Innovative Strategies for Funding SME

The MSME Segment

- Statistically, according to IFC World Bank report of 2012, there are 29.8 million enterprises in various industries, 51.8 per cent of which are rural enterprises.
- It employees 69 million people, contributes 45 percent to Indian industrial output and 40 percent to exports.
- Although 94 percent of MSMEs are unregistered, their GDP contribution has been growing consistently at 11.5 percent a year, much higher than the nation's overall GDP growth.
- The overall finance demand of MSME sector is around Rs 32.5 trillion. Of this a record 78 percent, or Rs 25.5 trillion is either self-financed or from informal sources. Formal sources cater to only 22 percent or Rs 7 trillion of the total MSME

Financial Inclusion- Part of Inclusive growth

- Financial Inclusion is important as it forms the basis for Inclusive growth of any country. In order to expand the necessities of remote areas, the resources must be provided. Flow of monies to these unbanked areas would attract other industries leading to the growth of area in a sustainable manner.

- Components of Inclusive growth:
  - Education
  - Basic necessities like home, road, water, electricity
  - Penetration of technology
  - Increased efficiency leading to productivity

- Components of Financial Inclusion:
  - Providing affordable banking services
  - Providing access to credit
  - Creating self sustainable economy in each areas

Financial Inclusion- A long way to go

Financial services are still not reaching majority of Indians. The single most frequently used source of loan is still the moneylender/Pawn Broker

50% of Indian households do not have any banking service – either savings or credit

According to the findings of World Bank Global Findex Survey – (2012)

- Only 35 %of Indian adults had access to formal bank account
- Only 8% borrowed formally in the last 12 months.
- Only 2 % of adult population used bank accounts to receive money (remittances) from members of family living elsewhere & 4 % received payments from the Government.

Business Correspondent Model

The RBI issued guidelines on BC's in January 2006 and the review of BC model was done in mid-2009. As per the report released in August 2009

- In 2006, RBI had permitted the following to be BCs - NGOs, MFIs, Section 25 companies, retired Government employees
- In late 2009, RBI also permitted individual shop owners, small savings / insurance agents, self-help groups linked to banks to be appointed as BCs
- In late 2009, RBI also permitted banks to collect "reasonable" service charges from the ultimate customer for services rendered through BCs
- As of August 2009, 27 public sector banks had appointed only 85 BCs and 22 private banks had appointed 44 BCs
- As of June 2012, RBI data show that the number of BCs established had risen sharply to 1,20,000
- The number of no-frill savings accounts (basic savings account without any minimum balance stipulation etc) also rose from 70 million to 145 million in that period

Business Correspondent Model

- Despite the rise in the number of BCs and in the number of basic savings accounts, the monetary characteristics of these accounts do not promise much business potential for banks – as indicated below
  - The total amount mobilized through the 145 million basic savings deposit accounts was only Rs.12,000 crore as of June 2012 (**An average balance of just around Rs.350 per savings account).**
  - Of these 145 million accounts, 3 million had a credit / overdraft facility with total outstanding of Rs.120 crore .
- Thus, instead of looking at BC model, the solution at this point is to move towards **Alternative Business Model**

Factors affecting access to formal financial services

- Non Availability of legal identity
- Limited literacy
- Level of Income
- Terms and Conditions of Banks
- Complicated procedures
- Psychological and cultural barriers
- Place of living
- Lack of awareness
- Non availability of customized products

NBFCs and Financial Inclusion

NBFCs by their incorporation have clear visibility to develop a section of society

- Asset Finance companies provide the resources for development in the sector like housing, commercial vehicle, construction equipment's, gold etc.
- Infrastructure Finance companies are focused at developing the overall infrastructure of the country like roads, bridges, railways, air traffic etc.
- Loan Companies help by providing loans to various sections of society and at various levels
- Micro Finance companies provide resources to rural population, SHGs etc.
- Investment companies help other organizations to flourish by providing them resources in time and thereby contributing to the development of society as a whole

