From aggression to caution: The new playbook in unsecured MSME lending

We hosted an expert session with a DSA/channel partner to understand on-ground dynamics in the unsecured MSME and micro-LAP segments, with a focus on demand patterns, asset quality, and steps being taken by the lenders to shield themselves in the (small-ticket) unsecured MSME segment. The DSA expert we hosted is a seasoned professional with over 17 years of experience in the banking and NBFC space, having previously held roles at ICICI Bank and Bajaj Finance. The session offered valuable perspectives on current demand trends, emerging stress in unsecured MSME loans, and whether the deterioration in asset quality signals a temporary phase or the onset of a broader credit cycle. It also covered shifts in lender strategies and discussions around which players are scaling back exposure to small-ticket unsecured loans and which ones still continue to remain active in this segment.

Unsecured MSME lending: Tightened norms amid rising stress

- The unsecured MSME segment has experienced significant pressure over the last one year, especially in small-ticket unsecured business loans and overdrafts. While some companies initially stopped offering unsecured overdrafts after RBI guidelines and revisions, major players like Bajaj Finance have restarted, though with a very cautious and restricted approach. The availability of unsecured funding has become much more difficult for small manufacturers, traders, and service providers.
- In response to elevated stress, lenders across the board have tightened credit criteria. Many lenders have pulled back from unsecured lending altogether or restricted it to only salaried or high-banking-profile customers.
- The stricter lending norms are being driven by multiple factors: 1) a weaker macro environment, with payment cycles stretching from 30-35 days to 60-90 days, causing cash flow issues; 2) a demand-supply mismatch, wherein demand for unsecured small-ticket credit in the market is not keeping up with supply; 3) rising bounce rates due to liquidity stress impacting EMI payments; and 4) borrower overleveraging, as many MSMEs have taken multiple unsecured loans from various lenders and fintechs, sometimes even doubling their number of loans outstanding.
- High interest rates on unsecured loans, coupled with the mismanagement of funds and investment of funds into real estate and stock markets that subsequently got blocked, could have also contributed to defaults and delinquencies. Even small retailers and traders have faced overexposure from fintech lenders, leading to a bounce in EMIs.

Divergence in lender strategies: Shift to secured; a few others making selective re-entry in unsecured

- Bajaj Finance has significantly reduced its aggressive funding, becoming very cautious about funding customers with check bounces or EMI issues. Their teams, which previously focused on small ticket unsecured loans, have been transferred to secured lending products like affordable secured business loans (INR2.5m-5m ticket size) and LAP Prime.
- Players such as UGRO Capital are also becoming cautious about unsecured lending and are prioritizing asset-backed loans like machinery finance, equipment finance, and solar loans. Conversely, some lenders are either becoming aggressive or re-entering the segment. IDFC First Bank has reduced interest rates for high-ticket-size customers (INR4m and above) and has restarted its small-ticket business loan program (INR100-900k segment) after closing it a year prior. Poonawalla Finance is also targeting customers with a loan ticket size of >INR4m and above by offering reduced interest rates. Piramal Finance has restarted small-ticket business loans. Tata Capital continues to offer micro business loans (INR300K-1m) without turnover criteria. Aditya Birla Finance also offers small ticket loans (INR500K-1m), but primarily through a scorecard-based system.
- **Overall, there is a noticeable trend of banks and NBFCs shifting their focus towards higher ticket size customers (loan ticket size above INR2.5m).**

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From favorites to fragile: Lenders redraw internal guardrails in the unsecured MSME segment

- The health of MSMEs is a significant concern, largely due to a liquidity crunch. While on the surface the economy appears to be growing, there is considerable liquidity stress at the MSME and retail level. The primary reason for stress is that MSMEs' working capital cycles have stretched, leading to delays in making EMI repayments. Despite the delays, the intent of these MSMEs to repay is generally good; they are not legal defaulters but are unable to pay on time. Many MSMEs took on significant debt based on anticipated demand that did not materialize, leading to overexposure.
- As traditional funding has become difficult for MSMEs, some are even gravitating towards FinTech apps that offer unsecured business loans. These loans come at a significantly higher interest rate (around 30-32% reducing balance). Borrowers availing these loans typically adopt a short-term survival mindset, expecting to repay through alternative means such as liquidating property or stock investments, rather than through steady business cash flows.
- Lenders have become highly selective about industry exposure. Segments like restaurants and hotels, scrap and metal trading/manufacturing, and jewelry are now classified in the cautious or negative category. Notably, the IT services sector, which was previously viewed as a *'green field,'* has also moved into the cautious zone. The Doctor segment, which was once favored for unsecured professional loans due to perceived income stability, has witnessed a sharp rise in delinquencies. Consequently, many lenders have reclassified both doctors and hospitals under the cautious category, reflecting a broader reassessment of unsecured risk.
- Loan application rejection rates have surged, with approval rates for loans dropping from 40-50% to 30-35%. The main reasons for rejections are ECS (Electronic Clearing Service) returns, cheque returns, and CIBIL (credit score) issues, such as overdues in credit card or bank accounts. The minimum CIBIL score requirement has risen to 700+ for most lenders, whereas previously scores around 650-680 were acceptable. One-time settlements are occurring, typically ranging from 20% to 25% of the outstanding amount.

DSA incentives rise, but tighter norms to rein in risk

- The commission structure for DSAs in the unsecured segment has generally increased from an average of 2.5-2.75% to 3.25-3.5%, and even higher for a corporate DSA, who sources significantly higher volumes.
- Lenders like ICICI Bank and Cholamandalam have introduced clawback clauses and penalties for DSAs if loans sourced by them face delinquencies within a specified period (e.g., within 6 or 12 months). They are also trying to prevent "multi-funding," where customers take loans from multiple lenders simultaneously.
- Lenders have also tightened their underwriting norms, with DSCR (Debt Service Coverage Ratio) norms now revised to 1.0 and above. The focus of banks and NBFCs is increasingly on the manufacturing segment, as they perceive these businesses to be more secure despite potential high bounce rates.

LAP and CGTSME-backed loans gain traction, but risks linger

- There is a strong growth in the LAP segment, partly because customers are consolidating unsecured loans into LAP to reduce their EMI burden due to longer tenors (7-15 years). This also provides customers with more time to repay, given their current longer working capital cycles.
- While consolidating unsecured loans into secured LAP reduces immediate EMI burden, there is a risk of increased delinquencies in the secured segment if economic conditions do not improve, especially for loans against investment properties compared to self-occupied residential (SoRP)/commercial properties (SoCP).
- The Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) segment is also growing, where the risk is divided with government funding. These loans are typically offered to MSMEs with at least two years of business vintage and audited financials, mostly by banks and select NBFCs such as Aditya Birla Capital.

Competitive dynamics in the NBFC space

- Several large players, such as Bajaj Finance, ICICI Bank, Axis Bank, and ABCL, have reduced exposure to unsecured business loans and are increasingly focusing on secured MSME segments.
- Jio Credit has recently entered the market with aggressive offerings in loans against security, home loans, and mortgages, aiming to build a significant presence. While it's early to gauge portfolio quality, the group's intent to build a diversified lending book is clear.

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