IIBF Diamond Jubilee and C H Bhabha Banking Overseas Research Fellowship project

Innovative Credit Products for MSME sector and to evaluate the Credit Guarantee Mechanism under CGTMSE and compare with Credit Guarantee Mechanism of Japan

Disclaimer

The views and opinions expressed in the report are those of the author and do not necessarily represent the views of the RBI.

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Supervisor's Certificate

This is to certify that the work incorporated in the report by E R Muthuselvan as part of the IIBF Diamond Jubilee and C H Bhabha Banking Overseas Research Fellowship project was carried out by the candidate under my guidance.

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Table of Contents

Abbreviations

AGF	Annual Guarantee Fee
ASF	Annual Service Fee
BoT	Board of Trustees
CEO	Chief Executive Officer
CGS	Credit Guarantee Scheme
CGCT	Credit Guarantee Corporation of Tokyo
CGTMSE	Credit Guarantee Trust for Micro and Small Enterprises
DFS	Department of Financial Services
DGM	Deputy General Manager
DR	Disaster Recovery
ECGC	Export Credit Guarantee Corporation of India
ERM	Enterprise Risk Management
FIs	Financial Institutions
GoI	Government of India
IBA	Indian Banks' Association
IMPS	Immediate Payment Service
IT	Information Technology
ITAT	Income Tax Appellate Tribunal
JFC	Japan Finance Corporation
KGB	Kerala Gramin Bank
KYC	Know Your Customer
LDO	Lead District Officer
MENA	Middle East and North African Countries
MGS	Mutual Guarantee Scheme
MIS	Management Information System
MLI	Member Lending Institution
MSE	Micro and Small Enterprise
MSME	Micro, Small and Medium Enterprise
MUDRA	Micro Units Development & Refinance Agency Ltd.
NABARD	National Bank for Agriculture and Development
NCGTC	National Credit Guarantee Trustee Company Ltd.
NEFT	National Electronic Fund Transfer
NGO	Non-Government Organisation
NPA	Non-Performing Assets
OECD	Organisation for Economic Co-operation and Development
OTS	One Time Settlement
PGS	Principal Guarantee Scheme
PMEGP	Prime Minister Employment Guarantee Program
PMMY	Pradhan Mantri Mudra Yojana
PSBs	Public Sector Banks

RBI	Reserve Bank of India
RBIA	Risk-Based Internal Audit
ROs	Regional Offices
RRBs	Regional Rural Banks
RSETI	Rural Self Employment Training Institute
RTGS	Real Time Gross Settlement System
RWAs	Risk Weighted Assets
SIDBI	Small Industries Development Bank of India
SME	Small and Medium Enterprise

"Credit is a system whereby a person who cannot pay gets another person who cannot pay to guarantee that he can pay"

- Charles Dickens

Chapter I

Micro, Small and Medium Enterprises in the global economy

Introduction

Small businesses are recognized as the best vehicles for generation of jobs. Micro, Small and Medium enterprises (MSMEs) make a significant contribution to the economies of Asia. It is estimated that worldwide MSME population is at 420 to 510 million, of which 360 to 440 million alone, are in emerging markets. Further, the formal SMEs contribute up to 45 percent of total employment and up to 33 percent of national income (GDP) in emerging economies and these numbers could be significantly higher when informal MSMEs are included. The Asia SME Finance Monitor 2014 published by the Asian Development Bank has estimated that 96% of all enterprises in the Asian region fall under the MSME category, absorb close to 2/3rd of the working force and contribute to about 42 % of GDP. They generate employment, make investments in plant and machinery, and create value through the production of goods and services. They play a far greater role than just providing employment. MSME sector is a nursery for entrepreneurship and a school for innovation. They are important for the national agenda of financial inclusion.

There is a huge variety of activities undertaken by MSMEs across the world. Most MSMEs are offering retail trade and services. They undertake operations as mundane as laundry, saloon shop, welding, automobile repairing to as sophisticated as defence equipment and aircraft part manufacturing. This heterogeneity of the activities undertaken by MSMEs makes us to group them into a single entity that requires Government's attention for the growth. MSMEs require Public support to grow since, they suffer from constraints that are related to their size. This is called "size induced market failures" (ADBI 2016). MSMEs find it difficult to access credit, market their products, deploy the latest technology, recruit skilled manpower and enter into export markets. Hence, implicit Government support is required to overcome the size induced market failures.

1.2. **Definition of MSME**

Internationally there are many differing definitions of the MSME sector. They depend on perspective. Banks / financial institutions following a client segmentation approach will have a different interest than tax authorities intending to target their tax control initiatives. Similarly, Governments interested in increasing their success in supporting the sector might choose other definitions than regulators interested in introducing workplace security standards and other regulatory bodies.

According to the World Bank Group and the European Investment Bank, enterprises defined as micro, small, and medium-sized enterprises as summarized in the tables below. In addition to the staff headcount ceiling, an enterprise is regarded as an MSME if it meets either the turnover ceiling or the balance sheet ceiling.

European Union definition

The main factors determining whether an enterprise is an SME are:

- staff headcount and
- either turnover or balance sheet total.

Company category	**Staff headcount**	**Turnover** or	**Balance sheet total**
Medium-sized	< 250	≤ € 50 m	≤ € 43 m
Small	< 50	≤ € 10 m	≤ € 10 m
Micro	< 10	≤ € 2 m	≤ € 2 m

World Bank definition

World Bank follows the definition based on headcount and annual turnover / asset size.

	Headcount	Annual Turnover	Assets
Medium	<300	<EUR 15m	<EUR 15m
Small	<50	<EUR 3m	<EUR 3m
Micro	<10	<EUR 100K	<EUR 100K

The World Bank also mentions proxies for the loan sizes as shown in the following table:

Category	Loan size proxy
Medium	<USD 1 million (<USD 2 million for some advanced countries)
Small	<USD 100,000
Micro	<USD 10,000

MSME definitions undergo change continuously - Case of China and Singapore

Countries occasionally change the definition of what qualifies as an SME. Changes are important as they affect which enterprises have access to government support programs. Definitions set in monetary terms (assets, sales) are subject to change because inflation erodes the real value. The People's Republic of China (PRC) revised its definitions in 2003 and again in 2011. The country now has one of the most varied structures in the world with specific definitions for 15 sectors. In most cases, the definition includes employment and operating revenue, but some include only employment, or assets and revenue. An SME in heavy industry has either fewer than 1,000 workers or revenue below CNY400 million (about $61 million). The revisions in 2011 tended to reduce the employment thresholds relative to 2003 criteria; for example, it fell from 3,000 to 1,000 workers in transportation. However, revenue criteria tended to rise; for example, it rose from CNY300 million to CNY400 million in the wholesale sector.

Singapore also changed its definition in 2011. Instead of separate definitions for manufacturing (based on assets) and nonmanufacturing (based on workers), a unified definition was created. Enterprises in all sectors are classified as SMEs if they have not more than 200 workers or sales of not more than S$100 million. The government dropped the criteria on assets because equipment and buildings are often leased, not owned. The change increased the number of enterprises classified as SMEs by 700 to 154,100.

Definition of MSME in India and priority sector lending status

The Government of India has enacted the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 and notified the same vide Gazette Notification dated June 16, 2006. With the enactment of MSMED Act 2006, the paradigm shift that has taken place is the inclusion of the services sector in the definition of Micro, Small & Medium enterprises, apart from extending the scope to medium enterprises. The MSMED Act, 2006 has modified the definition of micro, small and medium enterprises engaged in manufacturing or production and providing or rendering of services.

Category	**Manufacturing Enterprises** (investment in plant and machinery in Rs**)**	**Service Enterprises** (investment in equipment in Rs**)**
Definition	Enterprises engaged in the manufacture or production of goods	Enterprises engaged in providing or rendering of services
Micro	Upto Rs 25 lakhs	Upto Rs 10 lakhs
Small	Rs 25 lakhs to Rs 5 Crore	Rs 10 lakhs to Rs 2 Crore
Medium	Rs 5 crore to Rs 10 Crore	Rs 2 Crore to Rs 5 Crore

In terms of Ministry of MSME, GoI, Office Memorandum (OM) F. No. 12(4)/2017-SME dated March 8, 2017, it is clarified that for ascertaining the investment in plant and machinery for classification of an enterprise as Micro, Small and Medium, the following documents could be relied upon:

(i) A copy of the invoice of the purchase of plant and machinery; or

(ii) Gross block for investment in plant and machinery as shown in the audited accounts; or

(iii) A certificate issued by a Chartered Accountant regarding purchase price of plant and machinery.

Further, the Ministry has clarified that for the investment in plant and machinery for the purpose of classification of an enterprise as Micro, Small or Medium, the purchase value of the plant and machinery is to be reckoned and not the book value (purchase value minus depreciation)

Report of the Committee to re-examine the existing classification and suggest revised guidelines with regard to Priority Sector Lending classification and related issues (Chair : M V Nair) 2010 recommended among other things that within MSE sector, a sub-target for micro enterprises is recommended equivalent to 7 per cent of ANBC, upward revision in limits under MSE (both manufacturing and services) as prescribed under MSMED Act and Inclusion of medium enterprises, especially manufacturing enterprises within priority sector. Subsequently, Report of the Internal Working Group (IWG) to Revisit the Existing Priority Sector Lending Guidelines (Chair: Lily Vadera) recommended extending PSL status to Medium Enterprises in addition to the Micro and Small Enterprises. It also recommended a target of 7.5 per cent of ANBC for lending to micro enterprises. Based on the above two committee reports, RBI has amended the guidelines for lending to priority sector vide circular no. FIDD.CO.Plan.BC.54/04.09.01/2014-15 dated April 23, 2015.

The salient features of the guidelines are as under:-

(i) Categories of the priority sector: Medium Enterprises, Social Infrastructure and Renewable Energy will form part of priority sector, in addition to the existing categories.

(ii) Micro Enterprises: A target of 7.5 percent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher, has been prescribed for Micro Enterprises, to be achieved in a phased manner i.e. 7 percent by March 2016 and 7.5 percent by March 2017.

(iii) Bank loans to food and agro processing units will form part of Agriculture

On February 07, 2018, Cabinet Committee has approved change in the basis of classifying Micro, Small and Medium enterprises **from 'investment in plant & machinery/equipment' to 'annual turnover' (**PIB 2018**)** . While this step is expected to encourage ease of doing business, make the norms of classification growth oriented and align them to the new tax regime revolving around GST (Goods and Services Tax). The revised definition dispensed with different terms of classification of manufacturing and services units.

The new proposed definition is as under:

- A micro enterprise will be defined as a unit where the annual turnover does not exceed five crore rupees;
- A small enterprise will be defined as a unit where the annual turnover is more than five crore rupees but does not exceed Rs 75 crore;

- A medium enterprise will be defined as a unit where the annual turnover is more than seventy five crore rupees but does not exceed Rs 250 crore.

MSME definitions upper threshold across nations

	Sectors	Assets LCU millions	Revenue LCU millions	Assets $ millions	Revenue $ millions
High income					
Japan	manufacturing and others	300	...	2.8	...
	wholesale	100	...	0.9	...
	retail	50	...	0.5	...
	services	50	...	0.5	...
Rep. of Korea	manufacturing	8000	...	6.9	...
	primary/some services		20,000	...	17.2
Singapore	all	...	100	...	73.0
Upper middle-income					
PRC	heavy industry	...	400	...	61.3
	wholesale	...	400	...	61.3
Thailand	general	200	...	5.7	...
	wholesale	100	...	2.8	...
	retail	60	...	1.7	...
Malaysia	manufacturing	...	50	...	12.4
	services and others	...	20	...	5.0
Kazakhstan	all	...	5,200	...	15.6
Philippines	all	100	...	2.1	...
Lower middle-income					
Indonesia	all	10,000	50,000	0.7	3.6
India	manufacturing	300	...	4.5	...
	services	150	...	2.3	...
Sri Lanka	manufacturing	...	750	5.1	...
	services	...	750	5.1	...
Viet Nam	general	100,000	...	...	4.5
	trade and services	50,000	...	...	2.2
Bangladesh	manufacturing	300	...	3.8	...
	services	150	...	1.9	...
Low income					
Cambodia	all	...	...	0.5	...

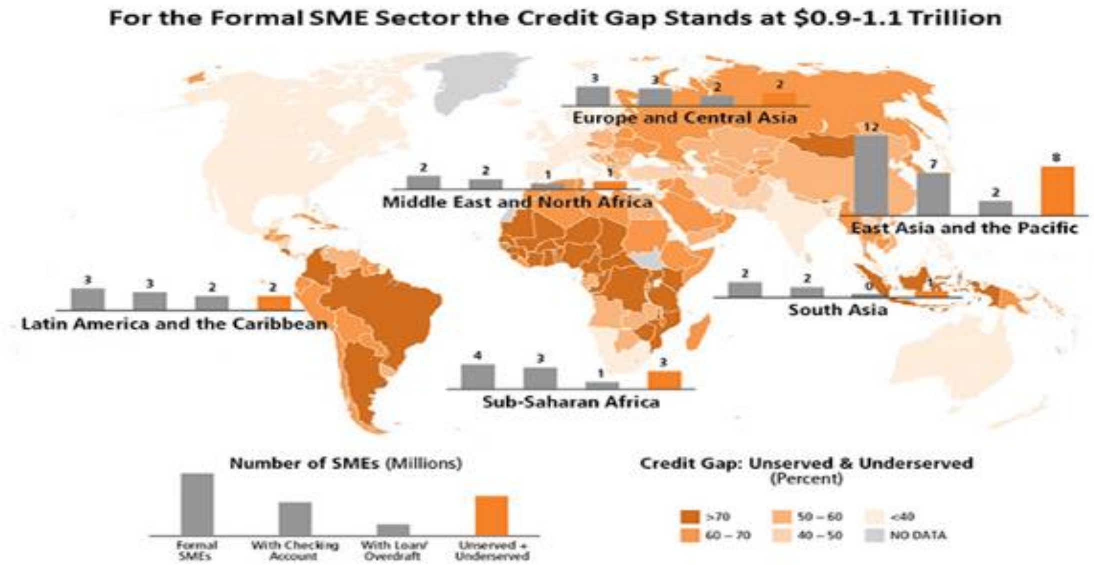
Source: ADBI, 2016, LCU – Local Currency Unit

1.3. Issues on access to finance by MSMEs

Before advent of the Global Financial Crisis (GFC) in 2008, due to stable macroeconomic environment, global liquidity and better banking practices through technology elevated the credit to private sector. It generally lead to financial deepening across the world. However, even during the benign macroeconomic environment, MSMEs have not benefitted through the financial deepening as benefitted by other class of banking customers. Banks often practice relationship based lending while lending to MSMEs due to paucity of financial statements. High transaction costs associated relationship based lending and high risk which is intrinsic to MSME lending explains the reluctance of bankers to lend this yet profitable sector.

Access to finance for MSMEs is considered as the most widely accepted market failure in developed as well as developing nations. Term loans, working capital finance, receivable finance, bill discounting and other forms of finance are critical to support the regular operations of the enterprise. They rely on internal or “personal” funds to launch and initially run their enterprises. Fifty percent of formal SMEs don’t have access to formal credit. The financing gap is even larger when micro and informal enterprises are taken into account. Overall, approximately 70 percent of all MSMEs in emerging markets lack access to credit. While the gap varies considerably between regions, it’s particularly wide in Africa and Asia. The current credit gap for formal SMEs is estimated to be US$1.2 trillion; the total credit gap for both formal and informal SMEs is as high as US$2.6 trillion (World Bank 2016).

MSMEs generally do not maintain audited financial statements due to their low levels of financial literacy and to avoid tax compliance. Hence, it is difficult for banks to conduct risk assessments, without audited financial statements. Nascent/ weak credit information systems in developing nations often exclude the smallest firms which make it even more difficult to collect historical credit information on these firms. In addition, emerging economies are often associated with weaknesses in collateral registration, contract enforcement, bankruptcy codes, and the slow judicial process and collection mechanisms which limit the ability for banks to recover assets of the enterprise. The limited liability structure (often termed as Own Account Enterprises (OWE)) of most MSMEs also prevents the lender from having recourse to the assets of the owners.



(Source : World Bank, 2016)

As reported by Stein, Peer; Ardic, Oya Pinar; Hommes, Martin. 2013 (IFC report on "Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises"), inadequate access to finance for MSMEs is due to three factors:

(i) informational asymmetries related to SMEs that create risks, e.g. banks are mostly unable to gauge the creditworthiness of SMEs and thus ask for higher charges and collateral requirements;

(ii) low revenue per client; and

(iii) The need for local presence, and thus for a large branch network, which may not necessarily be optimal from a cost perspective, especially in a developing country setting.

MSMEs in developing countries face an estimated financing gap of $2.1 to $2.6 trillion, which is equivalent to 30 to 36 percent of current outstanding MSME credit. The gap estimated by varies agencies vary substantially. There are 200 to 245 million formal and informal enterprises that do not have a loan or overdraft, but are in need of one—also referred to as the unserved sector—or do have a loan but still find access to finance as a constraint—also referred to as the underserved sector. More than 90 percent of the unserved and underserved enterprises are formal micro enterprises or informal MSMEs. With this challenge, an opportunity arises for both policy makers and the private sector to intervene at various levels to try to encourage better banking services, higher deposit rates, and greater accessibility of capital for MSMEs. Financing constraints are also magnified for informal firms, which tend to be small in size, and although often less productive than formal enterprises, contribute significantly to economic activity and employment. Informal firms are estimated to account for around 74 percent of all MSMEs in the world, and around 77 percent of all MSMEs in developing countries. Unregistered firms rely mostly on informal financing, which—although important in facilitating access to finance—is associated with lower firm growth and increased firm illegality. Although a sizable amount of the unmet demand for credit lies in the informal sector, many firms remain informal as they lack the incentives or capacity to formalize. Creating the appropriate environment for firms to formalize may take a long time, as it not only requires building an enabling environment—with solid institutions, laws and regulations, infrastructure, and education—but there is also a need to identify business-oriented incentives for firms, such as access to new market opportunities and access to financial and non-financial services, making it a profitable decision for firms to register their business (Stein, Peer; Ardic, Oya Pinar; Hommes, Martin. 2013)

To address the issue of access of finance, Governments in Asia have devised a variety of policies and programmes. The most direct approach is to establish a dedicated bank such as the Small and Medium Enterprise Development Bank of Thailand (SME Bank) or the Small Industries Development Bank of India (SIDBI). Central banks have mandated banks to extend finance to MSMEs through their directed lending programmes. The public sector bears the added cost of overcoming the asymmetry of information and a potentially higher default rate that is likely to develop because the government is normally not better able to assess creditworthiness than private banks.

Government can also overcome credit market failure by providing a guarantee on loans from commercial banks. Credit guarantee schemes operate in many upper middle-income and high-income countries but also in some less developed ones. Their clients are SMEs because large firms do not need a guarantee to secure credit. The share of the loan guaranteed varies by country and ranges generally from 50% to 90%. However, it is as low as less than 10% in many developing countries. But a high guaranteed share creates a moral hazard as the lender bears little risk, which discourages due diligence on loan appraisal. How much of the loan to guarantee—and therefore what share the bank bears—is a key public policy question.

Chapter II

Evolution of Credit Guarantee System (CGS)

Credit guarantee system (partial and full) had existed since 20^{th} century to alleviate the credit constraints of MSMEs. Many countries have focused on establishment of credit guarantee schemes as part of their public policy tool to increase the credit flow to the MSME sector. Credit guarantee schemes, in general, focus on a sector of MSME activity, or a particular geography or a segment of population who are involved in MSME activities. Credit guarantee system is essentially a risk diversification and risk transfer mechanism. It diversifies the risk by offering guarantee to different sectors and geographies. It lowers the risk of the lender by substituting the part / entire counterparty risk to the issuer of the guarantee scheme, which guarantees the lender to pay the loan in the event of default. It makes lending more attractive by absorbing or sharing the risks associated with lending. It can also increase the amount of funds lent to enterprises beyond its own collateral limits, because the guarantee is a form of collateral. A CGS can assume the additional role of loan assessor and monitor and thereby improve the quality of lending. The issue of information asymmetry can be overcome if the guarantor has more information than the lender (Zander, Miller, and Mhlanga 2013).

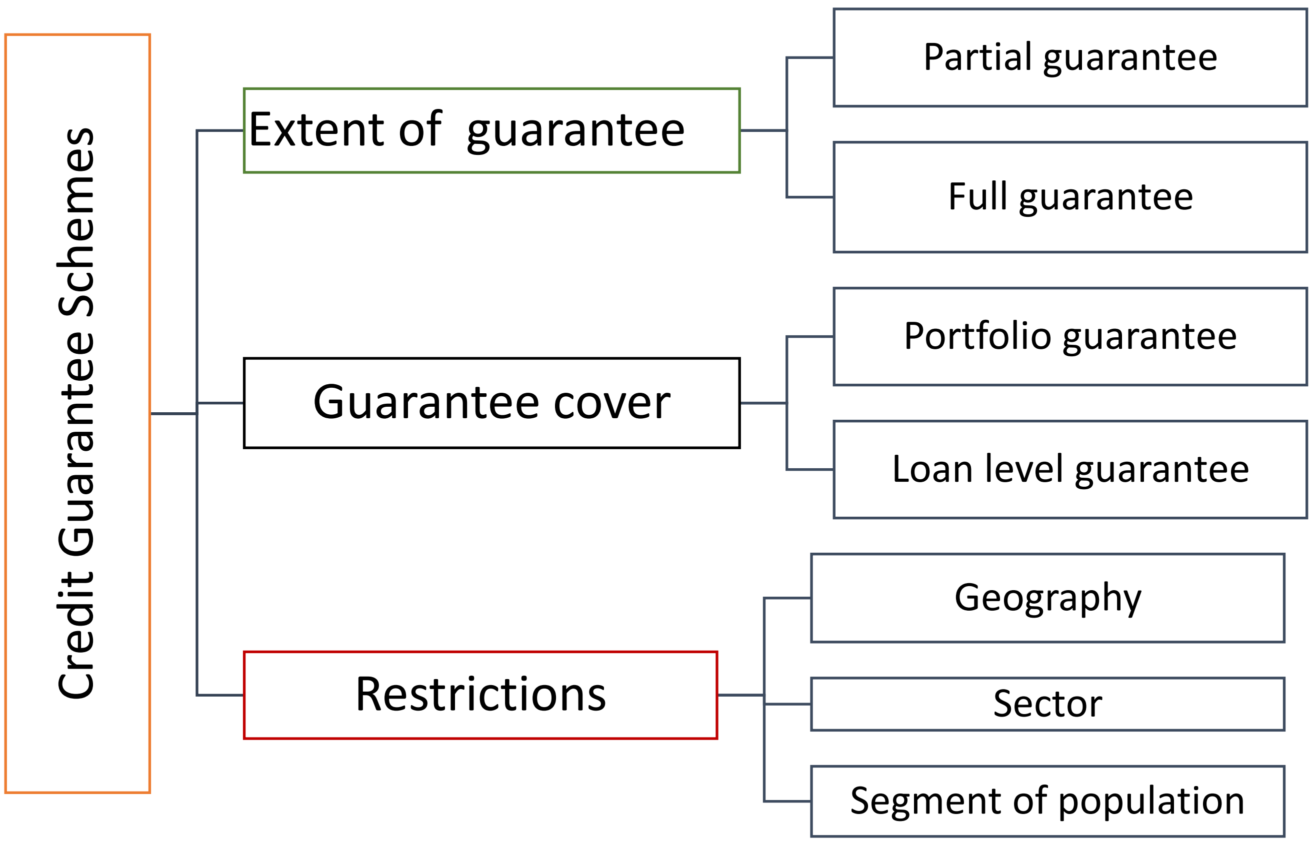
Demirguc-Kunt and Martinez Peria (2008) report that banks see partial credit guarantee schemes as the most common and most effective government support program for SME lending, ahead of directed credit and interest rate or regulatory subsidies. However, guarantee funds have a cost, which is paid by fees charged and/or subsidized by the government or a third-party institution.

Credit Guarantee Schemes emerged for the following main reasons.

- They are considered to be effective to increase credit flow to MSME in comparison with directed lending or interest rate subsidies.
- The scheme is market friendly as the decision to lend rests with the lender.
- Informational advantage of guarantor over the lender will overcome the information asymmetry, increase the flow of credit and reduce cost of borrowing.

- To diversify he risk of the lender by offering guarantee to various sectors, geographies and segments of population.
- To leverage the regulatory arbitrage, if the guarantor is not subject strict regulation as the lender.

Typology of Credit Guarantee Schemes



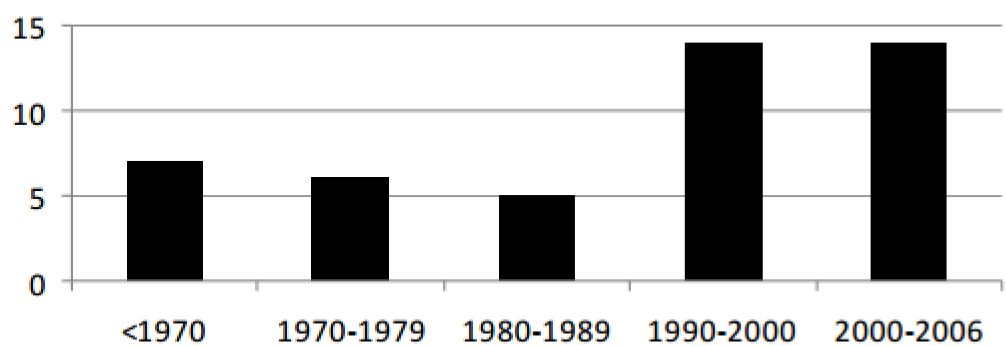
Individual vs loan portfolio guarantee

While most of the credit guarantee systems are Government sponsored, it is desirable to leave the credit risk assessment to the lender rather than Government bureaucrat. The dichotomy between individual vs loan portfolio guarantee is yet settled, both has certain merits and demerits. While individual loan guarantee reduces risk, it proves to be costly. It is also imperative in the scenario that guarantor has the capability to assess the risk. While guaranteeing, portfolio guarantee, appropriate risk management mechanisms have to be in place so that the guarantor will guarantee a certain minimum quality of the guaranteed loans. Coverage ratios based on past portfolio performance of the respective financial institution and / or on performing loans under the guaranteed loans and loan payout ratio may be used to limit the adverse selection.

Characteristics of Credit Guarantee schemes

Age - Credit Guarantee Schemes are in vogue for more than a decade. However, majority of the schemes came into existence during 1990s to 2010. While the median age for a selected (76 in number) is 15 years, the median age for the high income economies is at 27 years and middle / low income economies is at 13 years (Thorsten Beck et al 2008). It is interesting to note that many credit guarantee schemes were established after the global financial crisis 2008.

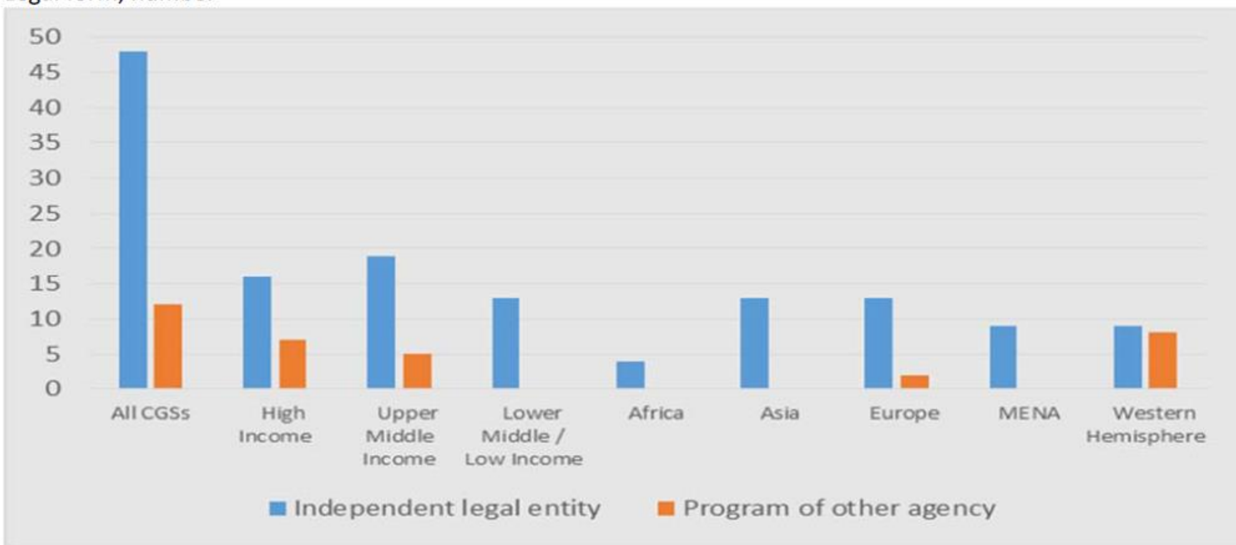
The distribution of CGS creation over time



Legal status of Credit Guarantee Schemes

The guarantee corporations are expected to operate on the basis of a sound and clearly defined legal framework. This is essential for communicating key expectations to shareholders, boards, management, and all other stakeholders, including MSME borrowers and the general public. The guarantee corporations should have clear mandate on which segments / sectors / geographies are they going to focus to increase the credit flow. The underlying aim of a strong legal framework is to make the broad policy directions of the government and the rules of the game clear for everyone, enhancing the credibility and reputation of the scheme. In Asia and Africa, they are by and large independent legal entity.

Legal form, number



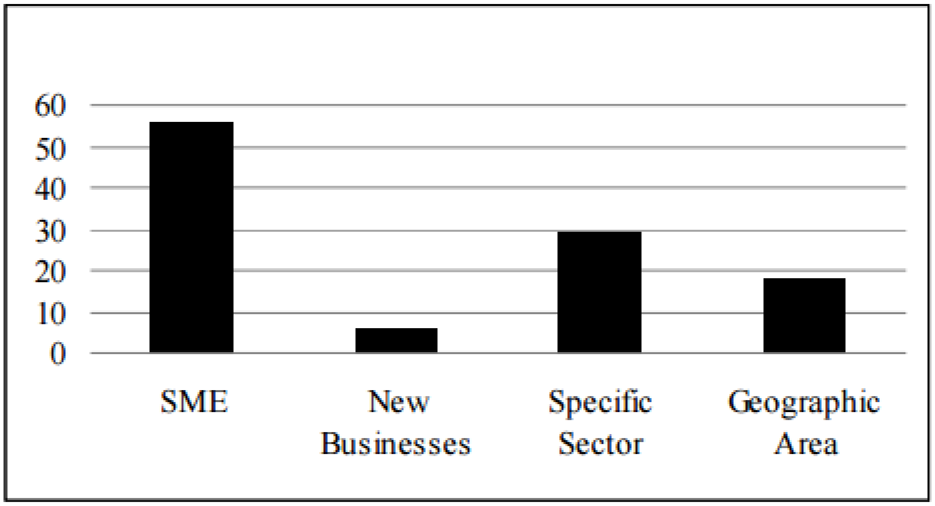
(Source: World Bank, 2015)

Total Outstanding Guarantees/ GDP - The median value stood at 0.61%, the value for high income economies is at 0.21% s and middle / low income economies is at 0.30%. Asia has a high median value of 4.7% total outstanding guarantees/ GDP and the value for Latin America is at 0.06%.

