

## **Swaminathan J: Local to global - the role of the financial sector in MSME's development**

Speech by Mr Swaminathan J, Deputy Governor of the Reserve Bank of India, at the Annual Day of the Foreign Exchange Dealers Association of India (FEDAI), Mumbai, 21 August 2024.

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Distinguished guests, ladies, and gentlemen. A very good evening to all of you.

It is a great honour to speak to this august gathering on FEDAI's Annual Day. Through its tireless efforts in clarifying the complexities of inter-bank foreign exchange business and serving as a crucial voice with regulators, FEDAI has played a pivotal role in shaping the rules of foreign exchange business in India. So, when Mr. Sindhvani, Chief Executive invited me to this event, I knew it was an opportunity I could not miss.

As we celebrate FEDAI's achievements, it is also an opportune moment to reflect on the broader vision for India's economic future. In 2022, as our nation commemorated 75 years of independence, the Hon'ble Prime Minister outlined five key resolves for the country, one of which was the ambitious goal of transforming India into a developed nation by 2047. Realising this vision will require a unified effort across all sectors, with Micro Small and Medium Enterprises (MSMEs) playing a pivotal role in driving economic output and boosting exports. MSMEs, often referred to as the backbone of our economy, hold immense potential to become national champions-potential that remains largely untapped. With this in mind, I have chosen the theme 'Local to Global: The Role of the Financial Sector in India's Development' for my address today.

### **The Role of MSMEs in India's Economic Growth**

With a vast network of approximately 63 million units, MSMEs contribute nearly one-third of the nation's GDP and account for around 40 per cent of its manufacturing output [1](#).

More importantly, it is the MSME sector's ability to foster entrepreneurship and create substantial employment opportunities –the key factors in realising India's demographic dividend. Additionally, as critical ancillary units, MSMEs support larger industries and significantly contribute to the secondary and tertiary sectors. With millions of jobs generated, the MSME sector stands as one of the most significant sources of employment in India, underscoring its importance in sustaining livelihoods and driving inclusive growth.

The MSME sector's impact extends beyond domestic boundaries. In the realm of international trade, these enterprises have proven their competitiveness, contributing more than 40 per cent to India's exports. This growing presence in global markets reflects the increasing acceptance and demand for Indian MSME products and services, positioning the sector as a key player in enhancing India's global economic footprint.

Despite these achievements, the sector faces significant challenges, notably the issue of the "missing middle". While micro-enterprises make up most of the MSME employment, they often struggle to transition into small or medium-sized firms. This limitation hampers their ability to achieve economies of scale, invest in fixed assets, and adopt innovative technologies. In my address today, I will focus on these challenges and explore how the financial sector can play a crucial role in addressing them, thereby supporting the growth and development of MSMEs into larger corporations.

## **Challenges Faced by MSMEs**

Let me discuss a few challenges that MSMEs face today. I am sure you are aware of most of them, so I will limit myself to briefly stating four key issues.

### **Access to finance**

The first issue is access to affordable finance. Credit is crucial for the growth of MSMEs, and affordable funds can boost their competitiveness. Banks often use asset-based lending, which relies on collateral rather than cash flow. However, many MSMEs lack adequate assets for collateralization, particularly for working capital needs, often leaving smaller businesses excluded from funding opportunities from the formal banking sector. Further, as many MSMEs mainly operate in the informal space, assessing their creditworthiness can be difficult due to information asymmetry, particularly with respect to the financial performance of their businesses. Although initiatives like GST and digital payments aim to facilitate digitisation among MSMEs, the adoption of formal digital documentation methods remains limited, which impedes an efficient credit underwriting process.

### **Delayed payments**

Secondly, MSMEs commonly encounter a persistent issue of delayed payments. The delay in receiving payments prolongs their operating cycles and diminishes their capacity to fulfil existing orders or secure new ones. Despite the existence of statutory provisions which entail penalties for delayed payments by buyers, MSMEs often refrain from invoking these provisions. Their reluctance stems from a combination of weak bargaining power and the fear of losing future business opportunities.

