, you trust me, why don't you give me money? So at this point, I'm guessing who takes a risk? The entrepreneur, largely. And he's probably delivered it. And the network. And then he's himself transacting on social capital to say if he loses it, he's not going to get the next amount of money. But that's his stake. What is Stage Two?

BA: [00:25:56] Yeah. So I think once there is some proof of concept, there are some early signs of, you know, just operations, revenue, etc. I think that's a good time for a financing conversation. And here I want to make the distinction between what can and should banks do and what can and should, you know, the whole NBFC (non-bank financial company) sector do, right. And it's an important distinction because banks are funded in large measure by deposits. And the theory is that depositors should never face any uncertainty over whether their money is safe or not. NBFCs in the Indian context - different countries have gone about it differently. I think the fantastic thing about regulation in India is that NBFCs are not permitted by and large to take deposits, which means that they are fully funded by wholesale lenders. So other banks, capital markets, who are all we would think of as sophisticated investors, not the naive depositor, but it's the sophisticated investor and they know how to assess the risks that the NBFC is taking and so on. So one of the things that we at Dvara have been very enthusiastic about is to say that if you want to solve the financial inclusion in a tangible, enduring way by which we mean, don't do it at the cost of putting the rest of the financial sector in trouble, then let's not push banks into directions that they're just not comfortable with, or not equipped to understand those risks. But on the other hand, there is a large group of entrepreneurs, institutions who are willing to go out there, take risks, set up NBFCs, do the somewhat riskier lending, even their shareholders are not going to let them do 0 to 1. But let's say 1 to 5. And assuming banks then come from 5 to 10 in our ten points journey, that's an opportunity that we are missing.

So if you look at the total credit flows in the country, I think, give or take, about 20-25 lakh crores is the total flows to MSME, each of which still a good 85% is coming from the banking sector. The NBFC share used to be close to zero. It's only in the last five years that it's come up to 10% to 15%. That could be a much larger number and it goes back a little bit to thinking about the structure of our financial sector and saying, well, for a number of reasons, we might not want to go all out and increase the number of bank licences by a factor of 10 or 100. But I mean, it's very appealing to think about why not grow the number of non-deposit taking NBFCs with explicit kind of goals and ambitions around inclusion, MSME financing. Let them go all out. I mean, what's the downside? If one of them fails, a few of them fail, there's no run on the banking system, right? The losses are limited and that's where the capacity then to take risks for the 1 to 5 will come from. Because even at that stage there's still there is some revenue, there is some evidence of operation, but there's still a fair bit of risk. These are probably still below investment grade in that sense. Businesses are borderline. So you just need a very different type of lender. You also need - I'm a little old fashioned about this - but you need the ability to actually in many cases see the business. In a lot of the businesses that we finance, there is no paperwork for your micro-enterprises, no meaningful paperwork, financial statements. So the only thing we take as an input into credit is, well, if you are a tea stall or if you're a *parotta* stall, I literally need to observe how much sales you're doing in a day, and then we can make some assumptions about what your monthly income is, annual income is. But I need to know that you exist. Somebody is making this stuff. Somebody is eating this stuff, right. So we still have a fairly long tail of enterprises that are not digital footprints, etc. I think that's rapidly evolving. That's fantastic. But I think for a while we'll also need to have lenders who have the capacity to do that sort of high-touch underwriting because otherwise what are they going to offer you? They have no evidence of their business performance to offer you, right?

RB: [00:30:46] I really like this framework. So let's say if there's a 0 to 1, 1 to 5 and 5 to 10, 0 to 1 is really nascent. It's just seed money in some form. Somebody gives it to you. 1 to 5 is really a risk capital, not from the formal banking systems, but NBFCs and so on. 5 to 10 is, you're a steady state business and there's known risks.

BA: [00:31:04] And that's a question to say who takes the uncertainty of that funnel and you know and you want the banks to just take the survivors of that whole kind of risk. But that's why we have to think about who bears what kind of risks.

RB: [00:31:23] Exactly what I wanted to say, which is to go back to our *parotta* maker, our white-shirt *masterji*. And let's say the startup entrepreneur, maybe a *parotta* maker is probably going to go from 0 to 1. In the 1 to 5, they'd probably go up to two or three. Yeah. And then our *masterji* might go a little bit more, but he's probably never going to hit 5 to 10. And then there is a startup entrepreneur who will probably get all the way to 5 to 10. If you think of this as a 3x3 matrix, where is the biggest need today and where? What is the problem that we if you had to prioritise and say, listen, the solving for this is going to be important. I know all of them are equally important, but what will be...

BA: [00:32:00] I would say two places that at least to us seem like very high-return. One is growing that pool of non-bank lenders so that there's just many more people who can develop more sophisticated, intuitive underwriting. In many countries, for example, you have a lot of exclusive small business banks, right? And I had the chance to visit one, I think it was in Indonesia, and just phenomenal because all the staff are drawn from that profile. Kids of traders, service entrepreneurs, and their branches are in the middle of the markets. These are not some high street. So I think for Indian banks, perhaps just given the state that we are in, that's perhaps a bit far away. But in the NBFC space we can get a lot more specialised. And we have a bunch of exciting companies. Kinara Capital, iFinance, Vistaar, Neogrowth. So I think these are all exciting NBFCs focused on MSMEs. There could be 100x more of them and people are willing. I think investors are willing, but it's really I would say right now regulators need to get more comfortable with that concept. It seems to me like a really kind of good place to place our bets.

The other place where I think, which is a little bit trickier, is around I, for one, don't think we can really come up with meaningful, scalable equity investments in the space because equity investment by nature is high monitoring. You need somebody to be sitting on the board because you don't have enough hard information coming out. So how are you going to replicate that high oversight monitoring in essentially a small business. Just for a baby you can do, it not for the smaller... the dwarf or the reluctant entrepreneur. So I think one other area which is promising, we have done a little bit here, but not that much success, is to think about how do we de-risk supply chains in a more systematic manner. I mean, often the reason as an entrepreneur why I need equity, why I need risk capital is because there's some uncertainty around my offtake.

