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ACCESS TO FINANCE FOR SUSTAINABLE CONSUMPTION AND PRODUCTION PRACTICES BY SMALL AND MEDIUM-SIZED ENTERPRISES IN INDIA

This briefing summarises main findings of a desk analysis, literature review and interviews conducted on the topic of access to finance for **Sustainable Consumption and Production** (SCP) practices by SMEs in India. The analysis was conducted as part of work in support of the EU SWITCH-Asia programme, by the SWITCH-Asia SCP Facility.

SCP IN THE INDIAN SME SECTOR

Mainstreaming SCP is urgently needed in India. The harmful effects of unshackled economic growth in form of pollution and adverse impacts on health and prosperity are already visible today. Especially in India's industrial and urban regions, air and water pollution levels are high, and directly affect the health and life prospects of hundreds of millions of people. India's formal collection and recycling rate is relatively low across waste sectors compared to global averages, leading to environmental problems. India's energy demand is rising in tandem with increased prosperity, while posing new challenges both in terms of infrastructure and emissions. According to IQAir, in 2020, 22 of the most polluted cities worldwide were located in India.[1]

In order to protect and continue the developmental progress made in India in past decades, pollution and resource efficiency need to be **tackled in a holistic manner, including along value chains**. Indian **small and medium-sized enterprises** (SMEs) are responsible for 70% of industrial pollution in India; dense SME clusters are particular sources of environmental contamination. Yet, some **companies already engage in sustainable production practices**, typically focusing on energy efficiency, waste management and cleantech (renewable energy, green buildings, management of (waste) water).

This emerging SCP action is largely due to **cost and external pressures**. The latter comes from both international buyers and investors, as well as existing and anticipated legislation.

SMEs engaged in (international) supply chains are increasingly **required to measure and manage their environmental, climate and social performance** as buyer countries/regions such as France, Germany, the UK and the EU tighten regulation on corporate supply chain management.

Under the current government, the **importance of environmental issues** was reiterated. At the same time, to ease economic recovery from the pandemic downturn, environmental regulations have been reduced, including on environment and wildlife protections for industrial projects.[2] Yet a longer-term legislative shift towards sustainability seems required, not least to meet the conditions set forth in the Paris Agreement. For example, the Securities and Exchange Board of India (SEBI) has updated its Business Responsibility and Sustainability Report (BRSR) framework, now requiring the 1000 largest Indian companies to report granular sustainability and corporate governance data from 2022 onwards.

1 https://www.iqair.com/th-en/world-most-polluted-cities
2 https://www.conservation.org/projects/global-conservation-rollbacks-tracker

Such drivers are **propelling the Indian industry and financial sector towards sustainability**. SMEs, as important economic actors and considerable polluters, will have to participate in this transformation and provide relevant data. They also need to anticipate closer scrutiny by the public as well as regulations by national and state legislators.

This trend is likely to continue: measurable sustainability impact is also of growing importance in light of more ambitious **climate and environmental goals** (as announced by several countries during US President Joe Biden's climate summit in April 2021) and growing **investor interest** for sustainable investment opportunities, e.g. via green bonds and investment funds. To address both, the EU, ASEAN and other regions are currently developing classification systems for sustainable economic activities ("taxonomy"; typically including SCP-related activities, e.g. related to the circular economy and pollution control) which will eventually affect investment decisions in all parts of the world.

Access to investment and working capital is crucial to support SMEs in professionalising and expanding their SCP practices and services. The following presents an overview of **financing opportunities** for SMEs and their SCP-related activities and summarises **recommendations to Development Finance Institutions** for increasing (access to) relevant funding.

FINANCING OPTIONS

SMEs can tap into several types of financing for their investments into SCP practices:

- **General:** Financing that does not have a specific (environmental or social) purpose beyond promoting the SME sector. The amount of general SME finance is growing and SMEs can try using it for their green projects. However, such funding typically considers only profit-driven aspects which might be less prominent (at least in the short-term) in SCP investments. Moreover, many SMEs **cannot access such funding, even for their non-green projects**. Primary reasons for this are high collateral requirement of banks and the lack of formal registration of many SMEs (Sanyal & Eisinger 2016). Many Indian enterprises thus **self-finance** their (SCP) investments (ACMFN 2020).

  Micro-finance seeks to fill parts of these gaps:

  There are numerous non SCP-specific funding programmes available, like for example "A Scheme for Promotion of Innovation, Rural Industry & Entrepreneurship (ASPIRE)", the Credit Linked Capital Subsidy Scheme (CLCSS) for technology upgradation, and the Scheme of Fund for Regeneration of Traditional Industries (SFURTI). The focus of these types of programmes is to improve productivity and strengthen the industrial sector in India.

- **SCP-specific:** Financing that is specifically earmarked for SCP-purposes, taking into account particular characteristics and financing needs of the implementing companies and their SCP measures. In India, such financing options are limited. A key concern is that most financial institutions prefer financing established technologies and lack knowledge of SCP-related innovations.