### **Infrastructure bottlenecks**

Thirdly, despite attempts to enhance infrastructure, MSME clusters, especially micro enterprises, lack vital support systems. This deficiency not only obstructs their day-to-day operations but also hinders their future growth potential. Developing MSME clusters can provide shared infrastructure, services, and access to larger markets, which can significantly enhance their growth potential.

### **Requirements of Compliance**

As businesses transition from an informal to a formal entity, they encounter significant rise in regulatory obligations and cost of compliance. Sometimes these requirements involve the interpretation of laws, knowledge of compliance procedures, etc. Instances of difficulties with financing entities are not uncommon as the MSMEs attempt to scale

up. The Government and Regulators have been taking various initiatives to reduce difficulties and ease the cost of doing business.

## **The Financial Sector's Role in Empowering MSMEs**

Having discussed some of the key challenges being faced by the MSME sector, taking advantage of the large audience that is present here from the financial sector, I would like to highlight some of the ways in which we can support its growth and development.

### **Digitisation and Innovative financing solutions**

With more MSMEs adopting digital payment systems, mobile banking, and online accounting tools, the resultant digital footprint allows financial institutions to gather more accurate and comprehensive data on an MSME's financial health, transaction history, and cash flow patterns.

We have seen significant traction towards end-to-end digitalisation of credit delivery in the past few years, largely in Retail and to some extent in MSME sector. I would urge bankers to explore these opportunities further for greater digitalisation of their transactions with MSMEs. Digital applications and platforms reduce the paperwork and administrative burden associated with traditional lending, and also brings in complete transparency. By using digital tools for application processing, verification, and disbursement, financial institutions can expedite approval times and significantly lower the costs of availing credit.

The data derived from the enlarged digital footprint would enable a better risk assessment and the development of customized financing products. Indeed, extending finance after a proper understanding of the cash flows of MSMEs, including factoring in the possible delayed payments from their buyers, will ensure a proper reading of the actual working capital cycle and ensure adequate financing. Inadequate understanding of the actual cash flows and its timings may result in the repayment schedules not keeping up with the reality.

On its part, the RBI has taken various initiatives to promote innovation in financing to MSMEs. Recently, the third cohort of the RBI Regulatory Sandbox<sup>2</sup> was dedicated for MSME lending, where five ideas were found viable. Earlier, to address the issue of delayed payments to MSMEs, RBI had initiated the Trade Receivables Discounting System (TReDS) in 2014. The scheme facilitates the financing of trade receivables of MSMEs from corporate and other buyers, including government departments and Public Sector undertakings (PSUs) through multiple financiers electronically. While there has been an uptick in transactions in the last couple of years, there is a long way to go in onboarding by more corporate buyers and MSME sellers on the platform to reap its full potential. RBI is engaging with the Government on this aspect, I would also urge bankers to leverage their corporate relationships to encourage larger corporates to get themselves onboarded on the TReDs platforms.

### **Capacity building and financial literacy**

Apart from access to finance and digital tools, enhancing financial literacy among MSMEs is equally important. Many small business owners lack the knowledge and skills to effectively manage their finances, which can hinder their growth.

While RBI has been facilitating capacity building on MSME finance for bankers under the NAMCABs<sup>3</sup> programme, I believe the financial sector can play a vital role in providing capacity-building programs tailored to the needs of MSMEs.

These programs could include training on financial management, understanding credit and forex products, and using digital tools effectively. By equipping MSMEs with the right knowledge and skills, we can help them make informed financial decisions, optimise their operations, and reduce the risk of default. Partnerships between financial institutions, government agencies, and industry bodies can ensure that these capacity-building initiatives reach the businesses that need them most.