There is important variation in the degree to which schemes are profit-oriented and subject to taxation. 40% of the schemes are for-profit, while the remaining 60% are non-profit; 52% are subject to corporate income tax, while 48% have tax-exempt status. The likelihood that a scheme is taxable does not vary across income levels of countries. In the East Asian and Pacific region, schemes are more likely to be tax-exempt than in other regions. Non-profit oriented CGS funds are typically tax-exempt (Thorsten Beck et al 2008).

The large majority of CGS funds were created with specific goals and thus have restrictions in terms of the sector, type of business or geographic area. More than 45% of the schemes were set up to assist MSMEs and close to 25% focus on particular geography. Certain schemes focus on specific sector and new business initiatives alone.

Number of CGS funds, by eligibility requirements



Overall, CGS funds focus on micro of MSME segment with fewer than 10 employees.

Number of employees employed - It is an indicator to assess how well the guarantee scheme is managed. There is a wide variation among the number of people employed. It is as high as 2200 in Korea Credit Guarantee scheme to less than 10 in Israel, India, Switzerland and Sri Lanka.

Maximum guarantee period – There is a wide variation among the maximum guarantee period offered by the credit guarantee schemes with a median guarantee period of 10 years. For example USA (US Small Business Administration) offers credit guarantee up to 25 years and the Peruvian credit guarantee scheme offers a maximum guarantee period of 3 years.

Governance of Credit Guarantee schemes

There are three general types of CGS being operated.

1. Mutual Guarantee Associations

   They are a collective of independent businesses and/or organizations that grant collective guarantees to loans issued to their 'members'. Examples include the partial credit guarantee schemes in Italy.

2. Publicly Operated National Schemes

   They are government initiatives at the local, regional, or national level. These are generally established as part of a public policy towards providing financing to SMEs or some other priority sector or demographic group (i.e. women or minorities). Although publicly funded, these might be managed by private groups. Examples include the credit guarantee schemes in Korea, India, and Japan.

3. Corporate Association

   They are generally funded and operated by the private sector. Examples include guarantee schemes in Greece and Romania

Region / income group where the CGS operates	**Age of the CGS**	**Outstanding guarantees (US$ mn)**	**Outstanding guarantees (% GDP)**	**Employees**
All CGS	21	203	0.11	99
Income group				
High income	21	727	0.33	189
Middle income	19	178	0.07	32
Low income	24	32	0.10	36
Regions				
Africa	26	3	0.01	26
Asia	27	214	0.10	371
Europe	22	579	0.29	93
Middle East	12	91	0.12	40
Western hemisphere	19	220	0.05	64

(Source: World Bank, 2015)

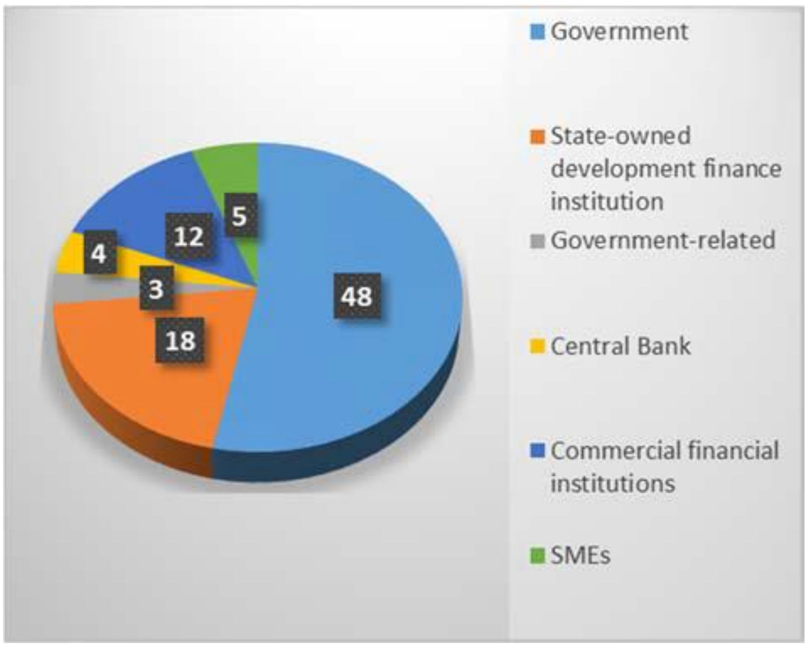
Funding, Ownership, and Management of CGS

Credit guarantee schemes are owned by Public and Private as well. But majority of them are owned by sovereign Government and to lesser extent by the Central banks (in Sri Lanka). However, there is no uniform pattern among the Government ownership. Some CGS are entirely owned by their Government, while others have partial private sector ownership too. The private sector entities are mainly commercial banks or financial institutions.

The table below summarises the role of Government, private sector, commercial banks in the management of the credit guarantee scheme, ex-ante credit risk assessment of loans and the ex-post responsibility of loan recoveries. Risk management and recovery are mostly in the hands of private sector i.e., the lender herself.

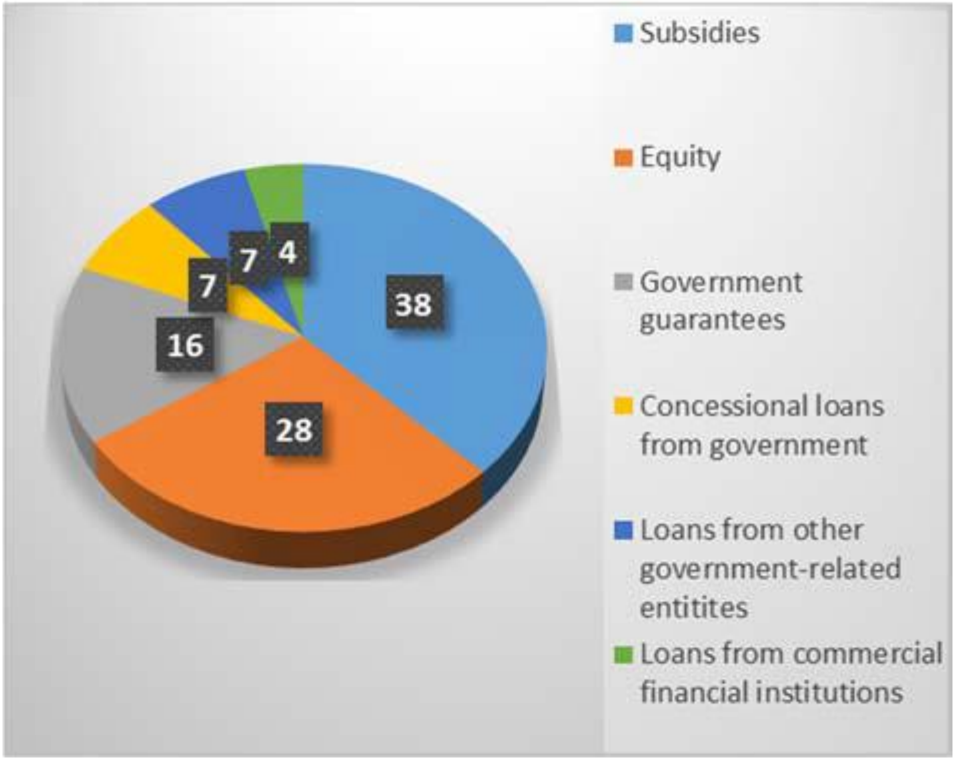
Agency	Funding (%)	Management (%)	Credit risk assessment (%)	Recovery (%)
Government	49	17	11	8
Government related	3	9	8	1
NGO	5	5	4	3
Private	58	51	57	55

Ownership, frequencies (%)



(Source: World Bank, 2015)

Funding, frequencies (%)



(Source: World Bank, 2015)

Central banks and supervisory authorities (government-related) have little involvement in the management and risk assessment and even less in funding and recovery. Similarly, donors have a limited role in the different aspects of partial credit guarantee schemes. Governments have an important role in funding – over a third of schemes rely at least partially on government funding – they have a much more limited role in management, risk assessment and recovery. Finally, while the private sector shares in funding with governments, it is dominant in management, risk assessment and recovery, i.e. the banks that are generating the loans being guaranteed are mostly responsible for credit risk assessment and recovery of defaulting loans.

Extent of loan coverage and guarantee mechanism

The extent of loan coverage varies between 50% of the loan value to 100% of the loan value. More than 40% of the schemes offer 100% coverage to the principal value. The median coverage value is at 80% of the loan. Only few CGS guarantee both principal and interest.

The guarantee mechanism operates in two general models.

- Credit guarantee organisations directly extend the guarantees to the lending bank directly
- Counter-guarantees or co-guarantee with mutual guarantee institutions who provides indirect protection to the lender through a guarantee of the main guarantor.

Most of the schemes operating across the world offer direct guarantee to the financial institutions. While few CGS offer counter guarantees along with direct guarantees, Japan Finance Corporation (JFC) exclusively offers counter guarantee to the direct guarantee corporations.

Performance of the Credit Guarantee Corporations

P Calice (2016) of World Bank evaluated the performance of credit guarantee scheme across 60 geographies and his findings are in the table below.

Region / income group where the CGS operates	Outreach (%)	Productivity	Leverage	Default rate (%)
All CGS	1.6	29	3.3	2.5
Income group				
High income	2.0	30	4.1	2.9
Middle income	0.9	29	2.9	3.0
Low income	1.6	21	1.0	1.0
Regions				
Africa	0.3	8	1.7	17.1
Asia	2.7	33	3.2	1.2
Europe	0.9	17	3.8	2.9
Middle East	2.2	22	4.4	3.8
Western hemisphere	3.4	164	3.0	2.0

Outreach - Number of SMEs served divided by total SMEs in the country.
Productivity - Number of guarantees issued divided by number of employees
Leverage - Outstanding guarantees divided by total capital
Default rate - Nonperforming guarantees divided by outstanding guarantees

Outreach is an important dimension of the CGS's overall performance as it measures the ability of the CGS to meet demand for guarantees. Outreach outcomes vary significantly by country: for example, CGSs in Mexico and Japan guaranteed loans to more than 130,000 SMEs in 2014, while in the same year schemes in Bosnia & Herzegovina and Jamaica (and others) served fewer than 30. Overall, it appears that older and well established CGSs display higher outreach outcomes.
Leverage is another important parameter to study the performance of the guarantee scheme in a sustainable manner. The median value stands at 3.3, i.e., the guarantee corporations have offered guarantee to 3.3 times of their paid up capital. There is no standard prescription on how much the guarantee corporations leverage their capital, it is desirable that the guarantee corporations are well capitalized.

Chapter III

Credit Guarantee mechanism for MSMEs in India

History of credit guarantee in India

I. The first phase: 1960-1990

Micro, Small and Medium Enterprises (MSMEs) play a vital role in growth of developing economies. India has accorded its highest priority for the development of robust MSMEs which are considered to be the seedbed for enterprise development. Credit is considered to be an important enabler in the development of robust MSME network across the country. Sovereign government and the central bank had taken various initiatives to ensure that the credit needs of the hitherto neglected sectors and weaker sections were met. The essential concern was to persuade banks to make available credit to creditworthy clients who are excluded from formal financial services..

The need for setting up of a credit guarantee system for MSMEs in India were felt long back when many nations have not thought of such an idea. In the year 1959, a seminar was conducted by Reserve Bank of India to find out ways and means of enlarging bank credit to small industries. During the seminar, it emerged that bank lending to small industries could be augmented by enabling credit institutions to share the risks involved with some other agency set up specially for that purpose (Report of the working committee to review deposit insurance and credit guarantee schemes 1987). Government of India, in consultation with the Reserve Bank of India, introduced a Credit Guarantee Scheme in July 1960. The Reserve Bank of India was entrusted with the administration of the Scheme, as an agent of the Central Government. Reserve Bank of India was designated as the Credit Guarantee Organization (CGO) for guaranteeing the advances granted by banks and other Credit Institutions to small scale industries including loans to farmers. The scheme was subsidized by Government of India to the extent that the premium was only 0.25% of the guaranteed amount. The scheme had also acted as a refinance scheme so that financial institutions to replenish their resources. It was part of the measures taken in the late 1960's aimed at encouraging banks to extend credit to priority sector. The loans were guaranteed with a system of prior scrutiny of individual applications for each eligible advance by the guarantee corporation.

Further, several measures were taken during 1960-1969 such as enhancing the guarantee cover, reduction in the rate of guarantee fee and refinance to banks at concessional rates. These efforts lead to increase in availability of finance to small industries. The nationalization of 14 major banks in the year 1969 gave further impetus to the growth of advances to this sector and the credit guaranteed loans had increased considerably. The system of prior scrutiny of individual applications was dispensed with in the year 1970 and guarantee cover was made available on automatic and bulk coverage basis based on principles of diversification of risk and large coverage (K N R Ramanujam working group 1971). Hence **all the eligible advances get automatically covered** without requiring the credit institutions to submit to the credit corporation each loan proposal for prior approval.

The Reserve Bank of India had also promoted a public limited company on January 14, 1971, named the Credit Guarantee Corporation of India Ltd. (CGCI) and all the credit guarantee corporations were brought under a single fold. In the year 1979, a working group was constituted by Government of India to look at the functioning of credit guarantee schemes and as per the recommendations of the working group, all credit guarantee schemes were integrated under one organisation.

The schemes covered under the credit guarantee scheme are:

(i) Small Loans Guarantee Scheme 1971
(ii) Small Loans (Financial Corporations) Guarantee Scheme, 1971
(iii) Service Co-operative Societies Guarantee Scheme, 1971
(iv) Small Loans (Small Scale Industries) Guarantee Scheme, 1981
(v) Small Loans (Co-operative Credit Societies) Guarantee Scheme, 1982;
(vi) Small Loans (Co-operative Banks) Guarantee Scheme, 1984

Initially, the **guarantee was extended upto 90 per cent of the total outstanding loan (including interest), which was reduced over time to 50 per cent of the principal amount**. No time limit had been prescribed for invocation of the guarantee and lodging the claim. After payment of the claim, the guarantee corporation were discharged of all its obligation and the credit institutions will continue its effort towards recovery and share the recovery to guarantee corporation on the basis of the loss shared by them.

The consideration for extension of the guarantee cover is the payment of guarantee fee at the stipulated rates calculated on the balances outstanding under the priority sector advances (except certain specified categories) and paid yearly in advance by the credit institutions. The **fee rate is 2.50 per cent per annum** for the Small Loans Guarantee Scheme, 1971. The guarantee fee rate for each of the two other schemes viz. Small Loans (Co-operative Banks) Guarantee Scheme, 1984 and Small Loans (SSI) Guarantee Scheme, 1981 is 1.50 per cent per annum. The Regional Rural Banks were, however, allowed to pay the fee at half the normal rate for first five years from the date of their joining the Scheme. The fee is required to be paid regularly on an annual basis in order to keep the guarantee in force. Penal interest @ 8 per cent above the Bank Rate is charged on overdue guarantee fee. The guarantee scheme had a capital of Rs 500 million as on 1986.

Small Loans (Small Scale Industries) Guarantee Scheme, 1981 covered credit facilities extended by commercial banks, RRBs, co-operative banks and state finance corporations. As at the end of 1986, 476 agencies were participating the credit guarantee programme. The total amount of claims received from credit institutions till 1986 were at 3.7% of the total guaranteed advances. However, the scheme was not attractive for term lending institutions due to combined fixation of credit guarantee under term loans and other credit facilities, like State finance corporations who are purveyor of credit to small industries.

The important principle in the scheme is that the eligibility condition for guaranteeing credit risks are related to particular economic activity of the borrower and the purpose for which the credit facility is extended. Hence, the availability of security / collateral in the account and their liquidity had no relevance for the eligibility criteria. To ensure that such benefits do not gravitate to relatively affluent persons, several stipulations have been made in the guarantee schemes, such as ceiling of Rs 0.4 million on sales turn over as in the case of 'retail traders and the value of equipment up to Rs 0.2 million as in the case of business enterprises and of plant and machinery in the case of small-scale industrial units. Besides, absolute limits have been placed on the Corporation's liability (Goiporia committee 1987).

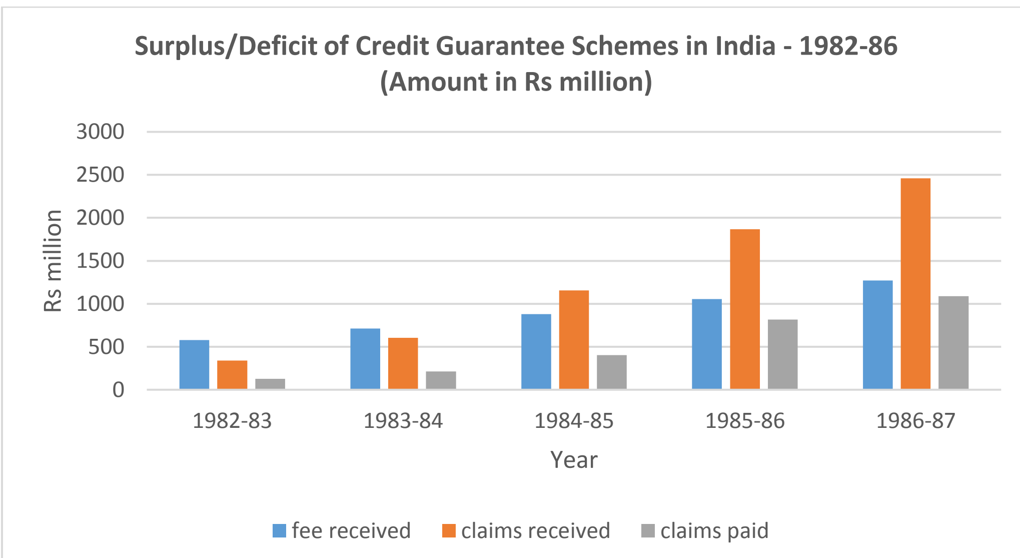
The position regarding the Small Loans Guarantee Scheme 1971 as on March 1986 is as below:

Name of the scheme	**Total guaranteed advances (in Rs million)**	**% to total guaranteed advances in respect of non MSMEs**	**% to total guaranteed advances (MSMEs and non MSMEs)**	**Guarantee fee**
Small Loans Guarantee Scheme 1971	103451.6	99.03	57.65	0.5% per annum for advances upto Rs 25000/- and 0.75% per annum for others

Source: Report of the Goiporia working committee 1987

The amount of fee received from financial institutions fell short of the claims received from them. Hence, in the year 1981, the extent of guarantee cover has been reduced from 75% of the outstanding to 60% of the outstanding.

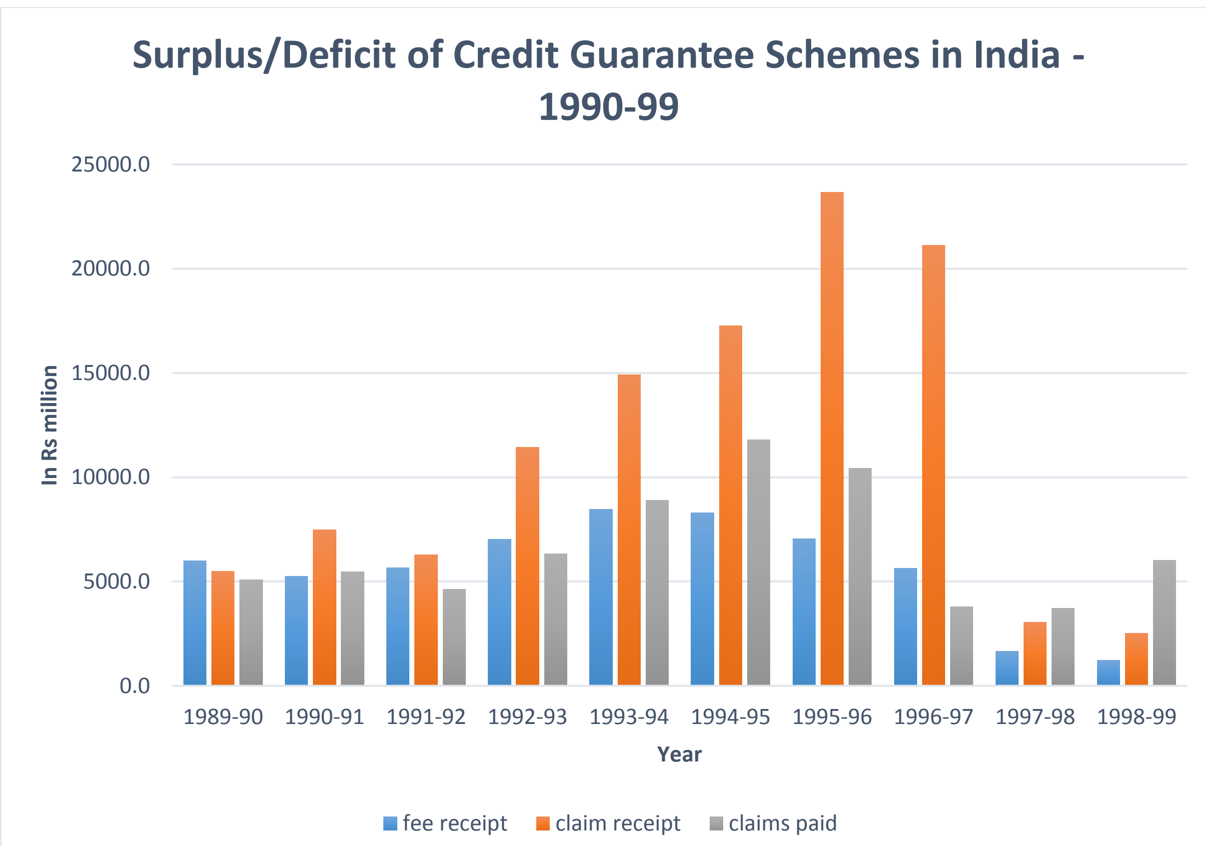
year	Fee received	Claims received	Claims paid	Gap (2-3)	Gap (2-4)
1	2	3	4	5	6
1982-83	576.6	341.1	128.7	235.5	447.9
1983-84	711.7	604.2	212.8	107.5	498.9
1984-85	879.1	1156.9	404.6	-277.8	474.5
1985-86	1056.6	1869	815.5	-812.4	241.1
1986-87	1272.5	2458.6	1086.9	-1186.1	185.6



One of the major areas of concern has been the enormous growth in the claims lodged by the credit institutions. Over the years, guarantee claims have been spiraling. The claims received had raised from Rs 94 million in 1982 to Rs 1049.5 million in 1986 (a tenfold increase over five years). There was no lock in period for the claim invocation and there are instances wherein the credit institutions have invoked the claim immediately after the disbursement of the loan.

Surplus/Deficit of Credit Guarantee Schemes in India - 1990-99 (Amount in Rs million)

Year	Guarantee fee receipts	Guarantee claims receipts	Claims paid	Gap (2-3)	Gap (2-4)
1	2	3	4	5	6
1989-90	5988.3	5483.3	5085.4	455.0	852.9
1990-91	5247.2	7487.6	5471.6	-2240.6	-224.4
1991-92	5658.8	6272.3	4622.9	-613.5	1035.9
1992-93	7027.8	11432.7	6335.5	-4404.9	692.3
1993-94	8460.9	14907.6	8899.9	-6446.7	-439.0
1994-95	8291.3	17268.2	11790.1	-8976.9	-3498.9
1995-96	7046.4	23652.3	10422.7	-16609.5	-3376.3
1996-97	5640.2	21123.7	3786.4	-15483.5	1853.6
1997-98	1649.1	3039.6	3714.0	-1390.5	-2064.9
1998-99	1232.1	2523.0	6019.1	-1289.6	-4786.8



Source: Report of the working group on reforms in deposit insurance in India, 1999

The credit guarantee schemes of DICGC have not been viable. The credit guarantee fund has been in deficit except for the year 1989-90, resulting in huge deficit for the DICGC as a whole. A major attraction of credit guarantee schemes for banks, apart from the guarantee, was that the guarantee fee paid to DICGC was tax-deductible. The DICGC has been forced to fund the credit guarantee fund by borrowing from the deposit insurance fund. To overcome deficits in guarantee funds, the guarantee fee was enhanced in April 1989. Then in 1995, the guarantee claims were confined to principal loan rather than outstanding loan, as was the practice earlier. These changes made the credit guarantee schemes an unattractive proposition for the banks. Consequently, most of the banks have opted out of the schemes.

The banks feel that with an in-house corpus (Fund created out of credit guarantee fee paid to DICGC) they can manage the overdues problem of the priority sector loans. The credit guarantee operations of the DICGC have been less attractive for the user and the fact that extension of loans and managing risks associated with it are the prerogatives of the lender and the fact that the deposit insurance fund has been cross-subsidising the credit guarantee fund, the working Group recommend that the credit guarantee on loans may be withdrawn. With the financial sector reforms undertaken in the 1990s, credit guarantees have been gradually phased out.

II. The second phase 1990 – 2000

During this phase, there is no guarantee scheme was in vogue. However, Reserve Bank of India was advising the bankers to extend credit to MSMEs without collaterals through its policies / directions. Reserve Bank had advised all scheduled commercial banks that viable MSME loan proposals be considered on merit and should not be turned down merely for want of collaterals such as immovable properties or third party guarantee. The central bank has enhanced the exemption limit for collateral free lending from Rs 25000/- to Rs 100000/- based on the recommendation of the Kapur committee during October 1999. Further, the limit was raised to Rs 500000/- during March 2000 and to Rs 1000000/- during June 2000 in pursuant to the announcement made by the Finance Minister in the Budget 2000-2001. The limit was further raised to Rs 1500000/- in April 2002 for units which have good repayment records and based on their financial position.

The third phase 2000 – 2014

Government of India and Small Industries Development Bank of India (SIDBI) set up the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) in August 2000 with a committed corpus of Rs 25000 million. The scheme has following features.

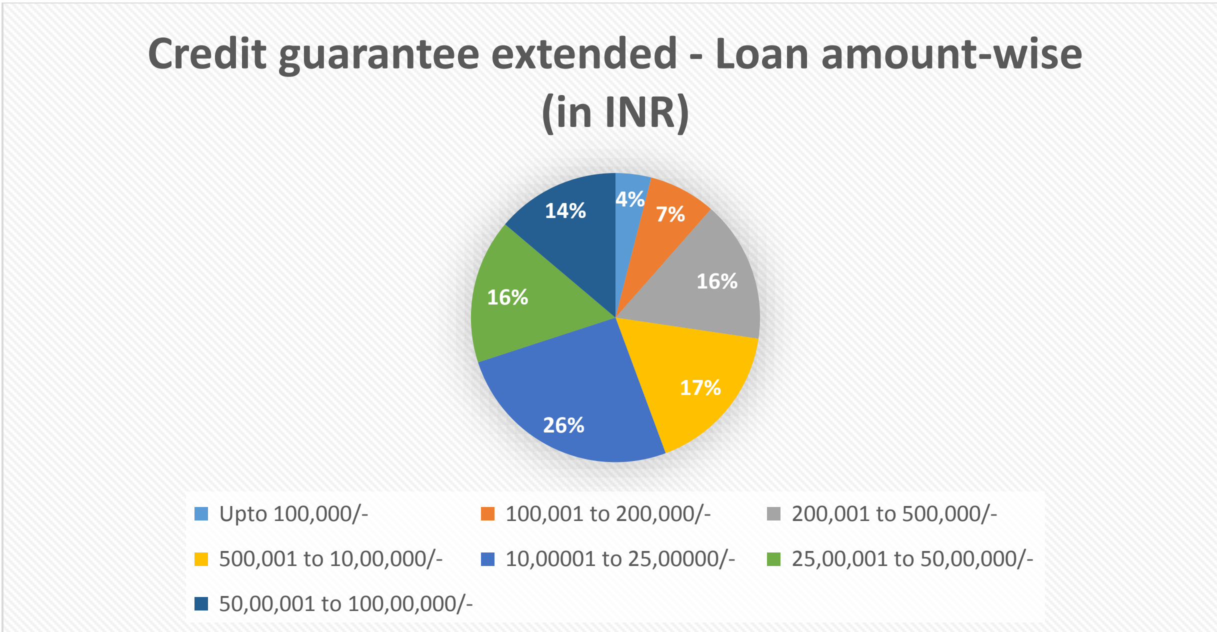
- The lender should give importance to project viability and secure the credit facility purely on the primary security of the assets financed,
- Maximum Guarantee Cover of up to 85% of credit facility extended by the financial institution,
- The financial institution availing the guarantee has to apply to the guarantee corporation for each loans.

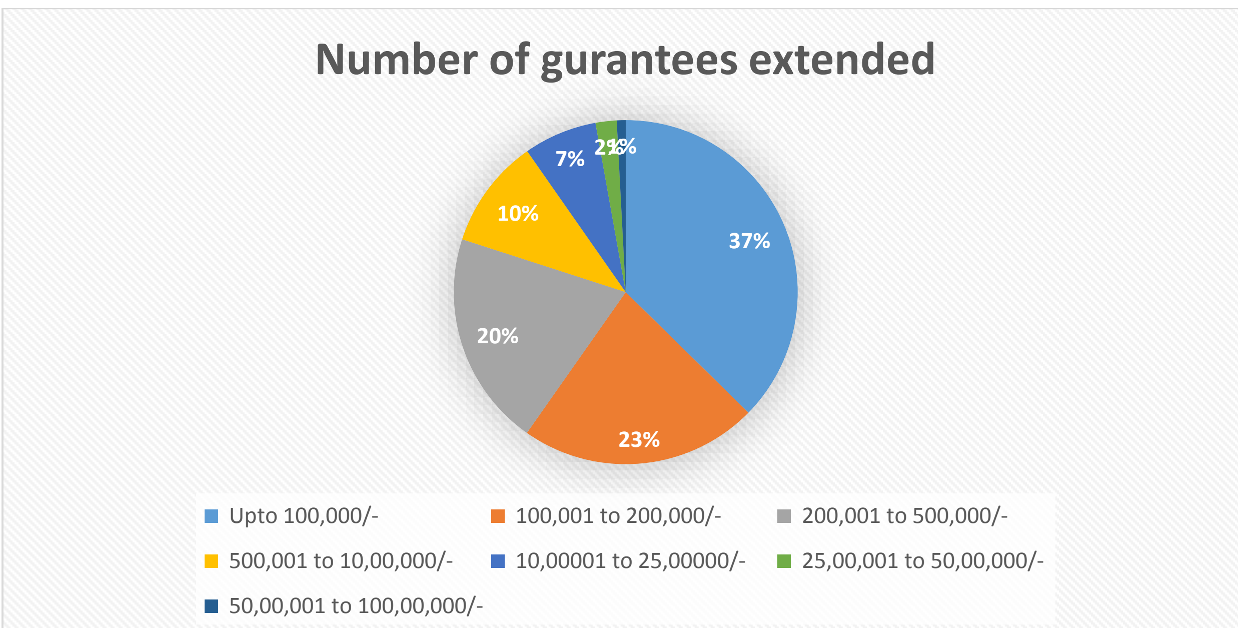
Over the years, the scheme has undergone various changes in terms of coverage and annual guarantee fee to be collected from financial institutions, quantum of loan to be guaranteed and preferential treatment to less developed region and women enterprises.

