Report of the Committee set up to examine the financial architecture of the MSME sector

February 2015

Glossary

ADB	Asian Development Bank
BMO	Business Membership Organisation (Germany)
BMWi	Federal Ministry for Economic Affairs and Energy (Germany)
CDC	Certified Development Companies (USA)
CGS	Credit Guarantee Scheme
CGTMSE	Credit Guarantee Fund Trust for Micro and Small Enterprises
CSIR	Council of Scientific and Industrial Research
DBT	Direct Benefit Transfer
DCCB	District Central Co-operative Bank
DCMSME	Development Commissioner, MSME
DFS	Department of Financial Services
DIC	District Industries Centre
DIPP	Department of Industrial Policy and Promotion
DoP	Department of Posts
EIS	Enterprise Investment Scheme (UK)
EM	Entrepreneurs Memorandum
EPFO	Employees' Provident Fund Organisation
ESIC	Employees' State Insurance Corporation
Exim Bank	Exim Bank of India
Ex-Im Bank	Export-Import Bank of USA
FICCI	Federation of Indian Chambers of Commerce and Industry
FISME	Federation of Indian Micro and Small & Medium Enterprises
GAFI	General Authority for Investment and Free Zones (Egypt)
GDP	Gross Domestic Product
HNI	High net worth individual
IBA	Indian Banks' Association
KVIC	Khadi and Village Industries Commission
KYC	Know Your Customer
LLP	Limited Liability Partnership
LOC	Line of Credit
MGIRI	Mahatma Gandhi Institute for Rural Industrialisation
ML	Maximum Liability (ECGC)
MLI	Member Lending Institution (CGTMSE)
MSE	Micro and Small Enterprises
MSEFC	Micro and Small Enterprises Facilitation Council
MSME	Micro, Small and Medium Enterprises
MSMED Act	Micro, Small and Medium Enterprises Development Act, 2006
MSME-DI	MSME Development Institute
MSME-RFS	MSME Receivable Finance Scheme

NAFIN	Nacional Financiera (Mexico)
NBFC	Non-Banking Financial Company
NPA/ NPL	Non-Performing Asset/ Non Performing Loan
NSDC	National Skill Development Corporation
NSE	National Stock Exchange
NSIC	National Small Industries Corporation
NTREES	Trade Receivable E-Discounting Engine
OBC	Other Backward Class
OSS	One-Stop Shop (Egypt)
PACS	Primary Agricultural Credit Society
PAN	Permanent Account Number
PCARDB	Primary Co-operative Agriculture and Rural Development Bank
PE	Private Equity
PMEGP	Prime Minister's Employment Generation Programme
PMJDY	Pradhan Mantri Jan Dhan Yojana
PBI	Post Bank of India
POSB	Post Office Savings Bank
PSU	Public Sector Undertaking
RBI	Reserve Bank of India
RIDF	Rural Infrastructure Development Fund
SARFAESI Act	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act
SBA	Small Business Administration (USA)
SBIC	Small Business Investment Company (USA)
SBLF	Small Business Lending Fund (USA)
SC	Scheduled Caste
SCARDB	State Co-operative Agriculture and Rural Development Bank
SEIS	Seed Enterprise Investment Scheme (UK)
SIDBI	Small Industries Development Bank of India
Sinosure	China Export and Credit Insurance Corporation
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
SSI	Small Scale Industry
ST	Scheduled Tribe
StCB	State Co-operative Bank
TAN	Tax Assessment Number
TReDS	Trade Receivables Discounting System
UCB	Urban Co-operative Bank
VC	Venture Capital

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Background

As announced in the Union Budget FY2014-15, a Committee to examine the financial architecture of the MSME sector was set up by the Department of Financial Services, Ministry of Finance vide notification dated September 26, 2014. The text of the notification including the constitution and terms of reference of the Committee as amended vide notification dated October 28, 2014 is set out in Annexure I.

The Committee held detailed deliberations over three meetings and over e-mail during November 2014 – January 2015. Several members/organisations represented on the Committee have made valuable written submissions which have informed the Committee's discussions. The Committee/members thereof have also interacted with industry associations, other financial institutions, MSME-focused financial services providers and experts as part of the process of understanding the current status and needs of MSMEs in India with respect to financial services and access to credit, and the experience of other countries. The Committee has received written submissions from a number of these organisations/individuals. The list of organisations/individuals who have contributed to the Committee's work is set out in Annexure II. The Committee thanks them for their valuable contribution. The Committee has also reviewed previous reports & recommendations on enhancing access to finance for MSMEs. The list of these reports is set out in Annexure III.

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1. Summary of Key Recommendations

The Committee's approach to the financial architecture for MSME encompasses the following key elements:

- encouraging registration;
- opening of bank accounts;
- access to equity financing;
- creating a platform for receivables financing;
- expanding and enhancing guarantee cover;
- and increasing distribution and reach to cover the large number of micro, small and medium enterprises (MSMEs) in the country through a wider base of financial intermediaries.

The Committee envisages creation of an apex policy administration authority to oversee administration of policy as seen in several countries with a well-developed MSME ecosystem.

The Committee recommendations stress on creating a financial architecture for the MSME sector that would use technology driven platforms to drive inclusion in financing of the large number of MSMEs which do not have access to credit. This will facilitate realisation of the Make in India goal as articulated by the Prime Minister and be in consonance with the Government's Digital India mission.

Simple registration/facilitation procedures, universal financial inclusion, strong guarantee programmes and a wider distribution network should enhance the connect between unbanked MSMEs and the financial system. Based on the recommendations of the Committee, bank credit to the MSME sector which was ₹ 10 lakh crore as of March 2014 could scale up to as much as ₹ 30 lakh crore in five years. The Committee recommendations would result in:

- reducing operating costs;
- augmenting existing credit analysis processes with use of payment information for assessing credit worthiness;
- reducing credit costs for financiers;
- and reducing borrowing costs for MSMEs.

The key recommendations to achieve the above goals are set out below:

1. **Create an apex authority which would be called the National MSME Authority under the Ministry of MSME.** To ensure a single point resource centre which will be a nodal agency to execute and administer programs, benefits & grievance redressal, facilitate ease of doing business, registration & inclusion and to design policy and implement the series of measures articulated in this report, there is a need for an apex authority to be established. The Authority will establish and administer an appropriate centralised and integrated National MSME Portal to **target universal registration of MSMEs** through an online, mobile-enabled **simple one-page registration/facilitation form** for MSMEs based on self-declaration with a simplified set of rules and documents, and issue a **unique identifier, or Udyog Aadhar** to the MSME. This should be augmented by **simplified mobile app based registration**. Registration can be further encouraged by providing incentives for registration with the Authority. These incentives could be on the lines of those provided for opening of Jan Dhan Yojana accounts. The Authority will:

    - Build seamless linkages with other relevant departments/ authorities to streamline other facilities, registrations & approvals
    - Establish linkages between the portal and credit providers and guarantee/ insurance providers
    - Act as a resource centre for all central government and state government MSME schemes across the country
    - Coordinate with institutions providing equity finance, guarantees and financial assistance to improve the programmes funded by the government
    - Enhance ease of doing business through accreditation of agencies to expand its own distribution reach
    - Focus on advocacy and capacity building by leveraging skilling and research initiatives already in place
    - Act as a grievance redressal forum

    The Ministry of MSME has operationalised a national portal for online registration of MSMEs through the District Industries Centers (DICs). The portal is planned to be linked with other departments of state governments for taxation, power, utilities and pollution control among others. This should be integrated with the E-Biz portal set up by the Department of Industrial Policy and Promotion (DIPP). The proposed National MSME Portal and central registry should dovetail with the work that has been done by the Ministry of MSME, while simultaneously drawing on the work of DIPP with an aim to develop a common system which is the best in the world. The Ministry of MSME may coordinate with various departments to ensure simplification of various registration requirements like the environmental clearances.

At present the office of the Development Commissioner within the Ministry of MSME is a nodal governmental body for MSMEs, this role can be suitably combined with the role of the Authority as appropriate.

The Committee envisages that such an approach can achieve **95% registration amongst MSMEs in six months**. (Chapter 8)

2. **Achieve, in a time bound manner, universal financial inclusion of MSMEs** by using the above registration to **ensure that every registered MSME has a bank account.** This can be an existing business banking account, and where bank account details are not available the process can facilitate opening a new business banking account with the information provided, including the ability to open a bank account entirely online using eKYC (electronic validation of KYC requirement). The bank account should be linked to the Udyog Aadhar.

   To facilitate ease of doing business certain changes in the Companies Act, the Limited Liability Partnership Act and the Income Tax Act could be undertaken are suggested to provide simplified compliance, presumptive taxation and simplified dissolution for MSMEs. (Chapter 8)

3. **Increase the flow of equity to the MSME sector** by operationalising the ₹ 10,000 crore fund proposed in the Union Budget FY2014-15. The fund can be further leveraged multiple times to mobilize additional capital from private and institutional sources by increasing the eligible pool of domestic investors, providing appropriate tax incentives to qualified investors, as may be determined by regulatory authorities, for equity investment in small enterprises and formulating an easy exit policy to encourage innovation and risk taking to start new enterprises. Simultaneously, there is a need to **introduce a level playing field for domestic equity financing** as compared to foreign investors investing in startups/MSMEs. The divergent treatment of capital gains compared to mutual funds and listed equity may also be removed. The measures to enhance flow of equity to the MSME sector and changes suggested to Section 56 (2) (viia) and (viib) of the Income Tax Act have been detailed in the chapter on equity financing. (Chapter 9)

4. **Encourage establishment of an effective, online, technology-driven receivables financing platform** with wide participation by credit providers, MSMEs, corporate and government units. This would be a key component of the new architecture, as permitted under the Trade Receivables Discounting System (TReDS) guidelines issued by the Reserve Bank of India (RBI). A strong receivables financing platform in the form of TReDS can lower the corpus requirement for guarantees for MSMEs. The bill acceptance and payment history data from TReDS should flow to credit bureaus to rate payment behaviour of corporate and government units. Initiatives to

achieve a robust receivables financing platform by providing strong operating guidelines for the proposed TReDS platform have been covered in depth in the chapter on receivables financing. (Chapter 10)

5. **Expand coverage under and enhance effectiveness & utilization of credit guarantee/insurance schemes** and **make the programmes accessible to a wider set of credit providers**, upto and including select NBFCs and micro finance institutions. For this purpose, a seven fold increase in the corpus from ₹ 4,000 crore to about ₹ 28,000 crore over the next five years may be considered. The Ministry of MSME could determine the corpus required for guarantee schemes targeted at MSMEs based on the above estimate and augment the corpus in yearly tranches over the next five years. Of this, an amount of ₹ 5,000 crore could be considered in the forthcoming year. Other measures have been spelt out in detail in the chapter on guarantee and insurance schemes.

   As seen in developed countries, export insurance has played a major role in encouraging MSMEs. Appropriate suggestions for expanding the role and scale of insurance agencies have been made in the chapter on guarantee and insurance schemes. (Chapter 11)

6. The **financial architecture to serve the MSME sector should encompass a wider and deeper set of entities which will include scheduled commercial banks, non-bank finance companies, micro finance institutions, cooperative banks, the proposed new small finance banks and the proposed Post Bank of India**. These entities could leverage outreach points outside the formal financial system (akin to the banking correspondent model) to enhance access to financial services through a **hub-and-spoke approach**, as also **leverage the National MSME Portal to expand access**.

   The post office network has 1,55,000 offices currently offering savings to individuals under the Post Office Savings Bank (POSB) small savings scheme. The proposed Post Bank of India (PBI) could become an effective channel for financial inclusion and delivery of credit to MSMEs. We understand that one of its key objectives could be to serve the MSME sector as well as individuals such as artisans, farm owners and rural micro enterprises. It could form an important part of the distribution architecture and boost potential employment generation through micro enterprises.

   The Committee received inputs from an industry body and one of the Committee members on the need to develop additional sources of formal finance for the MSME sector through a structure that would include in its ambit the existing non-institutional last mile financiers. The suggestions proposed an organisation on the lines of the National Housing Bank for registration and supervision of a new category of dedicated

Small Business Finance Companies, registration of non-institutional last mile financiers and other activities to promote flow of funds to the MSME sector. The proposal was discussed with the Ministry of Finance and the RBI and in view of the underlying risks associated with such a lightly supervised structure, the above structure was not considered feasible.

This has been covered in depth in the chapter on financial architecture. (Chapter 12)

7. **Encourage expansion in coverage of credit bureaus** to include a wider range of credit institutions and **a wider range of transaction records to facilitate a better credit and payment history of the buyer and the seller.** This is particularly relevant for MSMEs which seek credit from the formal financial sector for the first time and do not have a credit history. This has been further explained in the chapter on financial intermediaries. (Chapter 12)

2. Overview

The Micro, Small & Medium Enterprises (MSME) sector is a critical component of India's growth story, making significant contributions to GDP, employment and exports. MSMEs contributed around 37.5% of India's GDP in 2012-13, a number which has remained steady over the past three years. Of this, around 30% of the GDP is contributed by the services sector and the remaining by the manufacturing sector. This translates to a gross value added of ₹ 20.56 lakh crore. Of the aggregate gross value added, 71.2% was contributed by the services sector and 18.8% by the manufacturing sector.

Table 2.1 Share of MSME Sector in Total GDP (%)

Year	2010-11	2011-12	2012-13
Manufacturing Sector MSME	7.39	7.27	7.04
Service Sector MSME	29.30	30.70	30.50
Total	**36.69**	**37.97**	**37.54**

Source: Ministry of MSME

Table 2.2 Estimate of gross value added of MSME (₹ in lakh crore)

Year	2010-11	2011-12	2012-13
Manufacturing Sector MSME	3.63	3.82	3.86
Service Sector MSME	14.43	16.11	16.70
Total	**18.06**	**19.93**	**20.56**

Source: Ministry of MSME

As per the Ministry of MSME's Annual Report for 2013-14, MSMEs account for nearly 40% of India's exports and also contribute significantly to the generation of employment in the country, employing nearly 80-100 million people.

Availability of finance is a key enabler for economic activity and the growth of entrepreneurship. In the MSME context, finance encompasses equity capital, loans for fixed asset investment and working capital for meeting cash flow gaps. Several policy, regulatory & institutional initiatives have been taken to promote availability of finance to MSMEs. These include, among others, credit support mechanisms administered by government institutions.

As per data from RBI, aggregate credit outstanding from scheduled commercial banks to MSMEs has in aggregate increased from ₹ 6.81 lakh crore in March 2012 to ₹ 10.35 lakh crore in March 2014.

Table 2.3 Bank credit flow to Micro & Small Enterprises (Outstanding credit amount in ₹ crore)

Year (last reporting Friday)	Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial banks
March 2012	3,96,993.36 (7.5%)	1,08,982.78 (23.7%)	21,708.44 (3.5%)	5,27,684.58 (10.3%)
March 2013	5,02,459.09 (26.6%)	1,54,731.82 (42.0%)	30,017.83 (38.3%)	6,87,208.74 (30.2%)
March 2014 (Provisional)	6,15,976.38 (22.6%)	2,00,138.36 (29.4%)	30,020.06 (0.01%)	8,46,134.80 (23.1%)

Source: RBI

Note: Figures in brackets indicate year on year % growth/decline

Table 2.4 Bank credit flow to Medium Enterprises (Outstanding credit amount in ₹ crore)

Year (last reporting Friday)	Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial banks
March 2012	1,36,285.93	15,742.88	1,592.27	1,53,621.08
March 2013	1,41,065.93 (3.5%)	27,516.00 (74.8%)	13,233.47 (731.1%)	1,81,815.40 (18.4%)
March 2014 (Provisional)	1,38,414.69 (-1.9%)	45,887.40 (66.8%)	4,339.11 (-67.2%)	1,88,641.19 (3.8%)

Source: RBI

Note: Figures in brackets indicate year on year % growth/decline

Table 2.5 Aggregate bank credit flow to Micro & Small and Medium Enterprises (Outstanding credit amount in ₹ crore)

Year (last reporting Friday)	Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial banks
March 2012	5,33,279.29	1,24,725.66	23,300.71	6,81,305.66
March 2013	6,43,525.02 (20.7%)	1,82,247.82 (46.1%)	43,251.30 (85.6%)	8,69,024.14 (27.6%)
March 2014 (Provisional)	7,54,391.07 (17.2%)	2,46,025.76 (35.0%)	34,359.17 (-20.6%)	10,34,775.99 (19.1%)

Source: RBI

Note: Figures in brackets indicate year on year % growth/decline

Table 2.6 Gross non-performing assets (NPAs) for Micro & Small Enterprises (Outstanding gross NPA amount in ₹ crore & NPAs in percentages)

Year (last reporting Friday)	Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial banks
March 2012	24,272.44 (6.1%)	1,880.73 (1.7%)	159.83 (0.7%)	26,312.99 (5.0%)
March 2013	28,575.29 (5.7%)	2,506.44 (1.6%)	396.23 (1.3%)	31,477.96 (4.6%)
March 2014 (Provisional)	38,949.80 (6.3%)	3,021.63 (1.5%)	457.36 (1.5%)	42,428.79 (5.0%)

Source: RBI

Note: Figures in brackets indicate NPA percentages

Credit outstanding from scheduled commercial banks to the micro & small enterprises and medium enterprises has registered an annualised growth of about 23% from March 2012 to March 2014. This compares to the annualised growth in overall non-food credit of 14.1% during the same period.

