D&B

Decide with Confidence

Study on Designing New Risk Sharing Facility (RSF) Product and Suitable Corporate Structure

Overview of MSE Sector in India

Introduction

Micro and Small Enterprises (MSEs)[1] form the backbone of India economy, and play a critical role in the country's inclusive growth. India has about 15.5 Lakh registered units in MSE sector employing about 8.57 million people throughout the country, and contributing significantly to India's GDP, manufacturing output and exports[2]. Of the total registered MSEs, around 95.3% units are Micro Enterprises and 4.7% units are Small Enterprises. Within the MSE Sector, around 66.6% units belong to the manufacturing sector and the rest 33.4% belong to the services sector. The sector has played a significant role in balanced and sustainable economic growth, employment generation, entrepreneurial skills development, and export earnings of the country.

Performance of MSEs

The sector produces over 6,000 products ranging from traditional items to hi-tech products. Around 22% of the products belong to the food sector, 12% to the chemicals sector, 10% to the basic metal industry and rest to other sector such as metal products, electrical and machinery parts sector, rubber and plastics sector, etc[2].

Growth rate of MSE sector has been consistently higher than growth rate of overall industrial sector during the period from 2002-08[3]. The sector has investment of about `238,975 Crore and has

[1]According to MSMED Act 2006, definition of Micro, Small and Medium Enterprises based on investment of these enterprises in plant and machinery is as follows:

	Manufacturing	Services
Micro Enterprise	Up to `25 Lakh	Up to `10 Lakh
Small Enterprise	Over `25 Lakh and up to `5 Crore	Over `10 Lakh and up to `2 Crore
Medium Enterprise	Over `5 Crore and up to `10 Crore	Over `2 Crore and up to `5 Crore

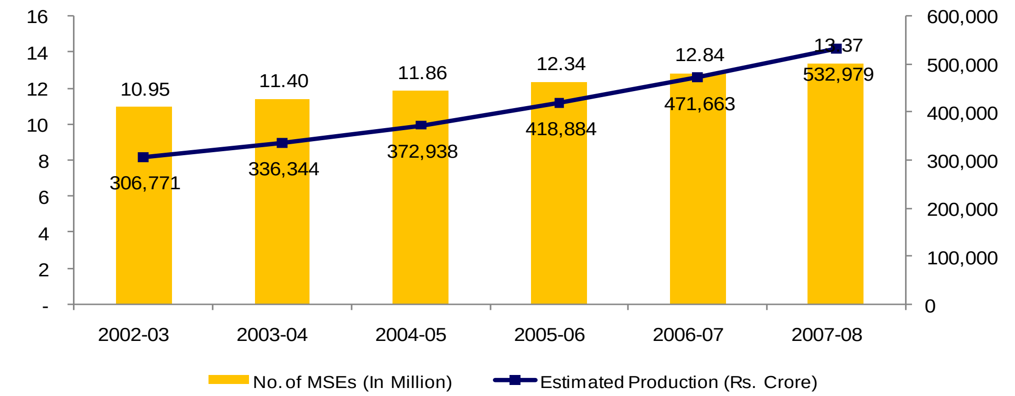
[2] Ministry of Micro, Small and Medium Enterprises, Annual Report 2008-09 and 2009-10

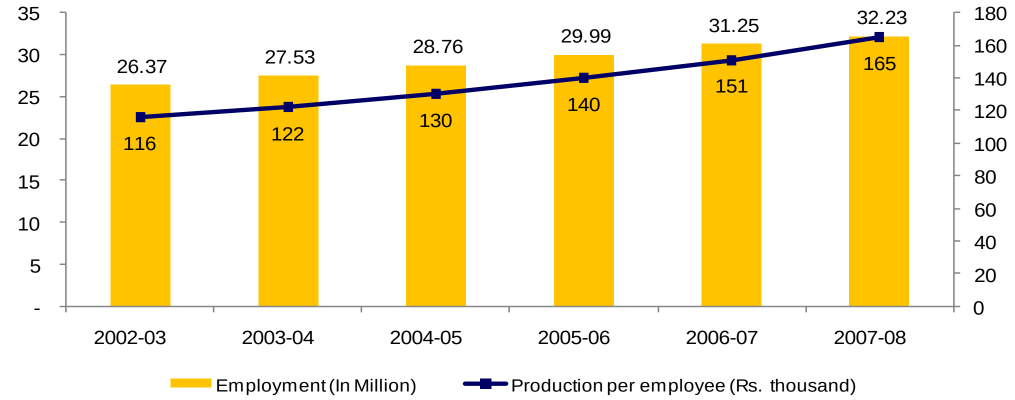
[3] Growth rate of MSE sector is 13% and growth rate in overall industrial sector is 8% in FY 2007-08 (Source: Ministry of MSME Annual Report 2008-09)

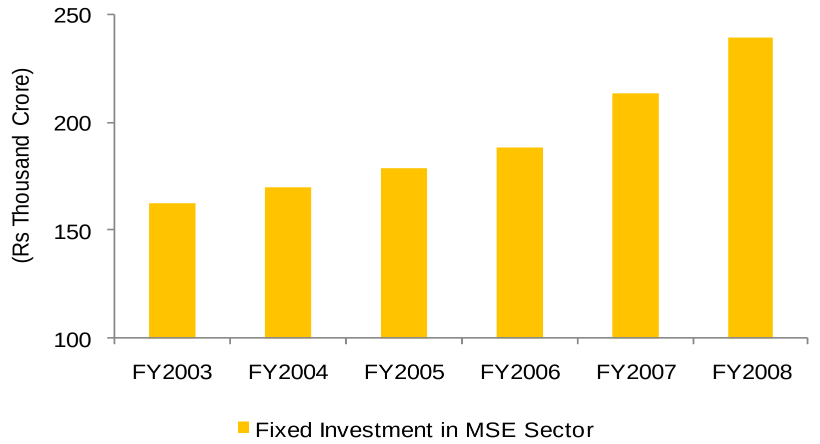
production of about `695,126 Crore in the year 2008. The annual growth rate for both number of MSE units and number of employees during FY 2002-08 is 3.38%[2] and the annual growth rate for both unit production[4] and production per employee is 6.05% during the same period.

Details about the performance of MSEs are as follows:

Performance of MSE Sector (FY2005-08)







Source: Ministry of MSME

[4] Annual production of MSE sector / number of MSE units

General Problems in MSE Sector

The main problems of MSEs can be broadly classified into four categories[5]:

- Managerial Problems
- Operational Problems (such as raw material, human resource, infrastructure etc.)
- Technological Problems
- Financial Problems

Managerial Problems

MSEs are generally managed by sole-proprietors / partnerships that very often do not possess the skills required for the efficient management of the enterprise. In addition, there is reluctance among the owners to adopt modern methods of organization and management. These problems often lead to improper division of work and lack of benefits of specialization in MSEs.

Operational Problems

Non-availability of quality raw materials on a timely basis in an adequate quantity is one of the main problems faced by MSEs. In addition, MSEs also face shortage of power due to which their plants are generally under-utilized.

MSEs often face problem in recruiting trained and experienced personnel as they find it difficult to afford remunerative salaries as well as to provide adequate training facilities to the employees. Further, they find it difficult to control the attrition rate[6] as skilled managerial and technical personnel tend to look for better opportunities in the medium and large scale industries.

MSEs face the problem of infrastructure bottlenecks in terms of inadequate transportation facilities, low / no access to power supply, lack of proper communication channels, inadequate marketing facilities, etc. These operational problems affect the sales / profits of MSEs as well as inhibit the chances of survival of these enterprises.

Technological Problems

Majority of the MSEs use old production techniques and outdated machinery and equipment. Due to various reasons such as lack of information related to latest technology, problems related to technology imports, and availability of requisite finance for technology acquisition, MSEs are not in a position to use latest production techniques. In addition, it is difficult for these firms to conduct

[5] Laghu Udyog Samachar publications and Business Portal of India

[6] Attrition rate in MSEs is as high as 40% in the year 2007-08, while India average in the same year is about 20% (ASSOCHAM Study – December 2007)

research and development on continuing basis. Therefore, productivity and quality in MSEs tends to be low while unit cost of production is generally high.

Financial Problems

Finance is one of the critical inputs for growth and development of MSEs. They need credit support not only for running the enterprise and operational requirements but also for modernization / upgradation of facilities, capacity expansion, etc.

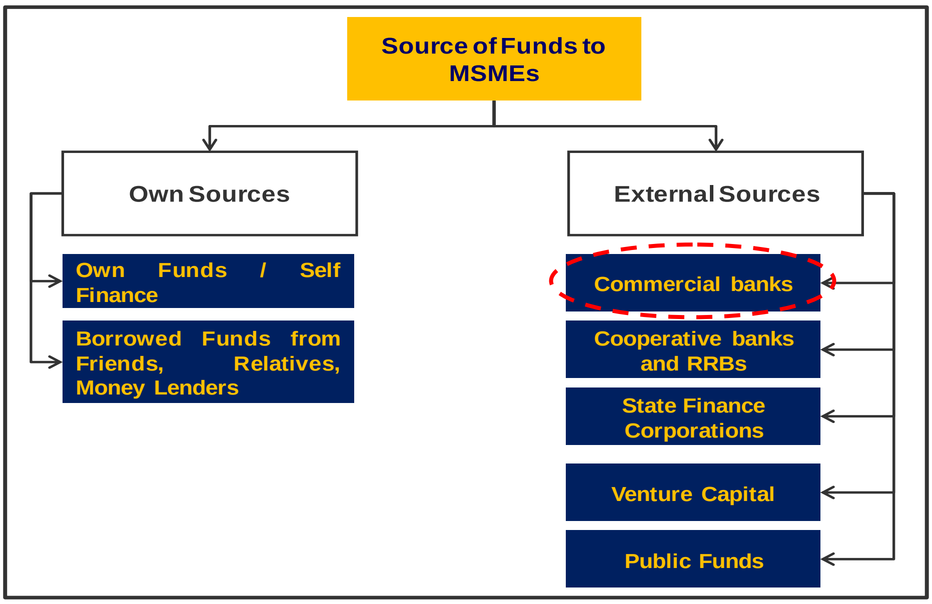
The problems faced by MSEs with regard to availability of credit are:

- Lack of availability of adequate and timely credit
- Limited access to equity capital to first generation entrepreneurs
- High cost of credit normally ranging between 13-16% as against relatively lower rate of interest charged from large units on the ground of latter's better creditworthiness

Credit Availability to MSEs

According to the 4th All India Census of Small Scale Industries (2006-07), only 11.2% of the registered units availed institutional finance, while only 4.8% of the unregistered units had access to bank finance. In other words, most of MSEs use self finance or borrowed funds from friends, relatives, and moneylenders.

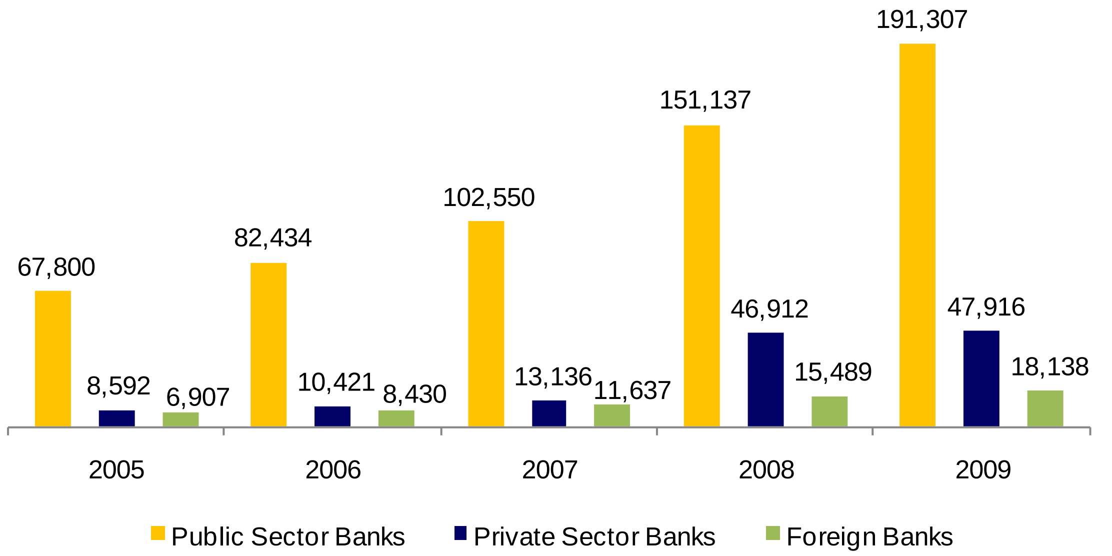
Source of Funds



Source: Report on Trend and Progress of Banking in India 2008-09 and Ministry of MSMEs, Annual Report 2009-10

Out of various sources of institutional finance, the prime source for credit to MSEs is through commercial bank lending. Within commercial banks, the contribution of public sector banks is highest compared to private sector and MNC banks. According to the RBI's "Report on Trend and Progress of Banking in India 2008-09", scheduled commercial banks (SCBs) extended loans amounting `2,57,361 Crore to MSEs as on March 2009, out of which public sector banks contributed 74.3% of total credit while private and MNC banks contributed the rest. The status of flow of credit to the sector from scheduled commercial banks and public sector banks as on March 2009 is as follows:

Bank Credit (In ` Crore)



Source: RBI

Based on numbers published by RBI, D&B estimates that the annual growth rate in net bank credit was 24% during the period 2005-09 compared to bank credit to MSE sector, which stood at 33% during the same period. The growth in MSE bank credit, especially after 2008, can be attributed to the reclassification of MSMEs according to MSMED act, 2006.

MSE Lending Scenario of Scheduled Commercial Banks

MSE Lending Process[7]

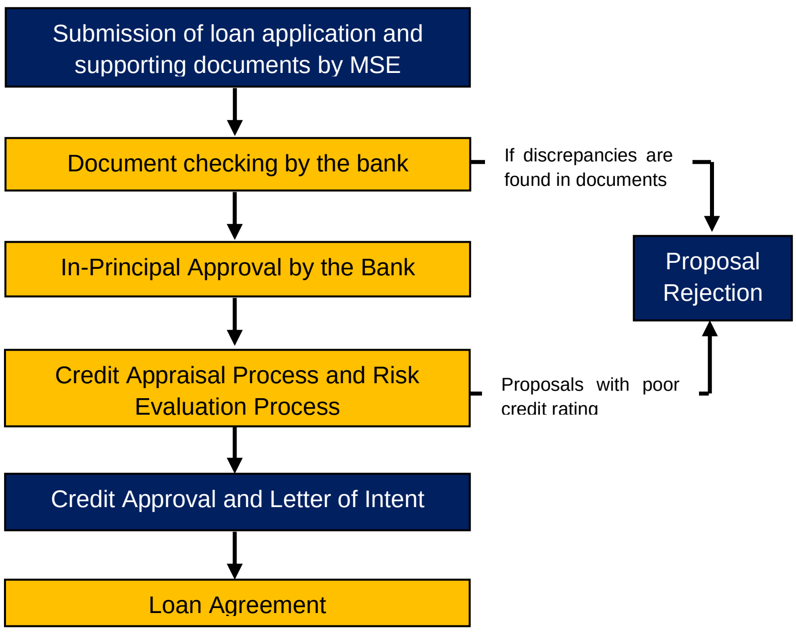
Several Nationalized banks in Public and Private sector extend loans to MSE sector through their branch offices / MSE specialized centers across India. Once a loan application is received, the bank assess the risk involved in the project based on various parameters such as Project details (project concept, project location, sector type, project strength through DSCR, Project IRR, Payback period etc.), borrower background, previous relationship of the bank with the borrower and details of existing

[7] Inputs obtained from primary survey of banks

and proposed credit facilities. Lending institutions have internal rating models for assessment of project proposals, and few lending institutions accept ratings of external credit rating agencies.

Out of total number of proposals received from registered MSE units availing institutional finance (about 11.2% of total MSEs), lending institutions generally accept about 80-85% of the proposals. The rejections are mainly due to non-viability of the project and past track record of the borrower. The proposal acceptance rate is high mainly because of RBI guidelines to lending institutions regarding MSE lending[8]. The proposal acceptance rate is relatively high (almost 90-95%) in case of Public Sector Banks compared to Private Sector and Foreign Banks. The lower rate of acceptance in case of Private Sector and Foreign Banks is mainly due to their focus on large corporates and perceived risk in MSE sector. Inspite of the above, these lending institutions are meeting the minimum MSE lending criteria set out by RBI.

MSE Lending Process



Source: Primary Survey of Lending Institutions, D&B India

<u>MSE Lending Scenario</u>

Overall Advances to the MSE Sector

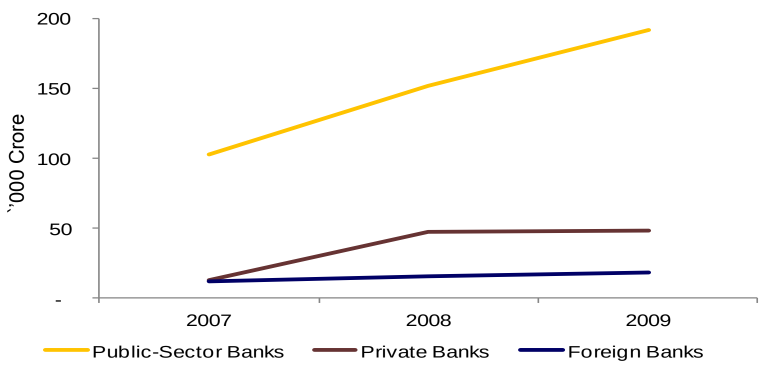
The outstanding advances to the MSE Sector have shown an increasing trend and constitute a major segment of total bank credit to the non-farm sector. By March 2009, the total outstanding credit by Scheduled Commercial Banks stood at `257,361 Crore, constituting 11.4% of the Net Bank Credit of SCBs[9]. Out of the total priority sector advances, the share of MSE sector for Public-Sector Banks was

[8] 40% of Net Bank Credit has to be provided to priority sector

[9] Report on Trend and Progress of Banking in India 2008-09, RBI

26.5%, and that for Private-Sector Banks was 25.3%. The overall amount of loans extended to the sector in last few years by different bank groups is as follows.

Advances to MSE Sector (FY2007-09)



Source: RBI

In the year FY2009, total advances to MSE Sector stood at `191,307 Crore for Public Sector Banks, `47,916 Crore for Private Banks and `18,138 Crore for Foreign Banks, as shown in the graph above. While there has been consistent increase in lending to MSE Sector in the range of 15-25% during FY2002-07, the lending to MSE sector has considerably increased from the year FY2008 for both Public and Private sector banks. The year FY2008 marked a turnaround in lending practices to MSEs, with Public-Sector banks being advised to make operational at least one specialized MSE branch in every district and centre within a MSE cluster[10]. In the same year, there was enhanced monitoring of bank advances to priority sector, and lending institutions were required to furnish data on such advances.

Government Initiatives

Commercial banks have been apprehensive to lend to the MSE sector in the past due to incidence of high sickness, high NPAs (especially in MSEs)[11], high transaction costs, inability of MSEs to provide collateral, and the difficulty in establishing the creditworthiness of the project proposals. Although the overall perception of these lending institutions related to risk in lending to MSEs has only improved marginally, several policy level changes had positive impact on the sector thereby boosting overall advances to MSEs in recent years. The details of few such Government initiatives are as follows:

- **Change in the definition of MSMEs:** The MSMED Act 2006[12] was established to facilitate the

[10] By March 2008, 638 specialized branches were operational in the country, and this number increased to 869 by the end of FY2009.

[11] NPAs of MSEs as a % of total NPAs of commercial banks is around 13%, and there has been 21% growth in sickness of MSEs in the year 2008-09 (Source: RBI and Development Commissioner MSME)

[12] Came into effect from October 2, 2006

development and promotion of Micro, Small and Medium Enterprises (MSMEs) and to enhance their competitiveness. Details of salient features of the act and their impact on MSEs is as follows:

Salient Features of the Act	Impact on MSMEs
Clear-cut demarcation of manufacturing and services enterprises	Facilitates SMEs to enter into service enterprises aggressively
Definition of Enterprises Specific ceiling limit for manufacturing / production and service enterprise definition for Medium enterprises	Existing small units can graduate into Medium units and avail facilities under the act.
Procurement Policies Notification of preference policies by central or State Governments for goods and services provided by Micro & Small enterprises	Facilitates opportunity for supply of goods / services without any hassles.
Delayed Payment Penalty • Period of payment by the procuring organizations: 45 days • Penal interest 200% of PLR	SMEs can plan their cash flow / financial requirements
Delayed Payment Deduction under IT Act 1961 disallowed to procuring organizations	This will encourage procurement agencies to ensure timely payment to SMEs.
Notification of guidelines or instructions for promotion of SMEs with respect to funds appropriation and release	Mandatory on all facilitating development of SMEs ensuring fast growth

- **Policy Announcements:** On the basis of the Policy Package announced by the Union Finance Minister on August 10, 2005, Public Sector Banks (PSBs) were advised to fix their own targets for funding MSEs in order to achieve a minimum 20% year-on-year growth in credit to MSEs. The objective is to double the flow of credit to the sector from `67,600 Crore in 2004-05 to `1,35,200 Crore by 2009-10 (i.e. within a period of 5 years). PSBs have surpassed this target in the financial year ending March 2008 itself (outstanding credit to the MSE sector by PSBs as on March 2008 is `1,51,137 Crore).
- **Refinance Facilities and Funding Support for MSEs:** In order to enhance credit delivery to MSE sector, RBI has provided refinance amount of `7,000 Crore to Small Industries Development Bank of India (SIDBI) in December 2008 (available up to March 31, 2010). This refinance was available against:
  - SIDBI's incremental direct lending to MSE and
  - SIDBI's loans to banks, NBFCs and State Financial Corporations (SFCs) against the latter's incremental loans and advances to MSEs.

  The utilization of funds was governed by the policy approved by the Board of the SIDBI.

- **Cluster-based Financing:** As part of the "Policy package for stepping up of credit to MSEs", public sector banks were advised to make operational at least one specialized MSE branch in every district and centre with an MSE cluster[13] and follow a cluster-based approach for financing MSE sector. The Reserve Bank's Annual Policy Statement for 2007-08 announced that banks were required to review their institutional arrangements for delivering credit to the MSE sector, especially in 388 clusters identified by United Nations Industrial Development Organisation (UNIDO) spread over 21 States in the country.

- **Working Group on Rehabilitation of Sick MSEs:** Reserve Bank constituted a Working Group in recognition of the problems being faced by the MSE sector particularly with respect to rehabilitation of potentially viable sick units. The group recommended setting up of several funds such as Rehabilitation Fund, Fund for Technology Upgradation, Marketing Development Fund and National Equity Fund by the Government of India to facilitate credit flow to the MSE sector[14]. Further, banks were advised to put in place loan policy on extension of credit facilities, restructuring / rehabilitation policy and non-discretionary one-time settlement to the MSE sector.

- **Credit Guarantee Fund:** The Government of India launched the Credit Guarantee Fund Scheme (operated by Credit Guarantee Trust for Micro and Small Enterprises (CGTMSE)) in the year 2000 with the objective of making available credit to MSEs without collateral / third party guarantees, especially for first generation entrepreneurs to set up their own enterprises. The Scheme covers collateral free credit facilities extended by lending institutions (MLIs) to MSEs up to a maximum limit of `100 Lakh. The number of proposals approved by CGTMSE has grown more than twofold in the last 3 years (From 30,285 proposals in the year 2007-08 to 1,51,387 proposals in the year 2009-10) mainly due to increased participation from various banks and financial institutions[15].

  In order to improve the reach and effectiveness of credit guarantee scheme, it was announced in the Reserve Bank's Annual Policy Statement for the year 2009-10 that the Standing Advisory Committee on MSEs will review the CGTMSE scheme and its operations. Accordingly, a Working Group reviewed the present CGTMSE scheme, with the objective of facilitating increased flow of collateral free credit to the MSEs by enhancing scheme's acceptability and usage among various member lending institutions, and suggested measures for simplifying the existing operational procedures of CGTMSE. The report was submitted to RBI on March 02, 2010 and the recommendations are currently under consideration.

[13] By March 2008, 638 specialized branches were operational in the country, and this number increased to 869 by the end of FY2009.

[14] These recommendations have been forwarded to the Government of India and SIDBI for their consideration and necessary action.

