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REIMAGINING OUR APPROACH TO **FINANCING MSMEs**

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CONTRIBUTOR
Ajit Raikar
Co-founder & Advisor
Validus Capital

INTRODUCTION

MSMEs are core to the economy

It is an accepted truth that MSMEs are the core and backbone for all economies in the World, representing 90% of the workforce and accounting for 40-60% of GDP of most countries. While definitions of MSMEs may differ, they are not a homogenous set, with needs of Micros being quite different from their Small and Medium sized brethren. However it is universally accepted that **MSME funding needs are not met fully** (more so for the Micro and Small segments), leading to them growing slower than their business potential, greatly due to lack of growth capital. It is estimated that the financing gap just in ASEAN is a staggering USD 420 Bn with USD 160 Bn in Indonesia and USD 17 Bn in Singapore alone.

Country	MSME Finance Gap (USD Bn)	% Financially constrained MSMEs
Indonesia	165.8	52%
Malaysia	21..4	38%
Thailand	40.7	55%
Vietnam	23.6	16%
Philippines	28.2	14%

Source: https://www.smefinanceforum.org/data-sites/msme-finance-gap

Why is there a funding gap?

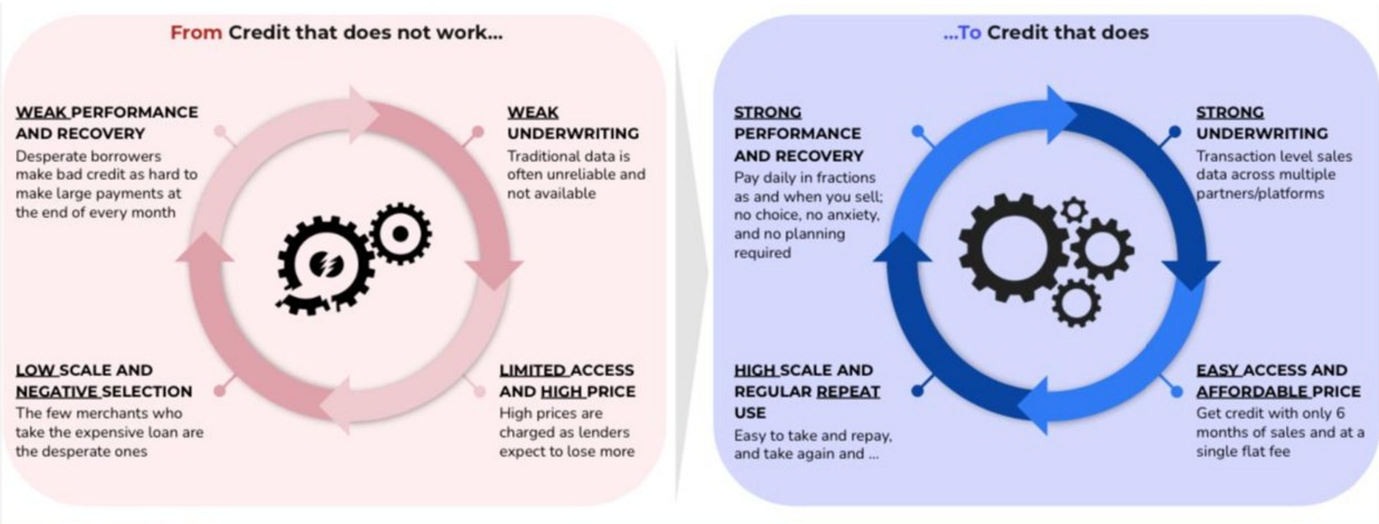
While there is adequate capital and liquidity sloshing around in the financial services industry and persistent calls from governments to support MSMEs, why does the funding gap exist? There is no silver bullet single answer to this important question but several such as:

- lack of hard collateral,
- inadequate risk / reward balance,
- often unreliable financials,
- high cost to serve,
- higher regulatory capital required for unsecured lending etc

... are some of the common reasons which lead to shortage of growth capital for the perceived higher risk MSMEs.

There isn't a single factor that drives this gap but many broken things, all of which need to be addressed to close this gap.

MSME credit is tricky not because one thing is broken; it is because many things are broken and they all need to be fixed at once