The incidence of NPAs in MSMEs is sizeable and this aspect needs to be addressed. An efficient system of receivables factoring/discounting is one way to significantly address this issue and recommendations for such a system form a part of this report.

Easing access to finance for the MSME sector is critical to job creation, export growth and development of a manufacturing base, as envisaged in the Government of India's "Make in India" initiative. The MSME sector forms the bedrock of Indian entrepreneurship, and must be nurtured appropriately to realise India's potential.

3. Key issues identified

Based on the deliberations of the Committee, engagement with various organisations and experts and review of material received by the Committee, the following key issues emerge that constrain the access of MSMEs to the formal financial sector:

1. **Equity as a source of financing is underutilised and the prevalence of investment by venture capital and angel investors is low** when compared to other countries. MSMEs in India rely on friends & family as sources of equity. This may be due to lack of awareness about MSMEs as well as absence of formal governance structures in small businesses which deter investors.

2. **MSMEs face the problem of delayed payments from their buyers**, which are mostly large corporates. **This adversely impacts their working capital as well as their next cycle of production** by affecting their ability to service existing debt.

3. The **utilisation of the available credit guarantee and insurance schemes by banks has been lower than potential** due to capacity constraints and conditions that limit eligibility and operational issues that limit flexibility and delay realisations.

4. **MSMEs lack adequate information about the various schemes and benefits made available by the government**. In some cases, they lack the technical know-how and the necessary wherewithal to furnish the required information to avail these schemes.

5. There is a need for deepening and widening the delivery of credit. **Formal financial institutions such as banks face challenges in credit risk assessment of MSMEs**, due to absence of financial information including historical cash flows, credit track record and tools to assess credit risk in the absence of the above.

6. Critically, **outreach to MSMEs, on-boarding as customers, building up of transaction & credit history and scaling up the utilisation of various schemes available is challenged by the lack of formal legal structure/non-corporate nature of much of the sector** and the absence of a centralised database and system which can be used to target and track these enterprises. Small enterprises also face challenges in registration and complex compliance requirements that act as deterrents to adopting formally registered legal structures.

Realising the potential of the MSME sector will require significant efforts even in areas other than access to finance, including infrastructure, skill development, technical & managerial capacity building, alignment of goals of industrial research institutions, ease of doing business and simplification of laws, rules & procedures. The Committee has deliberated on certain aspects of these areas to the extent they are closely-linked to the issue of enhancing the inclusion of MSMEs in the “formal” economy and financial system.

4. Definition of MSME

1. Current MSME definition in India

As per the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, the micro, small and medium enterprises are defined as below:

Table 3.1: Definition as per MSMED Act, 2006

Categories	**Manufacturing** (Investment in plant and machinery)	**Services** (Investment in equipments)
Micro	Does not exceed ₹ 25 lakh	Does not exceed ₹ 10 lakh
Small	More than ₹ 25 lakh but does not exceed ₹ 5 crore	More than ₹ 10 lakh but does not exceed ₹ 2 crore
Medium	More than ₹ 5 crore but does not exceed ₹ 10 crore	More than ₹ 2 crore but does not exceed ₹ 5 crore

2. MSME definition in other countries

In most domains, the definition of MSMEs is based on aspects such as sales turnover and number of employees.

2.1 United States

In the United States, the small and medium-sized enterprises (SME) sector is classified based on the criteria of number of employees or sales turnover. Firms with fewer than 500 employees are classified as SMEs. Micro enterprises have less than 10 employees, small enterprises have 10-99 employees and medium enterprises have 100-499 employees. According to the Small Business Administration (SBA), depending on the industry, business size eligible for classification as MSMEs are based on the average number of employees for the preceding twelve months or on sales volume averaged over a three-year period. For example, in case of manufacturing, the maximum number of employees may range from 500 to 1500, depending on the type of product manufactured. Similarly, for retailing, the annual receipts may not exceed USD 2.5 million to USD 21.5 million, depending on the particular service being provided.
(Link: https://www.sba.gov/content/what-sbas-definition-small-business-concern)

2.2 European Union

The SME sector is classified based on the criteria of number of employees and either turnover or balance sheet total. The European Commission has defined MSMEs for the European Union countries as follows:

Table 3.2: MSME definition criteria for European Union countries

Company category	Employees	Turnover	Balance sheet total
Micro	<10	<€2 million	<€2 million
Small	<50	<€10 million	<€10 million
Medium-sized	<250	<€50 million	<€43 million

(Link: http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm)

3. MSMED (Amendment) Bill, 2014

The Ministry of MSME has released a draft document on the proposed amendments to the MSMED Act, 2006 to incorporate a new section on a change in definition for MSMEs. The Bill proposes to change the definition of MSMEs by raising the capital limits in plant and machinery to the following revised levels:

Table 3.3: Proposed definition by Ministry of MSME

Categories	**Manufacturing** (Investment in plant and machinery)	**Services** (Investment in equipment)
Micro	Does not exceed ₹ 50 lakh	Does not exceed ₹ 20 lakh
Small	More than ₹ 50 lakh but does not exceed ₹ 10 crore	More than ₹ 20 lakh but does not exceed ₹ 5 crore
Medium	More than ₹ 10 crore but does not exceed ₹ 30 crore	More than ₹ 5 crore but does not exceed ₹ 15 crore

The Ministry of MSME in consultation with other government authorities may take a view on any modifications required to the MSME definitions from time to time. It is suggested that value-based limits such as investment should have a mechanism for automatic indexation linked to an appropriate inflation benchmark.

5. Global experience

A few trends that have been seen across economies with successful MSME models are: high involvement of central and provincial governments; excellent execution and effectiveness; one or two flagship programmes supported by several uniquely designed initiatives for local needs and priority; constant feedback and improvement process; and a single nodal entity for all MSME services. In particular the experience in USA, Germany, Mexico, Egypt and China is highly relevant.

1. United States of America

The small business sector in the United States constitutes 99.7% of US employer firms, and contributed around 46% to non-farm GDP (in 2008) and 33% to exports and 49% to private sector employment (in 2011). The sector created 60% of new jobs in the last few years. The institutional setup includes the Small Business Administration (SBA), Export-Import Bank, Small Business Lending Fund and Office of US Trade Representative.

1.1 Small Business Administration

The SBA was set up under the Small Business Act of 1953. It is a nodal, independent Federal government agency in the United States which 'aids, counsels, assists and protects, in so far as possible, the interests of small businesses'. Growing business, creating jobs and serving as the voice for small businesses by providing an advocacy role are some of the key strategic goals for SBA. It plays multiple roles to help the small business sector by providing access to capital, entrepreneurial development, access to government contracting and fostering a small business friendly environment by reducing unfair regulatory burdens.

The SBA supports an entrepreneurial ecosystem that serves over 1.2 million entrepreneurs and small businesses.

Organizational structure

The SBA consists of the Office of the Administrator, which include the Administrator, Deputy Administrator, Chief of Staff and Chief Operating Officer. The Senate confirms the appointment of the Administrator, Deputy Administrator, Chief Counsel for Advocacy and Inspector General. There are administrators or directors for the various offices such as capital access, entrepreneurial development, investments and innovation, government contracting and business development etc.

Funding mechanism

The SBA provides a number of financial assistance programmes for small businesses that have been specifically designed to meet key financing needs, including debt financing, surety bonds, and equity financing. SBA does not provide direct loans to small businesses, rather it sets the guidelines for loans and provides guarantee that these loans will be repaid. SBA’s Surety Bond Guarantee Program helps small business contractors. Through the Surety Bond Guarantee Program, the SBA's guarantee gives surety companies an incentive to provide bonds for eligible small business contractors, thereby strengthening a contractor's ability to obtain surety bonds and greater access to contracting opportunities for small businesses.

7(a) loan programme: The loan programme includes the SBA’s flagship loan programme, the 7(a) loan programme, which offers guarantees on loans up to USD 5.0 million. This programme can be used for various purposes such as working capital, revolving funds, equipment purchases and refinancing existing debt. The SBA guarantees as much as 85% on loans of up to USD 150,000 and 75% on loans more than USD 150,000, with the maximum exposure amount being USD 375,000.

504 Certified Development Companies (CDC) Guarantee programme: The 504 Certified Development Companies (CDC) Guarantee programme provides long-term, fixed rate loans up to USD 5.5 million in order to support investment in major assets such as real estate and heavy equipment.

In FY2014, SBA provided USD 29.0 billion of loans to support small businesses through the 7(a) and 504 loan programmes, with an average ticket size of around USD 0.5 million. The outstanding loan portfolio at FY2014 from the above two programmes was USD 95.4 billion. Overall, the SBA approved around 58,000 loans that supported more than 51,000 companies in FY2014.

Microloans to intermediary lenders: The SBA also provides microloans up to USD 50,000 to non-profit intermediary lenders, which are community based organisations with experience in lending and technical assistance, that in turn provide the loans to small businesses needing small-scale financing and technical assistance for start-up or expansion.

Export loans through banks: The SBA provides export loans through approved banks, including ‘SBA Export Express’ loans (up to USD 500,000), ‘Export Working Capital’ loans (up to USD 5.0 million), and ‘International Trade’ loans (up to USD 5.0 million) that provide small businesses with enhanced export financing options for their export transactions. The SBA provides technical assistance on export loans through U.S. Export Assistance Centres. The outstanding principal balance of export loans provided by the SBA at September 30, 2014 was USD 1.3 billion, assisting 1,392 small businesses.

Equity financing: The SBA helps in equity financing by licensing venture capital funds under the Small Business Investment Company (SBIC) programme, as well as supplementing the capital they raise from private investors with access to low-cost, government-guaranteed debt. The SBIC programme is a public-private investment partnership created to help fill the gap between the availability of growth capital and the needs of small businesses. The SBA does not invest directly in small businesses, relying instead, on the expertise of qualified private investment funds. In 2014, SBIC provided nearly USD 5.5 billion in growth capital to around 1,085 small businesses.

Government contracts to small businesses: The SBA leads federal efforts to deliver 23% of government contracts to small businesses. Contracting programmes include efforts to ensure that certain federal contracts reach women-owned, small disadvantaged businesses, service-disabled veteran-owned small businesses as well as businesses located in economically disadvantaged geographical areas. Since January 2009, federal agencies in the US have awarded more than USD 376.2 billion in federal contracts.

1.2 Small Business Lending Fund

The SME sector is further supported by the Small Business Lending Fund (SBLF). The USD 30.0 billion fund managed by the Treasury was established by the Small Business Jobs Act of 2010. It supports main street banks, community development loan funds and small businesses. The SBLF aims at stimulating small business lending by providing Tier 1 capital to qualified community banks with assets of less than USD 10.0 billion and purchasing preferred stock in each bank. Banks are incentivised to lend through coupon payments on the preferred stock which progressively reduce as lending to small business increases. Banks where the lending does not grow pay the highest coupon on the preferred stock.

1.3 Export-Import Bank

The Export-Import Bank of USA (Ex-Im Bank) is the official export credit agency in the United States which provides export financing to promote exports. Some of the key products provided for the SMEs are working capital loan guarantee, export credit insurance and term financing for foreign buyers. In 2014, 90% of all transactions undertaken by the bank were for the SME sector.

Working capital loan guarantee scheme: Under this scheme, the bank guarantees 90% of working capital loans made to US exporters. The working capital loans can help the exporters in financing foreign receivables and obtaining standby letters of credit which can serve as a bid or performance bond, in addition to facilitating payment for raw materials, equipment and supplies.

Export credit insurance: Ex-Im Bank's 'export credit insurance' covers the risk of the non-payment by the buyer for commercial risks and certain political risks. This enables exporters to extend competitive credit terms to buyers and export to new markets with confidence. Under their multi buyer policy, the bank covers 90-95% of commercial risks and 95-100% of political risks. The exporters can also insure all sales to eligible buyers on "open account" credit terms. Under the short term policy, insurance is covered up to 180 days and up to 360 days in case of capital goods and bulk agricultural commodities.

Term financing guarantee for foreign buyers: The bank guarantees commercial loans, up to ten years, to creditworthy international buyers. It supports up to 85% of supply contracts and 100% coverage for commercial and political risks. It also covers local costs up to 30% and ancillary services such as financial, legal and bank fees may also be included.

1.4 The Office of US Trade Representative

The Office of US Trade Representative is responsible for developing and coordinating US international trade and commodities and overseeing negotiations with other countries. In addition to launching a trade initiative in 2009 to enable SMEs growth in international trade, it helps SMEs engaged in agriculture and manufacturing to trade with 20 countries with which the United States has Free Trade Agreement, negotiate Trans Pacific Partnership with 11 countries to increase export opportunities for SMEs and identify trade barriers with the European Union that disproportionately impacts SMEs.

2. Germany

The MSME sector in Germany forms the backbone of the economy, accounting for 99% of all German businesses, 18% of exports, employing 67% of total workforce and contributing nearly 50% to the country's GDP. Therefore, Germany, in its economic policies provides abundance of support programmes and measures to support the sector. There is a strong institutional set up for the MSME sector in Germany.

2.1 German 'Mittelstand'

In Germany, the highly innovation-driven small and medium enterprises are referred to as the 'Mittelstand'. According to the definition produced by the Institute for SME Research, IfM Bonn, SMEs are businesses with an annual turnover of less than EUR 50 million and with fewer than 500 employees. They are owned and predominantly managed by families, with strong ties to the region and focus on long-term business policies. More than 99% of German firms belong to 'Mittelstand', contributing around 52% of total economic output. Investments by SMEs in new buildings and facilities represented a share of 31% of total gross fixed capital formation and 53% of total corporate investment in 2013.

Germany's vocational training system is regarded as a model all round the world because it guarantees a high quality of training and helps to meet the growing demand for skilled labour in Germany. The sector employs about 28 million people, therefore, providing more than 60% of all jobs. According to The Federal Ministry for Economic Affairs and Energy, BMWi, around 80% of all trainees in Germany receive their training in the 'Mittelstand'. Around 1,300 world market leaders from the 'Mittelstand' have successfully found niches for their products. This term is often used to include larger companies too if they are run in the same spirit as an SME enterprise.

Over the years, these companies have gained a relatively strong position in foreign markets. The government supports them on many key issues such as developing key technologies, making better use of skilled labour, boosting market opportunities abroad and financing needs, especially for start-ups.

2.2 Fraunhofer Society

The Fraunhofer Society provides support to small business sector by laying special emphasis on high-quality research and innovation for the sector. It is backed by an annual research grant of EUR 2.0 billion. The research projects are implemented by a network of 67 research institutions that specialise in creating innovations that can be applied by SMEs. These institutes have more than 250 focus areas and undertake around 6,000 to 8,000 projects per year. Each institute is linked to a German university and has a dual system of academic and factory apprenticeships. PhD students spend three to six years working part time at such institutes before moving into the industry. As the research activities undertaken are application and result-oriented, the programme has proven to be effective as there is immediate implementation of scientific research results, especially those which can be applied in a short duration.

The Fraunhofer Society receives funding both from the public sector and through contract research earnings. More than 70% of the contract research revenue is derived from contracts with industry and from publicly financed research projects. Almost 30% is contributed by the German Federal Ministry of Education and Länder (state) governments in a ratio of 90:10, in the form of base funding. As a consequence, they operate in a dynamic equilibrium between application-oriented fundamental research and innovative development projects.

2.3 Equity finance

The Federal Ministry for Economic Affairs and Energy, BMWi[1], is the apex body responsible to support the sector. BMWi provides direct or grant-based support to develop key technologies and provide financial incentives and promotion of investments, as well as

[1] Bundesministerium für Wirtschaft und Energie

indirect support in the form of boosting market opportunities abroad, better utilization of pool of skilled labour and enabling regional development for SMEs. Regional clusters are fostered by various federal and state governments supported by tax benefits and direct grants.

