

Pandemic induced credit crunch faced by MSMEs and a rise in alternate financing methods

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Covid-19 has had a devastating impact on economies across the globe. In developing economies like India, this impact has been felt most on the micro, small and medium enterprises (MSMEs) segment which forms an integral part of the economy. Due to the recurring lockdowns and ensuing halts in production, low demands and exodus of workers to their villages, the problems of the ever-vulnerable MSMEs have been magnified. One of the persisting issues of access to timely and adequate finance has further worsened due to the pandemic. According to a report by the International Finance Corporation,¹ the credit gap in the MSME sector is estimated to be INR25.8 trillion (US\$397 billion) and traditional sources of financing have not been able to successfully fund this gap. This article attempts to provide an insight into how the pandemic is giving a fillip to alternate modes of financing to MSMEs in India as opposed to the traditional sources, albeit with some challenges.

Difficulties in procuring funds from traditional sources

MSMEs, particularly the micro and small businesses, struggle to access formal sources of credit as financial institutions hesitate in lending to these enterprises. Some of the major roadblocks in financial institutions lending to MSMEs are as follows:

- Information asymmetry and higher degree of credit risk – due to poor bookkeeping practices followed by the small businesses, financial institutions find it difficult to ascertain their volume of business, financial health and credit worthiness;
- Insufficiency of collateral – financial institutions seek collateral to secure their lending to MSMEs, while most of the assets of the MSMEs are comprised of movable assets as against fixed assets; and
- Inability to meet globally acceptable know your customer (KYC) requirements of financial institutions – most of the MSMEs operate informally and are not registered under the Micro, Small and Medium Enterprises Development Act 2006 (MSMED Act). Due to this, MSMEs fail to comply with the KYC requirements of financial institutions.

With businesses of the MSMEs deteriorating due to the pandemic, lending by financial institutions to MSMEs in India has consequently reduced further. As per reports of the Indian banking regulator, the Reserve Bank of India (RBI), credit growth to MSMEs has decreased to 0.5 per cent in March 2021 from 1.7 per cent in March 2020.

Alternate sources of financing to MSMEs

The Indian Government, recognising this situation as well as the need of pushing MSMEs in reviving the Indian economy post pandemic, has pushed forth a plethora of revival measures. However, changes in investment and turnover criteria for defining MSMEs for availing benefits, loan moratorium schemes of the RBI, fiscal stimulation, etc have also not been able to completely resolve the liquidity crunch faced by MSMEs. Despite the continuous efforts of the government, there remains a huge credit gap. This gap beckons the exploration of unconventional sources of funding, mainly by technology driven solutions. With the advent of digitisation, the alternate sources of funding have given a new ray of hope to the MSME sector. Unsecured loan products, alternative credit assessment methods and minimal operational and KYC requirements are amongst some of the major benefits² of the new age digital financing modes.

Some of the alternate sources of MSME funding which have been on the rise are:

- Fintech lenders – leveraging technology to provide quick funding to the MSMEs. The process generally involves less or zero paperwork. These lenders use digital transactions history of the borrowers to assess the creditworthiness and smart contracts for legal security;
- Trade receivables discounting systems (TReDS) – online platforms which facilitate financing/ discounting of trade receivables of the MSMEs. The financial institution funds the MSME sellers by discounting its invoices drawn on established corporate and other recognised buyers; and
- Peer to peer (P2P) platforms – these marketplace lending platforms act as online intermediaries by bringing the lenders and the borrowers together. Lenders register themselves on the platforms with various criteria like interest rate offered, maximum tenor of loans, maximum amount of loans, etc. and borrowers post their loan requirements. The P2P platform then pairs suitable creditors and borrowers.

Given the enormous scale and opportunity, there have been several financing portals and platforms that have sprung up in past year alone. The push towards digitisation by the Indian Government in the banking industry has also assisted in this. However, to exploit such sources of funding, MSMEs need to be adept at basic technology and use digital modes for their payments. This remains a challenge for the small and micro enterprises in particular. Further, in the case of the TReDS platform, in order to avail financing, registration of the MSME under the MSMED Act is compulsory making its penetration challenging. Additionally, the lack of financial literacy amongst the MSMEs and the lack of awareness about these sources is a damper on the potential success of these sources.

Separately, digital lenders to MSMEs are also facing a new set of challenges induced by the Covid-19 pandemic. Reduction in disbursements of fresh loans and collections as well as lack of supply of funds from their traditional co-lenders (onboarded with them as creditors) ie the banks and the non-banking financial companies³ has necessitated them to tread cautiously as it has led to a liquidity issue for these digital lenders. However, with ease in lockdowns in the country and with fiscal and policy support from government, the aforementioned temporary issues should not hamper the digital lenders for long.

Conclusion

With India's advanced development in payment infrastructure and the government's push for "Digital India", the growth of the alternate modes of funding to MSMEs seems inevitable. Especially due to the disruption caused by the Covid-19 pandemic, digitisation is being perceived as the new normal and is here to stay. However, while these alternate sources are working towards bridging the credit gap faced by MSMEs, incentivising the MSME sector for digitisation of business and promoting digital literacy will go a long way in bolstering the growth of these alternate sources.

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ENDNOTES

1. International Finance Corporation's report on Financing India's MSMEs – Estimation of Debt Requirement of MSMEs in India, p 11.
2. International Finance Corporation's report on Financing India's MSMEs – Estimation of Debt Requirement of MSMEs in India, p 75.
3. Belgavi, V, "MSME lending: Digital lenders, fintechs at crossroads amid Covid-19", *Moneycontrol*, <https://www.moneycontrol.com/news/trends/expert-columns/msme-lending-digital-lenders-fintechs-at-crossroads-amid-covid-19-5346831.html>.

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