[15] In the year 2007, Banks were advised that they may extend collateral-free loans up to `5 Lakh, to all new loans sanctioned to the units of MSE sector as defined under MSMED Act, 2006

Overview of CGTMSE Scheme

Introduction

The Government of India launched the ‘Credit Guarantee Fund Scheme for Small Industries’ in August 2000, with the objective of facilitating credit to Small Scale Industries / Small Scale Service Business Enterprises without collateral / third party guarantees. The scheme has been operated by ‘Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)’ (formerly known as ‘Credit Guarantee Fund Trust for Small Industries (CGTSI)’), which was jointly setup by Government of India and Small Industries Development Bank of India (SIDBI). The main aim of the scheme is to support the MSE sector and encourage entrepreneurship and innovation by making available easy and timely access of funds. In addition, the scheme is expected to encourage banks and lending institutions to innovate their lending strategies to the MSE sector by employing de-risking measures, thereby providing continuous finance to the sector.

Based on the modifications suggested in the "Package for promotion of Micro and Small Enterprises" in February 2007, the scheme has been renamed as 'Credit Guarantee Fund Scheme for Micro and Small Enterprises'. The coverage of the scheme was extended to all new and existing Micro and Small Enterprises and the eligible loan limit under the scheme has been increased from `25 Lakh to `50 Lakh.

In September 2008, CGTMSE introduced Risk sharing facility (RSF-I) scheme on pilot basis (for 3 months), which enhanced the scope of the scheme to cover credit facilities in the range of `50 Lakh and `1 Crore. RSF-1 was implemented through 8 Member Lending Institutions[16] and covered total 64 loans under the scheme[17].

Based on the response obtained on RSF-I, the scope of CGTMSE scheme has been enhanced to cover collateral-free credit facilities (term loan and / or working capital) extended by eligible member lending institutions (MLIs)[18] to new and existing micro and small enterprises up to `100 Lakh per borrowing unit. The guarantee cover provided is up to 75% of the credit facility up to `50 Lakh with an incremental guarantee of 50% of the credit facility above `50 Lakh and up to `100 Lakh.

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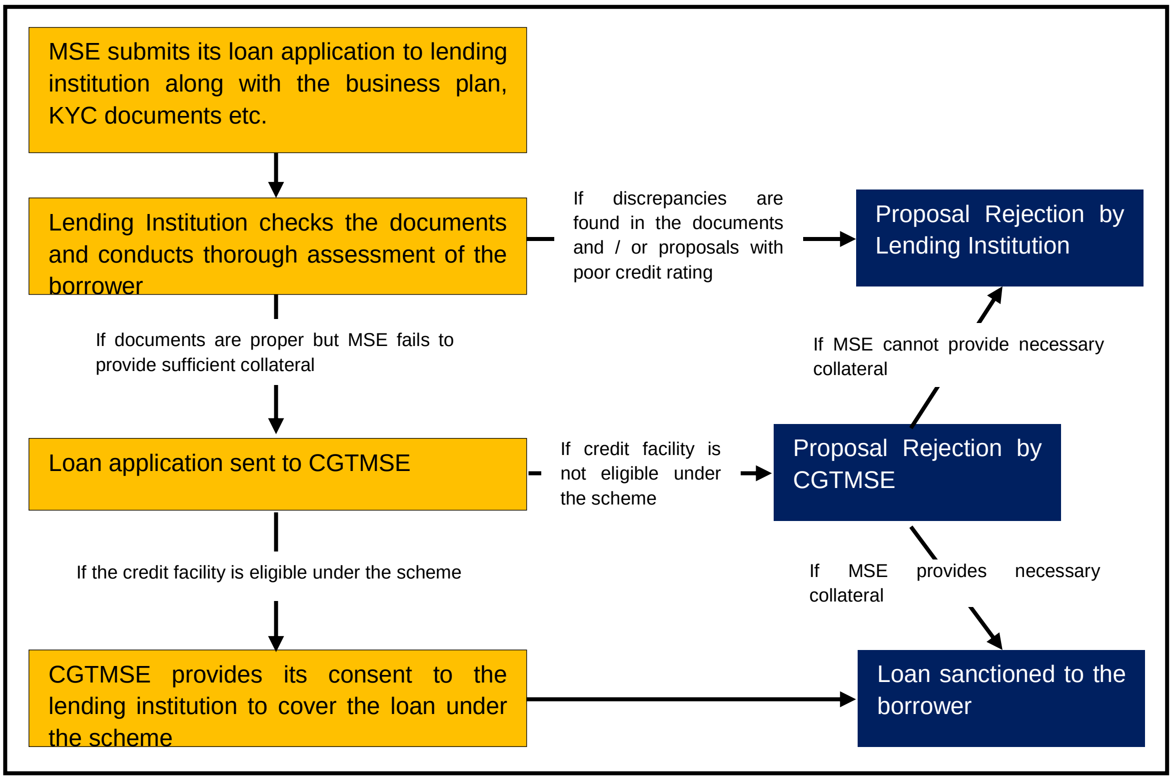
[16] “Banks” and “Member Lending Institutions” were interchangeably used in this report

[17] Refer to annexure for overview of RSF-I scheme

[18] CGTMSE currently has 111 MLIs as on date, which include Regional Rural Banks, Public and Private Sector Banks, Foreign Banks and Financial Institutions

Guarantee Process

Guarantee Process



Source: Primary Survey of Lending Institutions, D&B India

In order to avail the credit guarantee cover under CGMSE scheme, a financial institution should become a member with CGTMSE (called as "Member Lending Institution" or "MLI") by entering into an agreement. Subsequently, MLIs can upload credit facility proposals (loan applications that need credit guarantee cover) by logging into CGTMSE's website. CGTMSE provides its consent (approval / rejection of the proposal) to MLI within 2 working days, after checking for the eligibility of the proposal under the scheme. Based on interaction with CGTMSE and MLIs, D&B India understands that the current rejection rate of proposals by CGTMSE is low. The key reasons cited for rejection of proposals by CGTMSE are:

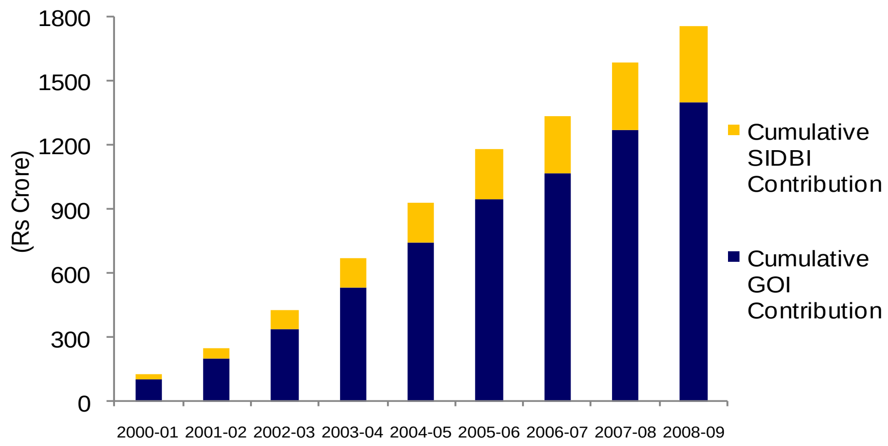
- Insufficient information / documents provided to CGTMSE
- MSEs operating in sectors that are not covered under the scheme such as retail trade and educational institutions
- Credit facilities in respect of which risks are additionally covered by Deposit Insurance and Credit Guarantee Corporation (DICGC) or the Reserve Bank of India (RBI) or by Government or any general insurer
- Credit facility sanctioned by a lending institution with interest rate more than 3% over the Prime Lending Rate (PLR) of the lending institution

CGTMSE adopts a fair and transparent process of approving / rejecting of proposals. In case, CGTMSE rejects any application, it informs the same along with the reasons for rejection of the proposal to MLI, which is enabling them for correct submission of applications or resubmission of proposals to CGTMSE.

Capital Fund

The initial corpus fund of CGTMSE in the year FY2001 was `125 Crore, out of which `100 Crore was contributed by the Government of India and the rest by SIDBI ("Settlers"). In the subsequent years, both the settlers maintained the ratio of contribution to the fund of 4:1. By the end of FY2009, the corpus fund of CGTMSE stood at `1,754.07 Crore[19], out of which `1,403.25 Crore (80%) is contributed by the Government of India and the rest is contributed by SIDBI. The growth in the corpus of CGTMSE since its inception until FY2009 is given below.

Capital Fund of CGTMSE



Source: CGTMSE

Performance of the Scheme

Of the 111 MLIs registered with the Trust as on May 31, 2010, 85 MLIs availed the guarantee cover. The performance history of CGTMSE is as follows:

Year	No. of Active MLIs	No. of Credit Facilities Approved	Key Initiatives
2000-01	9	951	• Introduction of Credit Guarantee Scheme for SSI / SSSBE

[19] Represents 70.16% of the total committed capital by the two settlers of `2500 Crore

Year	No. of Active MLIs	No. of Credit Facilities Approved	Key Initiatives
2001-02	16	2,296	• Promotion activities by CGTMSE to lending institutions • Modifications in scope of the scheme and payment terms (one-time guarantee fee)
2002-03	22	4,955	• Promotional activities by CGTMSE to lending institutions
2003-04	29	6,603	• Awareness creation programs (training and workshops) to MLIs • Software support to MLIs for submitting online applications • Introduction of minimum credit limit for SSIs (`5 Lakh)
2004-05	32	8,451	• Lending institutions were allowed extend additional loans to SSIs with credit facility requirements of over `25 Lakh, which are already covered under credit guarantee scheme. However, credit guarantee cover will be up to `25 Lakh only. • Lending institutions were allowed to take collateral for additional loan amount (beyond `25 Lakh that was covered under the scheme)
2005-06	36	16,284	• In order to make the scheme attractive to lending institutions, CGTMSE has brought changes in one-time fee structure (reduced it from 2.5% to 1.5%)
2006-07	40	27,457	• CGTMSE has provided one-time extension for lodging applications (because of problems in software). So, few applications pending in previous year also have been registered in this year. • CGTMSE has introduced differential pricing (One-time guarantee fee and annual service fee) to MLIs based on extent of guarantee cover.
2007-08	47	30,285	• Change in definition of SSI • Based on the modifications suggested in the "Package for promotion of Micro and Small Enterprises", the scope of scheme was changed to cover Micro and Small enterprises also. • The limit for credit facility requirements has been increased from `25 Lakh to `50 Lakh • Changes in fee structure for North-East Region
2008-09	57	53,708	• The limit for credit facility requirements has been increased from `50 Lakh to `100 Lakh • Modifications in scheme structure to benefit artisans and SC / ST borrowers
2009-10	85	151,387	• The extent of guarantee cover has been increased for credit facility requirements up to `1 Crore • CGTMSE made it mandatory for lending institutions to follow a centralized ASF payment system, following the model's success with few leading Member Lending

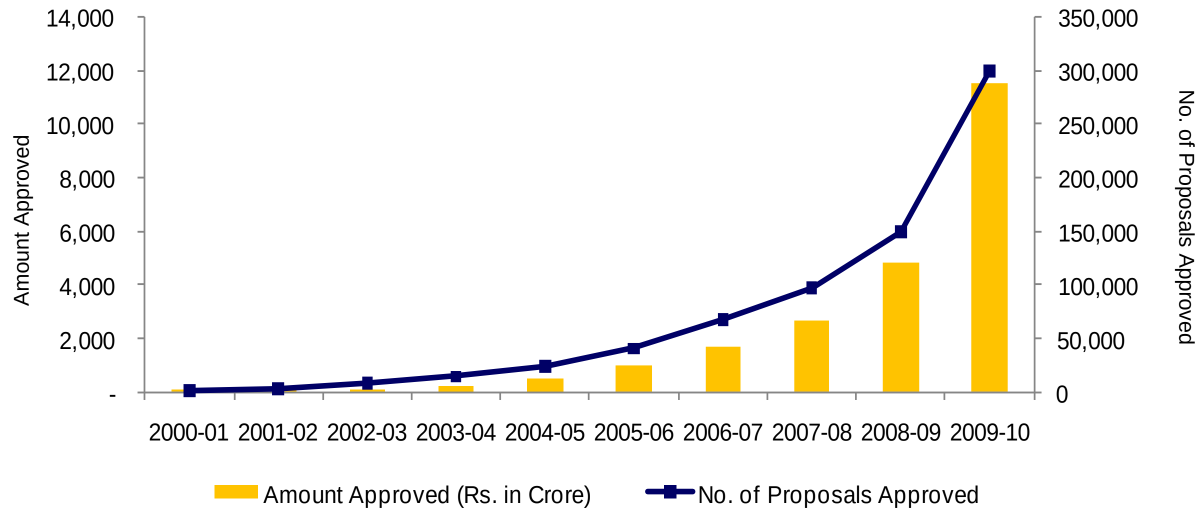
Year	No. of Active MLIs	No. of Credit Facilities Approved	Key Initiatives
			Institutions
Source: CGTMSE N.B.: Actuals may vary due to intervening cancellations / modifications			

Reach of the Scheme: Overall Trend

MSE Advances of Lending institutions covered under the Scheme

In the year 2007, RBI advised lending institutions to provide collateral-free loans to MSEs up to an overall limit of `5 Lakh. This policy decision has a positive impact on the performance of CGTMSE as witnessed from high growth in number of proposals and guarantee amount from the year 2007. By March 2009, around 3 Lakh cases amounting to `11,559 Crore have been approved by CGTMSE under the Scheme.

Year-wise Growth in Proposals Approved



Source: CGTMSE

The scheme was slow in taking off in the initial years and the cover availed remained below 10,000 proposals during the first five years. However, since 2005-06, there has been a steady growth in the issue of guarantees and the same has increased exponentially from 12,747 proposals involving `462.99 Crore in the year 2005-06 to 1,51,387 guarantee proposals for `6,875.11 Crore in the year 2009-10. Cumulatively, as on March 31, 2010, 3,00,105 guarantee proposals have been approved involving an aggregate amount of `11,559.61 Crore.

Marketing of the Scheme

CGTMSE has adopted multi-channel approach for creating awareness about the Credit Guarantee Scheme (CGS) amongst all the stake holders including banks, other lending institutions, Industry Associations, Entrepreneurs, etc. through various methods like print and electronic media, conducting workshops / seminars etc. CGTMSE's website has been reconstructed to make it more user-friendly and informative with hyperlink to websites of its Member Lending Institutions / other development institutions / agencies. Cumulatively, by January 31, 2010, more than 1010 workshops and seminars had been conducted on Credit Guarantee Scheme[20]. Recently, CGTMSE has launched advertisement campaign in Hindi, English, and regional languages. These advertisements are issued in newspapers across the country at periodic intervals as also in leading magazines and periodicals.

Inspite of several efforts made by CGTMSE, the existing coverage of total MSE accounts of lending institutions with CGTMSE[21] is still low. Out of the total MSE accounts of public sector banks, about 3.32% were covered under CGTMSE scheme as on March 2009[22]. In value terms, about 2.23% of total MSE advances of public sector were covered under CGTMSE scheme.

Data on Coverage of the Credit Guarantee Scheme for MSEs for the year March ended 2009

Slab-wise Amounts	Total Loans to MSE Sector		Accounts Covered under CGTMSE		% of Accounts Covered under CGTMSE	
	No. of Accounts	Amount Outstanding (In ` Crore)	No. of Accounts	Amount Outstanding (In ` Crore)	No. of Accounts	Amount Outstanding (In ` Crore)
Up to `5 Lakh	1,750,025	21,498.23	46,280	590.25	2.64	2.75
Above `5 Lakh and up to `15 Lakh	234,661	14,667.05	7,448	679.67	3.17	4.63
Above `15 Lakh and up to `25 Lakh	103,202	11,503.32	2,570	521.21	2.49	4.53
Above `25 Lakh and up to `1 Crore	92,148	27,863.84	1,254	485.1	1.36	1.74
Total	**2,180,036**	**75,532.44**	**57,552**	**2,276.23**	**2.64**	**3.01**

Source: Working Group Report on 'Review of Operations of CGTMSE' March 2010
Note: Data in respect of 24 lending institutions

[20] Working Paper on 'Review of Operations of CGTMSE' March 2010

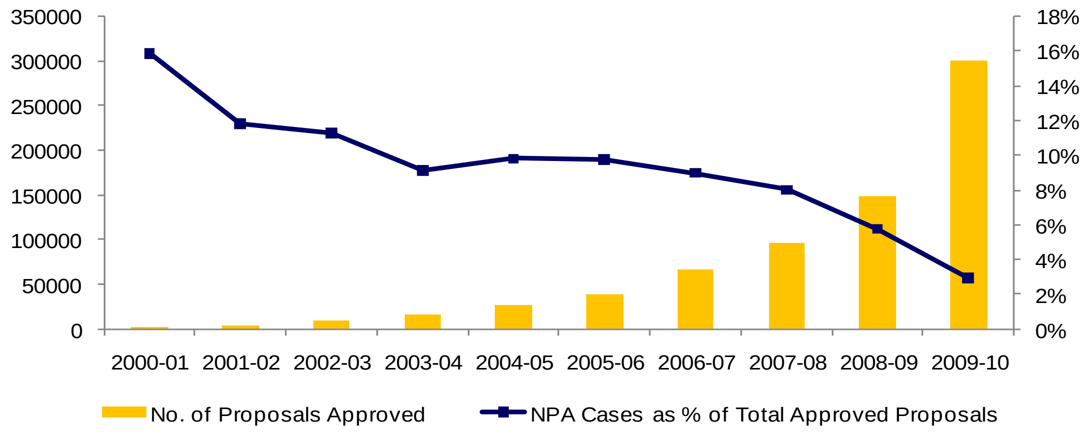
[21] RBI's report on Trend and Progress of Banking in India 2008-09

[22]Source: Rural Planning and Credit Department, RBI. Please refer to annexure for details.

Overall NPAs in MSE accounts covered under the Scheme

The year-wise distribution of advances and NPAs is as follows:

Year-Wise NPA Distribution



Source: CGTMSE

The portfolio quality[23] of CGTMSE has considerably improved in the last 10 years. The portfolio of CGTMSE has witnessed an annual growth rate of 78% in number of proposals approved, while the NPA rate has decreased from 16% in the year 2000-01 to 2.53% in the year 2009-10.

MLI-Wise Details

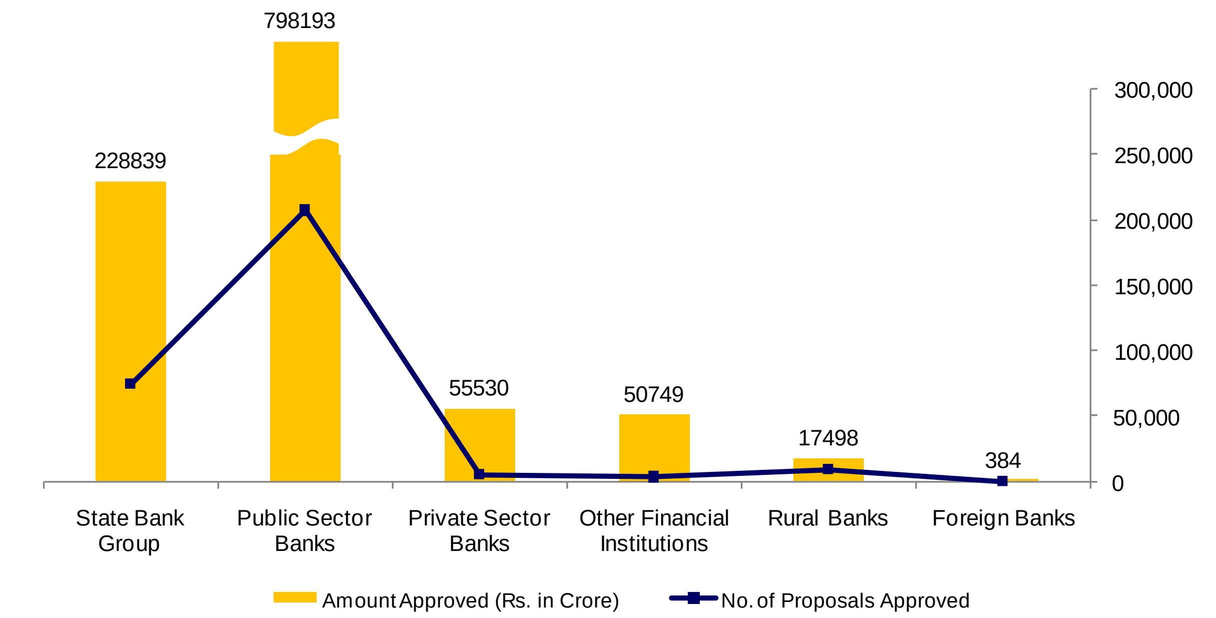
MSE Advances covered under the Scheme

All Scheduled Commercial Banks, specified Regional Rural Banks, and Lending Institutions which have entered into an agreement with CGTMSE are eligible for the Credit Guarantee Scheme. The application process for obtaining the guarantee cover for a loan as well as the claim settlement procedure is online, making the process of settling of claims efficient and transparent. CGTMSE has 111 MLIs as on date, which includes Regional Rural Banks, Public and Private Sector Banks, Foreign Banks and Financial Institutions.

The cumulative number of proposals and the amount approved under the scheme by different MLI groups is as follows:

[23] Portfolio Quality is defined as ratio of cumulative NPA cases to total approved proposals

MLI Participation: Bank Group-wise number of approvals (till March 2010)

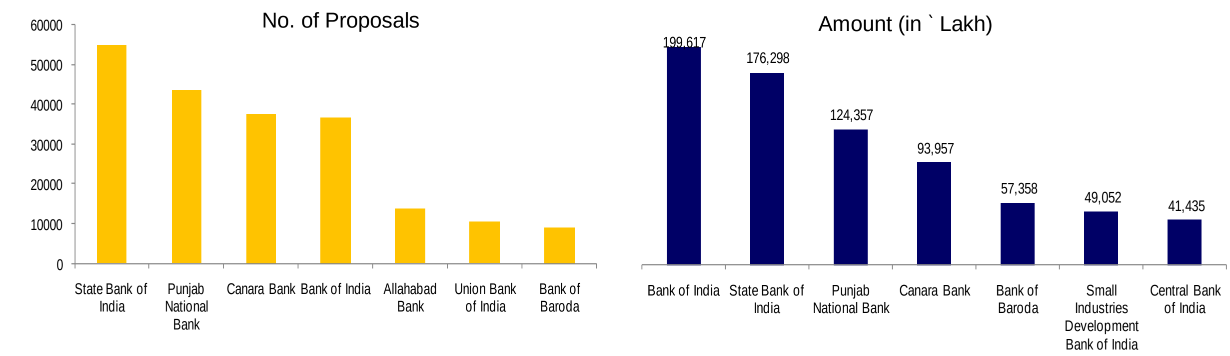


Source: CGTMSE

Public Sector Banks (including State Bank group) are the key MLIs for CGTMSE as compared to other categories of financial institutions. They contribute about 94% of the total proposals covered under CGTMSE and 89% of the total guarantee amount. State Bank group alone contributes about 25% of total proposals and 20% of total guarantee amount covered under CGTMSE.