Some of the key start-up funding programmes run by BMWi are the INVEST programme and EXIST programme. The INVEST programme provides subsidy up to 20% of investment to private investors to acquire shares of 'innovative' companies and hold them for three years. The 'EXIST business start-up' grant supports the preparation of innovative start-up projects at universities and research institutions. 'The EXIST transfer of research' complements the 'EXIST business start-up' by promoting technology-based start-up projects in the pre-start-up and start-up stage. The Federal budget of 2014 allocated EUR 67 million to the EXIST programme in order to help fund 'innovative' start-ups.

2.4 Business Membership Organisations

The Business Membership Organisations (BMOs) model in Germany plays a major role in promotion of MSMEs. The industry associations or chambers can perform registration, certification and inspections of the businesses in the MSME sector. In turn, these associations are registered with BMWi. These industry associations are not only involved in discussing, drafting and implementation of Government programmes but also support their member businesses by providing consultancy services to MSMEs.

3. Mexico

3.1 NAFIN productive chains model

A relevant example of increasing access to working capital for SMEs in the developing world is the National Financiera (NAFIN) model in Mexico. NAFIN is a Mexican state-owned development bank created in 1934 to promote Mexico's industrial development. NAFIN provides SME suppliers with automated reverse factoring through its *'Cadenas Productivas' (productive chains)* programme, linking "small suppliers" to "big buyers". Through this model small, risky enterprises that lack access to formal credit are able to use their receivables from big buyers to secure working capital finance, thereby transferring an SME's credit risk to their lower-risk customers.

3.2 Mode of operation

- Large buyers provide NAFIN with lists of their suppliers (i.e., the small firms holding their accounts receivables), who are then invited to register for the factoring service for their respective large buyer. Working with only the large, established buyers reduces both the cost of assessing accounts receivable risk and the risk of non-payment itself. As a result, all factoring services facilitated through NAFIN are provided “without recourse.”

- Once the goods have been delivered and the buyer has been invoiced, the large buyer posts a negotiable instrument online
- The supplier can access NAFIN’s website, and locates a list of lenders willing to factor the receivable, with their corresponding interest rate quotes
- Once the supplier chooses the preferred lender, the amount to be factored is transferred electronically to the supplier’s bank account
- When the invoice becomes due, the buyer pays the lender directly

3.3 Enablers

Factoring transactions are completed through NAFIN’s electronic platform, which reduces transaction costs and improves security. The platform also facilitates the participation of all commercial banks in the programme and introduces the element of competition for suppliers’ receivables. NAFIN covers all costs associated with the electronic platform and legal expenses, such as document preparation, signing and transfers. The small supplier and NAFIN sign a pre-agreement allowing electronic sale and transfer of receivables; other documents establish buyer/NAFIN obligations, including the buyer’s obligation to remit factored receivables to the banks directly.

In 2001, NAFIN had a 2% market share; and by 2004 it accounted for 60% of the factoring market in Mexico.

4. Egypt

4.1 One-stop shop (OSS)

The concept of one-stop shop (OSS) in Egypt was introduced to transition the General Authority on Investment and Free Zones (GAFI) from a regulator to a promoter or facilitator. GAFI became the sole body responsible for facilitating business in Egypt. For the OSS, a new business model was developed that treated the investor as a client whose convenience was the main priority. Its main purpose is to facilitate investors’ dealings with registration and licensing authorities by concentrating them in the premises of the OSS itself as well as to streamline and coordinate the process with the different ministries and agencies involved whose approvals are not located in the OSS. GAFI is governed by a board, majority of whose members are from the private sector. GAFI also established a board of trustees that includes representatives of investors, exporters and entities providing services to investors.

The following services are provided under OSS:

- Facilitating the issuance of tax card
- Facilitating the issuance of commercial registry
- Issuance of temporary license
- Facilitating the issuance of permanent license
- Issuance of national ID card for SMEs

As per the World Bank 'Doing Business' Report 2013, Egypt's overall rank in terms of ease of doing business was 109 in 2012, up from the rank of 126 in 2007. Significantly, after introduction of OSS, Egypt's rank on the sub-parameter of ease of starting a business improved from 55 to 26 in the same period. Compared to this, India's rank on both parameters has declined over the same time period.

The OSS has a helpdesk, legal counsellors and handles complaints. A single officer guides an investor for filling the contract. In addition the OSS provides post-establishment services provided by GAFI (such as residence and work permits or exemption from custom duties) as well as those by other entities (passport department, tax authority).

A key achievement is a dramatic simplification of business start-up. From the investor's perspective, the number of procedures was cut from 19 to 3 steps. They are:

- The investor presents the required documents and manually fills respective applications for different entities.
- Requisite fees are paid in one lump sum at the branch of the Bank of Alexandria on GAFI's premises. Investors then take their receipts back to the registration desk.
- A follow-up officer completes the process and an investor can complete all requirements at the OSS in one day. In most cases, the investor need not visit any other office.

4.2 Key success factors

- The OSS created a system of delegation and liaison officers for ministries and other affiliated entities which legally authorized some of the government entities represented at the OSS to perform the services of their agencies and give approvals on behalf of them without having to refer to a higher authority.
- There is a clear separation of the 'front' and 'back' office in order to limit points of contact. Investors should stay at the 'front' office and the approvals are done in the 'back' office by officials who have no contact with applicants.
- It allowed investors to start operating their businesses immediately by granting them temporary licenses from GAFI, pending security clearances, if any. All activities can

commence with the temporary license and the permanent license is to be granted once the security clearance is obtained.

- It implemented a system of internal quality control where the progress is monitored according to key data such as the number of firms registered, enquiries answered, and other key performance data.

The establishment of this OSS pre-dates the advancements that have been witnessed in technology. The Committee suggests the creation of a similar one-stop shop which will be completely online.

5. China

The SME sector contributes over 60% of China's GDP, 50% of tax revenues, 65% of the new patents and 80% of its new products and constitutes 99% of the total number of enterprises in China. They account for around 80% of China's manufacturing employment and are estimated to create 80% of new urban employment.

5.1 Cluster development approach

Development of clusters with support from local governments is the main direction for the development of SMEs in China. Different types of industry clusters have formed in coastal cities, along rivers and in inland regions of China. These SME clusters are marked by features such as 'one product, one town' type of centralised operation, specialisation through creation of specific professional divisions and market-oriented interaction.

5.2 Financing for development of SMEs

Government departments have established credit guarantee systems for SMEs and provided tax incentives to encourage their establishment and growth. In 2003, an SME promotion law was enacted under which the government protects the investments of SMEs and their equity investors alongside their investment earnings. Government administrative departments protect the legal rights of SMEs, including their rights to fair competition and fair trade.

5.3 Credit risk compensation fund for commercial banks

Commercial banks are encouraged to actively issue 'pilot' loans to the qualified small and micro sized enterprises by providing them appropriate risk loss compensation. Special fiscal funds called 'credit risk compensation funds' are allocated to commercial banks if their non-performing loan (NPL) on small and micro enterprise credit exceeds a certain percentage. Beyond this threshold of pre-defined NPL level, all losses, up to a certain NPL level are borne by the credit risk compensation funds. For example, in Shanghai, when the small and micro enterprises loans' bad debt ratio exceeds 3% at the end of a year, the bad debt loan losses that are more than 3% but less than 4% can be fully compensated by the municipal- and county-level financial credit risk compensation funds.

This credit risk-sharing mechanism for small and micro-sized enterprises is established at two fiscal levels, one, the city level, and two, the district and county level.

5.4 Tax incentives

Policy actions undertaken by the Government to support the SMEs include tax reduction and income tax waivers to SMEs that meet the state-stipulated number of jobs that are expected to be generated each year, SMEs operating in economically underdeveloped or impoverished areas, and SMEs which employ a prescribed number of physically challenged people. Other steps include taxing only half of the revenue for tiny companies with revenue less than RMB 30,000, tax payment grace period of 3 months for some SMEs, no tariff on equipment imported for SMEs investing in government-encouraged industries; and tax refund for SMEs provided by some local governments whose annual tax payment exceeds a defined amount depending on local policy.

5.5 Government support

In April 2014, the Ministry of Finance provided a special fund for SMEs whereby a maximum amount of RMB 3 million will be given to technological SMEs to subsidize their research and development expenses on innovative projects.

The Ministry of Finance released the Administrative Measures on the Development for SMEs engaged in Industries with local characteristics in 2013 which explicitly supports SMEs in an effort to cultivate their own brands. The measures incorporated setting up a development fund for SMEs in industrial clusters. The fund provides SMEs with three support methods. An enterprise can only apply for one of the three supporting methods each year. These methods are:

- **Financial aid:** The maximum financial aid provided to a project does not exceed RMB 3 million
- **Subsidies for loan interest:** The amount of subsidy for loan interest is determined by the amount of loan granted to the project and the benchmark loan interest rate published by the People's Bank of China for the corresponding period. The term of the subsidy for loan interest does not exceed two years. The amount of subsidy for a single project cannot exceed RMB 3 million
- **Capital investment:** The fund also supports the establishment of Guiding Fund for SMEs, which are venture capital funds established by local governments. The capital

investment is routed through the Guiding Fund and the maximum investment provided to a project does not exceed 30% of the total amount of the Guiding Fund

6. Learning

- The SBA in USA operates as a single apex authority for SMEs. As an apex authority it plays a significant role in representing the voice of SMEs, facilitating finance and government contracts for SMEs. India does not have a similar institution that plays all of these roles as a single apex authority.
- The SBA's financial support includes its flagship guarantee programmes, policy for equity financing under the SBIC programme for licensing venture capital funds and co-investing in small businesses, and a programme of providing microloans to small intermediary community based lenders that in turn lend to small businesses. While India's guarantee programme needs significant scale up to meet the needs of a growing MSME sector, programmes equivalent to the SBIC programme and refinance to intermediary community lenders can be considered.
- While Germany also has an apex authority in the BMWi, it has a strong model of skilling and innovation & technical research that can be commercially applied by MSMEs. The BMO model in Germany leverages industry associations to provide a wide distribution reach for registration, certification and inspection of MSMEs. India has the opportunity to learn from the Mittelstand for its national skilling programme, draw on the Fraunhofer Society model for national institutions like the Council of Scientific and Industrial Research (CSIR) and the BMO model for expanding reach to its vast MSME sector.
- The receivables platform in Mexico, the One-Stop Shop (OSS) as a central facilitation centre in Egypt and the second loss structure under the credit risk compensation fund in China can be appropriately considered for adapting to the Indian context.
- Activities of the guarantee institutions, insurance agencies and the export import bank in different countries are similar to the roles performed by SIDBI, ECGC and Exim Bank in India. There is, however, a need to strengthen and scale up the existing institutions and programmes for MSME financing in India.

In summary, across countries, the MSME sector has thrived primarily on the back of access to financing through various facilities such as government-backed guarantees, credit insurance for export oriented units and schemes for equity financing. These facilities are supplemented by institutional infrastructure for advocacy, technical research, refinancing platforms and easy access to services.

6. Administrative structure for MSMEs in India

MSMEs have always been one of the focus areas for the government and this has been reflected in the various measures taken, bodies created and schemes launched for MSMEs in India. The scale of the MSME sector in India is vast, and there are several programmes and schemes created by the central government under the Ministry of Micro, Small and Medium Enterprises, specialist institutions like the Small Industries Development Bank of India (SIDBI) and various schemes created by individual states.

1. Ministry of Micro, Small and Medium Enterprises

The role of the Ministry of MSME and its organizations is to assist the states in their efforts to encourage entrepreneurship, employment and livelihood opportunities and enhance the competitiveness of MSMEs. The schemes/programmes undertaken by the Ministry and its organizations seek to facilitate/provide:

- Adequate flow of credit from financial institutions/banks
- Support for technology up gradation and modernization
- Integrated infrastructural facilities
- Modern testing facilities and quality certification
- Access to modern management practices
- Entrepreneurship development and skill up gradation through appropriate training facilities
- Support for product development, design intervention and packaging
- Welfare of artisans and workers
- Assistance for better access to domestic and export markets
- Cluster-wise measures to promote capacity-building and empowerment of the units and their collectives.

1.1 Administration and supervision

The Ministry of MSME has two divisions - the SME Wing and the Agro & Rural Industry Wing, which undertake activities pertaining to the administration and supervision of the MSME programmes in India.

SME Wing

The SME Wing is allocated the work, inter-alia, of administration, vigilance and administrative supervision of the National Small Industries Corporation (NSIC) Ltd., a public sector enterprise and the three autonomous national level entrepreneurship development/training organisations. The SME Wing is also responsible for implementation of the schemes relating to credit ratings fee sharing and assistance to training institutions, among others.

Agro & Rural Industry Wing (ARI Wing)

The ARI Wing looks after the administration of two statutory bodies viz. the Khadi and Village Industries Commission (KVIC) and Coir Board of India and a society called the Mahatma Gandhi Institute for Rural Industrialisation (MGIRI). It also supervises the implementation of the Prime Minister's Employment Generation Programme (PMEGP).

1.2 Implementation of schemes

The implementation of policies and various programmes/schemes for providing infrastructure and support services to MSMEs is undertaken through the Ministry's attached office, Office of the Development Commissioner (DCMSME), niche development institutions like the National Small Industries Corporation (NSIC), Khadi and Village Industries Commission (KVIC) and training institutions.

DCMSME

Office of the Development Commissioner (MSME), DCMSME, is an agency for advocacy, hand-holding and facilitation for the small industries sector. It provides a wide spectrum of services to the MSME sector. These include facilities for testing, training for entrepreneurship development, preparation of project and product profiles, technical and managerial consultancy, assistance for exports, pollution and energy audits etc. Specialised services for marketing development, international cooperation and export promotion are also available through a series of schemes and incentives. DCMSME provides economic information services and advises Government in policy formulation for the promotion and development of Small Scale Industries (SSIs). The field offices, called MSME-Development Institutes (MSME-DIs) also work as links between the Central and the State Governments. The MSME-DIs work towards the promotion of new enterprises, facilitating sustainability and growth in existing enterprises and enhancing skill development. There are currently 30 MSME-DIs and 30 branch MSME-DIs across the country.

2. State government institutions

2.1 District Industries Centre (DIC)

The DIC programme was started by the Union Government in 1978 with the objective of providing a focal point for promoting small, tiny, cottage and village industries in a particular area and to make available to them all necessary services and facilities at one place. The finances for setting up DICs in a state are contributed equally by the particular state government and the central government. The administration of DICs, however, is solely handled by the respective state governments. To facilitate the process of small enterprise development, DICs have been entrusted with most of the administrative and financial powers. For purpose of allotment of land, work sheds, raw materials, etc. DICs functions under the 'Directorate of Industries'. The DICs were set up with a goal of acting as the focal point of industrialization in the respective districts. The DICs are also the nodal registration agency within each district. All MSMEs are required to submit the Entrepreneurs' Memorandum 1 and 2 at their respective DICs for registration. However, there is no centralised mechanism to collate all this information and bring all these registration under a common, uniform authority.

2.2 Micro and Small Enterprises Facilitation Council (MSEFC)

The MSEFC was constituted under the MSMED Act, 2006 to resolve the delayed payment issue for micro and small enterprises (MSEs). In case of delay in payment beyond 45 days, MSE suppliers may approach MSEFC for dispute resolution. The MSMED Act stipulates that every reference made to MSEFC shall be decided within a period of 90 days from the date of making such a reference. The Committee observed that the objective of establishing MSEFCs has not been fully met due to lack of judicial powers or legal enforceability of their decisions. Where rulings of MSEFCs are not honoured by corporates MSMEs are faced with further cost of time and expenses in pursuing an appeal in courts and may choose to drop their claims altogether.

Besides these, there are several state-level schemes that vary from state to state. Information about these can be found in Annexure IV.

In summary, the support architecture for MSMEs has developed over several years and various institutions have been set up reflecting a strong desire to focus on development of the MSME sector. The Committee members observed that although an enabling infrastructure with a number of organisations and bodies at both central and state levels has been set up, the current structure has room for improvement. Despite the plethora of schemes sponsored by central and state governments, specialist institutions and niche development bodies, the collective impact has been less than desirable. The Committee members observed that there is low awareness of schemes among the target segments, a problem that is compounded by the multiplicity of programmes on offer. Having a large number of schemes also dilutes focus, spreads resources thin and increases the complexity of both delivery and administration.

7. Small Industries Development Bank of India

Set up on April 2, 1990 under an Act of Parliament, Small Industries Development Bank of India (SIDBI) is the apex financial Institution for the promotion, financing and development of Micro, Small & Medium Enterprises (MSMEs) and for Co-ordination of the functions of the institutions engaged in similar activities in India.

