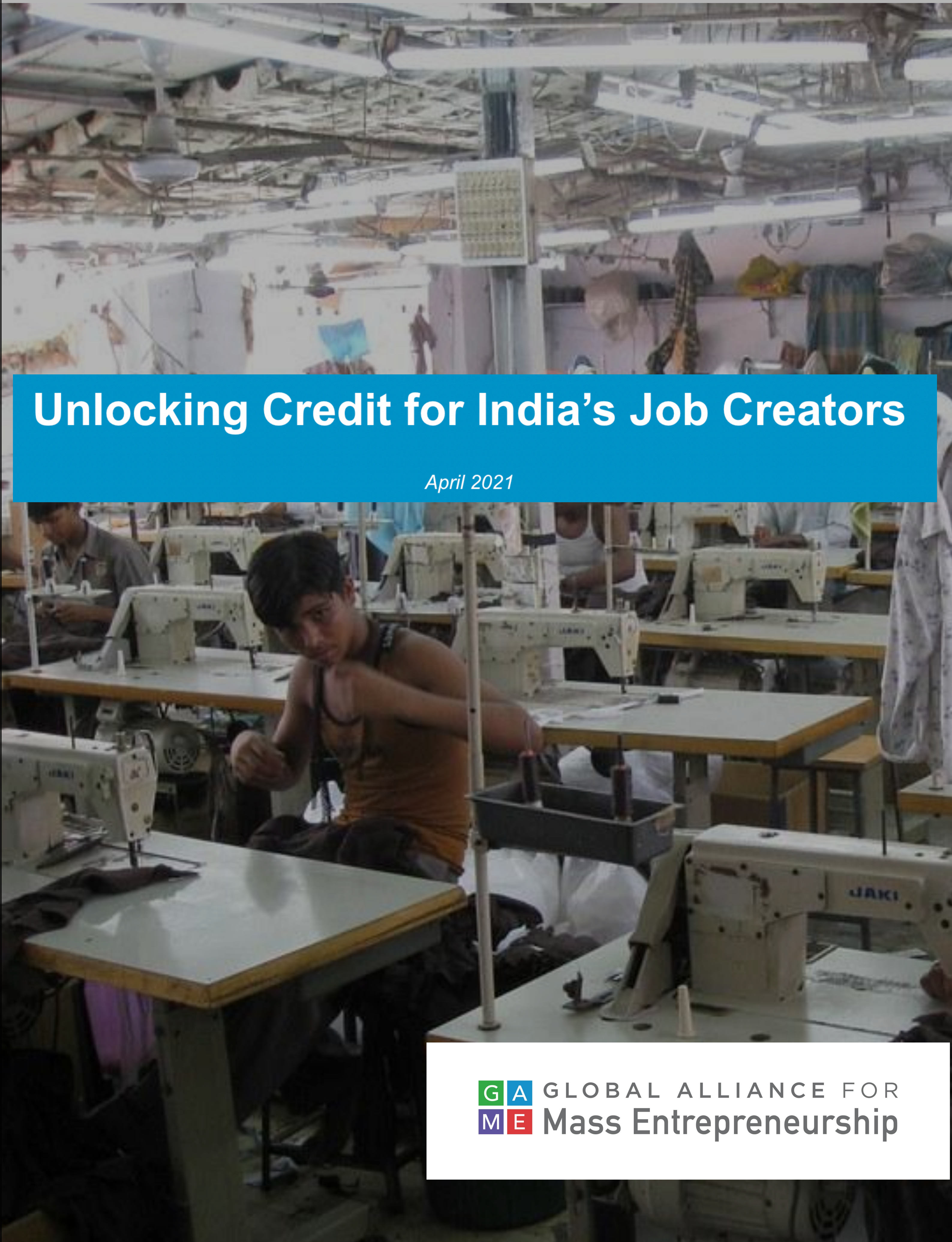
Unlocking Credit for India’s Job Creators

April 2021



GLOBAL ALLIANCE FOR Mass Entrepreneurship

Table of Contents

1. Abbreviations

Abbreviation	Description
B2B	Business to Business
CAC	Customer Acquisition Cost
CBIC	Central Board of Indirect Taxes and Customs
CEO	Chief Operating Officer
CGFSF	Credit Guarantee Fund Scheme for Factoring
CGTMSE	Credit Guarantee Fund Trust for Micro and Small Enterprises
CIBIL	Credit Information Bureau (India) Limited
CII	Confederation of Indian Industry
CMIE	Centre for Monitoring Indian Economy
CMR	CIBIL MSME Rank
CoGS	Cost of Goods Sold
CPSEs	Central Public Sector Enterprises
DSO	Day Sales Outstanding
ECLGS	Emergency Credit Line Guarantee Scheme
EDOs	Entrepreneurship Development Organisations
eNACH	Electronic National Automated Clearing House
ERP Systems	Enterprise Resource Planning systems
FI	Financial Institution
FICCI	Federation of Indian Chambers of Commerce & Industry
FinTech	Financial Technology
FISME	Federation of Indian Micro and Small & Medium Enterprises
FMCG	Fast Moving Consumer Goods
FY	Financial Year
GAME	Global Alliance for Mass Entrepreneurship
GDP	Gross Domestic Product
GeM	Government e-Market Place
GFR	General Financial Rules
GOI	Government of India
GST	Goods and Services Tax
ICOR	Incremental Capital Output ratio
INR	Indian Rupees
IPO	Initial Public Offering
IRDAI	Insurance Regulatory and Development Authority of India
KYC	Know Your Customer
M1 Exchange	Mynd Online National Exchange for Trade Receivables
MCA	Ministry of Corporate Affairs
Ministry of MSME	Ministry of Micro, Small and Medium Enterprises
MIS	Management Information System
MoSPI	Ministry of Statistics and Programme Implementation
MSEFCs	Micro and Small Enterprise Facilitation Council
MSEs	Micro and Small Enterprises
MSME	Micro, Small and Medium Enterprises

Abbreviation	Description
MSME Form-1	Micro, Small and Medium Enterprises Form-1
MSMED Act	Micro, Small and Medium Enterprises Development Act
MUDRA	Micro Units Development and Refinance Agency
NBFCs	Non-Banking Financial Companies
NCGTC	National Credit Guarantee Trustee Company
NGO	Non-Governmental Organization
NITI	National Institution for Transforming India
NODE	National Open Digital Ecosystems
NPA	Non-Performing Asset
NTC	New to Credit
OCEN	Open Credit Enablement Network
ODR	Online Dispute Resolution
OECD	Organization for Economic Co-operation and Development
PLI	Production Linked Incentives
PSBs	Public Sector Banks
PSE	Public Sector Enterprise
PSL	Priority Sector Lending
PSUs	Public Sector Utilities
RBI	Reserve Bank of India
RXIL	Receivables Exchange of India Limited
SEWA	Self Employed Women's Association
SBI	State Bank of India
TCI	Trade Credit Insurance
TLTRO	Targeted long-term repo operations
TReDS	Trade Receivables Discounting System
UPI	Unified Payments Interface
USD	United States Dollars
WOS	Wholly Owned Subsidiaries

2. Introduction

This short report has been written in the context of the widely felt need for India to urgently create more jobs. There is broad consensus that MSMEs will lead job creation; the challenge is to strengthen the credit, compliance and ease-of-doing-business ecosystem required for this. Low-cost finance, a key driver for MSME growth, is yet to reach a vast majority of India's MSMEs and for those who have access, this is sometimes neither sufficient nor timely.

Several committees, institutions, and policies have attempted to tackle this problem. In recent years, the UK Sinha committee provided a comprehensive set of measures to provide, inter alia, a fillip to MSME lending. Investors and philanthropies have poured strategic finance into lenders and ecosystem building efforts such as guarantee funds. There have been innumerable legislative and regulatory interventions focused on making the MSME segment healthier and more competitive. Similarly, numerous private sector initiatives like OCEN and iStack have been devised to bridge the MSME finance gap. The mere fact that so many efforts, for so long, have been directed to fill the 'MSME finance gap' suggests that there are stubborn problems here that require sustained attention, and also need the public, private, and the social sectors to work resolutely together.

The Global Alliance for Mass Entrepreneurship is an alliance of like-minded organisations and bodies committed to facilitating employment generation. A large group of people, from different sectors, has been working on some of the more persistent issues in easing access to credit by MSMEs, by studying the existing efforts, the data, polling various stakeholders and bringing them together for purposeful discussions.

This report attempts to bring problem articulation, data and solutions from these efforts in one place, and add insights arising out of collaborative processing of the former. The approach emphasizes solutions that align the interests of all stakeholders, in that the proposed solutions are market-driven and congruent with the commitment to enhancing the ease of doing business. Also suggested are solutions that require a more deliberative and consultative approach with the involvement of relevant stakeholders. And finally, in some instances, we have just scratched the surface and require additional data and insights from the research and advocacy community, to come to decisive conclusions.

This report is intended to share the results of this exercise with a larger group of interested parties, in the hope that it adds value, both by sharing insights and reinforcing steps already being taken, to the common objective of increasing employment opportunities. The collaborative exercise described above does not culminate with this report, and it is hoped that the ongoing commitment encourages new partnerships, ideas and platforms.

3. Research Methodology

3.1 A robust methodology was adopted in this report, which started with a macro view of the finance related gaps in the MSME sector and converged into a micro view of the scenario in the two key areas of easing access to credit to start an enterprise and working capital requirements. The research methodology was a combination of secondary research and primary research, including data analysis based on select hypotheses. The MSME Finance week conducted by the Global Alliance for Mass Entrepreneurship (GAME) in December of 2020, was crucial to providing deeper insights into the MSME Finance ecosystem in India.

3.2 The methodology for finance related aspects of the MSME sector involved five key stages; (i) Identifying gaps in areas of finance, (ii) estimating the size of the gaps, (iii) understanding the drivers of these gaps from the perspective of financiers, buyers, MSMEs and regulators, (iv) understanding the implications of these gaps on the entire MSME ecosystem, and (v) identifying key interventions to address these gaps. Interviews with key stakeholders were also conducted to validate our findings. The following were the key components of the research methodology, that drove the stages mentioned above:

3.3 Identifying gaps and size of the problem

3.3.1 The team conducted detailed secondary research to identify the gaps in access to credit, delay in payments to MSMEs and provisions for insurance in India. Estimation of the size of the problem was through secondary research and where required/ possible, data analysis was conducted. Prowess IQ database of CMIE, TReDS and MSME form-1 data was used for a comprehensive analysis of the delayed payments problem in the MSME sector, broken down to micro, small and medium enterprises. The estimations were based on the new 2020 definition of MSMEs in India. Appropriate assumptions were used to extrapolate delayed receivables to the larger population of MSMEs was done. Further secondary research was conducted to understand the drivers of these frictions. Primary interviews were conducted to understand the perspectives of buyers, financiers, and MSMEs.

3.3.2 Post identification, the size and drivers of these gaps, hypotheses on the implications of these frictions on the MSME ecosystem were developed. Secondary research was used to substantiate these hypotheses along with adding detailed descriptions. CMIE data on MSMEs, ICOR value from the RBI and GDP estimates from MoSPI were used to conduct data analysis and estimate the impact of long payment cycles on the GDP of India.

3.4 Testing findings

3.4.1 The team conducted multiple discussions with the GAME Finance Taskforce to discuss and test the applicability & prioritization of findings. Discussions and workshops on areas such as innovation in financing and MSME payables were conducted to test our findings and carve out nuances.

3.5 Consultations with external stakeholders

3.5.1 The MSME Finance week was a source of several insights into the MSME ecosystem. The 4 key themes of the week were innovations in credit, supply chain financing and factoring, MSME receivables, and micro-insurance. The week was inaugurated by Shri Amitabh Kant (CEO, NITI Aayog). This week-long convening closed with a keynote address from Shri Nitin Gadkari (Minister of Micro, Small & Medium Enterprises, Govt. of India). Through the week several eminent leaders[1] from banks, NBFCs, insurance players, corporations, philanthropies, and non-profits came together to discuss various solutions to help the MSMEs sector. Panel discussions on formal finance to women entrepreneurs and innovation mapping took place. Workshop on TReDS with attendance from key stakeholders, including the CEOs of the 3 TReDS platforms, was also conducted during the week.

3.6 Interventions

3.6.1 There were several rounds of discussions amongst the Taskforce members to build solutions that address gaps in the MSME finance landscape. The team conducted comprehensive secondary research, including studying key documents (e.g. U.K. Sinha Committee report, Parliamentary committee notifications on GST

[1] Mr. Dinesh Kumar Khara (Chairman, SBI), Mr. Ashish Agarwal (Principal, Sequoia Capital India), Mr. Anurag Rastogi (President - Chief Actuary and Chief Underwriting Officer), Mrs. Anjuly Chib Duggal (Chair, GAME Finance Task Force and former DFS Secretary, Govt. of India), Mr. Sathish Mathur (CEO, Pioneer Insurance & Reinsurance Brokers Pvt. Ltd), Mr. Amar Joshi (Chief Business Officer, SBI General Insurance), Mr. Akhil Handa (Head Digital Lending, Bank of Baroda), Mr. Dilip Asbe (MD & CEO, NPCI), Mr. Sundeep Mohindru (CEO, M1Xchange), Mr. Ketan Gaikwad (MD & CEO, RXIL), Mr. Prakash Sankaran (MD & CEO, Invoicemart) etc..

linkages to TReDS), existing initiatives in this area and subsequently built on what could be done further to strengthen them. The team also conducted over 40 interviews/group discussions with banks, NBFCs, buyers and MSMEs to validate key findings.

4. Executive Summary

4.1 As India deals with the health and economic impact of the COVID-19 pandemic, a legacy challenge demanding urgent addressal is how to gainfully employ India's large workforce. With 5 million young people joining the workforce each year, and 3.6 million exiting agriculture, India must create ~8.6 million non-farm jobs per annum[2]. However, net job creation in manufacturing and services between 2012-18 is estimated at 1.5 million per annum[3].

4.2 With the call for an 'Aatmanirbhar Bharat', India has signalled that MSMEs will drive job creation in India, MSMEs are expected to contribute 50% of the national GDP and 60% of exports[4] by 2025.

4.3 To achieve these targets, MSMEs in India must become more productive, competitive and scalable. An Indian MSME's contribution to GDP and employment is much lower than one in nations such as Vietnam, Malaysia, and Brazil[5]. Further, few MSMEs grow from small to medium to large. **Less than 5% of India's firms create more than 5 jobs each and fewer than 2% create 10+ jobs[6]. In comparison, among OECD nations, 10+ employee firms make up 40% to 95% of the enterprise landscape[7].** These statistics are critically important reminders of the work before us as a country. Given the limited scope of employment in the organized sector, the bulk of job creation must be done in the unorganized sector[8].

4.4 To flourish and grow, India's MSMEs require an ecosystem with favourable "Seed" (entrepreneurial mindsets and skills), "Soil" (infrastructure, connectivity, access to markets, access to credit/capital) and "Climate" (local culture, role models, and ease of doing business)[9] to grow. Surveys suggest that limited 'access to finance' is the biggest impediment to the growth of MSMEs[10]. With the onset of the pandemic, ensuring access to credit for MSMEs has become a central goal for the government. It is in this context that addressing finance related bottlenecks becomes a priority. Consequently, this report focuses on issues of access to credit/ capital for entrepreneurs, while identifying some areas where immediate interventions are expected to yield early results.