Digitization has helped increased SME digital footprint

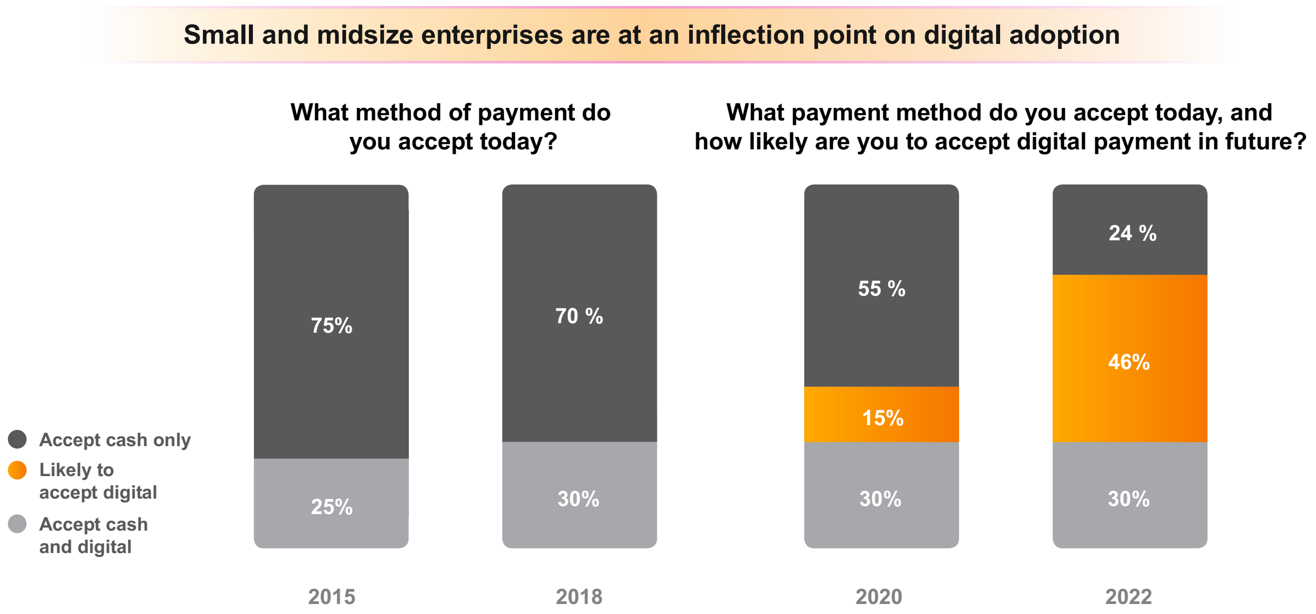
A positive development over the last 5 years, particularly after Covid, is the internal SME digitization efforts that have accelerated dramatically, with SMEs increasing their digital footprint through digital payment solutions, using E-commerce platforms, adopting accounting software and generating an alternate data footprint in multiple domains.

Increasing the digital footprint of SMEs has not only increased their digital discoverability but more importantly created digitally verifiable records of their business transactions. For e.g. a Gluten free cookie maker selling via her webstore and accepting digital payments now has all sales and payment receipts captured by credible intermediaries. Similarly a supplier of light use sustainable packaging material using an accounting and invoicing platform now has all of sales and payment records captured via software platforms.

There is a lot more alternate data / information available on SMEs now (e.g. Corp Pass / VAT records / Tax data / Telcom data) which can be accessed through APIs / public data which enable alternate lenders to lend to MSMEs . Also MSMEs are using a lot more digital services like account software (Xero etc) which allows banks and other lenders to get accurate data for analysis in a more digital footprint.

MSMEs are creating a richer set of data for digital lenders to use in their credit assessment as shown below:

Source: The Future of SEA's digital financial services report, Bain, Google and Temasek



Sources: Industry participant interviews; Bain Indonesia SME Merchant Survey (n=259)

But SMEs are still starved of growth capital

While digitization efforts have indeed increased it would be wrong to suggest that all MSMEs efforts particularly the micros and small segments have provided enough alternate data to financiers for increasing lending.

While P2P platforms and traditional lenders have benefitted from these developments leading to some increase in lending to SMEs (For example Funding Societies and Validus Capital, a Singapore based P2P platform has made big inroads into bridging the SME funding gap in Indonesia, Thailand and Singapore), the funding gap is still sadly huge. Many of these lenders have focused on digitization of processes making it easier for SMEs to borrow by sharing their documents digitally or verifying their identity (KYB) digitally.

But they have not generally speaking fundamentally designed a credit product that addresses specific needs of MSMEs for e.g. one based on cash flow transaction data alone or one where the repayment aligns with the fluctuating cash flow of a supplier of goods. As a result**, large part of the credit gap continues to exist.** While digital sales of SMEs have ballooned during the COVID period, digital credit has not kept pace.

The reason for this situation is the absence of any trusted public infrastructure/ platform that captures / aggregates this new digital data for financiers to assess.

So, is there a solution possible?