The progress under the scheme since inception is as below:

Credit Guarantee Fund Trust for Micro and Small Enterprises			
Slab-wise guarantee approvals for the June 30, 2016 (cumulative)			
Sl No.	**Range (in Rs)**	**Cumulative as on June, 2016**	
		No. of Proposals	**Loan Amount (Rs. Lakh)**
1	Upto 100,000/-	933066	461999
2	100,001 to 200,000/-	559591	869788
3	200,001 to 500,000/-	505160	1837313
4	500,001 to 10,00,000/-	257599	1973511
5	10,00001 to 25,00000/-	172193	2971531
6	25,00,001 to 50,00,000/-	49536	1874589
7	50,00,001 to 100,00,000/-	20935	1604209
	Total	**2498080**	**11592940.12**

As we can see from the above table, **more than 60% of the loans guaranteed (in terms of number) are under Rs 0.2 million.** However, these loans constitute only 11% of loan amount guaranteed by the credit guarantee corporation. More than 30% of the loans guaranteed in terms of value are over Rs 2.5 million.

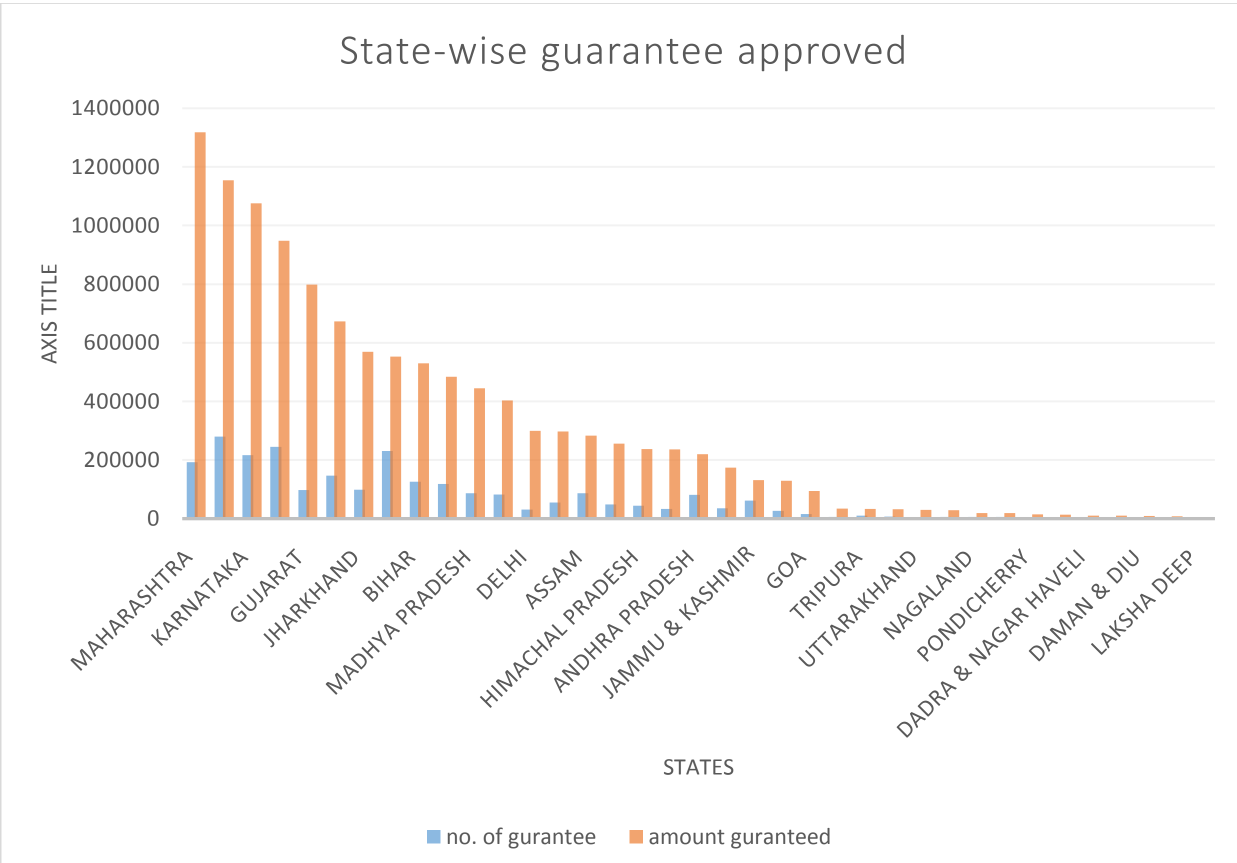




The scheme accords special treatment to women enterprises and enterprises operating in north eastern part of the country by offering concessions in annual guarantee fee. The annual fee prescribed by the guarantee scheme is as below.

Credit facility	Annual guarantee fee (% per annum)	
	Women, Micro Enterprises and units in North East Region	Others
Upto Rs 0.5 million	0.75	1.00
Above Rs 0.5 million to Rs 10 million	0.85	1.00

However, the credit facility to the north eastern region is negligible. All the seven north eastern states credit guarantee constitutes 5.08% of total guarantees with 3.58% of total credit.



It appears that only the industrialised states are benefitting from the guarantee. Less developed states, where credit origination is inherently risky have been left out which defeats the purpose of the credit guarantee scheme.

Exclusion of Regional Rural Banks and Co-operative banks

Regional Rural Banks (RRBs) and Co-operatives are the purveyor of credit in rural areas. Co-operatives were not eligible to avail the credit guarantee offered by the guarantee corporation. They should be made eligible to avail the credit guarantee scheme. At the same time looking at the state of co-operatives, it is imperative to improve their weakness especially the governance aspect.

Soundness indicators of rural co-operative banks (short-term)

(₹ billion)

Item	StCBs				DCCBs			
	As at end-March		Percentage Variation		As at end-March		Percentage Variation	
	2014	2015P	2013-14	2014-15P	2014	2015P	2013-14	2014-15P
1	2	3	4	5	6	7	8	9
A. Total NPAs (i+ii+iii)	57.0	57.2	1.2	0.4	209.0	208.0	15.8	-0.5
i. Sub-standard	20.7	20.8	0.3	0.5	100.2	93.2	27.3	-7.0
	(36.2)	(36.3)			(47.9)	(44.8)		
ii. Doubtful	26.1	24.7	31.2	-5.4	86.9	91.1	14.0	4.8
	(45.9)	(43.2)			(41.6)	(43.8)		
iii. Loss	10.2	11.7	-35.4	15.0	21.9	23.7	-14.4	8.3
	(17.9)	(20.5)			(10.5)	(11.4)		
B. Gross NPA-to-Loans Ratio (%)	5.5	5.0			10.3	9.5		
C. Recovery-to-Demand Ratio (%) (as on 30 June of previous year)	82.5	94.9			78.3	77.3		

Notes: Figures in parenthesis are percentages to total NPAs. P: Provisional.

(Source: NABARD & Report on Trend and Progress of Banking in India 2015-16)

There are 56 Regional Rural Banks are operating in the country. Out of that only 22 RRBs are eligible to become Member Lending Institutions, thus leaving majority of the RRBs. The following criteria has been adopted for RRBs to become members in the credit guarantee corporation.

- Capital to Risk Weighted Ratio (CRAR) of not less than 12%
- Net Profit for at least previous three financial years
- Net Non Performing Advances s below 5% of advances
- No regulatory defaults.
- More than 80 marks awarded by NABARD (supervisor) under Composite Rating (as per the latest available review) under its Supervisory Rating Scale for RRBs

The above norms made 34 out of 56 RRBs ineligible to become members of credit guarantee scheme.

Differential risk based premium to offer credit guarantee

Till, April 2016, the scheme adopted a non-discretionary approach in levying Guarantee Fee / premium without reference to the level of non-performing loans reported by the financial institutions. Currently, the scheme operates with a **differential risk premium based on the non-performing loan portfolio in the guaranteed loans and the claim pay-out ratio** by the financial institutions as below.

Risk based premium for credit guarantee

Risk premium on NPAs in Guaranteed portfolio		**Risk premium on Claim Pay-out Ratio**	
NPA Percentage	**Risk Premium**	**Claim Pay-out Percentage**	**Risk Premium**
0-5%	SR	0-5%	SR
>5-10%	10% of SR	>5-10%	10% of SR
>10-15%	15% of SR	>10-15%	15% of SR
>15-20%	20% of SR	>15-20%	20% of SR
>20%	25% of SR	>20%	25% of SR
SR–Standard Rate			

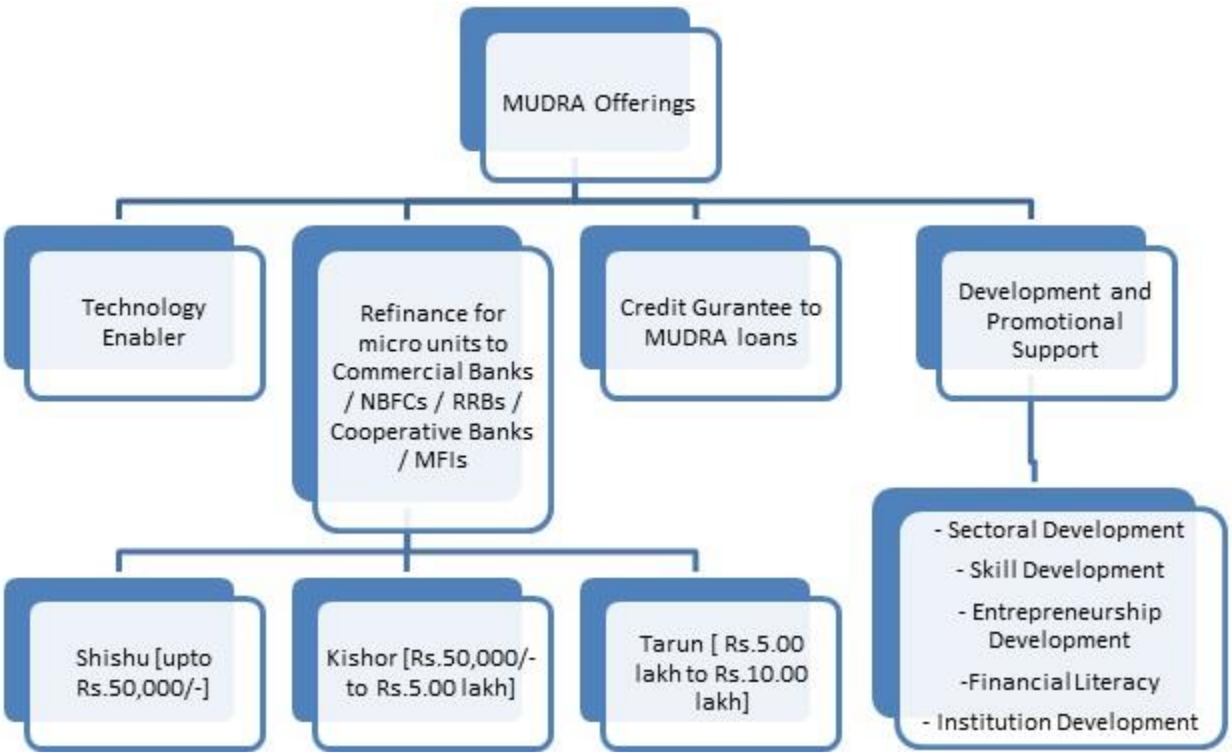
The fourth phase – 2014 onwards

Setting up of MUDRA and National Credit Guarantee Trustee Company Ltd (NCGTC)

MUDRA (Micro Units Development & Refinance Agency Ltd)

Micro Units Development & Refinance Agency Ltd (MUDRA) was set up by the Government of India (GoI) as a wholly owned subsidiary of Small Industries Development bank of India (SIDBI) with capital of Rs 1000 crores. It would be responsible for developing and refinancing all Micro-enterprises sector by supporting the finance Institutions which are in the business of lending to micro / small business entities engaged in manufacturing, trading and service activities. MUDRA would partner with Banks, MFIs and other lending institutions at state level / regional level to provide micro finance support to the micro enterprise sector in the country.

MUDRA offering



(Source: http://www.mudra.org.in/Offerings)

Under the aegis of Pradhan Mantri Mudra Yojana (PMMY), MUDRA has created the following products:

(i) Shishu : covering loans upto 50,000/-

(ii) Kishor : covering loans above 50,000/- and upto 5 lakh

(iii) Tarun : covering loans above 5 lakh and upto 10 lakh

The funding support from MUDRA are of four types:

- Micro Credit Scheme (MCS) for loans upto 1 lakh finance through MFIs.

- Refinance Scheme for Commercial Banks / Regional Rural Banks (RRBs) / Scheduled Co-operative Banks
- Women Enterprise programme
- Securitization of loan portfolio

Mudra loan is extended for a variety of purposes which provide income generation and employment creation. The loans are extended mainly for :

(i) Business loan for Vendors, Traders, Shopkeepers and other Service Sector activities.

(ii) Working capital loan through MUDRA Cards.

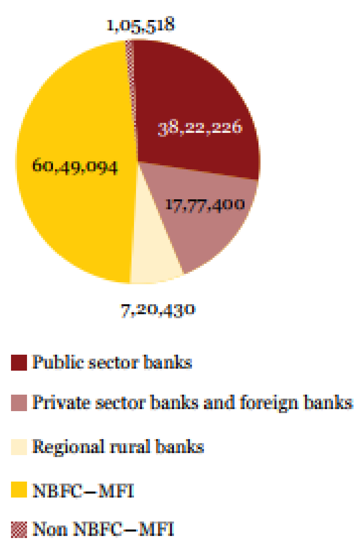
(iii) Equipment Finance for Micro Units.

(iv) Transport Vehicle loans.

Performance of banks under Prime Minister Mudra Yojana (PMMY)

The PMMY financial target for the year 2015–16 was surpassed by the end of the fiscal. As against a target of Rs 1,22,188 crore set for the year, notified banks and MFIs disbursed an aggregate sum of Rs 1,32,954.73 crore, achieving 109 per cent by year end. The Mudra loan objective of ‘funding the unfunded’ has twin purposes of seeding new enterprises and expanding existing units. Out of a total of 3.49 crore enterprises supported under PMMY during 2015–16, nearly 36 per cent (1.25 crore accounts) were for first time borrowers (new entrepreneurs).

Lending to new entrepreneurs by type of institutions (no. of accounts)



Categories of MUDRA loans and beneficiaries 2015−16

Category	*No. of accounts*	*Amount disbursed (₹ crore)*
Shishu	324.02	62,028
Kishore	20.69	41,073
Tarun	4.10	29,854
Total	**348.81**	**1,32,955**
Out of the above		
New entrepreneurs	124.75 (36%)	58,908
Women entrepreneurs	276.28 (79%)	63,190
Share of SC/ST/ OBC	184.00 (53%)	49,196.33

(Source: Annual Report, MUDRA 2017)

Setting up of National Credit Guarantee Trustee Company Ltd (NCGTC)

NCGTC was set up by the Department of Financial Services, Ministry of Finance, Government of India to manage and operate various credit guarantee trust funds on March 28, 2014 with a paid-up capital of Rs 100 million. The company is operating the following five credit guarantee schemes.

a) Credit Guarantee Fund for Micro Units (CGFMU)
b) Credit Guarantee Fund Scheme for Education Loans
c) Credit Guarantee Fund Scheme for Factoring
d) Credit Guarantee Fund Scheme for Skill Development Loans
e) Credit Guarantee Scheme for Stand Up India (CGSSI)

Among the schemes, Credit Guarantee Fund for Micro Units (CGFMU) will assume importance, as it guarantees loans to micro enterprises. The guarantee is in the nature of portfolio guarantee. In 'First Loss Portfolio Guarantee', first loss to the extent of 5% of the crystallized portfolio, will be borne by the lending financial institution and therefore, will be excluded for the claim. Out of the balance portion, the 'extent of guarantee' will be to a maximum extent of 50% of 'Amount in Default' in the portfolio.

This scheme is akin to the scheme operated by Reserve Bank of India namely Small Loans Guarantee Scheme, 1971, which also offered portfolio guarantee.

The scheme covers all the eligible financial institutions extending loans to MSME sector including microfinance institutions, Non-bank finance companies, co-operative banks which are not covered under the CGTMSE scheme.

The scheme follows the risk premium structure of CGTMSE for commercial banks and the premium for microfinance institutions and Non-bank finance companies is based on their rating score.

The Fee structure has in-built incentive / rebate for "No Claim Bonus". However, as in initial years, say first 2-3 years, since NPA / claims history would not have been established, risk premium for NPA / claim payout ratio shall be calculated in the same scale corresponding to credit rating / grading.

New initiatives for enabling credit growth to MSMEs

Various Committees set up by Government of India and Reserve Bank of India have dwelt upon extensively to increase the flow of credit to MSME and enhance their competitiveness right from Dr Raghuram Rajan's A Hundred Small Steps - Report of the Committee on Financial Sector Reforms 2008, RBI Committee on Comprehensive Financial Services for Small Businesses and Low Income Households 2014 (Chair: Nachiket Mor) and Government of India's Report on Financial Architecture for MSMEs 2015 (Chair : K V Kamath). The Committee reports led to introduction of

1. Priority sector lending targets for MSMEs
2. Priority sector lending certificates to trade the financial institutions excess portfolio
3. Setting up of small finance banks
4. Credit scoring model for loans up to Rs 10 million
5. Credit information sharing among the Credit bureaus
6. Setting up of movable registry

These initiatives will enhance the credit flow to MSME by formal financial institutions.

Chapter IV

Critical review of Credit Guarantee Scheme for MSMEs in India – CGTMSE

The Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) was set up by the Ministry of Micro, Small & Medium Enterprises (MSME), Government of India (GOI) and Small Industries Development Bank of India (SIDBI) in August 2000.The GOI and SIDBI as settlors of the Trust have committed a corpus of Rs.2,500 crore in the ratio of 4:1 to the CGTMSE. CGTMSE operates the "Credit Guarantee Scheme" (CGS) which guarantees grant of collateral-free and/or third party guarantee-free credit facilities to Micro and Small Enterprises by Member Lending Institutions (MLIs). It thus encourages MLIs to appraise credit proposals on the basis of viability of projects rather than merely on the basis of availability of adequate collateral. Although the CGS became operational in 2000-01, the trends in its operations indicate that during the initial years, the cover was low. Since 2005-06, i.e., after the enactment of MSMED act 2006, there has been a steady growth in guarantee cover.

Eligible Lending Institutions

All scheduled commercial banks and specified Regional Rural Banks, NSIC, NEDFi, SIDBI, which have entered into an agreement with the Trust for the purpose. The eligible lending Institutions, on entering with an agreement with CGTMSE, become Member Lending Institutions (MLIs) of CGTMSE.

Eligible Borrowers

New as well as existing Micro and Small Enterprises.

Maximum Risk Cover

Of the credit facilities extended by MLIs, Trust shall guarantee, in case of default by the borrower, up to 75 per cent (85% for select category of borrowers), of the defaulted principal amount in respect of term credit including interest on principal for one quarter and / or outstanding working capital advances (inclusive of interest), as on the date of account becoming NPA, or as on the date of filing the suit, whichever is lower. Other charges such as penal interest, commitment charge, service charge, or any other levies/ expenses shall not qualify for the guarantee cover.

Rehabilitation assistance

For the unit covered under CGTMSE and becoming sick due to factors beyond the control of management, assistance for rehabilitation extended by the lender could also be covered under the scheme provided the overall assistance is within the credit cap of Rs.100 lakh.

Review of functioning of CGTMSE

Over the past few years the amount of loans guaranteed by the CGTMSE is raising and the leverage of the CGTMSE too is on the rise. Since the corpus of CGTMSE is not benign continuously augmented and the claims settled by the corporation is rapidly increasing, this calls for an immediate attention. In the recent times, Non-Performing Asset (NPAs) under MSME category is also raisins. It is essential, therefore, all the concerns relating to its functioning be identified and addressed.

Operational Highlights of CGTMSE

As on May 31, 2016, cumulatively 24, 31,490 proposals from micro and small enterprises have been approved for guarantee cover for aggregate credit of Rs.1,13,500.61 crore, extended by 119 active MLIs. A year-wise guarantee approved growth position is indicated in the table below:

Period	No. of Active MLIs	No. of Credit Facilities Approved	Amount of Guarantees Approved (Rs. Crore)	Cumulative Guarantees Approved (Rs. Crore)
FY 2000-01	9	951	6.06	6.06
FY 2001-02	16	2296	29.52	35.58
FY 2002-03	22	4955	58.67	94.25
FY 2003-04	29	6603	117.60	211.85
FY 2004-05	32	8451	267.46	538.62
FY 2005-06	36	16284	461.91	1000.53
FY 2006-07	40	27457	704.53	1705.06

FY 2007-08	47	30285	1055.84	2701.59
FY 2008-09	57	53708	2199.40	4824.34
FY 2009-10	85	151387	6875.11	11559.61
FY 2010-11	106	254000	12589.22	23846.01
FY 2011-12	109	243981	13783.98	37139.31
FY 2012-13	117	288537	16062.48	52600.07
FY 2013-14	117	348475	18188.12	70026.28
FY 2014-15	119	403422	21274.82	90445.90
FY 2015-16	119	513978	19949.38	108990.85
FY 2016-17 *	119	106634	4037.07	113500.61

Financial position of CGTMSE - Leverage

A leverage ratio is any one of several financial measurements that look at how much capital comes in the form of debt (loans), or assesses the ability of a company to meet financial obligations. It is the ratio of credit guarantees outstanding to the institution's capital (net worth). It provides a good indication of the amount of risk taken by the credit guarantee institution. Although benchmarks for leverage vary in different countries, they are generally measured on the basis of outstanding guarantees. As per the World Bank study (2016), the worldwide average leverage stands at 3.3 times. In the developed countries an acceptable level of benchmark for leverage is 5 times and slightly higher for the emerging market economies (e.g. Philippines: 6 times, Korea: 8 times, Taiwan: 12 times).

As on May 2016, the CGTMSE had a corpus of Rs 2477.78 Crore which formed 99.11% of the committed Corpus crore against which it had approved cumulative guarantees of Rs. 113500.61 crore, thus leveraging its capital to the extent of **45.8 times**, which is one of the highest leveraged credit guarantee corporations in the world. While the worldwide average leverage stands at 3.3 times, the CGTMSE has 15 times higher leverage than the world average. Such a high leverage may lead to structural instability and weakness of the CGTMSE. For the credit guarantee scheme to operate optimally in a sustainable manner, capital of CGTMSE has to be augmented immediately. In addition, the Board of Trustees of CGTMSE have arrive at an optimum leverage ratio beyond which CGTMSE should not offer guarantee. Such a board approved policy will ensure sustainable operation of the system in the long run. As per para 5.2.1. of the Master circular on

DBR.No.BP.BC.1/21.06.201/2015-16 dated July 01, 2015 on Basel III Capital Regulations, **Reserve Bank of India assigned "zero risk weight" for the credit guaranteed by CGTMSE**. The same treatment has also been extended to the guarantees extended by National Credit Guarantee Trust Company ltd (NCGTC).

Claims Settlement & Closure

During FY 2014-15, 27,407 applications for an amount Rs 1,405.67 Crore have been received for, invocation of guarantee and settlement of claims against the defaulting borrowers against which guarantees have been issued by CGTMSE guarantees are in force. Out of the applications lodged, claims in respect of 26,183 units have already been settled installment aggregating Rs 723.61 Crore. The trust pays 75% of the guaranteed amount as first instalment and remaining 25% is paid after the compliance of legal proceedings by Member lending institutions.

It is inferred from the CGTMSE annual reports that the amount of claims from the financial institutions is on the rise and the trend will continue as the amount of guaranteed loans are on the rise. In addition to the claims settled for Rs 1004.74 crore, the trust had made a provision of Rs 1020 crore based on the actuarial evaluation by evolving regression equation between claims received and guarantees issued.

During 2015-16, the trust earned gross income of Rs 1036 crore, comprising mainly guarantee fee (Rs 159.67 crore) , annual guarantee and service fee (Rs 380 crore) , interest earned on investments (Rs 439 crore) and recoveries from MLIs (Rs 58 crore). It may inferred from the figures that the main income for the trust is accruing from the interest earned on their investments. In future, the sum may come down due higher claims.

Sl No	Financial year	Claims settled (in Rs crore)
1	2012-13	680.73
2	2013-14	775.6
3	2014-15	723.61
4	2015-16	1004.74

(Source: CGTMSE annual reports)

Non-performing loans under the guaranteed loans are on the rise during the last five years.

In addition, the financial woes of CGTMSE will become further complicated with taxation related issues as reported in their annual reports. The Trust was notified u/s. 10(23EB) of the Income A.Y.2009-10, Tax Act, 1961 (“the Act”) by Finance Act 2002 and accordingly the income of the Trust was exempt u/s. 10(23EB) of the Act for a period of five years commencing from A.Y. 2002-03 to A.Y. 2006-07 only.

Enhanced cover from January 01, 2017

The Hon'ble Prime Minister, Government of India, in his address to the Nation on December 31, 2016, increased the coverage of the eligible credit limit per borrower under the CGS from 100 lakh to 200 lakh extended by Scheduled Commercial Banks and select Financial Institutions to the units in Micro and Small Enterprises. An all-inclusive interest rate ceiling of 14.00 p.a (including cost of guarantee cover) is prescribed to obtain the guarantee cover.

<table>
<tr><th>Category</th><th colspan="3">Maximum extent of Guarantee where credit facility is</th></tr>
<tr><th></th><th>Upto 5 lakh</th><th>Above 5 lakh upto 50 lakh</th><th>Above 50 lakh and upto 200 lakh</th></tr>
<tr><td>Micro Enterprises</td><td>85% of the amount in default subject to a maximum of 4.25 lakh</td><td>75% of the amount in default subject to a maximum of 37.50 lakh</td><td rowspan="3">50% of amount in default subject to a maximum of 100 lakh</td></tr>
<tr><td>Women Entrepreneur's/Units located in North East Region (including Sikkim) (other than credit facility upto 5 lakh to micro enterprises)</td><td colspan="2">80% of the amount in default subject to a maximum of 40 lakh.</td></tr>
<tr><td>All other category of borrowers</td><td colspan="2">75% of the amount in default subject to a maximum of 37.50 lakh</td></tr>
</table>

During the informal discussion with commercial banks, it revealed that banks are not proactively claiming the guarantees. If, banks start claiming the guarantees, in a proactive manner, CGTMSE will find difficult to settle the claims at the current level of capital .Against this backdrop, it is necessary to augment the capital of CGTMSE from its stakeholders.

Risk based guarantee fee

The matured credit guarantee corporations across the world have evolved risk based pricing, individual exposure limits for member lending institutions, capital adequacy framework, provisioning norms and minimum liquidity requirements. However, CGTMSE is yet to evolve in many of the above parameters.

The guarantee fee payable by member lending institutions are flat irrespective of the risk profile of the underlying business (low risk, medium risk and high risk business). being funded by a collateral-free loan and irrespective of the internal ratings on the collateral-free MSE loans within the same bank and is not risk-based as in credit guarantee schemes operated in countries like Japan, Korea, Malaysia, etc.

For a risk-based fee, RBI committee appointed in the year 2010 (Chair : V K Sharma), it was suggested that an audit by a third party of the portfolio by sampling could be taken for each bank in order to decide the risk level of the portfolio and appropriate guarantee fee. The other alternative is to get the portfolio rated by an external agency which would however be a time consuming and costly process. Another suggestion was to decide the guarantee fee on the basis of gross NPAs in that portfolio the provision for claims made by the Trust in its Balance Sheet. However, the committee chose to continue with a flat premium structure during the review in the year 2010.

Calculation of Fair Value of Guarantee Fee				
Year	**Claims settled (in Rs Crore)**	**Cumulative guarantees approved (in Rs Crore)**	**Claims settled to cumulative guarantees outstanding (%)**	
2000-01	0	6.06	0.00%	
2001-02	0	35.58	0.00%	
2002-03	0	94.25	0.00%	
2003-04	0.03	211.85	0.01%	
2004-05	0.52	479.31	0.11%	

2005-06	1.10	941.22	0.12%	
2006-07	1.40	1645.75	0.09%	
2007-08	7.15	2701.59	0.26%	
2008-09	8.38	4900.99	0.17%	
2009-10	17.85	11559.61	0.15%	
2010-11	108	23846.01	0.45%	
2011-12	66.99	37139.31	0.18%	
2012-13	170.71	52600.07	0.32%	
2013-14	775.6	70026.28	1.11%	
2014-15	723.61	90445.90	0.80%	

(Source: RBI committee report on credit guarantee, CGTMSE annual reports)

It may be inferred from the table above that the Claims settled to cumulative guarantees outstanding, is increasing after 2010-11.

Though the value of average claims settled to cumulative guarantees outstanding during the past seven years works out to only 0.46% which is half of the premium collected from the member lending institutions, the reason for the institutions not invoking the guarantee needs to be studied further**.**

Till March 31, 2016, CGTMSE was adopting non-discretionary approach in levying Guarantee Fee (GF)/Annual Service Fee (ASF) / Annual Guarantee Fee (AGF) without reference to the level of NPAs he claims paid to the MLIs vis-a -vis the fees and recoveries received from the MLIs. Considering the very high level of NPAs reported by some of the MLIs as also significantly larger amount of claims settled for some of the MLIs, CGTMSE introduced risk based pricing structure rather than uniform fees being charged beginning April 01, 2016. The following risk premium structure in place of existing guarantee fee structure will be implemented:
The rates under this mechanism will be floating and will undergo changes every year based on the NPA level and payout ratios of the concerned Bank.