SIDBI provides financial support to MSMEs by way of (a) refinance and resource support through eligible Primary Lending Institutions (PLIs), such as, Banks, State Financial Corporations (SFCs) and other intermediaries for onward lending to MSMEs, (b) direct assistance to MSMEs, with focus on niche areas like risk capital/equity, sustainable finance for promoting energy efficiency and cleaner production, receivable financing, service sector financing, etc. and (c) Micro Finance through MFIs. Direct finance support to MSMEs is channelised through the Bank's network of 83 branch offices located all over the country. This is done using a wide range of financial products as well as non-financial services, with focus being on financial products for addressing gaps in the financing of MSMEs in the niche areas as described above.

The total MSME credit of SIDBI as on March 31, 2014 was ₹ 61,271 crore, with cumulative financial assistance provided by the Bank aggregating ₹ 3.37 lakh crore, benefiting more than 340 lakh units/persons. The Bank provides grant support towards Promotion and Development (P&D) of the MSME sector through specially designed programmes for promotion of micro enterprises, entrepreneurship development, skill upgradation, cluster development, etc. These P&D activities of the Bank have resulted in setting up of more than 1 lakh micro enterprises, benefitting over 4 lakh persons. Under its micro finance programme, SIDBI has cumulatively assisted over 140 micro finance institutions benefitting about 325 lakh disadvantaged people, mostly women.

SIDBI has also taken strategic initiatives for addressing various non-financial gaps for capacity building of the MSME sectors, as well as bankers. These activities include entrepreneurship promotion through a dedicated website www.smallb.in, Credit Advisory Services, Loan Facilitation, capacity building of banks, particularly Regional Rural Banks towards micro enterprise lending, etc.

In addition to its direct and indirect operations, SIDBI also plays a nodal agency role in implementation of various schemes for MSME sector undertaken by the Government of India (GoI), viz. Credit Linked Capital Subsidy Scheme (CLCSS), Technology Upgradation Fund Scheme for Textile Industry (TUFS), Integrated Development of Leather Sector Scheme (IDLSS), Scheme of Technology Upgradation / Setting up / Modernisation / Expansion of Food Processing Industries (FPTUFS) and Technology and Quality Upgradation (TEQUP) Scheme to encourage MSMEs in adopting modern/energy efficient technologies.

SIDBI has also provided institutional mechanisms to cater to the emerging needs of the MSME sector by setting up subsidiaries / associates viz. SIDBI Venture Capital Limited, Credit Guarantee Fund Trust for Micro and Small Enterprises, India SME Technology Services Limited, SME Rating Agency of India Ltd. and India SME Asset Reconstruction Company Ltd. It is also a co-promoter of two factoring companies established by commercial banks for establishing and spread of factoring business in India.

Key financial highlights at March 31, 2014

- Outstanding portfolio size: ₹ 61,271 crore, including refinance of ₹ 39,000 crore
- Total income (2013-14): ₹ 5,808 crore
- Profit after tax (2013-14): ₹ 1,118 crore
- Net non-performing assets: 0.45%
- Cumulative disbursements: ₹ 3.37 lakh crore
- Capital and reserves: ₹ 7,991 crore

Recommendation

The outstanding refinance of about ₹ 39,000 crore constitutes about 4% of outstanding bank credit to MSMEs (₹ 10.3 lakh crore). Considering a 25% increase in credit to account for economic growth, the outstanding bank credit to MSMEs would increase by three times over five years (by 2019). Assuming the same level of refinance penetration, SIDBI's refinance portfolio would need to grow to three times the current outstanding to about ₹ 1,20,000 crore, an increase of ₹ 80,000 crore or about ₹ 16,000 crore per year over the next five years. To achieve this, SIDBI's capital and funding base would need to be increased appropriately.

8. Improving administrative structure to facilitate ease of doing business

Ease of doing business encompasses the ease of starting a business, ease of complying with the stipulated norms and the ease of resolution and rehabilitation. Indian business does face challenges in this area and the Government of India is focusing on this aspect. The Honourable Prime Minister has set a target of moving to a rank above 50 in the global Ease of Doing Business rankings from our existing rank of 142.

The challenges faced by businesses in general are accentuated in the case of MSMEs given their lower capacity to manage compliance & the costs associated with the same. While discussions with various stakeholders have reiterated the difficulties MSMEs face in each life stage as stated above, the Committee has focused on the issue of complexity in registration which results in a vast informal sector. The Committee believes that this aspect is most relevant in the context of access to finance.

The Committee has received feedback that MSMEs currently avoid formalisation due to the high compliance cost associated with it. Efforts have been made in the past to simplify the MSME registration forms. However, the feedback received is that the process continues to be complex and can delay the registration.

As per the Ministry of MSME's Annual Report for 2013-14, about 95% of MSMEs are unregistered. The key implications of the vast number of unregistered MSMEs are set out below:

- The coverage of various government schemes & benefits is constrained;
- Data about the MSME sector is incomplete and subject to wide ranges and estimation, which poses a challenge for targeted interventions;
- The non-formalisation of MSMEs poses a challenge for access to credit and outreach by the financial sector; and
- Most importantly, this constrains economic growth.

The Committee noted that registration is currently facilitated through DICs through an online application form in several states which allow for a two stage registration process, as indicated in Annexure V. The DCMSME has operationalised a national portal for online registration of MSMEs through the DICs, which is planned to be horizontally linked with other departments of the state government for goods and services tax (GST), value added tax (VAT), power utilities, pollution control, etc. There is also a portal that is being developed under Department of Industrial Policy & Promotion (DIPP), Ministry of Commerce & Industry, to centralise a number of services under a single umbrella. The DCMSME portal should also be integrated with the E-Biz portal of DIPP.

While initiatives are in progress under the existing administrative structure, there is a need to simplify and extend distribution reach and achieve coordination between entities at central and state level through a single point registration interface. For this purpose the Committee recommends the setting up of a National MSME portal and central registry to integrate and centralise the online registration process and as explained in subsequent paragraphs extend the same application for a wide range of registrations and certifications to facilitate access to services for an MSME. As the services envisaged to be offered under the DIPP E-Biz portal are rolled out, there is a need to ensure that these services are made accessible under the proposed National MSME portal. The Ministry of MSME may coordinate with various departments to ensure simplification of various registration requirements like the environmental clearances. This will be an extension of the role being played by DCMSME for its national portal for online registration.

There is a need for an autonomous institution to build the linkages required for such a central registry to operate, create an efficient network of multiple stakeholders for supporting the MSMEs, operate as a single go-to repository for policies, benefits & information relevant to MSMEs that are currently dispersed at central and state levels, play an advocacy role for MSMEs, focus on capacity building and at the same time serve as a research and think tank for policy making. The DCMSME is currently mandated with several of these roles under the Ministry of MSME. The purpose of an autonomous institution could be achieved by elevating the role of an existing office, the DCMSME, with augmented authority as described in this chapter or by creating a new entity with the requisite authority and stature to work across silos.

The Committee recommends the following strategy to improve the ease of doing business:

1. Establishment of National MSME Authority, under the Ministry of MSME, as an apex authority for MSME sector

The multiplicity of schemes run by the central government as well as the state governments, limited information available on the same and the lack of awareness amongst MSMEs, along with the complex registration process, has created the need for a dedicated apex body to handle registration of enterprises. To ensure a single point resource centre which will be a nodal agency to execute and administer programs, benefits & grievance redressal, facilitate ease of doing business, registration & inclusion and to design policy and implement the series of measures articulated in this report, there is a need for an apex authority to be established. It is proposed that a National MSME Authority be established under the aegis of the Ministry of MSME by elevating the role of the DCMSME or by combining the office with the proposed National MSME Authority**.** This body can also coordinate with existing agencies like SIDBI on various equity finance, guarantees & financial assistance programmes and create a connecting bridge between the authorities, various institutions/platforms and MSMEs. It can also work to enhance ease of doing business for MSMEs, undertake advocacy, provide assistance and advisory services and make available a grievance redressal mechanism to MSMEs. Such an organization can act as a nodal registration point, aggregator and harmoniser of schemes and programmes and a helpdesk for MSMEs.

The Ministry of MSME has been rolling out a programme of an online registry system at a state level. This online initiative includes information for the Entrepreneur's Memorandum I (EM I) and EM II forms but does not yet have the provision of opening bank accounts, as envisaged in the Committee's recommendations. The DIPP is also working on a portal, Ebiz, for business friendly services with plans to provide of several services online. The Committee suggests that the proposed Authority should aggregate and expand the work that has already been done by the Ministry of MSME and leverage the work done under DIPP. The Authority can establish and administer a National MSME Portal for providing a unified registration/facilitation service to MSMEs. The portal can act as the aggregator for the various state government and departmental portals lending service to the MSME sector.

To promote registration, the National MSME Authority may work with various industry associations to devise strategies for achieving universal registration. The National MSME Authority would also be responsible for building seamless linkages with other relevant departments/ authorities to ensure issuance of the requisite registration numbers linked to the proposed unique business identifier, an Udyog Aadhar. The National MSME Authority would also coordinate with appropriate agencies on the equity and guarantee programmes funded by the government.

The following roles are envisaged for the proposed National MSME Authority:

1.1 Establish linkages with other platforms

The Committee recognizes that various approvals to set up and operate businesses fall within the domain of the state/ local governments. The National MSME Authority could explore mechanisms to link the same to the above registration, simplify the submissions required and create time-bound approval procedures. The above linkages should ensure that all application, registration & approval process are online and straight-through, and should have transactional as opposed to merely informational functionality. The experience of the One-Stop Shop (OSS) in Egypt, described earlier in this report, could be used to create facilitation centres at the appropriate level and/ or revitalize existing mechanisms intended to achieve the same purpose. Indeed, India has the opportunity to leverage technology to create an OSS model that is entirely online.

The National MSME Authority would also establish linkages between the portal and the credit providers and guarantee/ insurance providers as well as the proposed receivables financing platform, such that the registration on the portal and the linked bank account are universally used in all transactions.

To further enhance ease of doing business and to expand its own distribution reach it is suggested that National MSME Authority could undertake accreditation of agencies and involve accredited third-party agencies including industry associations in certification and inspection of MSMEs similar to the Business Membership Organisation (BMO) model in Germany.

1.2 Focus on advocacy & capacity building

The National MSME Authority would undertake advocacy efforts for the MSME sector, including policy inputs and suggestions for schemes and process changes to enhance ease of doing business and access to enablers such as finance. The National MSME Authority can act as a repository for information relevant to MSMEs. This will include information pertaining to existing MSME schemes, rules and regulations that they are expected to comply with and any proposed policy changes. The Authority can also ensure information dissemination amongst MSMEs about the various schemes launched for their welfare. At the same time, the National MSME Authority can also provide assistance to MSMEs to make adequate use of these government schemes. This can involve training and support in documentation.

By leveraging the national skilling initiative which has a national target of skilling/ up-skilling 500 million people by 2022 of which National Skill Development Corporation (NSDC) has a target of skilling/ up-skilling 150 million people, the authority can run programmes focused on MSME needs. The skilling institutes will not only involve training of individuals but will also grow as MSME enterprises in themselves.

Council for Scientific and Industrial Research (CSIR) is a premier national research and development organization which is among the world's largest publicly funded research organisations involved in pioneering sustained contributions to science and technology. The goals of CSIR, with focus on primary research and innovation, can be utilized to the benefit of MSMEs. The Authority can collaborate with CSIR to make available research grants and necessary technical expertise to designated research institutions to perform high-quality research and development, specifically for MSMEs. The approach can draw from the Fraunhofer Society model in Germany, where funding is received from a mix of private and public sources. Like the Fraunhofer Society, the focus should be on undertaking research activities that are application oriented. The designated research institutions should be made accountable for delivering tangible results and innovations that can be commercialized for use by MSMEs in short time.

The Authority could also examine ways of assisting MSMEs with dealing with direct & indirect taxes, including working with tax authorities to develop an advance rulings framework.

1.3 Grievance redressal forum

There is no existing forum which can provide a unified grievance redressal mechanism for MSMEs. The proposed Authority can act as a single line of command for resolution of all issues pertaining to MSMEs. Since the body is expected to establish linkages with other platforms and facilities for MSME, it is an ideal location for placing the MSME grievance redressal forum. The complaints so received can be aggregated and utilised for big data analytics on the collated data to determine critical systemic issues that require reform.

2. Universalisation of registration & access to basic banking

The Ministry of MSME can coordinate the simplification of registration and linkages to other departments/ministries. The proposed National MSME Portal can then require only a simple one-page registration form for MSMEs with a simplified set of information and documents. With the growing penetration of mobile phones in the country and the incremental usage of data services on mobile devices, this portal should also be easily accessible through mobile platforms. The Committee envisages that such an approach can achieve 95% registration amongst MSMEs in a time frame of six months.

2.1 Registration/ facilitation

The present registration process requires application in EM I and EM II forms as described in Annexure V. The major issue lies not with the registration process as per the MSMED Act, 2006, but with the conditions applied by the local DICs. There are localised rules and requirements which could vary even from district to district within the same state, which may result in delays in receiving the EM II acknowledgement. The Committee suggests the following measures to minimise such delays:

- Deemed acceptance of registration (EM II) within pre-defined time-frame. This could be a time period of one week from the filing of the online registration form. Since the form is proposed to enclose a self-declaration clause, all requisite verification can be done by the DICs subsequent to acceptance
- Since procedures like land allotment which are under the state government entail collection of information, it is suggested that no conditions should be imposed by the state government/DICs for acceptance of registration
- The requirement of a no-objection certificate with relation to pollution norms can be discontinued. This activity is already being carried out by the Pollution Control Department and the self-declaration by the MSME can be suitably worded to cover this aspect. If necessary, a negative list for industries where pollution certificate is required may be prepared.

A mobile application with an easy-to-use interface should be used to augment the registration process. Registration can be encouraged by providing incentives for registering with the Authority which could include benefits such as insurance for a nominal fee or free of cost, credit ratings for MSMEs at low rates and tax holiday for a limited time period.

It may be useful have a basic form such that 95% of MSMEs including most micro enterprises are eligible for a single-form based basic registration/facilitation and a full form is needed only for the remaining 5% of MSMEs. Even for these 5% MSMEs, the form should be simplified and based on self-certification with follow on validation by industry associations certified by the Authority on the lines of the BMO model in Germany, as detailed later in this chapter. The facility can be extended to have the ability to open a bank account entirely online using eKYC (electronic validation of KYC requirement).

The proposed one-page registration form would constitute a self-declaration format under which the MSME will self-certify its existence, bank account details, promoter/ owner's Aadhar details and other minimum basic information required. Based on the same, the MSME can then be issued online, at a minimum, a unique identifier, or Udyog Aadhar; a Permanent Account Number (PAN) and Tax Assessment Number (TAN); and Employees' Provident Fund Organisation (EPFO) registration and Employees' State Insurance Corporation (ESIC) registration, if applicable. The same should be issued online on a time-bound basis. For certain aspects like labour, where self-declaration may not be the best approach for all sizes of firms, it can be permitted depending on the number of employees in the firm. Information required in such a sample registration form is given in Annexure VI.

2.2 Certification and inspection

The Committee suggests a model under which accredited third party agencies including industry associations could be involved in certification and inspections for MSMEs in their respective industries. This is similar to the model followed in Germany where Business Membership Organizations (BMOs) are the industry associations responsible for registration. It is suggested that the National MSME Authority could undertake accreditation of industry bodies similar to the BMO model. The model should leverage technology to minimise or avoid inspectors and use proxies like electricity consumption to validate declarations made at the time of registration.

2.3 Universal access to a bank account

It is envisaged that, given the strong momentum in universal financial inclusion being achieved by the Pradhan Mantri Jan Dhan Yojana (PMJDY), targeting universal access to a business banking account in a time bound period is a feasible goal. For any MSME that does not have a bank account, the above registration should be used to ensure that every registered MSME has a bank account. The bank account should be linked to the Udyog Aadhar. The Udyog Aadhar and bank account together can then be used to track the MSME's payment record in credit & payment bureaus and linked to the receivables financing platform discussed earlier. This account can also be used for payments under various government schemes like subsidies, grants, credit and other benefits which can flow into this account as a direct benefit transfer (DBT) for small business. The proposed registration incentives like free insurance for MSMEs can be linked to this bank account, similar to the benefits given under the PMJDY.

The above approach would help in integrating more MSMEs into the formal registered ecosystem, thereby significantly enhancing their "visibility" to the formal financial ecosystem and enable measurement in national economic statistics. This formalisation of the micro and small businesses could substantially enhance their ability to get credit and get access to guarantees and other benefit schemes targeted at MSMEs. It would also enable the government to formulate targeted interventions to promote & assist MSMEs by creating a rich database that could serve as the basis of policy-making.