4.5 To address the immediacy of these issues, our approach lies in leveraging existing institutions and infrastructure to address opportunities for all stakeholders in financing MSMEs - financiers, Central and State governments, regulators, corporates / PSUs, insurers, industry associations, and most importantly, MSMEs themselves. Within MSMEs, we address the issues of 'New to Credit' (NTC) and 'women-led' enterprises as well, two categories facing unique financing challenges.

4.6 India's MSME credit ecosystem is a dynamic one, with facilitative steps being taken by practically all relevant institutions. Notable innovations include OCEN, iStack, amendments to TReDS, Bank-Fintech tie ups, setting up of SAMADHAAN and MSEFCs and more. Many innovations cited in this report are evident solutions and are being pursued by various stakeholders. This report seeks to integrate and develop solutions that could culminate in a shareable vision of a composite ecosystem.

4.7 Specifically, we focus on interventions that will (i) ease access to finance, (ii) ease working capital requirements, and (iii) mitigate risk for MSMEs. Challenges and proposed interventions are summarized below:

4.8 Improving access to formal and low-cost finance

4.8.1 MSMEs require capital to set up a new enterprise or expand an existing one. They may also need credit to manage cash flows. **The assessed debt demand of MSMEs is INR 69.3[11] lakh crores, of which only**

---

[2] S. Mehrotra, J.K. Parida, India's Employment Crisis: Rising Education Levels and Falling Non-agricultural Job Growth, Azim Premji University, 2019

[3] Ibid 1

[4] Aiming to enhance MSME contribution to GDP from about 30 % to 50%; and in exports from 49% to 60%: Shri Gadkari, PIB, 2020

[5] Secondary data analysis

[6] Improving Economic Dynamism and Accelerating MSME Growth, GAME National Taskforce, 2020

[7] V.A. Nageswaran, G. Natarajan, India's Quest for Jobs: A Policy Agenda, 2019

[8] Unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis with less than ten total workers according to National Commission for Enterprises in the Unorganised Sector

[9] Improving Economic Dynamism and Accelerating MSME Growth, GAME National Taskforce, 202

[10] What are the biggest obstacles to growth of SMEs in developing countries? – An empirical evidence from an enterprise survey, Yao Wang, Borsa Istanbul Review, Sep 2016

[11] Financing India's MSMEs: Estimation of Debt Requirement of MSMEs in India, International Finance Corporation, 2018

16% is formally financed[12]. The cost of informal borrowing (~38% [13] [14] per annum) is at least twice that of formal borrowing. This presents an opportunity for formal lenders (banks and NBFCs) to not only meet the potential demand of underserved MSMEs, but also to shore up their loan books.

4.8.2 MSMEs require capital that is affordable, appropriately timed, and on equitable terms[15]. However, our research reveals that the credit and finance market in India fails to deliver on these goals. For example, most MSMEs are unable to take loans without collateral of property, as they are unable to convey the viability of their business plans to the financiers[16]. This restricts credit access to entrepreneurs without adequate property. Similarly, repayment is typically structured as equal monthly instalments (EMI), even though many micro-enterprises prefer to repay in daily or weekly instalments[17]. These differences emphasise the heterogeneity in India's MSME landscape and call for greater diversity or customisation in finance offerings.

4.8.3 Banks cannot be expected to meet the entire need of direct lending to MSMEs for three key reasons; a) high customer acquisition cost relevant to low ticket size loans (<INR 10 lakhs) given the low digital penetration (47%[18]) among MSMEs; b) MSMEs' inhibition in approaching banks, on account of having incomplete albeit viable business plans, and c) Banks' commitment and obligation to extend larger loans for industry and infrastructure, diverting focus and processes away from smaller loans. A close look at the data and trends in MSME lending reveals a high NPAs of PSBs in the MSME segment (18.6%[19]), which can inhibit further lending. On the other hand, private sector banks and NBFCs have significantly lower NPAs on MSME exposure (~5% for private banks and 6% for NBFCs pre-Covid[20]). **FinTech, RRBs, and NBFCs account for over half of 'New to Credit' customers, while public and private banks together account for less than a fifth[21].** After weighing data, analyses and polling financial institutions and MSMEs, we are led to the empirical conclusion that NBFCs and FinTechs, with possibly a higher ability for hand holding, lower customer acquisition (2.0-2.5% compared to 3.0-3.5%[22] of banks) and collection cost, and lower NPAs are better placed to serve MSMEs, especially those which are 'New to Credit'. Further, since NBFCs and FinTechs must usually borrow before they can lend, the rate at which they lend to MSMEs depends largely upon their cost of borrowing.

4.8.4 NBFCs remain largely dependent upon banks for funds. **However, out of ~10,000 NBFCs in India, only the top 30 NBFCs get 80% of banks' sectoral exposure**[23]. To broad base credit access, it would be advisable to recognise the relative strengths of the stakeholders in this space and synergise these to the advantage of both the MSMEs and the financial institutions. Banks may be permitted to meet their MSME lending commitments by lending to 'smaller NBFCs' focused on MSME financing. This would mean lower costs of credit-worthiness assessment and collection for banks, allowing them to lend to NBFCs/FinTechs at lower rates of interest. In turn this would enable NBFCs and FinTechs to extend more affordable loans to the MSME segment, for which the present average interest rates are > 20%[24]. The nation would benefit even more by increasing credit outreach into the more remote nooks of the country as well as to new kinds of businesses, whose viability can be better assessed through greater geographical or technological proximity.

---

[12] Financing India's MSMEs: Estimation of Debt Requirement of MSMEs in India, International Finance Corporation, 2018
[13] In 2018
[14] K Chouhan, V Kurian, S Nair, A Singh, Study on Informal Sector Lending Practices in India, SIDBI, 2018
[15] Closing the gap: Finance pathways for serving the missing middle, Dalberg Advisors, January 2020
[16] Interviews with entrepreneurs
[17] Interview with experts
[18] A Ramachandran, S Klemperer, N Agarwal, S Aggarwal, T Ehrbeck, R Kudva S Tripathi, A Kumar, M Ramachandran, N Balaji, P Gupta, N Jain, K Sanghi D Mukherjee, Credit Disrupted, Omidyar Networks and BCG, 2018
[19] MSME PULSE, Transunion CIBIL and SIDBI, 2020
[20] MSME PULSE, Transunion CIBIL and SIDBI, 2020
[21] IBID 10
[22] A Ramachandran, S Klemperer, N Agarwal, S Aggarwal, T Ehrbeck, R Kudva S Tripathi, A Kumar, M Ramachandran, N Balaji, P Gupta, N Jain, K Sanghi D Mukherjee, Credit Disrupted, Omidyar Networks and BCG, 2018
[23] A Rao Palepu, RBI Financial Stability Report: NBFC Crisis Has Imposed Greater Market Discipline, Bloomberg, 2019
[24] Financing India's MSMEs, IFC, November 2018

4.8.5 The report highlights innovative models to underwrite 'thin file' and 'low collateral' MSMEs, especially 'new to credit' and 'women-led' MSMEs. For women-led enterprises, which have almost half the collateral intensity of those led by men[25], the ongoing data revolution can be particularly powerful. Further, 'phygital' models of borrowing would also aid these women entrepreneurs as these can correct for the gender gap in access to digital and financial tools. Such innovations, often deployed through unrated FinTech and NBFCs, can be given a fillip through credit guarantee schemes such as CGTMSE. Targeted credit guarantee schemes focused on marginalised entrepreneurial segments have shown early promise[26].

4.8.6 Several platforms such as OCEN, Google Pay, and GST are bringing MSMEs online and enabling operationalization of these channels for underwriting. Such platforms can serve as powerful mechanisms to formalise MSMEs by: a) Creating a frictionless ecosystem for MSMEs to operate in while generating a digital footprint, especially for 'new to credit' MSMEs; b) Providing access to trusted alternative data to lenders for underwriting in place of traditional KYC norms, and c) Supporting targeted policymaking and more innovative lending models through aggregation of data on MSMEs through digital platforms. Providing the appropriate regulatory support can bring about this formalisation. Onboarding a wide range of loan service providers (LSPs) under OCEN, especially EDOs, and industry associations will formalise and unlock credit for a much larger and often excluded group of entrepreneurs.

4.8.7 Moving beyond the role of government and financial sector, philanthropies also have a part to play in aiding MSMEs. One avenue to achieve this is through the mainstreaming of returnable grants. Philanthropic capital channelled via returnable grants can help build credit and digital footprints for the NTC segment firms. This can generate adequate credit history, which would allow these entrepreneurs to access loans from formal sources.

4.9 Delayed payments and working capital mismatch

4.9.1 While access to finance facilitates start-up and scale-up of MSMEs, a smooth working capital cycle enables continuity of business while bringing down costs of the goods and services provided by an MSME. Estimates from several studies indicate that the total outstanding payment by buyers to registered MSMEs[27] in India could be about 15 lakh crore[28] [29]. **The average payment period for MSMEs ranges between 3 months and 6 months and inversely proportional to the size of the enterprise**[30]. While there are nuances to these startling findings, there appears to be a clear asymmetry of power between buyers and MSMEs (especially the micro and small enterprises), which results in the terms of payment being adverse for MSMEs. According to buyers, the mismatch between their own working capital cycles with those of the MSMEs clubbed with limited digitisation among MSMEs further accentuates the problem[31]. The impact, however, is not limited to MSMEs, as delayed payments are expected to eventually result in higher costs of goods and services supplied to buyers. GAME's assessment suggests that **timely payments in adherence to MSMED Act can lead to unlocking ~0.42 % of India's GDP**[32].

4.9.2 Supply chain financing (SCF) and factoring are crucial in addressing delayed payments. These solutions leverage the credibility of a large buyer to address the working capital needs (or cash flow mismatch) of MSMEs. Buyer-led SCF contracts are common (e.g., Tech Mahindra, HUL, Aditya Birla etc.)[33] while factoring platforms such as TReDS offer an MSME-led option. However, these solutions do not offer an immediate incentive to buyers, thus limiting their uptake. The **three TReDS platforms have discounted invoices worth INR 23,000 Cr**[34]**, and less than 1% MSMEs**[35] **and ~20% of corporate buyers**[36] **(with**

[25] Micro-enterprises: a multi-dimensional analysis, 2019, GAME & Azim Premji University
[26] Returnable grants: reimagining credit for a better normal, Varad Pande & Priya Naik, The Economic Times
[27] 84.82 lakhs total registered MSMEs in India as per Annual Report 2019-20, Government of India, Ministry of MSME, 2020
[28] CMIE Prowess Data Analysis
[29] Assuming at least 10% of registered MSMEs face delay in payments and at most 50% of them face delay in payments
[30] CMIE Prowess Data Analysis
[31] Interviews with 4 large corporates
[32] CMIE Prowess Data Analysis
[33] Dalberg analysis
[34] Primary data analysis
[35] S. Khan, TReDS was touted as the tool to tackle delayed payments to MSMEs. Did it succeed?, The Economic Times,2021
[36] Primary data analysis

turnover greater than INR 500 Cr) are registered on the platforms. Trade credit insurance and improving liquidity through securitisation are expected to boost both the factoring and reverse factoring markets.

4.9.3 The Central government has taken several initiatives to ensure timely payments: mandating a 45-day repayment period under the MSMED Act 2006, MSEFCs, trade credit insurance and more. These have improved visibility on the standard industry practice of 'delayed payments'. However, our rapid research reveals that few MSMEs access these solutions today, largely on account of low awareness and fear of losing key buyers. We believe Industry Associations must play a more proactive role in balancing the scales for MSMEs. This would include building awareness and enhancing capacity on 'digital invoice generation'.

4.10 Limited insurance products for business interruption

4.10.1 In the wake of Covid, the fragility of India's MSMEs has become clear. Data suggest that just after the lockdown, 75% of India's MSMEs had cash reserves for less than a month while a vast majority dipped into meagre personal savings to keep their businesses afloat[37]. Even beyond Covid, MSMEs may struggle while facing natural disasters, injuries to workers, and damage to raw material among other risks.

4.10.2 Our research points to five major roadblocks in mainstreaming 'business interruption' insurance for MSMEs: fragmented nature of the insurance market (insurance agents and insurance companies have different goals and policies), rigid procedures for an insurance claim, non-affordability of policies for smaller firms, inadequate coverage (e.g. limited only to material losses) and an intangible trust deficit between insurers and MSMEs.

4.10.3 To ensure the survival of many MSMEs, there is a need for insurance products that cover non-material losses, simplify the claim procedures, fast track the payment schedules, and build trust and awareness through the entire customer journey. For insurers, this can be made viable through several techniques such as increasing loss coverage over time, providing a modular offering with a baseline no-frills product with universal coverage.

4.11 Recommendations

4.11.1 'Short term' action agenda

I. Encourage lending to 'New to Credit' and 'Women-led enterprises' through dedicated portfolios supported by the CGTMSE scheme; in particular, making the scheme more accessible to unrated and small NBFCs and FinTech firms will be crucial **(MSME Ministry and SIDBI)**

II. Philanthropies can support NTC and women entrepreneurs by providing partial guarantees or deploying innovative products such as returnable grants thereby bringing these segments into the formal fold **(philanthropies, investors)**

III. Support NGOs, and Industry Associations to onboard their member entrepreneurs on platforms such as OCEN, TReDS, and others to initiate the next wave of digitisation (post-GST) among India's MSMEs **(Platforms, EDOs, Industry Associations)**

IV. Reduce the turnover threshold for mandatory onboarding of buyers onto TReDS from INR 500 Cr to INR 250 Cr **(MSME Ministry)**

V. Mainstream NCGTC funds to encourage trade credit insurance initiatives on TReDS to reduce risk aversion among banks (**DFS, MoF)**

VI. Greater proactiveness by Industry associations such as CII, FICCI, FISME and others in helping MSMEs balance the scales of power with large buyers **(Industry Association)**

4.11.2 'Medium term' deliberative agenda

I. Constitute a multi-stakeholder policy advisory group to increase liquidity to NBFCs and FinTech firms focused on MSMEs; an immediate action agenda could be securitisation of the MSME lending market (e.g. secondary markets for NBFC portfolios, factoring units etc.). The advisory group members could include CGM – MSME at SBI, representatives of wholesale NBFCs (such as Northern Arc), representatives of FinTech associations (such as Digital Lenders Association of India), financial engineers at investment banking firms, industry associations, and the MSME Ministry.

II. 1-2 committed insurers to pilot, through IRDAI's regulatory sandbox, and scale 'break in business' insurance for MSMEs **(General Insurance Council)**

[37] GAME analysis in partnership with LEAD at KREA University

III. Design a pilot and scale SCF solutions for a particular cluster of MSMEs, leveraging the proximity of a large buyer and the presence of several smaller suppliers **(SIDBI, FinTech players)**

4.11.3 'Long term' research agenda

I. Study and test 'use cases' of blockchain technology especially in making visible supply chains that include informal and small micro-enterprises **(iSpirt)**

II. Build a blueprint for a platform or identify APIs for existing platforms that allow access to a range of MSME data (e.g. electricity bills, income tax, GSTN, fraud registry, psychometrics and more) **(NPCI)**

III. Segment and size the MSME landscape based on business characteristics, digital savviness, financing needs, supply chain integration and more towards the objective of designing focused solutions **(Consulting firms)**

5. Importance of MSMEs to India

5.1 The COVID-19 pandemic has created a tremendous shock for the global economic systems. The severity of this shock has been much higher in developing nations like India. This has not only created new challenges for the nation but also amplified numerous pre-existing vulnerabilities, which have been holding back the Indian economy. One such issue is that of unemployment, which was already rising prior to the onset of the pandemic. According to some studies, 5 million youth join the workforce every year. An additional, 3.6 million workers migrate out of agriculture annually due to unremunerative farm incomes. Thus, the labour pool is growing by 8.6 million every year[2]. However, between 2012-2018, only about 1.5 million jobs per annum were created in the manufacturing and service sectors [2]. Thus, an additional 7 million non-farm jobs need to be created to meaningfully absorb the increasing workforce.

