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A Review of the Scope of Fintech in Bridging the Credit Gap of Indian MSMEs – The Last Mile Borrowers

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ABSTRACT: *Micro, Small and Medium Enterprises (MSMEs) of India have been playing a significant role in strengthening the Indian economy through its crucial contribution to the nation's GDP, employment and exports. Despite its significant role, access to credit has been a perennial problem for the MSME sector, consequently a huge credit gap exists in this sector. Even though the existing financial system of India has deep penetration, MSMEs are often left out of their ambit as stringent eligibility criteria has to be met to access credit, which the MSMEs generally do not have the capacity or have the wherewithal to meet. Financial Technology (FinTech) companies backed by innovation, AI, Big Data Analytics, etc. take a completely different set of data than the existing financial system to make credit decisions. FinTechs can be a game changer in meeting the credit problems of MSMEs.*

The paper reviews the reasons behind rejection of loan proposals of MSMEs by the existing banking system and the scope of non-traditional FinTech models to address this problem.

KEY WORDS: *FinTech, MSME, Credit Gap, Digital Lending*

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I. INTRODUCTION AND LITERATURE REVIEW

The cornerstone of the Indian Economy, MSMEs (Micro, Small and Medium Enterprises) form a significant pillar of development for the economy through their crucial contribution of over 30% to the country's GDP (The World Bank) and 50% to India's exports (Ministry of Micro, 2019).

It is estimated that there are over 6.4 crore MSMEs in India, providing employment to over 11 crore people i.e., 25% of the working population (International Finance Corporation, 2018). Thus, the MSME sector in India is one of the strongest drivers of economic development, entrepreneurship and employment and has the potential to protect the economy from global adversities and shocks.

Despite RBI and the Government of India considering MSMEs as Priority Sector and making mandates for the banks to encourage this sector with adequate and timely credit, despite various Government schemes, access to credit has been a perennial problem for the MSMEs. A vast credit gap exists in this sector and the prevailing financial system is unable to meet this gap due to stringent eligibility criteria for credit which the MSMEs are often not in a position or do not have the wherewithal to meet.

FinTech (Financial technology) companies driven by innovation, technology, artificial intelligence and big data analytics are looking to use alternative forms of data and newer methods of analyzing that data to assess an applicant's creditworthiness and developing ways to make loan application and disbursement process easy and quick. These meet the niche or tailored credit needs of the MSMEs and hence fintechs could be the gamechanger in meeting the vast credit gap.

As per the Financial Stability Board, FinTech is defined as "technologically enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services".

There are various branches of FinTech, for the purpose of our study we are considering Digital Lending. Digital lending is the process of offering loans that are applied for, disbursed, and managed through digital channels, in which lenders use digitized data to make credit decisions and build intelligent customer engagement. (Stewart, Yaworsky, & Lamont, 2018)

MSME stands for Micro, Small and Medium Enterprises. As per MSMED (Micro, Small and Medium Enterprises Development) Act, 2006, MSMEs are enterprises involved in processing, production and preservation of goods and commodities.

Table 1: MSME criterion based on the Investment Amount and Turnover of the enterprise (Ministry of Micro S. a.)

Criteria	Parameters	
	Investment*	**Turnover Limit****
Micro	Less than INR 1 crore	Less than INR 5 crore
Small	More than INR 1 crore but less than INR 10 crore	More than INR 5 crore to less than INR 50 crore
Medium	More than INR 10 crore but less than INR 50 crore	More than INR 50 crore to less than INR 250 crore