3. Widening reach for specific regions/marginalised sections

The Committee envisages that its proposals - universal registration & financial inclusion of MSMEs (including leveraging the momentum in financial inclusion demonstrated by the Pradhan Mantri Jan Dhan Yojana); enhancing credit guarantee & insurance platforms; technology-enabling various processes; having a diverse set of institutional financial intermediaries; and using existing traditional sources of credit outside the institutional financial sector for outreach - should broaden and deepen coverage of MSMEs as a whole and substantially address concerns of exclusion of any region or section. The above architecture may be leveraged by Central & State Governments for further specific measures, including financial incentives, for specific regions/ sections. Contribution by banks to Rural Infrastructure Development Fund (RIDF) arising from the shortfall in meeting weaker section lending targets should be identified and allocated as a separate corpus for funding credit growth for weaker sections. Such credit could be at a concessional rate.

The Authority can also provide the necessary guidance and procedural help to MSMEs in applying for and obtaining government contracts, particularly to MSMEs belonging to marginalised regions/sections of our country. This will ensure balanced MSME development across regions and amongst all groups.

4. Other measures to enhance ease of doing business for MSMEs

MSMEs such as self-employed persons and small businesses are typically subject to unlimited liability. While MSMEs require the benefit of limited liability as available to companies, the related procedural requirements for compliance are a deterrent to adopt a corporate structure. The Companies Act, 2013 has provisions for the incorporation of One Person Company and Small Company however the required compliance may not be feasible for all MSMEs. The Limited Liability Partnership (LLP) Act, 2008 facilitates limited liability for partnerships but may not be suitable for all enterprises.

- **Simplified compliance requirements:** The LLP Act, 2008 was implemented with the objective of permitting partnership firms (firms having at least two members) to be free of individual partner liabilities. This statute allows partnerships to follow simpler compliance requirements with respect to maintenance of books of accounts, audit of accounts, disclosure of financial information and regulatory filings. Section 34 to 38 of the LLP Act read with Rules 24, 25 and 27 deal with the disclosure requirements for LLPs. Similar reduced compliance requirements could be made available to a One Person Company or a Small Company.
- **Presumptive taxation:** To give relief to small taxpayers under the Sections 44AD, 44AE and 44AF Income Tax Act, 1961 individuals, Hindu Undivided Families, sole proprietors and partnerships in certain businesses are eligible for a presumptive taxation scheme. If the turnover is upto a certain limit (cap for a business was ₹ 1.0 crore in 2012-2013), such entities can declare their taxable income at a flat rate (eg. 8% of turnover for certain businesses) without need to maintain audited books of accounts subject to eligibility. This scheme could be made available for One Person Companies, Small Companies and LLPs.
- **Simplified dissolution:** The LLP Act has provisions for easier winding up and dissolution of LLPs. Section 63 to 65 of the LLP Act read with Limited Liability Partnership (Winding up and Dissolution) Rules, 2012 deal with these issues. Similar, easier winding up and dissolution provisions can be provided to One Person Companies and Small Companies. Further, sections relating to revival and rehabilitation of sick companies in the Companies Act may be suitably amended so as to provide for special benches for dealing with cases for MSMEs.

It is suggested that necessary modifications in the Companies Act, LLP Act and the Income Tax Act can be undertaken to specifically facilitate MSMEs registered as One Person Company, Small Company or LLPs to obtain benefits of simplified compliance, presumptive taxation and simplified dissolution.

In summary, the Committee envisages a time-bound programme for universalization of MSME registration to bring them into the formal or organized economy, enhance the coverage of government schemes and facilitate outreach to MSMEs. The proposed National MSME Authority would be responsible for these areas and also act as a nodal agency to ease business procedures for MSMEs. Using the Udyog Aadhar and bank account, the National MSME Portal would link/ identify MSMEs for the purpose of (i) credit guarantee & insurance schemes (ii) other government benefits (iii) requisite central, state & local approvals for setting up & operating businesses (iv) credit bureaus (v) an effective receivables financing platform (discussed in this report) (vi) financial intermediaries. All these entities/ schemes would leverage the formalisation of MSMEs achieved through the Udyog Aadhar and bank account, including the benefits which can flow into this account as a direct benefit transfer (DBT) for small business, to enhance outreach. In due course, technology & connectivity should be leveraged to bring these processes online and straight through as far as possible. This would be in consonance with the Government's vision of a Digital India. Appropriate changes in statutes would encourage MSMEs to gain the benefit of limited liability by adopting suitable legal structures.

9. Equity financing

1. Need for equity financing

While MSMEs face challenges in accessing credit, they may also lack awareness of equity as an alternate source of financing. The nascent financing requirements for a start-up are met by informal financing from friends and family. Such seed money invested in a small business is in the nature of equity but is not formally recognised as such in MSMEs without a formal legal structure.

Even for start-ups that are more aware, the creation of a formalised venture often requires the aid of incubators and angel investors that provide financing and other services. Further scale-up then requires higher amount of capital, which is typically provided by venture capital funds. Apart from equity capital, the venture also needs debt for working capital.

Access to equity financing has been examined in detail in the Report of the Committee on Angel Investment and Early Stage Venture Capital (Mitra Committee), June 2012. The key issues are related to differential taxation of investments, and the need for certain enablers to expand the availability of equity capital for early stage companies.

2. Global experience in equity financing

2.1 USA

- Many states give tax write-offs for angel investments up to USD 500,000 in startups
- Small Business Investment Company (SBIC) under the SBA operates as a fund of funds
    - Invests up to 75% in a downstream venture capital (VC) funds' capital, subject to a maximum of USD 108 million
    - SBIC as at September 30, 2013 managed almost USD 20 billion in private capital and SBA guaranteed leverage and commitments

2.2 Israel

The government of Israel has directly funded incubators as well as venture funds, while also creating an environment conducive for entrepreneurship. Key government initiatives include:

- Public private partnerships with incubators to focus on domestic capacity building, for products manufactured in Israel. Programme created 1,600 companies in a decade with the government funding leveraged six fold by funding from private sources

- Access to capital for VCs from pension funds, endowment funds, corporate or strategic investors and high net-worth individuals
- Under Absorption Law, government absorbs a percentage of the losses that institutional investors might suffer from VC investments
- Lower company tax of 10% for priority areas compared to 15% for other areas
- Post incubation support through government R&D programmes
- Grants to Research & Development (R&D) centres that employ high salary staff

The government also set up a fund, YOZMA, to invest directly and also to operate as a fund of funds. Its objective was to promote technology initiatives and involvement of private venture capital in the Israeli technological sector. It can take up to 40% of the total fund size and has invested more than USD 200 million. It has led to 164 start-ups receiving funding, more than 50 per cent successful exits and original funds bought out or privatized within five years.

2.3 United Kingdom

The United Kingdom has two major schemes for start-ups, Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS). EIS was launched in 1994 and SEIS in April 2012. The basic features of both schemes are the same with differing quantum of tax reliefs. While EIS caters to slightly mature companies which are funded by VCs, SEIS caters to early stage companies which are usually funded by angel investors. Income tax payers can invest in start-up companies and receive the following tax reliefs:

- Income tax relief in the tax year of investment (30% relief for investments under EIS with maximum annual investment of GBP 1 million and 50% relief for investments under SEIS with maximum annual investment of GBP 100,000)
- Any gains upon realisation are free of capital gains tax as long as shares are held for a minimum of three years. For sale before the expiry of three year period, no capital gains tax is applicable in case the money is re-invested in a similar EIS/SEIS eligible company
- Investors can claim losses on investment up to a certain limit

From its launch in 1994 till December 2013, EIS had benefited over 20,000 companies with fund raising of over GBP 9.7 billion.
(Report of the Committee on Angel Investment & Early Stage Venture Capital: http://planningcommission.nic.in/reports/genrep/rep_eco2708.pdf)

2.4 Turkey

The Turkey Treasury has started a system for accrediting business angels. This is done by the Financial Markets Regulatory Department of the Treasury. Angels are allowed to deduct

75 per cent of their investments from income tax. There is also a joint mutual funds system, which is run by the government, which can match investments made by business angels.

3. Recommendations for improving access to capital for startups/ SMEs

3.1 Equity finance fund

The government had announced a ₹ 10,000 crore fund in the Union Budget 2014. If the initial corpus of ₹ 10,000 crore is funded by the government additional contribution can be mobilised from private and institutional sources increasing the pool available for investment. It is thus necessary to leverage this corpus to mobilise additional funding from private/other sources spread across the different components of the early stage entrepreneurial ecosystem such as incubators, angel investor groups and venture capital investors. Further, assuming a debt-equity ratio of 3:1, including equity from the fund and debt raised from other sources MSMEs would have access to capital that is multiple times the size of the fund itself. The asset intensive manufacturing firms are generally not serviced by angels and VCs. This government fund can also be leveraged to provide equity funding to manufacturing MSMEs.

The government would need to operationalise this fund at the earliest.

3.2 Promote equity investment by angel investors/venture funds

There is a need to recognise and incentivise early stage investor classes by a system for recognition/accreditation of angel investors. Qualified investors, as may be determined by regulatory authorities, including high net-worth individuals (HNIs), corporates and other investors in such early stage funds could be given incentives. The incentives could include tax credits, tax pass through limited liability partnerships structures, etc. for angel investors. They can also be provided tax incentives similar to the ones given in UK, including 50% tax rebate for investments up to ₹ 1.0 crore, no capital gains tax where investment is for a minimum period of three years and provision to claim loss on investment up to a certain limit.

To promote domestic investment, the government may permit & encourage pension funds, insurance companies and banks to invest a small part of their corpus in early stage VC funds to encourage domestic funding and introduce a level playing field for domestic equity financing as compared to foreign investors at the stage of investment, and as compared to mutual funds and listed equity on the treatment of capital gains by rationalising the tax structure.

Addressing anomalies in Section 56(2)(viib) of Income Tax Act: Under Section 56 (2)(viib) of the Income Tax Act, which deals with the consideration received by a company (not being a company in which the public are substantially interested) from any person being a resident, for issue of shares that exceeds the fair market value of the shares in the case of equity investment, the premium above fair market value is treated as income of the investee company and is taxable. A venture capital undertaking in the nature of a start up or early stage company usually has no revenues or profits at the point of time it is sourcing capital from financial/angel/VC investors. Therefore, it is very difficult to determine the fair market value of such a company's shares using conventional accounting / valuation methodologies which are typically based on revenue and profit streams of a company. Typically in such transactions, valuations are based largely on parameters other than accounting parameters. However, from a tax accounting perspective due to the aforementioned complexity, the book value of the shares is typically used as the default fair market value. Consequently, by virtue of Section 56(2)(viib), a large proportion of the capital invested by financial/angel/VC investors in such start up or early stage companies becomes liable for taxation under the head 'income from other sources' in the hands of the company. This provision applies only to domestic investors and not to foreign investors resulting in low domestic investment in funds due to differential tax laws for domestic and overseas investors. With the promulgation of the SEBI Alternative Investment Fund (AIF) Regulation, 2012, VC and private equity (PE) funds are now categorised under various categories of AIFs. Accordingly, venture capital funds form just one sub-category amongst various sub-categories of AIFs thereby resulting in other categories and sub-categories of AIFs attracting taxation under the provisions of Section 56(2)(viib).

It is, therefore, recommended that the current exemption under Section 56(2)(viib) of the Act which is applicable in respect of investments received by a venture capital undertaking from a venture capital company or a venture capital fund be extended to:

- Resident financial/angel/VC investors with appropriate carve outs, by way of checks and balances, in respect of promoters and their relatives so as to prevent any "tax avoidance" scenario and
- All other sub-categories of Category I and Category II AIFs

Tax pass-through for VC/PE Funds: VC and PE funds operate as limited life entities and complete tax-pass through status is essential for efficient fund operations and smooth closure of funds on completion of fund life. While such situation existed in earlier years after introduction of Venture Capital Guidelines by SEBI, there have been multiple changes in such status thereafter, affecting all fund managers in India investing in equity of MSME as VC or PE funds. Currently pass through status is available only to Alternative Investment Funds in Category –I (sub category Venture Capital Funds) and that too is limited to only investment income, whereas Funds necessarily receive non-investment in various forms as part of their operations, including income on funds in hand before investment is made or after exits and before distribution of proceeds.

There is a need to bring in more clarity on the "tax pass through status" for all categories of Venture Capital Funds and VCFs incorporated as Trusts by providing the benefit of Section 10(23FB) of the Income Tax i.e. tax pass through status to other categories of Venture Capital Funds and also Venture Capital Funds incorporated as Trusts to:

- Category I – SME Fund, Social Fund, Infrastructure Fund
- Category II – Private Equity and Debt Funds

The rationale of including Category II – Private Equity, herein is due to the fact that, Category I is very restricted category and very few funds register under this category as the investment opportunities may not be readily available and they are only for Social, Infra and SME Sector. Category II is the residual category of AIF which inter-alia includes Private Equity and Debt Funds. Private Equity Funds in Category II are primarily sector agnostic funds which provide growth capital including those in MSME and are much needed like an angel investment. Also, the exemption is only for a Trust and the income is ultimately being taxed in the hands of Investor, so there is no loss to the Government exchequer. But if this is accepted, it will bring lot of positive impact in PE investments.

The government may provide benefit of tax-pass through under 10(23)(f)(b) of Income Tax Act on all forms of income for all categories of funds registered with SEBI as AIF in Category I and II.

The government may also introduce a provision for Special Purpose Vehicle (SPV) to allow a group of angel investors to come together as an SPV and then invest in start-ups. Even though angel investments are generally in a group, there is no provision to create an SPV for the same, so all individuals have to invest separately, leading to a large number of shareholders, which becomes an impediment for raising further funding from institutional investors.

Further, at the time of exit the same capital gains tax regime may be provided for investments by angel groups and VC funds as is provided to mutual funds which invest in companies listed on stock exchanges.

3.3 Establish expeditious procedures for closing of businesses

Many of the start-ups fail and need to fold up efficiently and quickly to arrest losses and limit liabilities. To ensure that this is not a discouraging factor for starting and investing in risky but innovative enterprises, the process of closing a business needs to be made more logical and smooth for businesses. The energies of entrepreneurs & investors should not be dissipated in closing a business but rather focused on creating the next one. The Ministry of MSME has released draft guidelines for the same. The use of "One person company" with simplified compliances, limited liability at exit and an easy exit & bankruptcy policy could be examined.

10. Receivables financing

1. Need for receivables financing

A significant part of the working capital requirement of an MSME arises due to long receivables realization cycles. This is one of the leading causes of mortality in the sector during the downturn in business cycles. Hence, there is a need to formulate and implement corrective and supportive policies for the benefit of the MSME sector. Bill/ invoice discounting facilities are availed by MSMEs from their bankers. The banks provide the same based on their internal credit policy and documentation process which involves physical movement of documents. Such process leads to delay and also has an element of fraud risk involved in it.

2. Current initiatives

2.1 Initiatives by SIDBI

Through the MSME receivable finance scheme (MSME-RFS), SIDBI covers discounting of bills/ invoices arising out of sale of goods/ services provided by MSMEs. Under the scheme, transactions are backed by simple exchange of letters between SIDBI and the purchaser corporate and are largely unsecured. Discounting is done based on annual limits that are considered by the bank, within which the bills/ invoices are discounted and these limits relate to the outstanding face value of bills/ invoices discounted (and not aggregate face value of bills/ invoices discounted in a year. This scheme was further made available in the Trade Receivables E-Discounting Engine (NTREES) platform run by SIDBI and National Stock Exchange (NSE).

2.2 Government initiatives

- Delayed Payments Act 1993 was passed providing for payment of interest on delayed payments by the corporate linked to State Bank of India (SBI) rate. With the enactment of MSMED Act in 2006, the relevant provisions were incorporated therein.
- Interest payments made by corporates on delayed payments were not allowed as permissible expenses under the Income Tax Rules
- A legislation was passed in 2011 to create the legal framework for factoring services and establishment of a guarantee fund for covering MSME debts factored by the factoring companies.

3. Recent developments

3.1 NTREES

On the lines of NAFIN, SIDBI has set up an E-discounting platform for MSME receivables, in collaboration with NSE. The platform has been named NTREES. The platform is designed based on NAFIN for bidding of MSME receivables and was envisaged to be implemented in three phases.

- Phase I through single banking arrangement
- Phase II through multi banking (MSME linkage with corporate restricted to single financier)
- Phase III through full-fledged operations as exchange where bidding by MSMEs would be possible across multiple financiers, thereby also leading to price discovery (i.e. the most competitive discount rate)

Presently, Phase I of the platform through single banking arrangement (with only SIDBI as a financier) is operational. Under the scheme presently there are 3 large corporates and approximately 100 MSMEs which have availed the scheme benefits with outstanding of about ₹ 102 crore (annualised volume of ₹ 420 crore).

While the platform is five years old, it has not scaled up due to operational constraints. It is expected that this would be addressed under the proposed Trade Receivables Discounting System (TReDS) as discussed below.