(1) Risk premium on NPAs in Guaranteed portfolio		(2) Risk premium on Claim Payout Ratio	
NPA Percentage	**Risk Premium**	**Claim Payout Percentage**	**Risk Premium**
0-5%	SR	0-5%	SR
>5-10%	10% of SR	>5-10%	10% of SR
>10-15%	15% of SR	>10-15%	15% of SR
>15-20%	20% of SR	>15-20%	20% of SR
>20%	25% of SR	>20%	25% of SR
SR–Standard Rate			

Though the move is a welcome step, the following concerns will arise:

- The risk premium is based on the NPA level of bank and claim payout ratio. In this dispensation, the borrowers of such banks whose NPA / Claim payout ratio is high, would be penalized for no fault of theirs as most banks would simply pass on the additional risk premium on the collateral-free loans to them. The median interest rate for MSMEs today works out to 12% which is 200 basis points below the CGTMSE prescribed interest rate ceiling i.e., 14%.

- The present system did not obviate the issue of adverse selection by financial institutions.

It is suggested that the risk premium may be worked out based on the risk profile of the borrower rather than the financial institution which will benefit the borrowers. A lower-risk borrower will be charged a lower guarantee fee, while a higher-risk borrower would be charged with a higher fee. Such mechanism is already in vogue in Japan, Korea and many other nations. The table below gives a snapshot of practices followed across the world.

Country	**Fees**		
	Definition	**Basic Standardized Rate (% p.a.)**	**Link to Risk Exposure**
USA	2%-3.5% of the loan amount + annual rate of 0.55% of the outstanding guarantee balance	1.9%	Higher fees for larger loan amounts
Taiwan, China	0.75% to 1.5% per annum	0.8%	Fees are linked to risk profile
Romania	1.5% per annum	1.5%	Fees are linked to the coverage ratio
Netherlands	2% to 3.6% one-off	1.7%	Fees are linked to the coverage ratio
Malaysia	0.5% to 3.6% p.a.	1.5%	Higher fees for low credit rating
Korea	0.5% to 3% p.a.	1.2%	Higher fees for low credit rating along with higher coverage ratio
Hungary	1% - 5% p.a. of guarantee amount	2%	For loans over 350,000 Euros, fees vary according to firms’ credit ratings

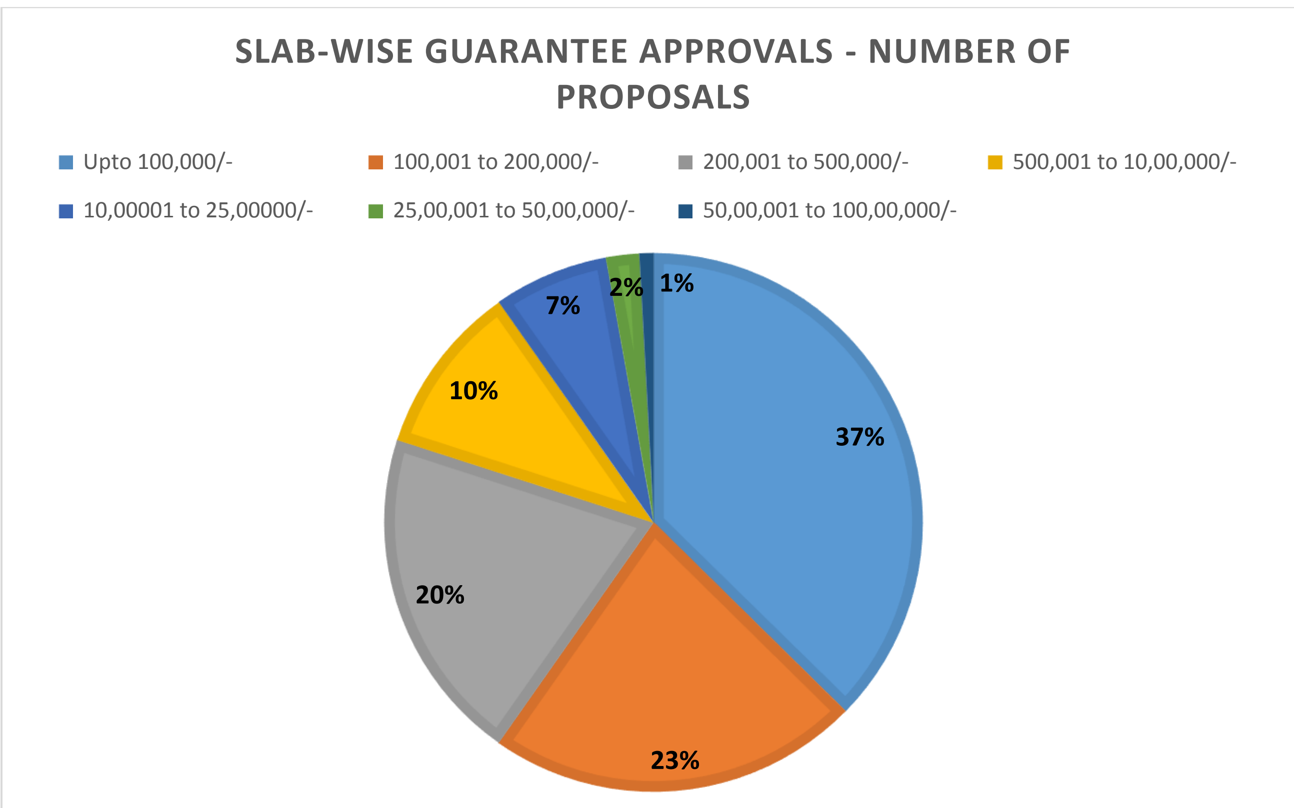
France	0.6% to 0.9% p.a. of the loan value	1.3%	Fees are linked to the coverage ratio: 0.6% (40% coverage ratio) 0.9% (70% coverage ratio)
Colombia	0.95% - 3.85% p.a.	-	Fees are link to the product and coverage ratio
Chile	1% to 2% p.a.	1.5%	Higher fees for banks with higher default rates
Canada	2% of the loan amount + 1.25% p.a. calculated on the loan balance	2.3%	No scalability

In line with good practices at the leading credit guarantee companies, the Annual Guarantee Fee should be market-driven and the CGTMSE should incentivize borrowers / MLIs with good account conduct i.e. zero NPAs or low NPAs on the guaranteed loans, by offering a rebate on the Annual Guarantee Fee (no claim, low claim bonus, etc)

Loan size-wise analysis

The following table presents the slab wise loan guarantee approvals for the years ended March 2016.

Credit Guarantee Fund Trust for Micro and Small Enterprises			
Slab-wise guarantee approvals for the June 30, 2016 (cumulative)			
SNo.	Range	Cumulative as on June, 2016	
		No. of Proposals	Loan Amount (Rs. Lakh)
1	Upto 100,000/-	933066	461999
2	100,001 to 200,000/-	559591	869788
3	200,001 to 500,000/-	505160	1837313
4	500,001 to 10,00,000/-	257599	1973511
5	10,00001 to 25,00000/-	172193	2971531
6	25,00,001 to 50,00,000/-	49536	1874589
7	50,00,001 to 100,00,000/-	20935	1604209
	Total	**2498080**	**11592940.12**
N.B.: Actuals may vary due to intervening cancellations / modifications			



The above table shows that 60% of the loans guaranteed by the CGTMSE is up to Rs 2 lakhs which is desirable. The scheme is meant for small borrowers who are having credit worthy proposals but not having adequate collateral.

However, when look at the amount covered under the scheme, the loans covered under up to Rs 2 lakhs accounts for a mere 11.00%. This anomaly needs to look at and appropriate mechanism needs to be deployed so that small ticket loans get the maximum share.

State-wise classification

The State wise coverage of the scheme has also showed a sked picture where Tamilnadu has 43448 proposals with Rs 1479.55 crore guarantee cover. The States having highest number of MSMEs are not getting the right share due to various issues. Though, the scheme has a inbuilt mechanism to support enterprises in North Eastern region, the share from these States is negligible.

State Wise Report Guarantee Approved from 01/01/2000 to 30/06/2016			
SNo.	**State Name**	**Proposals**	**Approved Amount (in Rs. Lakh)**
1	ANDAMAN & NICOBAR Wise	1956	9877.12
2	ANDHRA PRADESH Wise	80750	219759.18
3	ARUNACHAL PRADESH Wise	6237	28654.22
4	ASSAM Wise	86484	283658.86
5	BIHAR Wise	125528	530429.67
6	CHANDIGARH Wise	5608	34475.67
7	CHHATTISGARH Wise	35290	174243.81
8	DADRA & NAGAR HAVELI Wise	448	10429.28
9	DAMAN & DIU Wise	399	9534.38
10	DELHI Wise	30666	299376.21
11	GOA Wise	15494	93886.71
12	GUJARAT Wise	97299	798434.6
13	HARYANA Wise	32984	236614.16
14	HIMACHAL PRADESH Wise	44643	237624.26
15	JAMMU & KASHMIR Wise	61472	131528.17
16	JHARKHAND Wise	98217	569223.38
17	KARNATAKA Wise	216514	1075942.49
18	KERALA Wise	230525	553085.46
19	LAKSHA DEEP Wise	345	875.2
20	MADHYA PRADESH Wise	86258	444646.19
21	MAHARASHTRA Wise	192981	1318155.7
22	MANIPUR Wise	6015	18623.46
23	MEGHALAYA Wise	7310	32371.73
24	MIZORAM Wise	3606	13568.08
25	NAGALAND Wise	5571	19224.96
26	ORISSA Wise	118669	484639.18
27	PONDICHERRY Wise	4337	14388.58
28	PUNJAB Wise	54854	297321.61
29	RAJASTHAN Wise	82059	402843.9
30	SIKKIM Wise	1932	8005.39
31	TAMILNADU Wise	244708	947597.86
32	TELANGANA Wise	48262	256376.18
33	TRIPURA Wise	9860	33347.62
34	UTTAR PRADESH Wise	280471	1154492.06
35	UTTARAKHAND Wise	5224	30216.62
36	UTTARANCHAL Wise	27004	128982.16
37	W B Wise	146953	673447.45
Total		**2496933**	**11575901.59**

The MLI-wise classification of CGS cover

Public sector banks are the major clientele for CGTMSE. This defeats the risk mitigation policy. CGTMSE should strive to have broad clientele base. The recent inclusion of NBFC- MFIs under the guarantee scheme is a welcome step. The other left out, yet having significant rural/ semi urban presence is the rural & urban co-operative banks. It is desirable to add the co-operative banks under the eligible member lending institutions.

The detailed financial institution wise outstanding guaranteed loans are given below.

SNo.	MLI	Proposals	Approved Amount (in Rs. Lakh)
1	ALLAHABAD BANK	79466	325691.64
2	ALLAHABAD UP GRAMIN BANK	2759	5839.51
3	ANDHRA BANK	25822	83044.28
4	ANDHRA PRADESH GRAMEENA VIKAS BANK	4864	2825.76
5	ANDHRA PRADESH STATE FINANCIAL CORPORATION	70	2431.08
6	ANDHRA PRAGATHI GRAMEENA BANK	7161	5371.19
7	ARYAVART GRAMIN BANK	2191	8918.39
8	ASSAM GRAMIN VIKASH BANK	8483	20324.9
9	AXIS BANK LIMITED	1942	72229.98
10	BAITARANI GRAMYA BANK	2097	7200.06
11	BALLIA ETAWAH GRAMIN BANK	430	117.31
12	BANGIYA GRAMIN VIKASH BANK	2722	8661.09
13	BANK OF BARODA	84521	590976.74
14	BANK OF INDIA	289346	1669456.3
15	BANK OF MAHARASHTRA	23548	209390.65
16	BARODA GUJARAT GRAMIN BANK	132	866.1
17	BARODA RAJASTHAN GRAMIN BANK	46	376.4
18	BARODA UTTAR PRADESH GRAMIN BANK	3639	10047.61
19	BHARATIYA MAHILA BANK	892	5259.06
20	BIHAR KSHETRIYA GRAMIN BANK	845	2906.28
21	CANARA BANK	351439	1090334.7
22	CENTRAL BANK OF INDIA	68207	406086.51
23	CHAITANYA GODAVARI GRAMMENA BANK	69	92.78
24	CHATTISGARH RAJYA GRAMIN BANK	6682	4290.25
25	CITY UNION BANK	1322	12607.12
26	CORPORATION BANK	48136	280691.54

27	DELHI FINANCIAL CORPORATION	634	1455.03
28	DENA BANK	22493	114071.68
29	DENA GUJARAT GRAMIN BANK	207	532.43
30	DEUTSCHE BANK	5740	174760.43
31	EXPORT IMPORT BANK OF INDIA	16	618
32	GURGAON GRAMIN BANK	122	224.64
33	HADOTI KSHETRIYA GRAMIN BANK	44	180.6
34	HARYANA GRAMIN BANK	120	243.24
35	HDFC BANK LIMITED	4281	121362.91
36	HIMACHAL GRAMIN BANK	631	6172.52
37	ICICI BANK	858	5626.36
38	IDBI BANK LTD	2890	55634.33
39	INDIAN BANK	37153	106133.14
40	INDIAN OVERSEAS BANK	126489	580372.96
41	INDUSIND BANK	4	60.88
42	ING VYSYA BANK LTD	105	3084.78
43	J & K GRAMEEN BANK	20	109.28
44	JAIPUR THAR GRAMIN BANK	1116	292.67
45	JAMMU & KASHMIR DEVELOPMENT FINANCE CORPORATION LIMITED	3	75
46	JHARKHAND GRAMIN BANK	404	1857.09
47	KARNATAKA BANK LTD	22289	115054.68
48	KARNATAKA VIKAS GRAMEENA BANK	13619	28143.28
49	KASHI GOMTI SAMYUT GRAMIN BANK	2809	6108.13
50	KAVERI GRAMEENA BANK	316	1063.42
51	KERALA FINANCIAL CORPORATION	266	2508.06
52	KERALA GRAMIN BANK	18975	29009.97
53	KOTAK MAHINDRA BANK	144	5378.77
54	LAKSHMI VILAS BANK	216	3167.9
55	LANGPI DEHANGI RURAL BANK	538	1212.19
56	MADHYA BHARAT GRAMIN BANK	49	73.77
57	MADHYA BIHAR GRAMIN BANK	855	3176.56
58	MGB GRAMIN BANK	93	158.02
59	MIZORAM RURAL BANK	423	1452.93
60	NAINITAL-ALMORA KSHETRIYA GRAMIN BANK	11	66.26
61	NARMADA MALWA GRAMIN BANK	91	240.4
62	NATIONAL SMALL INDUSTRIES CORPORATION LTD	176	1458.57
63	NEELACHAL GRAMYA BANK	5633	18921.19
64	NORTH EASTERN DEVELOPMENT FINANCE CORPORATION LTD	14	240.5
65	ORIENTAL BANK OF COMMERCE	26758	233240.81
66	PALLAVAN GRAMA BANK	605	253.94
67	PANDYAN GRAMA BANK	3239	3759.86

68	PARVATIYA GRAMIN BANK	332	1814.16
69	PRAGATHI KRISHNA GRAMEENA BANK	4015	3511.98
70	PRATHAMA BANK	3609	10474.68
71	PUNJAB & SIND BANK	14071	43856.73
72	PUNJAB NATIONAL BANK	215444	885424.71
73	PURVANCHAL GRAMIN BANK	14966	23702.35
74	RAJASTHAN GRAMIN BANK	136	517.01
75	RUSHIKULYA GRAMYA BANK	9	41.86
76	SAMASTIPUR KSHETRIYA GRAMIN BANK	309	964.07
77	SARVA HARYANA GRAMIN BANK	1224	2487.08
78	SARVA UP GRAMIN BANK	4840	4362.75
79	SATPURA NARMADA KSHETRIYA GRAMIN BANK	433	833.48
80	SAURASHTRA GRAMIN BANK	187	1311.52
81	SHARDA GRAMIN BANK	64	216.71
82	SHREYAS GRAMIN BANK	157	286.2
83	SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA	5672	129131.28
84	STANDARD CHARTERED BANK	1429	36585.44
85	STATE BANK OF BIKANER & JAIPUR	25639	91391.2
86	STATE BANK OF HYDERABAD	18685	80295.17
87	STATE BANK OF INDIA	384071	1846257.3
88	STATE BANK OF MYSORE	17637	115553.71
89	STATE BANK OF PATIALA	19961	135232.7
90	STATE BANK OF TRAVANCORE	33166	132247.36
91	SUTLEJ GRAMIN BANK	97	35.82
92	SYNDICATE BANK	99112	477990.24
93	TAMILNAD MERCANTILE BANK LTD	1542	13466.22
94	TELANGANA GRAMIN BANK	282	502.96
95	THE BANK OF RAJASTHAN LTD	45	10.81
96	THE DHANALAKSHMI BANK LIMITED	98	1845.69
97	THE FEDERAL BANK LTD	5128	26790.7
98	THE JAMMU & KASHMIR BANK LTD	43988	57473.43
99	THE KARUR VYSYA BANK LTD	193	3560.86
100	THE NAINITAL BANK LTD	484	4181.79
101	THE SOUTH INDIAN BANK LIMITED	281	2271.12
102	THE TAMILNADU INDUSTRIAL INVESTMENT CORPORATION LIMITED	2717	5000.64
103	TRIPURA GRAMIN BANK	489	1149.74
104	TRIVENI KSHETRIYA GRAMIN BANK	4	45.35
105	UCO BANK	66975	270089.72
106	UNION BANK OF INDIA	124425	362454.96
107	UNITED BANK OF INDIA	44943	193686.55
108	UTTAR BIHAR GRAMIN BANK	1291	3059.28

109	UTTARANCHAL GRAMIN BANK	588	2788.01
110	UTTARBANGA KSHETRIYA GRAMIN BANK	1055	1470.95
111	VANANCHAL GRAMIN BANK	2642	7094.69
112	VIDHARBHA KSHETRIYA GRAMIN BANK	275	610.75
113	VIJAYA BANK	16319	133124.8
114	WAINGANGA KRISHNA GRAMIN BANK	545	3581.13
115	YES BANK LTD	79	3521.5
Total		2496933	11575902

As on March 31, 2015, the PSBs account for 221014 NPAs out of 224146 marked in the CGTMSE portal i.e. 98.6% of the NPAs by number. In terms of amount the PSBs account for Rs.10656.91 crore out of Rs.10900.11 crore i.e. 97.77% of the NPA amount

The share of cover of collateral free loans

The guaranteed portion of loan by CGTMSE stands miniscule at 2.81% and 2.15% with respect to number of accounts and amount outstanding respectively during the year 2014. The guaranteed loan portion at Japan stands at 40%.

Credit flow to MSME and guarantee cover

Sl No	Year	Number of accounts (in lakh)	Number of accounts covered under CGTMSE (in lakh)	% of accounts covered under CGTMSE	Amount Outstanding (in Rs crore)	Amount Outstanding under CGTMSE (in Rs crore)	% of credit outstanding covered under CGTMSE
1	2013	112	2.88	2.57	16062	687210	2.34
2	2014	124	3.48	2.81	18188	846130	2.15

Benchmarking CGTMSE with World Bank Principles for Credit Guarantee Schemes

In the year 2015, the World Bank Group convened a Task Force comprising international associations of both CGSs and lenders to develop a set of Principles for the design, implementation, and evaluation of public CGSs for SMEs. The objective of the Principles is to provide a generally accepted set of good practices, which can represent a global reference for the design, execution and evaluation of public CGSs. The Principles propose appropriate governance and risk management arrangements as well as operational conduct rules for CGSs, which can lead to improved outreach and additionality cum financial sustainability

Assessment of CGTMSE against the principles for the Design, Implementation and Evaluation of Public Credit Guarantee Schemes for Small and Medium Enterprises

Sl No	The World Bank principle	Assessment
	Principle 1 The CGS should be established as an independent legal entity on the basis of a sound and clearly defined legal and regulatory framework to support the effective implementation of the CGS's operations and the achievement of its policy objectives.	Government of India and SIDBI have set up the CGTMSE as a Trust in August 2000. It operates as per the trust deed in the Declaration of Trust. The operations of the Trust are based on the CGS framed by the Ministry of MSME, GOI. The World Bank task force also recognizes that governments may choose to operate CGSs through development finance institutions. The board of the trust is headed by Chairman, SIDBI and officials from Ministry of Finance and Ministry of MSME. Interestingly, in the initial years of establishment, Reserve Bank had representation in the board which was withdrawn in the later years. Now RBI l is not represented in the trust's board. The periodical reporting of the operations is done to the Ministry of MSME, GOI and the Board of Trustees. *There is no regulatory body / authority to oversee the functioning of the CGTMSE.* The world Bank task force advocates that Pay-as-you-go CGSs that are based on annual budgetary subventions and run as programs by government agencies should be discouraged.
2	**Principle 2** The CGS should have adequate funding to achieve its policy objectives, and the sources of funding, including any reliance	The CGS should have adequate capital and government financial support to ensure effective implementation of its operations and to achieve meaningful outreach and additionality with financial sustainability.

	on explicit and implicit subsidies, should be transparent and publicly disclosed.	Setting up a CGS with inadequate financial resources can result in a limited developmental effect and a lack of financial sustainability, thereby seriously undermining the confidence of lenders and endangering the achievement of the CGS's policy objectives. In CGTMSE, the settlors of the trust namely, Government of India and SIDBI have provided an initial corpus of Rs 125 crore in the ratio of 4:1 and committed to enhance the corpus to Rs 2500 crores. As on March 31, 2016, the trust has a corpus of Rs 2430 crore which formed 97% of the committed corpus. However, the trust acknowledged the fact that "with *growing preference of MLIs for CGTMSE cover and sharp increase in the guarantee approvals, it is felt that the corpus would have to be augmented urgently*" (Annual Report 2015-16). The Annual Report for FY 2014-15 of the CGTMSE also acknowledges this situation. The CGTMSE has taken up the issue with Ministry of MSME, Government of India (GOI)
3	**Principle 3** The legal and regulatory framework should promote mixed ownership of the CGS, ensuring equitable treatment of minority shareholders	Mixed ownership results when a government or ownership entity chooses a strategic private sector partner to invest in a CGS to access commercial and industry experience. The credit guarantee architecture is owned by Government of India and SIDBI. There is no private participation in the system. Thus the advantages of having a mixed ownership, namely, reducing moral hazard on the part of the CGS lenders and SME borrowers through peer pressure, shared responsibility and transparency in the decision-making process, etc., are not applicable.

4	**Principle 4** The CGS should be independently and effectively supervised on the basis of risk-proportionate regulation scaled by the products and services offered.	CGS supervisory accountabilities should be defined in the relevant legal and regulatory framework and should be clearly separated from CGS ownership and management. An effective system of supervision should assign clear responsibilities and objectives for the agency charged with the supervision of the CGS. The supervisor should ensure that the CGS is run as efficiently as possible while also minimizing the risk to taxpayers of any unexpected or unbudgeted losses that may occur in the course of normal business operations. There is a lack of clearly defined supervisory accountability separate from the management of the CGTMSE. As on September 30, 2015 the leverage of CGTMSE on the basis of cumulative guarantees stood at 20.33 times which is very high with reference to the total funds available with it.
5	**Principle 5** The CGS should have a clearly defined mandate supported by strategies and operational goals consistent with policy objectives	Clearly stating and communicating the mandate of the CGS is necessary for defining accountability, determining the scope of CGS activities, and forming the basis for identifying more specific targets for CGS operations. The mandate should be set in the legislation that establishes the CGS and include, at minimum, the target SMEs and the main line(s) of business of the CGS. For CGTMSE, there is absence of specific operational goals. Although the CGTMSE has become a very important instrument in facilitating flow of bank credit to the micro and small enterprises, the infrastructure facilities for managing are inadequate. There is a need for a Customer Charter with clear timelines and turnaround times for

		every customer facing activity such as guarantee approvals, claims processing, etc. and put the same in the public domain.
6	**Principle 6** The CGS should have a sound corporate governance structure with an independent and competent board of directors appointed according to clearly defined criteria.	The CGS's corporate governance framework should ensure that operational management is conducted independently. Thus business decisions are made on the basis of economic and financial considerations that align with the CGS's mandate and policy objectives and are free of political influence and interference. Board members should serve a fixed term and should act in the best interest of the CGS—without any conflicts of interest. Currently, the CEO of CGTMSE is also the CEO of the National Credit Guarantee Trustee Company Ltd. (NCGTC). An independent CEO for CGTMSE and NCGTC will result in improved outcomes. The Board of CGTMSE comprises only four persons, namely Chairman, SIDBI (as Chairman, Ex-officio), Special Secretary and Development Commissioner, Ministry of MSME, GOI (as Vice-Chairman, Ex-officio), Chairman, IBA (Ex-officio) and CEO, CGTMSE (as Member Secretary). Further, although the CGTMSE is in the business of managing risk, there is no Board member with expertise in Risk Management..
7	**Principle 7** The CGS should have a sound internal control framework to safeguard the integrity and efficiency of its governance and operations.	The CGS should have a strong system of internal controls proportionate to its size and complexity. Effective internal controls allow CGS management to know what is happening in the organization and whether instructions are being followed.

		There is a need for a regular risk based audit / supervision by an external agency in various areas of CGTMSE's operations.
8	**Principle 8** The CGS should have an effective and comprehensive enterprise risk management framework that identifies, assesses, and manages the risks related to CGS operations	The ability of a CGS to identify, measure, monitor, and control the risks it faces—as well as to determine that it holds adequate capital against those risks—is a critical component of the overall corporate governance framework. Credit risk is the main risk a CGS faces. Although credit risk management practices may differ depending on the specific nature of the CGS and on its delivery method, all CGSs should nonetheless develop a comprehensive credit risk management that clearly defines responsibilities and accountabilities CGTMSE as of now levies risk premium based on the MLIs NPA and claim payout ratio. It did not assess the inherent risk in the MSME proposal.
9	**Principle 9** The CGS should adopt clearly defined and transparent eligibility and qualification criteria for SMEs, lenders, and credit instruments.	The CGS should adopt clear eligibility and qualification criteria to guide operations in line with the CGS's mandate. These criteria should be publicly communicated and periodically reviewed. First, the SME target sectors and groups should be clearly defined in the policies or other relevant operational documents of the CGS. A CGS may create a "negative" list of ineligible SMEs (on the basis of their credit profile and repayment reputation, for example) and may even explicitly exclude some subsectors from its scope of operations. The qualification criteria is same for all PSBs irrespective of their interest and capacity in serving MSEs, level of NPA and risk

		management capabilities (except for RRBs). All the RRBs are not eligible to become MLIs. CGTMSE has prescribed eligibility criteria for RRBs to become MLIs.
10	**Principle 10** The CGS's guarantee delivery approach should appropriately reflect a trade-off between outreach, additionality, and financial sustainability, taking into account the level of financial sector development of the country.	CGTMSE follows the individual approach, where guarantees are provided on a loan by loan basis. The borrower approaches a lender, who reviews the project and makes the loan conditional upon a guarantee. This relationship has the probability of moral hazard on the part of the lender during the appraisal (adverse selection).
11	**Principle 11** The guarantees issued by the CGS should be partial, thus providing the right incentives for SME borrowers and lenders, and should be designed to ensure compliance with the relevant prudential requirements for lenders, in particular with capital requirements for credit risk	To avoid moral hazard on the parts of both lenders and SMEs, credit risk must be shared appropriately among the CGS, lenders, and SMEs. Sharing credit risk ensures that the right incentives are in place so that default and claim rates are kept as low as possible. The CGS can distribute risk to lenders through the guarantee coverage ratio, which is usually expressed as a percentage of the underlying loan exposure. The guarantees issued by CGTMSE are partial (75- 80% coverage) which is in line with most of the credit guarantee schemes operational in various countries. However, the coverage ratio is the same irrespective of the potential for job creation and / or preservation, or for early stage firms (although a higher coverage exists for Women Entrepreneurs / Units located in the North East Region).
12	**Principle 12** The CGS should adopt a transparent and consistent risk-based pricing policy to ensure that the guarantee program is	The CGS should charge fees for the guarantees it provides on the basis of the riskiness of the underlying loan, which is reflected in the combination of guarantee

	financially sustainable and attractive for both SMEs and lenders.	coverage ratio, exposure at default, and loss given default. Such risk-based fees signal that guarantees have a value and also that financial sustainability is a priority for the CGS. The CGTMSE has introduced a basic risk-based pricing structure for MLIs for payment of guarantee fees based on NPAs in the loans of the MLI guaranteed by the Trust and Claim Payout Ratio. While this approach is welcome, a negative outcome of this approach would be that the high rated borrowers without their fault if they approach a banks with high NPA and claim payout ratio may end up paying a higher gurantee premium. A better approach would be to shift from a flat rate guarantee to a guarantee rate by linking the guarantee fee to the rating of the borrower.
13	**Principle 13** The claim management process should be efficient, clearly documented, and transparent, providing incentives for loan loss recovery, and should align with the home country's legal and regulatory framework	A timely, efficient, and transparent procedure for triggering claims is important to build and maintain lenders confidence. Many CGSs have a minimum mandatory waiting period after loan disbursement before a claim can be entered. The trigger conditions for claims should specify the maximum period after a missed payment(s) and should not be conditional on initiating legal action against the SME borrower. CGTMSE has minimum lock in period of 18 months for invoking the claim and the trust expects the lenders to initiate legal proceedings before invoking the claim. The biggest concern faced by banks is slow realisation of claims. Faster settlement of claims under the CGTMSE scheme would help foster confidence amongst the MLIs.

		The invocation of guarantees can only be done after a lock-in period and initiation of recovery proceedings under due process of law. Further, given the legal issues and procedural delays involved, the number of cases for which full settlement of eligible claims (2nd instalment) was completed are negligible.
14	**Principle 14** The CGS should be subject to rigorous financial reporting requirements and should have its financial statements audited externally.	Timely, accurate, and appropriately audited financial statements hold the management of a CGS accountable for the stewardship of the organization. The CGS should produce and disclose financial statements—including a balance sheet, cash flow statement, profit and loss statement, statement of changes to equity, and notes—at least annually. CGTMSE is not subject to rigorous financial reporting requirements.
15	**Principle 15** The CGS should periodically and publicly disclose nonfinancial information related to its operations.	The CGS should publicly report nonfinancial information annually, at least. Such disclosure, often qualitative in nature, should give stakeholders key insights into the workings of the CGS, its prospects, and its relationship with the government or ownership entity. Nonfinancial reporting should be linked to the policy objectives of the CGS. At minimum, the following nonfinancial information should be disclosed: (a) social and economic commitments made, (b) social and economic outcomes, and (c) any other material engagement into which the CGS has entered as a result of its status as a government-owned institution. The CGTMSE in its Annual Report submits the overall impact of its operations claiming to have a positive impact on the economy in terms of turnover, exports and employment of credit guaranteed MSEs.