So let's say I'm a small craft producer in rural West Bengal and I've crossed the 0 to 1 stage. I've proven that I can execute stuff. Now I have a large buyer, single buyer, let's say FabIndia. They are the only person and the more they buy from me to a limit, I can expand, produce more, get more revenues. But as a lender, my constant question is going to be, what if FabIndia bails? Then this whole thing is a sitting duck, right? That is not something that the individual enterprise can do anything about. You could say put more equity on the table to protect against the risk of FabIndia withdrawing. But where are they going to raise that capital? So are there other ways, instruments to de-risk? For example, can a third party in this context, step in and say that I am providing a purchase guarantee for this group of entrepreneurs to say, as a lender, you're protected against the specific risk of FabIndia not buying from them. How can I do that? Because I understand the sector well, because I know FabIndia well. It could be one of those things, but that changes the game significantly, right? Because then as a lender, all I need to focus on is the idiosyncratic risk of this. Does she know how to stitch this well? Can she execute? The big risk of offtake is gone.

So I think that's a very interesting thread that has not been explored enough to say instead of pumping equity directly into the small entity, which for a number of reasons is hard to do, inefficient to do, can we attack the source of risk in the supply chain itself, which effectively then gets more people zooming up to the six or seven on your scale? Because the bank understands that the lender knows there is a guarantee here that I understand from a trusted third party, I can work with this. I can discount this invoice.

RB: [00:36:34] In the lender space, the second column we talked about, the NBFCs, there is still... I mean, maybe if there is a choice between building for the *parotta* lady versus the *masterji*, is there a prioritisation that we should probably design for the *parotta* lady, Because 90% of our people are really in some sense there. And so would love to hear your thoughts because questions on product design type of things we will do, etc. are going to be very different from one to another. Within that space, are we optimising for the single person or for the five-people employer? I think that's one question. I'll just as the second question, maybe related is, we talked about Kinaara Capital and a lot of the other players. One of the conversations I was having recently is, is the model for such NBFCs actually more district-level folks who are deeply embedded in social context than people sitting in

Mumbai and Delhi. I'm not taking anything away from any of the entrepreneurs, like, phenomenal people. But do you think that we'll probably have greater uptake if we're going to find people like this in Bhopal and Bihar and Patna, etc., who get the social context more. So they're probably not national players, but they're just deeply embedded district, state-level players who are going to become these innovative entities.

BA: [00:37:41] Just the whole local information and being able to be more specialised. And remember, a district is pretty large, right? You know, when we started our work in Thanjavur and people would be like, you know, you've been here for a year, you're just in Thanjavur because, you know, the model is, as you know, in India, quickly go to ten states. But Thanjavur is the size of Switzerland. If Switzerland can justify multiple international banks. So I think there's just there is too much of a bias towards national models in lending. It's partly driven, again, a longer conversation, but partly driven by rating agencies and the push to diversify because there's a fear that you are, you know, you are lending just in one district. That district has rainfall failure. You're gone. So again, there are ways to manage that risk. But today it's forcing a lot of lenders to spread themselves out thin.

I certainly believe that that takes away from some of the potential growth and ability to manage risks because, you know, there's just so much depth to be had within one district, one block, that we are leaving a lot on the table by being pan-India players. Again, I think these are things that will evolve if there are more if there is more entry of NBFCs, if there's more competition, I think that's going to force people away from the easy pickings and to say, where can I deliver sustainable ROEs? And that will require them to dig deep. Today everybody is benefitting from the fact that it's a small ecosystem. Like in Thanjavur, you know, we are pretty much the first lender. We have customers who've been with us for 15 years still borrowing from us. Sometimes I ask, where is the competition? So I think that that will evolve, but absolutely agreed, particularly for micro-enterprises.

Raghuram Rajan and others have written a lot about this to say, particularly for small business lending, no substitute to good local information. And when we talk about digital lenders, I think let's come back to this to say, whoa, they're going to fundamentally disagree with this because forget district-level, right? They are sitting two people in Bangalore and lending across the whole country without ever seeing their customer. So you have an interesting, I think, co-existence of multiple lending methods. And I would say on balance, listen, the need is so strong. The gap, give or take, is 20 lakh crores of financing. Let a thousand flowers bloom. Right. And just make sure that in some sense that underlying risks are being managed. You want to make sure that the individual is not pushed into bankruptcy distress, has to do terrible things. You want to make sure you're not pushing your banks into instability. If both of those are taken care of, I feel like there's a lot of room to play.

On the first question, again, similar, I would say, sentiment to see if you're asking the question based on where is a rupee allocated going to produce more growth, more productivity, well, that may be then tilted towards the textile owner owning five people because there is that multiplier of five jobs. But again, I think theory would suggest that as long as somebody is able to add the margin, you know, revenue more than cost, reasonable return on capital, by all means, you know, lend to all, right? You just don't want to be in a position in which you are lending to somebody who is not generating enough returns. And therefore, that's been a path to unviability. There is a question of, relatively speaking, where is there more impact? And again, obviously Abhijit Banerjee and Esther Duflo's work on this has been really interesting because they came at it and we were involved in this at that point from ICICI Bank, we were big lenders to many of these microfinance institutions, and we supported some of the early impact evaluations in this space and, you know, super disappointed when that paper got published. And they said, listen, roughly speaking, the impact of all of this work is zero. People are like, what? That was not what we were expecting or hoping. But I think if you read those papers more carefully, what they say is that on average, you know, microfinance is not making people better off, but the averages are so misleading.

If you look in terms of segments, the people who are benefitting a lot from microfinance, your classic microfinance, zero product innovation, just your standard Muhammad Yunus-style lending are people who have existing businesses. Because when an existing business meets ₹20,000 loan, magic can happen in terms of them being able to invest in some technology that earlier, the ₹20,000 is hard to put together. But for a household that doesn't have an existing business, the ₹20,000 goes into a little bit of I mean, it doesn't mean that it's doing harm. You're just not getting the sort of growth multiplier that you're getting with what they call the gung-ho entrepreneurs. So there's a lot of I think a lot of nuance here. Lenders have a huge role to play, and I think the better lenders can get at identification, the better they can answer at their end, who is the baby, who's the dwarf, who's the gung-ho? Develop some sort of credit models, pricing models. That could be amazing. I don't see many people doing that today. Our underwriting is still largely based on things like, what's your credit score? I mean that, then you're behaving a bit like the bank. Yeah, because if you have a credit score, you know, then what's the big deal? That means you already have demonstrated track record. The challenge is really about evaluating in the absence of prior credit history, you know, where do you fall, what is your potential to repay? What is your potential to grow? Yeah, but we need a lot more lenders and a lot more, I think, just sophisticated models.

