Navigating the World of MSME Financing: Key Considerations and Solutions

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Key Findings

- Indian SMEs (Small and Medium Enterprises) face very high loan rejection rates (28%) from banks, compared to Rapid Reformer countries (5%), thus jeopardizing an extremely important source of credit.

- The lack of credit history for Micro, Small, and Medium Enterprises (MSMEs), often cited as a major reason for loan rejection, can be addressed by setting up a Public-Private Partnership (PPP) venture like the Credit Risk Database (CRD) in Japan, which encourages participation by anonymizing participants' financial information.

- This can also help minimize the premium on MSME lending rates, compared to large companies, which can go as high as 4.7% as per our estimates.

- The scope of credit guarantee schemes in place should be expanded to include a wider range of credit types, such as factoring and financial leasing transactions, as has been replicated in Hungary.

- As a best practice followed by countries such as South Korea and Japan, the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) can publish its leverage ratio to assure lenders.

- Lending can also be promoted by improving the loan recovery process in the case of default. The Pre-Packaged Insolvency Resolution Process currently in place has an elevated recovery cost at 9% of the debtor's collective assets in India.

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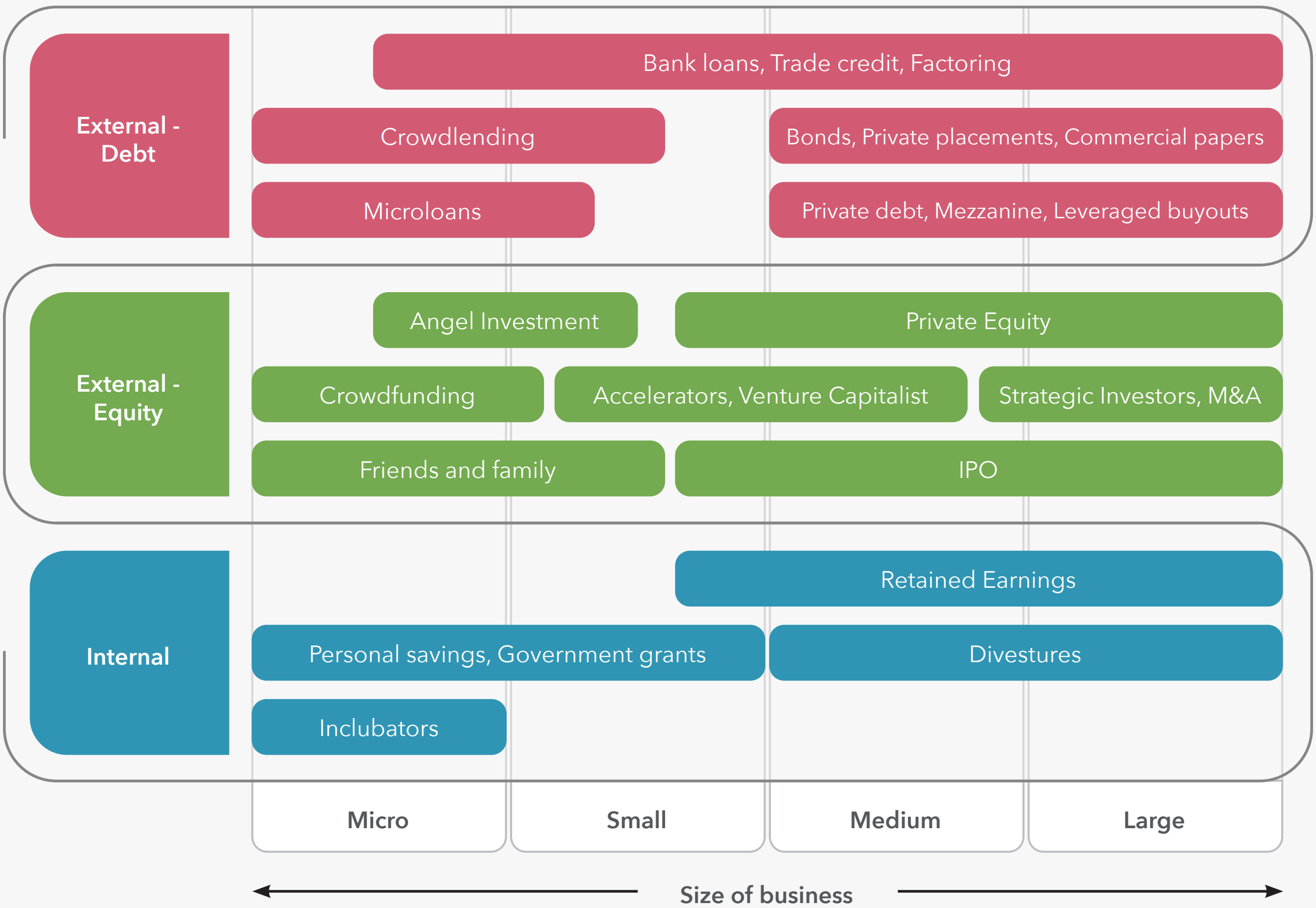
Locked Out: The Troubling Trend of Access to Bank Credit for MSMEs (Micro, Small, and Medium Enterprises)

