Budget 2024: Focus on MSME Credit and bridging the Funding Gap

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Budget 2024 showcases the vital role of MSMEs in India's economy, spearheading initiatives to address the sector's significant funding gap. Key measures include lowering the turnover threshold for the Trade Receivables electronic Discounting System (TReDS) from ₹ 500 crore to ₹ 250 crore, expanding access to collateral-free working capital, and introducing AI-led credit analytics for better financial inclusion. These steps are expected to improve cash flow, reduce reliance on costly financing, and foster a more inclusive financial ecosystem for MSMEs. The budget's focus on timely payments and innovative financing solutions will drive growth, innovation, and job creation in the MSME sector.

In the global economy, micro, small, and medium enterprises (MSMEs) play a significant role in job creation, innovation, and regional development. According to the United Nations, the MSME sector forms 50% of the global economy and generates 60 to 70% of employment. These enterprises drive local and national economies and sustain livelihoods, especially for the poor, women, youth, and vulnerable groups.

The 64 million-strong MSMEs are the front runners of the Indian economy, currently generating over 110 million jobs annually. With close to 23% of the workforce under its anvil, the MSME sector is the second-largest employment generator in India after agriculture. 30% of India's GDP, 38.4% of the total manufacturing output, and 45% of the country's total exports are led by this sector.

The July 2024 data of the Ministry of Micro, Small & Medium Enterprises shows a steady growth trajectory of MSME registration on the Udyam portal and the Udyam Assist Platform (UAP) hitting a 47.66 million mark. These include 46.82 million micro, 0.71 million small, and 0.067 million medium-sized enterprises, which are 98.4 %, 1.5%, and 0.1% respectively of the total registered entities. With a projected CAGR of 2.5%, the number of MSMEs will reach 75 million from 64 million soon.

Challenges and liquidity issues plaguing the MSME sector

Access to formal finance is a major challenge for most Indian MSMEs. According to a report, MSME credit penetration in India is only 14%, compared to 50% in the US and 37% in China. This shows a credit gap of ₹25 trillion in the Indian MSME sector. By the end of December 2023, the outstanding credit to MSMEs by scheduled commercial banks had grown by 20.9% annually, reaching ₹ 44.36 lakh crore. Additionally, MSMEs face delayed payments from buyers amounting to ₹10.7 lakh crore annually, further exacerbating their liquidity issues.

The lack of easily available and collateral-free credit sources intensifies these problems. Working capital shortages hinder daily operations and growth opportunities for MSMEs. High interest rates on loans make it difficult for MSMEs to repay and invest in their businesses, while complex loan application processes and a lack of technical expertise to explore alternative finance channels add to the challenge.

Banks often perceive MSMEs as risky investments, leading to insufficient and untimely funding. This results in a lack of capital to purchase necessary machinery, equipment, and raw materials, or even to cover basic living costs. MSMEs also struggle with market competition, scalability, and innovation. Regulatory issues, such as tax compliance and labour law changes, have further strained the sector, making it difficult for MSMEs to operate smoothly.

Insufficient conventional financing products

Banks and other lending institutions offer term loans and working capital loans to MSMEs. While working capital loans are for daily cash needs, term loans are for business expansion, capital expenditure, or for buying fixed assets. Each loan scheme has different interest rates based on factors like loan amount, repayment tenure, nature and tenure of business, creditworthiness, and repayment capability.

In April 2024, gross bank credit to MSMEs under priority sector lending norms grew by 18.1%, reaching ₹ 24.6 lakh crore, compared to ₹20.84 lakh crore in April 2023. Priority credit to MSMEs accounted for 14.9% of India's non-food credit during the month. Credit to micro and small enterprises grew by 18.6% to ₹19.64 lakh crore, while credit to medium-sized organizations increased by 16.5% to ₹4.98 lakh crore.

Delayed Payments as a major deterrent

Delayed payments from corporates are a significant issue for MSMEs already struggling with liquidity.

According to a report by the Global Alliance for Mass Entrepreneurship, delayed payments to MSMEs amount to approximately ₹10.27 lakh crore, which is estimated to be 7.8% of India's GDP. Typically, the payment cycle of MSMEs hovers around 90 to 120 days. This seemingly large window has the propensity to create a mismatch between the cash inflows and outflows of an entity. Therefore, the working capital requirements take a hit. Often MSMEs face cash flow disruption, making it difficult for them to meet operational expenses, pay salaries to employees, and invest in growth. Many of them resort to expensive alternative financing options to bridge the gap, leading to increased interest costs and debt burdens.

Limited working capital due to delayed payments restricts the ability of MSMEs to expand operations, invest in new technology, or explore new markets. This hampers growth potential and stifles job creation. Around ₹10.7 lakh crore is locked up in delayed payments from buyers to MSME suppliers, with 80% owed to micro and small enterprises, totalling ₹8.55 lakh crore.

Innovative supply chain financing products

Traditional bank loans are often hard for MSMEs to secure due to outdated financial records, a weak Balance Sheet and a lack of collateral. However, supply chain financing (SCF) offers a cost-effective, collateral-free alternative. SCF helps MSMEs improve cash flow, expand operations, and seize opportunities without long-term loan agreements.

For years, SCF couldn't cover the long tail of the supply chain ecosystem due to paper-based processes. But with increased collaboration between banks and fintech, the availability of rich business data with GST Authorities and the advent of technologies such as blockchain, SCF products are becoming more accessible. This allows for quick and easy access to SCF products, which can meet most of the working capital requirements for large/medium and small enterprises.