The top 7 participants of CGTMSE scheme as on March 2010, which contributes about 69% in terms of no. of proposals and 64% in terms of amount approved are as follows:

Top 7 MLIs (Cumulative as on March 2010)

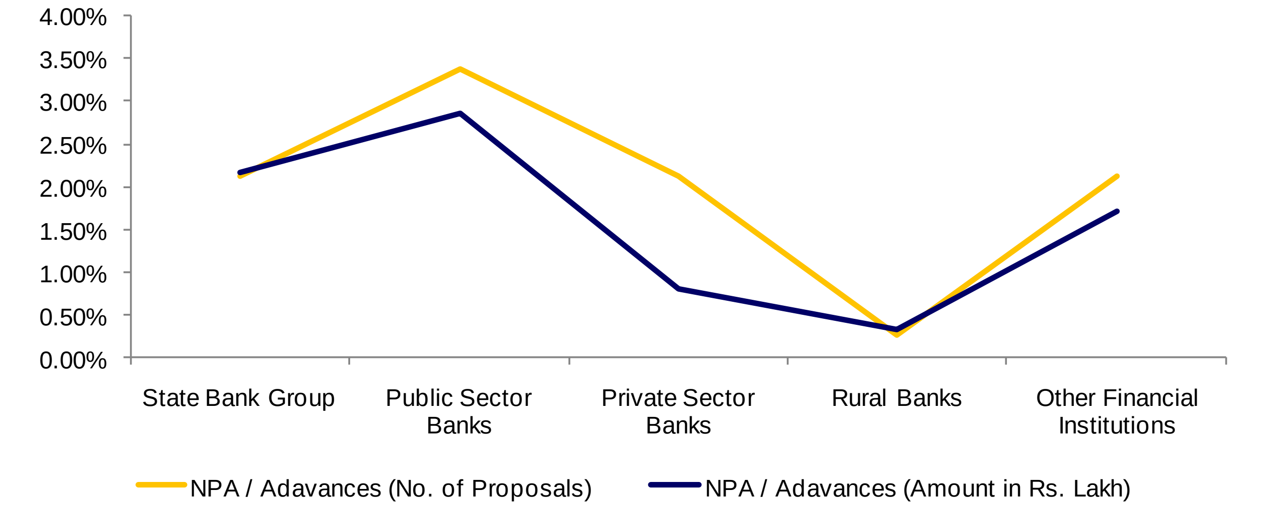


Source: CGTMSE

MLI-Wise NPA Details

The distribution of NPAs among various banks groups are as follows:

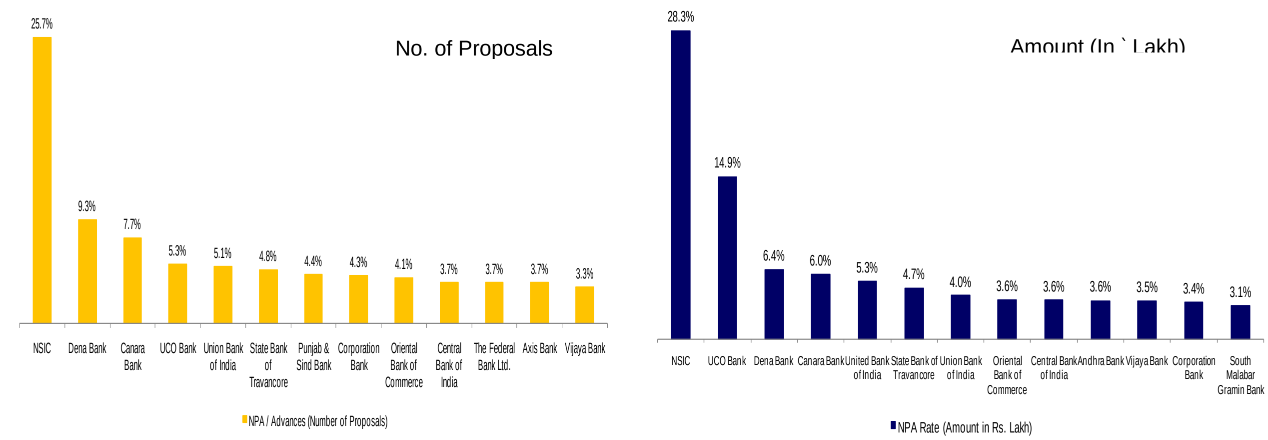
Distribution of NPAs (Cumulative as on March 2010)



Source: CGTMSE

The NPA rates of public sector banks and other financial institutions are high both in terms of number of proposals covered under the credit guarantee scheme and amount covered. On the other hand, there are no NPA cases (of the proposals covered under CGTMSE) in case of foreign banks and the NPA rate is very low for Rural Banks both in terms of number of proposals and amount covered. The average NPA rate of all MLIs with CGTMSE is 2.93% in terms of number of proposals and 2.54% in terms of amount. The details of NPA rates for various MLIs which are above these averages are as follows:

MLIs with high proportion of NPA of approved loans (Cumulative till March 2009)



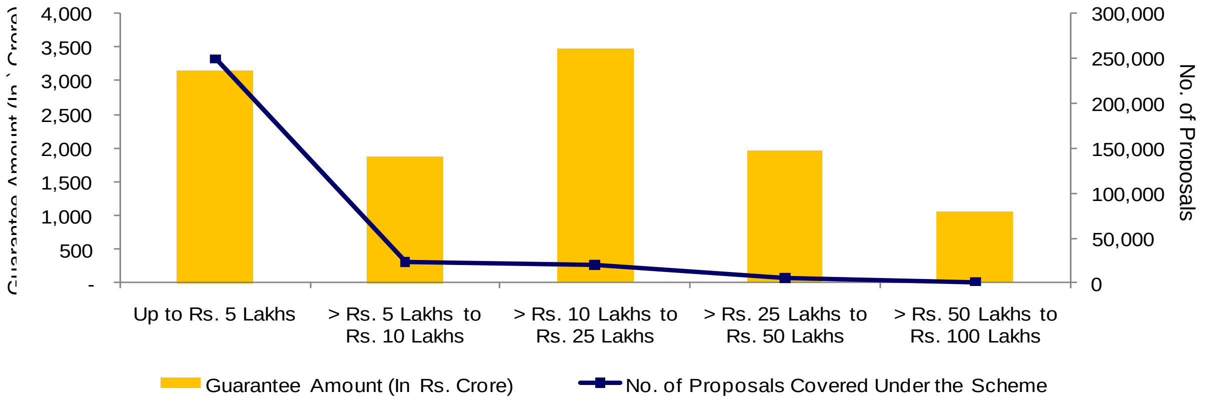
Source: CGTMSE

Slab-wise Details

MSE Advances covered under the Scheme

The distribution of MSE advances covered under CGTMSE is as follows:

Distribution of MSE Advances (Cumulative till March 2010)



Source: CGTMSE

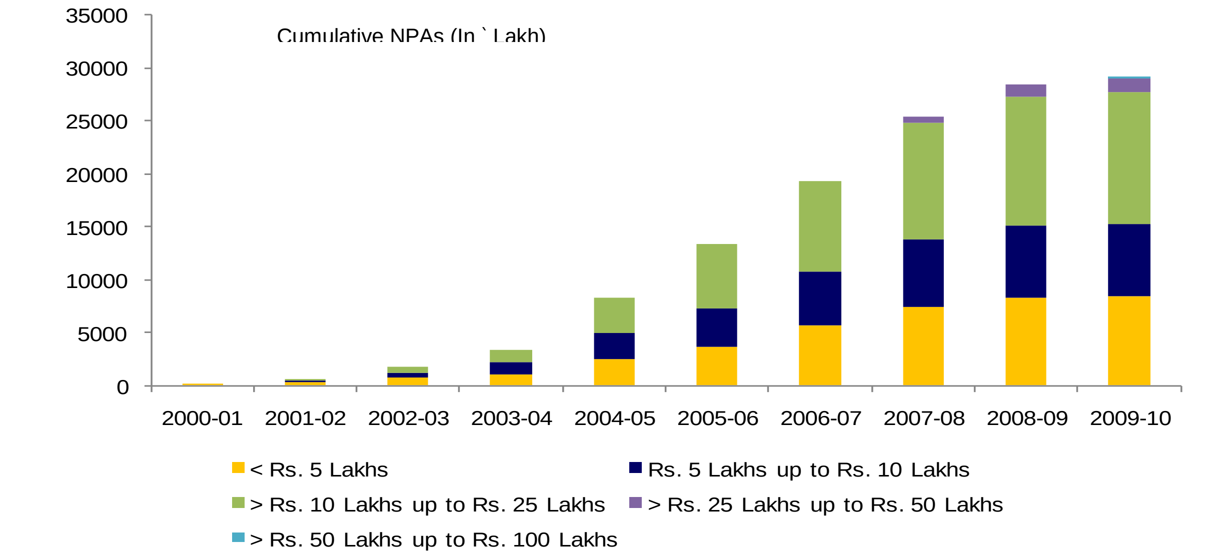
The following observations can be made based on distribution of cumulative MSE advances covered under CGTMSE as on March 2010:

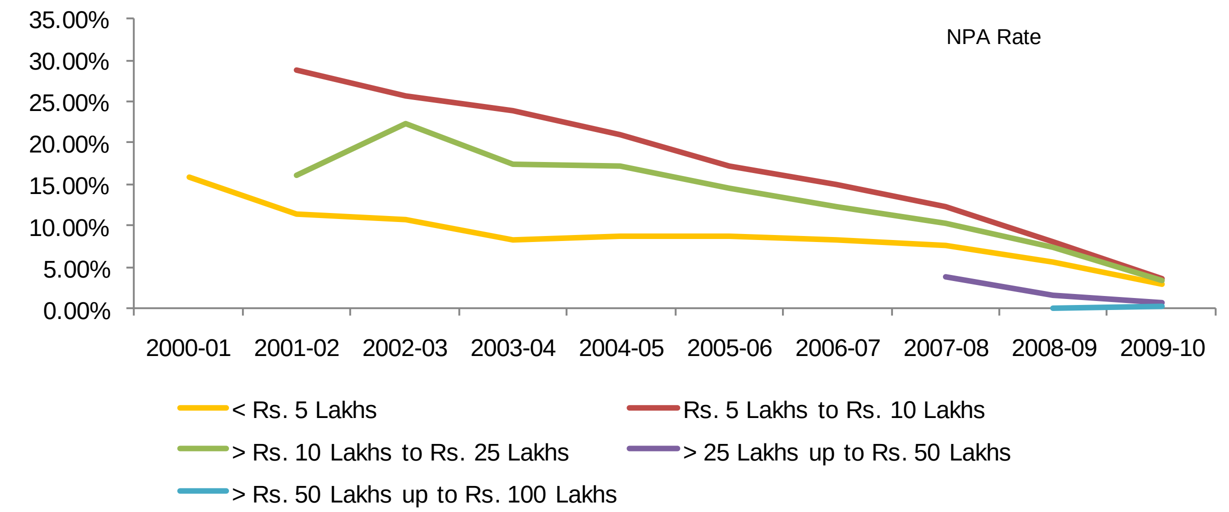
- Concentration of total volume of proposals is high in lower credit requirement slabs, while it is low in higher credit requirement slabs (especially in credit facility requirements over `50 Lakh and up to `100 Lakh). In volume terms, about 83.2% of total number of proposals covered under CGTMSE are credit facility requirements up to `5 Lakh, about 14.7% of total proposals guaranteed are credit facility requirements are between `5 Lakh and `25 Lakh and about 2.2% of total proposals guaranteed are credit facility requirements between `25 Lakh and `1 Crore.
- In value terms, 27.28% of amount guaranteed pertains to loan size below `5 Lakh, 16.34% of the amount guaranteed belongs to loan size between `5 Lakh and `10 Lakh, 30.14% of loans belongs to loan size between `10 Lakh to `25 Lakh, 17.03% of loans belongs to loan size between `25 Lakh to `50 Lakh, 9.21% of loans belongs to loan size between `50 Lakh to `1 Crore.

Slab-wise NPA Details

The year-wise and slab-wise distribution of number of MSE advances and NPA accounts covered under the scheme is as follows:

Distribution of Slab-wise NPAs (Cumulative)





Source: CGTMSE

There is a declining trend in NPA rate in all credit facility slabs, indicating an improvement in portfolio quality of CGTMSE. NPAs as a percentage of total MSE advances in the range from less than `5 Lakh up to `25 Lakh have decreased from as high as 15.92% in the year 2000-01 to 3.34% in the year 2009-10. On the other hand, NPAs as a percentage of total MSE advances in the range from more than `25 Lakh up to `1 Crore decreased from 3.92% in the year 2007-08 to 0.43% in the year 2009-10.

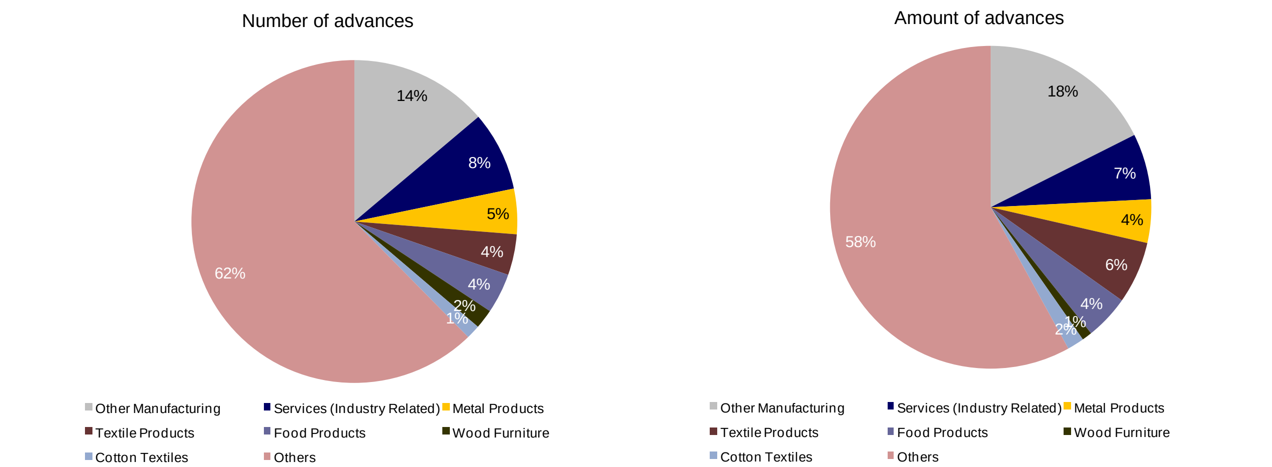
Sector-Wise Details

MSE Advances covered under the Scheme

The sector-wise assistance made available through MLIs under the Credit Guarantee Scheme is as follows:

- 'Other Manufacturing' units received maximum coverage in terms of amount of assistance as well as number of approvals.
- Other major beneficiary sectors are Industry-Related Services, Metal Products, Textile Products, Food Products, Wood Furniture and Cotton Textiles.

Sector-wise distribution of advances as on March 2010



Source: CGTMSE

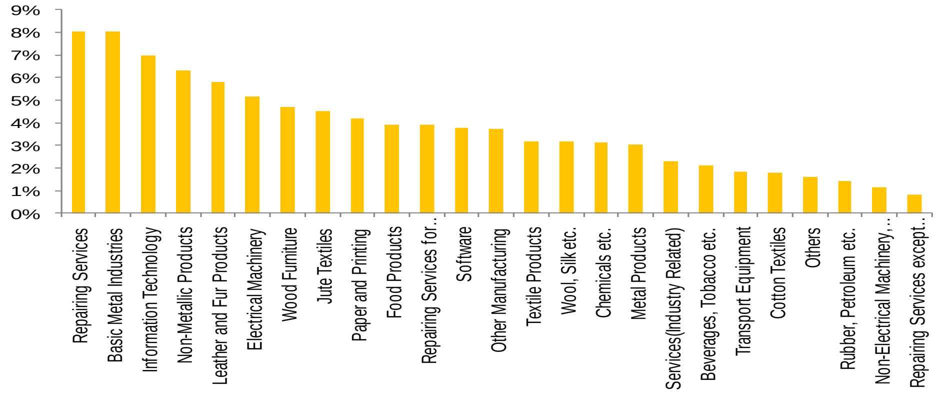
Moreover, in order to facilitate flow of credit to Handicrafts sector, the Office of DC (Handicrafts) has disbursed `2.80 Crore in April 2009 to CGTMSE. This fund will pay the Guarantee Fee and Annual Service Fee to CGTMSE for any advances provided by lending institutions to artisans.

Sector-Wise NPA Details

Historically, the high rate of NPAs in MSE sector has created risk aversion among lending institutions, which has hindered increase in flow of credit to the sector. Few reasons for high NPA rate in MSE sector are irregular cashflows due to delay in accounts receivables, heavy dependence on one or more customer accounts and constraints in availability of working capital . In addition, recession in 2008 had negative impact on almost all the MSE sectors in a Bank's portfolio.

The ratio of cumulative NPAs to MSE advances (amount) in various sectors is as follows:

Sector-wise distribution of Cumulative NPA Amount (As on March 2010)

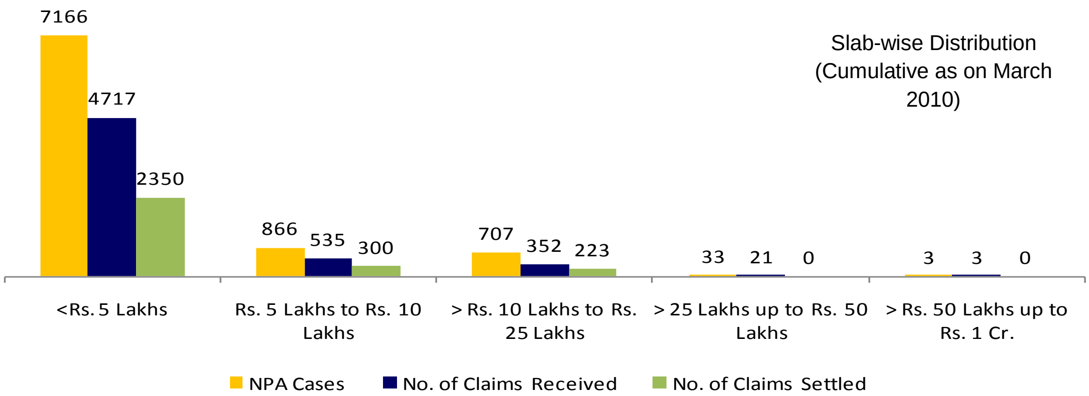


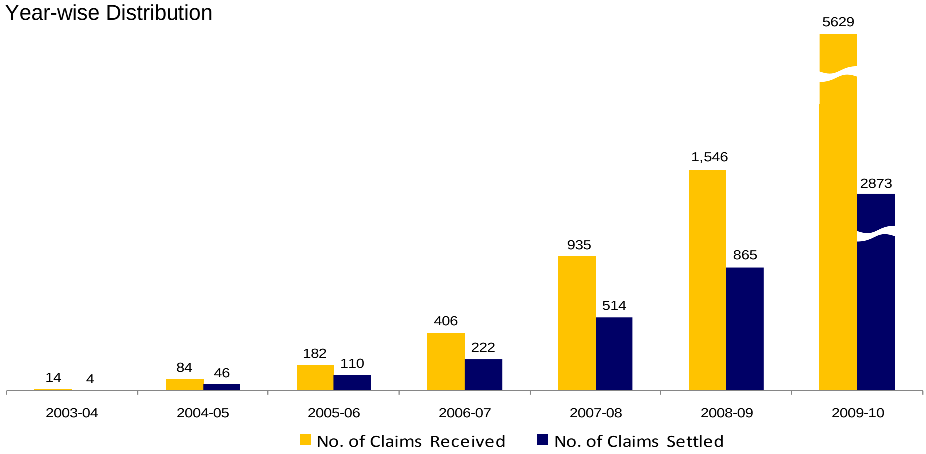
Source: CGTMSE

Claims Received and Settled by CGTMSE

The year-wise distribution of claims received and settled by CGTMSE is as follows:

Distribution of Claims





Source: CGTMSE

The following observations can be made on the trend in claims settled by CGTMSE (in the last 5 years FY 2005-10):

- CGTMSE has received claims equivalent to 64% of the total NPA cases covered under credit guarantee scheme, while 51% of claims received have been settled till date.
- Only 4,083 claims with aggregate amount of `95.02 Crore were lodged during 2009-10. The details of top 10 nationalized banks which lodged higher number of claims (86% of total number of claims received) as on March 2010 are as follows:

Extent of Claims Lodged (Cumulative till March 2010)				
Bank	**No. of Accounts covered under CGTMSE**	**No. of NPA Accounts**	**Claims Lodged (of the NPA Accounts)**	**No. of Accounts where claims were not Lodged**
Canara Bank	37,525	2,899	1,736	1,163
Punjab National Bank	43,371	975	725	250
State Bank of India	54,962	1,215	459	756
Union Bank of India	10,365	529	441	88
Bank of India	36,784	533	378	155
Dena Bank	3,316	310	267	43
State Bank of Travancore	5,908	285	252	33
UCO Bank	6,557	348	248	100
Central Bank of India	7,025	258	188	70
United Bank of India	7,669	208	151	57
Source: CGTMSE				

Overview of RSF-II Scheme

Background

In order to improve Micro and Small Enterprises (MSEs) access to finance and business development services, CGTMSE implemented Risk sharing facility scheme (RSF-I) under World Bank's parent project (WBLOC I). The project entailed bank funding of $120 million to the Small Industries Development Bank of India (SIDBI) for MSME financing and development[24]. The project has two World Bank financed components – (1) Credit Facility of $115 million and (2) Risk sharing facility (RSF-I) of $5 million. The RSF (RSF-I) was implemented through 8 Member Lending Institutions and covered total 64 loans under the scheme[25].

In order to expand and deepen the parent project, World Bank has made available additional funds (financing loans) of $400 million to SIDBI. The additional funds have two World Bank financed components – (1) Credit Facility of $390 million and (2) Risk sharing facility (RSF-II) of $10 million. CGTMSE expects to further issue guarantees to MSEs under new Risk Sharing Facility scheme (RSF-II) from additional funds available under World Bank's loan to SIDBI. The main objectives of RSF-II scheme are:

- To fund the creation of guarantee reserves (creating the capacity of the guarantee fund) and
- To expand the coverage of the product to a larger number of lending institutions and / or MSEs.

Based on feedback / lessons obtained from various key Member Lending Institutions (MLIs) related to effectiveness of the earlier credit guarantee schemes, CGTMSE would like to improve the design of RSF-II scheme in terms of size / scale, fees, extent of cover and risk sharing, target segment of borrowers and lenders, and claim settlement mechanism. The improved design of Risk Sharing Facility is expected to increase the coverage of the scheme to a wider section of Banks, Financial Institutions and MSEs.

Need for RSF-II Scheme

The respondents (lending institutions, industry association and MSEs) were queried on the need for a credit guarantee product providing guarantee cover of over `1 Crore. The details of the discussions are as follows:

[24] The Project was approved on November 30, 2004, and became effective on April 4, 2005 and the WBLOC I was effective till June 30, 2009

[25] Refer to annexure for overview of RSF-I scheme

Views of Member Lending Institutions

i. The bankers provided mixed views on the loan bracket for granting credit guarantees.

   a. Few bankers were of the opinion that the loan requirement limit of less than `10 Lakh and up to `1 Crore only (already covered by CGTMSE) is pertinent and the same should be adhered to.

   b. Whereas some of the bankers mentioned that it may be a good idea to consider increasing the upper limit from `1 Crore to `2 Crore.

ii. The various reasons that were provided for choosing the above brackets were:

   a. Associated risk in higher ticket size loans (credit facility requirements greater than `1 Crore) are relatively less, when compared to lower ticket size loans, as the borrowers can provide sufficient collateral (security or third party guarantee) to the lending institution.

   b. Although the incidence of default is low in case of higher ticket size proposals, the loss given default is high relative to lower ticket size proposals. This is leading to risk aversion of lending institutions for extending loans over `1 Crore to MSEs in new sectors / new entrepreneurs / new concepts.

It was observed that even though the size of the loans is a necessary consideration for providing credit guarantee cover, the need for the credit guarantee scheme is directly dependent on host of factors such as:

i. Definition of eligible borrowers
ii. Fees structure
iii. Claim settlement procedure

Thus the loan size to be considered for availing a credit guarantee can range from `10 Lakh and up to `2 Crore, and even more, depending on the structure of the credit guarantee scheme.

Industry Association

i. The following views were obtained from the industry association regarding need for credit guarantee scheme for loan requirements over `1 Crore:

   a. FISME opined that the need for credit guarantee lies in the loan requirement limit of less than `25 Lakh only and the need for a credit guarantee scheme covering for loan requirements over `1 Crore might be limited.

b. The rationale provided by FISME is that majority of MSEs with loan requirements over `1 Crore can provide sufficient collateral (security or third party guarantee) to the lending institutions.

c. However, FISME mentioned that there exists a section of MSEs such as MSEs in service sector / new entrepreneurs etc., with loan requirements over `1 Crore who often find it difficult to provide sufficient collaterals to lending institutions. The extension in upper loan limit from `1 Crore to `2 Crore might have a positive impact on these MSEs.

D&B India has obtained mixed views on the need for the proposed RSF-II scheme. As the need of the lending institutions was observed to be contingent upon the structure of RSF-II scheme, D&B India has worked out the structure of RSF-II (discussed in next chapter) taking into account the views and reservations of the various stakeholders. Subsequently, the proposed structure for the scheme was discussed with major MLIs to obtain their feedback and acceptability. (Details mentioned in section on Acceptability of the Scheme).

Desired Features of RSF-II Scheme

Perceptions of Member Lending Institutions

Based on the interviews and feedback from limited number of lending institutions[26], D&B India has obtained the following inputs regarding desired features of RSF-II scheme:

a. Eligible Borrowers: The definition of Micro and Small Enterprises (MSEs) in RSF-I scheme is as follows:

> *"Enterprises both in the manufacturing sector as well as in the service sector excluding retail trade, in respect of which an affidavit has been furnished by the owners or other parties entitled to act for that undertaking or the lending institution seeking guarantee has satisfied itself that the investment in plant and machinery is not in excess of such amounts as may be specified by the Central Government in regard thereto and subject to such other terms and conditions as may be prescribed by the Government or the Trust in this behalf."*

Based on inputs obtained from the interviews with bankers, it is observed that the bank's portfolio may constitute a high proportion of loans[27] extended to services sector such as retail trade and educational institutions.