5.2 In this context, the MSMEs could play a significant role in meeting this job deficit. Today, India's 63 million MSMEs employ ~24% of the workforce[38] while contributing ~30% to India's GDP [39] and ~48% to Indian exports [27]. The global experience from numerous developing as well as developed economies suggests that a large chunk of job creation is driven by small business owners i.e. MSMEs. In light of this experience, the government, under 'Atmanirbhar Bharat', has set the target for the sector to contribute at least 50% of the GDP, thus making MSMEs the flag bearers of India's job creation.

5.3 Despite the immense contribution of MSMEs to the Indian economy, there exists a significant untapped potential for the sector. Of these Micro, Small and Medium Enterprises (MSMEs), the micro enterprises account for 99% of all MSMEs and employ nearly 97% of the total employment of the sector[40]. Thus, there exists a plethora of cottage sector micro firms, which are largely labour intensive with low use of technology.

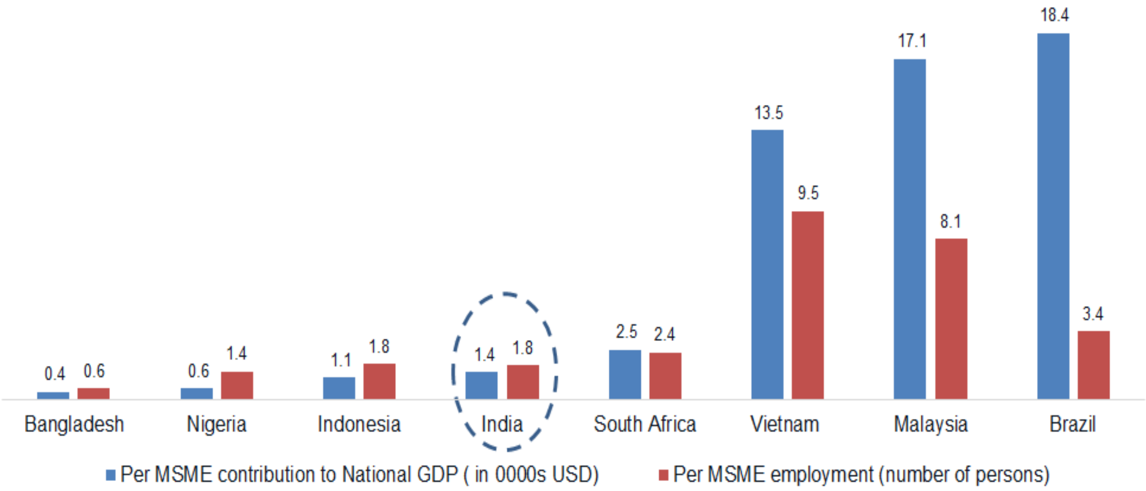


Figure 1: Country-wise comparison of per MSME contribution to national GDP and employment

5.4 These firms remain largely small in both output and employment, In India, fewer than 5% of the firms employ more than 5 workers and of these, only about 2% employ more than 10 workers [5]. In the OECD nations, this figure ranges from 40% to 95%[6]. This phenomenon is indicative of the 'Missing Middle' problem. This problem was also highlighted by the Economic Survey 2018-19, wherein firms instead of being 'infants' i.e. growing from small to medium to large firms, end up being 'dwarves' i.e. perennially small and unable to grow. Compared to other developing countries such as South Africa ($ 0.43 Tn)[41], Vietnam ($ 0.20 Tn), Malaysia ($ 0.39 Tn) and Brazil ($ 2.34 Tn), the per MSME firm's contribution to employment and GDP remains very low in India ($ 2.94 Tn) (Figure 1).

5.5 In an economy, only a healthy ecosystem of entrepreneurship can foster and encourage job-creating entrepreneurs. Like any other ecosystem, even an ecosystem of entrepreneurship needs favourable 'seeds',

[38] Based on the number of workers employed by MSMEs - Report of the Expert Committee on Micro, Small and Medium Enterprises, RBI, 2019 and India's labour force - P Jha, M Kumar, Labour in India and the COVID-19 Pandemic, Indian Economic Association, 2020

[39] MSME sector contributes 30% to GDP: Gadkari, IBEF, 2020.

[40] Annual Report 2019-20, Government of India, Ministry of MSME, 2020

[41] GDP of the economies – World Bank Data, WB, 2019

'soil' and 'climate'. 'Seeds' here refer to individuals with entrepreneurial mindsets and skills. 'Soil' refers to favourable infrastructure, both digital and physical, and access to finance and markets. Finally, 'climate' refers to non-physical attributes like values that encourage entrepreneurship, the presence of approachable and visible role models, and the general ease of doing business.

5.6 Though each of these aspects has a role to play, finance, both its availability and accessibility, has come to play a central role in the success of entrepreneurs. Affordable finance is essential not only for the firms to grow and scale up by allowing investment in machinery, plants, up-skilling of workers, etc but also to sustain the day-to-day operational expenses (like wages, etc) of the firm in the event of a liquidity crunch. However, in India, inadequate access to affordable finance has become a limiting factor for firms, thus halting the creation and growth of businesses. This phenomenon was further accentuated in the wake of the pandemic.

5.7 In order to address this, the government has initiated programs like ECLGS scheme and TLTRO mechanism to ensure adequate access to finance for MSMEs. However, there have been inadequacies that have prevented the growth of our MSMEs. These include the inability of the economy to bring entrepreneurs into the formal financing fold, protect well-performing businesses from exogenous shocks, and address the issue of delayed payments to firms.

5.8 In order to better target the focus of our intervention measures, it is pertinent to analyse these gaps in the financing ecosystem. There are broadly two areas that require our attention - ease of access to credit and working capital requirements, while providing insurance cover wherever required. Figure 2 presents the ecosystem of different stakeholders and their interlinkages for access to credit and working capital.

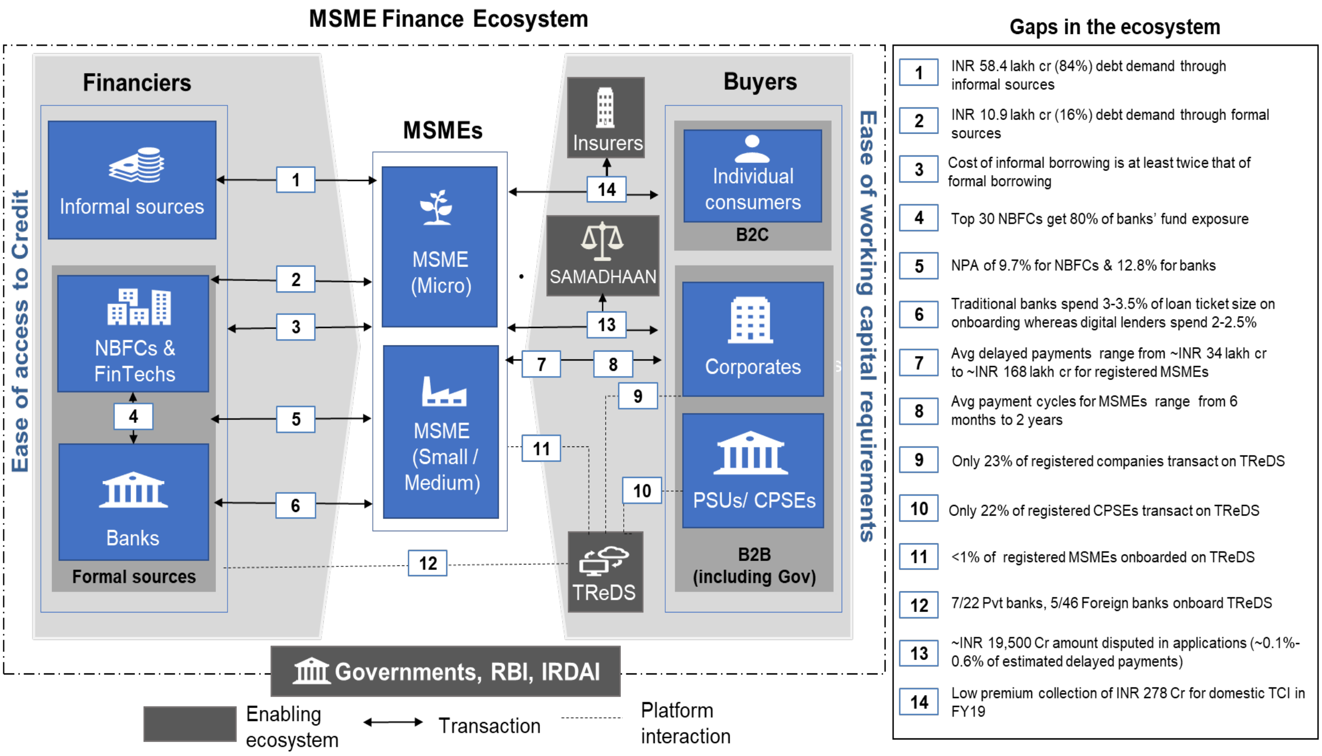


Figure 2: MSME Finance Ecosystem and gaps in the ecosystem

5.9 Capital plays a crucial role for MSMEs as it is needed to set up a new enterprise (start-up), to expand an existing one (scale-up) and to sustain their operational expenses. With a total debt demand of INR 69.3 lakh crore [7] and outstanding payments estimated to be at least ~INR 15 lakh cr[15] in the MSME sector, it is critical to immediately and effectively bridge these gaps in MSME finances.

6. Key MSME Finance gaps and implications

Despite the numerous mechanisms of finance available to MSMEs like equity, the report specifically focuses on the issue of debt or credit due to its considerable impact on this sector. In this report, 'access to credit' entails both the demand as well as the supply of credit for MSMEs. 'Working capital' refers to the liquidity requirements of an enterprise to run its day-to-day operations. In this section, the focus is on the former aspect, specifically the unavailability of low-cost capital for many entrepreneurs. Aside from focusing on the gaps in finance for the MSME sector as a whole, the report also addresses the needs of certain sub-categories of MSMEs, namely 'new to credit' and 'women-led' enterprises. These enterprises facing the issues low risk-appetite, diminished credit repayment abilities and inadequate bargaining power, require tailor-made interventions rather than a one-size-fits approach.

Given the importance of MSMEs and their potential to grow, it is clear that financing MSMEs is not only profitable for the MSMEs and the financial institutions but beneficial for the economy as a whole. Also, given the unique factors defining MSMEs, it is expected that these entrepreneurs will be primarily catered to by NBFCs and FinTech firms. Hence it raises the question as to why these financial institutions are unable to scale.

6.1 Gaps related to Access to credit and its implications

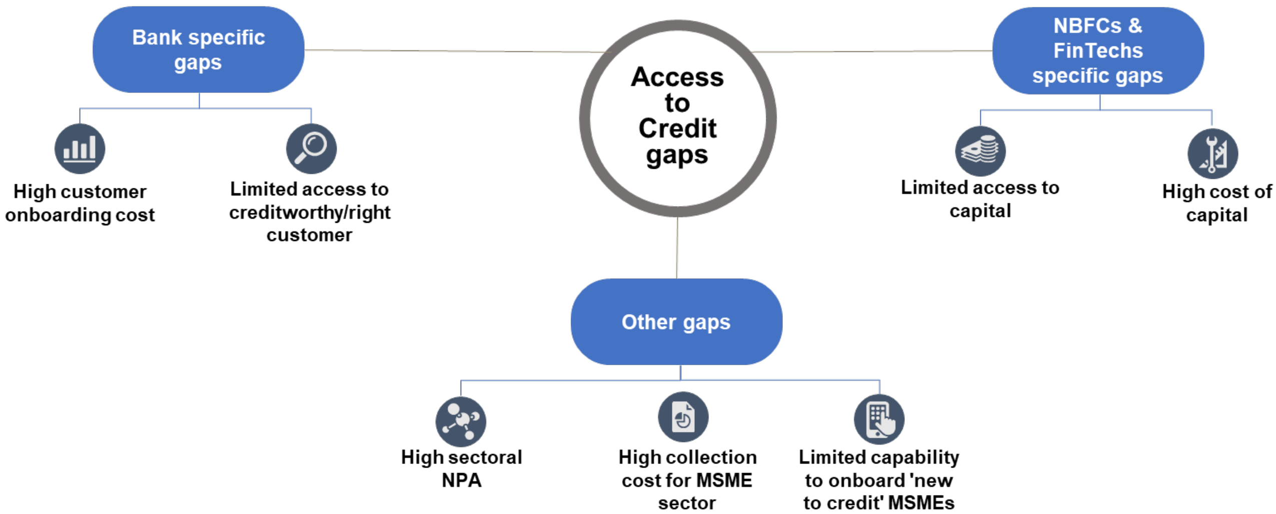


Figure 3: Gaps in access to credit

a. In India, MSMEs primarily rely on informal sources for their credit and liquidity requirements. Out of the total MSME debt demand of INR 69.3 Lakh Cr, **INR 58.4 Lakh Cr [7] is catered by informal sources.** Informal credit can cost at least twice[11] as much as credit from formal sources, thus indirectly placing an 'informality tax' on such sources for MSMEs. MSMEs require capital that is affordable, appropriately timed, and on equitable terms[42]. However, our research reveals that the credit market in India fails to deliver on these goals.

b. Traditional financial sources underwrite MSMEs based on parameters like CIBIL score, income, current debt and liabilities, collateral, etc. In India, **only 90 lakhs[43] of the 6.3 crore MSMEs are ranked on CIBIL MSME Rank (CMR)** while only 84.8 lakh[44] MSMEs are registered. Further, most MSMEs are unable to take loans without collateral of property, as they are unable to convey the viability of their business plans to the financiers[45]. This restricts credit access to entrepreneurs without adequate property. Even during repayment, the payment cycles are not customized to account for the needs of the firm. Repayment is

[42] Closing the gap: Finance pathways for serving the missing middle, Dalberg Advisors, January 2020

[43] Enhanced CIBIL MSME rank launched by transunion CIBIL to cover smaller business, United News of India, Apr 2020

[44] Based on total registered MSMEs in India and total MSMEs in India as per Annual Report 2019-20, Government of India, Ministry of MSME, 2020

[45] Interviews with entrepreneurs

typically structured as equal monthly instalments (EMI), even though many micro-enterprises prefer to repay in daily or weekly instalments[46]. These differences emphasise the heterogeneity of the credit requirements for MSMEs in India thus requiring greater customisation in finance offerings.

c. These rigidities disproportionately affect women-led enterprises more, which constitute about 14% of India's MSMEs[7]. India's women entrepreneurs **have an annual finance demand of ~INR 2 Lakh Cr**[47]. However, they face multiple challenges in accessing finance including low financial literacy, inadequate industry experience and a lack of awareness of available schemes. Even from a credit supply perspective, there are numerous gaps faced by banks, NBFCs and FinTechs which result in significant roadblocks for MSMEs in accessing formal credit.