Despite considerable progress in financial inclusion, MSMEs in India continue to face significant challenges in accessing financing. World Bank data indicates that only 15% of MSMEs in India have a bank loan, compared to 45% in Rapid Reformer countries (Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia). The crux of the issue lies in the loan rejection rates. A considerable 28% of Indian MSMEs encounter loan application rejections, while this number is just 5% among businesses in Rapid Reformers.

Unlike large firms, micro and small firms lack adequate retained earnings to reinvest in their businesses. These smaller businesses also suffer from diminished access to capital markets and other debt financing instruments.

Given the critical role played by banks in the context of MSME financing in India, this report focuses on the challenges faced by MSMEs in accessing bank credit and actionable policy measures to overcome those hurdles.

Financing Sources Across the Lifecycle of a Business



Source: Dun & Bradstreet

Unlocking Opportunities: Strategies to Expand Access to Bank Credit

The government has undertaken various measures to tackle these challenges; however, there remains room for refinement in order to align India's policies more effectively with the globally implemented best practices. Steps must also be taken to ensure all eligible businesses are aware of the initiatives taken thus far, and have the support they need.

Improving the Credit Guarantee Scheme for SMEs

While the Credit Guarantee Scheme (CGS) plays an instrumental role in improving access to credit for MSMEs, certain challenges still need to be addressed. During Dun & Bradstreet's interaction with some of the largest Indian public sector banks, cumbersome processes for claims settlement emerged as the key apprehension to lend under the CGTMSE scheme. Other challenges include the lengthy lock-in period of 18 months to invoke guarantee and lower payout cap for claims. Currently, claims are settled only to the extent of two times the guarantee fee, including recovery remitted by financial institutions during the previous financial year. Ideally, there is a need to simplify the claims process and reduce the burden of extensive documentation requirements on banks. Further, the lock-in period needs to be brought down from 18 to 12 months, and the payout cap needs to be increased from two times the guarantee fee to at least five times. While the claims payouts are stipulated to be completed within 30 days, an effort should be made to reduce this period to the internationally recommended timeframe of 7 to 14 days.

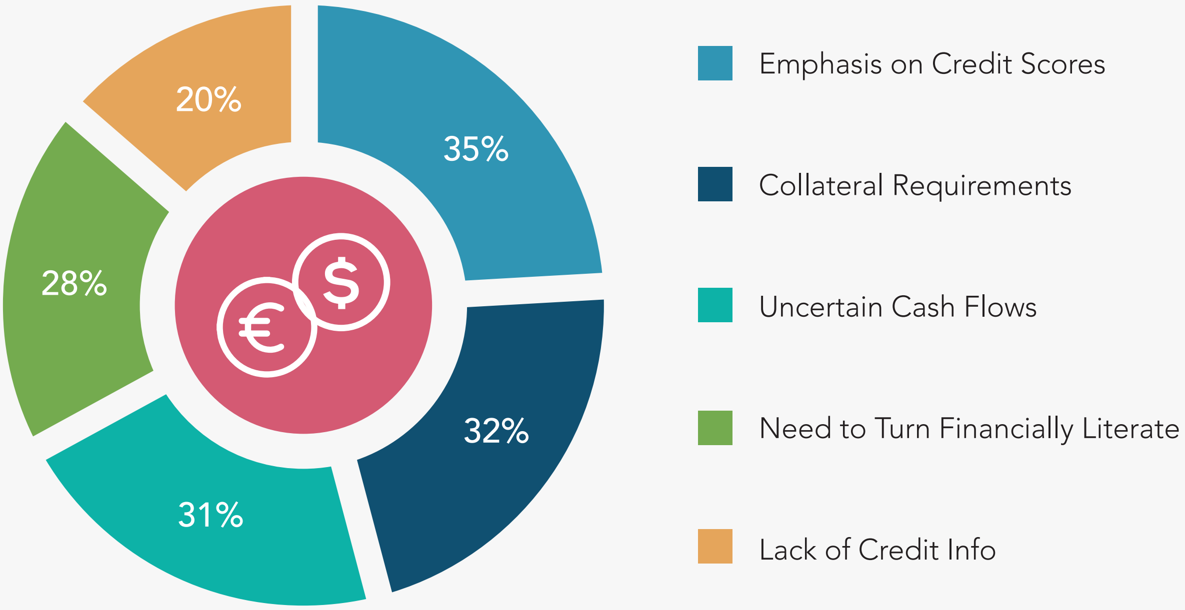
India would be to wise to take a lesson from other countries that run a successful CGS. In addition, the scope of the CGS in India could be expanded to cover trade credit. One of the early movers in this space is the Garantiqa Hitelgarancia Zrt., set up by the Hungarian government along with the private sector. Credit types guaranteed by this company include current account overdraft, operating loan, investment loan, and multi-purpose credit line. The company has also been covering factoring and financial leasing transactions since 2006.