Source: Ministry of Micro, Small and Medium Enterprises

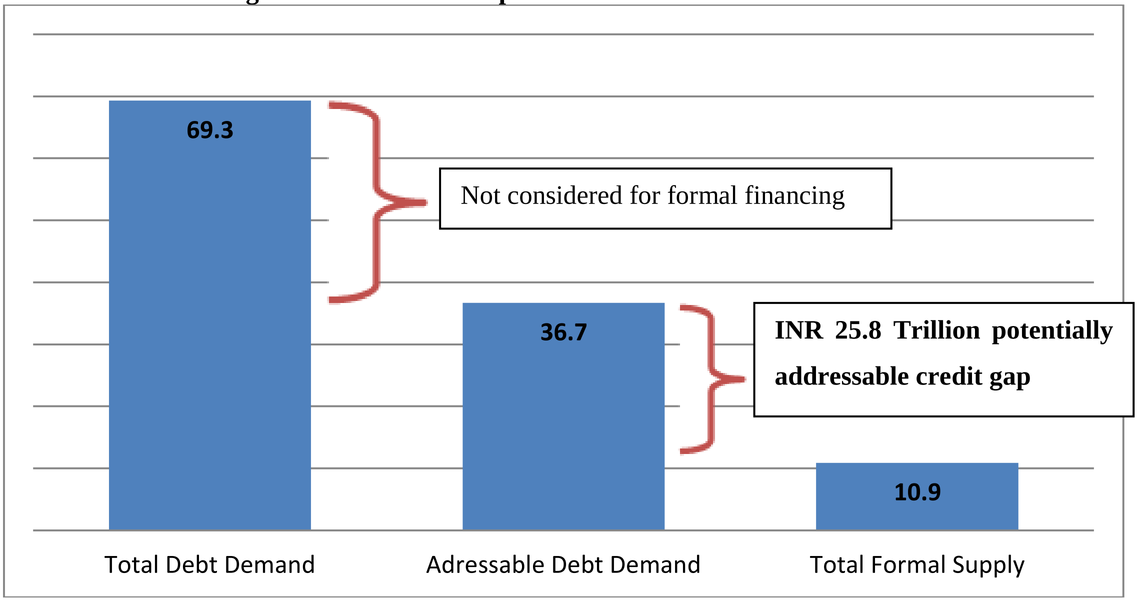
*Investment is counted for plant and machinery or equipment
** While computing turnover for MSMEs, it is provisioned to exclude exports turnover

MSMEs are considered among the priority sectors of India. Priority Sector includes those sectors which impact the large sections of the population, the weaker sections and the sectors which are employment intensive. Government of India and Reserve Bank of India consider these sectors important for the development of the basic needs of the country and are to be given priority over other sectors. Banks are mandated to encourage the growth of these sectors with timely and adequate credit.

MSMEs not only play crucial role in providing large employment opportunities at comparatively lower capital cost than large industries but also help in industrialization of rural and backward areas, thereby, reducing regional imbalances, assuring more equitable distribution of national income and wealth. (Sharma & Gill, 2016). Economic growth of any country is closely associated with MSME development and there exists a positive relationship between the relative size of the MSME sector and economic growth of a country. (Biswas, 2015)

Despite its crucial role, MSMEs have been struggling for access to credit since a very long time.

Figure 1: The Credit Gap in the MSME sector in India 2018



Source: International Finance Corporation

The overall demand for debt by MSME is estimated to be INR 69.3 Trillion. After excluding the enterprises that are either not considered commercially viable by formal financial institutions, or those enterprises that voluntarily exclude themselves from formal financial services, the viable and addressable debt demand was estimated to be INR 36.7 Trillion out of which only INR 10.9 Trillion was met, remaining INR 25.8 Trillion (70%) remained unmet (International Finance Corporation, 2018). The credit demand of MSMEs has increased by about 1.6x times the pre-Covid phase. (CIBIL, 2022)

1.2 Research Objectives

The objective of the research is to review the reasons behind rejection of loan proposals of MSMEs by the existing banking system and the scope of non-traditional FinTech models to address this problem.

1.3 Research Methodology and Data Analysis

In order to review the aforementioned objective, the paper is going to use information from secondary sources like Government Reports, MSME Annual Reports, Press Information Bureau releases, publications by International Organizations like The World Bank and International Finance Corporation, Reports published CIBIL, EY and other research articles.