Thus, there are limited general and SCP-specific financing options for Indian SMEs and **funding is low compared to actual demand** (Development Alternatives 2020). Priority sector lending targets, issued by the Reserve Bank of India to foster economic development (e.g. through micro enterprises and SMEs, social infrastructure and renewable energy) do not reflect in actual lending behaviour (Tandon 2020).

However, some financing options exist and they can be grouped into five categories:

Government schemes: A range of SCP schemes are directly accessible to SMEs.

- The Common Effluent Treatment Plants (CETP) Scheme offers up to 50% subsidy for in-vestments in CETPs.

- The Waste Minimization & Clean Technology Program supports SMEs in adopting cleaner production practices.
- The Atal New India Challenge offers grants for innovators across a range of different "challenges", many of which are related to cleaner production.
- A cluster development approach drives the Ministry of MSME's "Infrastructure Development Programme", enhancing productivity and competitiveness as well as capacity building of MSME clusters, including for SCP-relevant topics like wastewater treatment and storage.

Funding for **capacity building** is also available, e.g. via the Technology and Quality Upgradation programme or the National Institute for Micro, Small and Medium Enterprises.

Beyond direct funding opportunities, public schemes are also in place that **foster SME finance through other finance providers**, for example:

- The Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) provides guarantees to a large number of lending institutions which then can provide collateral-free loans of up to INR 2 Crore to SMEs.
- The Pradhan Mantri MUDRA Yojana (PMMY) Scheme is very similar to CGTMSE but allows only for providing smaller loans of up to INR 10 Lakh.
- The Bureau of India's Partial Risk Guarantee Fund for Energy Efficiency (PRGFEE) provides guarantees to financial institutions which extend loans to ESCOs for implementing energy efficiency projects.

  In addition to these schemes, the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) play an important role in the financing ecosystem for SMEs and larger companies; set up at state level, they are mainly active in industrially developed states.

Banks: The Indian banking sector[3] is the main financier of companies in India, with bank borrowings making up more than 50% of formal corporate debt in the last 20 years (Tandon et al. 2021). Conventional (micro) loans (without specific environmental or social objectives) are the most important sources of external formal funding for SMEs. A limited variety of green loans is also available – yet, mostly for large sustainable energy projects (Sanyal & Eisinger 2016), including solar rooftop financing, as implemented by Kreditanstalt für Wiederaufbau (KfW), a German development bank together with Bank of Baroda, one of the largest public banks in India, as well as several credit lines by Asia Development Bank (ADB). A small number of banks offer energy efficiency loans, including the Small Industries Development Bank (SIDBI). SIDBI is the apex bank for SME finance in India and offers standalone programmes for direct financing as well as those in cooperation with development financiers such as KfW, AFD, JICA or World Bank, Canara Bank and five banks participating in the PRGFEE Scheme. SIDBI also channels dedicated MSME funding to other banks and Non-Bank Financial Institutions (NBFIs). According to recent research by the Asian Cleantech MSME Financing Network, **no bank currently has loans for cleaner production** measures (ACMFN 2020).

Microfinance Institutions (MFIs): MFIs play an important role especially for households and micro-entrepreneurs. Microfinance is predominantly provided through Credit Unions, Commercial Banks and NGOs. MFIs are set up to cater directly to the needs of small enterprises, by being easily approachable, not in requirement of typical loan security, and offering individual support. Their resulting high transaction costs are passed onto clients by generally high interest rates. India has promoted Small Finance Banks (SFB) which have a mandate to ensure that at least half of their loans should constitute advances less than INR 2.5 million (28.000 EUR). Along with the MUDRA (Micro Units Development and Refinance Agency) scheme, that seeks to refinance micro businesses with loan requirements in the range of INR 50,000 to INR 1 million (560-11.200 EUR), these initiatives seek to build up the offer of small-ticket loans (ADBI 2016).

3 The banking landscape comprises a variety of bank types, most notably Public Sector Banks (PSBs, recently reduced to 12 banks after a series of mergers), private commercial banks, Regional Rural Banks (RRBs), Small Finance Banks (SFBs) and co-operative banks, with the latter two focusing on small-scale and grassroot-level financing opportunities (RBI 2020).

Non-Bank Financial Institutions (NBFIs): NBFIs are an important **source of debt financing** for SMEs. New fintech companies are emerging that provide data- and technology-driven lending solutions tailored to SMEs' needs (BCG & FICCI 2021). Yet, the large majority of NBFIs focuses on financing core business operations rather than the shift towards more sustainable consumption and production. Tata Cleantech Capital is a notable example of an NBFI that provides US$ 10 million of cleantech finance for SMEs, alongside advisory services (ACMFN 2020). Currently, Fintechs operate mainly in few urban centres. Oftentimes, they require technical savvy from their clients that they currently lack. But due to new legal requirements, many MSMEs needed to familiarise themselves with digital infrastructure, leading to a larger potential client base for Fintechs. Their services and conditions can be superior to traditional financiers, with some fintech lenders offering decisions within two work days. (ASSOCHAM, 2018)

Investors: India has a vibrant **venture capital and impact investment** scene. As with banks and NBFIs, however, only a small number of investors specifically focus on cleantech and SCP (e.g. Global Environment Fund and Green India Venture Fund). Several funds have been set up specifically for the agri-food sector, funding sustainable food solutions, for example by Ankur Capital, and Lightrock, or specific venture capitalists like Omnivore; impact investors in SCP-relevant sectors active in India include Circulate Capital, which specifically targets waste management and plastics.