A suggestion was provided by the bankers towards aligning the definition of MSEs in line with

[26] Refer to annexure for brief methodology adopted by D&B India

[27] *Loans provided to retail trade may be to the extent of one-tenth of the total SME portfolio for the interviewed banks.*

the RBI's definition of MSEs[28] (unlike RSF-I scheme definition of MSEs). The bankers opined that, considering the MSE definition of RBI may positively affect the number of loan accounts that may be covered under RSF-II.

b. **Incentives for support to service sector:** Few lending institutions mentioned that the inherent risk in loans provided to service sector is relatively high compared to loans provided to manufacturing sector (due to insufficient collaterals – both primary and secondary). These bankers opined that the focus of CGTMSE currently is more towards manufacturing sector compared to services sector[29]. They mentioned that providing special incentives for service sector in RSF-II scheme (in terms of higher guarantee cover and / or concession in guarantee fees compared to manufacturing sector) might have positive impact on both current lending scenario of lending institutions to service sector. Accordingly, number of proposals from the service sector covered under CGTMSE would also increase.

c. **Extent of Coverage:** A majority of bankers were comfortable with a 50%-65% credit guarantee cover. However, lending institutions are reluctant to provide collateral free loans for credit facility requirements over `1 Crore. They mentioned that the scheme should allow lending institutions to take collaterals from borrowers to the extent of the loan amount not covered under the scheme.

d. **Fee Structure:** Lending institutions suggested that the fee structure should be as follows:

   i. One-time guarantee fee could be in the range of 0.5% - 0.75% depending on the risk profile of the borrowers, while annual service fee could be in the range of 0.25% - 0.375%.

   ii. Annual service fee could be charged on loan amount outstanding at the end of the year (Reducing Balance Method) instead of initial loan amount covered under the scheme (Fixed Principal Method).

   D&B India has conducted a detailed assessment on the above observations and recommended an appropriate fee structure for RSF-II scheme. The assessment was carried out on the basis of multiple criterions such as:

   i. Borrower concentration (number of borrowers to a bank with loan requirements in the range of `1 Crore and `5 Crore)

   ii. Probability of defaults for CGTMSE and overall default rate in the above class of customers

   iii. Administrative costs for CGTMSE

e. **Claim Settlement Procedure:** The bankers mentioned that the lock-in period of 18 months, for settlement of claims, is reasonable and may continue in RSF-II scheme.

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[28] The 'Micro and Small Enterprises (MSEs)' means industrial undertakings or a business concerns or any other establishments, by whatever name called engaged in the manufacture or production of goods, in any manner, pertaining to any industry specified in the First Schedule to the Industries (Development and Regulation) Act, 1951 or engaged in providing or rendering of any service or services.

[29] 90% of CGTMSE's portfolio constitutes guarantees extended for loans to manufacturing sector, while 10% is for loans to service sector

The bankers indicated that they often faced problems during claim settlement in earlier schemes (claims rejected on grounds of non-timely payment of annual service fees). Thus, CGTMSE may consider settlement of claims based on overall experience with MLI (i.e. Performance of MLI in timely payment of annual service fees for all loans covered under the scheme instead of payment of annual service fees on case-to-case basis).

Moreover, bankers suggested that CGTMSE may take up subrogation rights and realize outstanding amounts from borrowers, and can charge an appropriate fee from the lending institutions.

Perceptions of Beneficiaries (MSEs)

D&B India has conducted primary survey on Federation of Indian Micro & Small and Medium Enterprises (FISME), and few beneficiaries of RSF-I scheme. An overview of their perceptions on credit guarantee scheme based on their experience with CGTMSE is as follows:

Views of Industry Association

a. **MSE Definition:** The current MSE definition of CGTMSE excludes retail trade and educational institutions from the purview of the credit guarantee scheme. A suggestion was provided by FISME towards aligning the definition of MSEs in line with the RBI's definition of MSEs (unlike RSF-I scheme definition of MSEs). FISME opined that, considering the MSE definition of RBI may stimulate the current lending scenario of lending institutions to these sectors.

b. **Support to Service Sector:** FISME opined that several borrowers in services sector (especially sectors related to technology, intellectual property etc.) fail to receive funding from lending institutions due to insufficient collaterals. FISME suggested that CGTMSE can play a vital role in increasing the participation of lending institutions to provide loans to these borrowers.

c. **Sector-specific products:** FISME suggested that the credit guarantee scheme should give equal priority to all the sectors instead of focusing on any specific sector(s) or type of borrowers (such as green field projects / energy efficient projects, etc.). However, FISME opined that the credit guarantee scheme should provide necessary support to women entrepreneurs and MSE borrowers from North-East region. Suitable concessions should be provided by the credit guarantee fund in fee structure and / or credit guarantee cover to these types of borrowers.

   Further, FISME opined that after CGTMSE attains critical mass of traction and stabilize (sufficient volume of guarantee accounts) it can explore the option of introducing sector-specific funds.

Views of RSF-I Beneficiaries and Industry Association

a. **Awareness of the scheme:** The major source of information regarding credit guarantee scheme to beneficiaries is MLI's branch level authorities (typically branch manager). Based on interviews with beneficiaries, D&B India finds that a majority of them are unaware about the scheme prior to obtaining the credit guarantee cover.

Lending institutions generally require a collateral security from the borrower, which is about 1.5 times the loan amount (Collateral security includes primary collateral such as Plant & Machinery, etc. and secondary collateral such as immovable property, third-party guarantees etc). In cases where a borrower could not able to furnish sufficient collateral, branch manager is providing the information to MSE about the credit guarantee scheme, its features / modalities, fee structure and payment details. On obtaining consent from borrower (to cover the loan under the scheme), the loan application is sent to CGTMSE for its approval. On receipt of approval from CGTMSE, lending institution approves the loan to the borrower.

b. **Fee Structure:** Both MSEs and FISME opined that the current fee structure of CGTMSE is high. The charges paid by the borrower in first year, in addition to the interest charges (which are about 11.5% - 12%), is atleast 1% of the sanctioned loan amount (including one-time fees and annual service fees). FISME and MSEs suggested that it would be beneficial if the fee paid to CGTMSE (both one-time fees and annual service fees) is shared between the MSEs and lending institution.

c. **New Areas of Support to Service Sector:** The funding to service sector (in its initial stages) is generally through equity funds (seed capital / venture capital). Few MSEs mentioned that availability of equity funds from angel investors / venture capitalists is currently limited to few companies in MSE sector. They mentioned that CGTMSE can explore the possibility of venturing into this space (CGTMSE providing credit guarantees to equity provided by angel investors / venture capital funds to MSEs and thereby reducing their default risk), which might aid in entry of several MSE sector specific equity funds and also increase in the participation of existing equity fund investors to the sector. Based on international study, D&B India finds that few international credit guarantee funds such as KODIT are providing credit guarantee support to equity provided by angel investors / venture capitalists. However, CGTMSE needs to explore this aspect in detail in later stages of development.

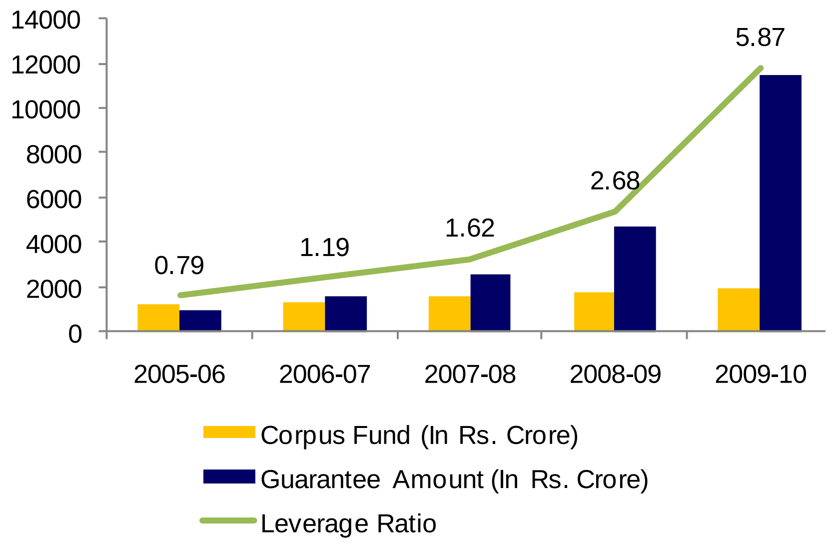
RSF-II Scheme Calculations

In order to prepare a broad framework / structure for RSF-II scheme, D&B India has computed[30] the following aspects of a credit guarantee scheme such as – (1) Leverage Ratio, (2) Extent of credit guarantee cover, (3) Number of guarantees, and (4) Fee structure. The details of RSF-II structure has been discussed in the next chapter.

Leverage Ratio

The cumulative fund size of CGTMSE has seen an annual growth rate of 31.68% in the last 10 years (FY2010), while the annual growth rate in cumulative guarantee amount in the last 10 years is about 114.63% indicating an increase in the leverage ratio. Based on cumulative guarantee amount and cumulative corpus fund available with CGTMSE, D&B has calculated leverage ratio for the last 5 years (FY2005-FY2010) as follows[31]:

Leverage of Capital Fund of CGTMSE



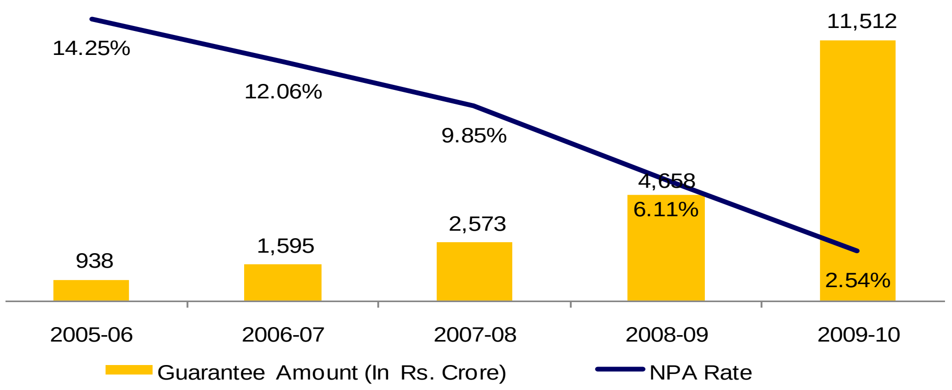
Source: CGTMSE

In the last 5 years, the leverage ratio of the scheme has increased steadily indicating (1) maturity in the scheme, and (2) increase in participation of lending institutions.

[30] Based on data available from RBI and CGTMSE, and inputs obtained from primary survey of Member Lending Institutions

[31] Cumulative corpus fund size in FY 2009-10 is `1,960 Crore (Source: Working Group Report on CGTMSE)

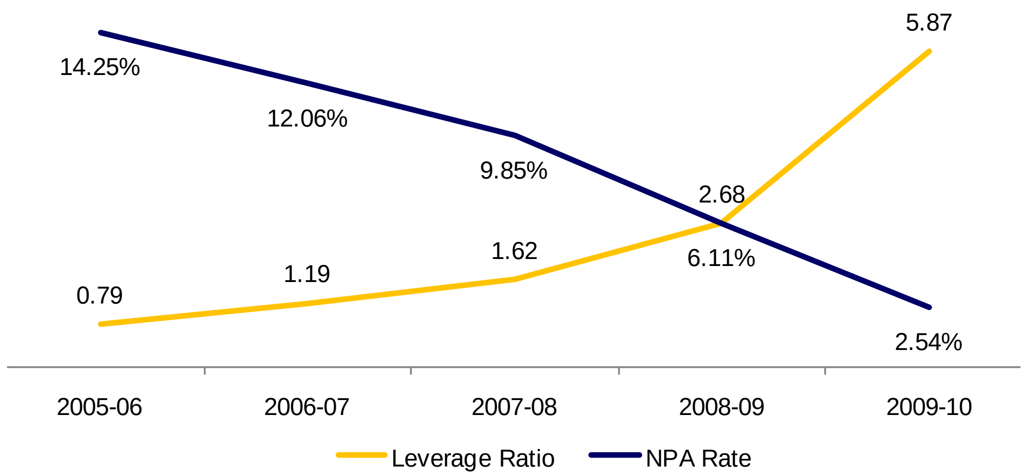
Year-wise NPA Rate



Source: CGTMSE

Further, D&B India has observed that the NPA rate has decreased from 14.25% in the year 2005-06 to 2.54% in the year 2009-10, while leverage ratio has increased from 0.79 in the year 2005-06 to 5.87 in the year 2009-10.

Leverage Ratio and NPA Rate



Source: CGTMSE

Out of the total additional funds ($400 million) available from World Bank to SIDBI, the corpus available for RSF-II scheme is $10 million[32]. For the purpose of calculations, D&B India has assumed the NPA rate of credit facility requirements over `100 Lakh as 2.54%[33].

Leverage ratio of CGTMSE in RSF-I scheme is 1.9 while average leverage ratio of CGTMSE is 3.39

[32] Equivalent to `46.94 Crore (Source: RBI - Exchange rate as on August 13, 2010 is $1 = `46.94)

[33] Average NPA Rate of CGTMSE's portfolio as on March 2010

in the last 3 years (1.62 in FY2008, 2.68 in FY2009, and 5.87 in FY2010). On the basis of historical trend in leverage ratio and corresponding NPA rate, D&B India has estimated the leverage ratio for RSF-II scheme as 3.68.

Amount available with CGTMSE for providing guarantees in RSF-II scheme = (Corpus available for RSF-II scheme) x (Leverage Ratio) = `172.95 Crore

Number of Guarantees

For the purpose of calculations, D&B India has assumed the following:

- Eligible credit facility requirements:
  - Lower limit: `1 Crore, Upper limit: `2 Crore, Average limit: `1.5 Crore
- Extent of credit guarantee cover = *65% of eligible credit facility requirements*[34]
  - Lower limit for guarantee amount: `65 Lakh, Upper limit for guarantee amount: `1.3 Crore, Average limit for guarantee amount: `97.50 Lakh

Based on total amount available with CGTMSE for providing guarantees in RSF-II scheme and extent of guarantee cover, D&B has estimated the number of guarantees as follows:

Number of Guarantees to be provided in RSF-II scheme = (Amount available with CGTMSE for providing guarantees in RSF-II scheme) / (Average Guarantee Amount) = 177

Fee Structure

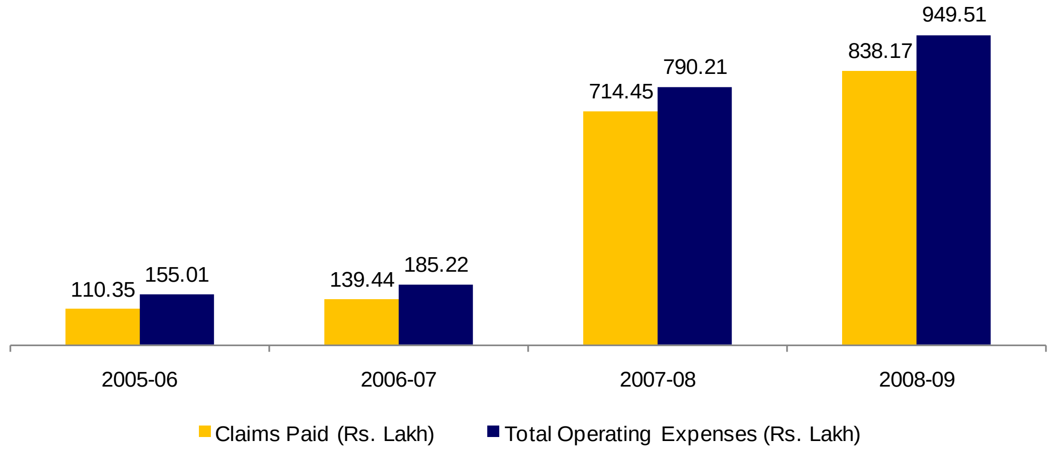
D&B India has determined the fee structure for RSF-II scheme based on operating expenses that CGTMSE needs to incur for providing guarantees. The details of major operating expenses[35] of CGTMSE in the last 5 years are as follows[36]:

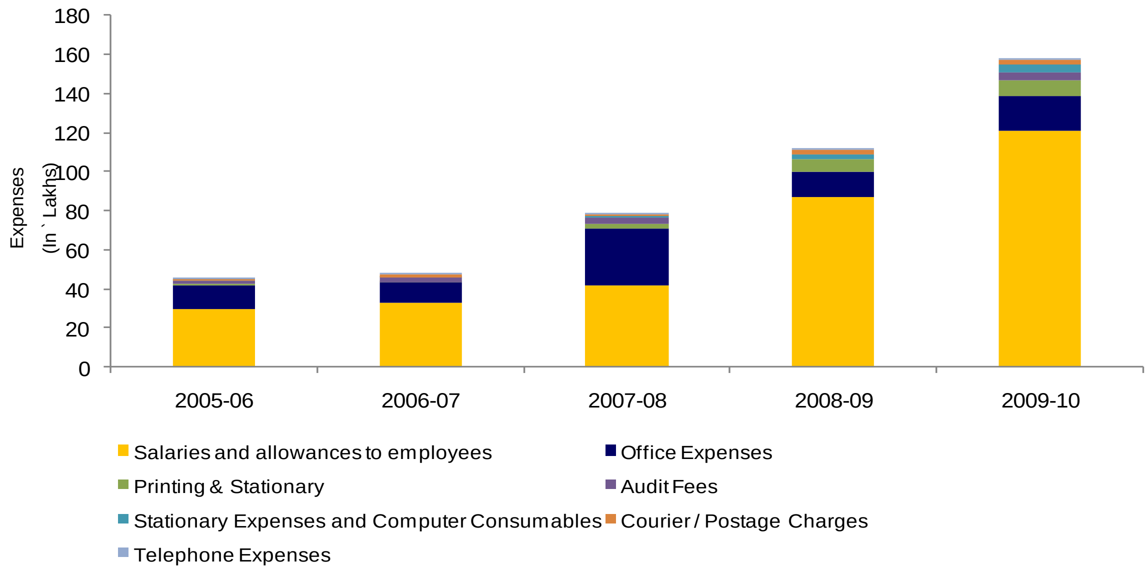
[34] Based on inputs obtained from primary survey of financial institutions

[35] D&B India assumed that Claims paid, Salaries and allowances to employees, Office expenses, Printing & Stationary, Telephone expenses, Courier and Postage charges, Stationary expenses and computer consumables as major operating expenses for CGTMSE

[36] Details on major Operating Expenses in FY2010 are not available. D&B India has estimated major operating expenses (except claims paid) on the basis of average growth rate (38%) in these expenses in last 3 years

Major Operating Expenses of CGTMSE





Source: CGTMSE Annual Reports

D&B India infers that on an average, the claims paid constitute major portion of operating expenses incurred by CGTMSE in the last 5 years (about 82.7%). D&B India has calculated a one-time guarantee fees[37] for recovering other operating expenses[38] that CGTMSE needs to incur for providing guarantees.

Based on the study of various international credit guarantee organizations, and primary survey inputs on problems faced by various stakeholders in India, D&B India proposes the formation of a Collection Agency that will monitor borrower accounts, collect service fees and notify MLIs and CGTMSE in case of any default in borrower's accounts. D&B India has assumed additional charges (in addition to other operating expenses) of `15 Lakh annually for engaging a collection agency, for the purpose of

[37] Paid by MLIs at the time of taking a credit guarantee cover

[38] Estimated major operating expenses (Salaries and allowances to employees, Office Expenses, Printing & Stationary, Telephone Expenses, Courier / Postage Charges, and Stationary Expenses and Computer Consumables) for the year 2009-10.

calculations.

Further, D&B India proposes a Quarterly Service Fee (QSF) structure for recovering the 'claims paid' expenses from Member Lending Institutions. The QSF will be charged on outstanding credit facility at the end of every quarter (calculated on reducing balance method) from MLIs. The periodicity of charging service fees in earlier credit guarantee schemes (including RSF-I) is on 'annual' basis.

The benefits accrued to various stakeholders by changing the periodicity of collection of service fees and engaging a dedicated collection agency are as follows:

Benefits to CGTMSE:

1. Faster realization of service fees will improve cash flow position of CGTMSE
2. Increasing the frequency of collection of service fees also provides better control on borrower accounts covered under CGTMSE
3. Engaging a collection agency will ensure a timely payment of service fees from MLIs / borrowers
4. Notification on any default in borrower accounts on quarterly basis will aid in estimation of future claims that CGTMSE might receive from MLIs

Benefits to Member Lending Institutions:

1. As the service fees is calculated on outstanding credit facility amount at the end of every quarter (through reducing balance method), the fees paid might be lower (compared to current system where fees is paid on sanctioned credit facility) and will depend on loan repayment schedule of the borrower.
2. Collection agency will liaison with head office of lending institutions and will intimate them on periodic basis about service fees amount and due date based on information furnished by branches of lending institutions. This system will ensure more regular updates to MLIs on QSF payments and also will avoid any late payment of service fees to CGTMSE (resulting into closure of guarantee accounts).
3. Collection agency will notify MLIs regarding any default in QSF payments. This will enable lending institutions to decide on future course of action.

The calculation of quarterly service fee and guarantee fee are as follows:

Quarterly Service Fees (QSF):

D&B India has taken the following assumptions for calculating the Service Fees:

Calculation Method	:	Reducing Balance Method
Average credit facility requirement	:	`150 Lakh
Tenure of Repayment	:	5 years
Loan Repayment Frequency	:	Quarterly (Equal installments)
Extent of Guarantee Cover	:	65%
Cost of Capital of CGTMSE	:	8.09%[39]
NPA Rate	:	2.54%
Number of Guarantees to be provided in RSF – II	:	177

D&B India has computed that 4 out of 177 guarantee accounts covered under CGTMSE (assuming NPA rate as 2.54% and average guarantee amount as `97.50 Lakh) might turn into NPAs i.e. total claim amount would be `390 Lakh[40]. D&B India has assumed that this claim amount would be recovered in the form of QSF from MLIs. Assuming the cost of capital as 8.09%, D&B India estimated that CGTMSE will need to charge 0.26% of total outstanding guarantee amount as QSF every quarter during the tenure of the loan.

Guarantee Fees:

D&B India has taken the following assumptions for calculating the Guarantee Fees:

Average credit facility requirement	:	`150 Lakh
Extent of Guarantee Cover	:	65%
Number of Guarantees to be provided in RSF – II	:	177
Description of Operating Expenses (Including additional charges of `15 Lakh annually for engaging a collection agency)	:	• Collection Agency Charges • Salaries and Allowances to Employees • Office Expenses • Audit Fees • Printing & Stationary • Telephone Expenses • Courier & Postage Charges

[39] 10 year G-sec rate as on August 13, 2010 (Source: RBI)

[40] Assuming that all NPA cases were claimed by banks

• Stationary and Computer Consumables

D&B India has assumed that one-time guarantee fees should atleast cover various operating expenses that CGTMSE needs to incur for providing guarantees. As it is difficult to apportion the expenses to RSF-II scheme only, D&B India has considered operating expenses that are only related to operating the scheme[41], while various other operating expenses such as rent, insurance, advertisement and publicity expenses etc. were excluded for the purpose of calculations.

Assuming average guarantee amount of `97.50 Lakh and operating expenses of `172.94 Lakh as on March 31, 2010, D&B India has estimated the guarantee fees as 1.00%.

1)	**One-time Guarantee Fees**	**= 1.00%**
	(% of total guarantee amount)	
2)	**Quarterly Service Fees**	**= 0.26%**
	(% of outstanding guarantee amount at the end of the quarter)	

Sensitivity Analysis

For the purpose of calculations, D&B India has assumed that the NPA rate in loans over `1 Crore as 2.53% (which is average NPA rate of current portfolio of CGTMSE). However, D&B India observed variations in NPA rate of various loan sizes covered under CGTMSE – 2.68% for loans below `5 Lakh, 3.65% for loans between `5 Lakh and `10 Lakh, 3.59% for loans between `10 Lakh and `25 Lakh, 0.65% for loans between `25 Lakh and `50 Lakh, 0.22% for loans between `50 Lakh and `1 Crore.