3.2 Trade Receivables Discounting System (TReDS)

In December 2014, RBI published final guidelines for setting up of and operating TReDS for facilitating financing of trade receivables of MSMEs from corporate and other buyers, including government departments and public sector undertakings (PSUs) through multiple financiers. The detailed guidelines are available on the RBI website.
(http://rbidocs.rbi.org.in/rdocs/Content/PDFs/TREDSG031214.pdf)

The Committee believes that this is a major step in further assistance to the MSME sector and could be leveraged as a key tool in the new financial architecture. A scale-up in TReDS could also lower the requirement for enhancing the corpus for providing guarantees to MSMEs in India. The salient features are summarised in the following paragraphs.

The TReDS platform will facilitate the discounting of both invoices as well as bills of exchange. It deals with both receivables factoring as well as reverse factoring so that higher transaction volumes come into the system and facilitate better pricing. The transactions processed will be 'without recourse' to the MSMEs.

A few eligibility criteria for entities desirous of setting up and operating the platform includes a minimum paid up equity capital of ₹ 25 crore; entities, other than promoters, are not permitted to have shareholding in excess of 10%; and it should have a suitable Business Continuity Plan including a disaster recovery site.

There will be a standardised one-time mechanism/ process for on-boarding of buyers and sellers on the platform by submitting all Know Your Customer (KYC) related documents along with documents specific to authorised personnel of the buyer and the MSME seller. A one-time agreement will be drawn up amongst the participants. The trigger settlement between financier and MSME for accepted bids will be on T+2 basis (T being the date of bid acceptance); and between the buyer and the ultimate financier on the due date.

The first phase facilitates discounting of factoring units by the financiers resulting in a final payment being made by the buyer to the financier on due date. In the second phase, the platform would enable further discounting/ re-discounting of the discounted factoring units by the financiers, thus resulting in its assignment in favour of other financiers.

Process flow

- Creation of 'factoring unit' by MSME seller and subsequent logging on to TReDS by the buyer to flag it as 'accepted'. In case of reverse factoring, this process is initiated by the buyer
- Uploading supporting documents in accordance with check-list of acceptable documents indicated in TReDS
- Standardised time window available for buyers to 'accept' the factoring units
- Each factoring unit to carry details such as details of the seller and the buyer, issue date, due date, tenor, balance tenor, amount due, unique identification number generated by TReDS, account details of seller for financier's reference, account details of buyer; and the underlying commodity (or service if enabled)
- Automatic generation of a notice/ advice to the buyer's bank informing them of such units
- The all-in-cost quoted by the financier can only be viewed by the MSME seller and not available for other financiers
- Financiers can freely determine the time-validity of their bid price. Once accepted by the MSME seller, there is no option for financiers to revise their bids
- On acceptance, the factoring unit gets tagged as 'financed' and funds will be credited to the seller's account by the financier on T+2 basis
- Non-payment by the buyer on due date to their banker will be outside the purview of TReDS
- These instruments may be rated by TReDS on the basis of external rating of the buyer, its credit history, the nature of the underlying instrument, previous instances of delays or defaults by the buyer with respect to transactions on TReDS, etc.

The rated instruments may then be further transacted/ discounted amongst the financiers in the secondary segment.

4. Recommendations

The Committee notes that operating guidelines for TReDS would follow in due course. In order to establish a robust receivable discounting environment, the following recommendations may be considered while drafting the operating guidelines:

- Mandatory registration of corporate and government institutions above a certain turnover to be accompanied by penal provisions/incentives which could include tax benefit schemes for corporate and government institutions
- Incentives can be provided to financiers for undertaking non-recourse transactions where corporate buyer is not a well rated entity
- Deemed acceptance/rejection of invoices uploaded by MSME by the corporate within 15 days of upload. Corporate can also upload invoices raised by MSME suppliers
- Fixed maturity date for payment of each invoice
- Scheme to be made available only to registered MSMEs
- Payments from the large corporates to MSMEs registered and processed only under the receivables platform
- All bills to go through the receivables exchange; encourage corporates and public sector units to accept and pay bills through the platform
- Scope for electronic recognition of goods delivery – excise payment to be a trigger to initiate an automatic invoice
- Link online bill acceptance and payment data from TReDS with mandatory reporting to credit bureaus for an online payment history and payment rating
- Scope for national registry of invoices may be begun. This will be a game changer as unified template for invoice will enable easier digitisation and electronic flow across stakeholders and will make TReDS an efficient platform
- KYC of MSMEs registered with TReDS should be deemed recognition of MSME status for Corporates – this is essential as a corporate would not be able to escape penalty for delayed payment on the plea that they do not know the status of MSMEs at all

5. Legal provisions

It is important that the TReDS mechanism is accompanied by a sound legal framework for effective implementation, in addition to other operational changes. The TReDS framework contemplates two possible modules - one each for negotiation and assignment of bills of exchange and invoices. Appropriate changes might need to be considered in the following statutes for these two modules to work:

Negotiable Instrument Act, 1981: Benefits of the Negotiable Instruments Act, such as negotiation, criminal action upon dishonour of the instrument amongst others which are applicable to instruments like cheques can be extended to factoring units. In addition, Section 14 of the Act may be amended to specifically include online negotiation in the definition of negotiation factoring units

Transfer of Property Act, 1882: In addition to assignment of debt, the bye-rules of TReDS must explicitly confirm that once the invoice / bill of exchange is accepted (deemed accepted) the same shall be a primary obligation of the buyer to make the payment irrespective of the underlying trade. This will resolve any dichotomy which might be created under Section 6 of Transfer of Property Act

Factoring Regulation Act: To provide legal sanctity to the TReDS mechanism and to facilitate resolution of disputes between the stakeholders, a provision may be made that the copies certified by TReDS shall be acceptable evidence of facts like acceptance of the factoring unit and date of acceptance amongst others. The conflicting interpretations about the applicability of state stamp legislation owing to the Section 35 of Factoring Regulation Act which provides for amendment to Indian Stamp Act, 1899 can also be clarified to reduce confusion.

Effective implementation of a robust receivables financing platform under the TReDS guidelines will effectively reduce the requirement for guarantees to support finance to MSMEs.

11. Guarantee and insurance schemes

1. CGTMSE

1.1 Current position of guarantees to the MSME sector

Availability of bank credit without the requirement of collateral/ third party guarantees is a major source of support to first generation micro and small enterprise (MSE) entrepreneurs. Keeping this objective in view, Ministry of Micro, Small & Medium Enterprises (MSME), Government of India launched Credit Guarantee Scheme (CGS) so as to strengthen credit delivery system and facilitate flow of credit to the MSE sector. The corpus of the scheme is contributed by the Government of India and SIDBI in the ratio 4:1. The scheme guarantees sanctioned facilities (Fund based and/or Non fund based) not exceeding ₹ 0.5 crore (for loans from regional rural banks/financial institutions) and not exceeding ₹ 1.0 crore (for loans from scheduled commercial banks and select financial institutions). Medium enterprises are so far not covered under the scheme.

At November 30, 2014, CGTMSE had:

- Total corpus funds of around ₹ 4,000 crore
- 133 registered member lending institutions
- Approved 1,689,439 proposals from MSE's for guarantee cover for aggregate credit of ₹ 84,026 crore of which guarantees worth nearly ₹ 70,000 crore are outstanding
- More than 49,000 claims for an amount of ₹ 1,296 crore have been settled cumulatively

1.2 Key challenges

- **Scheme administration:** The scheme faces limitations with respect to its corpus and thereby restricts its ability to guarantee more loans. The scheme does not have flexibility framework for risk based pricing.
- **MSME eligibility:** Although the scheme presently covers the early requirements of MSMEs, rigid parameters in the ceiling on the upper limit of loan affect their growth
- **Banks**
    - The scheme does not allow banks to avail of part collateral
    - The biggest concern faced by banks is slow realization of claims and no set parameters for onboarding clients
    - CGTMSE does not provide guarantee cover for loans under multiple banking arrangements

2. ECGC

2.1 Current position

ECGC Limited (ECGC, formerly Export Credit Guarantee Corporation of India Limited) was set up in 1957 and is a 100% Government owned company. It has a network of 58 branches & 5 Regional Offices. ECGC provides credit risk insurance covers to exporters, export credit insurance covers to banks and financial institutions and overseas investment insurance to Indian companies investing in joint ventures abroad in the form of equity or loan.

At March 31, 2014, ECGC had a paid up capital of ₹ 1,100 crore and net worth of ₹ 2,774 crore. The Maximum Liability (ML) that the Company can underwrite at any point of time, as approved by the Government of India under Article 72(b) of the Articles of Association of the Company was at ₹ 1.0 lakh crore as of March 31, 2014. The ML as on March 31, 2014 was ₹ 75,879 crore.

In FY2014, ECGC covered a total business of ₹ 2.80 lakh crore, earned a premium income of ₹ 1,300 crore and paid claims of ₹ 900 crore. Its main business areas are:

- **Exporter business:** At March 31, 2014 ECGC had about 11,000 exporters as policyholders in its fold, 82% of which were MSMEs. The value of exports covered under the policies in FY2014 was ₹ 1,31,343 crore out of which MSMEs contributed 55%. Premium income under policies in FY2014 was ₹ 389 crore out of which MSME contribution was 68%. Total claims paid under this sector were ₹ 109 crore of which MSME share was 68% for the same time period. ECGC has products that cater specifically to the small enterprises sector under this line of business. ECGC defines micro exporters as those with export turnover less than ₹ 1.0 crore, and small exporters as those with export turnover between ₹ 1.0 crore and ₹ 5.0 crore.
- **Bank business:** ECGC has an existing client list of 43 banks availing of its whole-turnover cover. At March 31, 2014 about 17,000 exporters were covered under this scheme 92% of which were MSMEs. The business covered under the whole-turnover cover amounted to ₹ 1,38,149 crore in FY2014, of which the MSME business contributed nearly 73%. The premium income for the same time period was ₹ 870 crore with MSMEs constituting 72% of this amount. Total claims paid for FY2014 were ₹ 640 crore of which MSME share was around 48%.
- **Medium and long term business:** The business covered under medium and long term business was ₹ 9,763 crore in FY2014 with premium income of ₹ 45 crore. Claims worth ₹ 149 crore were paid in the same time period.

3. Exim Bank of India

The Exim Bank of India (Exim Bank) is a specialised financial institution, wholly owned by the Government of India. It was set up in 1982 under the Export-Import Bank of India Act. Exim Bank provides suppliers' credit, letters of credit and guarantees to facilitate exports for Indian exporters. For overseas buyers, the bank extends the buyer's credit facility to assist them in financing their imports. At March 31, 2014 guarantees outstanding were ₹ 5,367 crore and letters of credit outstanding were ₹ 4,060 crore. The bank also extends 'export capability creation' loans for Indian companies investing in businesses overseas. Exim Bank extends lines of credit (LOCs) to overseas financial institutions, sovereign governments and other entities to enable import of goods and services from India. The bank extends LOCs on its own and also with the support of Government of India. It extended LOCs of USD 1.77 billion during FY2014.

4. Recommendations

4.1 CGTMSE

- **Inclusion of retail trade in the scope of the scheme:** Loans to all retail trade activities should be eligible for cover under CGS
- **Increase in exposure cap:** The eligible limit for loans to be covered under the programme to be increased from ₹ 1.0 crore to ₹ 5.0 crore to allow more entities to benefit from the scheme. The eligible limit needs to be increased to account for inflation, scale of investment and the proposed definition change that will increase the eligibility thresholds within which an enterprise qualifies as an MSME.
- **Allow collateral for uncovered part of loan:** Loans with partial collateral cover to also be eligible for guarantee
- **Computation of annual service fee on outstanding amount rather than sanction amount:** At present, the annual fee is charged on the sanctioned limit. The annual fee may be charged on the outstanding amount rather than on the sanctioned limit for term loans. Additionally, annual fee to be reduced on a year on year basis in lieu of good account conduct.
- **Prompt settlement:** There is a need to ensure prompt settlement of claims under the CGTMSE scheme to foster confidence amongst bankers
- **Increase participation:** Increase the number of member lending institutions (MLI) from 133 to include lenders such as micro finance institutions and NBFCs, as may be approved by the regulator, on terms and conditions that may be applicable. The sectoral coverage can also be increased by allowing guarantees for loans like retail trade, educational institutions, etc. which cannot currently avail CGTMSE guarantee.
- **Increase in CGTMSE corpus:** The corpus in December 2014 was about ₹ 4,000 crore. The recommendations from the Committee would lead to higher on-boarding

for MSMEs which is expected to lead to a rise in the demand for guarantees and hence the corpus will need to be increased as discussed in later paragraphs

- **Sustainable business model for CGS:** Credit guarantee mechanism should be accorded greater importance as a policy intervention tool. For this, establishment of a robust sustainable business model for credit guarantees is a must. Leverage of fund corpus should be specified accordingly and used as basis for making additions to corpus for time to time.
- **Risk mitigation:** CGTMSE should adopt better risk mitigation measures such as cap on payout ratio/ periodic independent risk assessment of MSME Portfolio of member lending institutions, etc.
- **Risk-based pricing:** Devise an appropriate model of risk based pricing of guarantee fee

The outstanding credit guaranteed under CGTMSE (for MSE) of ₹ 70,000 crore covers about 7.0% of the existing outstanding credit to the MSME sector (₹ 10.3 lakh crore in March 2014). This needs to be enhanced to an acceptable level of guarantees (around 15.0% of total MSME banking credit compared to around 25% as per global experience). Considering a 14.0% growth in banking system credit and 25.0% CAGR for MSME credit by banks to account for economic growth, the guarantee corpus would need to increase to about 7x the current size in five years (by 2019) if the current level of leverage of about 17.5 times on the corpus is maintained. This would require a seven fold increase in the corpus to ₹ 28,000 crore from the current ₹ 4,000 crore. Along with this, there is a need to increase the loan limits as explained earlier and allow for delivery through multiple lending partners. The increase in corpus to achieve the above would be about ₹ 24,000 crore. This does not account for potential NPAs in using this guaranteed credit portfolio, which will need to be addressed separately.

It is recommended that the Ministry of MSME could determine the corpus required for guarantee schemes targeted at MSMEs based on the above estimate and augment the corpus in yearly tranches over the next five years. A recommendation is being made to increase the corpus by ₹ 5,000 crore in the forthcoming year.

From April 1, 2015, the requirement for 20% procurement from MSMEs becomes mandatory for Public Sector Undertakings. Any shortfall in meeting this obligation could be monetised (say through a levy of 2%). The amount so generated could be used to augment the CGTMSE corpus.

4.2 ECGC

- Overseas trade has moved to open account (documents sent directly to buyers). Trade instruments are no longer used for extending credit to overseas buyers. ECGC should give cover for open delivery transactions more liberally, enabling smoother claim settlement irrespective of status of shipment
- ECGC can explore taking the micro exporters policy online, in line with global trends.
- ECGC currently only provides short-term cover (one year). The possibility of medium term cover for longer duration through ECGC can also be explored
- Expanding ECGC programmes by providing broader coverage through tie-ups with banks can be enhanced. The bancassurance programme which is currently small in size for ECGC can be further expanded
- Guarantee cover to banks extending export credits can be backed by the government
- Banks can be granted 100% capital relief while providing for outstandings as provided to banks in other countries
- ECGC covered accounts attract 20% risk weight to the extent of Maximum Liability (ML) which can be reviewed. As an alternative, ECGC can be authorized to issue covers with ML equal to outstandings so that banks get full benefit as it is only a notional limit
- ECGC is subject to insurance regulations, which requires it to price risk as per actuarial assessments. If the underwriting is done on behalf of the state, ECGC can reduce the premium rates since in that case it will not be subject to insurance regulations
- ECGC can consider differential treatment of MSME accounts (liberal approval of limits, reduced premium rates, higher cover, etc.) under covers extended to banks to encourage banks to increase export credit to MSMEs

A tie-up between CGTMSE and ECGC can be explored whereby clients who need to apply to both CGTMSE and ECGC can do so via a single common application.

In summary, both CGTMSE, which is focused on MSMEs, and ECGC, which serves large and small enterprises, address a critical need for enabling access to finance. Given the scale of the MSME sector and the potential unmet demand the guarantee and insurance programmes need to grow several times larger than the current size.