RB: [00:44:13] Absolutely. And I think that goes back to the two points we made. One, why local context is critical. Because understanding this for a Bihari will be very, very different from understanding it for somebody in Tamil Nadu. Second, it also helps us go back to the 1 to 5 and 5 to 10 models. Sometimes we take the 5 to 10 models, apply it to 1 to 5, and then hope that we'll get better insight, which we don't. One meta question again is, as you were talking about the whole value chain piece and taking the risk there, etc... I was also thinking and something we discussed in the beginning as well. There's probably a lot more systemic faults in growth and access to markets. Like we are working with limited oxygen in general, and a lot of it is actually borne by credit. So the failures of access to markets actually are borne by credit, the failure in creation of jobs, because of which we're getting subsistence entrepreneurs and reluctant entrepreneurs is borne by credit. In some sense. I think we’re using credit as a panacea to solve for problems it's not designed to solve. It's like vocational skilling for people because school education is poor. Whatever you do, it's not going to change anything. And as you were talking, I was realising that there's such limited oxygen in each of these ecosystems. Because what does a farmer supposed to do when his land gets shrunk? He becomes an entrepreneur, and that becomes a credit issue because the entrepreneur has inherent limitations in some sense. Right? And some at some place you might need a clearing house and saying some of these people shouldn't be even running businesses or these businesses shouldn't be existing, etc. But that's a larger question of growth that I want to come to. But let's come to payments, which is, I think, an important point. Because like we said, it's a cash flow problem. Taking a loan is a way of solving the cash problem, but getting paid on time is probably a better solution to solve. And we just looked at the data as well to say MSMEs are actually the worst affected with debt with respect to payments, it is usually the small guy who is actually carrying the greatest risk.

BA: [00:45:59] Which is so ironic because in some sense, who owes you money? It's, you know, people higher up in the supply chain, who are by definition, financially stronger, better ratings. So the working capital, and a lot of large corporates are zero debt, which means that they are not borrowing from anybody, but they are being lent to by the units that are lower down in the supply chain, not by banks. Right. And so you're pushing the working capital issue to the bottom of the chain, which is then showing up, as I would say, misleading credit demand. So I think super important to get to the bottom of this payments issue. And maybe let's spend a few minutes on that. There is legislation. The MSME Act says that no later than 45 days, all of that you have to disclose on your balance sheet if you have. So there's a lot of, I think, just stick-type approaches that have been taken, but, you know, very little results to show for it, including from government and PSU enterprises. Right. So you would imagine that they get their act together. But we looked at this data for Tamilnadu, for the committee, and we found that just state government, PSUs and state government departments alone owed about ₹50,000 crores plus to MSMEs at the end of last year. So, you know, before talking a big game, just, you know, get your own departments to pay and even if those diktats are out. So there's a big kind of enforcement issue there and it is a bit of a David-Goliath type problem because the law actually empowers me to complain and say, I'm supposed to get it in 45 days, but you, PSU, have not paid me. I can take you to - there are these facilitation bodies that have been set up. But really, am I going to take my biggest customer or, you know, I've struggled to get this procurement order. I'm not going to take you to this council because then I'm just out. Right? So I think that's where we need a little bit more automation, transparency around these invoices, so that in some sense there is somebody in the system, some body who can just look at the status and ageing of invoices, without the business owner having to report it. Because that puts her business at peril. She can't do that. So I think that's just a feature there to say, just the law's not going to help, we need to create a little bit more just autocorrect in the system because everything else, we all agree that we should not squeeze the MSME. Yet I think consistently, both public and private sectors continue to do that. And like you said, that's then showing up as credit and worse. Then there's a lot of lobbying with banks to say if MSME loans are overdue by 90 days, let's not call them NPAs because you know how bad the payments problem is. But then go fix the payments problem! Why should banks take on more risk and kind of jeopardise their, you know, their own businesses? Right. So this is a very naughty problem and I think great to be able to disentangle.

RB: [00:49:34] So I want to summarise. I think we've covered a lot of ground and I want to switch tracks to solutions. But we started off by saying, who is this MSME, this mythical MSME? And it was good to take the *parotta* lady example, the *masterji* example, and the Koramangala entrepreneur example, and in some sense, looking at their personas differently, but also looking at their journeys differently, the 0 to 1, the 1 to 5 and the 5 to 10. And then where banks can potentially come, where can NBFCs come, where are social capital of friends and family coming into play and what sort of risks? I think your point around idiosyncratic risks and systemic risk was important because across the spectrum there is also what the state is supposed to do, and what are individuals supposed to carry as entrepreneurs in terms of risks. And then we talked about what are external circumstances that potentially impact them in terms of markets and so on. And, you know, the last point that we made around how access to credit today is seen as a catch-all to a wide range of other systemic failures and solving for the right problem at the right time. And then looking at credit is important. I want to shift to the solution space. You know, I think we've depressed a lot of people in the conversation so far. So I think it'll be good to look at and I'm trying to break this down, even in our conversation Bindu. One, it'll be good to spend some time on the digital lending space. What is the promise? What is the bargain? What are the risks that we are carrying? I would love to talk to you about a lot of this public rails infrastructure that is emerging, the Account Aggregator, the Open Credit Enablement Network, etc... What does it mean for us? I want to tie both of them together to the point that we made about hyperlocal contextual solutions compared to more nationwide players. And is there a way to marry the two? And I have a hypothesis I want to run by you as well. And at some point, we probably also want to close on the payments piece and the work that TReDS does. And another fifth thing, and if you have time for it. I also want to talk about mindsets, you know? Like in enabling all of this, are there things that need to be done at a level of an entrepreneur and an enterprise and how they look at their work, etc., which is not system provisioning and supply side. It's actually defining the demand itself.