D&B India has calculated the sensitivity on NPA rate to understand its impact on number of guarantees under the RSF-II scheme, leverage ratio and fee structure. The details are as follows:

[41] Operating expenses such as salaries and allowances to employees etc. as on March 31, 2010 (D&B India has estimated these operating expenses in 2009-10 on the basis of average growth rate (38%) in the expenses in last 3 years). In addition, collection agency charges were assumed as `15 Lakh

NPA Rate	Leverage Ratio	Number of Guarantees	Quarterly Service Fees	One-time Guarantee Fees
0.22%	42.52	2047	0.03%	0.09%
0.50%	18.71	901	0.06%	0.20%
1.00%	9.35	450	0.13%	0.39%
1.50%	6.24	300	0.19%	0.59%
2.00%	4.68	225	0.25%	0.79%
2.50%	3.74	180	0.31%	0.99%
2.54%	**3.68**	**177**	**0.26%**	**1.00%**
3.00%	3.12	150	0.38%	1.18%
3.50%	2.67	129	0.44%	1.37%
4.00%	2.34	113	0.50%	1.57%
4.50%	2.08	100	0.56%	1.77%
5.00%	1.87	90	0.63%	1.97%
5.50%	1.70	82	0.69%	2.16%
6.00%	1.56	75	0.75%	2.36%
6.50%	1.44	69	0.65%	2.57%
7.00%	1.34	64	0.71%	2.77%
7.50%	1.25	60	0.94%	2.96%
8.00%	1.17	56	0.81%	3.17%
8.50%	1.10	53	1.06%	3.35%
9.00%	1.04	50	1.13%	3.55%
10.00%	0.94	45	1.25%	3.94%

Based on the above table, D&B India has made the following observations:

- With increase in NPA rate, the tendency to leverage the fund by covering higher number of guarantees reduces (as the inherent risk in a loan will increase with increase in NPA rate).
- At 0.22% NPA rate, CGTMSE can provide 2,047 guarantees (i.e. Corpus available for RSF-II

scheme can be leveraged by 42.52 times). On the other hand, at 10% NPA rate, CGTMSE can provide 45 guarantees (i.e. Corpus available for RSF-II scheme can be leveraged by only 0.94 times).

- One-time guarantee fees will increase with decrease in number of guarantees. As one-time guarantee fees is calculated on the basis of operating expenses (which are relatively 'fixed' in nature), the fee burden will reduce with increase in volume of guarantees due to economies of scale.
- Quarterly Service Fees are increasing with increase in NPA rate (number of defaults will increase with increase in NPA rate, and in turn will have an impact on amount required to cover the defaults). At 0.22% NPA rate, 1 out of every 455 loans covered under CGTMSE might turn into NPA, while at 10% NPA rate 1 out of every 10 loans covered under CGTMSE might turn into NPA. (Accordingly, at NPA rate of 0.22%, QSF is 0.03%; at NPA rate of 10%, QSF is 1.25%).

Acceptability of the Scheme

Based on discussions with MLIs, D&B India finds that the key issues faced by lending institutions for participating in existing credit guarantee scheme are as follows:

- Mandatory collateral-free loans even to large ticket size loan requirements
- Calculation of annual service fees through fixed principal method (based on initial sanctioned amount) instead of reducing balance method (based on loan amount outstanding at the end of the year)
- Cumbersome claim settlement procedure

D&B India has designed RSF-II structure with the objective of making the product attractive to MLIs, thereby increasing their participation rate in the scheme. In the process, several concerns of stakeholders were taken into consideration and following modifications were suggested in the scheme:

- Modification in earlier MSE definition of CGTMSE to include retail trade and educational institutions also
- RSF-II scheme will cover loans between `1 Crore and upto `2 Crore
- MLIs can accept collateral security and / or third party guarantees from MSEs to the extent of the unsecured portion of the amount (which is not covered under the scheme)
- Fee structure is calculated in fair and transparent manner (One-time Guarantee fee will cover operating expenses of the scheme while service fees will cover claim settlement amount)
- Periodicity of service fees is changed to quarterly, instead of annual

- Quarterly service fees is calculated according to reducing balance method instead of fixed principal method

With the above structure in place and proper operation of the same, major MLIs opined that 20%-35% of total number of proposals sanctioned by them in the range of `1 Crore and `2 Crore can be covered under the scheme.

Variations in the Proposed Scheme

In order to understand the changes in the proposed scheme (such as number of guarantees, extent of guarantee cover, and fee structure) with changes in the composition of RSF-II scheme's portfolio, D&B India has explored the following variations in the proposed scheme:

1) Extending concessions to women entrepreneurs and MSEs from North-East region ("Special MSEs")
2) Extending concessions to Scheduled Caste (SC) / Scheduled Tribe (ST) MSE borrowers ("Minority Groups")
3) Earmarking a portion of the fund for services sector

In addition, D&B India tried to obtain perceptions of various MLIs on extending loans to Cleaner technology sectors[42] and details on their MSE loan portfolios such as classification of loans (slab-wise, sector-wise etc.), default rate in loans, etc. in order to understand the following variations in the proposed scheme.

1) Earmarking a portion of the fund for Cleaner technology sectors
2) Risk based differential pricing
3) Portfolio based guarantees

Details are as follows:

Observations:

Option 1: Concessions provided to Women Entrepreneurs / MSEs from North-East Region

(1) Particulars	(2) Proposed RSF-II Scheme (Base Case)	(3) Option 1: Concessions provided to Women Entrepreneurs / MSE from North-East Region
Eligible Credit Facility	`1 Crore to `2 Crore	`1 Crore to `2 Crore
Portfolio Mix	-	Regular MSEs: Special MSEs = 70:30

[42] Clean technology includes the renewable energy (wind power, solar power, biomass, hydropower, biofuels), Information Technology, green transportation, and green buildings (lighting, and energy efficient appliances)

(1) Particulars	(2) Proposed RSF-II Scheme (Base Case)	(3) Option 1: Concessions provided to Women Entrepreneurs / MSE from North-East Region
Extent of Credit Guarantee Cover	Upto 65% uniform	Upto 65% uniform
Number of Guarantees	177	Regular MSEs: 124 Special MSEs: 53
One-time Guarantee Fees	1.0%	Regular MSEs: 1.18% Special MSEs: 0.59% (50% concession in one-time fees)
Service Fees	0.26% quarterly on outstanding credit facility	0.26% quarterly on outstanding credit facility

- Based on the primary survey of various stakeholders, D&B India finds that the lending institutions are not providing any special concessions (in addition to regular concessions in interest rates to MSEs) to women entrepreneurs / MSEs from North-East region. Further, these institutions opined that the need for any concessions in structure of RSF-II scheme might be limited for special MSEs.
- However, industry association is of the alternate opinion that additional concessions (in structure of RSF-II scheme) to special MSEs might have positive impact on the loans provided by lending institutions to women entrepreneurs / MSEs from North-East Region. Special MSEs generally face problems in securing funds due to non-availability of collaterals (lack of title on borrower's name) and limited knowledge about sources of funds.
- D&B India has considered a variation in the base case (i.e. proposed structure for RSF-II scheme provided in column no. 2 in the table above) by incorporating concessions to women entrepreneurs / MSEs from North-East region.
- It was assumed that the portfolio mix would be 70:30 (i.e. number of proposals covered under the scheme from regular MSEs would be 70%, while number of proposals covered under the scheme from special MSEs would be 30%).
- The extent of credit guarantee cover is assumed as upto 65% for both categories of MSEs, while a 50% concession in one-time fees is provided to special MSEs (compared to regular MSEs).
- Therefore, if CGTMSE choose to provide concessions to women entrepreneurs / MSEs from North-East region, it needs to charge one-time fees of 0.59% for guarantees provided to special MSEs, while 1.18% for guarantees provided to regular MSEs. In addition, CGTMSE should charge 0.26% quarterly service fees on outstanding credit facility from both categories of MSEs.

Option 2: Extending concessions to minority groups

(1) Particulars	(2) Proposed RSF-II Scheme (Base Case)	(4) Option 2: Concessions provided to Minority groups
Eligible Credit Facility	`1 Crore to `2 Crore	`1 Crore to `2 Crore
Portfolio Mix	-	General Category: Minority Groups = 76:24
Extent of Credit Guarantee Cover	Upto 65% uniform	General Category: Upto 65% Minority Groups: Upto 75%
Number of Guarantees	177	General Category: 134 Minority Groups: 43
One-time Guarantee Fees	1.0%	General Category: 1.14% Minority Groups: 0.57%
Service Fees	0.26% quarterly on outstanding credit facility	General Category: 0.25% quarterly on outstanding credit facility Minority Groups: 0.23% quarterly on outstanding credit facility

- Based on the primary survey of various MLIs, D&B India finds that the lending institutions are providing relaxations to minority groups in terms of age limit, loan eligibility criteria, etc., in addition to regular concessions in interest rates. However, these institutions opined that the need for any special concessions (in structure of RSF-II scheme) to minority groups might be limited.
- D&B India has considered a variation in the base case (i.e. proposed structure for RSF-II scheme provided in column no. 2 in the table above) by providing concessions to minority groups (SC/ST entrepreneurs).
- It was assumed that the portfolio mix[43] would be 76:24 (i.e. number of proposals covered under the scheme from general category would be 76%, while number of proposals covered under the scheme from minority groups would be 24%).
- D&B India has provided higher credit guarantee cover to minority groups (compared to general category MSEs) in the structure of credit guarantee scheme. The extent of credit guarantee cover is assumed as upto 65% for general category and upto 75% for minority groups. Moreover, D&B India has assumed a 50% concession in one-time guarantee fees to minority groups (compared to general category MSEs).
- Therefore, if CGTMSE extends concession to minority groups, it needs to charge one-time guarantee fees of 0.57% to minority groups, while 1.14% for guarantees provided to general category MSEs. In addition, CGTMSE should charge 0.25% quarterly service fees on outstanding credit facility from general category borrowers and 0.23% quarterly service fees on outstanding credit facility from minority groups.

[43] Based on proportion of general category and minority groups in India's population (Source: Census 2001 statistics)

Option 3: Earmarking a portion of fund for Services sector

(1) Particulars	(2) Proposed RSF-II Scheme (Base Case)	(5) Option 3: Earmarking a portion of fund for Services sector
Eligible Credit Facility	`1 Crore to `2 Crore	`1 Crore to `2 Crore
Portfolio Mix	-	Manufacturing: Services = 70:30
Extent of Credit Guarantee Cover	Upto 65% uniform	Manufacturing: Upto 65% Services: Upto 80%
Number of Guarantees	177	Manufacturing: 124 Services: 43
One-time Guarantee Fees	1.0%	Manufacturing: 1.09% Services:0.55%
Service Fees	0.26% quarterly on outstanding credit facility	Manufacturing: 0.34% quarterly on outstanding credit facility Services: 0.17% quarterly on outstanding credit facility

- D&B India finds that 90% of CGTMSE's portfolio[44] constitutes guarantees extended for loans to manufacturing sector, while 10% is for loans to service sector.
- Based on primary survey, D&B India finds that the service sector (even established companies) finds it difficult to secure funds from lending institutions due to lack of sufficient collaterals (fixed assets) compared to manufacturing sector.
- Moreover, the proposed change in the definition of MSE sector (to include retail trade and educational institutions in current RSF-II structure) might have positive impact on the loans to service sector. In addition, FISME mentioned that CGTMSE needs to provide additional support to borrowers in service sector as these borrowers often face constraints in securing funds from lending institutions due to insufficient collaterals. Hence, D&B India has explored a variation in the base case (i.e. proposed structure for RSF-II scheme provided in column no. 2 in the table above) by earmarking a portion of fund for services sector. Details are as follows:
  - Based on primary survey of lending institutions, D&B India finds that the loans to service sector covered under the credit guarantee scheme might increase (as a percentage of total loans covered under the scheme by these lending institutions) from existing level of 10% to 30% due to the proposed changes in the scheme.
  - Hence, it was assumed that the portfolio mix would be 70:30 (i.e. number of proposals covered under the scheme from manufacturing sector would be 70%, while number of proposals covered under the scheme from services sector would be 30%)
  - The extent of credit guarantee cover is assumed as upto 65% for manufacturing sector,

[44] Guarantees to following sectors were grouped under "Services": Information Technology, Repairing Services, Repairing Services except Capital Goods, Repairing Services for Capital Goods, Services (Industry related), Software. All other sectors were grouped under "Manufacturing". Overlap in nature of activities (manufacturing / services) may exist.

while a higher credit guarantee cover of upto 80% is assumed for services sector, while a 50% concession in one-time fees is assumed to services sector (compared to manufacturing sector) in the structure of proposed scheme.

- Therefore, if CGTMSE choose to provide special support to services sector, it needs to extend 43 guarantees to services sector and needs to charge 0.55% as one-time guarantee fees, while 0.17% quarterly service fees on outstanding credit facility.
- Additionally, CGTMSE needs to extend 124 guarantees to manufacturing sector and needs to charge 1.09% as one-time guarantee fees, while 0.34% quarterly service fees on outstanding credit facility.

Option 4: Earmarking a portion of fund for Cleaner technology sectors

(1) Particulars	(2) Proposed RSF-II Scheme (Base Case)	(5) Option 4: Earmarking a portion of fund for Cleaner technology sectors
Eligible Credit Facility	`1 Crore to `2 Crore	`1 Crore to `2 Crore
Portfolio Mix	-	Traditional Tech: Clean Tech = 90:10
Extent of Credit Guarantee Cover	Upto 65% uniform	Traditional Tech: Upto 65% Clean Tech: Upto 80%
Number of Guarantees	177	Traditional Tech: 160 Clean Tech: 14
One-time Guarantee Fees	1.0%	Traditional Tech: 0.95% Clean Tech: 0.48%
Service Fees	0.26% quarterly on outstanding credit facility	Traditional Tech: 0.41% quarterly on outstanding credit facility Clean Tech: 0.20% quarterly on outstanding credit facility

- Various Clean Energy research and trading organizations including Bureau of Energy Efficiency (BEE) defines clean technologies as renewable energy, such as biomass and biofuels, waste-to-energy, solar power, wind power, geothermal, hydropower, and ocean power, hybrid and co-generation, and energy efficiency technologies for power generation; alternative fuels; Information Technology and advanced technologies for transportation. Clean technology should provide efficiency in operations of a company / project, and should essentially reduce emissions.
- According to Ministry of Environment and Forests, general barriers to development of clean technologies in India are:
  - Most of these technologies are proprietary in nature, and are protected by strong patent

regimes held abroad. Due to large premium paid to the vendors (patent owners), in several cases, the projects might become unviable or the end-product cost is significantly higher compared to traditional technologies.

- Coordination in R&D efforts in India aimed at developing a shelf of commercially viable clean technologies is negligible.
- Support from financial institutions in terms of loan approvals is quite low compared to loan approvals to traditional technologies because of high risk and high failure rates involved in cleaner technologies.

- Due to lack of support from financial institutions, most of the clean technology projects are currently funded either through private equity / venture capital support or internal equity sources of a company[45].
- Inspite of the apprehensions about funding to cleaner technologies, MLIs mentioned that the loan approval rate might slightly improve compared to existing scenario, in case CGTMSE provides additional support through credit guarantee scheme to cleaner technology sectors.
- However, FISME is of the alternate view that the credit guarantee scheme should give equal priority to all the sectors instead of focusing on any specific sector(s) or type of borrowers (such as cleaner technology, energy efficient projects, etc.). Further, FISME opined that after CGTMSE attains critical mass of traction and stabilize (sufficient volume of guarantee accounts) it can explore the option of introducing sector-specific funds.
- D&B India finds that CGTMSE's portfolio[46] predominantly consist of guarantees extended to companies operating in traditional technologies (over 95%). D&B India has assumed that the loans to cleaner technology sectors covered under the credit guarantee scheme might increase (as a percentage of total loans covered under the scheme by lending institutions) from existing level of 5% to 10% due to the proposed changes in the scheme.
  - CGTMSE may provide guarantees to loans for projects whose research has already completed and are ready for pilot / full scale implementation, but not for undertaking any research on clean technologies.
  - CGTMSE should ensure that the proposals are classified under clean technology only if the loan application is accompanied by one of the following documents - grants from various Government bodies, Renewable Energy Certificate (REC) from Government of India, Certificate from qualified energy auditors, etc.
- Accordingly, D&B India has assumed that the portfolio mix would be 90:10 (i.e. number of proposals covered under the scheme from traditional technology sectors would be 90%, while

[45] During the year 2010, Clean Technology companies have seen 13 investments worth $462.4 Million (~ `2,221 Crore) from private equity players.

[46] Guarantees to Software and Information Technology sectors only were grouped under "Cleaner Technology". All other sectors were grouped under "Traditional Technology". Overlap in type of technology (traditional / cleaner technology) may exist.

number of proposals covered under the scheme from cleaner technology sector would be 10%).

- The extent of credit guarantee cover is assumed as upto 65% for traditional technology sectors, while a higher credit guarantee cover of upto 80% is assumed for cleaner technology sector, while a 50% concession in both one-time guarantee fees and quarterly service fees is provided to cleaner technology sector (compared to traditional technology sectors).
- Therefore, if CGTMSE choose to provide special support to cleaner technology sector, it needs to extend 14 guarantees to cleaner technology sector and needs to charge 0.48% as one-time guarantee fees, while 0.20% quarterly service fees on outstanding credit facility.
- Additionally, CGTMSE needs to extend 160 guarantees to traditional technology sector and needs to charge 0.95% as one-time guarantee fees, while 0.41% quarterly service fees on outstanding credit facility.

Option 5: Risk Based Differential Pricing

(1) Particulars	(2) Proposed RSF-II Scheme (Base Case)	(5) Option 5: Risk Based Differential Pricing
Eligible Credit Facility	`1 Crore to `2 Crore	`1 Crore to `2 Crore
Portfolio Mix	-	Grade 1 Banks*: 38.7% Grade 2 Banks*: 34.6% Grade 3 Banks*: 11.9% Grade 4 Banks*: 14.7%
Extent of Credit Guarantee Cover	Upto 65% uniform	Upto 65% uniform
Number of Guarantees	177	Total: 177 Grade 1 Banks: 69 Grade 2 Banks: 61 Grade 3 Banks: 21 Grade 4 Banks: 26
One-time Guarantee Fees	1.0%	1.0%
Service Fees	0.26% quarterly on outstanding credit facility	Grade 1 Banks: 0.16% Grade 2 Banks: 0.37% Grade 3 Banks: 0.54% Grade 4 Banks: 0.87%

*D&B India has classified various Member Lending Institutions into four Grades based on NPA rates as on March 2010

- D&B India has discussed the matter of introduction of risk-based guarantee fee with various MLIs. Presently, the risk assessment process for approval of credit guarantee loans is not uniform across various MLIs. In order to arrive at uniform risk assessment model, CGTMSE would require to participate in the risk assessment process of MLIs.

- Moreover, MLIs mentioned that they are not favorably inclined to the idea of differential rates of guarantee fee. However, few banks opined that the scheme should provide some relaxations / concessions based on their track record with CGTMSE.
- D&B India has considered a variation in the base case (i.e. proposed structure for RSF-II scheme provided in column no. 2 in the table above) by providing differential rates for various MLIs based on riskiness of the proposals covered by them under the credit guarantee scheme (including concessions to MLIs based on their track record with CGTMSE).
- For the purpose of calculations, D&B India has classified various Member Lending Institutions into four grades based on NPA rate[47] as on March 2010.
- D&B India has calculated the cut-off grades based on dispersion of data on NPA rates of various MLIs (for guarantees obtained from CGTMSE) as on March 2010. The cut-off grades are as follows:
  - Grade 1 Banks: Upto 1.67% ;
  - Grade 2 Banks: Above 1.67% and upto 2.54%
  - Grade 3 Banks: Above 2.54% and upto 4.01%
  - Grade 4 Banks: Above 4.01%
- Details are as follows:

Grade 1 (Top 30) MLIs **(NPA Rate below 1.67%)**	**Grade 2 MLIs** **(NPA Rate between 1.67% and 2.54%)**
Bank of India	Syndicate Bank
Bank of Baroda	Indian Bank
Small Industries Development Bank Of India	Punjab & Sind Bank
Allahabad Bank	State Bank of India
IDBI Bank Ltd	State Bank of Mysore
Bank of Maharashtra	Indian Overseas Bank
State Bank of Bikaner & Jaipur	Punjab National Bank
State Bank of Hyderabad	Axis Bank Limited
The Federal Bank Ltd	**Grade 3 MLIs** **(NPA Rate above 2.54% and below 4.01%)**
State Bank of Patiala	Union Bank of India
Karnataka Vikas Grameena Bank	Oriental Bank of Commerce
Purvanchal Gramin Bank	Central Bank of India
HDFC Bank Limited	Andhra Bank
Prathama Bank	Vijaya Bank
State Bank of Indore	Corporation Bank
Ing Vysya Bank Ltd	South Malabar Gramin Bank

[47] Ratio of total outstanding NPA amount to amount approved by CGTMSE as on March 2010

Grade 1 (Top 30) MLIs (NPA Rate below 1.67%)	Grade 4 MLIs (NPA Rate above 4.01%)
Uttaranchal Gramin Bank	NSIC
Aryavart Gramin Bank	UCO Bank
Durg Rajnandgaon Gramin Bank	Dena Bank
The Nainital Bank Ltd.	Canara Bank
The Jammu & Kashmir Bank Ltd	United Bank of India
Assam Gramin Vikash Bank	State Bank of Travancore
Deutsche Bank	
Tripura Gramin Bank	
Himachal Gramin Bank	
ICICI Bank	
Tamilnad Mercantile Bank Ltd	
Baroda Uttar Pradesh Gramin Bank	
Allahabad UP Gramin Bank	
Delhi Financial Corporation	

* Top 30 Grade 1 banks listed above cover 98.2% of total approved proposals and 99.6% of total approved amount in Grade 1 category.

- The details of number of approved proposals and total approved amount by each grade of MLI as on March 2010 are as follows:

Details	Grade 1	Grade 2	Grade 3	Grade 4	Total
Number of Approved Proposals (as a % of total number of approved proposals)	90,431 (30.2%)	120,782 (40.3%)	27,347 (9.1%)	61,150 (20.4%)	299,710 (100%)
Total Approved Amount in ` Crore (as a % of total approved amount)	445,799.56 (38.7%)	398,819.14 (34.6%)	136,816.60 (11.9%)	169,757.13 (14.7%)	1,151,192.44 (100%)

- It was assumed that the portfolio mix for RSF-II scheme would be same as existing CGTMSE's portfolio mix i.e. amount covered under the scheme by various MLIs would be 38.7% for Grade 1 MLIs, 34.6% for Grade 2 MLIs, 11.9% for Grade 3 MLIs, 14.7% for Grade 4 MLIs.

- The extent of credit guarantee cover is assumed as upto 65% uniform for all the MLIs. Differential rates in service fees are assumed for all the MLIs based on their track record of NPA rate[48] with CGTMSE, while a uniform one-guarantee fee is assumed for all MLIs.

- If CGTMSE choose to adopt a risk based differential pricing model, it needs to extend total 177 guarantees under the scheme.

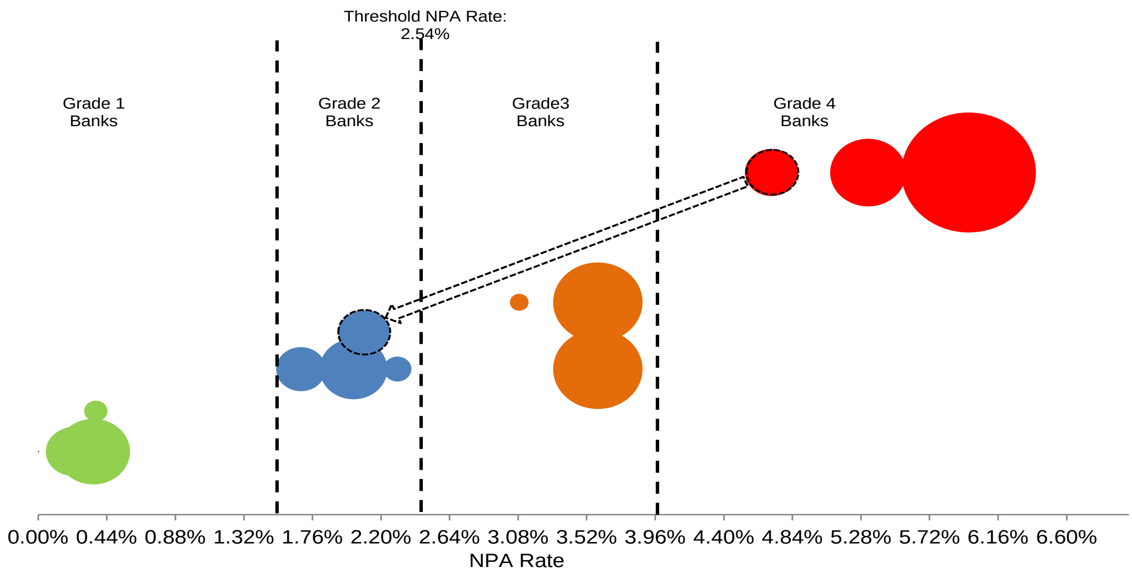
[48] NPA rates of each grade of bank is relative to cut-off NPA rate, which is assumed as 2.54% (NPA rate of CGTMSE's portfolio)

- 69 guarantees to Grade 1 MLIs, 61 guarantees to Grade 2 MLIs, 21 guarantees to Grade 3 MLIs, and 26 guarantees to Grade 4 MLIs.