RECOMMENDATIONS TO DEVELOPMENT FINANCE INSTITUTIONS

Both SME finance in general and specific SCP finance for SMEs need to be further strengthened in India, if SMEs are to successfully transition to SCP practices. Development finance institutions (DFIs) can play an important role in shaping conducive framework conditions. Existing literature (see "Sources") highlights the following recommendations:

Understanding the variety of SCP practices in the SME context, financing needs and priority sectors

- Numerous examples of commercially successful SCP-relevant business cases exist, including case studies by the SWITCH-Asia programme. Given the increasing importance of SCP, it would be advisable for DFIs to **analyse their setups and success factors**, in order to be **well-positioned to act as financiers**; this is similar to the last decade of investments in renewable energy and energy efficiency, where DFI capacity has grown considerably. A specific sector focus, for example, could amplify competencies and impact. Potential sectors include textiles and buildings.
- SMEs investing into SCP practices often have unique needs. DFIs should dedicate efforts into understanding these and also build up their knowledge on financially directly or indirectly relevant impacts (like supply chain requirements, cost structure, reputational risk, etc) as well as the larger policy context (Paris Agreement, SDG 12, Green Deal, etc). to be able to develop targeted and impactful programmes in line with the EU's policy priorities.

Working with the financial sector to structure/design relevant financial products and services

- DFIs could support domestic banks and financial intermediaries who have not yet ventured into SCP specific instruments and help them in **broadening their knowledge** about SCP (incl. potential for cost savings, international supply chain and disclosure requirements) so as to strengthen their motivation to provide relevant funding.
- DFIs could join forces with Indian banks to increase the share of blended finance specifically addressing SCP investments. Particular attention could be placed on helping companies grow and reach maturity so that they can access conventional funding. Relevant finance schemes could serve as benchmarks for regional promotion plans or governmental guidance and regulation.
- There is still lack of procedural and technology skills at many of India's banks catering to SMEs. Working with the Reserve Bank of India, DFIs could engage and support domestic financial institutions in the standardisation of the credit granting process to decrease administrative costs related to small ticket sizes. Focus could be on promoting digital credit application tools and clear sustainability benchmarks.

- DFIs do not have to focus exclusively on banks – it could be interesting to scope for collaboration opportunities with well-established investors and NBFIs. Together, creative financing instruments could be developed, e.g. equity-raised instruments starting off as debt preference; financial models focusing on no or low collateral, faster lending and lower interest rates; and innovative tripartite financing agreements between suppliers, SMEs and industry associations.
- When channeling funds through local institutions, DFIs can also require dedicated credit lines for financing projects of on high-impact SCP practices, for example waste management or wastewater treatment. These could also be sector-specific, or address specific industrial clusters. This targeted financing could be rendered even more effective if paired with national or state legislation targeting at improving sustainability.
- DFIs can help build and strengthen a landscape of intermediaries that 1) help SMEs to develop sound business models and demonstrate demand for cleantech financing instruments to local and regional banks, 2) accelerate matchmaking and 3) offer cleantech capacity building.

Embedding SCP in broader sustainability frameworks

- DFIs can use "performance-based financing" also for SCP practices and priorities. This would require that capacities for **evaluation, measurement and reporting of impact** are built up at partnering financial instruments. This is beneficial for companies that create not only economic but also environmental and social benefit, e.g. through SCP practices. Suitable credit lines and other instruments should combine impact- and profit-considerations.
- DFIs can analyse whether methods / lessons learned from **sustainable energy finance** could be applied to SCP finance (such as scenario analysis, impact verification/audits).
- Jointly with domestic financial institutions, DFIs can assess whether **international climate and biodiversity finance** can be used to support SCP practices and facilitate domestic companies' and financiers' access to those funds.

Taking policy action to improve framework conditions for SME (SCP) finance

- DFIs should consider working closely with policy makers and regulatory authorities to help them gain a better understanding of **financial sector's important role** for a green transformation, especially considering a) international trends around sustainable supply chain management, investment and disclosure and b) the need to generate (sustainable) financing for post-COVID-19 recovery.
- Establish baseline for existing SCP SMEs in India. DFIs can encourage domestic financial institutions and government or statistical authorities to **assess the number of SMEs that engage in green businesses or invest in and promote SCP**, to a) increase transparency and attention to sustainable business models and b) increase potential share of resources flowing to these businesses as part of regional, national or international (green) recovery plans.
- Together with the Indian government, DFIs could work towards **establishing an SCP fund / financing programme** which has less restrictions than conventional funds and guarantees broader coverage of financing options for SCP/cleantech SMEs nationwide.
- In addition to existing EU-India financing initiatives, explore policy-based loans for financing SCP practices at SME level, for example, for cleaner production or value chains.

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