RB: [00:51:49] Let's start with digital. I think of the solution space and this proliferation of digital in India, like in general, the finance space. And I feel like we're far ahead in terms of a lot of things that we're doing. But when we come to the issue of credit that we discussed in MSMEs, that we discussed in digital, if you can just lay the land for us and start.

BA: [00:52:06] No, I think it's incredibly exciting and there are two-three different ways to look at it. One is that, you know, when you lend to individual small businesses, etc., it's fairly expensive. And it's expensive because of the paperwork involved, the process times, you know, KYC, all of that. And so when those costs add up as a lender, I'm saying, well, then I might as well maximise my revenue by making larger loans than smaller loans. Because there's a fixed cost of all of this paperwork. And that's where I think IndiaStack, etc has done a phenomenal job because essentially, it's taken those costs to near-zero. I mean, I think there are still some things that need to be smoother, but by and large, I think that whole acquisition of a small customer, the costs associated with it. So there's a lot to be said about just bringing down... For example, if you look at some of the traditional small business lenders, including our own Dvara companies etc, cost of operations for a typical loan size of maybe ₹70,000 to 1 lakh or so in the small/micro business context can vary between 6% and 12%. And what are these costs? It's the people, it's the KYC, it's the paper, it's the documentation, all of that. So I think one that's just a fantastic opportunity to cut through a lot of that sludge. And so I think one wave of digitisation that we are seeing is just more process innovation and lenders doing things differently, cheaper, all of that and hopefully all of that flows back to the customer. That's fantastic. But I think a deeper promise is also then to say, can we get newer lenders? One, is existing lenders more efficient? Correct. But can the whole wave of digitisation also produce just you know, we talked about how the country needs many more lenders, at least, let's say 10,000 NBFCs against the few hundreds that we have today. I think the whole digital wave is also in the work of folks like OCEN etc is kind of painting a future in which really many more people can become lenders. Your traditional notion of a lender is somebody who can put down 100 crores of capital. Ex-banker, knows how to underwrite risk, so on and so forth. But I think tools like OCEN make it possible for somebody who has a business relationship. Let's say I'm an e-commerce platform or I'm a logistics partner, they actually know their supply chain really well. There are transactions. It's not like a lender who's sitting outside and then trying to understand your business. A lot of the business players are right there. They understand the supply chain, they understand the risks. And I think many of them will start to do lending as an add on. Which they could not have done in a pre-digital world because the cost would have killed them. But if in some sense credit becomes one more embedded service that business entities are starting to do, we still have to figure out the regulations around all of this. I think there is a proposal to think of a larger group of entities as loan service providers as opposed to NBFCs or banks, which then they could do even more and take potentially even more risk. But I think that's the deeper promise of digital, to say that you now have a proliferation of lenders rather than two or three entities going to mega scale, and that's built around business relationships, supply chain relationships, as opposed to the older credit underwriting models. And I think the third thing, the power of data science, analytics, all of that, the ability to just understand risks, tailor for risk, price risk. Today, a lot of lenders are still very, you know, in that sense, crude about risk. Most customers, it's either an in or out decision. And if you're in, you pretty much face a standard rate of interest. And I think in the new world, it's almost, you can do infinite customisation. Every customer, depending on maybe a few of the data points, you can decide what's the optimal loan amount, what's the optimal interest rate, very importantly, the repayment structure. This is something that I think the industry struggled with because a lot of our traditional models have a very, you know, every month it's a term loan, payback every month in equated instalments. But the fact is that's not quite how business cash flows work. There are peak seasons that are off-seasons and something that's more working capital, like shorter-term lines of credit. These are just financial instruments that work better for businesses, as opposed to salaried individuals. You and I love the monthly structure because that's how we get paid. But a lot of people have stayed away from that sort of product innovation because of the costs of administering it. And that's, I think, the brave new world that I'm hoping digital lenders right now, not that much evidence of it. We still have pretty old-fashioned designs, but being executed in modern ways. But can we get just more fundamental product innovation as well?

RB: [00:57:44] Again, three parts of what you said Bindu. First part is, the part one and part two, which is existing players digitising to creating the rails for promoting innovation. I think it's like a fundamental difference because with existing players digitising, they probably have more data, they have their better leverage and some of the efficiencies get transferred to the client, but it's very siloed buckets. It doesn't foster innovation unlike when you create a public rail. I want to come back to the district-level innovation that we wanted to have. Is that a way of thinking of this problem as a stack where there is non-contextual stuff which can be done more as infrastructure? Like Account Aggregator- I get data from five accounts and what we've talked in the past about, you know, get telecom data, get other data, non-contextual stuff. And use that and give it to an entrepreneur in a district to say, hey, now do contextual lending, because all the non-contextual stuff the public rails will give you. So you know how much money this person is getting, what is their UPI-level transactions, how many times they charge their phone, how much they travel through GPS data, all of that. But then, you know, here is the actual person he is sitting in this part of Thanjavur, doing this type of business, and hence this is a loan. One I wanted to know, is that promise going to be... is it as exciting for you as it is for me? Because I think that's going to be the Holy Grail, where we're going to create large-scale digital infrastructure. But local innovation, that's contextual. Two why is it not happening at the moment?

BA: [00:59:12] Yeah, I think that's a really nice way to think about it and to say that there's room for both because the profile that is getting created by the rails, etc. may allow the person to get, let's say, some amount of credit. But for example, if they want to set up a new project, you know, there's no way around the fact that you have to assess what is the project? Why do you think this is a good idea? What will the cash flows be? So that conversation is what you are calling contextual, I guess. Which then lets us go deeper and say you're not just skimming the surface with small-value credit. That's an important first step. But then you can really back the high-potential entrepreneurs, a lot more with tailored capital, etc. Again, I think these things will evolve. It's just right now this it's early days. I think people are still trying to figure out what is the promise of many of these platforms. How connected is it to the rural customers' reality, for instance? And these things I think, will change all of a sudden. But I feel that's the way things are going to go. So it doesn't mean that therefore you don't need any more lenders and platforms are going to automate because remember, there's also collections, there's risk. So in credit, we always think about, you know, are you fit for a loan? Are you a good client? But also then post that, are you willing to repay? So that is the whole moral hazard aspect of it which comes after the loan decision is made. For example, many, many borrowers, if they feel there is no consequence, will default, of course. And that's just the nature. And so I think the evolution of credit models is going to be a little bit more, you know, platform plus. And I think the good thing is then it'll force some of the local lenders to start being more specialised. You are not now going to get away with just doing the ₹10,000 loan. If you have to kind of earn your worth, then you have to get into more specialised activities, which I would imagine is good for the customer.