NBFCs and Financial Inclusion

- Most of the NBFCs have developed their own competencies in the segments like Gold Finance, Commercial Vehicle Finance, funding in securities markets etc.
- Most NBFCs have reach in rural areas.
- NBFCs try to create the self sustained economy by providing funding against assets for the business purposes
- NBFCs try to create their own market from unbanked population as they have high competition form banks for the population with good credit history
- NBFCs have flexibility in their policies as compared to banks so as to accommodate underprivileged people with no access to banks for want of credit history or other costly requirements.
- NBFCs can offer customized services to different customers and thereby fulfilling specific needs.
- Most of the NBFCs want to expand in rural areas and increase their share of business to diversify the risks involved with dealing with rural population

Innovative funding to SME is possible

- Due to rapid growth of NBFC-Corporate sector the current structure of NBFC Sector (excluding the Housing Finance Companies) is such that NBFC Corporate account for less than 5% of the total NBFC's by number but have more than 75% of the total Assets of the NBFC sector of Rs. 10,000 Billion.
- SBFC's (SMALL BUSINESS FINANCE COMPANY'S/ENTITIES) who play a very significant role in promoting Financial Inclusion account for by numbers nearly 85% of the total NBFCs but have only 15% of the total Assets of the NBFC sector. Most of the SBFC are very small but there are a few large pan India Organizations such as Shriram Finance, Mahindra Finance, Bajaj Finance, etc.
- The remaining 10% NBFCs are MFI Sector, Gold Loan, etc. By Global Standards NBFC sector in India is rather small around 12% of GDP as against a global average of 52%.
- It is clear for the above that the SBFC sector which is critical to Financial Inclusion is rather small and only One Sixth of the NBFC-Corporate.

Shadow Banking & GDP growth

- In politics, at least in the Westminster system, a shadow minister refers to the MP in the opposition party with the same portfolio as the incumbent. This is the more accurate analogy to shadow banking, suggesting an alternative in waiting, rather than an activity which is in any way underhand, or "in the shadows".

- But one aspect of shadow banking is a discussion of its impact on economic growth, if enhanced oversight and/or regulation slows the growth of credit or causes credit creation to actually contract. Research suggests a contraction in shadow banking can have notable negative impacts on economic growth. A 2012 study by economists at the International Monetary Fund found that on average, GDP growth decreases by 0.4 percentage points for every 1 per cent decline in private credit.

SBFCs as a Part of Shadow/Formal Banking system/channel

- Advantages of NBFCs being a Part of Banking system in India:
  - Enhanced risk Taking Capabilities
  - Flexibility in Underwriting
  - Flexibility in Documentation, thereby reaching unbanked population
  - Customized product designing
  - Presence in niche segment, knowledge and ability to handhold the customer in the need of the hour