6.1.1 Bank-specific gaps in Credit Supply:

A high credit gap and a high cost of informal borrowing present a good opportunity for banks to lend to these MSMEs. However, there are limitations, mainly in the form of **high customer acquisition costs** and **inadequate access to the right customers**.

6.1.1.1 High customer onboarding cost: About 96% of MSMEs in India have an annual turnover less than INR 1 Cr[11]. The loan requirements of these firms would generally be less than INR 10 lakh. Traditional lenders due to their high customer onboarding expenditure of about **spending 3-3.5%**[11] **of the loan size** are generally not attracted to these firms in the low-ticket size customer segment. In comparison, digital lenders (e.g. Aye Finance, FlexiLoans, etc.) spend only about 2.0-2.5%[11] of loan size on customer acquisition for firms in this sector. For lenders using e-commerce, payment providers and similar platforms for acquiring customers, the cost further reduces to only 1.5-2.0%[11] of loan size.

6.1.1.2 Limited access to creditworthy/right customers: Banks largely rely on traditional underwriting techniques such as asset-based underwriting, etc. These techniques are based on standardized documentation, which several MSMEs are unable to furnish. As a result, a majority of MSMEs without adequate assets often get excluded from accessing formal credit. Low approval rates for loans applied by these firms highlight the extent of this phenomenon.

6.1.1.3 Issues with MSMEs: The prevalence of low formalisation among MSMEs leads to inadequate documentation. Banks with their high KYC requirements are unable to lend to these enterprises. ***According to SBI CGM, about ~50% of micro enterprise loan applications get rejected due to a lack of basic KYC***. Further, MSMEs' inhibition in approaching banks, on account of having incomplete though viable business plans.

6.1.1.4 Priority of the Banks: Banks, especially PSBs, in recent years have committed to lend to large infrastructure and industry projects. These commitments have increased in light of COVID-19 pandemic and Atmanirbhar Bharat Abhiyan. As a result, MSMEs tend to get a lower priority in their lending requirements.

6.1.2 NBFCs and FinTechs specific gaps in Credit Supply:

According to Mr. Sanjay Thakur, Senior Banker and SME Evangelist - "NBFCs are better placed to service MSMEs due to their ability to differentiate credit underwriting using both formal and informal sources of data, offer custom products such as flexible collateral structures and deliver faster turnaround time. Distribution, servicing and compliance cost of banks to service MSMEs in smaller locations like tier II and below also makes it a compelling proposition for NBFCs and FinTechs that are nimbler and better placed to service the largely underserved and informal MSME segment." NBFCs have geographical proximity to the MSMEs and a deeper understanding of this segment. NBFCs, along with using alternative underwriting techniques, also maintain a dynamic list of target sectors based on emerging industry scenarios, global and national benchmarking, etc. **FinTech, RRBs, and NBFCs account for over half of 'New to Credit' customers, while public and private banks account for less than a fifth**[11]**.**

6.1.2.1. Limited access to capital: Over the past few years, there has been an increase in NBFCs' capital borrowed from banks (as shown in Figure 4). However, the bank's fund exposure to the NBFC sector is

---

[46] Interview with experts

[47] R Singh, P Chhabra, Financial Inclusion for Woman-Owned Micro, Small & Medium Enterprises (MSMEs) in India, International Finance Corporation, 2019

skewed towards the **top 30 NBFCs, which get 80% of banks' fund exposure**[12]. There are two key reasons for such skewed lending – (i) risk-averse nature of banks along with strict policies related to NBFC portfolio health and (ii) lack of lending models based on historical data of default rates of NBFCs vis-à-vis risk spread.

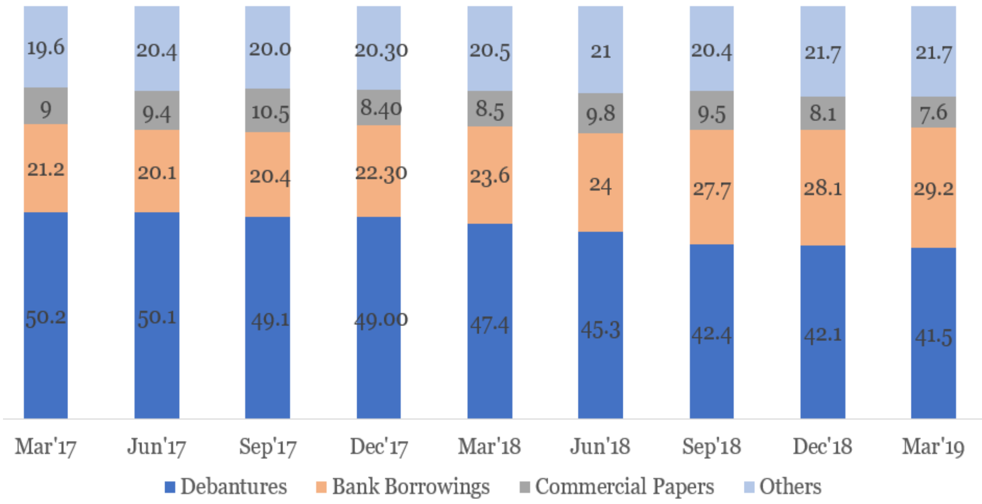


Figure 4: Source of funds for NBFCs (in %)[12]

6.1.2.2. High cost of capital: NBFCs avail funds from banks at high interest rates. Since NBFCs and FinTechs must usually first borrow before they can lend, the rate at which they lend to MSMEs depends largely upon their cost of borrowing. After factoring in their operational costs and expenses, NBFCs are forced to lend to MSMEs at even higher rates than bank rates. Thus, loans offered to MSMEs under government schemes such as MUDRA charge interest as low as 8.05%[13], making it unviable for NBFCs to participate in such initiatives. ***According to Mr. Sanjay Sharma, Managing Director, Aye Finance Pvt. Ltd. - "If you want to encourage lending to the unorganised micro businesses, then allow Mudra to refinance such loans without a cap on the end interest rate. The market will price in the risk-reward premium and find equilibrium on its own."***

6.1.3 Other gaps: Some additional considerations for lenders are the risk of high Non-Performing Assets (NPAs), high cost of collection and a limited capability to onboard 'new to credit' MSMEs.

a. **High sectoral NPA**: The increasing NPAs across the MSME segment dissuade banks from lending to MSMEs. The MSME sector (which is also covered under Priority Sector Lending guidelines) has accumulated NPAs to the tune of 18% for Public Sector Banks, even before the onset of COVID-19 pandemic[48]. This sector gets deprioritized within the PSL portfolio due to better performance of other sectors such as agriculture (i.e. with NPA ratio of 8.5%[49]). Owing to this higher sectoral NPA for MSMEs, NBFCs tend to have a higher spread despite having better reach and underwriting techniques to assess MSME creditworthiness for safeguarding themselves. This ultimately results in an increased cost of borrowing for MSMEs.

b. **High collection cost for MSME sector:** Traditional lenders, which primarily rely on branch-led model of lending, have high servicing and collection costs. **These lenders end up spending 0.6-0.8% of loan size on the collection when compared to digital lenders, which only spend 0.4-0.6%**[11] **of loan size**. The cost of collection is linked to the credit behaviour (i.e. the intent to repay) of the borrower and the extent of financial digitization (eNACH, UPI, etc). This presents an opportunity for greater adoption of digital payment tools to address both these factors attributing to the cost of collection.

c. **MSME related issues:** Addressing the problems plaguing MSME financing requires not only interventions targeting the supply factors (like financial institutions) but also the demand bottlenecks i.e. the MSMEs themselves. MSMEs in India (especially those at the lower end of the spectrum, up to 1/2 Cr turnover) usually tend to be thin-file (i.e. with little or no credit history), with low collateral and have a lower proclivity to adopt digital channels, varied business and cash flow cycles, etc.

d. **Limited capability to onboard 'New to Credit' (NTC) MSMEs:** NTC MSMEs are typically micro enterprises with loan requirements less than INR 1 lakh. They are less likely to have a credit / CMR score

---

[48] This many MSME loans are at higher risk of becoming NPAs in next 12 months: CIBIL, Financial Express, 2020
NPA for Private sector banks stands at 5.0%, PSUs - 18.7% and NBFCs - 7.6% as of Dec 2019
[49] K Vikram, Farm loan waiver bad? Data shows true picture, The New Indian Express, 2020

or a loan history. Traditional lenders, functioning under rigid underwriting criteria, are unwilling to assess credit-worthiness of MSMEs without a CMR score. This presents a great opportunity to underwrite these NTC MSMEs through alternate data. However, only a limited number of traditional lenders currently leverage this capability. Thus, **FinTech, RRBs, and NBFCs account for over half of 'New to Credit' customers, while public and private banks account for less than a fifth[11].**

6.2 Gaps related to Working Capital and Implication

While the issue of 'ease of access to credit' is centred on the formalization of credit and the growth of MSMEs, the issue of working capital or liquidity gap of MSMEs is due to factors like delayed payments and lack of securitization of working capital.

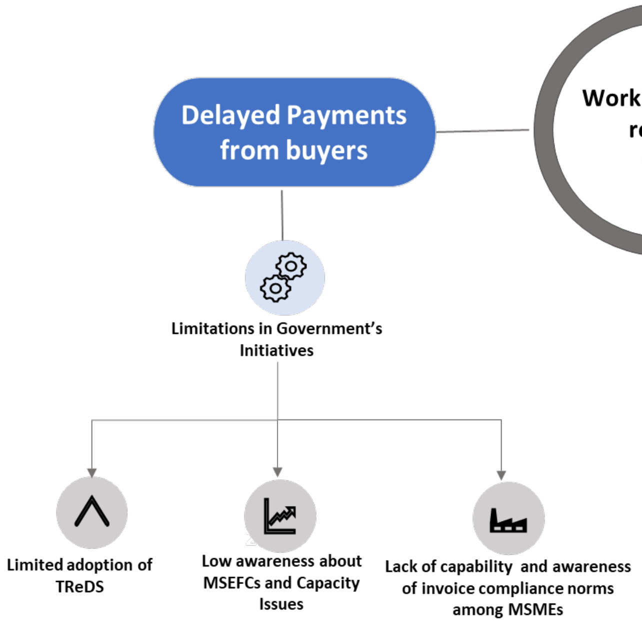


Figure 5: Gaps in working capital requirement

6.2.1 Delayed payments from buyers

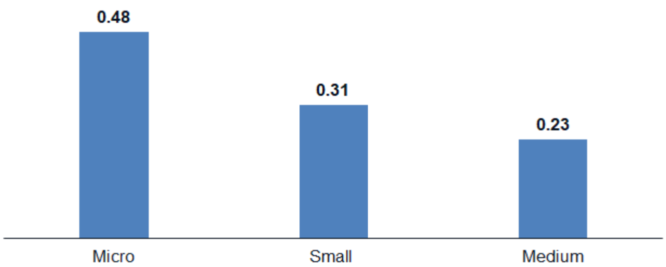
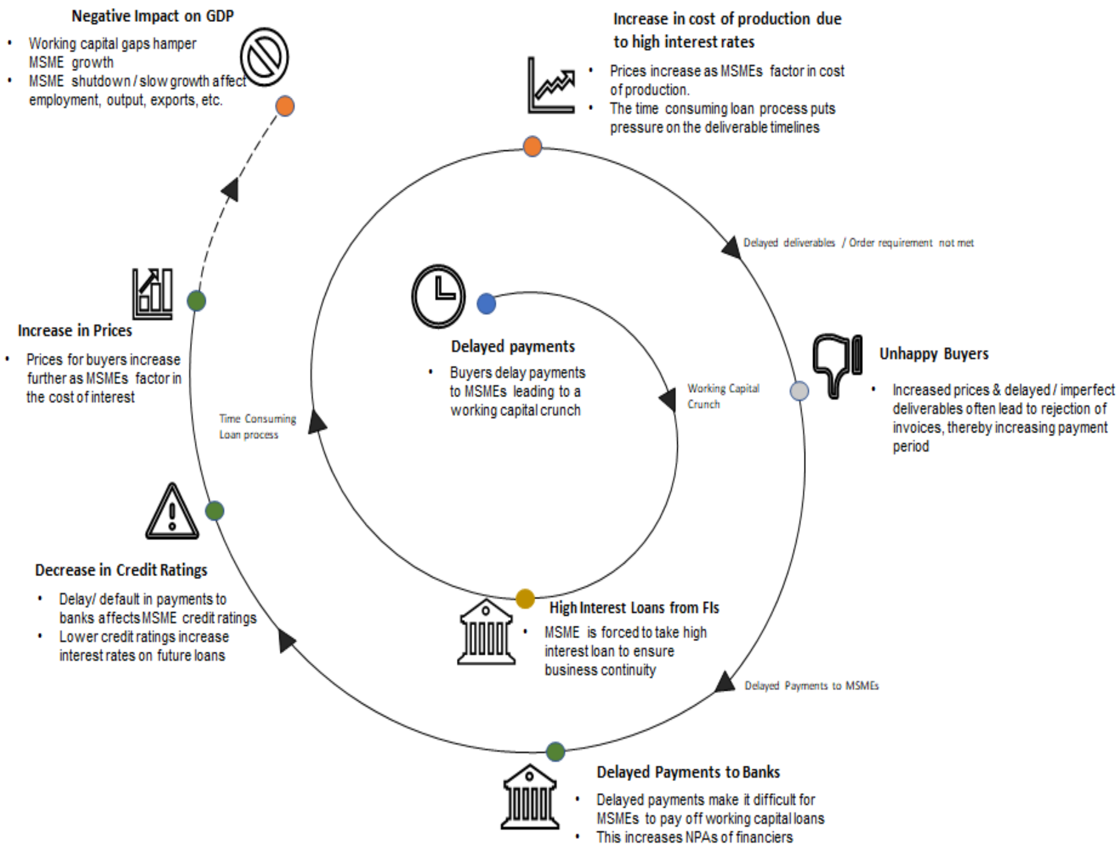


Figure 6: Segment-wise Receivables to Sales Ratio

a. Credit sales refer to purchases in which full payment is made at a later date. These credit sales are a norm in B2B transactions and if they are not paid in time, it can lead to a severe pressure on an MSME's cash flow and eventually its sustenance. **The total outstanding payments towards registered MSMEs are at least[16] INR 15 Lakh Cr[50]**. As registered MSMEs comprise only a mere 13% of all MSMEs, the true extent of this problem is much larger. Figure 6 depicts the ratio of receivables to total sales ratio for all segments of MSMEs i.e. Micro, Small and Medium enterprises[30].