The banking sector has an extensive reach across the country. However, being traditional lending institutions, they have certain stringent requirements to be met which act as constraints in servicing the last mile segment like established credit history, provision of collateral, extensive documentation, etc. Hence, MSMEs are often left out of their ambit. Some of the most commonly cited challenges, both from the lenders' and borrowers' perspective, include: (i) lack of formal data for credit assessment, especially with the regard to informal MSMEs, (ii) lack of bespoke products that suit lender appetite and the risk profiles of borrowers, (iii) long turn-around-time for receiving loans, (iv) requirement of collaterals/guarantees by the traditional lenders, (v) high interest rates, and (vi) complex application procedures (Balakrishnan & Srinivasan, 2019)

As banks and traditional lending institutions fail to cater to these tailored needs, only with technical disruptions the niche financing needs of the MSMEs can be met. As on 2022, with 87%, India took the lead of Fintech Adoption Rate compared to the world average of 64% (Finance, 2023). Fintech companies doubled disbursements in the financial year 2021-22, disbursing a total of 2.66 Crore loans worth of Rs 18,000 crores (Fintech Association for Consumer Empowerment, FACE). Digital lending can be a powerful force for financial inclusion. Innovations in digital lending are enabling financial service providers (FSPs) to offer better products to more underserved clients in faster, more cost-efficient, and engaging ways. (Stewart, Yaworsky, & Lamont, 2018)

1.4 Findings and Interpretation

The MSMEs need specific tailored services or certain niche financing sources, which the banks are unable to provide. Certain MSMEs may be new to credit or may not have the wherewithal to submit collateral in exchange for a loan, consequently they need simplified application process, non-traditional evaluation and credit underwriting mechanisms to get a business loan.

FinTechs do not require collateral, established credit history or credit score, audited financial statements and extensive documentation. Using their proprietary algorithms backed by AI, Big Data Analytics, etc. they measure the credit worthiness of borrowers with the help of alternative data like:

- The quantum and nature of UPI transactions,
- Number and amount of PoS transactions in the name of the borrower,
- Rent Payment histoy,
- Invoices, Bills Receivables etc.

Such kind of data are easily available with the MSMEs and hence they can get loans from FinTechs on much easier terms than commercial banks.

Moreover, Fintech lending platforms have much lower customer acquisition costs than the banks and hence will be able to service target niche customer segments that need small value loans.

Fintech lenders can leverage their use of technology to develop alternative forms of credit risk analysis using tools such as artificial intelligence and big data analytics which allow them to understand and predict credit risk effectively and quickly.

Currently, the risk assessment framework is over-dependent on asset ownership, CIBIL scores, documentation, etc. which is incompatible with the informal nature of MSMEs. Fintech can provide a cash-based lending model that will assess the creditworthiness of an MSME based on its cash flows leveraging the power of digital payments.

Some of the existing Fintech models which are painting the white space left by commercial banks are as follows:

- Fintech models leveraging technology to utilize alternative data such as GST (Goods and Services Tax) that allows an insight into business parameters such as inputs, value, place of business, amount of taxes levied to derive information about business book size, assess financial risk appetites and gauge capacity to service further debt obligations. Utility bills, bank account statements are some other data points that are used.

- Fintech lenders offering invoice financing as a short-term working capital facility based on unpaid invoices of MSME clients/customers to help in solving liquidity related challenges in the short term.
- Peer to Peer (P2P) lending model that is a digital marketplace connecting borrowers with lenders allowing quick access to low cost loans.

India has a growing FinTech lending ecosystem, the technology adoption rate of India is also one of the highest. Government has recognized the importance of digitisation in financial inclusion and hence encouraging the public through various means. With cheapest data costs across the world and notable mobile phone penetration, market reach of businesses has grown considerably. The crucial MSME sector, if their credit demands are met can pave the way for economic prosperity for the nation. Hence, proper institutional support and recognition should be given to the non - traditional FinTech models and reliable regulatory framework should be designed. FinTechs with their technological know-how and unconventional models can solve the problems faced by the MSMEs in accessing credit and bring about economic prosperity to the nation.

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