RB: [01:01:33] For me, it's also that the other benefit is for a local entrepreneur in Thanjavur who might not have any of the digital expertise to do some of the sophisticated stuff. There's already a platform that enables all of that for them so that they can focus on what they're very good at. I mean, one again, a meta question on this. There's one thing I've always wondered is, we're creating these pipes, let's say, to go to individual districts. Is that sufficient capital that is flowing? I always look at impact investing. People say impact investing is investing for impact, but they're getting money from the mainstream markets who still have the same financial expectations from the money they're investing. When we talk about investing for the 1 to 5 space, NBFCs getting money etc., are the larger capital markets robust enough for the cash to come to the NBFC to the entrepreneur today? Or is it largely states pumping funding into this and so on?

BA: [01:02:23] I mean, it's gotten a lot better. One of our significant interventions at Dvara was on the whole kind of problem statement of how can we get more wholesale capital available to NBFCs who are doing cool things for the customer. Because the fact that they are non-deposit taking, as we talked about earlier, they're entirely dependent on local banks. And banks, at least 10-15 years ago were much more driven by things like, does it fit priority sector? Then I will lend. If not, forget it. Because there is so much demand that supply is always going to be a bit rationed. So we created this entity called Northern Arc Capital, earlier called IFMR Capital, and they've played, I think, a really important role in just channelling more funds into high-quality NBFCs from the domestic capital markets, which we are fortunate to have pretty deep capital markets. But the problem 10-15 years ago was, a mutual fund is sitting on fairly large pools of capital, but a microfinance institution in Mirzapur, I mean, come on, that's not a risk that they want to touch. But the emergence of intermediaries like Northern Arc has made it possible for... Mutual funds are now big participants in these markets through structured instruments, securitisation, bond issuances. This was unthinkable 15-20 years ago when we had just started our journey. And how did some of that happen? I know we'll talk about philanthropy more later. In the early days was really important because, you know, you can't bring in a mutual fund without a sense of 'I've got you covered'. I'm putting money where my mouth is. Here are guarantees that are backing up the performance of the NBFCs. Dependence on wholesale capital, to your question, continues to be a challenge. Whenever there is any crisis in the NBFC sector, which unfortunately is pretty often, there's a lot of kind of exit. But I have actual customers waiting outside, waiting for their kind of promise. So that is in the life of an NBFC a pretty big challenge. And it's also expensive. That money is available at 13-14% for an NBFC, which means that after adding everything else, it's pretty hard to do a sub-20% loan in this space. And then for the micro-enterprise, that then means you've got to generate a return on capital that's well above that 20 if you have to retain something and grow. Right? So a lot of work to be done there. But I would say relative to say, maybe, Africa where large markets in Africa where you don't have domestic capital markets, then you're entirely dependent on foreign funding. And that's just always going to be a bit of a challenge.

RB: [01:05:22] You know, 75% of all philanthropy in India is now domestic, and global funding is actually coming down significantly. In the last ten years, it's gone from 55% to 25%. Interestingly, a lot of the domestic philanthropists, you know, are grappling with this dichotomy of a grant where I give the money and I don't get it back, or pure equity investments where I'm promoting my wealth. So they're saying, listen, the grant is going to run out and we don't have dollar leverage. It's just that the rupee is a rupee. So there is an interest in domestic philanthropy to say, how can I make my money create better value that will have social impact, but it's not a black and white. It's not like, okay, here I've built a temple and here I'm going to run my business, you know? And I think the emergence of that blended capital for domestic finance to say, listen, I have I don't have two jars of money. I have three jars of money. This is entirely focused on the highest value generation. This is going to be focused on growing the capital, but not at a smaller clip rate, but creating value. And this is just giving it away, you know? And I think that's going to unlock (a) the size of the capital. It's going to go from 2% to about 20%.

But also then if the pipes are ready and if the governance is strong and the risk is, of course, going to be there, I mean, people have to know that they might lose the money here. But if there is no risk, there is no return. I feel like there is some level of orchestration that is possible there, which is very interesting. And that, again, where I think philanthropy can play a role.

So one thing we talked about was using the digital to drive more local innovation. The second thing I think we've been talking through the podcast is product design. You know, there are such ridiculous top-level designs. You know, I did this entire a little bit of a search on insurance, you know, how to make insurance work in India. And I know it's an interesting area of interest for you as well, but I feel like insurance is broken in India significantly, given where we are. And one of the conversations I had, where the person said when you start with a product and insurance market often breaks down because you take a very top-down view to the product and then doesn't take cover the risk for the person. Similarly, here today, the loans are structured in a manner where there is very limited customisation because of lack of data.

For example, I took a loan and they told me, you are an entrepreneur, so you're going to have a higher interest rate. They didn't look at my actual financial performance, how do I get my salaries every month? None of that. Because I check in the box and I've been allocated. What is stopping us from innovating on products today? I mean, also, is it a big ailment in general and what is ailing us in driving more innovation in products?

BA: [01:07:52] Yeah, no. Great question. And so I think some of it is that retail finance in India has been very product-driven and typically single product. So whether you think about credit cards or personal loans, commercial vehicle loans, or even micro-loans for that instance, so you have entire institutions built around a single-product construct. And then the journey for everybody has been, 'let's put your foot on the pedal and take it to the maximum national scale'. So you have all of these product rails, to use your language, that has gotten created. But for the customer, it is very bewildering, because now I am dealing with, you know, five, six different providers. One is the credit card guy, one is a personal loan guy, yet another guy is the LIC. So I think part of something we've believed in fundamentally, personally also, as Dvara is to say financial services in India just needs to go through that transformation and become just fundamentally more customer-centric. As in start with the customer, not the product. The customer likely needs more than one product. And the way it's evolved in that way is also, I think, older structure, four different regulators sitting on four different products.