[50] CMIE Prowess Data Analysis from FY 17 to FY 19, n (FY 17) = 13898, n (FY 18) = 13125, n (FY 19) = 12093 enterprises



b. DSO (the number of days taken by an enterprise to collect payment after a sale) has a direct impact on the working capital requirements of an enterprise. **Within MSMEs, DSO ranges from 3 months for medium enterprises to 6 months for micro enterprises**[29]. Given the asymmetry of power between buyers and MSMEs (especially the micro and small enterprises) in favour of the former, the buyers dictate the terms of payment and also its schedule. According to RBI Expert Committee on MSME (UK Sinha Committee), this also results in a reluctance to initiate legal action under MSMED Act, 2006.

c. Large corporate buyers, despite having strong internal governance policies, fail to meet the MSMED Act mandate. One of the major challenges faced by buyers is that MSMEs do not send invoices on time and the invoices are often riddled with errors. Further, the MSMED Act, 2006 is vague and does not precisely state what the start date for the 45-day payment cycle is. This results in differing interpretations of the law by different buyers, in turn leading to different payment norms.

d. These delayed receivables have a negative impact not only on the firm, but also create a cascading effect on the entire ecosystem. As per our analysis, **77% of Micro, 69% of Small and 65% of Medium enterprises had their payments delayed beyond 45 days**[51]. Delay in payments to MSMEs has adverse implications on their business operations. This delay can force MSMEs to take working capital loans to sustain their business operations. This phenomenon of continued delays in payments can make these MSMEs debt-ridden, thus hindering their potential to grow. **Complying with the MSMED Act, 2006 by ensuring a 45-day limit on the payment cycle can unlock working capital of INR ~38 Lakh Cr for Micro Enterprises and INR ~32 Lakh Cr for Small enterprises respectively**[31].

e. For the buyers, a delay in payments can negatively affect their costs in the long run. Most MSMEs calculate the cost of goods sold (CoGS) after factoring in the interest payments made towards working capital loans (interest on working capital loans). This increases the cost of goods sold (CoGS) by the MSMEs, which eventually results in higher prices for the buyers. Even from a legal point of view, buyers are liable to pay heavy penalties under the MSMED Act, 2006 for a delay in payments to micro and small enterprises.

[51] CMIE Prowess Data Analysis, n = 12093 Enterprises

Illustrative Case Study[52]: *Shanti Devi's Wheat Mill*

Ms. Shanti Devi is a wheat miller from Amritsar. She records a turnover of 5 Crore annually, selling to a few FMCG corporates operating in Punjab. Ms. Shanti Devi's business has been booming off late, thanks to the credit sales and the good customer relations she has cultivated in the market. Owing to the large nature of orders, Ms. Shanti Devi incurs a cost of INR 40 Lakh and enjoys a profit of INR 5 Lakh on each order.

M/s. Shanti Devi just landed a huge consignment of INR 2.5 Crores from a leading FMCG corporate and is working extra hours to ensure timely delivery of the products. However, huge orders also indicate the need for huge investment for raw materials and other production costs. To meet production costs, she reaches out to her clients for their outstanding payments of earlier orders. These delays make her turn to financial institutions for a working capital loan of 50 Lakhs at an annual interest rate of 10%. Working capital loans increase the cost of production. Moreover, the long turnaround time on these loans can itself become a death knell.

As a result of the working capital loan, Ms. Shanti Devi's Cost of Goods Sold (CoGS) increased by INR 2.5 lakhs (interest on the principal amount of INR 50 lakhs for a period of 6 months[53]). To maintain the same profit margin, she factors in the new CoGS in her selling price, increasing the cost to buyers by ~INR 2.5 lakh per order. The FMCG is now required to pay extra.

Most buyers fail to realize this effect of their delayed payments on the entire business ecosystem and actively continue the practice.

f. For the financiers, delayed payments lead to multiple issues like: (a) a higher NPA ratio and (b) a drop in customer credit rating resulting in a low lifetime value of the customer.

g. These adverse effects on MSMEs, buyers and financiers create a vicious cycle that adversely affects the economy as a whole. Thus, inadequate working capital not only hampers the growth of MSMEs but also slows the growth of the economy itself. **We estimate that reducing the payment cycle of registered micro and small enterprises to 45 days[54], may unlock interest on working capital loans equivalent to ~0.42% of the GDP[31].**

h. Due to the importance of the role of working capital and receivables for the economy and the nation, the government and regulators have undertaken multiple initiatives and policies to enable timely payments. These not only include the provisions of the MSMED act 2006 but also schemes like TReDS platform, SAMADHAAN portal, MSEFCs etc. However, there is still an opportunity to further enhance the adoption, implementation and efficacy of these initiatives.

6.2.1.1 Limitations in Government's initiatives - Following are the gaps in adoption and efficacy of these initiatives:

a. **Limited adoption of TReDS -** TReDS, introduced by RBI, is an electronic platform that facilitates the financing of trade receivables of MSMEs through multiple financiers. In addition to invoice discounting by auctioning the receivables for the best price, it also supports supply chain financing for MSMEs. However, despite its benefits, there are some gaps owing to which this platform has seen limited adoption. These are primarily due to low awareness, low enthusiasm or low participation.

I. **Lack of awareness amongst MSMEs:** According to Mr. Pawan Verma, Associate Director - Purchasing, P&G, "***MSMEs have low awareness of supply chain financing platforms like TReDS***." This lack of awareness among MSMEs, especially in Tier 3 & Tier 4 districts, is a significant bottleneck in the adoption of the platforms. **As a result, less than 1% of registered MSMEs are onboarded to TReDS[18].** Thus, despite TReDS being designed to ensure timely payments to MSMEs, a majority of MSMEs are unable to benefit.

II. **Low enthusiasm amongst buyers:** GoI has mandated all corporates with turnover above INR 500 Crore to register on TReDS. However, **only 20% of such corporates are registered, and only 23% of those registered transact on the platform[17].** The statistics are similar even for CPSEs - **only 22% of the registered CPSEs have transacted on TReDS[17]**. Buyers with longer working capital realization cycles opt out of TReDS due to a lack of flexibility. Buyers missing payments on TReDS, get tagged under special mention accounts creating a strong disincentive to join TReDS.

[52] This is a fictional case study

[53] Assuming Ms Shanti Devi gets payment against receivables in 6 months (DSO for a typical micro enterprise as per our analysis)

[54] Buyers are supposed to make payments to the MSEs within 45 days from the day of acceptance or from the day of deemed acceptance

III. **Limited participation of financiers:** Most banks on TReDS are unwilling to discount invoices pertaining to buyers with credit rating BBB or less (credit score <700), thus excluding 66%[55] of potential buyers.

b. Low awareness about MSEFCs and capacity issues:

I. The Ministry of MSMEs launched a delayed payment monitoring portal, SAMADHAAN, where MSMEs can file applications for delayed payments from the buyers. These applications are processed by Facilitation Centers (i.e. MSEFCs) which try to ensure that payments are made to MSMEs. However, MSEFCs' awareness among MSMEs remains low. **As per SAMADHAAN portal, less than 1% of all registered MSMEs[56] have filed delayed payment applications, which amounts to only ~1.3%[57] of the estimated outstanding payments due to registered MSMEs.** This signifies the reluctance of MSMEs to file complaints against buyers (despite the large quantum of receivables) owing to the asymmetry of bargaining power between them.

II. There are also capacity issues with MSEFCs, which is evident from the high pendency in application processing. **About 40% of registered applications on SAMADHAAN portal are pending to be processed by MSEFCs[58].** There is also a spatial disparity in the number of MSEFCs in each state. Despite a national average of 1 MSEFC per 10 Lakh MSMEs, some states have very few MSEFCs. For example, Uttar Pradesh[59], the state with the highest number of MSMEs in India, has only 1 MSEFC per 1 Cr MSMEs[60] with each MSEFC having about 2,400 pending applications. Figure 10 is a heat map showing the number of pending applications per MSEFC in each state.

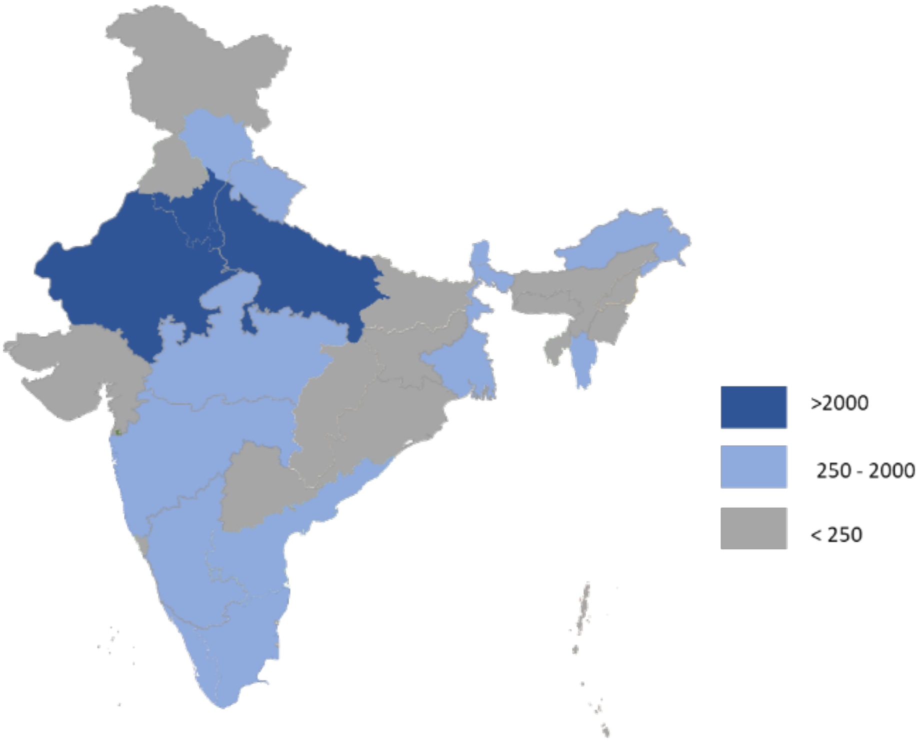


Figure 8: State-wise pending applications per MSEFC

c. Lack of capability and awareness of invoice compliance norms amongst MSMEs: Most MSMEs have a limited ability to generate invoices as per the buyer agreements. Further, there is low awareness about government compliances such as GST norms etc. This often leads to the rejection of MSME invoices by buyers. MSMEs also lack awareness and resources to access modern-day digital technologies for automatic e-invoice generation. The lack of such digital capabilities leads to a possibility of manual errors in invoice generation and delay in submission.

[55] [The AAA ratings debate 320 Fahrenheit ≠ 320 Celsius](), CRISIL - An S&P Global Company, 2019

[56] Assuming all the applications on the SAMADHAAN portal are filed by different MSMEs

[57] Secondary Data Analysis based on amount involved in applications on SAMDHAAN portal as of 27 Feb 21 and CMIE data analysis

[58] Secondary Data Analysis based on the pending applications data on SAMADHAAN portal as of 27th Feb 2021, 2021

[59] Based on number of MSEFCs in Uttar Pradesh on SAMADHAAN Portal as of 22 Jan 2021 and Total number of MSMEs in Uttar Pradesh , Annual Report 2019-20, Ministry of MSME, 2020

[60] Based on number of MSEFCs in Uttar Pradesh on SAMADHAAN Portal as of 22 Jan 2021 and Total number of MSMEs in India , Annual Report 2019-20, Ministry of MSME, 2020

6.2.2 Lack of Working Capital Securitization:

Table 1: Comparison of Trade Credit Insurance offerings across countries

Particulars	India	China	Singapore	US	Canada	Sweden
Flexibility in cover	Limited to whole credit turnover	Flexibility to opt for specific contracts /transaction	Flexibility to opt for specific contracts /transaction	Flexibility to opt for specific accounts	Flexibility to opt for specific accounts	Flexibility to opt for specific contracts /transaction
Policyholder eligibility	Seller of goods and services	Seller of goods and services, financial institutions	Seller of goods and services, financial institutions	Seller of goods and services, financial institutions	Seller of goods and services, financial institutions	Seller of goods and services, financial institutions
Premium	Percentage of annual turnover	Percentage of sales value to be insured	Percentage of sales value to be insured	Percentage of sales value to be insured	Percentage of sales value to be insured	Percentage of sales value to be insured
Value-added services	-	Risk transfer enabled by bank acceptance drafts	Govt support for SME sector in the form of absorbing 50% of premiums paid	Risk transfer enabled by securitization of receivables	-	-

a. Trade credit insurance (TCI) is a risk mitigation tool that provides insurance cover against delay or default in payments, thus bearing a significant potential to counter the financial challenges faced by enterprises. Insurance products, such as TCI which help hedge against risks of delayed payments, are constrained by their design in India. In Table 1, we compare TCI products across countries to show gaps in TCI offerings in India.

b. In India, as per the current TCI guidelines, the product offering for TCI is restricted to a 'whole credit turnover' policy. In the case of 'whole credit turnover', the entire receivables' balance for an enterprise is insured with the premium being charged as a percentage of the actual/forecasted sales. This provides lesser flexibility in cover options when compared with other nations, where TCI can be chosen for specific contracts or even transactions. In addition, this insurance cover is available only to sellers of goods and services and not for financial institutions engaging in invoice discounting on receivables. Further, there is a limited capability to provide value-added services.

c. Further, in India, **the premium collected for domestic trade credit insurance was only a mere INR 278 Cr in FY19, which was mainly collected from large enterprises**[61]. Delayed payments have a disproportionately adverse impact on micro and small enterprises due to their small scale of operation, hence it is imperative for these firms to ensure working capital securitization. However, since TCI is too expensive for enterprises operating at the 'micro' level, small enterprises emerge as the ideal target segment. According to our analysis, the **registered small enterprises have the potential to pay more than INR 11,000 cr[31] in average annual premiums**. However, the present product is not suitable for small enterprises due to extensive documentation requirements, high rate of premium and the lack of flexibility to choose which invoice/buyer to insure. Thus, there is a need for suitable modifications to ensure viability.

d. However, these modifications in TCI offerings must be viable not only for the enterprises but also for the insurer. It is critical to modify TCI offering as the inability to securitize working capital by MSMEs results in compounding loans with high-interest liabilities. Additionally, it creates a significant gap in cash flow management and may even cause delays in payments to suppliers.

6.3 Gaps related to Business Interference Insurance

a. At the onset of the COVID-19 induced lockdown, 75% of India's MSMEs had cash reserves for less than a month while a vast majority dipped into meagre personal savings to keep their businesses afloat[62]. Many entrepreneurs without adequate personal savings were forced to close down their businesses despite having viable business ventures. This problem is not limited to Covid, as businesses are vulnerable to all sorts of risks. MSMEs may struggle due to natural disasters, accidents, worker injuries, and damages to raw material among other risks.