16	**Principle 16** The performance of the CGS—in particular its outreach, additionality, and financial sustainability—should be systematically and periodically evaluated, and the findings from the evaluation publicly disclosed.	A comprehensive evaluation of the CGS's performance is necessary to account for the use of public resources, to measure the achievement of CGS policy objectives, and to improve CGS operations. The CGS should establish a sound mechanism for systematically assessing the performance of its operations. No such evaluation has been done / available on the public domain on the above parameters.

Chapter V

SMEs in Japan – An overview

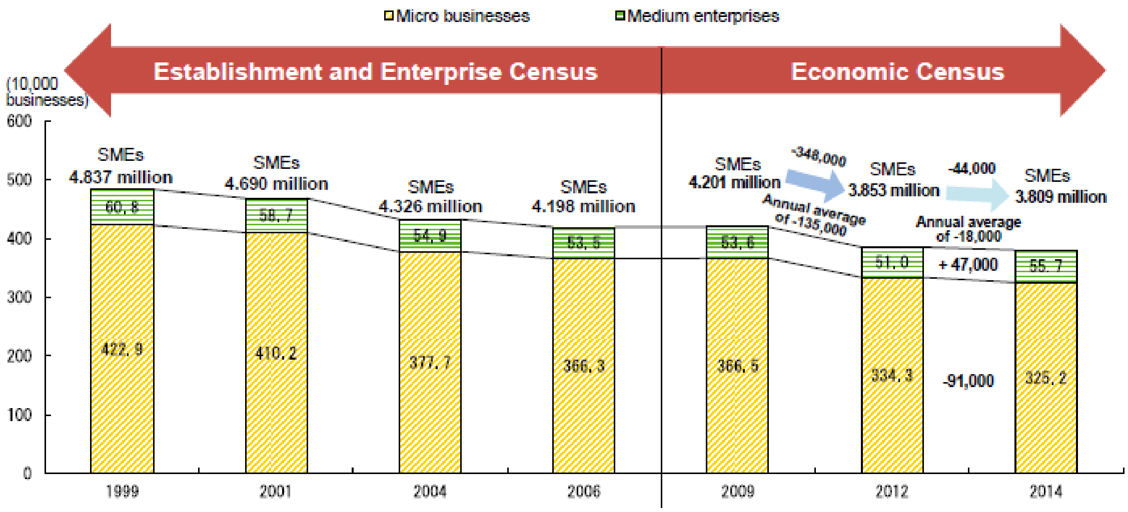
Small and medium enterprises (SMEs) account for 99.7% of all enterprises in Japan and close to 70% of private sector jobs. Moreover, SMEs account for approximately 55% of gross value-add across the Japanese economy. They are the foundation of Japan's labor market and essential for Japan's economic growth.

Definition in the SME Basic Act				**Definition in the Corporation Tax Act**
SME operators			Of which, micro enterprises	
Industry Type	**Stated capital**	**Employees**	**Employees**	**Stated capital**
Manufacturing	¥300 million or less	300 or fewer	20 or fewer	¥100 million or less
Wholesale	¥100 million or less	100 or fewer	5 or fewer	
Service industry	¥50 million or less	100 or fewer	5 or fewer	
Retail	¥50 million or less	50 or fewer	5 or fewer	

Trends in SME operation

The number of SMEs has been declining over the long term, with a decline of 44,000 during the most recent two years, from 2012 to 2014. However, the rate of decline has become gradual. While the number of SMEs declined by an average of 135,000 per year from July 2009 to February 2012, it declined by an average of 18,000 per year from February 2012 to July 2014. In terms of enterprise size, the number of micro enterprises declined by 91,000 over the two years from 2012 to 2014, but the number of medium enterprises contrarily increased by 47,000 over the same period, for a total decline of approximately 44,000. The number of exits largely surpassed the number of entries by 171,000 With respect to changes in enterprise size, 68,000 micro enterprises grew into medium enterprises, and 63,000 medium enterprises downsized into micro enterprises. This means there were 5,000 more micro enterprises that became medium enterprises than the opposite.

Numbers of SMEs in Japan and its trend (1999-2014)



Sources: Recompiled from MIC, *Economic Census for Business Frame*; *Establishment and Enterprise Census* and MIC, METI, *2012 Economic Census for Business Activity*.

Notes: 1. Number of enterprises = Number of companies + Business establishments of sole proprietors
2. The 2009 and 2014 *Economic Census for Basic Frame* was conducted on July 1, and the 2012 *Economic Census for Business Activity* was conducted on February 1.

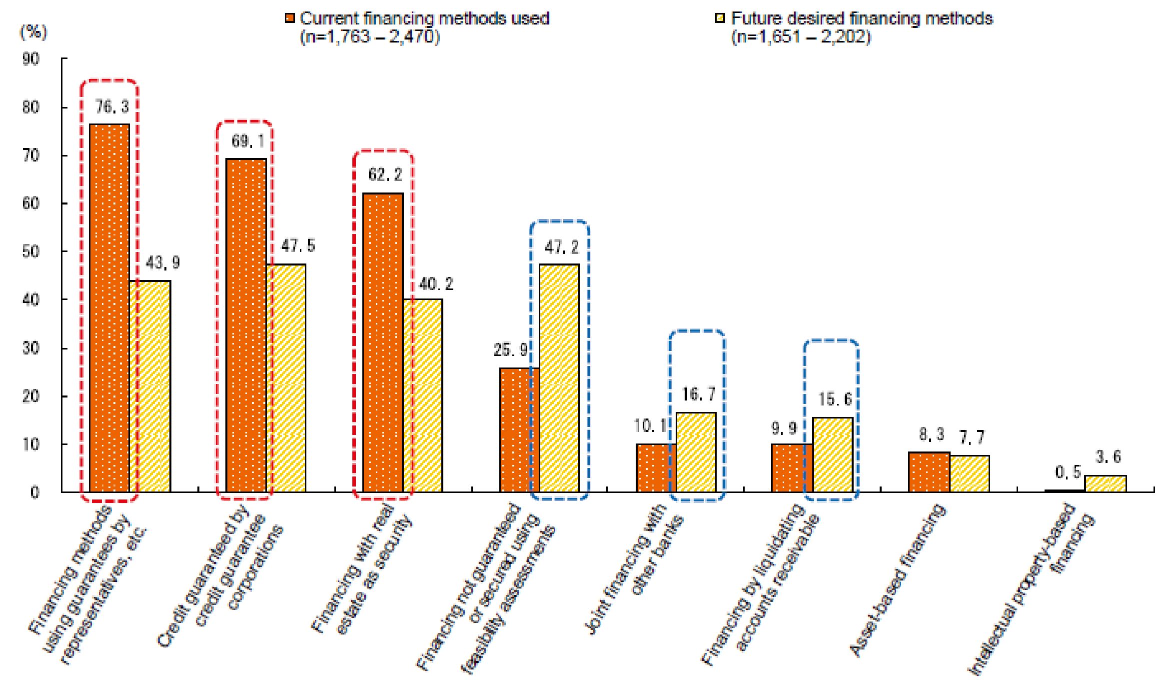
(Source: White paper of SMEs in Japan, METI 2017)

Financing methods currently used by SMEs

The most frequently used method at present is "Financing methods using guarantees by representatives, etc.", followed by "Credit guaranteed by credit guarantee corporations" and then "Financing with real estate as security". Popular choices as preferred financing methods for future borrowings were "Credit guaranteed by credit guarantee corporations" and "Financing not guaranteed or secured using feasibility assessments (financing based on feasibility assessments"). From this, we see that the need for guaranteed financing from credit guarantee corporations is deeply rooted, but that the need for financing based on feasibility assessments is growing when compared with its current level of use.

Financing methods currently used by SMEs and preferred financing methods for future borrowings

While financial institutions currently use credit guarantee corporations, they are putting more effort into financing based on feasibility assessments and intend to give feasibility assessment-based financing greater priority in the future. In this respect, their policies are coming into line with the future needs of SMEs



Source: Mizuho Research Institute Ltd., *Survey of Fund Raising by Small and Medium Enterprises* (December 2015), commissioned by the SME Agency.

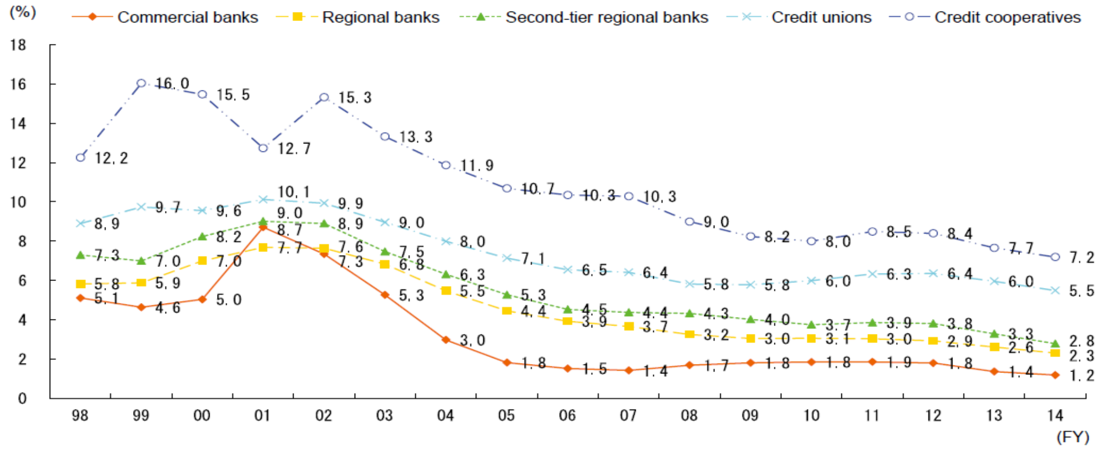
Notes: 1. Figures were totaled only for enterprises with borrowings from financial institutions.
2. Total does not always equal 100% as multiple responses were possible.

(Source: White paper of SMEs in Japan, METI 2017)

Trends in non-performing loan ratios

In the period of financial system instability in the early 2000s, non-performing loan ratios temporarily increase, but subsequently went into a downward trend year on year. The financial situation for enterprises temporarily worsened during economic shocks such as the Lehman crisis, but even at those times non-performing loan ratios at financial institutions did not increase significantly, and the management of financial institutions remained sound.

Trends in the non-performing loan ratio according to financial institution type



Source: Prepared by the SME Agency based on data published by the FSA.

(Source: White paper of SMEs in Japan, METI 2017)

Chapter VI

Credit guarantee scheme for MSMEs in Japan

Credit Guarantee System in Japan is a unique combination of credit guarantee and credit insurance system. This is referred as credit supplementation system for MSMEs in Japan. The credit guarantee system is operated by Credit Guarantee Corporations in each province which were established through financial assistance from the respective local government, and the credit insurance system is operated by the Japan Finance Corporation, an institution owned by the national government.

History of Credit Guarantee Systems in Japan

Credit Guarantee Corporation of Tokyo which was established in 1937, was the first corporation established in Japan. Till the World War II, only three Credit Guarantee Corporations were operating in Japan. Credit Guarantee Corporations were established around Japan to spur the economy and were established with the help of the local Government.

After the 2008 Global Financial Crisis (GFC), 19 out of the 23 OECD countries have strengthened their credit guarantee system or introduced a new credit guarantee system to ward off their MSMEs from the adverse effects of GFC. Japan too has strengthened its credit guarantee system as its guarantee system namely, Emergency Credit Guarantee programme (ECG) is the biggest credit guarantee system amongst the OECD countries.

In 1954, CGCT was transformed into an approved corporation pursuant to the Credit Guarantee Corporation Law, which was enacted to facilitate our services and strengthen our organizational base.

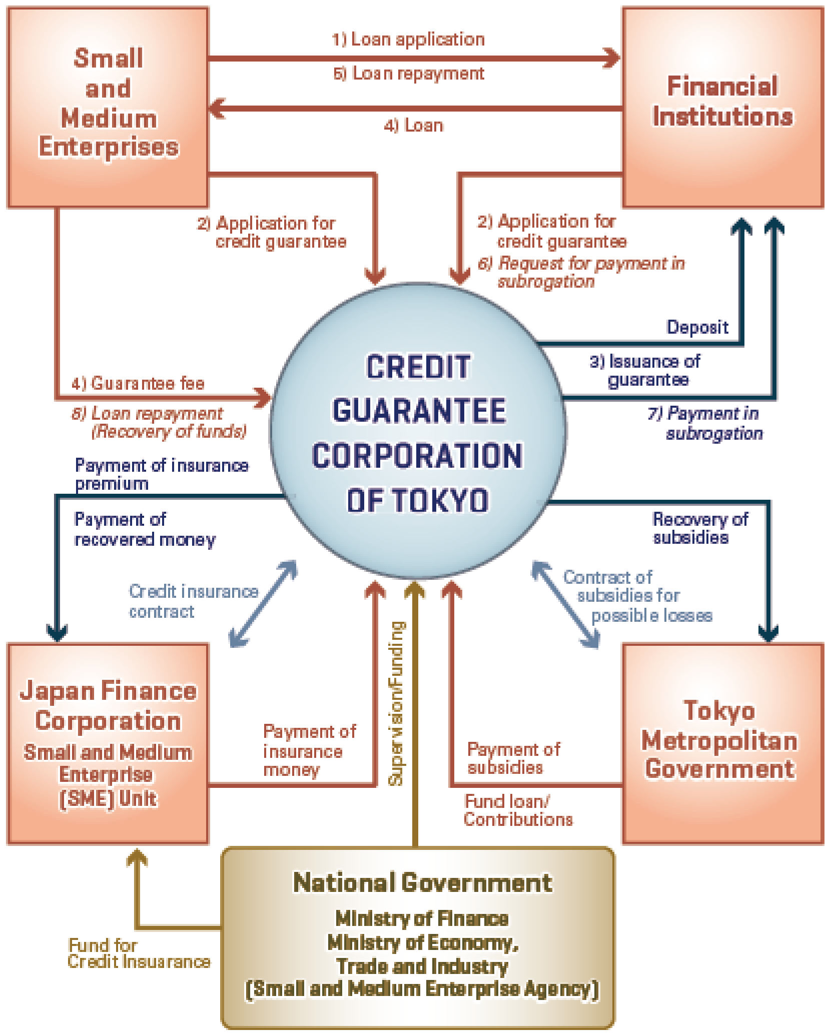
BUSINESS OBJECTIVES OF CREDIT GUARANTEE SYSTEM OF JAPAN

The central objective of the credit guarantee corporation of Tokyo (CGCT) is to support the many Small and Medium Enterprises (SMEs) that are managing their businesses in a reliable manner and striving to grow. Our chief tool is to offer credit guarantees to SMEs so that they can raise necessary funds from financial institutions or the capital market

Establishment of the Credit Supplementation System

In 1958, the Small Business Credit Insurance Corporation (now the Japan Finance Corporation) was established as a government agency to provide insurance for the guarantees offered by credit guarantee corporations across the country. It was at this point that the current framework of Japan's credit supplementation system was completed.

In order to strengthen the credit guarantee system, which supports the financing and growth of small and medium enterprises, a credit insurance system has been established. The credit insurance system is a mechanism to cover the risk that a credit guarantee corporation may have to make payment pursuant to a guarantee, using insurance offered by the Japan Finance Corporation, an organization fully funded by the government. The credit guarantee system and credit insurance system are collectively termed the "credit supplementation system."

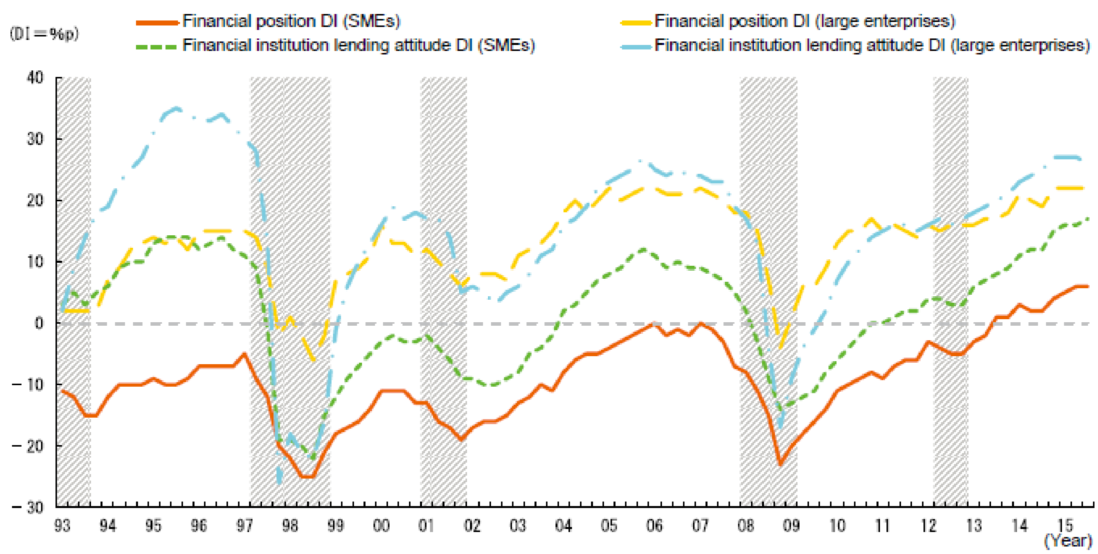


(Source : Credit Guarantee Corporation of Tokyo, Annual Report, 2015)

Development of the System

The credit supplementation system has been greatly enhanced since its establishment. For example, the definition of SMEs has been expanded to include larger firms, the range of business categories eligible for guarantees has been broadened and the value limit for unsecured guarantees has been increased several times. Moreover, in response to the diverse needs of SMEs, various new types of credit guarantee programs continue to be developed, such as the Safety-Net Guarantee Program, CLO (collateralized loan obligation) guarantees, corporate bond guarantees and ABL (asset-based lending) guarantees. Based on the report by the Council on Government Policy for SMEs, various efforts are being made to better respond to the needs of the times, such as the implementation of a responsibility-sharing system with financial institutions and a guarantee rate system based on the client's degree of credit risk.

Cash-flow and ease of borrowing from financial institutions by enterprise size

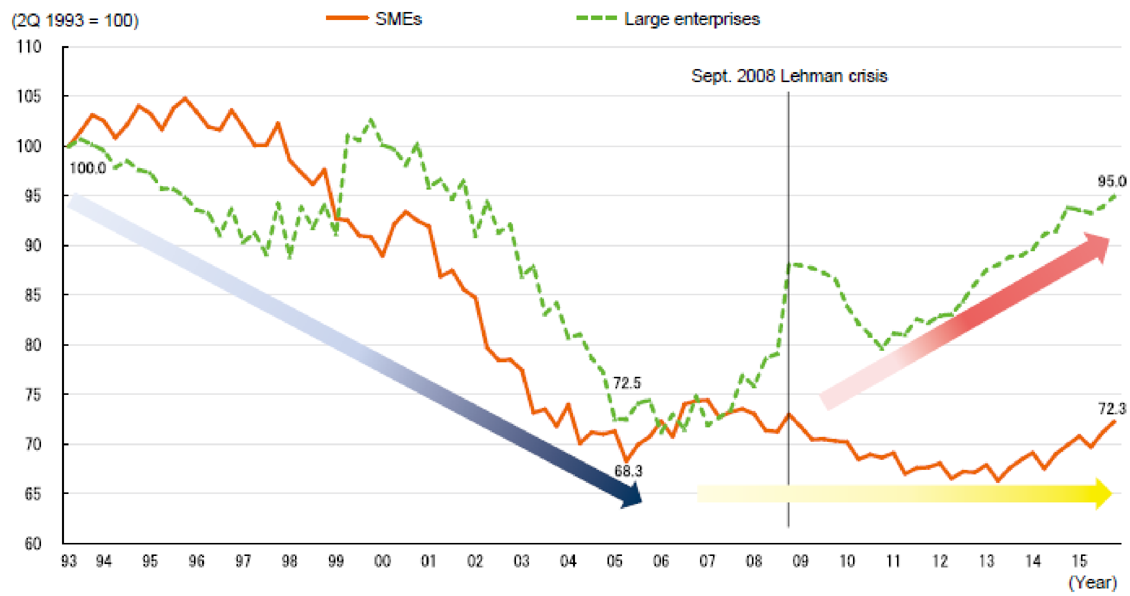


Source: BOJ, *Short-Term Economic Survey of Enterprises in Japan* (BOJ Tankan).
Notes:
1. Large enterprises here refer to enterprises with capital of ¥1 billion or more, and SMEs refer to enterprises with capital of ¥20 million or more and less than ¥100 million.
2. The financial position DI was calculated by taking the proportion (%) of enterprises who responded that their recent cash-flow situation was "Comfortable" and subtracting the proportion (%) who responded "Difficult".
3. The financial institution lending attitude DI was calculated by taking the proportion (%) of enterprises who responded that recent financial institution attitudes to lending were "Generous" and subtracting the proportion (%) who responded "Strict".
4. The shaded sections of the graph indicate periods of economic recession based on the business cycle reference dates from the Cabinet Office.

(Source: White paper of SMEs in Japan, METI 2017)

Trends in loans from financial institutions by enterprise size

The total amount of money lent to enterprises by Japanese banks according to enterprise size is depicted in the picture below. Taking the second quarter of 1993 as a reference, loans to both SMEs and large enterprises shrank significantly during the period from the collapse of the bubble to the mid-2000s, decreasing around 30% by the middle of the 2000s. After that point, total loan amounts differ by enterprise size, with large enterprises weathering the turbulence of the Lehman crisis to move into a generally growing trend, paving the way for a recovery to 1993 levels. After the Lehman crisis, SMEs generally declined and their recovery stalled, leaving them no higher than their peaks of the mid-2000s, despite the underlying growth trends during the economic expansion phase.



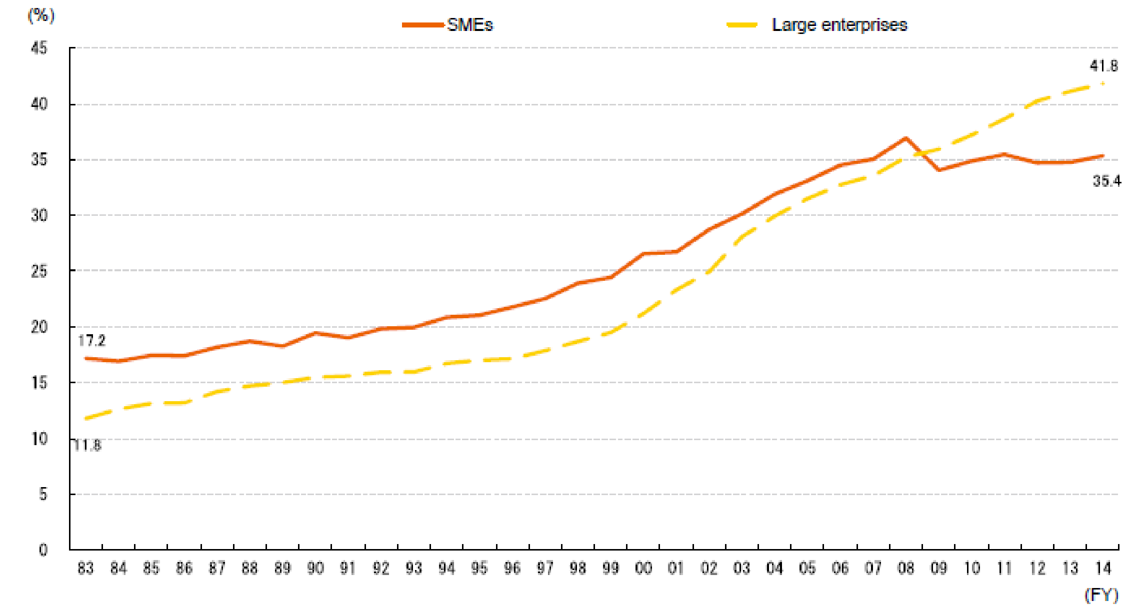
Source: BOJ, *Monthly Report of Recent Economic and Financial Developments*.

Notes:
1. Loans include trust and overseas accounts.
2. Totals are only for Japanese banks.
3. Figures shown in the graph are for 2Q 1993, 2Q 2005 and 4Q 2015 respectively.

(Source: White paper of SMEs in Japan, METI 2017)

Proportion of debt-free enterprises according to enterprise size

The proportion of "debt free enterprises" that have no borrowings from financial institutions is depicted in the figure below. There is a rising trend in the proportion of debt-free enterprises for both SMEs and large enterprises, with more than 40% of large enterprises becoming debt free by 2014. Looking at the past 30 years, SMEs had a larger proportion of debt-free enterprises for a long time, but after the Lehman crisis the proportion of debt-free enterprises flat-lined, and in recent years the proportion of debt-free businesses has been higher among large enterprises



Source: Recompiled from MOF, *Financial Statements Statistics of Corporations by Industry, Annually*.

Notes: 1. Here, debt-free enterprises refer to enterprises that have no borrowings from financial institutions at the end of the current and previous periods.

2. Large enterprises here refer to enterprises with a capital of more than ¥100 million, and SMEs refer to enterprises with a capital of ¥100 million or less.

The Credit Insurance System

(Cooperation between Japan Finance Corporation and CGCT)

Pursuant to a credit insurance contract between the Japan Finance Corporation (hereinafter referred to as "JFC") and CGCT, JFC undertakes to insure the credit guarantees issued by CGCT. CGCT pays credit insurance fees to JFC, from the credit guarantee fees received by CGCT. In the event that CGCT must make a payment in subrogation to a financial institution, JFC will pay to CGCT as insurance proceeds 70% or 80% of the principal amount which CGCT pays in subrogation. In the event CGCT recovers money from a defaulting SME, CGCT will pay to JFC a portion, in the same ratio as the amount received from JFC bears to the principal amount.

Establishment of New Guarantee Schemes

Considering the economic environment and SME operators' needs, the following new guarantee schemes were established in fiscal 2014 to enhance financial support through guarantees.

1. **Thanks 10 Special Guarantee Scheme ("Thanks 10")**

Period available: April 2014 - September 2014

To convey CGCT's appreciation to SME operators who have used our services several times, this scheme offered such users major reductions in guarantee fees.

2. **Short-Term Finance Guarantee Scheme ("Step")**

Period available: October 2014 - March 2015

By quickly and flexibly providing short-term finance to meet forward demand,this scheme supported further business development as the economy regained buoyancy.

3. **Special Scheme for Guarantees Teamed With Unguaranteed Loans ("Tie-up")**

Period available: October 2014 onward

This scheme meets the total financing needs of SME operators fulfilling certain conditions, including business history and financial position, by offering unguaranteed loans from a financial institution in tandem with finance guaranteed by CGCT.

Eligibility for the Credit Guarantee System

CGCT provides credit guarantees to companies that satisfy certain conditions regarding company scale, business type and company location, as described below:

1. **Company Scale**

In principle, CGCT can offer credit guarantee services to small and medium enterprises as specified in the Small and Medium Enterprise Credit Insurance Law. SMEs that satisfy either of the limits on the maximum number of full-time employees or the maximum capital listed in the following table qualify for application.

Business Type	Maximum Amount of Capital	Maximum Number of Employees
Manufacturing, etc.	¥300 million	300
Wholesale trade	¥100 million	100
Retail trade	¥50 million	50
Services	¥50 million	100
Health care, etc.	-	300

2. Business Type

The credit guarantee service is available to most types of businesses. Categories that are not eligible for the service include agriculture, forestry, fishery and finance. When SMEs are engaged in businesses which require a license or registration, they must obtain the relevant license or registration.

3. Company Location

A company seeking credit guarantees must operate business facilities in Tokyo, either from a Tokyo head office or from another business facility. In case of individually owned and operated businesses, the owner must live in Tokyo or operate the business in Tokyo.
In the case of special financial programs offered by the government, companies must also meet any conditions established by the government

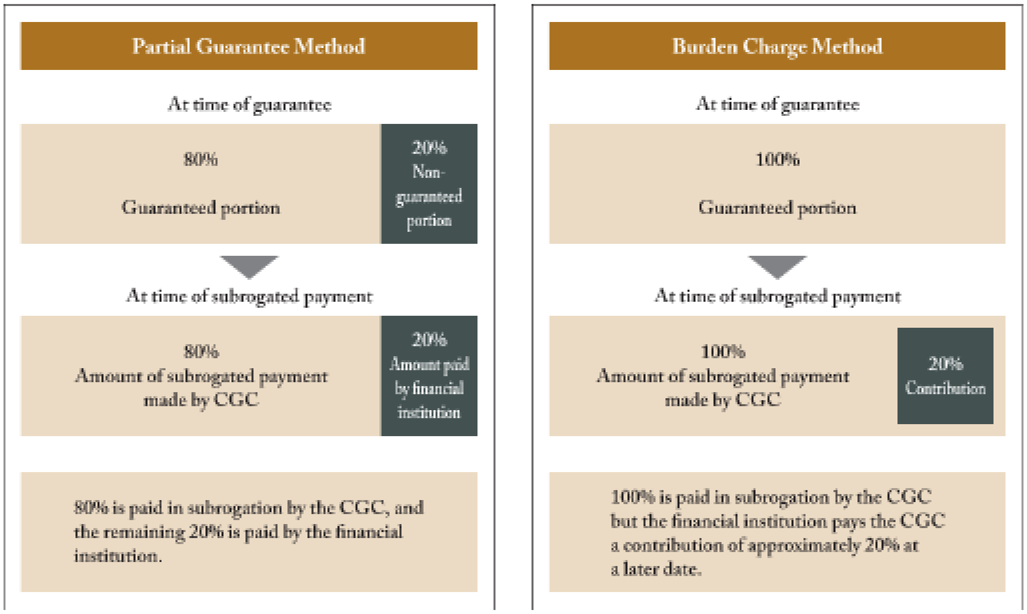
Maximum Term and Amount of Guarantees

In principle, the guarantee ceiling for a company is 200 million yen for a general guarantee and 80 million yen for an unsecured guarantee, bringing the total to 280 million yen. As noted in the table, the maximum term and amount of guarantee are prescribed by the type of guarantee, and the conditions of the guarantee are set within a prescribed range. Special conditions are available for companies that have been approved by the national or local government.