So even if I wanted to, I couldn't, for example, easily combine an insurance and a credit offering because I have two sets of regulations. So I think those are the things that I'm hopeful will change going forward. Partly, new entrants are bringing a very different DNA, and I think the kind of product design that would be very exciting to see is where, for example, the lender is taking away some of the risks, not because of their benevolence or because the government asked them to do so, but because a better product design. So, for example, if the lender bought insurance that protected against, let's say, you know, rainfall uncertainty in the case of a farmer or, you know, the business generating subpar returns for a few months because of external factors, etc. Then in some sense, as a lender, you are able to offer a little bit more cushion. You're not going to go knocking on the door for collections when you clearly know that this household has no money to give you.

That's the unfortunate situation that many of us find ourselves in, to say COVID has happened. We know, but we are supposed to start collecting because the moratorium is over. And if you don't, then it has all kinds of repercussions on provisions, balance sheets. And there's a good reason for all of these things. But I think the root of it is to say, can we de-risk? Because when you lend to a customer, inherently, you're adding to her risk, right? Because on top of your already variable cash flows, you've now added leverage. Many micro customers, for example, we found through our research that often they are paying lenders by cutting back on their food consumption. Listen, that's not why any of us got into this work, right?

So I think that's a very important conversation in product design to say how can we make it possible for providers to bundle more, which then shows up to the customer as better-designed products. I know KaleidoFin, for instance, Sucharita and Puneet are doing interesting work in terms of being able to blend some of this for the low-income households so that they're not making, again, three or four separate purchase decisions. I'm doing some new work on health financing where I'm trying to combine savings, insurance and access to outpatient care into one account. So I think a lot of the future of product design is going to be these intersections. And for the customer, listen, it's fantastic because otherwise I'm just wasting so much of my time, which I would much rather spend on my business or my family, on figuring out the finances and the five different providers that I have to deal with and maintain relationships with. So I think that will change.

RB: [01:12:15] And I think it segues to the third point that I picked up from what you said, which is today, financial industry is stand-alone. All of these inbound calls from third-party players saying, "do you want a home loan?" in the middle of a meeting? I don't want a home loan. There is zero context to why you're selling me that. But if I'm actually making a purchase decision and there you are embedded saying, listen, if you click here, you're going to get a loan at this rate, this context, and I know who you are and hence, here are your terms. It's a lot easier for us to discuss. So I think this transformation that you talked about, where financial services get very contextualised into the market decisions that MSMEs make, saying, I'm buying, I have a supplier invoice, I have an order, how do I integrate that into that? That allows you to (a) your customer acquisition cost comes down because you're selling it in context and you can do it as contextually to the need of the person as possible, which again is something digital will enable.

BA: [01:13:07] OCEN, I think this is what OCEN is so well-positioned to do. Let's say I'm selling you some inputs and you know, I want to offer it on credit, then I can, one is to informally do it, but the other is to formally make that BNPL-type proposition. And then I have a proper lending book with the subset of customers that I'm anyway transacting with. I'm not going to go out there and acquired one brand new cohort, but this is coming out of my trade relationships, my business understanding. And that's also then likely to be a much better-performing portfolio, right.

RB: [01:13:50] And is there a bit of an incumbent risk here, in the sense that the entrenched players in the financial system, they've made massive investments. And themselves as a standalone business, being able to adapt to this structure. I mean, we've been able to show that with UPI, it's not been an easy ride. So I don't know if there's an incumbent risk in an industry as strongly regulated, well entrenched as a financial industry.

BA: [01:14:12] Yeah, yeah. I mean, I think there is a lot of that going on. But for example, something like Account Aggregator is interesting because in a way it benefits the new entrant with the incumbent, right? So State Bank of India has hundreds of millions of accounts and relationships. Now you're seeing some of that information can be made available to this startup digital lender, with the customer's consent, of course. But you know that customer data, which would have otherwise been proprietary, it's now available for a new entrant to build credit models, etc., around. Otherwise, in some sense, without that data, you're starting from scratch. So I think there are some things that are going in the way of startups, but I think clearly it's a lot up to how incumbents are also then responding to this, you know, repurposing themselves. And at the end of the day, I think there's just so much need. Yeah, I feel like there is enough for everybody to build fairly large-sized businesses around, and I wish people would start to move away from the urban salaried group and start to look at more of the kind of segments that we talked about today. That will happen, would be great if it happened faster.

RB: [01:15:29] You know, two questions, which is more on the risk side of digital. One is where the rails already exist or let's say the digital channels already exist for us to reach the MSME, it's a lot easier now. You're selling it on Amazon, for example, and stuff. But our *parotta* maker lady, unless she integrates herself into the digital channels and the players that exist, everybody is going to find the cost of providing her credit very, very difficult to do. How do we solve the problem? Is there a huge exclusion risk in what we're trying to do here?

BA: [01:15:57] Which is why I would very strongly advocate that in some sense we have to advance some of these threads simultaneously. One is the growth of the digital platforms, all of that good stuff. Also, think about how all of us can play a role in enabling digitisation. So how can we get more people on these platforms? And the third thread is really about therefore continuing role for the NBFC sector, which is willing to work with people who are in transition or pre-transition. And just that could take us years, right? I mean, it's not one of those things in which you can say, that problem will eventually get solved. Let's just focus on the platforms.

I think we need effort at both ends. Otherwise, there is a pretty big risk of exclusion. And not all enterprises are particularly the subsistence enterprises. They may never connect up to a platform because they're serving local markets, I mean the market for the *parotta* master is the, you know, agricultural labour in her village who eat there because they don't have time to cook at home. That's a very local market. How is she even going to get to Chennai? Pretty hard to see. So what is the need to get onto Amazon? And many of these are deep local markets. So we have to have a way in which we can underwrite, reach out to those enterprises affordably. But their own rates of return are also pretty high. That's why they are able to justify a 20% plus borrowing rate from NBFCs. So we've got to grow, I think, all of this. And when the big transition happens, well, great, good times, but that could be a pretty long transition.