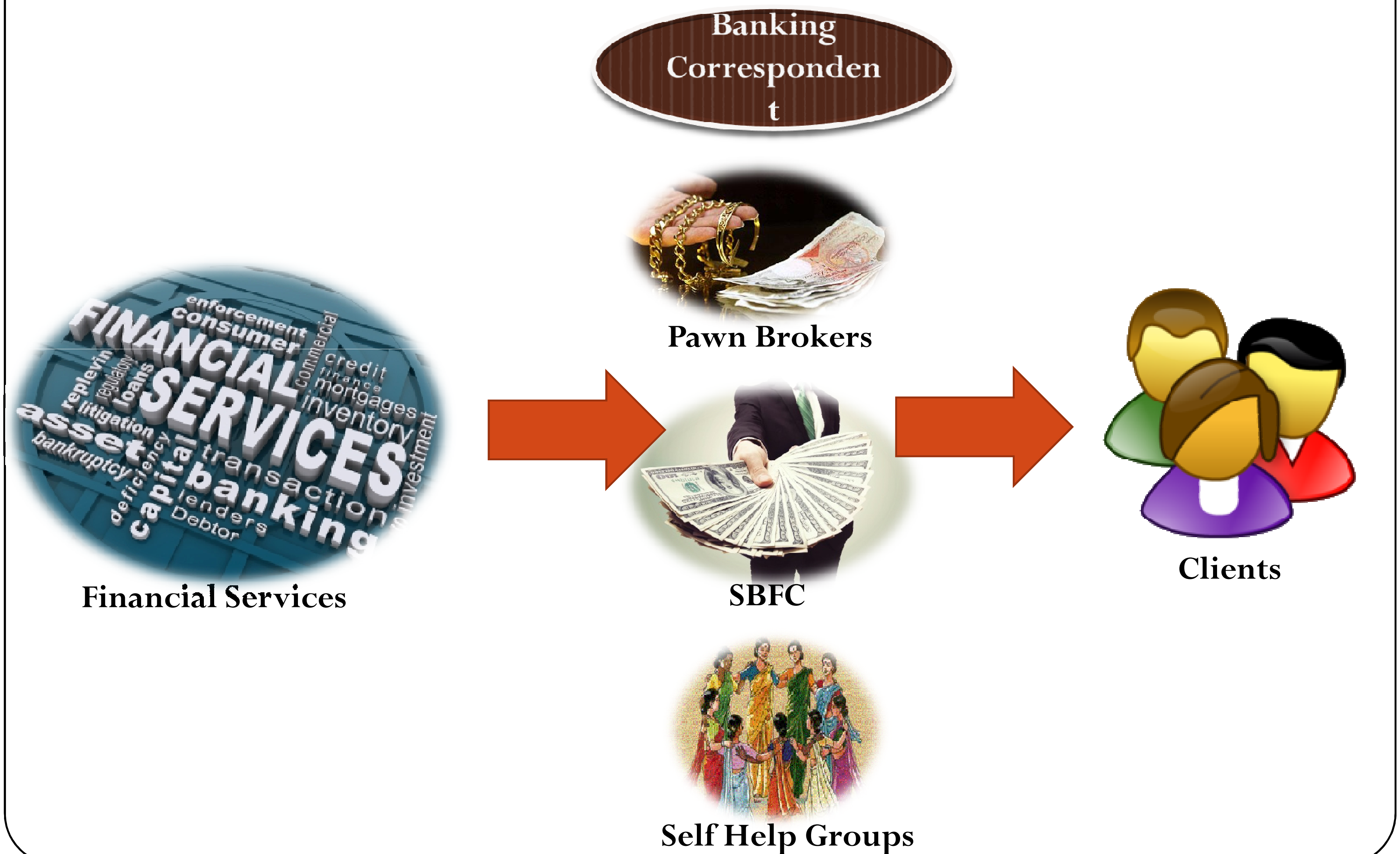
Limitations of Banks

- All over the world, Banks are under severe criticism for not serving their customers well, taking excessive high ticket risks and for high levels of employee compensation. In India, Policy makers and Regulators have relied on the Banks to promote Financial Inclusion of SMEs who do not have access to formal financial products, but the progress over the past several decades has been minimal in this sector. B C Model, mini-branches, etc. have not worked and are unlikely to succeed.
- The aspirations of their financially excluded low income families and SME owners have increased and they want to improve their economic situation by accessing credit and deposit products. These needs have been addressed largely by the SBFCs who are best suited to end the Financial Exclusion of these low income families and enable them to enter financial mainstream.
- SBFCs act in a complementary and supplementary manner to Banks in serving low income families and SMEs. They provide last mile delivery of financial products to the poor who are unlikely to be served by the Banking System for the following reasons:
- Banks are complex multi product organizations much more suited to serving large corporate sector and families in middle and upper class. They are not comfortable in serving low income families and SMEs who do not have adequate documentation like tax returns, audited accounts etc. SBFCs are simpler organizations focused on serving low income families and SME sector with deep domain expertise. They offer limited financial products and are able to manage risk very well.