[61] Revisiting guidelines on Trade Credit Insurance, Insurance Regulatory and Development Authority of India, 2020
[62] GAME analysis in partnership with LEAD at KREA University

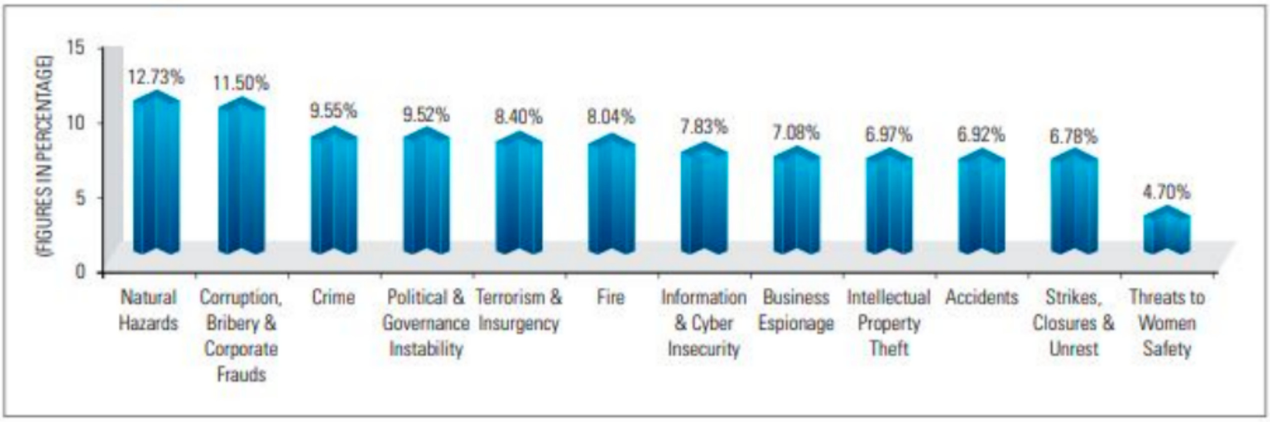


Figure 9: Biggest Risks faced by firms - FICCI

b. As a result of these exigencies or challenges, both internal and external, firms are forced to halt business or production. Figure 9 highlights the major risks faced by industries according to FICCI Risk Survey, 2019. The three biggest risks for firms were: a) natural hazards; b) corruption, bribery and corporate frauds; and c) crime.

c. The ratio of insurance premiums to the gross domestic product of the country was 0.9% in India in 2019 compared to the global average of 2.8%. Though recent years have seen increased participation of the private sector in the insurance sector (48% of market share in 2019), but only 5% of MSMEs[63] have insurance cover in 2020. As per FICCI-KPMG report, only 10% of MSME employees have health coverage while only a mere 0.1% of core property risks like fire are covered for MSMEs.

6.3.1. Reasons for low Insurance Penetration:

6.3.1.1. MSME related gaps: Most MSMEs have a low demand for insurance products due to: a) Limited awareness about the right insurance products; b) Financial constraints that prevent purchase and renewal of insurance; c) A low perceived return on insurance; and d) Lack of trust on insurance providers.

6.3.1.2. Insurance sector related gaps: The untimely nature of insurance settlement reduces the viability of the insurance products (especially during a crisis) for the MSMEs. There is a prevalence of a trust deficit between insurance providers and MSMEs due to the cumbersome nature of the claim settlement process, which creates a perception of the insurer being the exploiter. There is a rigidity in insurance product packaging which doesn't allow a firm to choose a customized product, thus increasing the cost incurred by the MSMEs. Further, different aspects of the insurance sector are siloed, as the sellers of insurance and insurance companies are different, thus further increasing this trust deficit.

6.3.1.3. Non-material losses not adequately insured: Most insurance products do not cover non-material losses like revenue/profit losses. The shock of the COVID-19 pandemic to MSMEs was mainly in the form of these non-material losses either due to delayed payments from buyers or reduced demand for products. MSMEs are highly susceptible to this loss of revenue/profit, which creates undue stress on their viability given their small scale of operations and limited liquidity.

[63] George Mathew, [IRDAI working on 2 insurance schemes for MSMEs](), The Indian Express, September 18th 2020

7. Interventions to tap current opportunities

a. The gaps in areas of finance for MSMEs discussed in the previous chapter have been long-standing ones and need to be addressed with utmost priority. Coupled with the onset of the COVID-19 pandemic amplifying these pre-existing frictions, there is an urgent need to tap into the most immediate and effective opportunities to ensure the revival of the sector and its subsequent growth.

b. While developing these opportunities and interventions, emphasis has been laid on leveraging pre-existing institutions and infrastructure. This would not only allow for faster implementation of these solutions but also help strengthen these very institutions. The design principles followed while developing these solutions are: a) market-driven interventions; b) promote the ease of doing business; and c) sustainability of interventions. The solutions intend to align the interests of all stakeholders, thus making them sustainable in the long-run.

c. The section below provides interventions that key stakeholders ought to undertake to ensure adequate access to credit and working capital requirements of MSMEs. Other relevant interventions which are directional and need further detailing (prior to implementation) are listed in the annexure of this report.

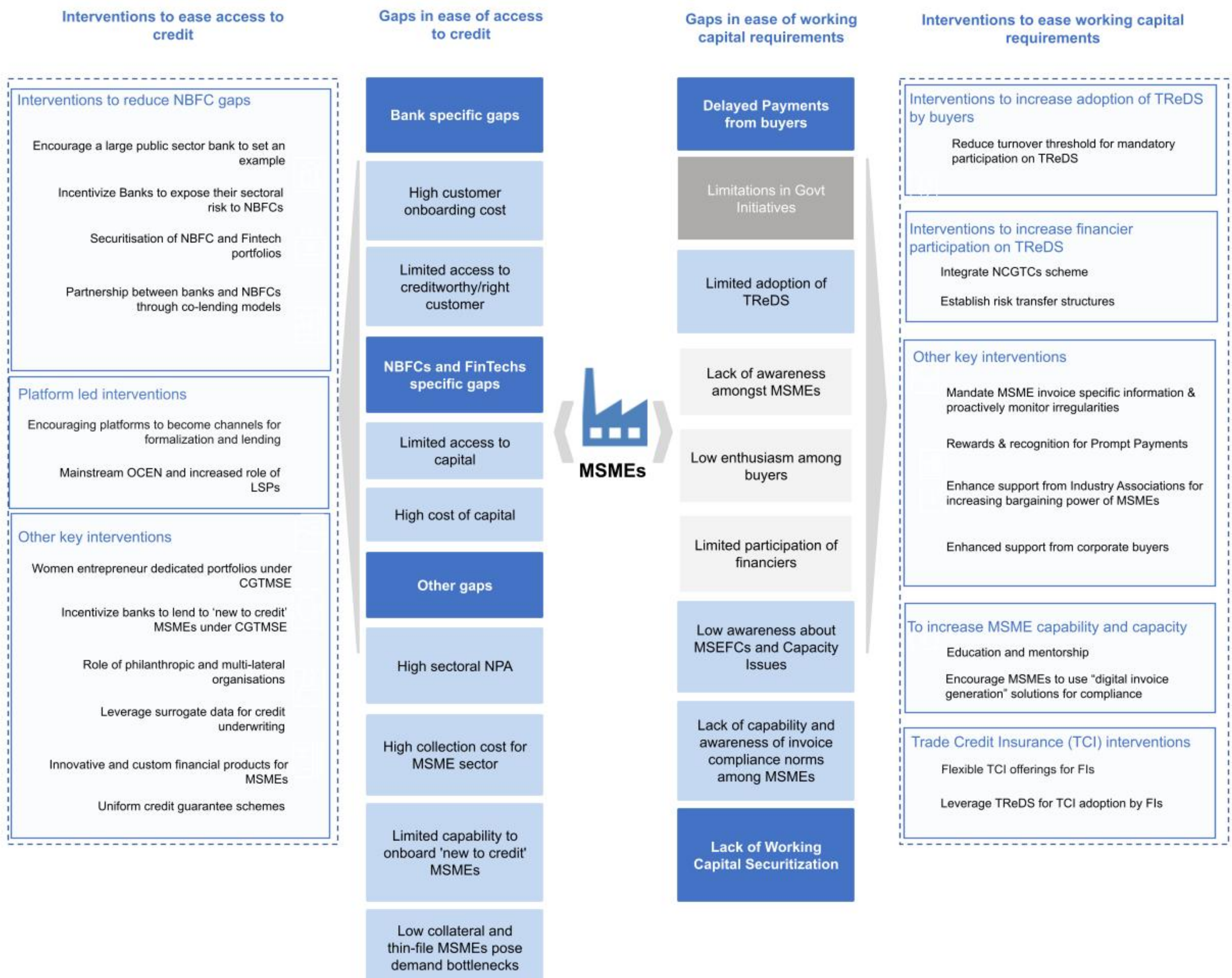


Figure 10: Gaps and interventions in areas of Finance for MSME

7.1 Interventions to ease access to credit

To enhance the ease of access to credit, it is imperative to identify innovative and practical solutions to serve MSMEs, especially new-to-credit and low-ticket size enterprises, as they constitute the majority. In order to sustainably meet MSMEs' demand for credit, a systemic change is needed in the functioning of MSME financing. Different financial institutions need to play different roles based on their strengths and institutional appetite for risk. The following are a few interventions that may help address gaps identified in this sector:

7.1.1 **Interventions to reduce NBFC gaps:** The following interventions aim to address NBFC specific gaps through motivational, incentive-based and partnership-based approaches.

a. **Motivational Approach i.e. Encourage a large public sector bank to set an example:** A large public sector bank may undertake an initiative to lend to smaller NBFCs having appropriate risk exposure and having access to 'New to Credit' customers. It may experiment with a select set of small NBFCs to evaluate the efficacy of their end-to-end operations. This may motivate other banks to follow the suit and include smaller NBFCs in their portfolio.

b. **Incentive-based Approach i.e. incentivize banks to finance smaller NBFCs:** Regulators should encourage banks to expose their sectoral risk to smaller NBFCs having access to "New to Credit" MSMEs. This will help correct the skewness of banks' sectoral fund exposure and reduce the preferential allocation of funds to a few large NBFCs. This incentive may be in the form of risk sharing with the Government through RBI support. One way to achieve this is by launching schemes like CGTMSE specifically for systemically important NBFCs. ***According, to Mr. Alok Mittal, Cofounder and CEO, Indifi Technologies Pvt Ltd - "If we have better data on NPAs of different rating families of NBFCs, we will notice that BBB grade NBFCs are not as risky to partner with Banks as the current risk premiums indicate"***

c. **Support-based Approach i.e. securitization of MSME portfolios:** Banks can provide additional support through securitisation of NBFCs and FinTech portfolios, by listing them in the secondary markets. This would not only allow for efficient transfer of risk but also improve the liquidity condition of the lenders. ***According, to Ketki Bhagwati, Board Director, Axis Bank – "To address the current MSME financing gap, we need policy interventions that enable financial institutions to attract diversified sources of risk capital and liquidity for financing this sector. Capital markets can play a bigger role in increasing the supply of funding available to financial institutions, particularly NBFCs, SFBs and MFIs. These institutions should have access to innovative financing structures like credit enhanced bond issuances and portfolio securitization to attract a broader range of investors and free up capital for loan growth."***

d. **Partnership-based Approach i.e. partnering with NBFCs through co-lending models**: Regulators should promote banks to partner with FinTechs and NBFCs either by extending their credit lines or by co-lending with them. NBFCs/FinTechs have better systems to analyse unstructured MSME data for credit underwriting (especially for MSMEs up to 2 Cr turnover or those MSMEs that rely on cash-based transactions). Thus, NBFCs and FinTechs can be leveraged to serve as channels for banks to serve a larger number of MSMEs. Risk sharing by the Government with RBI support can create a willingness among banks to partner with NBFCs. Table 2 contains details about a few innovative FinTech NBFCs that we interviewed during our research. Banks may want to consider similar NBFCs for prospective partnership, after appropriate due diligence. ***According to Mr. Dinesh Khara, Chairman, State Bank of India - "Banks are keen to work with NBFCs with strong books and track record"***

Table 2: Exhibit: Innovative FinTech NBFCs

Particulars	**Fintech NBFCs**		
	AYE [आय]	FLEXILOANS	KINARA CAPITAL
AUM (in INR)	1600 Cr	760 Cr	800 Cr
No. of loans disbursed	2.5L+	28K+	50K+
Average loan ticket size (in INR)	1.2L	3L	4L
Core Innovations	**Cluster-based financing** Solves underwriting challenge through its cluster-based approach supported by its data science models	**Flow-based ecosystem for smooth lending** Creating India's largest eco-system-based lender with integration with 30+ partners such as Flipkart, Paytm, etc.	**Alternative credit scoring** 115 data points used for customers underwriting which include traditional as well as non-traditional parameters

	Phygital Operational Model Uses technology in its processes to deliver low unit costs for origination, underwriting and servicing	**Automated touchless disbursals** Automated touchless disbursements capabilities on digital eco-systems (in <5 seconds)	**Fast Turnaround & Flexible Products** Products tailored to SME needs such loan decision in 24 hours
	Women focused program Potential plan to lend to women entrepreneurs with custom underwriting	**Fast loan disbursal** Sharp focus on automation for scale - helping FlexiLoans disburse 90% of its loans in 48 hours	**Unique collection strategy** Leverages 400+ payment apps for digital collections and Airtel Payments Bank outlets (5.5L+) for cash collections
	Build capability of micro SMEs Assists in creating digital footprints by educating MSME owner to build his/her credit record	**Proprietary technology** Has 10+ proprietary algorithms and risk models. It is also building data science assets across value chain-origination, processing, underwriting & collections	**Women focused program** Planned a women focused program to disburse Rs 100 Cr. Loans

7.1.2 **Encouraging e-commerce platforms to become channels for formalization and lending:** India, in recent years, has seen an explosion of digital payments and e-commerce, both in terms of scale as well as last-mile penetration. E-commerce platforms not only aggregate entrepreneurs but also help digitize records of transactions. These platforms will help create a frictionless ecosystem for MSMEs to operate in and create a digital footprint, especially for 'New to Credit' MSMEs. They can act as a mechanism for 'formalisation' of MSMEs by providing access to trusted data to lenders for underwriting in place of traditional KYC norms. Aggregating this data on MSMEs can not only optimize innovative lending models but also create better targeted policies for MSMEs. Such platforms should be encouraged to partner with financial institutions by helping them collect better data on financial transactions. This would reduce the lenders' risk by providing better information about the borrower's creditworthiness and the ability to repay, thus promoting lending. Several platforms such as UPI, and GST are bringing MSMEs online and these channels must be leveraged for underwriting through better information and subsequently, enhance credit flow.

7.1.3 **Mainstreaming Open Credit Enablement Network (OCEN):** OCEN is a great platform to facilitate a collaboration between these players by bringing down the cost of loans, creating suitable use cases for many different kinds of MSMEs at a marginal cost. OCEN is attempting to disrupt the current lending scenario for MSMEs by converting what is now a lender's market to a borrower's (MSME) market. In this marketplace there are many more credit choices for the borrowing MSME at lower costs and a highly convenient end-to-end loan cycle. At the lender's end, mindsets need to change and there needs to be a shift from collateral to data, as a basis for lending. NPAs can be addressed through continuous engagement with the borrower and sharing early data signals to the lenders. Despite the potential opportunity that OCEN brings, there remain challenges at the demand end: including hesitance to borrow, low digital penetration & trust in the digital world.