RB: [01:17:42] And I think one of the things that I picked up in our conversation today was that it's not going to be one large mission mode approach. Everyone's building building blocks like the Northern Arc's work in getting the capital, the fintechs' work in creating the products, and there's the Account Aggregator work that gives us the credibility information. And I think the question for us is, are we thinking of all the building blocks that we need to be able to do this? Like I remember in one of our conversations, you mentioned this whole MUDRA card having 20% of the money going into the Rupay card so that they can make digital transactions. So suddenly digital behaviour is starting to emerge and so on as well. I think in some sense, the urgency of digital for the sake of digital with the existing MSMEs, maybe it's still necessary because it doesn’t fit into a theory of change saying, okay, now all of this will tie into this. But it just enables them to be readier. You know, when the wave comes in hopefully.

BA: [01:18:34] I mean, people see a benefit. They know a benefit when they see one. So I am very much opposed to some of the heavy-handed 'shock and awe'-type ways to get people to transform. I think that could be pretty disruptive. The benefits are clear, so let's build more on the business case to digitise and people will come. But you can't force people's hands on some of these things. So I think that's probably something for us to be more kind of careful about, because also the fact that a lot of the pieces of the ecosystem are not ready. There are still connectivity issues. And so large parts of the country, sometimes Internet is not available, it gets shut off because some examination is happening. Did you know that? That's the big thing...

RB: [01:19:23] I heard. Yeah.

BA: [01:19:24] To prevent cheating in some of these large exams, they just open this stop internet. So what happens to a business that's then fully dependent on internet payments?

So I think we have some way to go for all of that. I think we should give people the kind of runway and then let that adaptation happen and not a lot of big push.

RB: [01:19:47] No, I agree with you. I think to promote entrepreneurship by removing agency will be very ironical. I have two questions. One, Bindu, was around the payments piece. We've talked about the credit. We've talked about how the digital enables the three things that we talked about. One is local innovation on top of public rails. It allows for greater product innovation and product benefits and so on as well. And what we just discussed. What is happening in the payments space, and maybe TReDS as a system and what is happening there. Maybe it's a good thing to just touch upon as well as part of this overall.

BA: [01:20:12] So I think TReDS is also solving much more the receivables problem. That's again taking a slice of it that's more solvable than the overall kind of credit axis. So I think there have been quite a few licenses that have been given. I think some of them doing well, activity picking up, all of this could be much bigger. But I think we just need to stay with some of these ideas, give it the time. So right now, again, there are some issues such as, banks can participate in TReDS platform, not NBFCs. So with all of these, I think where the idea is to build a marketplace or a platform, the general rule has to be - the broader the participation, the more liquidity, the more competition, the better outcome for the end customer. So I think smaller issues like that are to be ironed out, but my sense is that's going well. The other is this GeM platform of the government, which by the way, I think globally, if you look at what's helped SME development, preferential public procurement has been a very important tool. And we are doing it a little in bits and pieces. Some of it is left to states, so you get a bit of a lack of uniformity, but I think the GeM portal is an interesting, once again, digital platform that is creating more transparency aroundthe kind of government requirements and this is a criterion and I think that can certainly provide a nice push for many MSMEs. There is a certain percentage of procurement as part of policy that is done through MSMEs in specific sectors, etc. So that kind of encouragement is interesting because it's not adding to the government's expenditure. It's just saying I'm going to take my existing purchasing power and allocate some of that to this sort of sector where we know they can do well. So I think some of these are interesting phenomena.

RB: [01:22:24] I'm just stacking up everything we discussed. I think at some point we said, okay, how do we unlock more wholesome capital to come into this space, which is really the flow of capital itself? And then we put a layer on top of the public rails and saying, okay, all of these public rails allow for greater innovation to happen. We talked to the district-level entrepreneurs who potentially can become lenders in context, etc. On top of that is the product layer and the innovations that can happen in the product, both in payments and in terms of credit. The last layer I wanted to talk about was the demand itself, which is all of this is supply. There is the mindset of the entrepreneur and the work that we need to do to say, how do they imagine their business and so on, which is not to say that make the *parotta* lady like Nykaa's owner, etc. But in the way they understand credit, in the way they understand access to capital and all of that, is there work to be done there, and who is best placed to do that work?

BA: [01:23:17] I myself think about in general because there's so much of a quick resort to saying that something demand is a problem or people are not smart about their finances. So in general, I don't go there. My starting point has been to say that people, low-income households, they are all optimising. We don't always see what are the things going on, right? We don't know what is the struggle at home, what is the struggle at business. So my general assumption, and that's the way we operate our finance businesses as well, is that assume that the customer is doing the best they can in the circumstances. We can never, there are lots of unknowns over this there. But over a period of time, a lot of what we consider fixed mindsets can change because if you experience growth, if you see peers operating at a different level. So these are not, in that sense, immutable. So start with where the customer is. Do the best you can in terms of the solutions you can provide. That's why product design is so important. I mean, really frustrates me when people say, "they don't want to take more risk, how silly of them! You can't become an Ambani without taking risks.' But! So an entire conversation we had around, who has the luxury to take risk and what safety nets do you have? So I think. Surely, I think that thought around, are there ways to make people more entrepreneurial? Can there be things that happen at an earlier age that kind of get people's minds opened up to more entrepreneurial work. I know, for example, there's some interesting work I heard about in Delhi, in the Delhi government schools, where they've implemented a curriculum in entrepreneurship. I mean, it sounds intriguing to me because in some sense you're going at a stage in life when people are starting to think about what might they do. And I don't know in the long run, whether it's effective or washes out, but just given where we operate, I would much rather put our weight behind - let's fix the supply side. Let's assume that there is a lot of activity that's possible. And there's just a lot of gaps because of which people are being held back. That's where I would come, but I am curious, how do you think about this?

RB: [01:26:01] So I'm a huge believer in individual agency. I believe people have to be given choice. This whole Adam Smith 'man of the system' approach of saying, I'm going to find a way to play systems and people in a certain way I completely don't believe in. But at the same time, I struggle with the fact that much like our healthcare, finance is actually a place where we are poorly educated. Like no one is taught to sell, no one's taught to save money effectively. My son could go to the best school in Bangalore, but he probably still wouldn't know how to manage money effectively. And there is a principal-agent problem here. The person who's advising you, especially in finance, may be conflicted in terms of what is good for you versus what is good for them. And sometimes it's also just, and recently, even when I was looking at my own saving financial behaviour and those of people around me, the opportunities that are available in the financial markets versus what I was making use of is still very far and wide. And this is me, digitally connected, reading all the news and all of that stuff. With all of the innovation that's happening in the financial space, things like TReDS, and things like financial innovation, fintech, etc. at one level there is an awareness. There is also the fear that comes and there is also, to imagine the possibility of a future knowing this feature is available. And you don't even know it, you probably don't even think of it. I do feel there is something to be done there, not in a way which is directive and undermines agency, but in a way that enables.