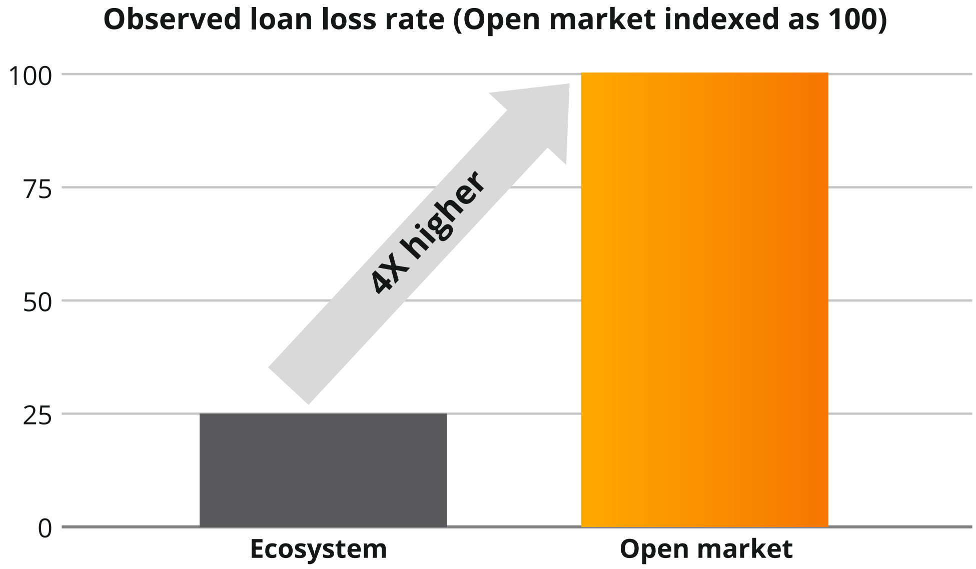
Given that most Micro and Small businesses are in the Services sector with little hard collateral, underwriting will need~~s~~ to be unsecured, based on cash / trade flows and possibly Bank statements, and not quite based on reported financials. A strong underwriting coupled with seamless and practical way of repayment will lead into pricing for the risk and as a result shift the balance of Risk and Reward for a lender.

A number of private and public enterprise led solutions have come into play that make~~s~~ it easier for lenders to evaluate MSMEs based on their transaction flow information. There have also been attempts made to create institutional infrastructure that helps build trust in the system of MSME credit and leads to a more favourable risk-return trade-off for lenders.

MSME credit enablement initiatives	Public sector role / example	Public sector role / example
Account aggregation - makes it easier for MSMEs to share their banking data	India has created an AA framework that allows financial information providers to share data with Financial Information User with auditable customer consent	Plaid has created a similar solution in US as a private player creating an trusted platform for secured banking information sharing
E-invoicing solution - Often a tax collection driven initiative that ends up creating effective digital record of MSME sales	Mexico has been a leader in this space with the introduction of CFDI in 2004. Other Latin American countries have followed and now Malaysia is also starting a similar platform.	A number of Fintechs have started their own e-invoicing and invoice financing platforms in UK e.g. Kriya, Bibby and Aldermore
Ecosystem transaction data sharing and embedded lending - Allowing / mandarin sharing of transaction data by digital ecosystems	No country or public enterprise has yet created an effective platform for consent based sharing of MSME transaction data from digital ecosystems (e.g. on demand / payment / online marketplaces)	A number of digital ecosystems have built up their own Fintech lending arm to serve their ecosystem MSMEs e.g. Square, Grab, Mercado Libre and Shopify
Credit guarantee / support schemes - Provides risk support for private lenders helping to improve risk - return trade off in the segment	MSME focused credit guarantee schemes have been set up across developing markets e.g. Indonesia, Malaysia, India. However their focus has often been limited to rural / agriculture / manufacturing MSME and less on services segments	Private providers of trade credit insurance (e.g. Allianz, Atradius, Coface) have played a similar role in enabling credit access. However these players also focus on larger and often cross border trade rather than small ticket MSME transactions

We are also seeing a new array of MSME focused Fintech lenders developing their business models anchoring primarily on sales / payment transaction data flows and flexible repayment arrangements. These are often called embedded and / or revenue based financing companies. Examples range from large ticket e-commerce credit providers like Clearco (US and Canada) to mid-sized Saas focused lenders like Recur (India) and small ticket B2C MSME focused players like Seedflex (SE Asia). An example of these new models is explained below:

Cash flow-based lending models can offer better risk return trade-offs in underserved segments



- Ecosystem offers an embedded cash flow-based lending solution on their platform.
- Open market loss rates were established by looking at an overlapping set of customers who had taken a loan from the ecosystem and had credit history with the credit bureau based on their “non ecosystem” borrowing experience
- This study was conducted in The Philippines

WHERE TO NEXT?

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In conclusion

- MSMEs are core to economic progress but they remain significantly underserved when it comes to credit access
- There is no one reason fits all when it comes to lack of credit access in MSME segment; consequently a number of interrelated factors need to fall in place for credit to flow and risk-return trade off to mostly work
- While COVID driven digitization has driven a step change in use of digital products, platforms and payments for MSMEs; credit has not yet followed the same pace
- Future of MSME credit will need to be shaped by a joint public & private enterprise
- Public policy making and infrastructure building is critical, and should focus on creation of trusted platforms for credit relevant data sharing and institutional trust creation
- Private enterprise should focus on developing new credit solutions based on dynamic sales / payment data coupled with flexible product design uniquely suited to MSME needs

I write and am passionate about innovations in SME Banking

The author is a 30-year practitioner in SME lending across multiple geographies and Financial Institutions including Citibank , DBS Bank, Bank Danamon and Validus Capital.

The views expressed here are his own and do not necessarily reflect the views of company or its staff.