- A uniform guarantee fee of 1.0% will be charged to all MLIs while differential rates in service fees are assumed for various MLIs as follows:
  - Grade 1 MLIs, because of their good track record with significantly low NPA rate, will be charged a lower service fee (compared to Grade 2 MLIs) of 0.16%
  - Grade 2 MLIs, with good track record and cut-off NPA rate, will be charged a service fee of 0.37% of outstanding credit facility
  - Grade 3 MLIs, with good track record and higher NPA rate, will be charged a service fee of 0.54% of outstanding credit facility
  - Grade 4 MLIs, with good track record and significantly higher NPA rate, will be charged a service fee of 0.87% of outstanding credit facility
- NPA rate should be calculated as ratio of outstanding NPA amount to amount approved by CGTMSE as on date. The calculation of NPA rate of each bank (and their classification into various grades) will be dynamic in nature, and CGTMSE has to review the NPA rate of each bank once in every six months ("Review Period").
- During the review period, MLIs can constantly improve their grading position by covering good cases (whose perceived risk by the bank is low) with CGTMSE[49].

Illustration:

Scenario 1: Reduction in NPA Rate of a Bank from Existing Level



Source: D&B India

[49] By registering good cases (whose perceived risk by the banks is low) with CGTMSE, the existing NPA rate can be kept constant inspite of increase in loan amount by the bank. Thereby the NPA rate of the bank will be lowered.

- As shown in the above figure, each bubble indicates a bank classified into one of the four grades based on its NPA rate as on March 2010. Size of the bubble indicates approved amount to a bank by CGTMSE in `Crore.
- Bank A (say) is currently in Grade 4 category due to high NPA rate for total guarantees obtained from CGTMSE. So, for all the proposals it registers with CGTMSE, it has to pay a one-time guarantee fees of 1% and higher quarterly service fees of 0.87% on outstanding credit facility.
- During review period, if Bank A maintains a lower NPA rate on existing cases and improve on its credit assessment process to provides new cases (whose perceived risk by the bank is low) to CGTMSE, the overall bank grading by CGTMSE may improve (say Grade 2) in the next review period.

Existing Scenario: NPA rate is high due to which the bank is in Grade 4

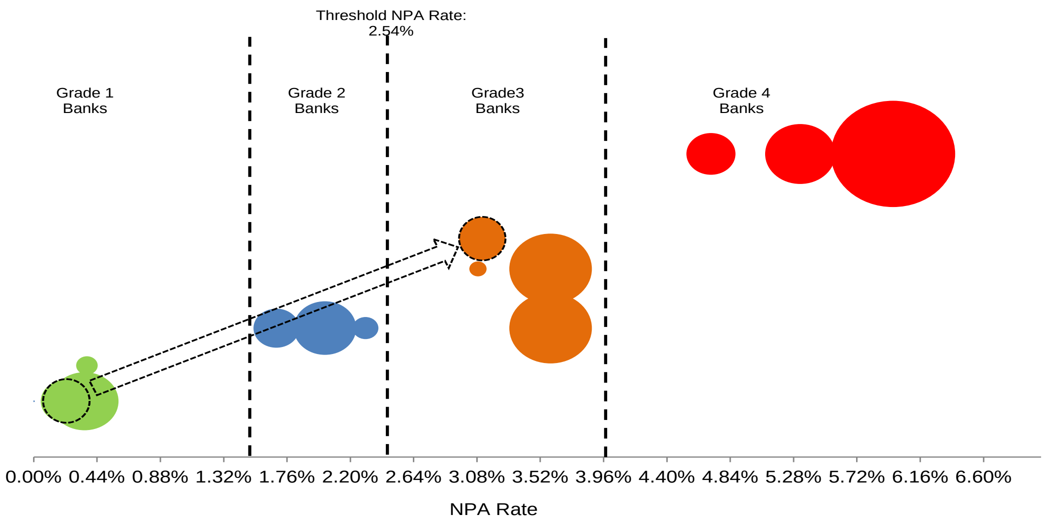
$$NPA\ Rate = \frac{Oustanding\ NPA\ amount}{Amount\ approved\ by\ CGTMSE}$$

After Review Period: NPA rate may reduce due to which the bank grade will improve (say Grade 2)

$$NPA\ Rate = \frac{Oustanding\ NPA\ amount\ of\ old\ loans + (new\ loans = 0)}{Amount\ approved\ by\ CGTMSE\ for\ old\ loans + new\ loans}$$

- Consequently, Bank A will benefit from the reduced quarterly service fees of 0.37% for all its cases registered with CGTMSE (for both old and new cases under the proposed scheme).

Scenario 2: Increase in NPA Rate of a Bank from Existing Level



Source: D&B India

- Bank B (say) is currently in Grade 1 category due to low NPA rate in guarantees obtained from CGTMSE. So, for all the proposals that it register with CGTMSE, it has to pay a one-time guarantee fees of 1% and enjoys a concessional quarterly service fees of 0.16% on outstanding credit facility.
- During review period, if Bank B fails to maintain its lower NPA rates and provides default cases (whose perceived risk by the bank is higher) to CGTMSE, the overall bank grading by CGTMSE will deteriorate (say Grade 3) in the next review period.

Existing Scenario: NPA rate is low due to which the bank is in Grade 1

$$NPA\ Rate = \frac{Oustanding\ NPA\ amount}{Amount\ approved\ by\ CGTMSE}$$

After Review Period: NPA rate increased due to which the bank grade will shift to Grade 3 (say)

$$NPA\ Rate = \frac{Oustanding\ NPA\ amount\ of\ old\ loans + new\ loans}{Amount\ approved\ by\ CGTMSE\ for\ old\ loans + new\ loans}$$

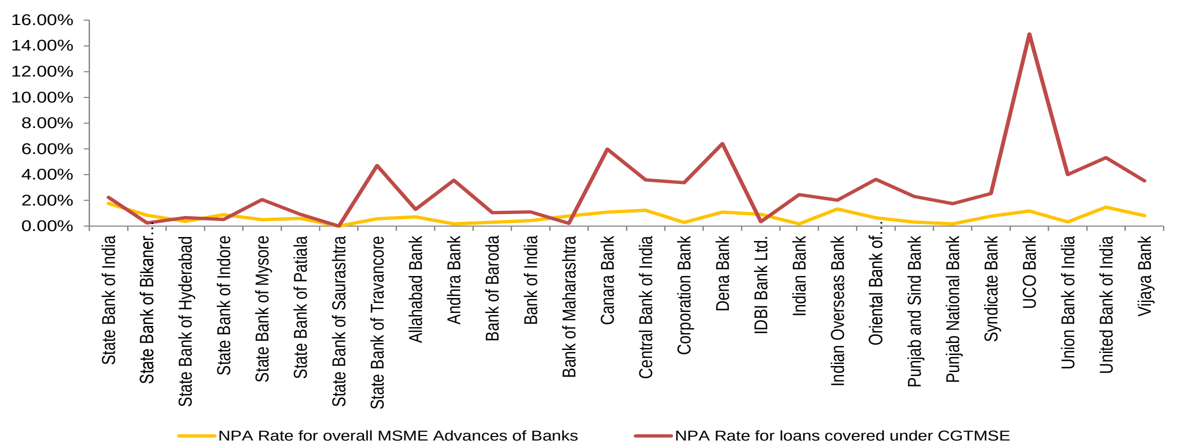
- Consequently, Bank B may not be able to maintain the concessional rates and would pay high quarterly service fees of 0.54% for all its cases registered with CGTMSE (for both old and new cases under the scheme).
- With this risk based pricing mechanism, MLIs with rigorous credit assessment process and lower NPA rates will be benefited with concessional rates for quarterly service fees. Other MLIs, with higher NPA rates, will try to maintain or reduce their NPA rates to improve their grades to benefit from concessional rates.

Option 6: Portfolio based Guarantees

(1) Particulars	(2) Proposed RSF-II Scheme	(6) Option 6: Portfolio based Guarantees
Eligible Credit Facility	`1 Crore to `2 Crore	`1 Crore to `2 Crore
Extent of Credit Guarantee Cover	Upto 65% uniform	Upto 65% uniform
NPA Rate	2.54%	0.72%
Leverage Ratio	3.68	12.99
Number of Guarantees	177	625
One-time Guarantee Fees	1.0%	0.28%
Service Fees	0.26% quarterly on outstanding credit facility	0.09% quarterly on outstanding credit facility

- D&B India tried to obtain details on the portfolio of various MLIs related to classification of loans (slab-wise, sector-wise etc.), default rate of loans etc. However, these details were not shared by MLIs citing that these details are confidential in nature.
- Due to lack of sufficient data from MLIs on their portfolio, in order to explore the concept for its theoretical understanding, D&B India has used the information available in public domain to arrive at the concept of portfolio based guarantees.
- NPA rates of various banks[50] for their overall MSME advances and for proposals covered under CGTMSE are as follows:
    - For overall MSME lending, the median NPA rate for State Bank group is 0.60% and median NPA rate for various nationalized banks is 0.75%
    - For proposals covered under CGTMSE, the median NPA rate for State Bank group is 0.79% and median NPA rate for various nationalized banks is 2.96%.

NPA rate of various banks for overall MSME advances and loans covered under CGTMSE



Source: RBI and CGTMSE

- The high risk associated with the proposals covered by various banks (compared to the NPA rate in overall advances to MSMEs) has a bearing on leverage ratio of the corpus fund (which is determined in base case as 3.68 at an overall NPA rate of 2.54%).
- However, if CGTMSE adopts a portfolio based lending approach[51], the NPA rate of CGTMSE will be similar to the NPA rate of respective MLI.
- In such case, CGTMSE can have higher leverage for its corpus fund as the overall NPA rate of CGTMSE's corpus fund will be low (due to presence of both high risk and low risk proposals in the portfolio) compared to existing level of 2.54%. If the default rate is low, CGTMSE can cover even larger portfolios of banks.

[50] Source: RBI and details provided by CGTMSE

[51] CGTMSE will tie-up with a MLI for covering all MSE loans extended by the bank under credit guarantee scheme

Portfolio-based Guarantees Concept

- (Say) CGTMSE ties-up with Bank for covering all loans provided to MSE sector in the range of `1 Crore to `2 Crore and the extent of credit guarantee cover is 65%.
- The relation between bank portfolio, loan default rate and RSF-II corpus fund can be explained through the following formula:

$$\textit{Bank Portfolio X Default rate} = \textit{RSF Corpus fund} + \textit{Constant}$$

- It means that if the bank portfolio is high, then the default rate should be low in order to maintain the corpus fund at same level[52].

Default Rate		Small	Large
	High	Undesirable	Neutral
	Low	Neutral	Desirable
		Bank Portfolio	

- If the bank's portfolio is low / high and the default rate is also high, then quarterly service fees will not be sufficient to cover the claims received by CGTMSE[53], ultimately affecting the RSF-II corpus fund.
- Hence, D&B India has proposed a uniform default rate cap of 2.54%[54] ("Specified Limit") in the proposed scheme for any MLI that CGTMSE may partner with. This specified limit ensures that the maximum risk borne by CGTMSE is limited to 2.54% of total portfolio of the bank covered under the scheme.
- In case a MLI breaches the specified limit, the maximum claim amount payable by CGTMSE will still remain at 2.54% of total registered portfolio of MLI.
- The following scenarios provide an illustration of the above details:

[52] It is not desirable to have low bank's portfolio with high default rate

[53] It was assumed that Quarterly service fee will cover claim amount and one-time guarantee fees will cover operating expenses of the scheme

[54] Median NPA rate calculated from historical data of CGTMSE

Scenario 1: Portfolio details of Bank A (Having large presence in MSE lending):

- Total MSE advances of the bank in the range of `1 Crore to `2 Crore as on March 2010 is `1,850 Crore[55] and NPA rate of the bank for loans in the range of `1 Crore to `2 Crore as on March 2010 is 0.72%[56].
- With default rate of 0.72%, CGTMSE can leverage its corpus fund upto 12.99 times, and can provide guarantees to the tune of `938.23 Crore, which covers 51% of total portfolio of MSE advances of the bank in the range of `1 Crore to `2 Crore as on March 2010.
- As the volume of guarantees is high, CGTMSE can have a significantly low fee structure (one-time guarantee fees and quarterly service fees) due to distribution of expenses over large customer base.
- (Say) If the leverage ratio of CGTMSE increases beyond 12.99 times to say 15 times at 0.72% default rate, then RSF-II corpus fund will become `40.66 Crore instead of `46.94 Crore i.e. the corpus fund is deteriorated to the tune of `6.28 Crore. So, it is not feasible for CGTMSE to go beyond 12.99 times leverage ratio at 0.72% default rate for bank A.
- Similarly, the cut-off amount that can be guaranteed by CGTMSE or leverage ratio can be calculated as follows:

$$\frac{Total\ amount\ that\ can\ be\ guaranteed\ by\ CGTMSE\ X\ Extent\ of\ Credit\ guarantee\ cover}{Leverage\ ratio} = RSF - II\ Corpus\ fund$$

Or

$$Total\ amount\ that\ can\ be\ guaranteed\ by\ CGTMSE\ X\ Extent\ of\ credit\ guarantee\ cover\ X\ Default\ rate = RSF - II\ Corpus\ fund + Constant$$

- However, if the bank desires to obtain credit guarantee support to complete portfolio i.e. `1,850 Crore, then it has to reduce its existing default rate of 0.72% to 0.37%, which is highly difficult to achieve. Hence, the overall proposal may seem unreasonable to the bank.

[55] D&B India has assumed that total MSME advances of Bank A as on March 2010 as `15,423 Crore, out of which 80% is from loans to MSE sector. In the year Mar 2010, it was assumed that the breakup of loans to MSE sector by Bank A in the range of `1 Crore and `2 Crore is 15%.

[56] Say NPA rate of Bank A for overall MSME advances is 0.44%

Scenario 2: Portfolio details of Bank B (Having small presence in MSE lending):

- Total MSE advances of the bank in the range of `1 Crore to `2 Crore as on March 2010 is `250 Crore[57] and NPA rate of the bank for loans in the range of `1 Crore to `2 Crore as on March 2010 is 1.72%[58]
  - With default rate of 1.72%, CGTMSE can leverage its corpus fund upto 5.44 times, and can provide guarantees to the tune of `392.75 Crore, which covers 100% of total portfolio of MSE advances of the bank in the range of `1 Crore to `2 Crore as on March 2010.
  - Alternatively, the bank can avail complete portfolio support from CGTMSE upto a default rate of 2.70%. However, due to default rate cap, the bank will not be entitled to complete portfolio support if its default rate exceeds 2.54%. So, the bank has to balance its portfolio by minimizing the default cases with CGTMSE so that the NPA rate does not exceed 2.54% at any point in time.

- For the purpose of calculations, D&B India has assumed that the NPA rate of a MLI as 0.72%[59]. As the NPA rate is low, CGTMSE can leverage the fund to as high as 12.99 (i.e. it can extend guarantees to the tune of `938.23 Crore with a corpus fund of `46.94 Crore in RSF-II scheme).
- In addition, D&B India has assumed that the extent of credit guarantee cover would be 65% uniform for all the proposals. Accordingly, CGTMSE can provide 625 guarantees in the range of `1 Crore to `2 Crore.
- As volume of guarantees is significantly high and NPA rate lower than the uniform default rate cap, one-time guarantee fees will be reduced to 0.28% only and quarterly service fees would be nominal at 0.09% of outstanding credit facility. Hence, the MLI can receive credit guarantee at concessional rate.
- D&B India recommends that CGTMSE should calculate "Specific Limit" for MLIs if it wishes to offer portfolio based guarantee scheme to MLIs. This will ensure that the corpus fund of RSF-II scheme is not affected. Similarly, MLIs with loan portfolio of lower NPA rates will receive credit guarantee at concessional rates

[57] D&B India has assumed that total MSME advances of Bank A as on March 2010 as `1,150 Crore, out of which 80% is from loans to MSE sector. In the year Mar 2010, it was assumed that the breakup of loans to MSE sector by Bank B in the range of `1 Crore and `2 Crore is 15%.

[58] Say NPA rate of Bank B for overall MSME advances is 0.44%

[59] Median NPA rate of State Bank group and various nationalized banks

Structure of RSF-II Scheme

Snapshot of the Proposed Scheme

Particulars	Features of CGTMSE Scheme	Features of Proposed RSF-II Scheme
Eligible Credit Facility	< `5 Lakh up to `1 Crore	`1 Crore to `2 Crore
Extent of Credit Guarantee Cover	• Up to `5 Lakh: 85% of the amount in default • Above `5 Lakh and up to `50 Lakh: 75% of amount in default • Above `50 Lakh and up to `1 Crore: Incremental 50% of amount in default	Up to 65% uniform
One-time Guarantee Fees	1.0%	1.0%
Service Fees	0.50% annual on credit facility sanctioned	0.26% quarterly on outstanding credit facility
Lock-in Period	18 months	18 months

Definitions

a. **Credit Facility:** Any financial assistance by way of term loan and / or fund based and non-fund based working capital (e.g. Bank Guarantee, Letter of credit etc) facilities extended by the lending institution to the eligible borrower.

For the purpose of calculation of guarantee fee, the “credit facility extended” shall mean the amount of financial assistance committed by the lending institution to the borrower, whether disbursed or not.

For the purpose of the calculation of service fee, the “credit facility extended” shall mean the outstanding credit facilities (both fund and non-fund based) covered under credit guarantee scheme and for which guarantee fee has been paid, as at March 31, of the relevant year. The outstanding credit facilities shall be calculated by the lending institution at the end of every quarter ended June 30, September 30, December 31 and March 31 during the tenure of the credit facilities.

b. **Collateral Security:** The scheme may cover the credit facilities which are secured by both primary collateral and secondary collaterals.

"Primary collateral" in respect of a credit facility shall mean the assets created out of the credit facility so extended and / or existing unencumbered assets which are directly associated with the project or business for which the credit facility has been extended.

"Secondary collateral" means the security provided in addition to the primary security, in connection with the credit facility extended by a lending institution with no personal liability to the borrower.

c. **Eligible Borrower:** New or existing Micro and Small Enterprises to which credit facility has been provided by the lending institution with or without any collateral security and / or third party guarantees. As per the MSMED Act, 2006, the 'Micro and Small Enterprises (MSEs)' means industrial undertakings or a business concerns or any other establishments, by whatever name called:

   i. Engaged in the manufacture or production of goods, in any manner, pertaining to any industry specified in the First Schedule to the Industries (Development and Regulation) Act, 1951 or;

   ii. Engaged in providing or rendering of any service or services (including retail trade and educational institutions).

d. **Guarantee Cover:** Maximum cover available per eligible borrower in respect of the credit facility extended by the lending institution.

e. **Tenure of Guarantee Cover:** The maximum period of guarantee cover from Guarantee start date which shall run through the agreed tenure of the term credit and for a period of 5 years or block of a 5 years where working capital facilities alone are extended or loan termination date, whichever is earlier or such period as may be specified by the Trust.

Scope and Extent of the Scheme

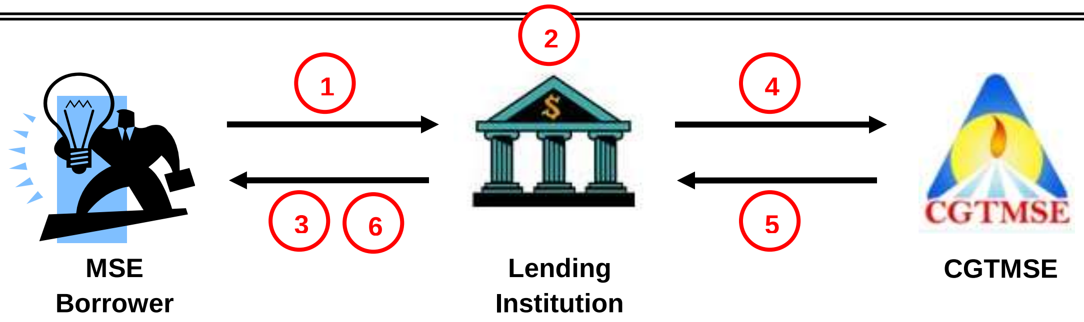
<u>Credit Facilities Eligible under the Scheme</u>

CGTMSE can cover credit facilities extended by MLIs which meet the internal rating criteria for sanction of credit in respect of a single eligible borrower in the MSE sector for a minimum of `1 Crore and not exceeding `2 Crore[60] ("Eligible Credit Facility"). The credit facilities can cover various loans provided by MLIs (after MLIs enter into an agreement with CGTMSE) to MSEs by way of term loans and / or working capital facilities.

[60] As this would atleast cover the category of small enterprises (engaged in services as per the definition proposed under the MSMED act, 2006)

MLIs can accept collateral security and / or third party guarantees from MSEs to the extent of the unsecured portion of the amount (which is not covered under the scheme). At the time of registering the credit facility proposal with CGTMSE, lending institutions need to submit the fair value of the collaterals, assessment done by an independent valuer. The lending institution should apply for a guarantee cover within a period of 90 days from the date of sanction of loan to the borrower.

Illustration:



1. Borrower approaches a Bank with loan requirement of `2 Crore.
2. Bank conducts a detailed assessment of the borrower (including sufficiency of collateral provided by the borrower) based on its internal rating criteria and / or additional credit rating by provided by rating agencies. In addition, Bank obtains a report on fair value of the collaterals provided by the borrower, if any, by an independent valuer.
3. Bank sanctions the loan to the borrower (in-principal approval subject to approval of guarantee cover by CGTMSE. In case, CGTMSE declines the proposal, Bank will provide the final approval / disbursement only if the borrower provides sufficient collateral).
4. Bank submits an application to CGTMSE (within 90 days from date of sanction of the loan) specifying details such as borrower profile, credit facility requirements, fair value of the collaterals obtained from borrower, credit rating of the borrower and extent of guarantee cover required.
5. CGTMSE checks the application submitted by the bank and approves the guarantee cover to the lending institution. (In case, CGTMSE rejects any application, it will assign reasons for the same to the bank, which will enable the branches for correct submission of applications, or resubmission of proposals).
6. Bank provides the final approval to the borrower.

In addition to the above, lending institutions should adhere to the following necessary conditions at the time of applying for a guarantee cover:

1) The dues to the lending institution should not have become bad or doubtful of recovery; and /

or

2) The business or activity of the borrower for which the credit facility was granted has not ceased; and / or

3) The credit facility has not wholly or partly been utilized for adjustment of any debts deemed bad or doubtful of recovery, without obtaining a prior consent in this regard from CGTMSE.

4) Credit facilities extended by more than one bank and / or financial institution jointly and / or separately to eligible borrower up to a maximum of `2 Crore per borrower subject to ceiling amount of individual MLI or such amount as may be specified by CGTMSE.

Illustration	
Scenario 1: Credit Facility Requirements Provided by MLIs with Collaterals	
Credit Facility Requirement (In ` Lakh)	200
Collateral Obtained by Lending Institutions (In ` Lakh) (Considering collateral requirement as 1.5 times Credit Facility Requirements)	300
Recovery Rate of Lending Institutions in case of Default (40% - 60%)[61]	50%
Amount Recovered in case of Default (In ` Lakh)	100
Scenario 2: Credit Facility Requirements Provided by MLIs with Credit Guarantee Scheme and Collaterals (Proposed Structure)	
Credit Facility Requirement (In ` Lakh)	200
Amount covered under Credit Guarantee Scheme (In ` Lakh) (Considering Extent of Credit Guarantee Cover as 65% of eligible credit facility requirements)	130
Unsecured Amount (In ` Lakh)	70
Collateral Obtained by Lending Institutions for unsecured amount (In ` Lakh) (Considering collateral requirement as 1.5 times Credit Facility Requirements)	105
Amount Recovered in case of Default (In ` Lakh) (Considering Recovery Rate from CGTMSE as 75% (1st Installment) of guaranteed amount and Bank's recovery Rate as 50% of unsecured amount)	132.50
Source: D&B India (Inputs obtained from primary survey of MLIs on collateral requirements and recovery rate in loans over `1 Crore)	

[61] Minimum recovery time is 12-24 months (Inputs obtained from primary survey of MLIs)

Benefits to Member Lending Institutions with the Proposed Structure

1. Lending Institutions will have flexibility to decide between the following two options for loan requirements over `1 Crore and up to `2 Crore:
   a. Providing loans by taking collaterals from borrowers
   b. Providing loans by taking credit guarantee cover from CGTMSE and collaterals from borrowers (for amount not covered under credit guarantee scheme)
2. In case of a default, Lending Institutions will get an assured recovery of 48.75% from CGTMSE if the bank opts for a credit guarantee cover (along with collaterals for unsecured portion). This will enable lending institutions to estimate their cash flows with much more accuracy (for NPA accounts).
3. Lending Institutions will have higher realization from a defaulted account by taking a credit guarantee cover along with collaterals instead of taking only collaterals (Recovery rate in case of only collaterals is in the range of 40%-60%, while recovery rate in case of credit guarantee cover along with collaterals is 66.25%[62])

Credit Facilities Not Eligible under the Scheme

The following credit facilities **shall be excluded** for being guaranteed under the Scheme:

i. Any credit facility in respect of which risks are additionally covered under a scheme operated / administered by Deposit Insurance and Credit Guarantee Corporation or the Reserve Bank of India, to the extent they are so covered.

ii. Any credit facility in respect of which risks are additionally covered by Government or by any general insurer or any other person or association of persons carrying on the business of insurance, guarantee or indemnity, to the extent they are so covered.

iii. Any credit facility, which does not conform to, or is in any way inconsistent with, the provisions of any law, or with any directives or instructions issued by the Central Government or the Reserve Bank of India, which may, for the time being, be in force.

iv. Any credit facility granted to any borrower, who has availed himself of any other credit facility covered under this scheme or under the schemes mentioned in clause (i), (ii) and (iii) above and where the lending institution has invoked the guarantee provided by the Trust or under the schemes mentioned in clause (i), (ii) and (iii) above, but has not repaid any portion of the amount due to the Trust or under the schemes mentioned in clause (i), (ii) and (iii) above, as the case may be, by reason of any default on the part of the borrower in respect of that credit facility.

