

# AFRICA SME FINANCE FORUM NAIROBI

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## PROCEEDINGS

### Digitization in Trade Finance: India's Experience

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#### Executive Summary

India has achieved significant success in the digitization of business transactions. Despite people's tendency to pay with cash, the national government changed its policies and withdrew some Rupee banknotes from circulation in late 2016. This provided a significant impetus to the development of digitization. Thanks to strong government support and smart policies, widespread digital transactions have become possible across India, and both merchants and consumers have reaped benefits from this process. However, bank charges for digital payments remain a major deterrent to increased usage. These charges range between 1-2 percent, as compared to SME profit margins of 3-4 percent. As experience from India shows, the establishment of a regulatory mechanism and the involvement of the non-banking financial sector are both necessary for the development of the digitization of business transactions.

#### SMEs in India

- SMEs constitute one of the most important sectors of India's economy. With 60 million enterprises in 2016, SMEs accounted for approximately 30 percent of the country's gross domestic product (GDP), employing 400 million people. Yet only 7 percent of SME financial needs were met by the formal banking sector. (The remainder of SME financial needs were met by informal means, including family members and friends). This means that 93 percent of SMEs lack financial and digital inclusion in India's overall economy.
- Previously, most business transactions in India were conducted in cash, accounting for 95 percent of total transactions. Merchants and consumers alike did not want to shoulder the

additional costs associated with digital payments and preferred to use cash instead. The merchants also had to pay for the device to process digital payments, which did not make much financial sense given the low volumes of digital transactions.

## **Impact of Government Policy Changes in India**

- Policy changes by the Indian government have had an enormous impact on the development of mobile transactions. For example, in November 2016, seeking to eradicate black money and corruption, Indian Prime Minister Modi announced that 500 and 1,000-Rupee (US\$7 and US\$14 respectively) banknotes would be withdrawn from the financial system virtually overnight. This represented 86 percent of the country's currency. Due to the sudden unavailability of large amounts of cash, the announcement prompted about 40+ percent of SMEs across the country to adopt digital transactions. Consumers also began to favor digital transactions because of the shortage of physical money.
- The Indian government developed several policies to promote digital transactions. The government encouraged each citizen to open/own a bank account and a national biometric identification (ID) called Aadhaar. The government then leveraged the mobile ecosystem, particularly because India already had 1.3 billion mobile phone holders and about 350 to 400 million smart phone users, which will reach 700 million by 2022. Indeed, the use of mobile phones has made it possible for small traders to become digitally conscious.
- Strong government support for the use of digital transactions makes India unique. For example, India's government was able to cover the cost of certain fees associated with digital payments for small merchants for a period of three years, a situation rarely found in other markets. This helped to make digital transactions for even very small amounts possible.
- India made two extraordinary efforts with regard to the development of digital transactions. India is the first country in the world where the Quick Response (QR) Code is interoperable. In particular, BharatQR, which was developed by the National Payments Corporation of India, Mastercard, and Visa. It is an integrated payment system that only requires a single QR code to access all payments. Indian users will receive more value from digital transactions for their businesses with the introduction of Goods and Services Tax (GST). There will be incentives in the form of cashback for payments digitally.
- In this context, one of the major reasons why the Indian government decided to enable the discounting of digital transactions is to enlarge the country's tax base.

## **Potential and Challenges**

- With the available platform for digital transactions, there is potential to create infrastructure to enable the widespread use of digital transactions. However, the cost of the device to process digital payments needs to be lowered. The government should work toward making all payments interconnected, which in turn will facilitate the e-Know Your Customer (KYC) requirement in a quick manner using Aadhaar. Last, there must be a policy in place to make receivables and payables far more transparent.
- Women can also be increasingly brought into the system, particularly those 33 percent of Indian women who are self-employed, small merchants. In this context, it should also be noted that 75 percent of all purchasing decisions are made by women in India. Thus, women should be targeted in the development of the digitization of the payment system and trade finance.

- As SMEs go digital, it will be increasingly easier to make more data available to the financial sector.
- Bank charges on digital payments are a major deterrent in the use of digital transactions in India. Neither merchants nor consumers are willing to pay bank charges. Bank charges range between 1 and 2 percent, as compared to SME profit margins of 3-4 percent. Therefore, if bank charges remain in place, digital adoption will slow. However, the national government could institute a subsidy and pay bank charges directly to the banks. Thus, there would not be any levy of bank charges on either the merchant or the consumer.

### **Policy Recommendations for Africa**

- Establishing a regulatory mechanism, such as a digital payment board, is the first step. Furthermore, for developing countries with low literacy rates, it is necessary to launch a mass awareness campaign about digital payments. The less developed cities should be especially targeted. Also, incentives should be provided by the government for each usage of digital payments, especially for the initial four or five years. In addition, bank charges should be kept at a low rate. Later, as transactions grow, the discount rates should continue to decrease.
- Cyber security systems are essential to protect the transaction ecosystem. More importantly, policy makers should focus on creating a SME lending ecosystem to promote digital payments, and allow for the monitoring of different categories of loans.
- Digitization itself can help pay for the process. If even 10 percent of the systems can be digitized, it would mean a 27 percent increase in value. That 27 percent is more than enough to pay for all the systems, as in the case of Hong Kong SAR, China and Singapore.
- The digitization process cannot proceed further without involving the non-bank financial sector. In acting as actual lenders to SMEs, non-bank financial companies and microfinance institutions should also be allowed to become an integral part of the digital payment system.