As you may be aware, the Government of India has adopted the Cluster Development approach as a key strategy for enhancing the productivity and competitiveness as well as capacity building of Micro and Small Enterprises (MSEs). In this connection, RBI has advised convenors of all State Level Bankers' Committees (SLBC) to incorporate credit requirements of these identified clusters in their Annual Credit Plans. To further support this initiative, I would request banks to consider opening more MSE-focused branch offices preferably with forex facility, within these clusters. These specialised branches will not only facilitate easier access to credit for MSEs but will also serve as Counselling Centres, offering tailored financial advice and capacity-building services to these enterprises.

### **Boosting MSME Exports**

The financial sector can play a crucial role in boosting MSME exports by offering targeted support and tailored services that address the unique challenges these businesses face in the global market.

Beyond traditional products like pre- and post-shipment finance, factoring, and invoice discounting, the sector can significantly aid MSMEs in managing risks through export credit insurance and currency risk hedging solutions. These financial instruments not only protect against payment defaults and currency fluctuations but also provide MSMEs with the confidence to explore and expand into new international markets.

Current regulations mandate that forex needs, including cash and hedging products, must be met through authorised dealers, with scheduled commercial banks playing a dominant role. These banks, holding a privileged position, have a fiduciary duty to act fairly and transparently, particularly with smaller clients like MSMEs.

The introduction of the FX-Retail platform in 2019 aimed to enhance transparency and fairness in retail foreign exchange transactions has seen only a limited success. I would request banks to take proactive steps to increase awareness and facilitate higher customer participation on the FX-Retail platform.

### **Sensitivity towards the sector**

Finally, considering the key role that MSMEs play in the economy, the financial sector should adopt a more sensitive and empathetic approach towards them. While financial discipline is crucial, the unique challenges faced by MSMEs-such as low capital base, lack of scale, cash flow constraints from delayed payments, fluctuating market conditions, and external economic pressures-necessitate a more nuanced approach to assessment as well as follow up.

While timely repayment of dues is crucial to maintain the health of the financial system, financial institutions should focus on deploying supportive measures such as restructuring options, grace periods, and tailored repayment plans that give MSMEs the breathing space they need to recover and get back on track while encountering difficult situations.

Collaboration and dialogue between lenders and borrowers can help create solutions that protect both the financial interests of the lender and the viability of the MSMEs.

## Conclusion

In conclusion, the journey of India's economic transformation cannot be complete without the robust development of our MSME sector. MSMEs are not just the backbone of our economy-they are the engines of growth, innovation, and employment. However, for these enterprises to truly thrive and scale up, the financial sector must step up with innovative solutions, sensitivity, and a forward-looking approach. This is not just about providing credit; its about enabling these enterprises to compete globally, drive exports, and contribute to the nation's goal of becoming a developed economy by 2047. While financial instruments and support mechanisms are crucial, the way we engage with the MSME sector-our sensitivity to their challenges and our commitment to their success-will ultimately determine the strength and sustainability of this partnership.

With this I thank FEDAI for inviting me and wish it continued success in its role as a catalyst for the smooth functioning of foreign exchange markets through close coordination with stakeholders. Thank you all for your attention.

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<sup>1</sup> As per press release dated December 11, 2023 by the Ministry of Micro, Small and Medium Enterprises, the share of MSME Gross Value Added (GVA) in all India Gross Domestic Product (GDP) was 29.15 per cent for FY 2021-22 and the share of MSME manufacturing GVA in all India Manufacturing GVA was 40.83 per cent for the same period. The percentage share of Export of MSME related products in All India Exports was 43.59 per cent for FY 2022-23.

<sup>2</sup> The RBI has put in place an enabling framework for Regulatory Sandbox to facilitate live testing of new products or services in a controlled/test regulatory environment for which regulators may (or may not) permit certain regulatory relaxations for the limited purpose of the testing. There have been five cohorts under the framework since its issuance in August 2019.

<sup>3</sup> National Mission for Capacity Building of Bankers (NAMCABs)