As a best practice, the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTSME) should publish its leverage ratio to assure lenders. Successful CGSs such as the Kodit Korea Credit Guarantee Fund (leverage ratio of 10 vs. a cap of 20) and Japan Federation of Credit Guarantee Corporations (leverage ratio of 2.7 vs. a cap of 6) operate well within their leverage ratio caps, giving comfort to financial institutions.

Lack of Credit History for MSMEs

The SME survey conducted by Dun & Bradstreet in Q4 2020 indicates that 20% of MSMEs consider the lack of credit history a hurdle in obtaining financing. A possible workaround can be that in cases where a firm's credit history is absent, banks may rely on the credentials of investors to grant credit. However, World Bank data shows that credit bureau coverage is only for 63% of India's population, compared to 94% in Rapid Reformers (excluding Estonia), rendering it an impractical alternative. Moreover, even if MSMEs establish a credit history, they may lack sufficient knowledge on how to maintain a good credit score. That anecdotal evidence is corroborated by the findings of the SME survey, in which 30% of MSMEs stated the need to turn financially literate, while 35% cited emphasis on credit scores as a barrier to obtaining financing.

Top Challenges in Getting Access to Financing (% of Respondents)



Source: Dun & Bradstreet

The MSME Databank initiative, launched by the Ministry of MSMEs, moved us all a step closer toward improving the financial transparency of MSMEs. Unfortunately, this initiative has not been able to garner an impactful response rate. Many MSMEs are reluctant to share their information due to concerns about data privacy and security, and the process of providing information is perceived as too time-consuming and complex. Another challenge was the lack of awareness among MSMEs about the benefits of registering on the Databank platform. A regional study by the International Journal of Creative Research Thoughts (IJCRT) designed to gauge awareness about government-sponsored schemes revealed that nearly 40% of respondents were neutral or had no awareness about the Udyog Aadhaar Memorandum (UAM), a precursor to the Databank initiative. Neutrality implies that businesses might not see the value in registering, and the promotional efforts to create awareness and drive participation have been insufficient.

India can learn from Japan's Credit Risk Database (CRD), which was established in 2002 as a joint initiative between the government and private sector to develop a database with financial data of SMEs. The CRD is a credit information center designed to collect anonymous financial information and has no individual information reference function. Since information cannot be traced back to the reporting firm, it incentivizes accurate and full disclosure of financial information. The database quantifies the credit quality of an average borrower in the group with similar attributes, which leads to a better prediction of the credit risk based on a large database. This approach has several advantages:

- It imposes discipline on borrowers, supplying the motivation needed to provide account figures for gaining better loan conditions.
- It promotes competition in the financial market and increases the financial opportunities for the borrowers.

- It better predicts default risk over collective MSME loans and reduces the overestimated risk premium in the fund provision side, which encourages the flow of funds to MSMEs.

For the creditors, it helps in:

- Improving portfolio risk management over pooled loans
- Supporting the securitization of various MSME-related assets, including loan assets
- Enabling stochastic risk control

Below are three key factors that contributed to the success of the CRD system in Japan that can be successfully replicated in India:

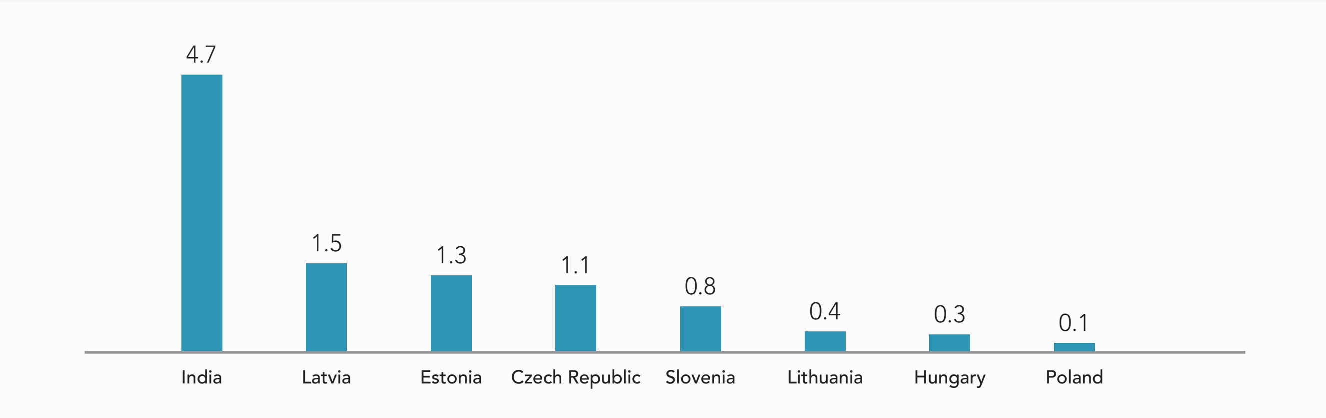
1) The system was developed with the government's support, which provided a regulatory framework and incentives for banks and financial institutions to participate in the initiative.
2) The involvement of the private sector, incentivized via anonymity, ensured that the system was developed with the needs of lenders and borrowers in mind.
3) The system was designed to be flexible and adaptable due to the depth and regularity of reporting, which allowed it to evolve with changes in the business environment.

Premium on Lending Rates

We know that a lack of credit history is a significant deterrent in banks extending credit to Indian SMEs. To compensate for this risk, banks price their loans significantly higher than they would for large companies, or those that have a solid credit history. According to data from OECD and Dun & Bradstreet research, interest rate differential between MSMEs and large firms can be as high as 4.7% in India, compared to a mere 0.8% in Rapid Reformers—a pattern that dissuades MSMEs from borrowing.

The development of an MSME databank on the lines of CRD in Japan, along with improvements in the previously mentioned credit guarantee scheme, can reduce information asymmetry and boost creditors confidence. In theory, this can lead to a reduction in risk premium rates for MSMEs.

Interest Rate Spread Between MSMEs and Large Enterprise Loans



Source: OECD, Dun & Bradstreet

Simplifying Bankruptcy and Insolvency Laws

Interest rates are also driven by bankruptcy and insolvency costs, which have two key components: Recovery rate and recovery cost. When the recovery rate is low, the cost of capital rises. Between 2014 and 2019, creditors in India were only able to recover 26 cents on the dollar, compared to 51 cents in Rapid Reformers, and 85 cents in Asian Tigers (which includes Hong Kong SAR, Taiwan Province of China, Singapore, and South Korea), according to data from the World Bank.

In addition to low recovery rates, creditors in India face high recovery costs, which consist of court fees, government levies, insolvency administrator fees, auctioneer fees, assessor fees, and lawyer fees. Recovery costs in India amounted to 9% of the debtor's collective assets, a more favorable outcome than the 13% for Rapid Reformers but more than double the 4.1% recorded for Asian Tigers. Further, resolving insolvency in India was a lengthy process, taking 1.8 years and 3 years longer than Rapid Reformers and Asian Tigers, respectively. However, it should be noted that the recovery rate has increased to 72 cents on the dollar, and the recovery time has reduced from 4.3 years to 1.6 years due to various initiatives taken by the Indian government.

The use of out-of-court and hybrid restructuring techniques is well suited for the MSMEs sector as these are cost-effective and speed up restructuring of viable firms. South Korea also provides valuable insights that can be adopted, such as implementing strict deadlines for arbitrations to reduce the overdependence on the formal judicial process in resolving disputes and enforcing penalties for failing to comply with these deadlines. Ultimately, these actions motivate parties to work toward resolving their disputes. Additionally, providing incentives for fresh funding can aid in financing restructuring efforts, while promoting financial institutions' participation in the accord can prove beneficial.

The introduction of Pre-Packaged Insolvency Resolution Process (PPIRP) by India in 2021 is a step in the right direction. However, only four applications have been admitted under the PPIRP as of March 2023. The banking sector has been hesitant in initiating PPIRP because they are required to take a voluntary haircut and are apprehensive about the possibility of their decisions being scrutinized later. To address these concerns, India can learn from the experiences of countries such as Croatia, Latvia, and Slovenia, which have overhauled their insolvency regime by introducing enhanced features, like debt-to-equity swaps, equity injections, and other debt-restructuring mechanisms. Despite the potential benefits of out-of-court and hybrid restructuring mechanisms, cultural factors can significantly influence their usage, as was observed during the European Crisis. Therefore, it is crucial to engage in further discussion with the banking sector to develop policies that are better suited to India's cultural context.

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How Dun & Bradstreet Can Help

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- Secure lower interest rates
- Enhance your cash flow
- Negotiate favorable payment terms
- Attract new B2B customers

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