7.1.4 **Increased role of Loan Service Providers (LSP):** The credit gap for MSMEs cannot be solved by a single platform or transaction or set of stakeholders. LSPs are entities that act as the bridge between the lenders & borrowers, by continuously collaborating with both ends to ensure the flow of loans. LSPs can bring distribution & data to the lending value chain, thus improving the profitability of both the lenders and borrowers. Especially on the distribution side - LSPs add additional conduits for lending, with strong relations with many customers acquired, thereby improving the loan application and collection performance

7.1.5 **Other key interventions:**

a. **Women entrepreneur dedicated portfolios**: To introduce such portfolios, lenders may be incentivized through initiatives like CGTMSE or interest rate subvention. Certain NBFCs (e.g. Kinara Capital) are experimenting with a dedicated portfolio for women entrepreneurs, to promote lending to those without collateral. We recommend Banks and other NBFCs to create similar women entrepreneur dedicated portfolios.

b. **Incentivize banks to lend to 'New to Credit' MSMEs:** Regulators may incentivize banks by introducing new sub-categories within pre-existing Government schemes such as MUDRA or CGTMSE. This allows for reorientation and diversification of goals by leveraging already successful initiatives. ***According to Mr. Ashok Garg, Ex- Director of Board, Bank of Baroda, "Cashflow based approach used by FinTechs***

for assessing the working capital requirements of MSMEs would also be more relevant for banks than the existing typical asset based approach to help them in financing the viable MSMEs. Also, post-disbursement monitoring and ring fencing of cash flows being exercised by FinTechs for MSMEs also needs to be effectively implemented by banks to arrest further slippages and to implement remedial measures in a timely manner to support a needy MSME unit"

c. **Philanthropic and Multi-lateral Organizations**: Another potential intervention could be philanthropic and multi-lateral organizations providing these NBFCs and FinTechs with providing partial guarantees/first loss covers. Access to partial guarantees or first loss covers would allow them to lend more efficiently to a larger base of MSMEs by reducing their cost of capital and risk. Another avenue is the mainstreaming of returnable grants. Returnable grants are financial products, where the borrower can receive a grant without a legal obligation to pay, rather the obligation is moral. Philanthropic capital channelled via returnable grants can help build credit and digital footprints, especially for the NTC segment firms. This can generate adequate credit history, which would allow these entrepreneurs to access loans from formal sources

d. **Surrogate Data:** With the increased availability of newer data about borrower behaviours, existing financial data like GSTN, Credit Bureaus, Fraud registry, etc could be interlinked. This would provide useful surrogate data to faster underwriting and loan disbursal. – UK Sinha Committee Report

e. **Innovative Products**: Last mile financiers need to create customized financial products rather than following a one-size fits all approach while catering to MSMEs. These include 'Phygital' models, innovative credit underwriting models (that can analyse unstructured MSME data), collateral free lending products, etc. These products should address the specific challenges faced by MSMEs in accessing finance.

f. **Uniform Credit Guarantee Schemes:** As highlighted by UK Sinha Committee Report, the present credit guarantee schemes (for MSME loans) of NCGTC and CGTMSE could be brought under RBI supervision to better manage the credit risk for lenders and bring uniformity in their functioning. These regulatory guidelines should be in consonance with the World Bank Group's principles on credit guarantee schemes for SMEs.

7.2 Interventions to ease working capital requirements

This section focuses on interventions in two aspects: (i) to increase adoption and efficacy of Government and regulator initiatives that aim to promote timely payments and improved liquidity; and (ii) to improve the trade credit insurance (TCI) offerings in India. The government in recent years has taken numerous measures to promote smoother and faster payment of receivables to MSMEs.

These include: mandating a 45-day repayment period under the MSME Act 2006, MSEFCs, trade credit insurance and more. Some recent initiatives, especially with regard to TReDS, include easier tracking of payments to be made to MSMEs along with disclosure of details regarding ageing of the trade receivables. Recently, the Parliamentary Standing Committee on Finance has recommended certain suggestions to be incorporated into the Factoring Regulation (Amendment) Bill, 2020. These include mandatory use of TReDS by Union and State governments. It also recommends compulsory listing of all GSTN invoices on TReDS along with the extension of credit listing to include factoring. A full implementation of these measures would not only bring about large-scale adoption of TReDS, both by buyers and sellers, but also promote the formalization of MSMEs.

7.2.1 Interventions to increase adoption and efficacy of Government and Regulator initiatives:

7.2.1.1 Interventions to increase adoption of TReDS by buyers and financiers:

a. **Increase buyer participation**

I. **Reduce Turnover threshold:** There are around 7,500 companies[64] with turnover of over INR 500 Cr. Out of these, only 20%[17] of the companies are on TReDS despite the rules made by the Government of India. **Reduction in this mandatory turnover limit to INR 250 Cr for buyers may add ~20,000 buyers on TReDS[19]**. The increase in the number of buyers on TReDS will also encourage more MSME sellers to join the platform, thus allowing the platform to reach its potential. Assuming the new buyers transact in a manner similar to existing companies (with turnover of more than INR 500 Cr), **the amount of invoice discounting on TReDS will increase by ~INR 26,000 Cr[65]**.

[64] GST 3 Years of Commitment: 3 Years of GST A Statistical Report on Completion of 3 years of GST, GSTN, 2020

[65] CMIE data analysis, Assuming the average amount of invoices discounted for Companies in the Turnover Slab >250 Cr - < 500 Cr is half of the average amount of invoices discounted by the companies in turnover slab >500cr

b. Increase financier participation

I. Supply Chain Financing: The goal of SCF is similar to TReDS, wherein the credibility of a large buyer is leveraged to meet the working capital needs (or cash flow mismatch) of MSMEs. SCF contracts like Tech Mahindra, HUL, Aditya Birla etc[66] present a buyer-led approach as opposed to an MSME-led option like TReDS. MSME suppliers can use invoices and receivables as intermittent collaterals for quick access to credit at discounted rates through factoring and reverse factoring services. For the buyers, it ensures long term and stable vendors, while improving cash flows and reducing administrative costs, etc. For MSMEs, it allows easier access to loans as these invoices act as collateral. Finally, for the financiers, allows for better and more efficient underwriting, thus reducing credit risk while improving profitability. Despite these benefits, SCF penetration in India stands at <1% of GDP when compared to 12% of GDP in similar countries[67].

II. Integrating NCGTC's Credit Guarantee Fund Scheme for Factoring: Factoring is a process wherein an enterprise sells the value of its current invoices (for a lumpsum payment) to a third-party company called a factor. The factor then collects the invoices from the buyers. GoI established a *credit guarantee fund for factoring* (for MSMEs) which is managed and operated by the NCGTC in order to promote "factoring without recourse". The CGFSF[68] offers a credit guarantee cover[69] in such a way that the first loss of 10% of the amount in default is to be borne by factors, and the remaining 90% of the amount is to be borne by NCGTC and Factors in the ratio of 2:1 respectively. Integrating the CGFSF with TReDS will enhance banks' risk appetite to discount invoices pertaining to buyers with lower credit ratings i.e. BBB and lower. Thus, this will not only increase the participation of financiers but also buyers on the platform.

III. Risk Transfer Structures: Mechanisms and structures to transfer risk transfer from enterprises need to be established. This could be established via (a) Receivables securitization market - Trade receivable, which is a form of an asset due from different classes of buyers may be combined, underwritten and sold in the capital markets in the form of asset-backed securities, thus reducing the exposure of banks; and (b) Integrating Trade Credit Insurance with TReDS would be a win-win situation for the financiers and insurers as TCI may further help reduce financiers' risks by providing cover against the risk of non-payment by buyers. Presently, low volumes being attached along with documentation compliance make it unviable for insurers to offer products to financial institutions. TReDS could tackle this challenge as it not only brings the relevant stakeholders together on a unified platform with a high volume of invoices, but also acts as an intermediary for data requirements to be able to offer an on-the-go product. The platform already gathers the relevant information in the form of KYC details and credit agency reports (to help to pre-underwrite the product for different buyers). TReDS can also better collate this data through MIS reports. These reports contain information about all relevant stakeholders including intimation of receivables position, the outstanding positions with details of beneficiaries and beneficiary accounts to be credited and financed position.

7.2.1.2 Other Key Interventions:

a. Mandate reporting of MSME invoice specific information and proactively act on delayed payments: As per the notification dated 2nd November 2018, issued by the Ministry of Corporate Affairs (MCA), all companies[70] are mandated to file a half-yearly return with the MCA in MSME Form-1, stating the amount due towards MSMEs and the reasons for delay. Our primary research suggests that a significant number of invoices generated by MSMEs are rejected by buyers. This information is not collected through MSME Form-1. Hence, it is recommended that companies should be required to provide the following additional information in MSME Form-1:

- Count & Value of MSME *invoices received*
- Count & Value of MSME *invoices approved*
- Count & Value of MSME *invoices rejected*
- Reasons for invoice rejection
- Count & Value of MSME *invoices awaiting payment*

---

66 Dalberg analysis

67 Measures to boost supply chain finance for MSMEs is well-intended – The Economic Times, 8th Feb 2021

68 Credit Guarantee Fund Scheme for Factoring

69 Government Notification, Ministry of Finance, 2015

70 Companies which get supplies of goods and services from micro and small enterprises and, whose payments to micro and small enterprise suppliers exceed 45 days from the date of acceptance or deemed acceptance of goods and services.

- Count & Value of MSME *invoices payment for which is due for more than 45 days*
- The value of Interest accrued at the end of the quarter as a result of the penalty for the delayed payables.[71] (Section 16, MSMED Act 2006)

An existing government authority (e.g. MCA, Ministry of MSME) may be empowered to take proactive action against buyers based on the information obtained under MSME Form-1. This would be in case of irregularities like those involving inordinate delays or involving significant amounts of payment. Information about such buyers may be put in the public domain for increasing the accountability of buyers and to make MSMEs aware of such buyers. This action may be enabled through a data-driven approach by constructing a digital intelligence system that verifies and alerts the authority of these irregularities. Integration with the GST Network (GSTN) may further bolster the invoice verification process. This kind of proactive data-driven monitoring would not only reinforce the accountability of buyers in ensuring timely payments to MSMEs but would also reduce the scope of discretion and manual errors. To ensure that these new compliance norms don't undermine the ease of doing business in the economy, a committee comprising government authorities (e.g. MCA, Ministry of MSME, MoF), MSME representatives and Industry associations may be constituted.

b. **Rewards and recognition for Prompt Payments**: Prompt payments to MSMEs should be encouraged through initiatives like 'Prompt Payment' awards to buyers when no payments are delayed for transactions above a certain threshold. This will not only encourage ethical behaviour by buyers but would also allow MSMEs to better identify prompt payers.

c. **Enhanced support from Industry Associations for increasing the bargaining power of MSMEs**: Owing to the asymmetry of bargaining power between large buyers and MSMEs, industry associations such as CII, FICCI, FISME could be encouraged to actively support the MSMEs in ensuring fair payment terms and responsible business practices.

d. **Measures by Buyers**: Some large corporates[72] have strong governance policies in place for MSME payments such as: a) Tagging vendors as an MSME in their systems to ensure that the vendor gets tagged to a priority list; b) Running educational camps for their MSME vendors and setting up an integrated helpline in case MSMEs face a challenge with generating invoices; and c) Dedicated monitoring of payables to MSMEs in company board meetings Other buyers could also be encouraged to enact similar policies to assist their MSME suppliers through adequate incentives.

7.2.1.3 Increase the capability and awareness amongst MSMEs on delayed payments:

a. **Education and mentorship to MSMEs regarding invoice generation compliances and processes:** Targeted training and mentorship programs would better educate MSMEs about the compliances and the processes that need to be followed while generating invoices and would help reduce invoice rejection rates. A large number of medium enterprises were brought under the ambit of GST e-invoicing when the GST Council recommended that GST e-invoicing be mandatory for any firm whose turnover exceeds Rs 100 crore from January 1, 2021[73]. Amidst this change, the industry associations and the Common Service Centres (CSC) should encourage MSMEs to use 'digital invoice generation' solutions for raising e-invoices as they not only reduce the scope of errors but also make compliance with government norms easier. With a basic digital system in place, the e-invoice generation becomes a fairly simple process as MSMEs can GST compliant e-invoices (with unique invoice reference number) with a click of a button by simply uploading their basic invoice.

7.2.2 Interventions for Working Capital Securitization: The following interventions can help make trade credit insurance offerings in India more viable for adoption by the MSMEs.

7.2.2.1 Flexible Trade Credit Insurance for Banks/Financial institutions: Existing guidelines have restricted the definition of a policyholder to a "seller of goods and services" and exclude other players such as financial institutions. However, these financial institutions also play a key role in liquidating the huge receivables balance for small enterprises by providing invoice discounting facilities (factoring without recourse). Without insurance cover, these institutions would be vulnerable to the same risk of delay/default in payment, thus reducing their willingness to participate. Insurance cover to financial institutions on an invoice basis would instil a higher confidence and willingness to participate by optimizing their risk-return ratio, thus bringing in greater funds for MSME finance.

7.2.2.2 Flexible Options: The TCI product should offer flexibility to choose from a whole turnover, a single buyer or even a single invoice cover option. The results from a regulatory sandbox initiative, conducted between

[71] Section 16, MSMED Act, 2006, Ministry of MSME, Government of India
[72] Based on discussions with Hindustan Unilever and P&G India
[73] P. Borpuzari, GST e-invoicing mandatory from Jan 1, 2021, if turnover exceeds INR 100Cr, The Economic Times, 2020

April and October 2020, show that the product must be financier oriented and be limited to a single factoring unit (all invoices related to a single transaction between an MSME seller and a buyer). However, this sandbox product design, despite having an immediate effect discounting for large corporate buyers, would require capacity-building to make it scalable for low rated buyers. All these measures will eventually enable easy invoice discounting, which would ensure working capital financing for MSMEs.

7.3 Interventions to increase Insurance Penetration

In light of the problems faced by MSMEs due to the onset of the COVID-19 pandemic, a comprehensive Business Interruption Insurance would not only promote an efficient transfer of risk but also allow firms to set aside more funds for capital expenditure.

Business Interruption (BI) add-on would not only cover for material loss (as in traditional insurance products) but also cover for non-material loss arising due to lower demand or delayed payment cycles. Putting in metrics and placeholders for a faster turnaround for claim settlements will also support in popularizing such an insurance cover. The goal is to enhance the utility of the insurance for MSMEs while ensuring financial viability for the insurer. This can be done by incorporating the following mechanisms in the insurance cover:

a. **Swift Claim Settlement**: Having a benefit-based pre-underwritten product for easier claim settlement than having an indemnity driven process; technology can also have a great role here with limited direct human interactions
b. **Covering Non-material Losses**: MSMEs not only facing material loss due to events like breakdown of machinery or damage to their plants/offices, but also non-material losses due to loss of revenue/profit due to inability to produce and sell goods and services. These losses should also be covered in insurance as this also allows services MSMEs across various sectors to overcome such difficulties.
c. **First-loss Cover with increasing Loss Coverage**: An MSME can start with a 20% first loss cover to begin with. This can be increased on a year on year basis to eventually a 70-75% first loss cover. Such a structure will ensure that as the MSME garners more trust with the insurer due to increased visibility on business practices, metrics and viability over a period of time, such a cover becomes financially viable for both the insurer and the insured.
   I. One simple yet powerful way to achieve this could be to let the BI insurance cover be available to only those MSMEs who have been insured by the insurer for at least 3 consecutive years to have built enough history and trust

(Table 3: Sample first loss cover structure)

Number of Years	3	4	5	6	7	8	9	10
% First Loss Cover	20%	25%	30%	35%	40%	50%	60%	75%

   II. Another way to achieve this would be to work through existing networks (could be industry associations, clubs, SME bodies) where entrepreneurs may have existing credibility

7.3.1 Interventions to increase adoption of Business Interruption (BI) Insurance: A significant step towards mainstreaming BI as an add-on cover is to build the product structure and test it in a sandbox environment with a small but diverse group of existing MSME policyholders. This approach will help test the viability of such a cover and provide insights on potential gaps and revisions that will help build a full-fledged mainstream product.

8. Call to Action

8.1 Table 4 is a call to action to key stakeholders and covers the interventions that are executable immediately (quick wins) and the interventions that need further consultation before execution.