Type of Guarantee	Use of Funds	Maximum Term	Maximum Amount
Individual guarantee	Operations, Equipment	10 years	¥280 million
Revolving guarantee	Operations	2 years	
Revolving guarantee for overdrafts	Operations, Equipment	2 years	

Responsibility-Sharing System

For the purpose of providing more suitable financial and management support for all SMEs, in October 2007 CGCT introduced a Responsibility-Sharing System to more closely coordinate services and responsibilities between CGCT and financial institutions. Whereas in principle CGCT used to guarantee 100% of a loan, after the implementation, financial institutions must bear a fixed portion (about 20%) of the burden (except for some guarantee programs).



(Source) CREDIT GUARANTEE SYSTEM IN JAPAN 2013

Credit Guarantee Fee

Credit guarantee fees are calculated based on the loan amount, the applicable credit guarantee fee rate, the term of the loan and the method of payment. As indicated in the table below, the main credit guarantee fee rate is basically linked to each company's business situation and is divided into nine levels. The applicable rate classification for each borrower is determined utilizing the SME Credit Risk Database (CRD) which was established to facilitate the financing of SMEs, is the largest database regarding SMEs in Japan.

Credit Guarantee Fee during 2014

Main credit guarantee fee rate (%) - 2014									
Classification	1	2	3	4	5	6	7	8	9
Credit guarantee fee rate	2.20	2.00	1.80	1.60	1.35	1.10	0.90	0.70	0.50
Credit guarantee fee rate under Responsibility-Sharing System	1.90	1.75	1.55	1.35	1.15	1.00	0.80	0.60	0.45

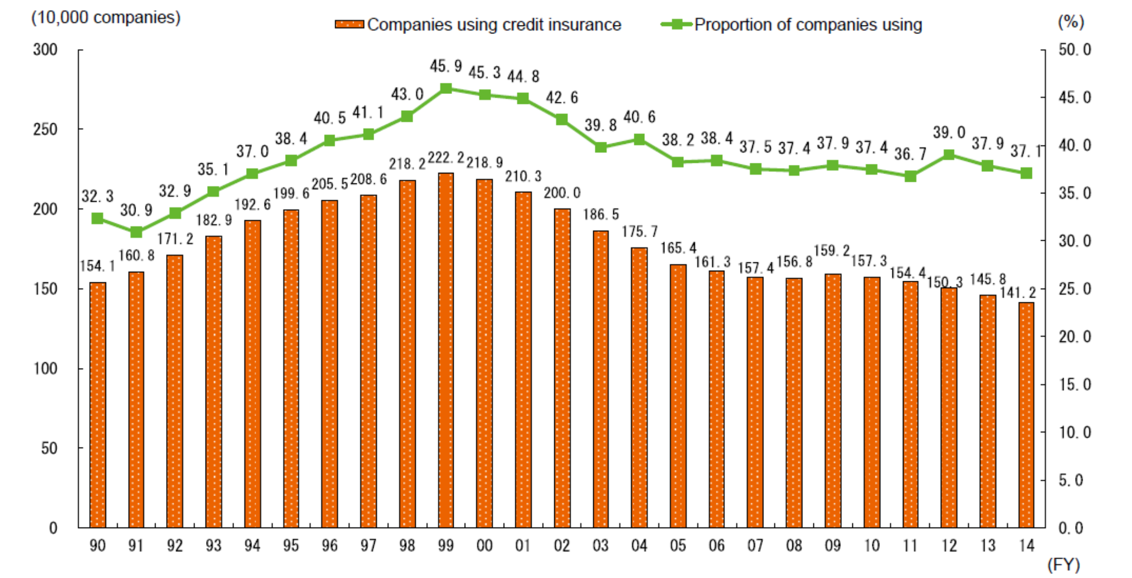
Trends in the use of credit guarantee schemes

Credit guarantees are offered by credit guarantee corporations that were established to help SMEs cope with cash-flow issues. When SMEs take out loans with private financial institutions, the loans are guaranteed by credit guarantee corporations so as to facilitate funding procurement by SMEs. In this section, we will look at the trends in the users of such credit guarantee schemes and factors such as the loan balances.

Numbers of credit guarantee users and their balances

We will begin by looking at the situation around the use of credit guarantee corporations by SMEs. Fig. 2-5-24 shows the number of credit guarantee users and the number of SMEs as a proportion of credit guarantee users. The figure shows that the number of credit guarantee users rose until 1999, reaching 2.222 million at its peak. Subsequently the number declined slowly and most recently stood at 1.412 million. The proportion of SMEs among credit guarantee users was 32.3% in 1990 and had climbed to 45.9% by 1999. It then declined through the mid-2000s before leveling off after the Lehman crisis, and was most recently at 37.1%.

Trends in the numbers and proportions of credit guarantee users

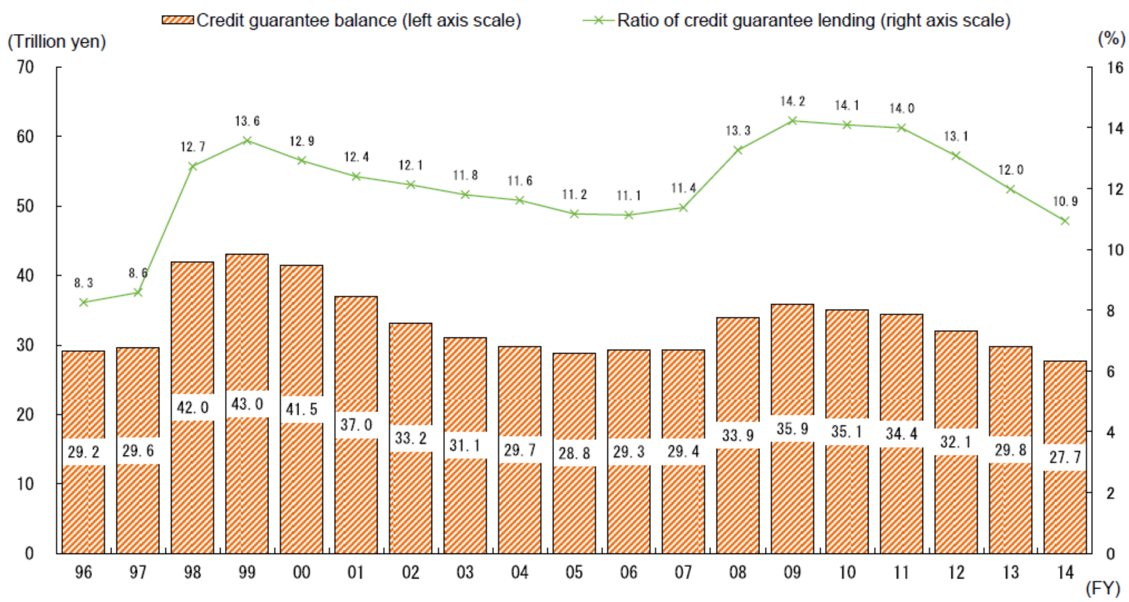


Sources: Recompiled from MIC, *Establishment and Enterprise Census*, 2009 and 2014 *Economic Census for Business Frame*; MIC, METI, *2012 Economic Census for Business Activity*; materials of Japan Federation of Credit Guarantee Corporations.
Note: Here, "Proportion of companies using" refers to the number of SMEs using credit guarantees as a proportion of the total number of SMEs.

(Source: White paper of SMEs in Japan, METI 2017)

The above figure shows the trends in credit guarantee balances and the loans to SMEs as a proportion of the total. The emergency guarantee program introduced to combat the financial system instability that arose at the end of the 1990s significantly boosted the credit guarantee balance at the time and also led to a similarly large increase in the rates of credit guarantee lending. Subsequently there was a gradual decline in the 2000s until the rate again rose with the Lehman crisis. The improved economic conditions in recent years have again lowered credit guarantee balances to the levels of the mid-1990s, with the figure for end of FY2014 standing at ¥27.7 trillion.

Trends in credit guarantee balances and ratio of credit guarantee lending



Sources: Prepared by the SME Agency based on Japan Federation of Credit Guarantee Corporations, *Current Status of Credit Guarantee Corporations*; Bank of Japan, *Monthly Report of Recent Economic and Financial Developments*.

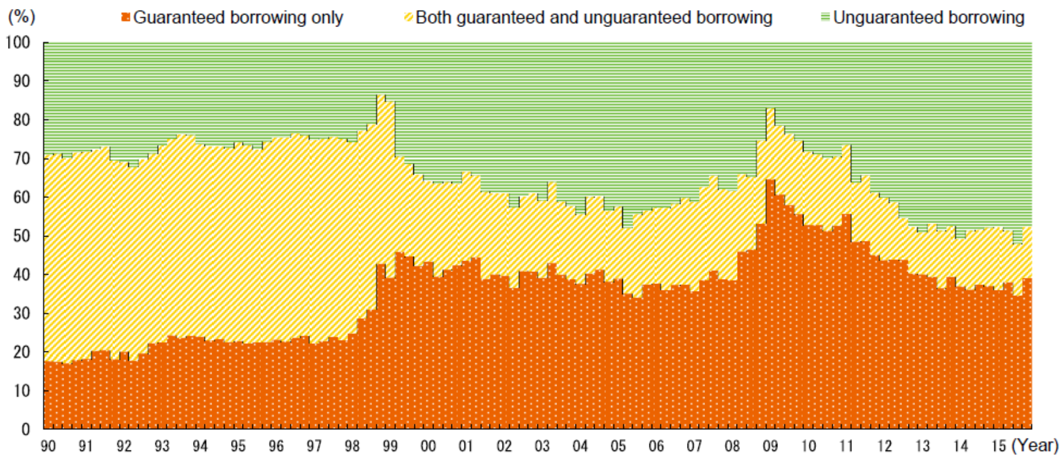
Note: Here, "Ratio of credit guarantee lending" refers to the total credit guarantee balance as a proportion of the amount of lending to SMEs.

(Source: White paper of SMEs in Japan, METI 2017)

Trends in credit guarantee users

Next we look at the situation of enterprises that use credit guarantees when procuring funding (Fig. 2-5-26). This examines those SMEs who use credit guarantee schemes for new borrowings in the fourth quarter, and looks at whether they opt for borrowings with credit guarantees, or use "proper" financing9) from financial institutions, or both. The figure shows that more than half the enterprises used a combination of credit guarantees and proper financing from financial institutions in the 1990s, so that risks were shared between credit guarantee corporations and financial institutions. Later, during the instability in the financial system in the late 1990s and through to the Lehman crisis in 2008, an increasing proportion of users opted to use only borrowings that came with credit guarantees or borrowings without credit guarantees, indicating an increasing polarity in their financing choices.

Use of credit guarantees for new borrowings among enterprises using credit guarantees



Source: Prepared by the SME Agency based on Japan Finance Corporation (JFC), *Survey on Financial Status of SMEs with Guarantees*.

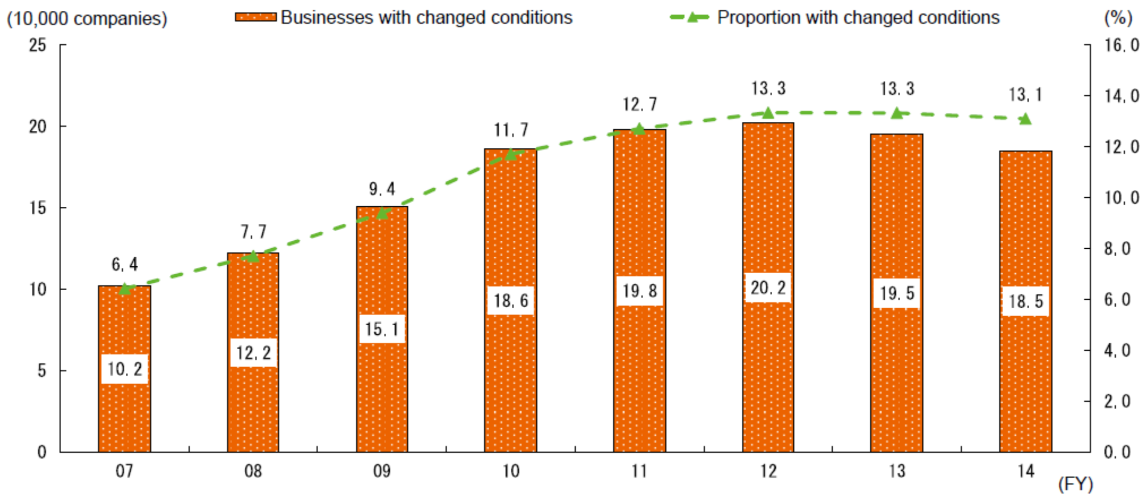
Note: This survey is directed at enterprises who use credit guarantees and classifies the respondents into enterprises who, for new borrowings in the fourth quarter, use only unguaranteed borrowings, those who use both guaranteed and unguaranteed borrowings, and those who use only guaranteed borrowings. The survey then calculates the proportions of enterprises in each category.

(Source: White paper of SMEs in Japan, METI 2017)

Trends in credit guarantee users with changed conditions

Fig. 2-5-27 looks at SMEs who use credit guarantee corporations and shows the number of enterprises with changed conditions and the number enterprises with changed conditions as a proportion of all the enterprises who use credit guarantees. Looking at the figure, we can see a rise in the number of enterprises with changed conditions after the Lehman crisis, rising to 202,000 in FY2012. But in recent years there has been a gradual decline, with the number falling to 185,000 in FY2014. Enterprises with changed conditions as a proportion of credit guarantee users climbed similarly from 6.4% in FY2007 to 13.3% in FY2012, but then remained more or less steady and stood at 13.1% in FY2014.

Trends in enterprises with changed conditions among credit guarantee users



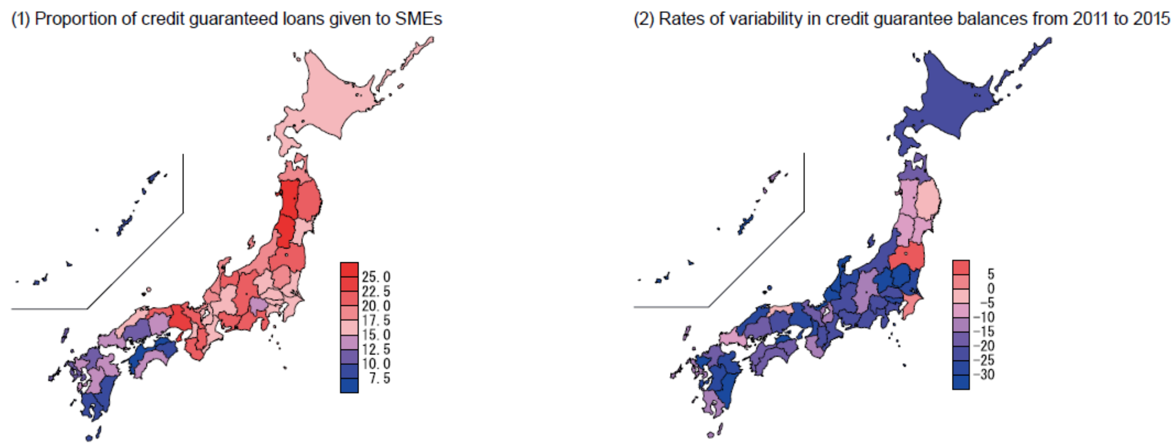
Source: Materials formulated by the SME Agency.

(Source: White paper of SMEs in Japan, METI 2017)

Current status of credit guarantees by region

Finally, we examine the proportion of credit guaranteed loans as a proportion of the loans given to SMEs by region. Fig. 2-5-28 (1) shows credit guaranteed loans as a proportion of the lending to SMEs by regional financial institutions. The proportion is high in the Tohoku region, particularly in Akita and Yamagata prefectures. If we also look at the fluctuations in the credit guarantee balance between 2011 and 2015, we see that the balance fell significantly everywhere other than the Tohoku region (Fig. 2-5-28 (2)). This, as we saw in Fig. 2-5-25, is because even though there was a decreasing trend in credit guarantee balances and rates of credit guaranteed lending in Japan as a whole, measures such as the Great East Japan Earthquake Recovery Emergency Guarantee following the Great East Japan Earthquake had the effect of strengthening the need for borrowing backed by credit guarantees in the Tohoku region especially. By contrast, the rates of credit guaranteed lending decreased in the Chugoku, Shikoku and Kyushu regions, with the general trend shifting from east to west

Trends in credit guarantees by region



Source: Prepared by the SME Agency based on data published by regional financial institutions and credit guarantee corporations.

Notes:
1. Proportion of credit guaranteed loans = Credit guaranteed lending/lending to SMEs
2. Lending to SMEs is calculated as the average figure for FY2013 and FY2014, totaled for each prefecture based on the figures published by the respective financial institutions. Note also that personal lending, such as housing loans, is subtracted from the lending to SMEs published by the financial institutions.
3. Credit guaranteed lending is calculated as the average balance at the financial institutions for each prefecture for FY2014.
4. The trends in credit guarantees show the fluctuation rate for credit guarantee balances at credit guarantee corporations from the end of March 2010 to the end of March 2015.

(Source: White paper of SMEs in Japan, METI 2017)

Chapter VII

Review of operations of Credit Guarantee Corporation of Tokyo

We are "Marugamo Oental," CGCT's mascot.

Support for Entrepreneurs

CGCT was the first of Japan's 51 credit guarantee corporations to establish a department specializing in providing support for start-up SMEs. With the slogan "From Sowing to Sprouting," our Start-Up Business Assistance Plaza provides continuous support to pre- and post-start-up entrepreneurs from both management and financial perspectives. To support the smooth supply of finance to entrepreneurs and the growth of new business, in the second half of fiscal 2014 discounted credit guarantee fees were offered to users of TMG's start-up finance scheme who fulfilled certain conditions.

The Plaza provides comprehensive management support services for SMEs, from pre-establishment financial advice and business planning to post-establishment management advice. CGCT also holds seminars and entrepreneurial training courses designed to equip people with the know-how for launching and running a business.

Cooperation between Tokyo Metropolitan Government and CGCT

In order to facilitate the financing of SMEs in Tokyo, the Tokyo Metropolitan Government ("TMG") implements various loan programs in cooperation with CGCT and financial institutions in Tokyo. TMG lends funds to CGCT for the purpose of smooth implementation of such loan programs, and CGCT deposits all of such funds in banks.

In addition, pursuant to a contract of assistance for losses, TMG will, in the event CGCT makes guarantee payments under TMG's loan programs, provide to CGCT assistance money covering all or part of such guarantee payments which is not covered by JFC's insurance.

CGCT will pay to TMG a portion of any money that CGCT recovers from a defaulting SME, in proportion to the TMG assistance money.

Bank Deposits

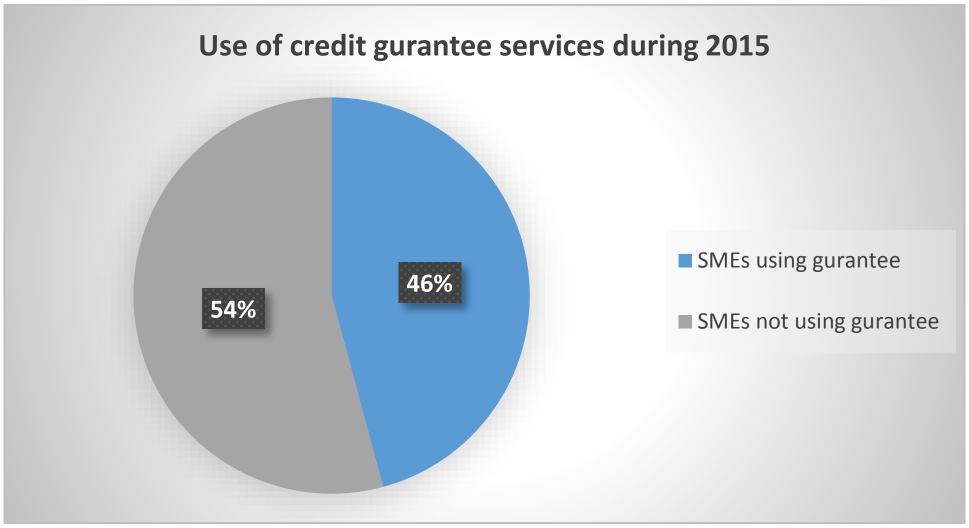
The deposits which CGCT makes in financial institutions influence financial institutions to lend positively to SMEs, and at lower interest rates. Such deposits are derived both from loans from TMG and from funds provided by TMG to CGCT to promote the various TMG loan programs.

CGCT makes such deposits in banks whose loans are guaranteed by CGCT, and distributes the deposits so as to promote proper guarantees, taking into consideration both the quantity of guarantees (outstanding guaranteed liabilities, average of outstanding guaranteed liabilities, and amount of guarantee acceptance or number) and the quality of guarantees (subrogation rate or amount of subrogation).

Use of Credit Guarantee Services

1. Almost half of Tokyo's small and medium enterprises use the service

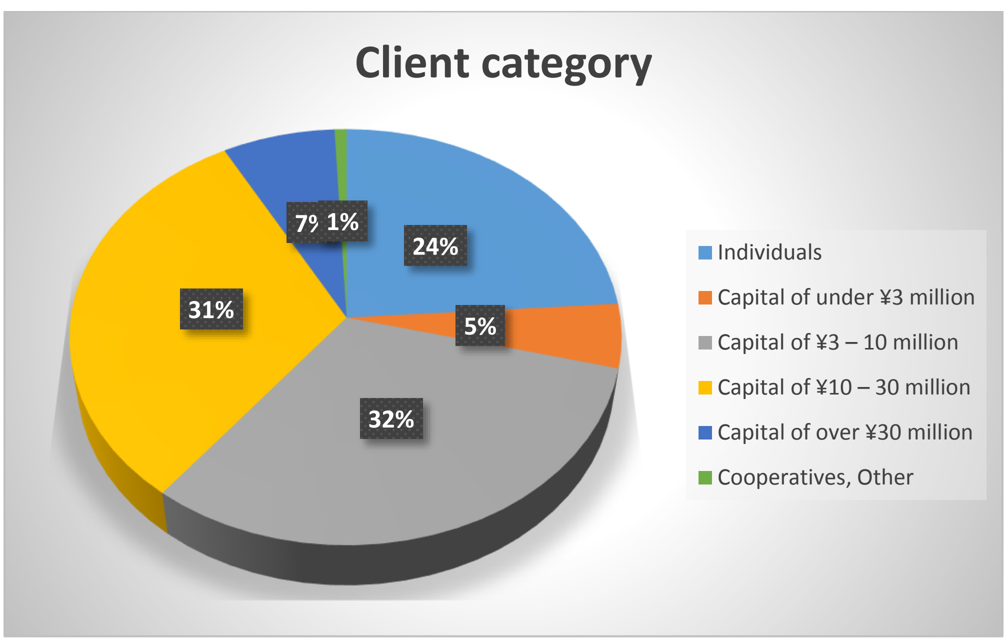
CGCT currently serves around 45.8% of the small and medium enterprises operating in the Tokyo Metropolitan area; that is, 202,942 out of 442,952 businesses.



2. About 60% of our clients are companies with capital under 10 million yen or individuals

Client category	Number of users	Percent of users
Individuals	48,545	23.92%
Capital of under ¥3 million	10,045	4.95%
Capital of ¥3 – 10 million	64,372	31.72%
Capital of ¥10 – 30 million	63,803	31.44%
Capital of over ¥30 million	14,629	7.21%
Cooperatives, Other	1,548	0.76%
Total	202,942	100%

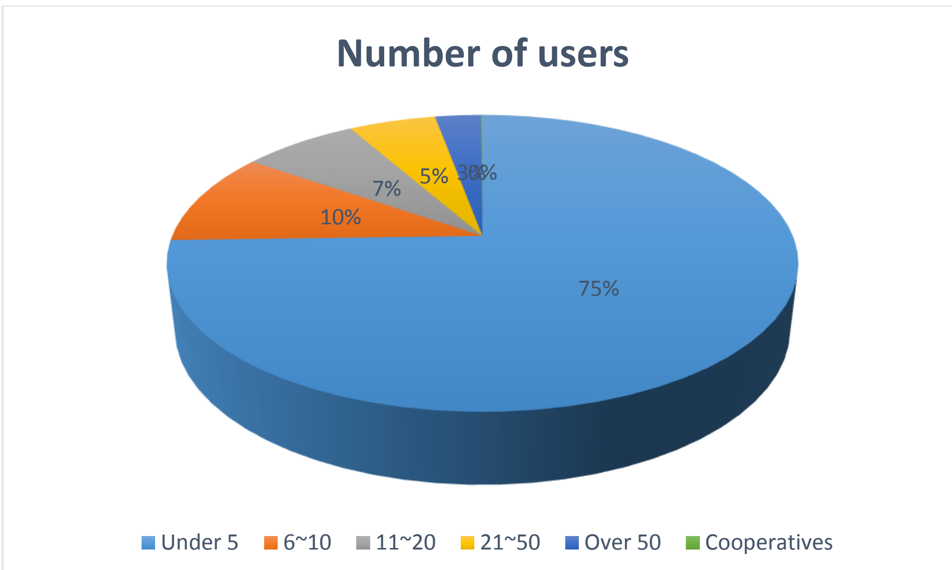
(Source : Annual Report, CGCT, Various issues)



3. About 75% of our clients are companies with fewer than five employees

Number of employees	Number of users	% of users
Under 5	151,289	74.55%
6~10	20,575	10.14%
11~20	14,376	7.08%
21~50	10,816	5.33%
Over 50	5,744	2.83%
Cooperatives	142	0.07%

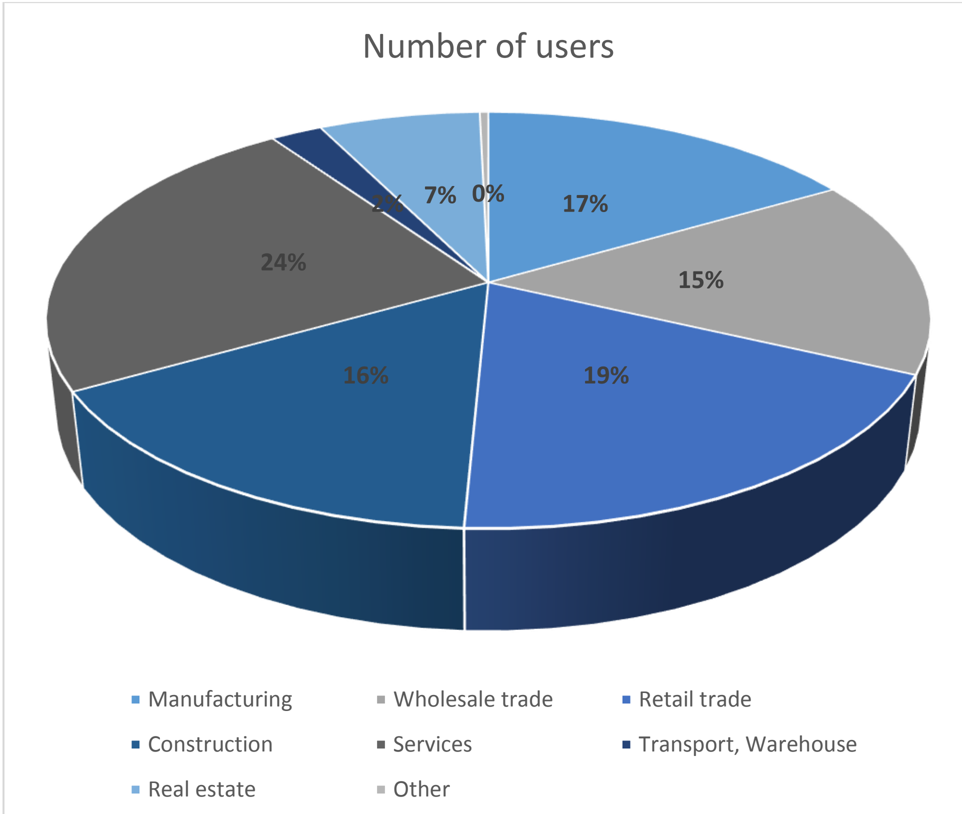
(Source : Annual Report, CGCT, Various issues)



4. A broad range of business types use credit guarantees

Sector	Number of users	% of users
Manufacturing	33,704	16.61%
Wholesale trade	31,193	15.37%
Retail trade	38,054	18.75%
Construction	32,537	16.03%
Services	47,878	23.59%
Transport, Warehouse	4,573	2.25%
Real estate	14,250	7.02%

Other	753	0.37%
Total	202,942	100.00%



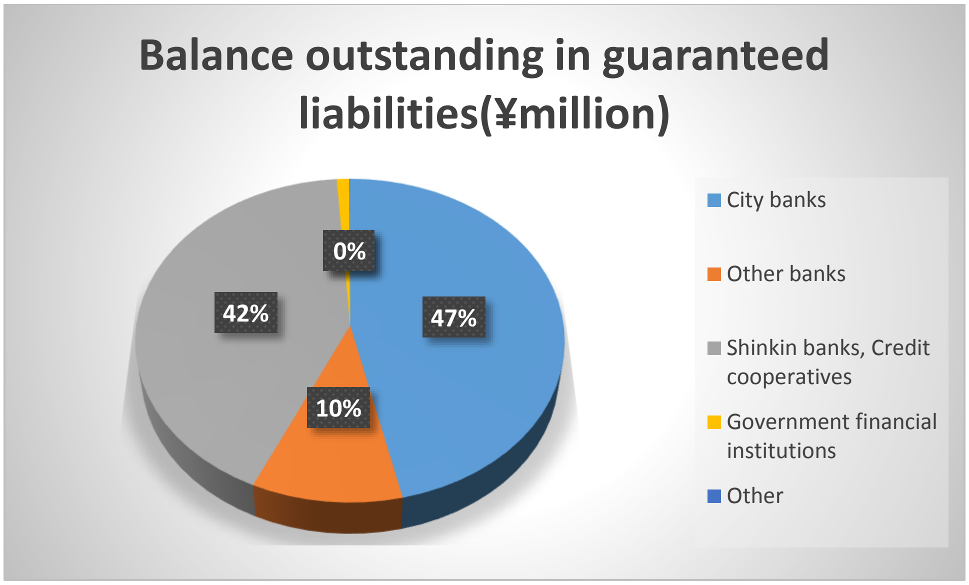
(Source : Annual Report, CGCT, Various issues)

5. Use of credit guarantees by different types of financial institutions

Lender type	Balance outstanding in guaranteed liabilities(¥million)	Percent
City banks@	1,806,456	46.42%
Other banks	403,974	10.38%
Shinkin banks, Credit cooperatives	1,637,609	42.09%
Government financial institutions	40,417	1.04%
Other	2,717	0.07%
	3,891,173	100.00%