Banks vs SBFCs

	Advantages	Disadvantages
Banks	Defined policies and procedures, economies of scale, bulk lending reduces recovery cost increasing NII	Very highly regulated, Strict KYC norms, strict documentation, RBI watch on product specifications, bank branches situated in far places, very low contact with rural customers
SBFCs	Flexibility in product designing, flexibility to choose customer, day to day personal contact with customer, personalized services to customers	Non availability of cheaper funds, high recovery costs, transition of customers to banks over a period

Channel for Financial Product Delivery



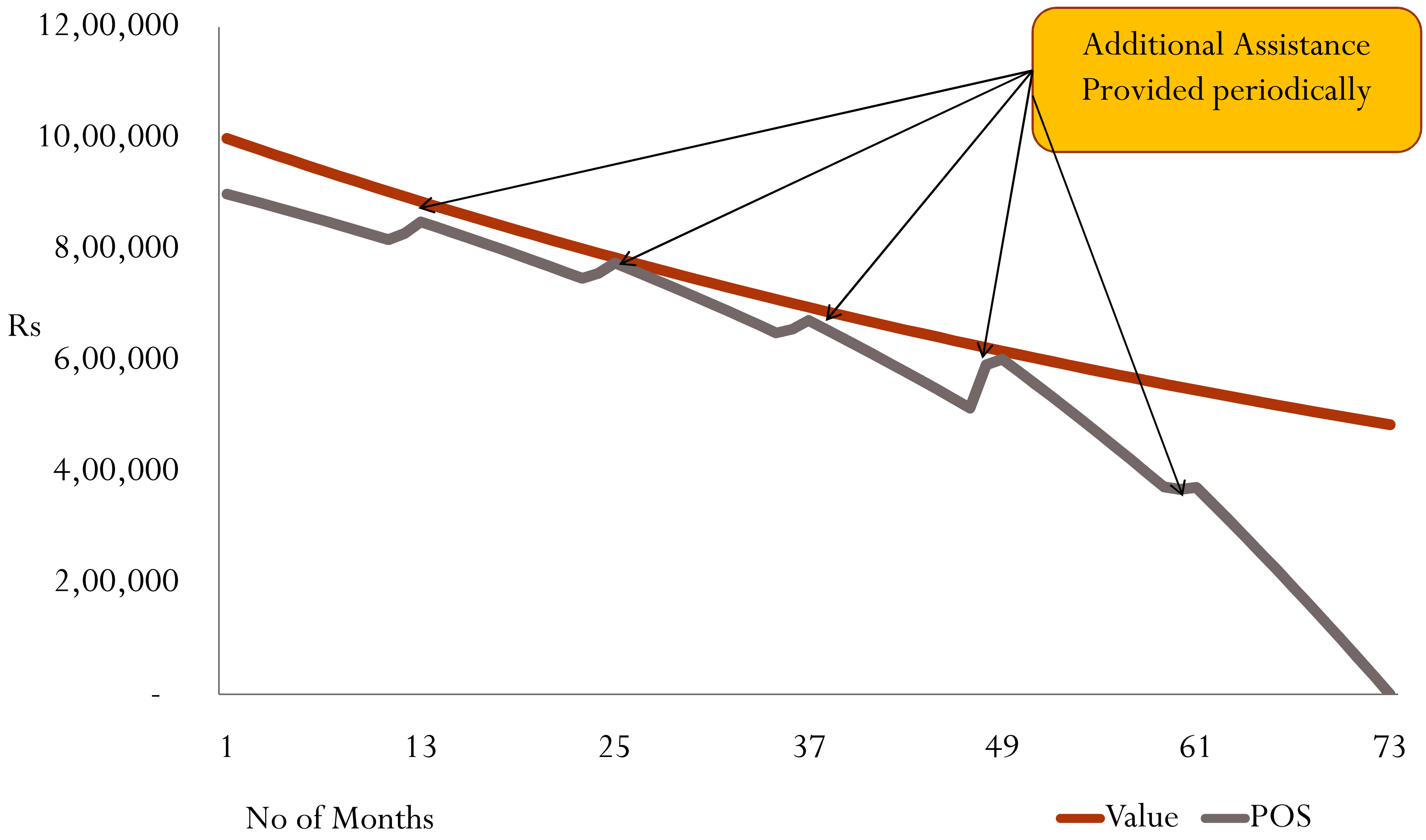
STFC Customer

Start → Owner Driver → Avails Finance from STFC → Proud owner of truck → Earns Livelihood, pays back loan → Upgrades/ adds to the fleet → Owner of multiple trucks → Expansion of business → Economic independence