12. Financial intermediaries

The current financial sector landscape in India comprises of a variety of institutions & intermediaries. The type & number of institutions relevant for the MSME space together with their physical network (where available) is summarised in the following table:

Table 12.1: Financial sector landscape

Type of institution	Number of entities	Branch network
Universal banks	89	1,02,820
Regional rural banks	56	17,524
Non-banking finance companies	12,139	-
NBFCs (non-deposit taking)	*11,913*	-
NBFCs (deposit taking)	*226*	-
Microfinance companies (registered with RBI as NBFCs)	48	-
Urban cooperative banks	1,584	-
Scheduled UCBs	*50*	-
Non-scheduled UCBs	*1,534*	-
Rural cooperative banks	93,550	-
Long-term[1]	*717*	
Short-term[2]	*92,833*	
Registered money lenders	19,627	
Post offices (take deposits)	1	1,55,000

1. Comprise a two-tier structure of 20 State Co-operative Agriculture and Rural Development Banks (SCARDBs) at state level and 697 Primary Co-operative Agriculture and Rural Development Banks (PCARDBs) at village level
2. Comprise a three-tier structure of 31 State Co-operative Banks (StCBs) at state level, 370 District Central Co-operative Banks (DCCBs) at district level and 92,432 Primary Agricultural Credit Societies (PACS) at village level

In November 2014, the Reserve Bank of India issued guidelines on Small Finance Banks and Payments Banks, with the objective, inter alia, of enhancing access to credit for MSMEs and overall financial inclusion. These would gradually join the financing ecosystem.

In addition to institutional financial intermediaries, Department of Posts (DoP) has a large distribution network of about 1,55,000 post offices. The Task Force on Leveraging the Post Office Network ("India Post Task Force", November 2014, Chairman Shri T.S.R. Subramanian), had recommended establishment of a Post Bank of India (PBI). At present, the DoP operates a small savings scheme called Post Office Savings Bank (POSB) which is offered through a network of 1.55 lakh post offices of which about 1,40,000 post offices are in villages. The total small savings deposits with DoP exceeds ₹ 6,00,000 crore. About 1,50,000 post offices have connectivity through mobile internet, and within these about 26,000 post offices have broadband connectivity. Governments in many countries, notably

China, Japan, France, Germany and South Africa, have succeeded in leveraging the multi-tasking and cash-management capabilities of their pre-existing postal network to further the countries' financial inclusion agenda.

Presently, the POSB services cannot meet the requirements of MSMEs since it is open only to individuals, and not institutions. Further, POSB does not have loan products in its portfolio. Establishment of the proposed PBI could help to overcome both these limitations, and could serve as an important channel for increasing the distribution reach of institutional credit to MSMEs. The India Post Task Force envisages a PBI that will operate as hub and spoke model, with about 600-650 branches, one in each district. The PBI will leverage the post offices as a third party distribution network, as post offices will remain with the DoP and not be part of the PBI.

As mentioned in an earlier Chapter, credit from the scheduled commercial banks (the largest constituent of the existing financial architecture) to MSMEs has grown at a compounded annual rate of 23% between 2012 and 2014, compared to the annualised growth in overall non-food credit of 14.1% during the same period. However, there is a feeling in the industry that the access to credit from the financial sector for MSMEs remains a challenge. There are four key factors to which this can be attributed:

- Enterprises in the MSME sector are predominantly non-corporate entities and a large proportion (about 70%)[2] are micro enterprises which do not have a formal legal structure. As such, identification of and outreach to these enterprises remains challenging and incomplete.
- The institutionalized financial sector has a high risk perception of the MSME sector, owing to their vulnerability to economic trends and risk of elongation of working capital cycles.
- The traditional methods of credit appraisal used by banks and financial institutions are based on evaluation of financial information and documentation which may be unreliable or simply not available in the case of MSMEs. Estimates have in fact indicated that more than 90%[3] of MSMEs do not have adequate financial statements, account books and history of tax returns, effectively excluding them from access to formal financing.
- The vast number and dispersed nature of MSMEs (with estimates of the number of MSMEs ranging from 4.5 crore to 6.0 crore) makes physical outreach through traditional banking channels challenging both in terms of scaling up and viability.

[2] Estimate from Action Committee for Formal Finance for Non-corporate Small Businesses
[3] Estimate from Janagraha

In previous Chapters of this Report, the Committee has made recommendations for:

- Aiming at universal formalization of MSMEs through a simple registration process along with opening of a bank account, if not already existing; and
- Reducing risk perception & elongation of working capital cycles for MSMEs through enhancing the efficacy of existing credit guarantee & insurance schemes and creating/ enhancing receivables financing mechanisms.

This Chapter deals with the financial intermediation architecture to cater to MSMEs with a focus on enhancing distribution & outreach, improving credit infrastructure & available credit risk assessment tools and also suggests potential innovative credit analysis mechanisms that the policy & regulatory authorities may encourage and players may adopt. Leveraging technology developments & evolution to build and use effective electronic platforms is a key area of focus.

The Committee received inputs from an industry body and one of the Committee members on the need to develop additional sources of formal finance for the MSME sector through a structure that would include in its ambit the existing non-institutional last mile financiers. The suggestions proposed that the government may consider establishing an entity modelled on the lines of the National Housing Bank to perform the following functions:

- Registration and supervision of a new category of dedicated Small Business Finance Companies
- Registration of non-institutional last mile financiers
- Refinancing and other activities to promote flow of funds to the MSME sector

Under this proposal, community based lenders would have an incentive to register as formalisation would enable them to access refinance from larger financial institutions and give access to guarantee schemes to support lending to MSMEs. This proposal was discussed with the Ministry of Finance and the RBI and in view of the risks associated with such a lightly supervised structure, the above structure was not considered feasible. One of the Committee members had a dissenting view, which is appended in Annexure VIII.

Recommendations

1. **Types of institutional intermediaries**: The various existing types of institutional financial intermediaries as well as the proposed new differentiated banking structures introduced by the RBI may continue. These entities differ widely in terms of business models, focus segments, cost structures, geographical presence and core competencies, and provide sufficient diversity to the financial sector.

The intermediaries would thus comprise:

- Universal banks
- Small finance banks
- Payment banks (as channels of outreach since they are not permitted to lend)
- Regional rural banks
- Cooperative banks (urban & rural)
- Non-banking finance companies
- Microfinance companies
- Proposed PBI operating through the post office network

Intermediaries should be encouraged to register and become a part of the formal regulated financial system. With 95% of the formal credit to MSMEs coming from banks, and the rapid pace of bank credit growth to MSMEs which is growing faster than the system credit growth, increasing formalisation, leveraging of non-traditional methods of assessing credit worthiness, etc. it is expected that the depth of the financial architecture for MSMEs can be greatly enhanced.

2. **Leveraging complementarity**: While encouraging the continued growth of different forms of financial intermediaries, there is a need to focus on leveraging complementarity between these intermediaries. For example, large universal banks may not be able to penetrate the last mile and may not have the local knowledge & MSME client relationships that smaller and more localized entities would have. However, they have significantly better access to capital and funding. The use of smaller entities as originators of credit for large banks should be encouraged.

   There is a significant opportunity to leverage the vast network of post offices for credit. At present POSB provides savings accounts through its vast network. The proposed PBI would be well positioned to focus on the unbanked sections in the urban, semi urban and rural regions. Presently, the POSB services cannot meet the requirements of MSMEs since it is open only to individuals, and not institutions. Further, POSB does not have loan products in its portfolio. The PBI would help to overcome both these limitations. The key competitive strengths of PBI would be a lean operating model to focus on unbanked sections and regions and a wide distribution reach that leverages the DoP network. The PBI could focus on lending and business bank accounts for MSMEs. Key beneficiaries would be small and micro enterprises and individuals such as artisans, farm owners etc. and become an effective channel for financial inclusion of and delivery of credit to MSMEs. Extending reach to support rural and micro enterprises will have significant employment generation potential.

3. **Leveraging touchpoints outside the institutional financial sector:** India has a vast number of informal financial intermediaries who provide need-based credit to

MSMEs who are not able to access the formal financial sector. As stated in Table 10.1, there are also over 19,000 registered moneylenders. While the various recommendations made in this Report should significantly enhance access to the formal financial sector, the informal local lenders have been a part of the non-corporate small business system for a long time and have considerable experience in lending and collecting from such businesses. This experience could be leveraged to bring them under the formal financial sector through a hub-and-spoke model whereby they complement the larger financial system participants. Since the late 1990s, banks in India have scaled up "hub-and-spoke" approaches to customer outreach, operating through agents. In the initial years, this was used to scale up delivery of retail credit in urban India. Since the introduction and liberalisation of banking correspondent regulations, banks have partnered with non-bank entities to enhance outreach in rural areas. A similar hub-and-spoke model can be adopted for the MSMEs, including leveraging the traditional unregistered local community credit providers.

4. **Universal access to credit guarantees:** Currently, government-backed credit guarantee schemes i.e. CGTSME is available for lending by a limited set of credit providers including all scheduled commercial banks, select regional rural banks and institutions including SIDBI, NSIC and North Eastern Development Finance Corporation Ltd (NEDFI). The same should be accessible to all types of supervised lending institutions. This could be appropriately notified by the regulator.

5. **Universal membership of credit bureaus:** Unavailability of credible client information for MSMEs is a major barrier for credit flow to the sector. It is suggested that the coverage of credit bureaus should be expanded to include all credit institutions including micro-finance institutions, leveraging technology channels. This will facilitate analytics, credit scoring and credit risk assessment. The data on online bill acceptance and payments from TReDS should be linked online to credit bureaus to provide an online payment history and payment rating.

6. **Partnering with emerging platforms:** Banks in India have in the past leveraged the corporate sourcing & distribution value chain to access suppliers & dealers of large corporates. Globally, models are emerging where successful e-commerce platforms are being tapped to provide credit to participants in these online marketplaces. The Alibaba group in China, which operates a large business-to-business e-commerce platform, has tied up with Bank of China and China Export & Credit Insurance Corporation to provide a credit facility to participants on the platform. This is further detailed in Annexure VII.

7. **Use of new credit tools:** In the absence of information required by traditional methods of credit analysis, models are emerging where secondary information is used to assess credit worthiness and provide easy access to funding. Submission of payments made by corporates to telecom companies, electricity boards, general/ life

insurance companies, current account track record etc. should also be encouraged. Banks & other financial intermediaries, credit rating agencies and credit bureaus should be encouraged to develop and use new tools for risk assessment. These tools include bank transaction analysis, analysis of utility & other payment history, business volumes and even social media activity. Analytics and algorithms can then be applied on this payment data to arrive at a credit score, as is being done globally. Financial intermediaries are currently experimenting with psychometric evaluation as a means of credit assessment. A well-thought out framework for credit rating for the purpose of bank lending would facilitate flow of credit to MSMEs.

8. **Collateral registry:** Pursuant to the announcement made by the Finance Minister in the budget speech for 2011-12, a Central Registry, Central Electronic Registration under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act became operational on March 31, 2011. The objective of the Registry is to prevent frauds in loan cases involving multiple lending from different banks on the same immovable property. Feedback from bankers indicates that the system needs to be made more robust to leverage its full potential. Introduction of unique identification number is suggested to ensure there is no duplication. The search functions could be made more versatile by enabling PAN-number based searches. The duplication due to differing old and new survey numbers for the same property needs to be eliminated. A prescribed, granular protocol is needed to ensure that lending institutions enter the details correctly and adhere to the prescribed timeframe for registering the property.

9. **SME Exchange:** BSE and NSE started their SME platforms in 2012. There were less than 100 companies listed on these platforms till January 2015 with 84 companies listed on the BSE platform (BSE SME) and 6 companies listed on the NSE platform (Emerge). Efficient SME platforms can prove to be a vital source of capital for MSMEs. However, the two platforms have not expanded in the way it was envisaged. It is, thus, suggested that the existing requirement of market making for a period of three years could be reduced to a shorter period as deemed appropriate by the regulatory authorities. In addition, a separate SME index can be developed for the SME exchange platforms.

In summary, the Committee envisages a scenario where existing financial institution models and upcoming new models co-exist and flourish by taking advantage of complementarities & accessing government credit enhancement/ insurance mechanisms; outreach is enhanced by establishing linkages with informal credit channels & by leveraging the proposed online MSME platform; credit markets are deepened; and innovative new ways to assess credit risk are adopted.

13. Conclusion

The MSME sector, with its significant contributions to the Indian economy, is expected to be one of the pillars of the Make in India push. However, to ensure that it is well established as a bellwether of the Indian economy, it is essential that enabling infrastructure, particularly in terms of financing for MSMEs, is made available to them. The Committee has aimed to a create an environment where MSMEs can thrive through not only easier access to finance but also an entire enabling ecosystem where MSMEs are able to access benefits created for them under a formal mechanism.

Through the Committee's suggestions, encompassing areas from MSME registration to increasing the distribution and reach of the financial architecture for MSMEs through a wider base of financial intermediaries, including suggestions on business banking accounts for MSMEs, equity financing, receivables financing and guarantee and insurance schemes, the Committee hopes to leverage and improve upon the existing MSME financial architecture to create a new financial construct wherein financing is considerably easier to obtain, available in all corners of the country and at competitive rates of interest. It is hoped that such an approach will not only provide a concerted push to the MSME sector in India but will also provide collateral benefit for the financial sector, employment generation and economic growth of the country.

Annexures

Annexure I

Constitution & Terms of Reference – Notification No.8/67/2014-IF.II dated September 26, 2014

1. Pursuant to the Budget Announcement for FY2014-15, regarding setting up of a Committee to examine the financial architecture for the MSME sector and giving concrete suggestions within three months, the Department of Financial Services, Ministry of Finance hereby appoints the Committee consisting of the following:

Chairperson

(i) Shri K.V Kamath, Chairman, ICICI Bank

Members of the Committee

(ii) Secretary, Ministry of MSME or his nominee not below the rank of Joint Secretary
(iii) Secretary, DIPP or his nominee not below the rank of Joint Secretary
(iv) Secretary, Department of Skill Development and Entrepreneurship or his nominee not below the rank of Joint Secretary
(v) Shri Sushil Muhnot, CMD, Bank of Maharashtra and Ex-CMD, SIDBI
(vi) Representative of RBI not below the rank of CGM
(vii) DMD, SIDBI
(viii) CEO, Indian Banks' Association (IBA)
(ix) Representative of Federation of Indian Micro and Small & Medium Enterprises (FISME)
(x) Mrs. Rajni Bector, Cremica Food, Ludhiana
(xi) Shri Saurabh Srivastava, Founder, India Angel Network
(xii) Shri R. Vaidyanathan, Professor, IIM Bangalore
(xiii) Shri Gopal Agarwal, FCA
(xiv) Shri Nilesh Shah, CEO, Axis Capital
(xv) Joint Secretary (IF), DFS

2. The terms of reference of the Committee are as follows:
    1. Assessing the current structure of flow of finance to MSME sector- delivery channels, products and services and policy environment.
    2. Comparison with financial architecture in other developed and emerging economies for strong support to MSMEs.
    3. Analysing the gap areas and suggesting measures for addressing the same with regard to the following to bring about significant improvement in India's position in *ease of starting business* and *ease of doing business* indices for speedy growth of the sector.
        - Role and scope of financial intermediaries- existing as well as proposed.

- Financial products and services
- Incentives and risk mitigation/ credit enhancement measures; and
- Medium term and long term policy prescriptions and directions.

3. The Committee may also lay particular focus on the following aspects and come up with concrete suggestions:

(i) Improving the share of institutional finance to MSME from low level currently seen.
(ii) Regional disparities in credit flow to MSMEs.
(iii) Credit for self-employment based MSEs, particularly those established by SC/ST/OBC entrepreneurs.
(iv) Innovative financial products for MSMEs.
(v) To increase flow of equity support to MSMEs by targeting incubator based Funds, Angel/Seed Funds, Impact Funds and VC/PE funds.