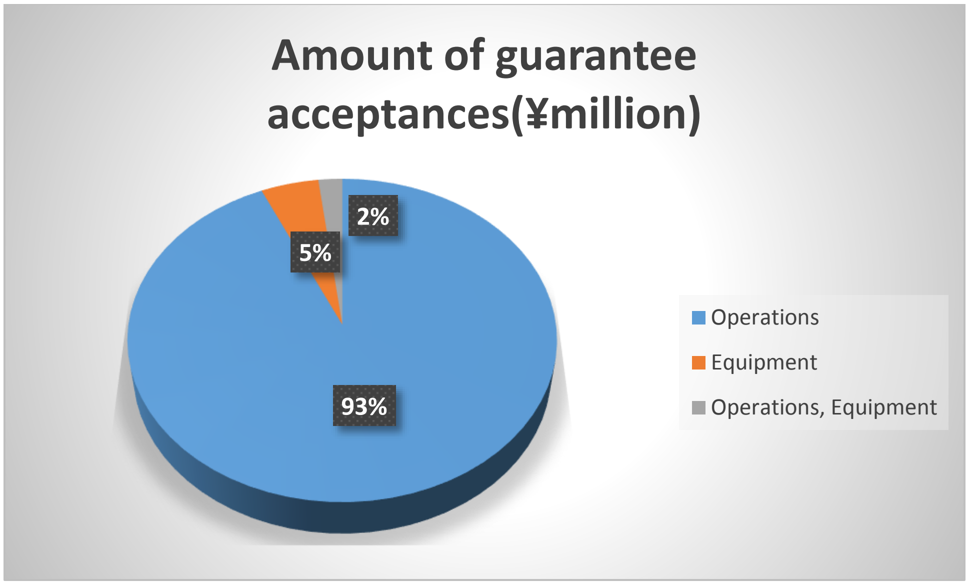
(Source : Annual Report, CGCT, Various issues)

@ - City banks refers to Mizuho Bank, Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corp., Resona Bank, Mizuho Corporate Bank, Saitama Resona Bank



6. More than 90% of guarantee acceptances are for operating funds

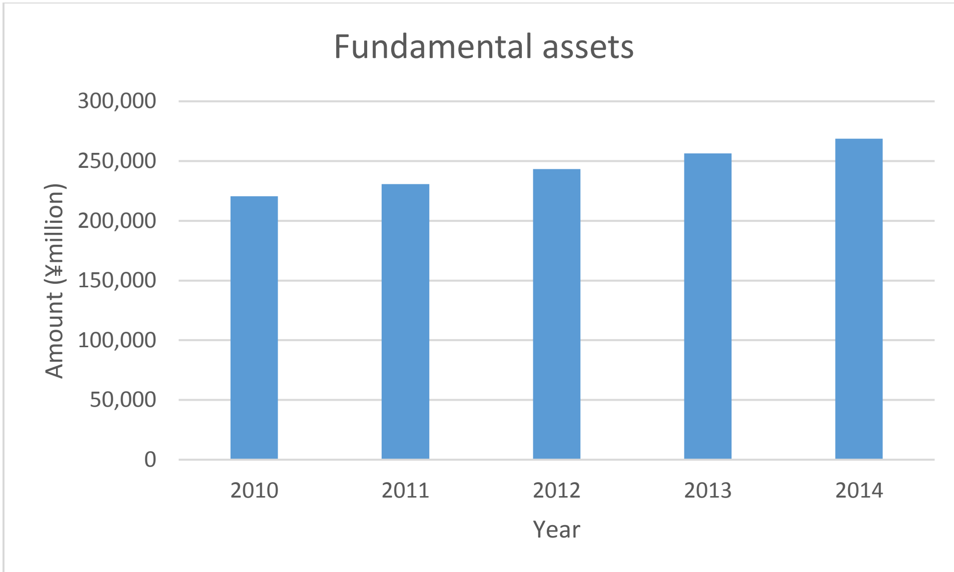
Use of funds	Amount of guarantee acceptances(¥million)	Percent
Operations	994,599	93.27%
Equipment	50,808	4.76%
Operations, Equipment	20,996	1.97%
Total	1,066,403	100.00%



7. Fundamental assets

Fundamental assets	
Year	**Amount (¥million)**
2010	220,572
2011	230,801
2012	243,221
2013	256,292
2014	268,691

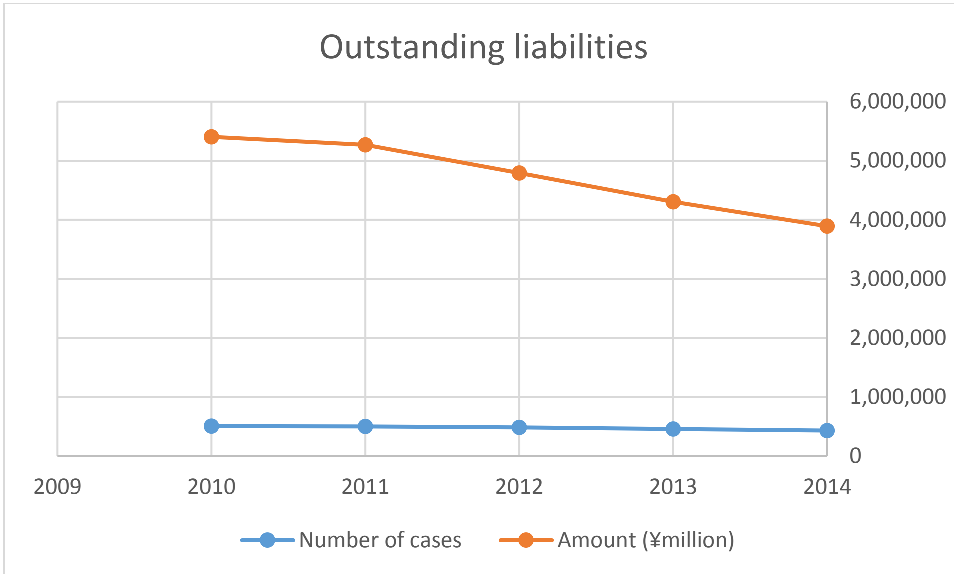
(Source : Annual Report, CGCT, Various issues)



8. Outstanding liabilities

Year	Number of cases	Amount (¥million)
2010	504,289	5,404,272
2011	500,761	5,268,183
2012	480,883	4,793,820
2013	453,061	4,305,352
2014	429,598	3,891,172

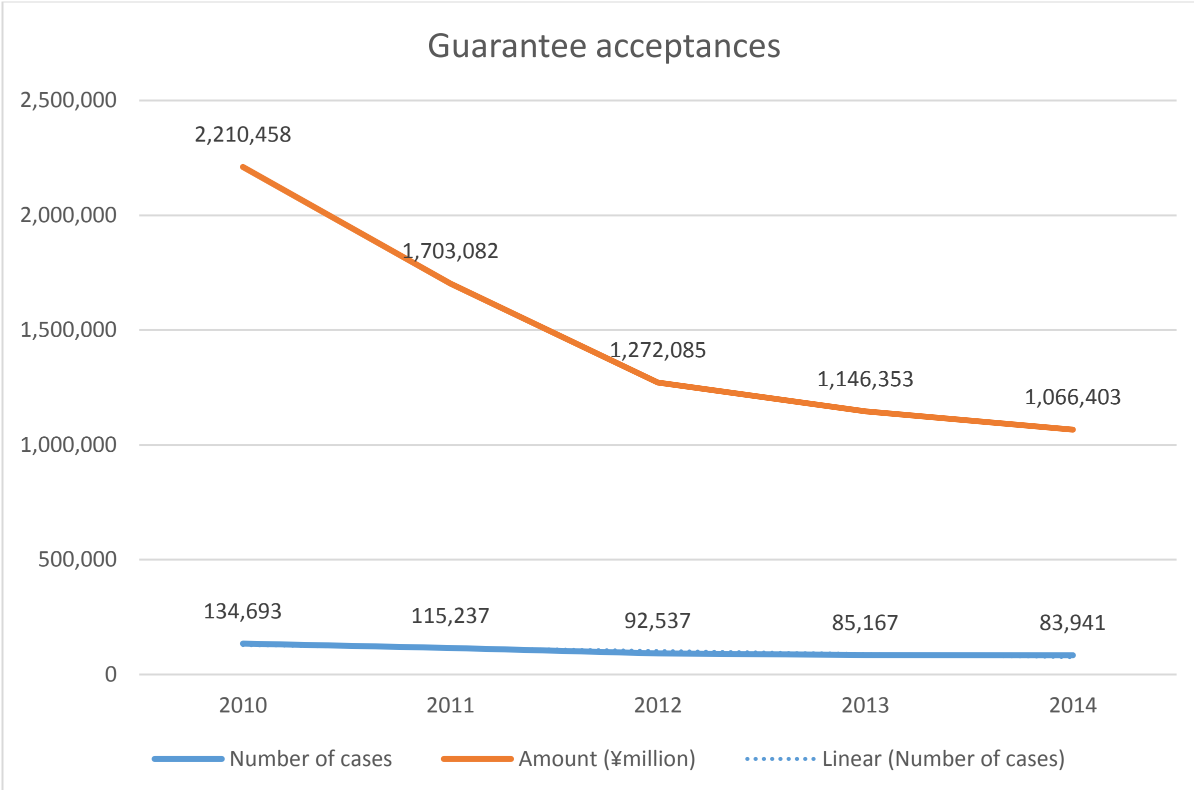
(Source : Annual Report, CGCT, Various issues)



9. Guarantee acceptances

Year	Number of cases	Amount (¥million)
2010	134,693	2,210,458
2011	115,237	1,703,082
2012	92,537	1,272,085
2013	85,167	1,146,353
2014	83,941	1,066,403

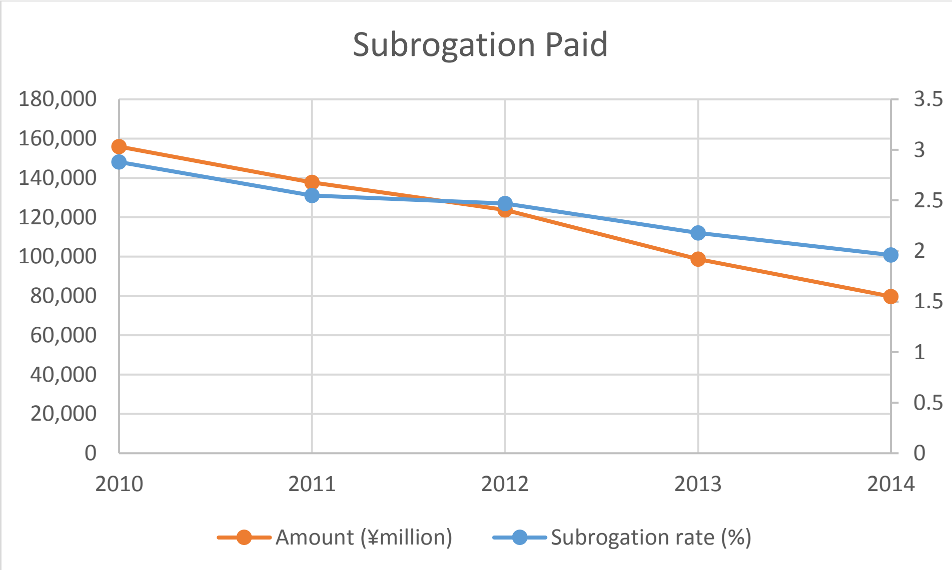
(Source : Annual Report, CGCT, Various issues)



10. Subrogation Paid

Year	Subrogation rate (%)	Amount (¥million)
2010	2.88	155,950
2011	2.55	137,722
2012	2.47	123,703
2013	2.18	98,756
2014	1.96	79,720

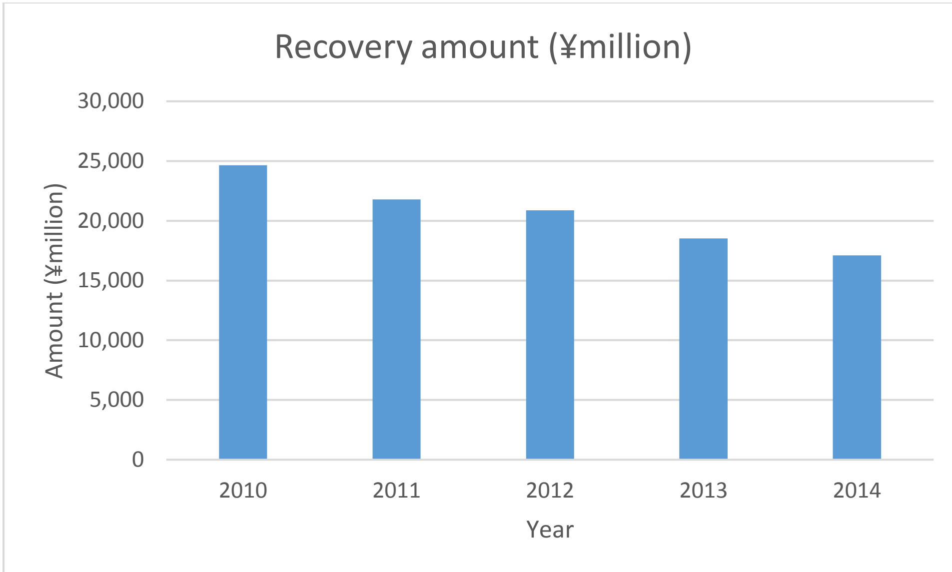
(Source : Annual Report, CGCT, Various issues)



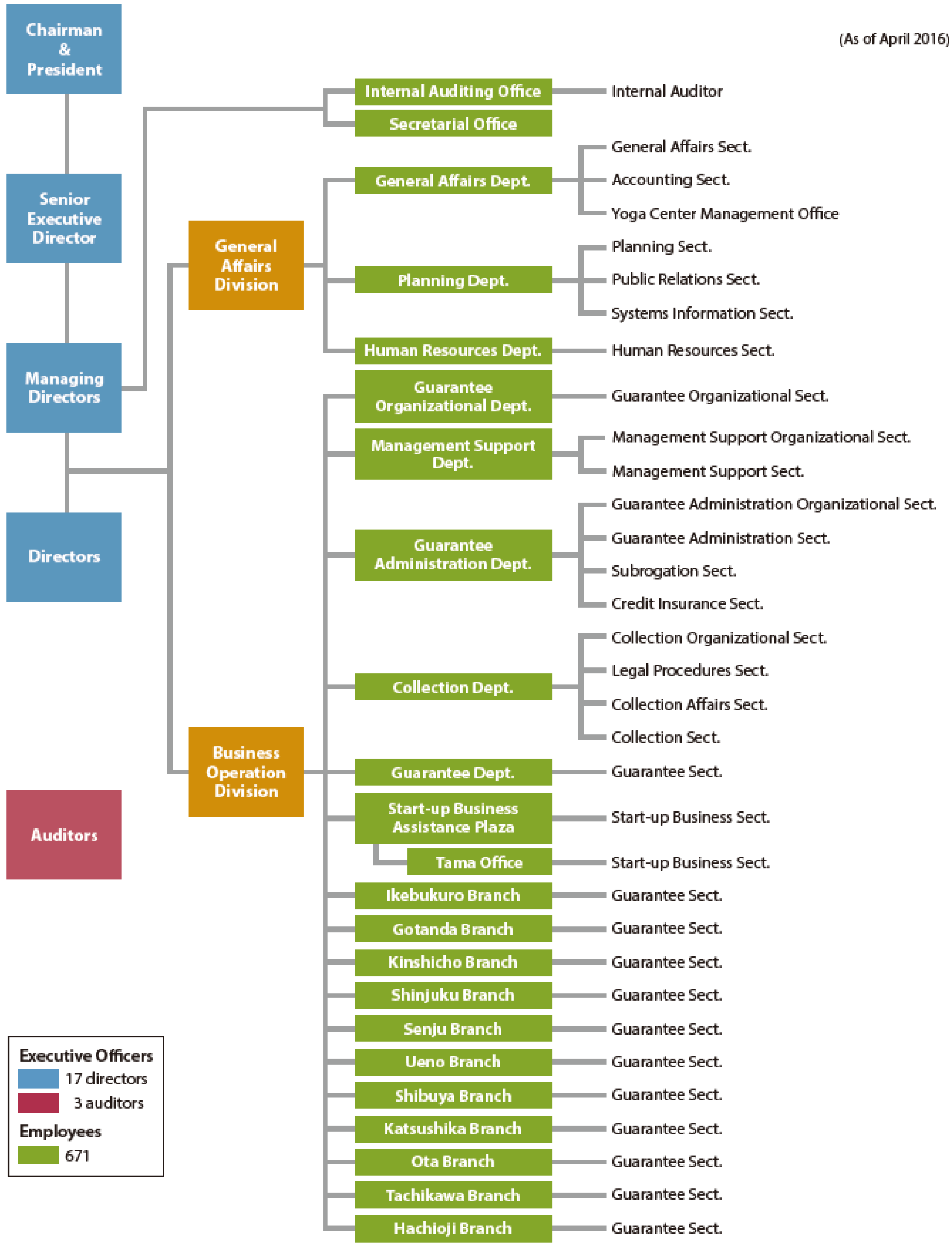
11. Recoveries from the guarantee operations

Year	Amount (¥million)
2010	24,661
2011	21,789
2012	20,867
2013	18,523
2014	17,096

(Source : Annual Report, CGCT, Various issues)


Recovery amount (¥million)
30,000
25,000
20,000
15,000
10,000
5,000
0
Amount (¥million)
2010
2011
2012
2013
2014
Year

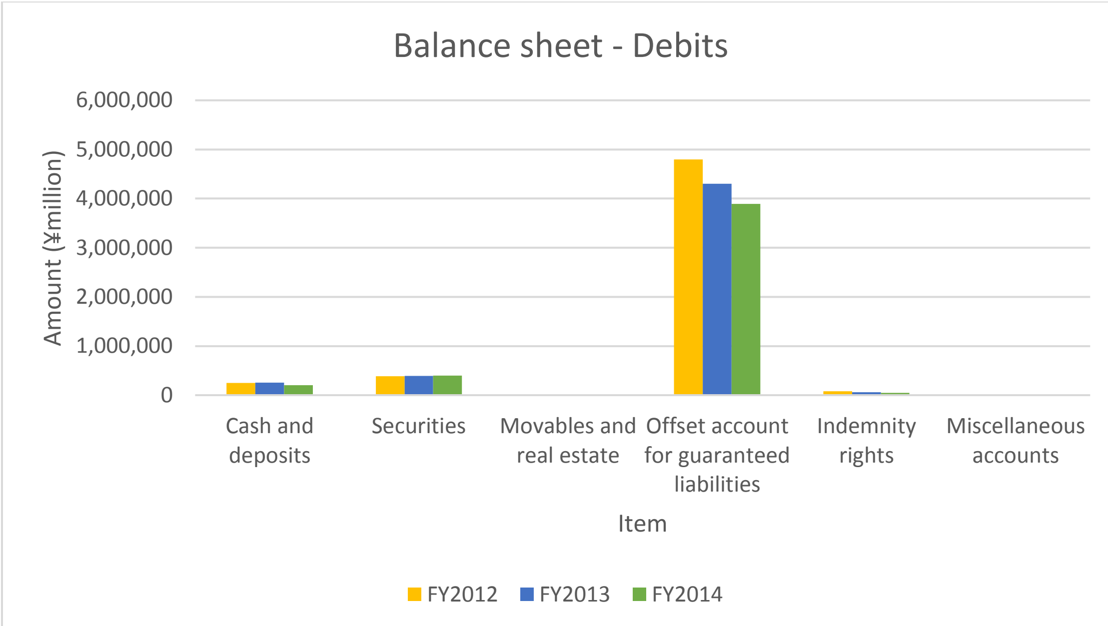
Organisational structure of CGC, Tokyo

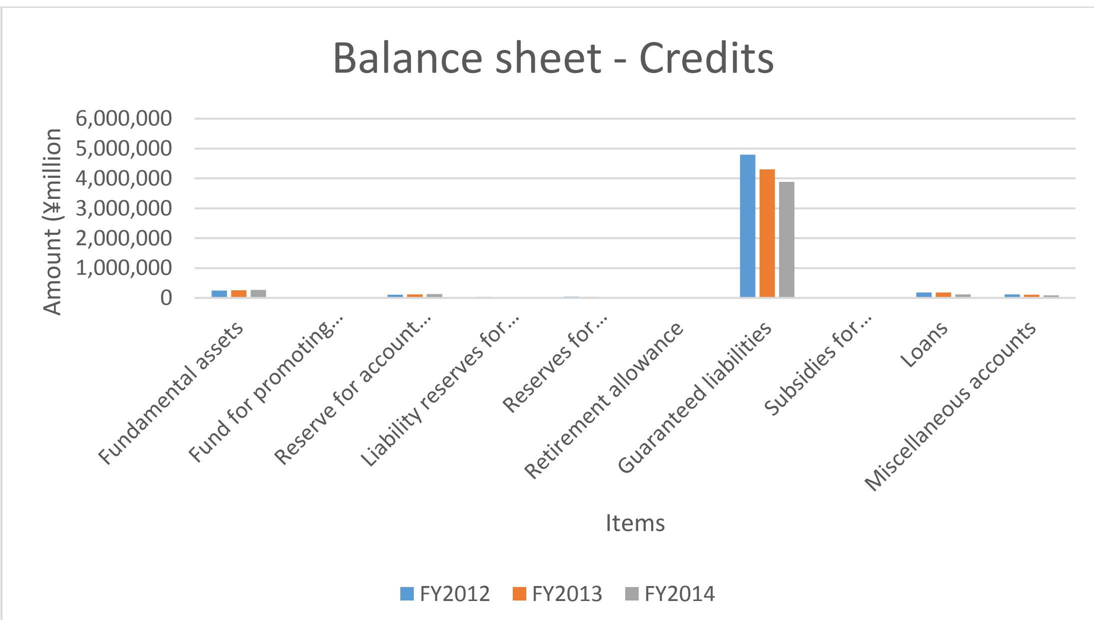


Source : CGC, Tokyo, Annual report 2016

Analysis of Balance Sheet of Credit Guarantee Corporation of Tokyo

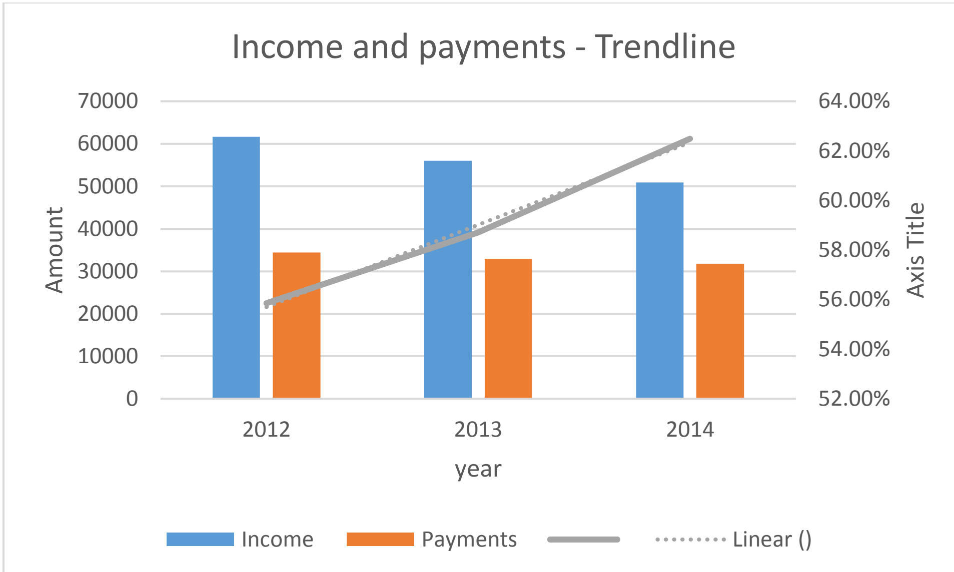
Debits	**Item**	**FY2012**	**FY2013**	**FY2014**
	Cash and deposits	250,297	255,043	204,344
	Securities	383,802	392,285	399,918
	Movables and real estate	7,791	7,695	7,629
	Offset account for guaranteed liabilities	4,793,820	4,305,352	3,891,172
	Indemnity rights	78,989	63,174	47,866
	Miscellaneous accounts	12,085	11,607	10,682
	Total	**5,526,784**	**5,035,156**	**4,561,611**
Credits	Fundamental assets	243,221	256,292	268,691
	Fund for promoting credit guarantee system reform	0	0	0
	Reserve for account balance fluctuation	105,500	118,400	130,700
	Liability reserves for guarantee payments	29,882	26,677	24,037
	Reserves for amortization of indemnity rights	39,788	33,881	26,170
	Retirement allowance	7,598	7,692	7,854
	Guaranteed liabilities	4,793,820	4,305,352	3,891,172
	Subsidies for indemnity rights	5,310	3,329	1,288
	Loans	181,182	179,697	123,119
	Miscellaneous accounts	120,483	103,836	88,580
	Total	**5,526,784**	**5,035,156**	**4,561,611**


Balance sheet - Debits
Amount (¥million)
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
Cash and deposits
Securities
Movables and real estate
Offset account for guaranteed liabilities
Indemnity rights
Miscellaneous accounts
Item
FY2012
FY2013
FY2014


Balance sheet - Credits
Amount (¥million
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
Fundamental assets
Fund for promoting...
Reserve for account...
Liability reserves for...
Reserves for...
Retirement allowance
Guaranteed liabilities
Subsidies for...
Loans
Miscellaneous accounts
Items
FY2012
FY2013
FY2014

Statement of Receipts and Disbursements for the years 2012, 2013 & 2014

Statement of Receipts and Disbursements				
Income	Item	FY2012	FY2013	FY2014
	Guarantee fees	49,350	44,273	39,700
	Deposit interest	69	37	40
	Interest and dividends on securities	6,297	6,323	6,162
	Interest for indemnity rights; Other	5,909	5,358	4,972
	Total	**61,625**	**55,991**	**50,874**
		FY2012	FY2013	FY2014
Payments	Business costs	11,615	11,540	11,528
	Interest on borrowed money			
	Credit insurance premiums	20,132	19,258	18,434
	Other	2,673	2,074	1,830
	Total	**34,420**	**32,872**	**31,792**
	Balance of current accounts	27,205	23,119	19,082
	Balance of non-recurring accounts	-2,455	2,780	5,542
	Disposition of fund for promoting credit guarantee system reform	69	72	73
	Balance of income and payment for this term	24,819	25,971	24,697


Income and payments - Trendline
70000
60000
50000
40000
30000
20000
10000
0
Amount
64.00%
62.00%
60.00%
58.00%
56.00%
54.00%
52.00%
Axis Title
2012
2013
2014
year
Income
Payments
Linear ()

Chapter VIII
Summary and conclusion

It is agreed all that the credit guarantee system is important for the support of SMEs in India and Japan. The credit guarantee schemes has be devised that the greater benefit accrues to small borrowers and credit flow is encouraged towards them. Appropriate provisions should be built in the scheme like guarantee fee, claim payout ratio and lower fee for the marginalised section so that the scheme is viable and address the credit needs of vulnerable segments. Credit guarantee corporations are **highly leveraged** institutions. For example, in India, the CGTMSE scheme with a capital of Rs 250000 million is extending guarantee to the tune of Rs 1.2 billion, thus a leverage ratio of more than 25 times. Hence, appropriate regulation and capital adequacy norms are necessary to sustain the guarantee corporations

Measures to improve credit guarantee coverage

- Product diversification is necessary and also critical to the financial sustainability of the CGTMSE
- The scheme mandates the MLIs not to obtain any form of collateral. Reserve Bank has also mandated banks not to obtain collateral for loans upto Rs 10 Lakh. Mundra, 2016 mentioned that these provisions have not led to desired outcomes and the guideline on collateral-free loans has led banks to at times devise ways of denying credit to the MSMEs borrowers, while on the other extreme, the provision for credit guarantee has potential to cause deterioration in quality of credit appraisal and due diligence, consequently straining the resources of the CGTMSE. Clearly, both outcomes are undesirable. It is advocated that borrower should be compensated by way of a better pricing in loan for the availability of collateral. Further, CGTMSE shall evolve a framework for making the pricing risk-based rather than having a uniform risk premium related to the past performance and quality of individual portfolios. Eventually, this activity should also move to an open market system. Eventually, such a risk based pricing and allowing banks to avail guarantee for the loans which are partially covered with the borrower's collateral will ensure better penetration of the scheme.

- CGTMSE should strive to have broad clientele base. The recent inclusion of NBFC- MFIs under the guarantee scheme is a welcome step. The other left out, yet having significant rural/ semi urban presence is the rural & urban co-operative banks. It is desirable to add the co-operative banks under the eligible member lending institutions.
- The CGTMSE needs to put in place a strong data analytics team and a robust oversight mechanism over the MLIs. The advertisement from CGTMSE to recruit specialists for big data analysis is welcome step. A dedicated Data Analytics and MIS Division needs to be set up in the CGTMSE to monitor the data on a regular basis and also develop system-based alerts for the top management of CGTMSE and the Controllers at the MLIs. It can also develop dashboards on critical parameters for regular monitoring by the management of CGTMSE and the Controllers at the MLIs. The CGTMSE also needs to put in place a robust mechanism to detect fraudulent claims. The dedicated Data Analytics and MIS Division can study the claims data and draw patterns through analytics for further scrutiny and action.
- The introduction of more products and private players is a must to prevent a monopoly situation and provide choice to the MLIs to either avail credit guarantees from public institutions or commercial guarantees from the private companies. The feedback from MLIs indicates that the absence of competition has severely impacted efficiencies in the pricing, settlement procedures, customer service, etc. at the CGTMSE
- There is also a need to introduce counter guarantee and re-insurance companies, which serve as guarantors of guarantors and insurers of insurers. This will help promote more sustainable forms of guarantees in the market. Japan, for instance, has a network of 52 credit guarantee schemes backed by counter guarantee programmes. This allows smaller, regional agencies to focus on their own local industries, while a central agency oversees their working

- CGTMSE should strive to have broad clientele base. The recent inclusion of NBFC- MFIs under the guarantee scheme is a welcome step. The other left out, yet having significant rural/ semi urban presence is the rural & urban co-operative banks. It is desirable to add the co-operative banks under the eligible member lending institutions
- There is a need for CGTMSE to be able to carry out field-level evaluations of the collateral-free loans being lent by the MLIs
- Inclusion of retails trade in the scope of the scheme
- Increase in the exposure cap to Rs 5 crore
- Allow collateral for the uncovered part of loan
- Computation of annual service fee on outstanding amount rather than sanction amount and
- Prompt settlement of claims

In case of japan, the Emergency Credit Guarantee Program which was introduced after the Global Financial Crisis in October 2008, has 100% guarantee and fixed fee rates were applied. These were characters of old system. Approval amounts of new loan guarantees jumped Yen 20 trillion in the year 2009. However, the scheme has its own issues. It is reported that non-viable SMEs have kept afloat due to various credit support policies after the Global Financial Crisis (GFC). Despite their low profitability and high leverage, there have been only limited restructuring or exits of nonviable SMEs, mainly due to the present credit guarantee system. Creditors and nonviable SMEs have little incentive to restructure loans. The size of individual SME loans is usually small and makes it too costly to restructure on a case-by case basis. In addition, recognizing the losses would reduce profit and capital, especially for smaller regional / shinkin banks that generally lack expertise in business restructuring. India can learn from the experiences of Japan while revisiting its credit guarantee programme.