STFC Products

Truck Finance, Tyre Loan, Engine Loan, Personal Loan, Accident Funding, Credit Card, Insurance Services

Partnering Truck Owners



Case study for a Vehicle valued at Rs 10 Lakh with 90% funding and 15% ROI

Road Transport Market Size in India

SEGMENT	EST NUMBERS	EST MKT VALUE (Rs Cr)
Passenger Vehicles	29,486,390	689,316
M&HCVs	5,267,424	316,045
LCVs	4,306,283	172,251
TRACTORS	6,394,943	127,899
Three Wheeler	1,843,379	11,060
Three Wheelers	443,033	2,658
Construction Equipment	927,629	92,337
Total Industry Size	48,669,081	1,411,568

Regulatory Policy Framework:

- Try to limit the growth of NBFC sector by reducing availability of resources available to it. The number of Deposit Taking NBFC's has come down from 1420 to 310 in the past decade and such NBFCs have only 0.06% of Bank Deposits though NBFC Sector extends around 15% of Bank Loans. Acceptance of deposits by NBFC's has also been gradually reduced over the years. Currently it is at a maximum of 4 times the Net Owned Funds.
- Recently the Thorat Committee has even proposed reducing deposit limit from 4 times Net Owned Funds to 2.5 times. This is in spite of RBI mandating adequate safeguards in case of deposits, including having a requirement that deposits should be fully covered by a charge on the NBFC's assets and regulating the overall borrowing powers of NBFCs.
- Make no distinction in Regulations governing SBFC's promoting Financial Inclusion and NBFC-Corporate which play no role in Financial Inclusion. Only NBFC's serving Infrastructure section within NBFC-Corporate have been given additional support such as ECB financing.
- Capital requirements for NBFC's have been progressively increased and are currently at 15%, out of which Tier I is at 7.5%. It is proposed by RBI to increase the Tier I capital requirements from 7.5% to 10%. This will further reduce the ability of SBFCs to provide credit.

Nachiket Mor Committee Recommendations

Committee supported NBFCs by following recommendations-

- Complete elimination of 15% SLR on deposits
- Duration to qualify for NPA : Risk-based approaches recommended
- Definition of sub-standard asset : Risk based approaches recommended
- Definition of doubtful assets : Risk based approach recommended
- Eligibility for SARFAESI recommended
- Clear policy recommended for "shelf prospectus" eligibility for debenture issues
- More flexibility in ECB norms for NBFCs
- Recommendation on enabling NBFCs to avail of Credit guarantee cover (CGTSME scheme) for lending to small units

Information Technology for Financial Inclusion

- Mobile Technology could be leveraged to provide banking platform in rural areas
- Low cost equipment may make banking office feasible in remote areas
- Continuous education on importance of banking and usage of technological platform is the way forward
- Use of local language in banking applications, stationary may help over period of time
- Leveraging technology used presently for prepaid mobile recharge may help for banking transactions too.
- UIDAI platform could be used to build on the base to open savings account of each person

Financial Inclusion- Social or Business Obligation

- Business Obligations-
  - Making profits for shareholders
  - Targeting High ROI

- Social Obligation-
  - Giving back to the society
  - Building sustainable solutions
  - Targeting long term inclusive growth

- Balancing:
  - Banking in rural areas is costly affair
  - Break even would take very long
  - Investment is very high
  - Recognizing the role played by NBFC and other financial entities
  - Balancing between social and business obligations will only give the way.

Thank You