4. The Committee may hold discussions with the Minister of State for Finance before finalizing the report.

5. The Committee may submit its final report within three months.

(Alok Tandon)
Joint Secretary to the Government of India

Annexure II

List of organizations and individuals who have provided inputs to the Committee

Sr. no	Organisations/individuals met
1	Action Committee for Formal Finance for Non-Corporate Small Businesses
2	Association of National Exchange Members of India (ANMI)
3	Bharatiya Mazdoor Sangh (BMS)
4	Bhartiya Vitta Salahkar Samiti (BVSS)
5	MSME Council, Confederation of Indian Industry (CII)
6	ECGC Limited
7	Federation of Industrial and Commercial Organisation (FICO), Ludhiana
8	Indian Banks' Association (IBA)
9	Mr. Ramesh Ramanathan, Janaagraha
12	Laghu Udyog Bharati
13	McKinsey & Company
14	Dr. Nachiket Mor
15	Ms. Chitra Ramakrishna, National Stock Exchange (NSE) MD
16	Sync Legal
17	Tamil Nadu Small and Tiny Industries Association (TANSTIA)
	Representations/inputs received from
1	Apex Chamber of Commerce and Industry (Punjab)
2	Dalit Indian Chamber of Commerce and Industry (DICCI)
3	Jharkhand Small and Tiny Industries Association
4	India Venture Capital Association (IVCA)
5	Federation of Indian Chambers of Commerce and Industry (FICCI)

Annexure III

Reports reviewed by the Committee

The following reports were reviewed by the Committee:

1. Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, Reserve Bank of India, January 2014 (Chairman: Dr. Nachiket Mor)
2. Inter-Ministerial Committee for Accelerating Manufacturing in Micro, Small and Medium Enterprises Sector, Ministry of MSME, September 2013 (Chairman: Shri Madhav Lal)
3. 'Creating a Vibrant Entrepreneurial Ecosystem in India', Report of the Committee on Angel Investment and Early Stage Venture Capital, Planning Commission, Government of India, June 2012 (Chairman: Shri Sunil Mitra)
4. Prime Minister's Task Force on Micro, Small and Medium Enterprises Sector, Government of India, January 2010 (Chairman: Shri T K A Nair)
5. 'A Hundred Small Steps', Report of the Committee on Financial Sector Reforms, Planning Commission, Government of India, 2009 (Chairman: Dr. Raghuram Rajan)

Annexure IV

State level schemes

1. **Uttar Pradesh:**
    - Selected 22 clusters for support under the Government of India cluster development scheme
    - Financial assistance for ISO/ISI certification
2. **West Bengal:**
    - Financial Assistance for cluster development
    - Subsidy for intellectual property
    - Financial assistance for ISO/ISI certification
3. **Tamil Nadu:**
    - Mini Tool room scheme
    - Financial assistance for obtaining patents
    - Waiver on earnest money deposit
    - Reimbursement of hall rent for conducting exhibition by MSME association
4. **Odisha:**
    - Cluster development scheme
    - Reimbursement of technical know-how cost
    - Clean development mechanism
5. **Gujarat:**
    - Financial assistance for cluster development
    - Grant for technology acquisition
    - Support for quality certification and patent registration
    - Assistance for participation in international exhibitions
6. **Punjab:**
    - Dedicated annualized fund for marketing and cluster development
    - Financial assistance for quality certification
    - Market development support for national/state/local level associations
7. **Maharashtra:**
    - Support for quality certification
    - Incentives for credit rating of MSME's
    - Subsidy for technological up gradation
    - Financial support for patent registration

Annexure V

Entrepreneurs' Memorandum I and II

EM (Entrepreneurs' Memorandum) I

This is an information on a format on the proposed unit giving details on proposed name, address, item of manufacture, proposed investment in fixed assets (to determine whether micro, small or medium unit, power requirement, expected date of start of production, etc. Application can be made online and acknowledgement is to be taken from the local DIC (District Industries Centre). The DIC issues an acknowledgement along with the EM Number which is valid for two years.

EM (Entrepreneurs' Memorandum) II

EM II is to be filed after start of production. It is a permanent registration for the enterprise. Information required is almost the same as EM I except that actual data (date/investment/employment) is filled in this form. The acknowledgement is given by the DIC after filling the codes and allotting an EM number. The time stipulated for this is five days after receipt of form by post or same day if delivered personally or online.

There are localised rules and requirements which could also vary from district to district within the same state, which may result in delays in receiving the EM II acknowledgement.

Annexure VI

Sample of a simple registration form

Suggested simple registration form for MSMEs to obtain a unique business identifier number (Udyog Aadhar), Permanent Account Number, Tax Assessment Number, Employees' Provident Fund number and Employees' State Insurance number, together, in a simplified manner. It will also enable MSMEs to open a new bank account, in case an existing account is not already available.

	Assessing Officer (AO) code which is a combination of Area Code, AO type, Range Code and AO number)	
1.	**Establishment details**	
	Name of the enterprise	
	Date of commencement	
	Address (with address proof such as copy of passbook/ statement, copy of telephone bill, copy of water or power connection)	
	Telephone details	
	E-mail address	
2.	**Ownership details**	
	Name of the owner(s)	
	Aadhar number	
	Bank account details	
3.	**Primary business activity (Eg: paper products, stationery products, garment making etc.)**	
4.	**Employment details**	
	Total number of	
	-Full-time employees	
	-Part-time employees	

Annexure VII

Alibaba group

The Alibaba group in China, has jointly launched e-Credit Line with two state-owned enterprises: Bank of China and China Export & Credit Insurance Corporation (Sinosure) in January 2013. e-Credit Line provides buy on credit facility for up to 80% of the amount payable and offering credit (Open account) up to 120 days. e-Credit Line provides overseas buyers with extended payment term for products sourced, and acts as one-stop export-related service, making purchases from suppliers in mainland China simple, flexible and convenient.

Bank of China is e-Credit Line's major funding partner. It is responsible for providing the capital for the e-Credit Line project. Sinosure is the insurance services provider for e-Credit Line. It is responsible for investigating the authenticity of e-Credit Line applicants, issuing the financing, and also providing a guarantee for the financing. With export credit insurance, payment of up to 80% of the value of an order are guaranteed to suppliers as soon as the order clears customs in China. The balance 20% is due up to four months later, depending on the terms of the credit line granted to individual buyers.

Alibaba.com and Sinosure investigate and approve the creditworthiness of buyers, who can apply for loans of USD 1.0-2.0 million. To help ensure all deals are completed reliably, OneTouch conducts onsite inspections of suppliers and provides logistics and customs-clearance services for e-Credit Line transactions. Alibaba also reviews the production capacity and the business background of the suppliers. Suppliers have to provide their business licenses, tax registration certificates, previous invoices and other supporting documents for getting approval from Alibaba.

Alibaba Group has also invested directly in a bank. In July 2014, China Banking Regulatory Commission has given approval for Alibaba Group Holding to set up a commercial bank called 'Zhejiang Wangshang Bank'. The Bank will function as an internet finance bank by nature to mainly serve small businesses and individuals. It will provide deposit products lower than RMB 200,000 (About USD 32,000) and loan products of less than RMB 5 million (About USD 800,000).

Annexure VIII

Dissent Note to Committee on MSME on the Report

Prof R. Vaidyanathan
Indian institute of Management Bangalore

The terms of reference of our committee clearly indicate

- Improving the share of Institutional Finance to MSME sector from the low level currently seen
- Credit for self-employed based MSEs particularly those established by SC/ST/OBC entrepreneurs

The final report mentions in chapter 12

Quote

The Committee has received inputs from an industry body on the need to develop additional sources of formal finance for the MSME sector through a structure that would include in its ambit the existing non-institutional last mile financiers. The suggestions received propose that the government may consider establishing an entity modelled on the lines of the National Housing Bank to perform the following functions:

- Registration and supervision of a new category of dedicated Small Business Finance Companies
- Registration of non-institutional last mile financiers
- Refinancing and other activities to promote flow of funds to the MSME sector

Under this proposal, community based lenders will have an incentive to register as formalisation will enable them to access refinance from larger financial institutions and give access to guarantee schemes to support lending to MSMEs."

Quote

It also adds that "This proposal was discussed with the Ministry of Finance and the RBI and in view of the risks associated with such a lightly supervised structure, the above structure was not considered feasible.
I would rather say that what was contained in the draft report was better –namely "This would need careful consideration by the RBI and the Ministry of Finance before a view could be taken."

Actually This- I feel must be part of our main recommendations without any caveat due to the following reasons and corresponding structure is also suggested.

The suggestions given by us in terms of New Financial Architecture are in addition to registration etc. given by the main report

I. The Size/contribution of small businesses in our Economy

- In all there are estimatedly 5.8 crore enterprises according to Survey on Unincorporated Non-Agricultural Enterprises—[Excluding construction] NSSO 67th round [July 2010-June 2011]
- In manufacturing the share of these is nearly 50% in value addition
- In sectors like Trade/Construction/Transport/Hotels& Restaurants/Business services – their share is more than 70% in value addition
- Of these nearly 90% do not have access to outside-institutional sources of finance
- In 1990 the share of Non-corporate enterprises had 56% of the Banking finance and in 2012 it is less than 35% [Basic Statistical returns RBI]—[See Tables 1 and 2 in Appendix]
- These provide nearly 90% of employment
- More than 50% of these are owned by OBC/SCs/STs

II. Financing architecture for these should have the following characteristics

- Relationship based and not just rule based
- Easy accessibility with less paper work
- It is cash flow based lending rather than asset based lending
- More requirements for cash credit or working capital limit than for fixed assets
- They are substantially in service sectors and so more need to focus on income generated rather than fixed assets etc.
- The institutions should be less rigid in terms of risk adjusted capital/NPA provisioning etc.
- Collection mechanisms are to be technology based for ease of transactions

III. Given the nature of our self –organized or the informal sector the funding mechanism should have

- Separate financial architecture is needed for MSMEs
- It must be an inclusive and rainbow financial architecture which will enable the present lenders for different MSMEs to migrate to organized lending by refinancing by wholesale finance providers
- The regulatory framework should be different than that of RBI
- It can be similar to say NHB in the housing sector

- Larger number of existing NBFCs and other forms of funding agencies like Chits etc. can be under the new financial architecture
- It can and will integrate existing financiers to the informal sector particularly in services

IV. The following structure may be considered

1. Small Businesses:

Small business means and includes manufacturing, trading and services by sole proprietors, family concerns and partnerships, including limited partnerships and one person companies within the meaning of the Indian Companies Act.

This definition we think is more appropriate than assets/Investments/turnover based definitions—since they are in services as well as in manufacturing. Definitions based on turnover etc. will make them split etc. after reaching a size.

2. Development and Regulatory Authority: Small Business Finance and Development Authority [SBFDA]

The authority to register, develop, wholesale fund and regulate small business finance institutions. This will be fashioned on the lines of the National Housing Bank. This will be initially owned by the nationalized and private banks to the extent of 51% and by the Central government to the balance extent. It must have the right to offer shares to foreign institutions through their funds floated for financing small businesses. This will also float long term bonds to augment funds from banks and foreign sources. SBFDA may formulate guidelines for minimum capital for SBFIs and also capital adequacy norms for all SBFIs.

The SBFDA shall have a subscribed capital of Rs10000 Crore. The SBFDA shall frame rules for the migration and registration of all existing small business finance institutions whose main business is to provide finance for small businesses as small business finance institutions under the new law as well for new small finance business institutions promoted for financing small businesses

3. Small Business Finance

Small Business Finance means extend finance to small businesses by way of term loans, working capital, venture capital and other means of finance for small businesses

4. Small Business Finance Institutions [SBFI]

Small Business Finance Institutions means and includes finance institutions which are promoted for and engaged in providing small business finance and the main business of which is provide small business finance. Main business means more than 60% of the average loan and credit portfolio of which consists of small businesses. The SBFI shall include all small business finance institutions including chit funds; Unincorporated Business [UIBs] and other traditional institutions which satisfy the criteria of small business finance as defined herein.

5. National Small Business Finance Institutions [NSBFIs]

National Small Business Finance Institutions are small business finance institutions which have business operations in more than one state and which are engaged in providing small business finance directly to SBFIs or act as wholesale funding institutions for other finance small business finance institutions.

Provided that the existing NBFCs which as their main business provide finance for small businesses may migrate and get registered as NSBFIs and that existing NBFCs which apply for carrying business mainly as providers of finance for small businesses may be allowed to be registered as NSBFIs on the condition that within a period of 3 years small business finance must consist of 60% their loan and credit portfolio, failing which their registration as NSBFIs shall stand forfeited.

Provided further that State Small Business Finance Institutions may be allowed to migrate and get registered as NSBFIs.

6. State Small Business Finance Institutions [SSBFIs]

Existing NBFCs which are engaged in providing finance to small businesses either directly or act as wholesale funding institutions for other small business finance institutions but operates within a particular state may be allowed to migrate from the existing law and regulations if any and get registered as SSBFIs.

7. Other Small Business Finance Institutions [OSBFIs]

All SBFIs, other than NSBFIs and SSBFIs, which operation in parts of any state shall be allowed to migrate from the existing law and regulations if any and get registered as OSBFIs

8. Registration of all existing small business finance institutions

All small business finance institutions which satisfy the criteria of SBFIs within the meaning of this law shall within a period of 90 days of the coming into being of the new law apply for registration with SBDA. The SBDA shall frame rules for the registration and regulation of the said SBFIs.

9. Issue of bonds or deposit

National SBFIs[NSBFIs] and State SBFIs[SSBFIs] may, subject to such regulations SDBA may formulate including deposit insurance condition, permit SBFIs to access public funds by way of deposits and bonds without issuing advertisements or otherwise soliciting subscriptions.

10. Ratings/due Diligence: To integrate existing lenders from UIB onwards it i9s required to undertake a massive survey cum rating exercise involving State level NBFCs and further lower level financing entities. This will bring orderliness and inclusiveness of the existing lenders in the new financial architecture

Appendix

Table – 1 Distribution of Outstanding Bank Credit by categories [%]

Category	March 1990	March 1996	March 2005	March 2008	March 2009	March 2010	March 2011	March 2012
Household Sector (1)	58.3	51.1	37.9	36.8	33.0	32.8	36.2	37
Private Corporate sector (2)	31.3	38.6	46.6	46.51	48.0	48.6	44.1	42.7
Public sector (3)	10.2	10.3	15.5	16.7	19.0	18.6	19.7	19.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: (1) Household sector includes Partnership, Proprietorship concerns, joint families, associations, clubs, societies, trusts, groups and individuals for all account.

(2) Private Corporate sector includes private Sector and cooperative sector excluding those mentioned in (1).

(3) Public Sector, that is all Government activities, includes joint sector undertakings.

Source: Extracted from table – 1.15; Outstanding Credit of Scheduled Commercial Banks according to Organizations; Basic statistical returns; various years; RBI

We find from Table --1 that the share of the Household [consisting of Unincorporated or small and Micro units] has come down to 36 per cent from 58 percent in the last twenty years, during which time the role of the Uninc. Sector in trade, transport, construction, restaurants, and other business services has been growing at more than an 8 per cent compounded annual growth rate (CAGR).

This form of banking is not only lazy banking but also banking with significant structural distortions. The share of the private corporate sector in National Income is around 18% but it takes away nearly 43% of the credit provided by the banking sector. The fastest growing Uninc. Sector gets lesser share of bank credit, which reveals that the non-banking financial sector is playing an increasingly important role in the credit delivery mechanisms in the economy.

We observe from Table --2 that the number of accounts for smaller customer has shown significant increase in the last ten years but the share has come down. For instance, up to Rs. 10 lakhs category, this amount outstanding to total SCB outstanding has come down from 32% to 21%. Same is the case for up to Rs. 1 crore borrowers – from 45% to 33%. Even for up to Rs 10 crore borrowers the proportion has come down from 68 % to 45%. We find that there is something that is really problematic in our banking sector, particularly in providing credit to the sections, which not only require them the most, but are also those which are the fastest growing sectors.

Table -- 2 Outstanding Credit of SCBs –Size of loan up to Rs 25 crores:

	Mar-00		Mar-05		Mar-10		Mar-11	
Credit Limit Range (In Lakhs)	No. of Account	Amount outstanding	No. of Account	Amount outstanding	No. of Account	Amount outstanding	No. of Account	Amount outstanding
Up to 10 Lakhs	54,085,209 (99.40)	14,589,937 (31.70)	76,379,233 (99.00)	38,074,692 (33.00)	116,252,358 (98.0)	78,037,871 (23.40)	1,179,255,950 (97.70)	86,168,756 (21.20)
Up to 50 Lakhs	54,284,893 (99.80)	18,349,586 (39.90)	76,991,817 (99.80)	48,054,547 (41.60)	118,257,220 (99.60)	108,533,162 (32.60)	1,202,612,880 (99.2)	122,518,825 (30.10)
Up to 1 Crore	54,320,824 (99.90)	20,515,002 (44.60)	77,056,223 (99.90)	51,672,603 (44.70)	118,424,427 (99.70)	117,954,649 (35.40)	1,204,550,270 (99.60)	133,598,874 (32.80)

Up to 10Crores	54,365,164 (100.00)	31,126,396 (67.70)	77,135,212 (100)	69,991,776 (60.60)	118,591,634 (99.90)	160,657,063 (56.40)	1,206,679,290 (99.90)	183,218,936 (52.70)
Up to 25 Crores	54,368,748	35,465,898 (77.10)	77,144,439	80,288,674 (69.90)	118,614,765 (99.90)	188,310,864 (56.40)	1,206,958,610 (99.90)	214,664,310 (52.70)
Above 25 Crores	54,370,397	46,008,070 (100)	77,150,794	115,246,794 (99.80)	118,636,305 (100)	334,516,933 (100)	1,207,240,950 (100)	407,564,699 (100)

Note: Figures in brackets are percentages to total.

Source: Extracted from table 1.12"Scheduled commercial banks in India from various issues of RBI. Figures in brackets are percentages to total Figures in brackets are percentages to total