Table 4: Call to action for key stakeholders

Objectives	Interventions executable immediately	Interventions needing further consultation
Ease of access to credit		
To assist NBFCs to get access to capital	A large public sector bank may set an example by extending lines of credit to smaller NBFCs **(SBI)**	Incentivize banks to expose their sectoral risk to smaller NBFCs and partner with them **(Government and RBI)**
	Partnership between banks and NBFCs through co-lending models **(Banks, RBI and Government)**	-
To encourage competitive platforms	Support NGOs, and Industry Associations to onboard their member entrepreneurs on platforms such as OCEN, TReDS, and others to initiate the next wave of digitisation among India's MSMEs **(Platforms, EDOs, Industry Associations)**	Encouragement to build competitive platforms that provide different services **(FinTechs, NBFCs)**
	-	Build a blueprint for a platform or identify APIs for existing platforms that allow access to a range of MSME data (e.g. electricity bills, income tax, GSTN, fraud registry, psychometrics, etc) **(NPCI)**
To empower women entrepreneurs and 'New to Credit' MSMEs	Encourage lending to New to Credit and women entrepreneurs through dedicated portfolios supported the CGTMSE scheme; in particular, making the scheme more accessible to unrated and small NBFCs and FinTech firms will be crucial **(SIDBI and MSME Ministry)**	-
To ease access to finance at a lower cost for MSMEs	Revise PSL guidelines to include banks' lending to NBFCs focused on MSMEs **(RBI)**	-
Increased use of Returnable Grants to develop credit profile for NTC	Leverage philanthropies and investors to aid NBFCs and FinTech firms serving NTC and women entrepreneurs for providing partial guarantees or first loss covers **(philanthropies, investors)**	-
Develop surrogate data to improve lending decision	With the increased availability of newer data about borrower behaviours, existing financial data like GSTN, Credit Bureaus, Fraud registry, etc could be interlinked. (**Scheduled Commercial Banks and DFS)**	Segment and size the MSME landscape based on business characteristics, digital savviness, financing needs, supply chain integration and more towards the objective of designing focused solutions **(Consulting firms)**
Uniform Credit Guarantee Schemes	The present credit guarantee schemes (for MSME loans) of NCGTC and CGTMSE could be brought under RBI supervision in consonance with the World Bank Group's principles on credit guarantee schemes for SMEs. (**RBI and DFS**)	-
Ease of working capital requirements		
Increasing adoption of TReDS: To increase buyer participation	Reduce buyer turnover threshold for TReDS from INR 500 Cr to INR 250 Cr **(MSME Ministry)**	-
Increasing adoption of TReDS: To increase financier participation on the TReDS platform	Mainstream NCGTC funds to encourage trade credit insurance initiatives on TReDS to reduce risk aversion among banks **(DFS, MoF)**	-
	-	Establish Risk Transfer Structures like TCI and receivables securitization market to reduce the exposure of financiers on TReDS **(RBI, IRDAI)**

Other key interventions	Mandate reporting of MSME invoice specific information in MSME Form 1 & proactive monitoring of irregularities by an existing Govt Authority **(MCA, MSME Ministry)**	-
	Prompt payment awards for corporates through information captured via MSME form 1 **(MCA, MSME Ministry)**	-
	Enhance support from Industry Associations for increasing bargaining power of MSMEs **(Industry Associations)**	-
Enhancing the capability and capacity and awareness amongst MSMEs	Education and mentorship to MSMEs regarding invoice generation compliances and processes **(MSME Ministry, Industry Associations)**	Encourage MSMEs to use 'digital invoice generation' solutions for compliance **(Industry Associations)**
Working Capital Securitization: Modifications to the current TCI offerings	-	Flexible TCI offerings for FIs to reduce the risk involved in invoice discounting for buyers & leveraging TReDS platform to enable adoption of TCI **(IRDAI, RBI)**
Supply chain financing	-	Design a pilot and scale SCF solutions for a particular cluster of MSMEs, leveraging the proximity of a large buyer and the presence of several smaller suppliers **(SIDBI, FinTech players)**
	-	Study and test 'use cases' of blockchain technology especially in making visible supply chains that include informal and small micro-enterprises **(iSpirt)**
Increase Insurance Penetration		
Business Interruption Cover	-	1-2 committed insurers to pilot, through IRDAI's regulatory sandbox, and scale 'break in business' insurance for MSMEs (**General Insurance Council**)

9. Annexure

Directional Interventions

The section below provides directional interventions which are critical to both ease of access to credit and working capital requirements; however, further deliberation and detailing are required to implement them.

9.1 Key interventions to ease access to credit

9.1.1. Execute MSME registration program along with lending: MSME Udyam registration may be promoted by banks and NBFCs, while onboarding new customers for loans. Several informal or KYC light MSMEs could be provided KYC support at the point of lending. This will create an immediate pull for formalisation. The *carrot* of 'credit' will encourage several of India's informal enterprises to formalize.

9.1.2. Dedicated portfolios under credit schemes for employment generating MSMEs: Dedicated portfolios under government sponsored credit schemes such as MUDRA may be created for MSMEs employing more than 5 employees.

9.1.3. Promoting credit education, financial literacy and digital adoption amongst MSMEs: Lenders may focus on adopting strategies to assist MSMEs in developing relevant capabilities and improve their financial literacy, which will eventually result in greater creditworthiness of MSMEs. A number of FinTech lenders have adopted this model; traditional lenders may consider emulating or even partner with such players (e.g., Aye Finance, Flexiloans, etc.). The following is a list of initiatives that may be considered by lenders:

a. Run cluster-focused MSME programs to educate and help them explore best practices to grow their business. This may be done through focused agencies (NGOs and for-profit bodies).
b. Opting for 'Phygital' models to digitize MSME footprints and provide financial literacy through 'feet on the street' workforce.
c. Adopt and encourage usage of digital repayment techniques including e-Nach, UPI, etc.
d. MSME footprint digitization by collaborating with ecosystem partners (e.g. KhataTechs).

9.2 Interventions to ease working capital requirements

Interventions to increase adoption and efficacy of Government and Regulator initiatives

9.2.1 Interventions to increase adoption of TReDS:

a. Interventions to increase buyer participation:

Mandate Public sector enterprises to upload invoices to TReDS: It is recommended that a stipulated proportion of invoices pertaining to MSMEs, for CPSE buyers, may be mandated to be paid through TReDS. This may potentially increase the utilization of the platform by both CPSEs and MSMEs.

b. Interventions to increase financier participation

I. **Onboard NBFCs and FinTechs onto TReDS:** If onboarded, NBFCs and FinTechs with their higher risk appetite, can discount invoices of buyers with a credit rating below 700. The implementation of the government's decision to onboard NBFCs on TReDS may be expedited.

II. **Revision of Credit scoring methodology of MSMEs and Buyers on TReDS:** The TReDS platform may be used to publish a list of MSMEs and buyers with low credit risk, given their payment history on TReDS. This list can help the financial institutions and credit rating agencies revise their credit scoring methodology in assessing the MSMEs and buyers present on TReDS. This may encourage more financiers to participate on TReDS platform, as they will get access to a verified customer segment.

III. **Increase participation of Private and Foreign Banks:** Though there are around 46 Foreign banks and 22 Private banks recognized by RBI, only a mere 11 Private banks and 5 foreign banks have registered so far with one of the three TReDS facilitating platforms[17]. Regulatory measures to mandate the registration of Private banks and Foreign banks on TReDS platforms will increase the number of financiers thus enabling more supply chain financing on TReDS.

c. Platform related interventions

I. **Increase awareness of TReDS among MSMEs**: Awareness of TReDS in tier 3 & 4 districts is very low[17]. Though the RBI has taken steps to increase awareness through initiatives like RBI financial literacy week etc. the impact has not been adequate. An outbound marketing program with multiple touch points in tier 3 & 4 districts will help increase awareness in these regions. For tier 1 & 2 districts, in addition to awareness, the government may focus on addressing entry barriers to the platform while promoting the benefits for MSMEs in participating on the platform.

II. **Discounting invoices for BBB MSMEs when buyers have better credit rating:** Invoices pertaining to BBB enterprises may be discounted on the basis of buyers having a better credit rating. Segmenting all the BBB enterprises which are in business with buyers with better credit ratings will help in increasing the risk appetite of the financiers. This will increase the number of invoices discounted on TReDS, eventually benefiting even the BBB rate MSMEs.

III. **Integrate TReDS with e-commerce platforms:** Integration of TReDS with e-commerce platforms such as Amazon, GeM etc. could enable independent invoice validation. This convergence may promote outreach and allow for open access to many lenders like banks, NBFCs and even the lending arms of these e-commerce platforms.

9.2.2 Interventions to increase the outreach of facilitation councils:

a. Increase awareness of MSEFCs and SAMADHAAN portal: The awareness patterns, akin to the case of TReDS, may differ across different tiers (of districts) for MSEFCs and SAMADHAAN portal as well. The Government may run focused awareness campaigns (through multiple channels industry associations, CSCs, etc.) in order to increase awareness by explaining the benefits of the portal for MSMEs in addressing delayed payments.

b. Increase MSEFCs / Leveraging ODR platforms: The Central Government may direct the state governments to increase the number of MSEFCs in proportion to the number of applications filed by MSMEs and the number of MSMEs in the state. The MSEFCs may be increased in a phased manner subject to the number of pending applications of MSMEs. This will increase the capacity of MSEFCs and help address the issue of pending applications on the SAMADHAAN portal. The Central Government may also direct the state governments to improve digital infrastructure in order to promote Online Dispute Resolution for disputes involving delayed payments.

9.2.3 Other key interventions:

a. Quarterly reporting of MSME invoice specific information during Corporate Board Review: As mandated by the Companies Act, 2013, companies must hold at least 4 meetings with its Board of Directors every year with not more than 120 days between two consecutive meetings of the Board. It is recommended that cases of inordinate delays in payment to MSMEs may be included in the agenda of these board meetings. This will enable senior leadership of companies to proactively monitor delays in payment to MSMEs, thus pushing the concerned departments in the company to release timely payments.

b. Amendment to prohibit orders beyond approved budget: A key reason for the delay in payments from PSUs is the placement of orders beyond their approved budget. Amending the General Financial Rules (GFR) and Departmental Procurement Codes/ Manuals, to prohibit Government Departments from placing orders (to MSMEs) that are beyond their annual budget will reduce the delay in payments to MSMEs.

Table 5 summarizes the interventions above and calls to action key stakeholders.

Table 5: Call to action for key stakeholders

Objectives	Interventions executable immediately	Interventions needing further consultation
Ease of access to credit		
To increase financial literacy among MSMEs	Education & financial literacy programs for MSMEs **(by Banks and NBFCs)**	Program like MUDRA to focus more on subsidized loan requirements of micro-enterprises with more than 5 employees. **(by RBI)**
To ease access to finance at a lower cost for MSMEs	Dedicated portfolios under government sponsored credit schemes such as MUDRA may be created for MSMEs employing more than 5 employees. (**Credit Rating Agencies**)	Banks and NBFCs can drive an MSME registration program along with RBI to encourage formal lending**. (by Banks and RBI)**
Ease of working capital requirements		
Increasing adoption of TReDS: To increase buyer participation	Mandate invoice uploading to TReDS for Public sector enterprises **(RBI)**	-
Increasing adoption of TReDS: To increase financier participation on TReDS	Expedite the passing of the bill regarding onboarding of NBFCs to TReDS and onboard FinTechs to TReDS **(MCA, MoF, MSME Ministry)**	-
	Increase participation of Private & Foreign banks on TReDS **(RBI)**	
	Revision of Credit scoring methodology of MSMEs and Buyers on TReDS (**RBI and Government of India**)	-
Increasing adoption of TReDS: To enhance the TReDS Platform	Increase awareness and promotion of TReDS among MSMEs **(Industry Associations)**	Integrate TReDS with e-commerce platforms such as (e.g. Amazon, GeM etc.) for independent invoice validation **(RBI)**
	-	Discounting invoices pertaining to BBB corporates basis their buyers with better credit rating **(RBI)**
Increasing the capacity and outreach of the facilitation councils	Increase awareness and promotion of MSEFCs and SAMADHAAN portal **(Industry Associations)**	Leverage ODR platform for settlement of disputes regarding delayed payments [or Increase the number of MSEFCs in proportion to the number of applications filed by MSMEs and the number of MSMEs in the state] **(MSME Ministry)**
Enhancing the adoption and efficacy of Govt and regulator initiatives	Cases of inordinate delays in payment to MSMEs to be included in the agenda of board meetings of corporates and PSUs - Regulation in Companies Act 2013 **(MCA, MSME Ministry)**	-
	Prohibit Govt orders to MSMEs beyond approved budget **(MoF, MSME Ministry)**	-

10. Acknowledgements

We are deeply grateful to all the stakeholders, including experts from banks, NBFCs, insurance companies, philanthropic organisations, EDOs and policy making institutions, who were part of the GAME Finance Week held in December 2020. Their participation in the various panels and working sessions helped provide significant insights and ideas that have given the needed impetus to this report and enriched the proposed recommendations that we hope will transform the financing landscape for MSMEs in India. The event was made possible by the tremendous support and participation of key partners and individuals: State Bank of India, WhatsApp India, Sequoia Capital India, Michael & Susan Dell Foundation, NPCI, Bank of Baroda, LendingKart, Kinara Capital, Aye Finance, Kyepot, Flexiloans, NITI Aayog, FICCI, MSME Ministry, Saha Fund, ISpirt, CredAll, YourStory, M1Xchange, RXIL, Invoicemart, LEAD at KREA University, Frontier Markets, Northern Arc Capital, SEWA Bharat, TATA AIG General Insurance, HDFC ERGO General Insurance, SBI General Insurance, Hindustan Unilever, P&G India, PwC and Pensaar Design among others.

We are thankful for the invaluable insights that we have received from the many stakeholders who have taken time out to guide us at different points in this journey; PS Jayakumar (Former MD, Bank of Baroda), Ashok Garg (former CGM, Bank of Baroda), Alok Mittal (Co-Founder & CEO, Indify Technologies), Anu Mishra (Director, Hindustan Unilever), Pawan Verma (Head Purchases, P&G India) among others.

We are especially thankful to all the entrepreneurs who we have had the opportunity to interact with and who have shared their invaluable experience regarding the on-ground financing challenges faced by them.

This report would not have been possible without the unwavering support of the GAME Finance Taskforce members: Anjuly Chib Duggal, Chairperson (former DFS Secretary, Government of India); Ketki Bhagwati, Board Director, Axis Bank; Pranay Bhargava, Entrepreneur in residence, Sub-K Impact Solutions; Sharon Buteau, Executive Director, LEAD at KREA University; Shantanu Ghosh, Head, Social Finance India; Shivaprasad Krishnan, Founder, Flow Finance; Nat Mallupillai, Director, Michael & Susan Dell Foundation; Paromita Sen, Research Manager, SEWA Bharat; Hemant Seth, Treasurer, FICCI-CMSME & Director, FICCI; Sanjay Sharma, MD & Co-founder, Aye Finance; Tushar Thakkar, Associate Partner, Dalberg; Sanjay Thakur, Senior Banker and SME Evangelist; Mekin Maheshwari, Co-founder, GAME (CEO & Co-Founder, Udhyam); Ramesh Dharmaji, Advisor, GAME (former CGM, SIDBI).

We would also like to acknowledge the efforts and support of the GAME team in driving and executing this report: Ravi Venkatesan, Founder, GAME; Madan Padaki, Co-Founder, GAME; Ashwin Chandrasekhar, Vice President, GAME; Priyadeep Sinha, Vice President, GAME; Harshita Agarwal, Manager, GAME.