It is evident that there is no one size fits all approach in SME finance. Each nation has to study the operation of the credit guarantee scheme and tailor them accordingly. The Indian banks are facing asset quality challenges in all their portfolio. Apart from that, the banking system is also facing a key challenge is on capital and human resources front. In fact, part of the asset quality problem is also attributable to poor underwriting skillset of the bank staff for credit appraisal of large projects at the head office level and for lending to retail and SMEs at operating unit level. To address the issue, banks need to train the staff and mandatory certificate courses are to be prescribed. MSME branch managers and other field level functionaries need to be trained in credit appraisal, credit-score-based lending and SME cluster financing for MSMEs. With these measures from central bank and Government of India, the sector is poised to grow rapidly to leverage our demographic dividend.

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Annex - 1

Japan's Small and Medium-sized Enterprise Basic Act

(Purpose)

Article 1: The purpose of this Law is to promote in a comprehensive manner measures for small and medium enterprises (hereinafter referred to as "SMEs") by establishing the basic principles, basic policies and other basic matters relating to measures for SMEs and clarifying the responsibilities, etc. of the State and of local public entities, so as to contribute to the sound development of the national economy and improvement in the quality of life of the people.

(Scope of SMEs and Definitions)

Article 2: The SMEs covered by the measures adopted by the State under this Law shall in general be those that fall under any of the following items, and the scope thereof shall be determined for each measure so that such measures may be effectively implemented to realize the basic principles described in the following Article:

(1) Any entity which is a company whose capital or total amount of investment does not exceed three hundred million yen (300,000,000 yen), or a company or an individual whose regular workforce does not exceed three hundred persons, and which is principally engaged in manufacturing, construction, transportation or any other category of business (except those categories of business mentioned in any of items (2) to (4) below);

(2) Any entity which is a company whose capital or total amount of investment does not exceed one hundred million yen (100,000,000 yen), or a company or an individual whose regular workforce does not exceed one hundred persons, and which is principally engaged in the wholesale trade;

(3) Any entity which is a company whose capital or total amount of investment does not exceed fifty million yen (50,000,000 yen), or a company or an individual whose regular workforce does not exceed one hundred persons, and which is principally engaged in the service industry;

(4) Any entity which is a company whose capital or total amount of investment does not exceed fifty million yen (50,000,000 yen), or a company or an individual whose regular workforce does not exceed fifty persons, and which is principally engaged in the retail trade.

2. The term "business innovation" as used in this Law shall mean the substantial improvement of business through the development or production of new products,

development or provision of new services, introduction of new methods of producing or marketing products, introduction of new methods of providing services, introduction of new methods of business management, or other new business activities.

3. The term “creative business activity” as used in this Law shall mean those business activities which are the object of business innovation or start-ups and which involve the use of remarkably original techniques or remarkably creative methods of business management.

4. The term “business resources” as used in this Law shall mean the plants, equipment, technologies, skills and knowledge of individuals, and other resources utilized in business activities.

5. The term “small enterprise” as used in this Law shall generally mean an enterprise with a regular workforce not in excess of twenty persons (or five persons in the case of enterprises which are principally engaged in commerce or the service industry).

(Basic Principles)

Article 3: In the light of the fact that SMEs, by engaging in distinctive business activities in a variety of fields of business and providing diverse employment opportunities where individuals can demonstrate their abilities, form the foundations of the Japanese economy, and that many SMEs, which display originality and resourcefulness and engage in business activities with the aim of improving business, have a particularly important role to play in maintaining and strengthening the vitality of the Japanese economy by, among other things, creating new industries, increasing employment opportunities, encouraging competition in the market, and vitalizing regional economies, the diverse and dynamic growth and development of SMEs must be encouraged by promoting business innovation and start-ups among them, strengthening their business fundamentals, and smoothing their adaptation to changes in social or economic conditions so as to foster the autonomous efforts of independent SMEs.

(Responsibility of the State)

Article 4: The State is responsible for formulating and implementing overall measures for SMEs in accordance with the basic principles described in the preceding Article (hereinafter referred to as the “basic principles”).

(Basic Policy)

Article 5: The Government shall adopt measures for SMEs in accordance with the following basic policy of:

(1) Promoting business innovation and start-ups and promoting creative business activity among SMEs;

(2) Strengthening the business fundamentals of SMEs by facilitating the acquisition of business resources by SMEs and improving the fairness of transactions involving SMEs, etc.;

(3) Smoothing adaptation to changes in the economic or social environments by promoting the business stability and facilitating the business conversion of SMEs in response to such changes, etc.;

(4) Facilitating the financing of SMEs and enhancing the equity capital of SMEs.

(Responsibility of Local Public Entities)

Article 6: Local public entities are responsible for formulating and implementing measures for SMEs which are suited to the natural, economic or social conditions in a local public entity's locality, and which are in accordance with the basic principles and based on an appropriate division of roles with the State.

(Efforts of SMEs, etc.)

Article 7: SMEs must endeavor to independently improve their management and terms and conditions of business in order to respond to changes in the economic or social environment and to grow and develop their businesses.

2. Associations related to SMEs, such as organizations for furthering business cooperatives among SMEs, must endeavor to work with SMEs to realize the basic principles in the performance of their business activities.

3. Any party other than SMEs whose activities bear on SMEs must cooperate in the implementation by the State and local public entities of measures for SMEs.

(Consideration for Small Enterprises)

Article 8: Given the many particular difficulties faced by small enterprises in acquiring business resources, the State shall, in devising measures for SMEs, endeavor to develop and improve the management of small enterprises and shall, with regard to finance, the taxation system and other matters, show due consideration for the business conditions of small enterprises.

(Legislative Steps, etc.)

Article 9: The Government shall take the necessary legislative, fiscal and financial steps to implement measures for SMEs.

(Surveys)

Article 10: The Government shall, after hearing the opinion of the Small and Medium Enterprise Policy-Making Council, periodically conduct the necessary surveys to determine the actual conditions of SMEs and shall publish the results thereof.

(Annual Reports, etc.)

Article 11: The Government shall, every year submit to the Diet a report on trends among SMEs and measures implemented by the Government for SMEs.

2. The Government shall, every year after hearing the opinion of the Small and Medium Enterprise Policy-Making Council, prepare a statement explaining the measures to be adopted in the light of the trends among SMEs described in the report stipulated in the preceding Subsection, and shall submit it to the Diet.

CLAUSE 1 Promotion of Business Innovation and Start-Ups of SMEs

(Promotion of Business Innovation)

Article 12: In order to promote business innovation at SMEs, the State shall promote research and development related to technologies for developing new products and services; promote the introduction of plants and equipment to substantially improve the efficiency of production and sale of products; promote the introduction of new methods of business management for integrated control of product development, production, transportation and sale; and take any other necessary measures.

(Promotion of Start-Ups)

Article 13: In order to promote start-ups of SMEs, the State shall provide information on and improve training for start-ups, facilitate the financing of start-up expenses, and take any other necessary measures, and shall also endeavor to increase public interest in and understanding of the importance and need for start-ups.

(Promotion of Creative Business Activity)

Article 14: In order to promote the creative business activities of SMEs, the State shall promote research and development concerning remarkably original techniques related to the production or sale of products or provision of services, develop systems to facilitate the acquisition of the necessary human resources and financing through such means as shares and corporate bonds, and take any other necessary measures.

CLAUSE 2 Strengthening of Business Fundamentals of SMEs

(Acquisition of Business Resources)

Article 15: In order to contribute to the acquisition of the necessary business resources to improve business methods and techniques and otherwise strengthen the business fundamentals of SMEs, the State shall take the following measures and any other necessary measures:

(1) In order to encourage the introduction of plants and equipment by SMEs, the State shall promote the installation and maintenance of plants and equipment furnished for use in business by SMEs;

(2) In order to encourage the improvement of SMEs' technologies, the State shall promote technological research and development undertaken by SMEs; encourage the active participation of SMEs in technological research and development undertaken by the State; promote cooperation between SMEs and the State, independent administrative institutions, prefectural public test and research institutes and universities; and develop programs to train engineers and technicians;

(3) In order to promote the increase of knowledge that is of use in the business activities of SMEs, the State shall develop training programs for business managers and promote the provision of information contributing to the development of new fields of business and other information.

2. In addition to the measures specified in the preceding Subsection, the State shall develop systems to help SMEs acquire business resources by such methods as providing information and advice as required by SMEs.

(Promotion of Exchanges, Business Relationships and Cooperatives)

Article 16: In order to encourage SMEs to complement each other's business resources, the State shall encourage exchanges and business relationships among SMEs, develop organizations for furthering business cooperatives among SMEs, subsidize projects undertaken jointly by SMEs, and take any other necessary measures.

(Vitalization of Industrial Agglomeration)

Article 17: The State shall take the necessary measures to vitalize industrial agglomeration in areas deemed natural, economic or social units where a substantial number of SMEs associate organically in the same category of business or closely related categories of business.

(Vitalization of Commercial Zones)

Article 18: In order to vitalize commercial zones such as shopping districts where a substantial number of small and medium retailers or small and medium service providers engage in business, the State shall develop facilities to help improve convenience for local residents such as customers, develop joint stores, and take any other necessary measures.

(Measures Concerning Labor)

Article 19: The State shall take the necessary measures to help further proper labor relations and improve the welfare of employees in SMEs, and shall develop vocational training and employment service programs and take any other necessary measures to help SMEs acquire the labor force they require.

(Improving Fairness of Transactions)

Article 20: In order to improve the fairness of transactions involving SMEs, the State shall prevent overdue payment of subcontracting fees, promote clarification of the terms and conditions of business, and take any other necessary measures.

(Expansion of Opportunities to Receive Orders from the State, etc.)

Article 21: In order to contributing to the increase in demand for the goods and services provided by SMEs, the State shall expand opportunities for SMEs to receive orders for goods and services from the State, etc., and take any other necessary measures.

CLAUSE 3 Smoothing Adaptation to Changes in the Economic or Social Environment

Article 22: Where the business activities of a substantial number of SMEs in the same region or the same category of business are or may be impeded as a result of marked changes in the economic or social environments, such as in the structure of trade or in the conditions of supply of raw materials, the State shall take measures to promote the business stability of SMEs, and to facilitate business conversion by SMEs, and take any other necessary measures.

2. The State shall develop systems to prevent unfair impingement on the interests of SMEs resulting from the business activities of parties other than SMEs, so as to promote the business stability of SMEs, and take any other necessary measures.

3. In order to prevent the occurrence of events such as the bankruptcy of an SME resulting from the bankruptcy of its business connections, the State shall develop mutual relief systems for SMEs and take any other necessary measures.

4. In order to facilitate the restructuring or closure of SMEs, the State shall develop business recovery systems, and mutual relief systems for small enterprises, and take any other necessary measures.

5. In taking such measures as stipulated in Subsection 1 and the preceding Subsection, the State shall show due consideration for facilitating the employment of employees of SMEs.

CLAUSE 4 Facilitation of Financing and Enhancement of Equity Capital

(Facilitation of Financing)

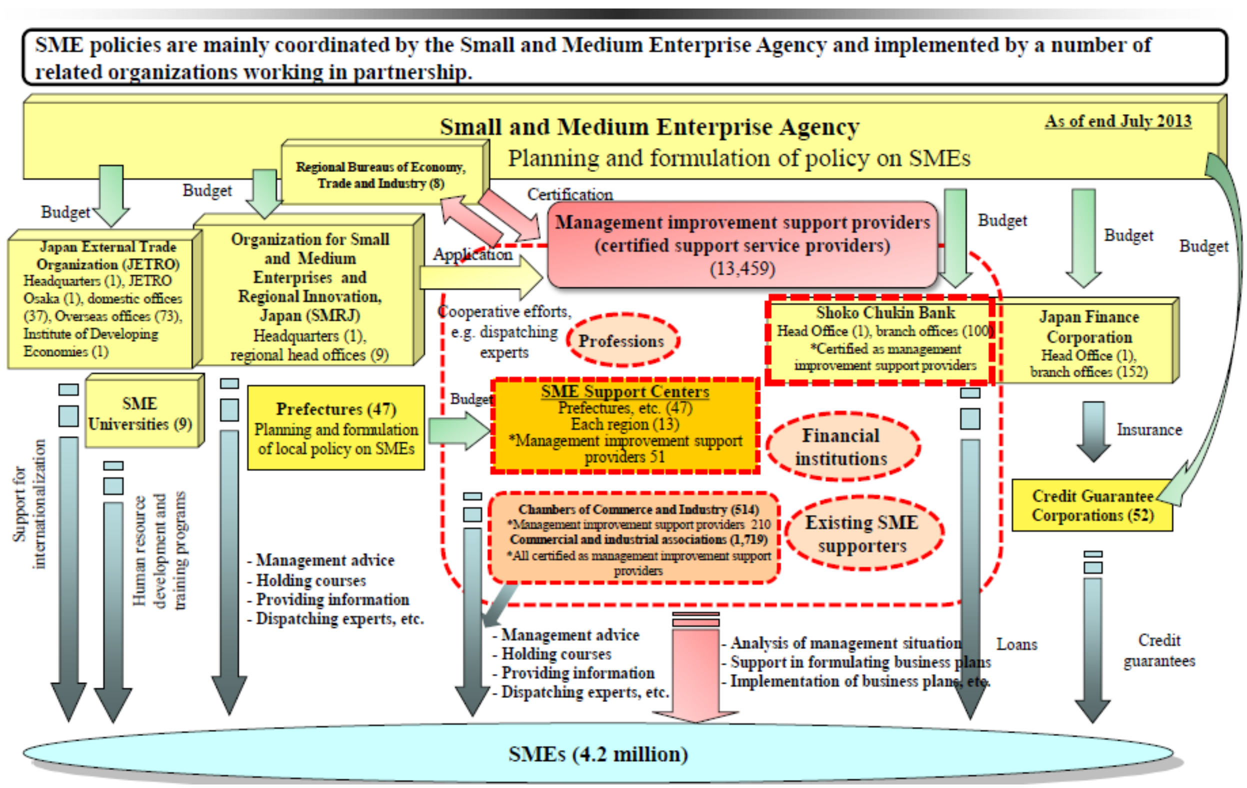
Article 23: In order to facilitate the financing of SMEs, the State shall strengthen the functions of governmental financial institutions, develop a credit insurance system, foster proper lending to SMEs by private-sector financial institutions, and take any other necessary measures.

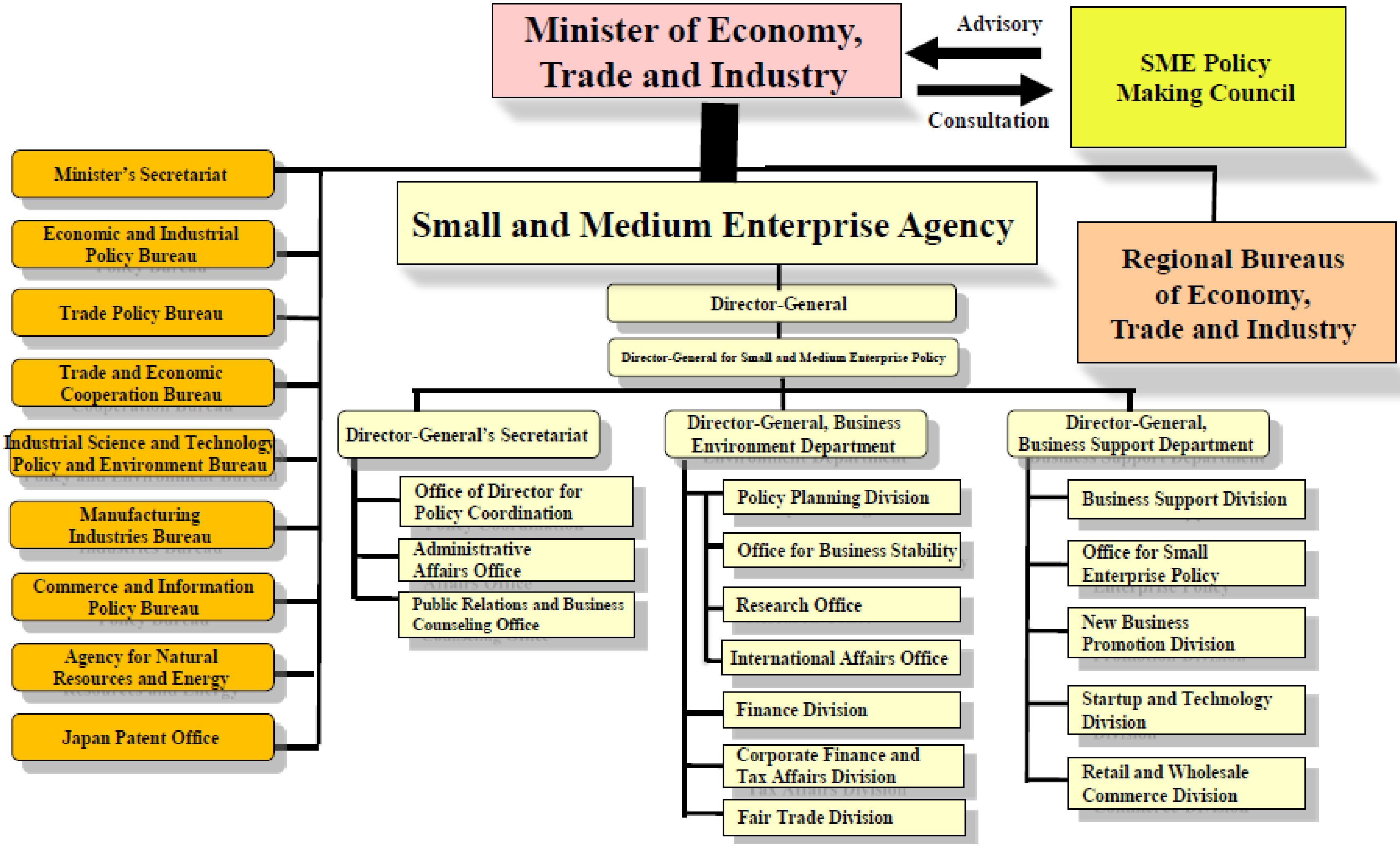
(Enhancement of Equity Capital)

Article 24: In order to enhance the equity capital of SMEs and help strengthen the business fundamentals thereof, the State shall develop systems for facilitating investment in SMEs, make the tax burden fairer, and take any other necessary measures

Article 25: The State and local public entities shall cooperate each other and shall endeavor to develop an administrative structure and improve the efficiency of its operation in implementing measures for SMEs.

SME support system in Japan

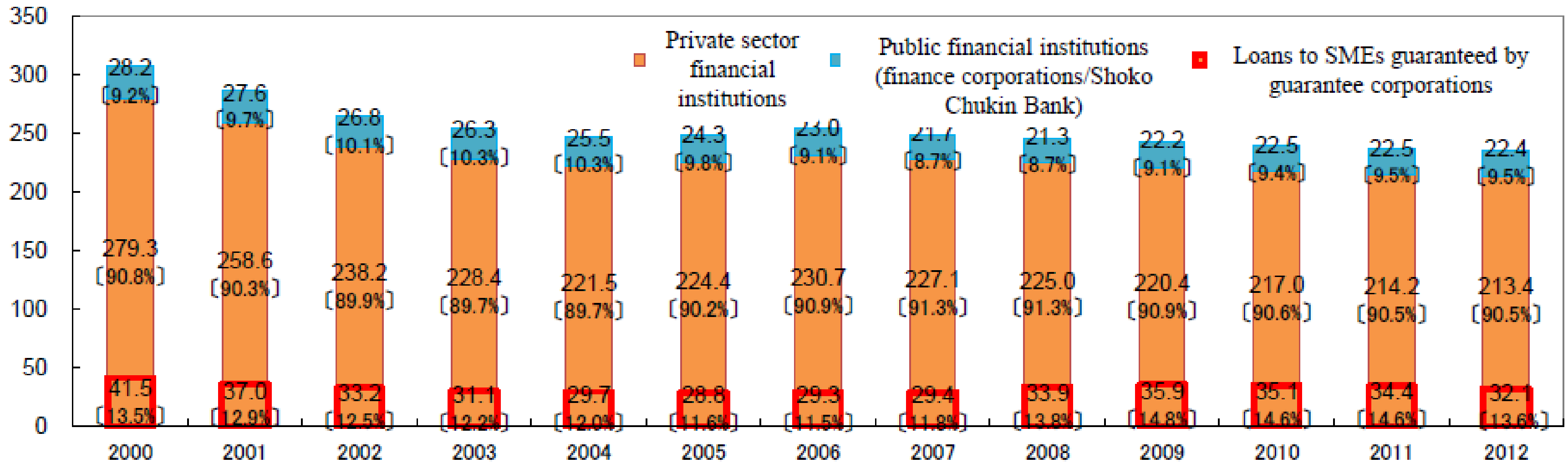




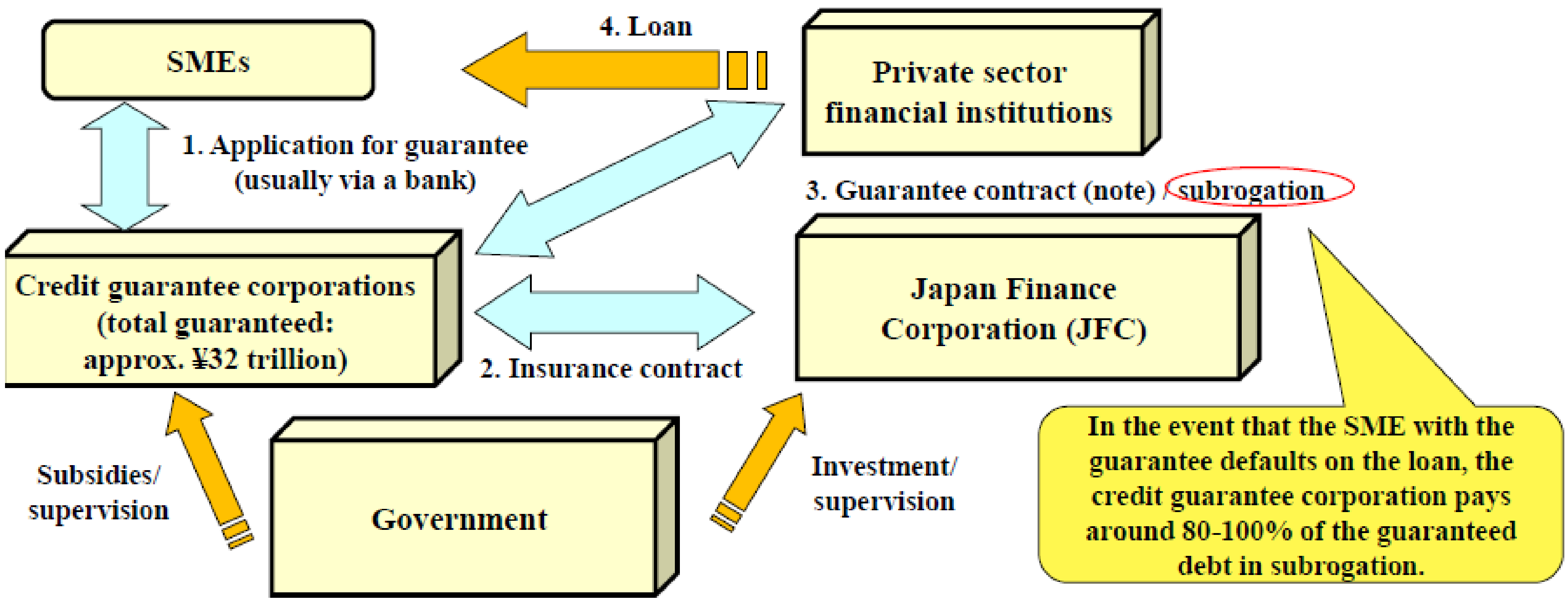
Minister of Economy, Trade and Industry
Advisory
Consultation
SME Policy Making Council
Minister's Secretariat
Economic and Industrial Policy Bureau
Trade Policy Bureau
Trade and Economic Cooperation Bureau
Industrial Science and Technology Policy and Environment Bureau
Manufacturing Industries Bureau
Commerce and Information Policy Bureau
Agency for Natural Resources and Energy
Japan Patent Office
Small and Medium Enterprise Agency
Director-General
Director-General for Small and Medium Enterprise Policy
Regional Bureaus of Economy, Trade and Industry
Director-General's Secretariat
Office of Director for Policy Coordination
Administrative Affairs Office
Public Relations and Business Counseling Office
Director-General, Business Environment Department
Policy Planning Division
Office for Business Stability
Research Office
International Affairs Office
Finance Division
Corporate Finance and Tax Affairs Division
Fair Trade Division
Director-General, Business Support Department
Business Support Division
Office for Small Enterprise Policy
New Business Promotion Division
Startup and Technology Division
Retail and Wholesale Commerce Division

・As SMEs have few assets and weak financial foundations, it is difficult for them to procure capital from the stock market, so securing a smooth supply of funds is one of their key challenges.
Accordingly, government-affiliated financial institutions have been established to create a system to provide SMEs with long-term funds at low rates of interest.
There are limits to the funding that can be provided by public financial institutions alone, so a system of credit enhancement has also been introduced. This enables SMEs to make use of funds from private sector financial institutions, as the government guarantees the loans taken out with such institutions by SMEs and pays it back in subrogation if the SME concerned does not.
・Currently (as of at the end of FY2012), the value of outstanding loans by public financial institutions to SMEs is ¥22.5 trillion, about 9% of the ¥240 trillion total value of all outstanding loans to SMEs, while the value of loans subject to credit guarantees is ¥32 trillion, about 13% of the total value. Thus, this system complements provision by private sector financial institutions.

Changes in outstanding loans to SMEs



・In order to facilitate the supply of finance required by SMEs, which lack creditworthiness and adequate collateral, credit guarantee corporations (52 nationwide) provide private sector financial institutions with guarantees for the debt obligations of SMEs.
・If the guaranteed debt is not repaid, the credit guarantee corporation repays it in subrogation



Annex 2

Priority Sector Guidelines for MSME sector

Manufacturing Enterprises

The Micro, Small and Medium Enterprises engaged in the manufacture or production of goods to any industry specified in the first schedule to the Industries (Development and Regulation) Act, 1951 and as notified by the Government from time to time. The Manufacturing Enterprises are defined in terms of investment in plant and machinery.

2.2.2 Service Enterprises

All bank loans to MSMEs, engaged in providing or rendering of services as defined in terms of investment in equipment under MSMED Act, 2006, shall qualify under priority sector without any credit cap.

2.3 Khadi and Village Industries Sector (KVI)

All loans to units in the KVI sector will be eligible for classification under the sub-target of 7.5 percent prescribed for Micro Enterprises under priority sector.

2.4 Bank loans to food and agro processing units shall form part of agriculture.

Targets / sub-targets for lending to Micro, Small and Medium Enterprises (MSME) sector by Domestic Commercial Banks and Foreign Banks operating in India

Domestic Commercial Banks are required to achieve a sub-target of 7.5 percent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher, for lending to Micro Enterprises.

n terms of the recommendations of the Prime Minister's Task Force on MSMEs, banks are advised to achieve:

(i) 20 per cent year-on-year growth in credit to micro and small enterprises,

(ii) 10 per cent annual growth in the number of micro enterprise accounts and

(iii) 60 per cent of total lending to MSE sector as on corresponding quarter of the previous year to Micro enterprises.

Collateral

Banks are mandated not to accept collateral security in the case of loans up to Rs.10 lakh extended to units in the MSE sector. Banks are also advised to extend collateral-free loans up to Rs. 10 lakh to all units financed under the Prime Minister Employment Generation Programme (PMEGP) administered by KVIC.

Composite loan

A composite loan limit of Rs.1 crore can be sanctioned by banks to enable the MSE entrepreneurs to avail of their working capital and term loan requirement through Single Window

Framework for Revival and Rehabilitation of MSMEs

The salient features of the Framework are as under:

i) Before a loan account of an MSME turns into a Non-Performing Asset (NPA), banks or creditors should identify incipient stress in the account by creating three sub-categories under the Special Mention Account (SMA) category as given in the Framework

ii) Any MSME borrower may also voluntarily initiate proceedings under this Framework

iii) Committee approach to be adopted for deciding corrective action plan

iv) Time lines have been fixed for taking various decisions under the Framework

Specialised MSME branches

Public sector banks are advised to open at least one specialised branch in each district. Further, banks have been permitted to categorise their general banking branches having 60% or more of their advances to MSME sector as specialized MSME branches in order to encourage them to open more specialised MSME branches for providing better service to this sector as a whole. As per the policy package announced by the Government of India for stepping up credit to MSME sector, the public sector banks would ensure specialized MSME branches in identified clusters/centres with preponderance of small enterprises to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop requisite expertise. Though their core competence will be utilized for extending finance and other services to MSME sector, they will have operational flexibility to extend finance/render other services to other sectors/borrowers. Banks may take care to train the officials posted in such branches appropriately.

Delayed Payment

In the Micro, Small and Medium Enterprises Development (MSMED), Act 2006, the provisions of the Interest on Delayed Payment Act, 1998 to Small Scale and Ancillary Industrial Undertakings, have been strengthened as under:

(i) The buyer has to make payment to the supplier on or before the date agreed upon between him and the supplier in writing or, in case of no agreement, before the appointed day. The period agreed upon between the supplier and the buyer shall not exceed forty five days from the date of acceptance or the day of deemed acceptance.

(ii) In case the buyer fails to make payment of the amount to the supplier, he shall be liable to pay compound interest with monthly rests to the supplier on the amount from the appointed day or, on the date agreed on, at three times of the Bank Rate notified by Reserve Bank.

(iii) For any goods supplied or services rendered by the supplier, the buyer shall be liable to pay the interest as advised at (ii) above.

(iv) In case of dispute with regard to any amount due, a reference shall be made to the Micro and Small Enterprises Facilitation Council, constituted by the respective State Government.

Further, banks are advised to fix sub-limits within the overall working capital limits to the large borrowers specifically for meeting the payment obligation in respect of purchases from MSMEs.