[62] Realization from credit guarantee cover is 48.75% and realization from collaterals taken for unsecured portion is 17.50%

Agreement to be executed by the lending institution

In order to avail guarantee cover under this scheme in respect of any eligible credit facilities granted by a lending institution, it should necessarily enter into an agreement in such form as may be required by the CGTMSE.

Responsibilities of lending institution under the scheme

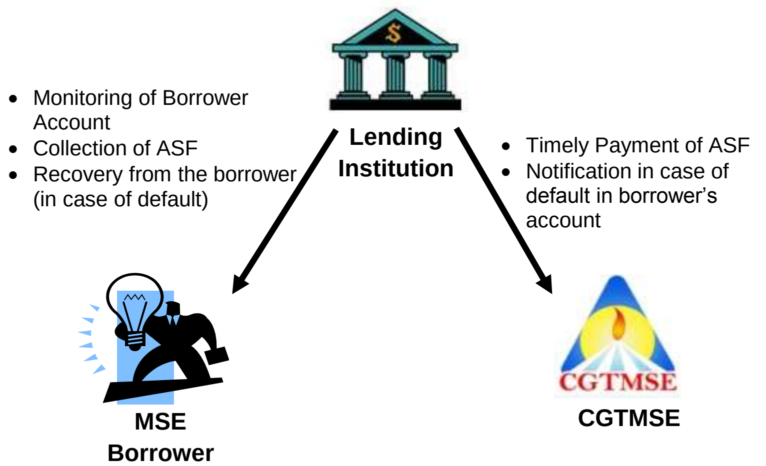
The lending institution shall evaluate credit applications by using prudent banking judgment and shall use their business discretion / due diligence in selecting commercially viable proposals and conduct the account(s) of the borrowers with normal banking prudence.

Based on the study of structure of various international credit guarantee organizations, and in context of the various needs of the stakeholders of credit guarantee schemes in India, D&B India proposes the formation of a Collection Agency[63] to monitor collection of service fees, ensure timely collection of Quarterly Service Fees and notification to MLI and CGTMSE in case of any default. Please refer to the previous chapter for the benefits accrued to CGTMSE and various Member Lending Institutions by engaging a collection agency.

Illustration:

Current Scenario: Responsibilities of Lending Institution

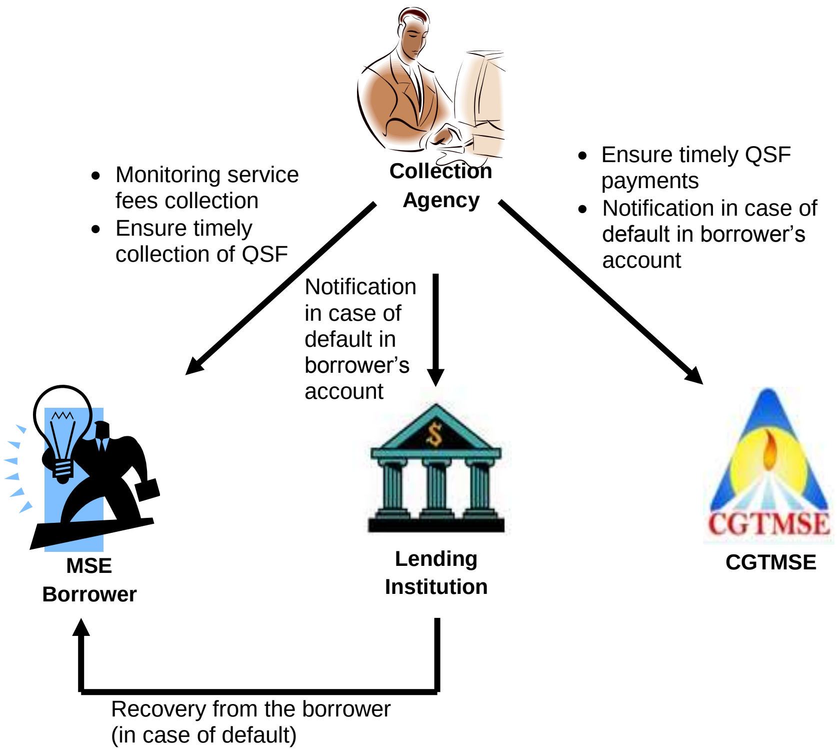
1. Bank closely monitors borrower account covered under CGTMSE. The lending institution safeguards the primary securities taken from the borrower in respect of the credit facility in good and enforceable condition.



2. Bank pays service fees periodically to CGTMSE and debits the same from borrower's account.
3. Once the account turns NPA, the borrower stops servicing the account. Bank notifies CGTMSE about the same. Bank pays ASF to CGTMSE even after borrower account becomes NPA till settlement of the Claim.

[63] Refer next chapter for detailed responsibilities of Collection Agency

Proposed Scenario: Revised Responsibilities



1. Collection Agency liaisons with lending institutions (head office / branches) and monitors the collection of service fees for accounts covered under CGTMSE.
2. The Collection Agency calculates the outstanding credit facility at the end of every quarter during the tenure of the loan based on information furnished by MLI branch, and collects the Quarterly Service Fees from the respective MLI Head Office. This system ensures timely payment of QSF to CGTMSE and avoids any chances of closure of borrower accounts by CGTMSE due to delay in payment of ASF.
3. In case of any default in borrower account, Collection Agency will notify the same to MLI and CGTMSE for further action.

D&B India agrees with the recommendation of 'Review Committee report on operations of CGTMSE' on discontinuation of collection of Service Fees from lending institutions from the date the account becomes NPA. The lending institution should lodge the guarantee claim (without any delay on its part) in the form and in the manner and within such time as may be specified by CGTMSE.

The payment of guarantee claim by CGTMSE to the lending institution does not take away the responsibility of the lending institution to recover the entire outstanding amount of the credit from the borrower. The lending institution shall exercise all the necessary precautions and maintain its recourse to the borrower for entire amount of credit facility owed by it and initiate such necessary actions for recovery of the outstanding amount, including such action as may be advised by CGTMSE. In addition, the lending institution shall comply with the directions, if any, issued by the Trust (from time to time) for facilitating recoveries in the guaranteed account, or safeguarding its interest as a guarantor, and the lending institution shall be bound to comply with such directions.

Guarantee Fees

Guarantee Fee

A one-time guarantee fee at the rate of 1.0% of the credit facility sanctioned, (comprising term loan, and / or working capital facility) shall be paid upfront to CGTMSE by the lending institution availing the guarantee cover.

Service Fee

A quarterly service fee at the rate of 0.26% on the outstanding guarantee amount, shall be paid to CGTMSE within 30 days of every quarter i.e. before July 31, October 31, January 31and April 30 of every year during the tenure of the loan. The service fees shall be collected from borrower accounts by a third-party collection agency and deposits the same with CGTMSE.

Any delay beyond 30 days in payment of QSF and / or non-payment QSF in borrower accounts will be treated as default, and the collection agency on-timely basis shall report regarding these delay / non-payments of QSF to the concerned lending institution and CGTMSE.

The guarantee under the scheme shall not be available to the lending institution unless CGTMSE agrees for continuance of guarantee and the lending institution pays penal interest on the service fee due and unpaid at 4% over Bank Rate, per annum, or at such rates specified by CGTMSE from time to time, for the period of delay.

In addition, in the event of non-payment of quarterly service fee within the stipulated time or such extended time, liability of CGTMSE to guarantee such credit facility would lapse in respect of those credit facility against which the service charges are due and not paid.

Extent of Guarantee

The Trust shall provide guarantee cover of up to 65% of the eligible credit facility extended by the lending institution to a borrower, subject to a maximum amount of `97.50 Lakh (Rupees Ninety Seven Lakh Fifty Thousand only) per borrower. The guarantee cover will commence from the date of payment of guarantee fee and shall run through the agreed tenure of the term credit. Where working capital alone is extended to the eligible borrower, the guarantee cover shall be for a period of 5 years or a block of 5 years, or for such period as may be specified by CGTMSE.

Claims

Invocation of Guarantees and Settlement of Claims

The lending institution may invoke the guarantee in respect of eligible credit facility within a maximum period of one year from date of NPA, if NPA is after lock-in period or within one year of lock-in period, if NPA is within lock-in period, if the following conditions are satisfied:

a. The guarantee in respect of that credit facility is in force

b. The lock-in period of 18 months from either the date of last disbursement of the loan to the borrower or the date of payment of the guarantee fee in respect of credit facility to the borrower, whichever is later, has elapsed;

c. The amount due and payable to the lending institution in respect of the credit facility has not been paid and borrower account has been classified as NPA by the lending institution.

d. The loan facility has been recalled and the recovery proceedings have been initiated under due process of law;

The Trust shall pay 75% of the guaranteed amount to the lending institution, within 30 days, subject to the claim being found in order and complete in all respects. The balance 25% of the guaranteed amount will be paid on conclusion of recovery proceedings by the lending institution. On a claim being paid, the Trust shall be deemed to have been discharged from all its liabilities on account of the guarantee in force in respect of the borrower concerned.

In case of claims settled accounts, the lending institution shall apportion the recovery amount (75% of recovery amount from defaulted borrowers by way of takeover of their assets) and shall pay this apportioned amount to CGTMSE. Lending institutions do not need to seek permission of CGTMSE for adjusting the settled amounts to the borrower’s account (as MLIs furnish an undertaking that they would take all possible steps for recovery including legal action). The lending institution shall pay recovery amount in full first to CGTMSE before it claims the remaining 25% of the guaranteed amount.

International Study

D&B India conducted a detailed study on credit guaranteed schemes internationally, in order to identify the best practices followed by these international funds in terms of:

1. Eligible credit facilities
2. Guarantee Fee
3. Annual Service Fee
4. Guarantee coverage
5. Participating FIs
6. Procedure for invocation of guarantee
7. Claims settlement mechanism
8. Taxation structure

In addition to the above, D&B studied various successful / innovative risk sharing models for SMEs in these countries.

D&B India considered the following key steps while conducting the international study:

1. Determining key drivers for development of innovative SME financing methods in the country
2. Overview of SME financing in the country
3. Development of credit guarantee systems
4. Understanding key strengths of the model and benefits accrued to SMEs in the country
5. Structure of the credit guarantee funds
6. Tax and regulatory structure of the credit guarantee fund

The above study assisted in understanding various risk-sharing models for SMEs in these countries, appraising their merits, understanding structure of these institutions and exploring the possibilities for replicating the same in India.

Japan

Introduction

Small and Medium Enterprises (SMEs) in Japan, account for 99.7% of all businesses (amounting to 42 Lakh units as against 12,000 units of large enterprises) and 70% of employment[64]. In terms of total value-added to the economy, their contribution exceeds that of large enterprises (being around 55-60%[65] consistently over the years). The Japanese economy is characterized by the co-existence of large corporations and SMEs, and the latter are responsible for playing a critical role in the creation of new industries, products and services. Also, SMEs in Japan foster increased competition in the market, vitalize regional economies, and boost employment opportunities to a great extent. Lending Institutions in Japan are increasingly looking at (and advocating), SMEs as a major revenue source. Japanese financial institutions cater to the need of SMEs by providing diversified financing options such as lending based on risk-scoring model, asset-backed loans, securitization and credit guarantees.

Definition of SMEs

In Japan, SMEs are defined by an upper limit on paid-up capital or number of employees. While there is a common upper limit for paid-up capital for small as well as medium enterprises, there are separate limits in terms of number of employees for the two categories. The definition of SMEs in Japan is as under:

Sector	Paid-up capital not more than[66]:	Number of Employees:	
		Small	Medium
Manufacturing	¥300 million	<20	20< <300
Wholesale Trade	¥100 million	<5	5< <100
Retail Trade	¥50 million	<5	5< <50
Services	¥100 million	<5	5< <50

[64] SME Unit, Japan Finance Corporation (JFC)

[65] Japan International Cooperation Agency (JICA)

[66] ¥300 million = `16.17 Crore

¥100 million = `5.39 Crore

¥50 million = `2.69 Crore

(Based on eight-day average exchange rate of August, as on August 12, 2010)

Financial Support to SMEs by Public Sector

Some findings suggest that SMEs that are old and well-established have been able to build a reputation for themselves, enjoy lower cost of borrowing. For SMEs whose credit risk is difficult to assess, collaterals and personal guarantees have played an important role in enhancing access to finance. On the other hand, government interventions in the form of a public guarantee system have helped alleviate the financial constraints faced by SMEs particularly in times of financial crisis. SMEs faced a severe credit crunch in the period 1998-2001, when the Japanese economy was on the verge of falling into a deflationary spiral. Repayment guarantees provided by the government during this period covered roughly 10% of total outstanding SME loans and greatly helped improve the financial environment as well as the business performance of companies. Empirical study[67] shows that for companies with low credit risk, the profit margin improved substantially for firms covered with public guarantee compared to those which were not. For companies with high credit risk, the profit margin remained low despite the loan guarantees. Nevertheless, the presence of public credit guarantee has been very conducive to the efficient credit allocation in the Japanese economy.

The public sector supports Japanese SMEs through three major interventions: financing, credit supplementation and enhancement of capital. The **Japan Finance Corporation** (JFC) was established in October 2008 by integrating Japan Finance Corporation for Small and Medium Enterprises (JASME), National Life Finance Corporation (NLFC), Agriculture, Forestry and Fisheries Finance Corporation (AFC), and the International Financing Operations of Japan Bank for International Cooperation (JBIC).

JASME, since its establishment in 1953, has provided various financial supports to the SME sector through initiation of several programs such as loan programs, securitization support programs, credit insurance programs, and consulting services. The loan programs included direct loans to SMEs, purchase of corporate bonds with subscription rights to newly issued shares, and securitization of loan claims against SME corporate bonds. It promoted 'policy-oriented special purpose loans' such as New Business Development Loans, Corporate Revitalization Loans, Safety Net Loans, Loans for Environment and Energy Measures, etc. The securitization support program includes securitizing loan claims taken over from private financial institutions and partially guaranteeing asset-backed securities.

The credit insurance program is where the JFC provided insurance for guaranteed liabilities of the Credit Guarantee Corporations of Japan.

History of the Credit Guarantee System

The first Credit Guarantee Corporation (CGC) in Japan was established in Tokyo in the year 1937. It was funded by 156 members including the Tokyo Metropolitan Government, commercial and industrial organizations, and financial institutions. During the Great Depression, the government introduced various measures to deal with the crisis including the introduction of a 'loss compensation'

[67] Uesugi, Sakai, Yamashiro, 2006, " Effectiveness of Credit Guarantees in the Japanese Loan Market"

system for SMEs. However, the number of loans extended in this system was limited, as collateral was a precondition for the extension of such loans. Thus emerged the concept of a 'credit guarantee institution', which, backed by public fund, provided credit guarantees on loans to SMEs. The second CGC was established in Kyoto in 1939 and the third in Osaka in 1942. In 1951, moreover, the Small Business Credit Insurance Law was partially revised, and credit insurance was used for the credit guarantees provided by CGCs. This led to the current "Credit Supplementation System" in Japan, a system that combines credit guarantees with credit insurance. In 1953, the Credit Guarantee Corporation Law established the public status of CGC as a government-backed corporation.

Since their Establishment, Credit Guarantee Corporations have been in the business of providing 'indirect finance' through guaranteeing loans by financial institutions to small businesses. Since 1999, CGCs have also provided 'direct finance' by guaranteeing corporate bonds issued by SMEs through private subscription.

Several other schemes have also been launched by the CGCs in the subsequent years to deal with various financial and economic crises. Some of the schemes launched by CGCs in recent years are as under.

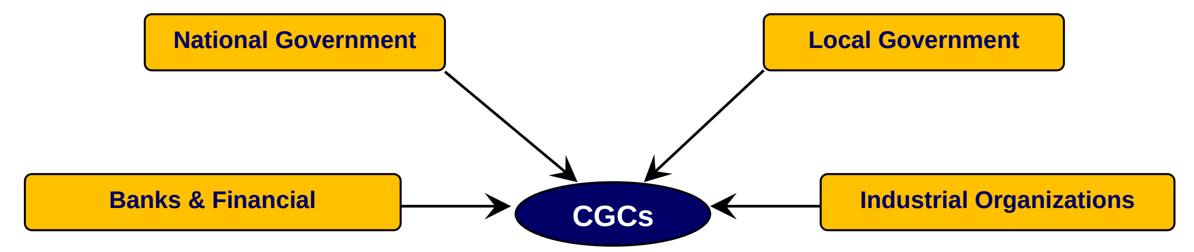
- December 2001: As a measure against economic deflation, “Guarantee for Loans secured by Accounts Receivable” was launched.
- December 2002: In light of the severe and frequent occurrence of SME bankruptcy, “Business Rehabilitation Guarantee System” was launched to support legal rehabilitation of SMEs.
- May 2006: Start-Up Business Assistance Plaza was established by CGC, Tokyo to offer financial support, management assistance from pre- to post- finance stages and entrepreneurial training courses.
- October 2008: The “Emergency Guarantee Program to Cope with Price Hikes of Raw Materials, Etc.” was launched as a central financial support measure by the government to deal with the economic slowdown of unprecedented magnitude. The CGCs put effort into ensuring smooth financing for the SMEs by actively utilizing this program. The program was modified several times to broaden the scope of covered businesses, and was renamed “Emergency Guarantee Program” in April 2009.
- February 2010: The Emergency Guarantee Program was extended and replaced by the “Emergency Guarantee Program In Response To Business Conditions”, which expires in March 2011.

The Credit Guarantee Fund

The Credit Guarantee Fund in Japan is the largest in the world. It has the highest capital fund in the world which is over 4 times that of the second-highest fund (that of South Korea) and works through 52 Credit Guarantee Corporations (CGCs) distributed in all the regions of the country. The Credit Guarantee System consists of a "credit guarantee function" where CGCs guarantee loans to SMEs by financial institutions and a "credit insurance function" where the Japan Finance Corporation (JFC) reinsures these guarantees. The 52 CGCs are located in each 47 prefectures, and in 5 major cities.

The capital fund of Japan's CGCs has been developed by contributions from the national and the local governments on a 50-50 basis. This constitutes almost 77% of the current capital fund of CGCs. Besides this, 4 governmental and 75 private financial institutions contribute to around 22% of the fund and the rest 1% is contributed by industrial organizations. Such contributions are tax deductible under Japanese law.

Contributors to Capital Fund



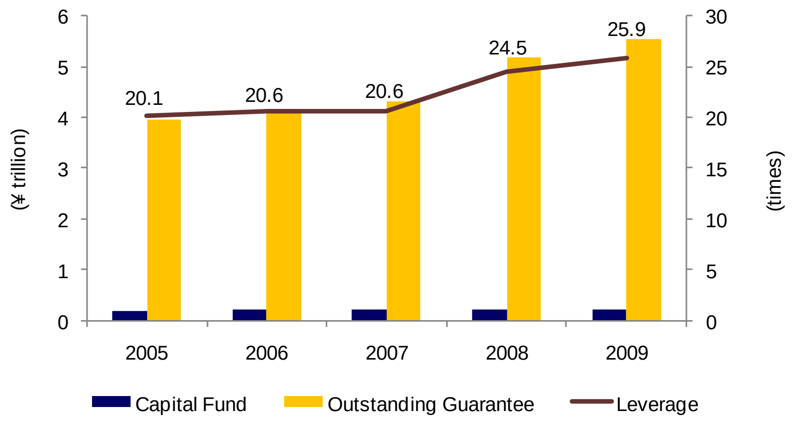
Source: CGC, Japan

The sources of income of the credit guarantee organization are guarantee fees, interest income & dividends on securities and subsidies.

Credit Guarantee Corporation of Tokyo (CGCT), established in 1937, was the first institution in Japan to provide credit guarantee services to small enterprises suffering from shortage of funds. Other credit guarantee corporations in Japan were founded in the period 1937-1961, and currently the total number of CGCs in Japan stands at 52.

The size of the credit guarantee fund of CGC Tokyo and the outstanding guarantee by the organization over the last few years is given below. The leverage of the guarantee fund has ranged from 20 to 26 over the recent years.

Capital Fund and Leverage



Source: CGC, Tokyo

The outstanding guarantee by CGCT represents around 15% of the total outstanding guarantees by all 52 CGCs in Japan in terms of amount, and around 16% in terms of number of cases[68].

The Credit Guarantee Product

The main features of the credit guarantee product provided by CGC Japan is summarized in the table below.

PARAMETERS	FEATURES	
% of loan amount covered	Upto 80% (was 100% till October 2007)	
Fee Structure	0.5-2.2%, based on credit score, maximum of 0.1% discount	
Eligible SMEs:	**Paid-up Capital up to:**	**Employees below:**
Manufacturing	¥300 million (`16.17 Crore)	300
Wholesale	¥100 million (`5.39 Crore)	100
Retail	¥50 million (`2.69 Crore)	50
Services	¥50 million (`2.69 Crore)	100
Healthcare, etc.	-	300
Businesses not eligible	Agriculture, Forestry, Fishery and Finance	
Ceilings on Guarantee:	**Individuals / Corporations**	**Co-operatives**
General Guarantees	¥200 million (`10.78 Crore)	¥400 million (`21.56 Crore)
Guarantees without Collateral	¥80 million (`4.3 Crore)	¥80 million (`4.3 Crore)

[68] D&B Literature Study

PARAMETERS	FEATURES	
Bond Guarantees	¥500 million (`26.95 Crore)	NA
Collateral	Collateral taken by CGCs, not taken by lending institutions	

The Credit Guarantee Process

- **Guarantee Procedure:**

  The SMEs apply for credit guarantees to CGCs and pay the fees directly to the CGC. They can apply through financial institutions or directly to CGCs.

  In case the SME applies for guarantee through financial institution, the latter submits the application to the CGC. The CGC, after carrying out a credit check on the enterprise, issues a credit guarantee certificate to the financial institution.

  In case the SME directly applies for guarantee to the CGC, it approves the application based on credit checks. Then it arranges for a financial institution to extend loan. After obtaining loan approval from the lending institution, the CGC issues credit guarantee certificate to the financial institution.

  In the event that SME is not able to make all or part of the repayments within the term, the financial institution requests CGC for payment under guarantee, when the loan is overdue by 90 days. CGC makes repayments on the loan to the financial institution on behalf of the enterprise within one month, or in few CGCs, within two months.

- **Insurance of credit guarantee payments:**

  The credit guarantee made by CGC is automatically insured by JFC, and CGC pays a premium to JFC for the same. This premium is collected from SMEs and is 0.87% for majority of the SMEs, 0.4% for very small enterprises and 0.47% for accounts receivable backed SMEs. In case of subrogation, CGC can claim 70-90% of the amount paid from JFC. In case the subrogated amount is eventually collected, CGC pays 70-90% of the amount to JFC. This system plays a crucial role in ensuring the solvency and creditworthiness of the CGC. It is also the main reason that contributes to CGCs achieving very high leverage levels.

  The premium collected by JFC was historically not in line with the default rates and therefore led to high operational losses and high budgetary outlays, leading to eventual reforms.