A financial lifeline called TReDS

The Trade Receivables electronic Discounting System (TReDS) platform is fast growing as a crucial supply chain financing mechanism in an era of banking and fintech collaboration. This platform simplifies the financing process for MSMEs by making transactions-based financing smooth and quick. TReDS provides unsecured financing, which remains an off-Balance Sheet liability in the hands of the MSME. As soon as an MSME supplier submits unpaid bills on the TReDS platform, these invoices are then verified and approved by the corporate buyers. Once approved, the invoices are auctioned to by the registered financiers on the platform. Financiers bid on approved bills, and MSME sellers choose the best-interest bid. The financier then transfers the funds directly to the seller's bank account. On the due date, the corporate buyer pays the invoice amount to the financier.

By lowering the annual turnover threshold for buyers from ₹500 crore to ₹250 crore, the government is enabling TReDS to expand significantly.

This digital process enhances transparency, efficiency, and security for all parties, offering instant liquidity, and significantly improving cash flow for MSMEs. So far, TReDS has enabled transactions worth over ₹3 lakh crore and facilitated 1 crore invoices by onboarding over 90,000 MSMEs. Interest rates on TReDS range between 7% and 11% per annum, compared to 16% to 24% per annum outside on an unsecured line of credit. This minimizes paperwork, ensures timely payments, and reduces risk for MSMEs by promptly crediting their accounts 24 hours after accepting an offer.

Impact

Earlier this year, a new regulation mandating companies to settle dues with Micro, Small, and Medium Enterprises (MSMEs) within 45 days had somehow impacted the MSME sector. This regulation, introduced as a new clause (h) to Section 43B of the Income Tax Act, in the Finance Act 2023, stipulates that any payments owed to MSMEs not resolved within the 45-day window will be disqualified for tax deductions until the payment is made. This provision aims to motivate larger entities to prioritize their settlements with MSME counterparts, thereby fostering a more robust economic environment for these smaller businesses. While these amendments aim to instil financial discipline and safeguard MSMEs against delayed payment their impact is felt by both the MSMEs and their corporate counterparts. This regulatory shift highlights the importance of timely payments, placing added pressure on businesses to manage their cash flow effectively. For MSMEs already struggling with liquidity challenges, delayed payments from corporates can exacerbate their financial strain. Conversely, corporates face the challenge of balancing their payment obligations with maintaining liquidity reserves, especially in the wake of economic uncertainties. It is important to realise the far-reaching implications of these regulatory changes across various sectors is crucial.

By enforcing timely payments, the regulation ensures a healthier cash flow for MSMEs, mitigating the common issue of delayed payments that often hamper their operations and growth. This legislative change is expected to create a ripple effect across the supply chain, encouraging a culture of prompt payments and financial discipline among larger corporations. Here, TReDS can become the simplest, well-meaning and straightforward solution for the Buyers to make timely payments to MSME suppliers at the TReDS platform and avoid disallowance under the IT Act. Since TReDS provides MSMEs with quick access to working capital at a very reasonable cost, the MSMEs can offer a much better price to the Buyer in the next contract. Also, the implementation of TReDS can create a healthier and more robust supply chain ecosystem, resulting in better product quality, shorter lead times, and enhanced overall supply chain efficiency.

In the recent amendment notified by the Ministry of Corporate Affairs (MCA) to MSME Form-1 reporting requirements, the Govt. has made its intentions clear that all buyer companies should make timely payments to MSMEs and for any delay in payment they are

answerable. TReDS is recognised as an important mode of payment to MSME suppliers and related reporting is specifically asked for in the recently amended MSME Form-1.

The focus on TReDS in this Budget 2024 further amplifies the positive impact on MSMEs. By lowering the annual turnover threshold for buyers from ₹500 crore to ₹250 crore, the government is enabling TReDS to expand significantly. This change is projected to bring 22 Central Public Sector Enterprises (CPSEs) and 7,000 additional companies onto the platform, thereby enhancing MSMEs' ability to convert trade receivables into cash more efficiently. Consequently, Banks and Non-Banking Financial Companies (NBFCs) will be attracted to TReDS, offering MSMEs collateral-free working capital at competitive rates.

The inclusion of tier 2 and 3 MSMEs in the financial ecosystem through an AI-led credit analytics engine for better credit assessment will further broaden their access to necessary funds. Further, the inclusion of Trade Credit Insurance for TReDS transactions will significantly improve the confidence of banks and NBFCs in underwriting the invoices of low-rated/ un-rated buyers of MSME suppliers. This initiative highlights the government's commitment to integrating a wider array of MSMEs into the mainstream financial system, promoting inclusivity and growth.

Conclusion

The Union Budget 2024 brings a renewed focus on supporting MSMEs, recognizing their indispensable role in driving job creation, innovation, and regional development. With 64 million MSMEs contributing significantly to India's GDP, employment, and exports, addressing the sector's challenges is crucial for sustained economic growth. The budget highlights key initiatives such as lowering the turnover threshold for TReDS from ₹500 crore to ₹250 crore, aiming to onboard more companies and Central Public Sector Enterprises, thereby enhancing the accessibility of collateral-free working capital for MSMEs. Furthermore, the introduction of AI-led credit analytics for better credit assessment will broaden financial access, integrating more tier 2 and 3 MSMEs into the mainstream financial system.

MSMEs must leverage the enhanced opportunities provided by the TReDS platform and innovative supply chain financing solutions to secure the necessary capital for growth and expansion. To ensure timely payments to support the working capital requirements of MSMEs, the other stakeholders, including banks, NBFCs, and larger corporations must also be active participants in the TReDS ecosystem. By working together, we can close the funding gap, foster financial inclusivity, and unlock the full potential of India's MSME sector, driving robust economic growth and development.

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