BA: [01:27:22] But you mean look at the WhatsApp QR code. I mean, I'm just blown away by the rapidity with which... And we didn't have training programmes to tell people how to use WhatsApp for your business. I think when the product is so intuitive, then people get it and then, you know, adoption and there will be early adopters, all of that stuff, right? Because I worry about if you have to prop up something a lot, is it even something that is good for the customer? Is it solving a problem? If so, why don't they see it, right?

RB: [01:28:03] No, I think it's a good pushback. It's a good pushback because we did all the skilling programmes that we did when OLA started. They got enough drivers without any of this. Because incentives were very clear for people to come and join. Philanthropy, ironically, almost always assumes that there is an agency problem. And so, which is why there's a lot more demand-side intervention that we try and do. And some of it is effective or not. But I'd love to hear your thoughts on, in this entire conversation on MSME lending, where is the value that philanthropy can actually play?

BA: [01:28:31] You know, just reflecting on the experience of the microfinance sector, etc, the whole role of philanthropy, some of the developmental financial institutions that stepped in, the first loss default guarantee became a very, very important tool for us to make this market clear. So I think even within the narrower financial social products, kind of getting all the pieces to fit in, there are some spaces where there is not enough risk capital, but I think there could be an ongoing role. I think the second area is there's just a lot of related but broken markets. So in the context of MSME, one of the things we've been really interested in is thinking about the role of second-hand markets, right? Because one of the ways in which one of the reasons why entrepreneurs need money is to often buy equipment, whether it's agricultural equipment or a fridge or a machine or something like that. And my ability as a lender to lend to you goes up significantly if I know that there is a thriving second-hand market. Right? Because if you default, I can repossess and the loss given default, as we call it, on my loan, then it's looking much better because I have another buyer. There was some work ICICI had done with Amazon to create this, because at one point I think ICICI was sitting on a large stock of repossessed tractors. Really? Yeah, because we were big farm lenders. But how do you get liquidity from that collateral? So I think there are these second-order type things that is really interesting for philanthropy to...but we have to get into it and we have to think about it deeply to see what are the markets, if they work well, release, to use your term, more oxygen into this relationship. What makes it easier? Otherwise, it's too easy to just fall back on banks, to say, *tum karo yaar* (you do it), take all the risk, do all the hard work. But that's not sustainable. So I think that's worth thinking about. You mentioned Skilling. I think that's a super naughty but interesting problem. Again, you think about small businesses, they very rarely hire outside the family. And research shows that that's because they just don't know, you know, how to hire, who's qualified. And it just feels too much of a risk. So even if they remain small, they remain within the limits of the labour that they can get from family and extended family. So are there things that we can do on the skilling side that provide, in some sense, a bit of a cadre who has some sort of certification, etc. But that's much more suited to these sectors. I mean, you have to flesh this out, but those are problems that I feel like the market is not just solving by itself and definitely might be interesting for us to think about work and patient capital, philanthropic capital etc.

RB: [01:31:38] I mean, I think one, the point you made about risk pooling I think is a very important one, because first loss guarantee allows us to actually innovate on instruments and say, hey, does this work for the construction micro contractor and does it work for anyone else etc.

BA: [01:31:51] ...and keep the FLDG, make it available only if you know that the underlying product is new.

RB: [01:31:59] Absolutely.

BA: [01:32:00] Don't FLDG a microfinance loan because that was helpful 20 years ago. That's a thriving market now. But if somebody wanted to go out there and say that I want to lend as per the cash flows of this business and give a 30-day moratorium, et cetera, et cetera, great. In some sense, enable the lender to also take more risk and try new things, because it is otherwise pretty hard for the lender, because I can't justify to my shareholder why I'm doing this quirky stuff which might have higher rates of default. Nobody wants to use their capital for that. So I think, use that capital in a very intentional way, we should have a clear sense of what is the missing innovation in the space and nudge that there. I think that's where folks like yourself can play a great role because you provide that knowledge capital to the philanthropic firms to see these are the missing things and this is where we think the capital could be catalytic.

RB: [01:32:59] Yeah, and another area that I think philanthropy can play a role and it's a longer conversation is gender. It's just that there is a significant... And I don't know if you believe this, because I've asked this to other speakers who've come on the series as well, is that there is clear behaviour difference between men and women in terms of how they access credit. And even when I speak to philanthropic donors, they do emphasise the fact that there needs to be more that needs to be done to encourage women to take more loans, etc. But do you think that's a good idea, in terms of solving for maybe systemic challenges in the way women access credit, and anything philanthropy can do there?

BA: [01:33:33] I definitely think it's important and worth doing, and a lot of it is household models, right? I mean, we talk about, we take great pride in microfinance, that 99% of our customers are women. But a lot of, in that sense, the women are the, kind of, front, but the money is going to the household. But again, research tells us that even if the woman is just the front, it influences the nature of deployment. It goes into the margin stuff that's better for the family, education, etc. So I think that's a really important channel of impact. I'm a little bit more torn when it comes to thinking about businesses and entrepreneurs because in some sense, there women face multiple hurdles and are likely to disproportionately feature in our reluctant entrepreneur category. And so there it may be much more pertinent to think about what are those barriers.

RB: [01:34:32] ...and solve for them.

BA: [01:34:32] ... And solve for them. And then we will get hopefully the natural progression.

RB: [01:34:39] I have so much more I can speak to you about, and I wanted to talk to you about the whole market piece, the PLIs and aggregator platforms. I wanted to talk to you more about the gender piece as well, but I think we are out at time and I think but this has been a fascinating conversation. I've thoroughly enjoyed speaking to you. And I think we've covered a lot of ground, both in terms of problems in the solutions and where we are. And, you know, thank you so much for your time.

BA: [01:35:00] Thank you so much. It was great fun for me.

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