Overview of the Performance of the Credit Guarantee System

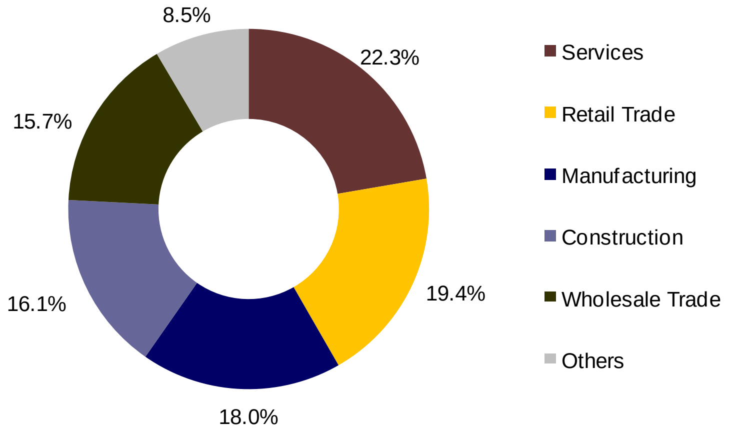
1. Coverage:

The credit guarantee system in Japan covers around 38-48%[69] of SMEs and around 12% of amount of SME loans, which is the highest in the world. For instance, 38% of SMEs in Japan had guarantees from CGCs in Q2 of the year 1999, and as high as 48% of SMEs had guarantees from CGCs in Q4 of the year 2008. In case of break-up of SMEs in terms of number of employees, while 45.5% of SMEs with employee strength of 0-20 were covered under guarantees in Q4 of 2008, and 61.4% of SMEs with employee strength of 21 and above were covered under guarantees during that period[70].

In case of Credit Guarantee Corporation, Tokyo (CGCT), around 47.4% of small and medium enterprises (excluding the ineligible businesses of agriculture, forestry and fishery) in Tokyo metropolitan area were covered by the organization's services as on March-end 2010[71]. Moreover, around 60.6% of the clients of CGCT have capital of less than ¥10 million (`53.9 Lakh) and around 70% of the clients have employee strength of less than 5 (on March-end 2010)[72].

The major business sectors of CGCT that receive credit guarantees and their share in terms of number of users are provided below.

Major sectors served by CGCT, in terms of number of SMEs (March-end 2010)



Source: CGC, Tokyo

[69] Small and Medium Enterprise (SME) Unit, Japan Finance Corporation

[70] 2009 White Paper on Small and Medium Enterprises in Japan, Japan Small Business Research Institute (JSBRI)

[71] 2009 White Paper on Small and Medium Enterprises in Japan, Japan Small Business Research Institute (JSBRI)

[72] Annual Report 2010, CGC Tokyo

2. **Leverage:**

   The guarantee fund has historically achieved a leverage of as high as 35-60 times. The leverage of the CGCT fund in the year FY2009 was 26.

3. **Default Rate:**

   The default rate of the guaranteed loans has historically been at around 2%. The subrogation rate for CGCT has ranged from 2.3-3.9% in the period 2005-09[73]. The low default rate of the guaranteed loans can be attributed to the long history of the credit guarantee system and the highly developed database system due to many years of existence of the system.

4. **Recovery Rate:**

   The recover rate (subrogation payments for defaulted loans divided by recovery amount) for CGCs in Japan has been quite high. For instance, the recovery rate for CGCT was around 44% in the period 2005-06. However, it decreased to 12-13% in the period 2008-09 due to the severe financial conditions.

Organizational Structure

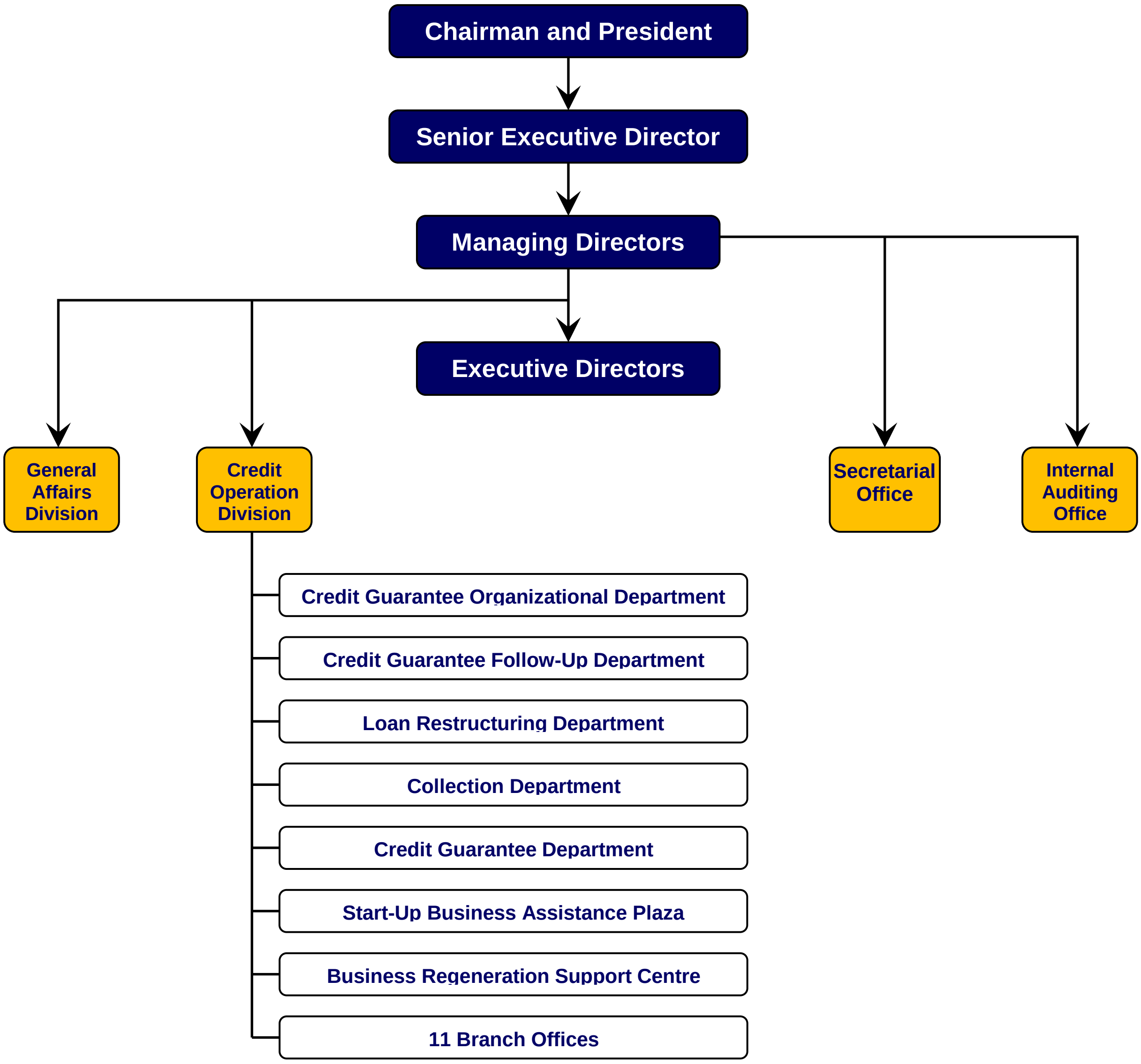
The Credit Guarantee Corporation, Tokyo (CGCT) consists of 16 directors and 3 auditors. The employee strength of Credit Guarantee Corporation of Tokyo is 663. At the top of the hierarchy is the Chairman and the President of CGCT, under whom is the Senior Executive Director, followed by the Managing Directors. Directly under the Managing Directors are the Internal Auditing Office and the Secretarial Office. The Managing Directors and the Executive Directors together manage the two divisions called the General Affairs Division and the Credit Operation Division.

Within the General Affairs Division are the General Affairs Department (for general affairs, accounting, international affairs, etc.), the Planning Department (which takes care of planning, public relations, systems information, etc.) and the Personnel Department.

The overall organizational structure of CGCT and the departments under the Credit Operation Department are provided in the Organizational Structure chart below.

[73] Annual Report 2010, CGC Tokyo

Organizational Structure – CGC, Tokyo (as of April 2010)



Source: CGC, Tokyo

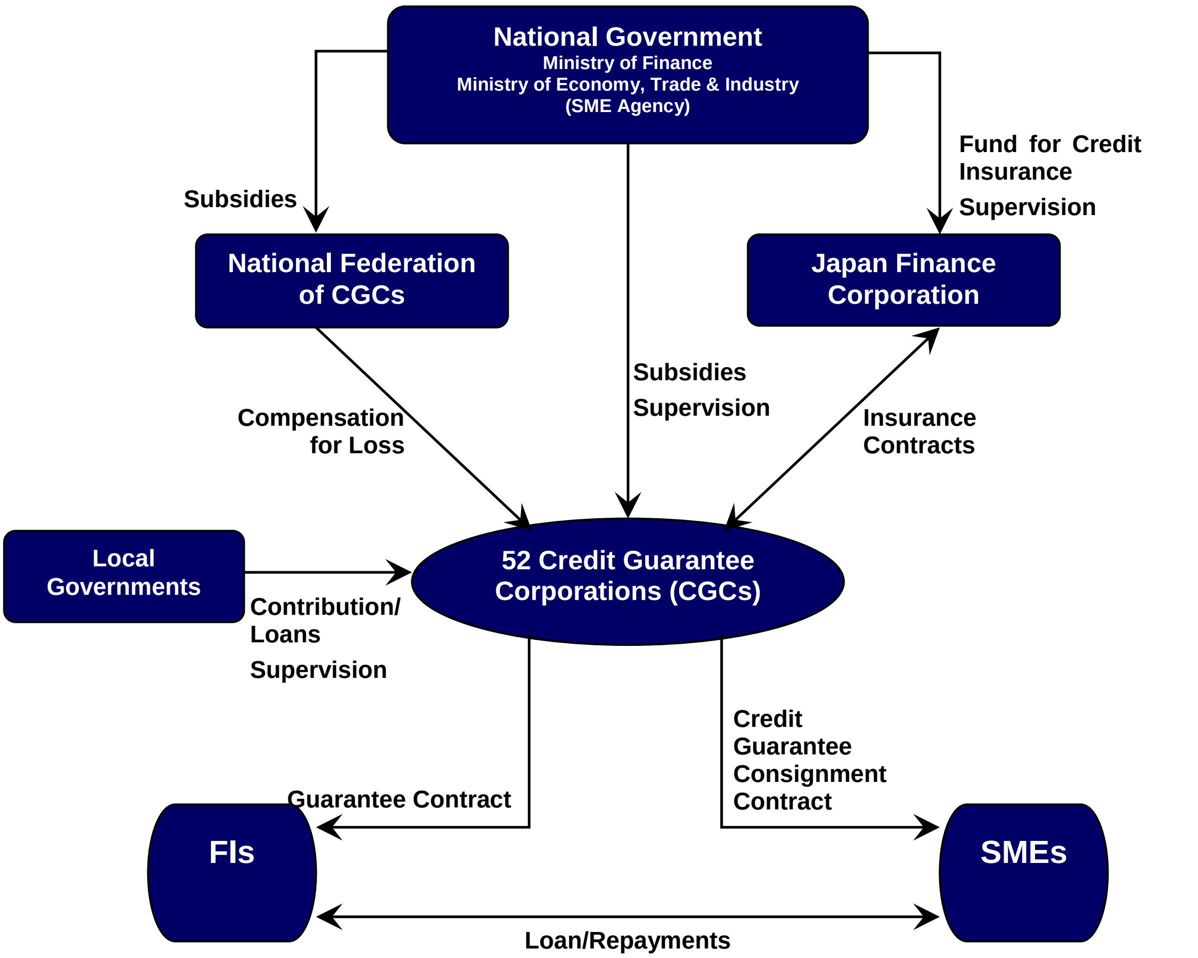
The Credit Guarantee Organizational Department supervises the credit guarantee affairs of the organization. The Credit Guarantee Follow-Up Department conducts follow-up of credit guarantees extended, subrogation (paying for defaulted loans) and obtains credit insurance (from JFC). The Collection Department looks after collection affairs and legal procedures of the organization. The Credit Guarantee Department takes care of Corporate Bond / Institutional Credit Guarantees.

Apart from the Head Office in Chou-ku, Tokyo, CGC Tokyo has 11 branch offices of CGCT in Tokyo Metropolitan. These branch offices operate under the Credit Operation Division of CGCT.

Institutional Structure

The institutional structure of the credit guarantee system of Japan is provided in the Institutional Structure chart below.

Institutional Structure - Japan



Source: CGC, Japan

While an SME can apply for credit guarantee either through the financial institution or directly to the CGC, the CGC conducts credit check on the SME before extending the guarantee and the SME pays guarantee fee directly to CGC. The functions of various organizations and bodies are as under:

1. **Role of Japan Finance Corporation:**

   The Japan Finance Corporation (JFC), besides reinsuring the credit guarantees, also lends funds to CGCs which the latter deposits with financial institutions. These deposits lead to expansion in guaranteed loans and reduction in lending rates.

2. **Role of National Federation of Credit Guarantee Corporations:**

   The National Federation of Credit Guarantee Corporations (NFCGC) conducts research and surveys on financing of SMEs, designs to improve credit guarantee business, etc. and compensates for the loss of CGCs for certain credit guarantee systems. Being a liaison between CGCs, JFC, financial institutions, and the ministries and agencies, it provides guidance, advice, recommendations and reports to CGCs, and facilitates information exchange between the various financial and economic organizations. It is a government funded not-for-profit association.

3. **Role of Financial Services Agency:**

   The Financial Services Agency (FSA) approves entry, exit and merger of CGCs and changes to leverage. It conducts on-site inspection of CGCs every 2-3 years through its Regional Finance Bureaus.

4. **Role of Government:**

   The national and local governments provide financial support to CGCs. The national government also provides funds to JFC for credit guarantee insurance. Both the national and local governments provide direct subsidies for CGC fund which can be utilized by CGCs to compensate for any losses. Besides, they also provide compensation for loss to NFCG.

   The national government plays a supervisory role for the CGCs through the FSA, as well as the JFC. The local governments also supervise the CGCs. The government’s Board of Audit supervises the NFCGC through periodic inspections.

<u>Tax Structure</u>

CGCs in Japan enjoy the status of independent state-owned companies based at the prefectural and city level. The National Federation of Credit Guarantee Corporation (NFCGC) is a not-for-profit association, established in 1951, and funded by government. The CGCs also enjoy the status of not-for-profit organizations exempt from Income Tax and Value-Added Tax. Moreover, the contributions of private financial institutions and industry organizations to the credit guarantee fund are tax-deductible.

The CGCs operate under the Japan Credit Guarantee Corporation Law of 1953 and is supervised by Japan Financial Services Agency (FSA), through Regional Financial Bureaus in coordination with Prefecture & City Governments.

Conclusion

The credit guarantee system in Japan is the largest guarantee fund and one of the oldest in the world. It has been running successfully over the years, with very high coverage and low default rates. D&B India has identified a few aspects of the credit guarantee mechanism in Japan that are adoptable in the Indian scenario. These factors contribute to the smooth-running of the guarantee system as well as the wide acceptance of the guarantee product.

- Guarantee Mechanism as a Tool for Financial Stability

  The credit guarantee schemes in Japan are considered an important tool for the government to bring about financial stability in the economy in the form of support to SMEs during times of financial crisis. The Credit Guarantee Corporations have introduced several schemes depending on the need of SMEs in a given economic situation, such as the deflationary spiral of the economy (2001), the increased bankruptcies (2002), the raw material price hike (2008), and the economic slowdown (2008-10).

  D&B India believes that the credit guarantee schemes in India can offer specialized products for a specified period, in addition to the existing scheme (once the existing scheme gains sufficient momentum), which will cater to the needs of SMEs in changing economic situations.

- Risk-based pricing

  In April 2006, the Variable Guarantee Fee Rate System was launched in Japan. Consequently, the guarantee fee charged by CGCs in Japan ranges from 0.5-2.2%, based on a credit score. This helps SMEs with lower risk to pay low fee and increases opportunities for high-risk SMEs to get finance at a justified cost, through the guarantee program.

  The credit score of the SME is calculated through a Credit Risk Database (CRD) system, and is based on nine criteria. Also, if the SME meets certain criteria, a maximum of 0.1% discount is also offered. Since the CGCs in Japan carry out their own risk assessment, it is possible assign credit scores to SMEs based on their own credit check criteria. The strong database system and the thorough credit risk assessment have helped the CGCs in Japan maintain very low levels of default rate over the period.

  In the event that CGTMSE decides to introduce risk-based pricing for the credit guarantee schemes, similar pre-defined criteria can be applied to price the guarantee product according to the risk level of the SME, so that the mature and stable SMEs with good credit record but lack of collateral can obtain the guarantee at lower cost.

  At present, the risk assessment procedure is carried out by the bank / financial institution. Most of the lending institutions have their own internal credit rating model to evaluate MSEs. D&B India believes that a common risk-scoring model for MSEs could be adopted across all MLIs, in order to have a pre-defined criteria for credit scoring, according to which the guarantee scheme could be priced. Alternatively, the internal credit rating model of each MLI could have a comparative benchmark, and the credit score could be identified based on the benchmark value.

- Insurance of Guarantee Payments

  The Credit Supplementation System of Japan, which includes the Credit Guarantee System and the Credit Insurance System, plays a vital role in the government's SME finance policy. In the Credit Supplementation System, the Japan Finance Corporation (JFC) insures the guarantee payments made by CGC in case of default. Since the SME loans guarantee coverage is very high (13% of SME loans and 38% of SMEs as of end-March 2009), the insurance system has helped CGC fund remain solvent, ensured smooth flow of funds, and has made CGC achieve high level of leverage.

  In the scenario that with increased awareness, the credit guarantee schemes of CGTMSE gain wide acceptance, an insurance system could be put in place (in case the default rates witnessed are high) to ensure that the fund remains solvent. It would also enable the fund to achieve high leverage rates.

South Korea

Introduction

SMEs in South Korea account for around 99.8% of total business units, and 86.7% of employment. While around 30% of units are into wholesale and retail sector, 21.5% account for food and hotel sector, 11.3% for manufacturing sector, 9% for repair services, and the rest in education, real estate and other sectors.[74]

Until the mid-1970s, most of the SMEs concentrated in the manufacturing sector. However, in the last three decades, they have expanded in services sectors such as the wholesale and retail trade sectors. The rate of establishment of SMEs in Korea increased significantly post the 1997 crisis. For instance, in the period 1994-1996, the number of newly established SMEs increased by 4.5% a year, whereas in the period 1999-2000, the number increased by 14.3% a year[75].

Most of the SMEs in South Korea engage intensively in technology improvement and international competitiveness, and the government has taken various steps to foster innovation in SMEs, such as, setting up around 300 incubators, decentralizing policy responsibility to strengthen regional innovation clusters, and encouraging local linkages between universities, technology centers and companies. The country was ranked 6th in World Economic Forum's country technology index rankings (2004). South Korean SMEs account for a large proportion of FDI in the Asian region in a range of sectors such as automotive, electronics, leather, textiles, etc.

The differentiating South Korean strategy towards SMEs as opposed to SMEs in rest of the world is that while the latter promote SMEs for their employment and income generating potential, Korea emphasizes on the economic dynamism and competitiveness in the global market through encouraging hi-tech durables and other innovative products and services.

Definition of SMEs

SMEs in South Korea are defined by the Small and Medium Industry Basic Act of 1966 in the manner provided below[76]. The requisites for qualifying as a Micro, Small or Medium enterprise are in terms of number of employees and capital / sales. Some exceptions are made for labor-intensive subsectors (upto 1,000 employees) and for some capital-intensive industries (which might otherwise be excluded for having a higher level of capital). Any firm once defined as an SME but grows beyond the defined limits (through expansion or merger) continues to be regarded as an SME for three years.

[74] Dea Seong Jeon, Industrial Bank of Korea

[75] Asia and Pacific Studies

[76] Small and Medium Business Administration, Korea

Sector	Small & Medium Enterprises		Small Business	Micro Enterprise
	Number of Workers less than	Capital / Sales less than or equal to (billion ₩)[77]	Number of Workers less than	
Manufacturing	300	8 (Capital)	50	10
Mining, Construction & Transportation	300	3 (Capital)	50	10
Large general retail stores, hotel, recreational condominium operation, communications, information processing and other computer-related industries, engineering service, hospital and broadcasting	300	30 (Sales)	10	5
Seed and seedling production, fishing, electrical, gas and waterworks, medical and orthopaedic products, wholesales, fuel and related products wholesales, mail order sale, door-to-door sale, tour agency, warehouses and transportation-related service, professional, science and technology service, business support service, movie, amusement and them park operation	200	20 (Sales)	10	5
Wholesale and product intermediation, machinery equipment rent for industrial use, R&D for natural science, public performance, news provision, botanical garden, zoo and natural parks, waste water treatment, waste disposal and cleaning related service	100	10 (Sales)	10	5
Other Sectors	50	5 (Sales)	10	5

[77] ₩8 billion = `31.66 Crore; ₩3 billion = `11.87 Crore; ₩30 billion = `118.7 Crore; ₩20 billion = `79.16 Crore; ₩10 billion = `39.58 Crore; ₩5 billion = `19.79 Crore;

(Based on eight-day average exchange rate of August, as on August 12, 2010)

Financial Support to SMEs by Public Sector

There are various SME supporting institutions in Korea. The highest organization for SME-related policies and in direct control of the President is the **Presidential Commission on Small and Medium Enterprises**. It reviews, mediates and evaluates policies to promote SMEs and provides suggestions and advice to the President on policies for SMEs. The **Small and Medium Business Administration** (SMBA) is a government agency established to seek efficient promotion of SMEs through systematic implementation of government SME policies. The **Bank of Korea** (BOK) is the central bank of the country. Apart from carrying out the monetary and credit policies, it supplies funds to general lending institutions to expand SME loans through a variety of systems such as the total credit limit system, the obligatory SME loan ratio system, and the import / export financing support system.

The **Industrial Bank of Korea** (IBK) is the only government-owned SME-specialized bank in Korea and was established in 1961 to promote smooth economic activities and growth of SMEs. It has actively strengthened the capital supply to SMEs, especially, during financial crisis, through capital support for management support and restructuring, facility funds with low long-term interest rates, active development and support of small-scale companies, and expansion of credit loans. It also facilitates financial support from other general commercial banks, and also supports export / import activities of SMEs. Moreover, it develops venture firms with technologies and growth potential, and undertakes loans for facility investment funds. It provides research and surveys and corporate cooperative businesses for SMEs, such as government statistics and consulting services.

The general **Commercial Banks** participate in the sale of SME financial products centering on working capital. The **Small Business Corporation (SBC)** implements government's major policies to promote SMEs and manages government funds for development of SMEs. **Korea Federation of Small and Medium Businesses** (KFSB) is a non-profit SME organization to further the common interests of SMEs.

The major sources of financing for SMEs largely depend on the stage and growth of development of the business units. However, most SMEs in South Korea heavily depend on bank loans as main source of funds. While total SME loans accounted for 75% of corporate loans in the year 1997, they accounted for 90% of corporate loans by 2005, which confirms the increasing presence and importance of SMEs relative to the overall economy. Borrowing terms for SMEs have improved significantly in recent years. Interest rates for SMEs have declined from 14.34% in 1997 to 7.82% in 2000, to 5.78% in 2005[78]. In terms of direct funding, there has been a rapid and significant decrease in bond and equity capital for SMEs.

[78] Dea Seong Jeon, Industrial Bank of Korea

History of Credit Guarantee System

The government of South Korea established the Credit Guarantee Reserve Fund System in November 1961. The credit guarantee system, with the establishment of the fund, came under the administration of Industrial Bank of Korea (IBK). Funds for credit guarantee were originally raised through extra premium on interest of loans to small businesses. With the implementation of the Small and Medium Industry Credit Guarantee Act of 1967, the Korean government and the banks began to contribute funds.

The credit guarantee system underwent a series of changes in 1972, through the Presidential Emergency Decree for Economic Stability and Growth, under which, the fund was expanded to include various domestic banking institutions. The Korea Credit Guarantee Fund Act was enacted in 1974, which provided the foundation of an independent institution specializing in guarantee services. In June 1976, the Korea Credit Guarantee Fund (KODIT), a special legal entity, was established as the singular provider of the credit guarantee services in South Korea.

In August 1987, KODIT was temporarily adopted as an institutional agent for Korea Technology Credit Guarantee Fund and in April 1989, the Korea Technology Credit Guarantee Fund was established as a separate entity to support technology-based enterprises.

In September 1997, KODIT started bill insurance services under Special Measures for Supporting Small Enterprises, and in January 1998, it introduced special credit guarantees to assist SMEs hit by the Asian Financial Crisis. In the year 1998 itself, the credit guarantee product was altered in the form of partial credit guarantees, where KODIT did not cover the complete loan amount and the creditor institutions shared a portion of the risk on loans.

KODIT became the sole management institution of Korea Infrastructure Credit Guarantee Fund in the year 1999. The 'Special Guarantee Services for Micro Start-up Business' was introduced by KODIT In July 1999 to support all types of start-up businesses. Special guarantees for Collateralized Bond Obligations (CBO) and Collateralized Loan Obligations (CLO) were introduced in the year 2000 to help medium and large enterprises issue corporate bonds. In 2001, two major developments took place in the history of KODIT, the development of the ‘Corporate Credit Rating System’ to support the decision-making process for guarantees by enhancing the credibility and objectivity of firms, and the introduction of e-commerce credit guarantee services to facilitate online business transactions of SMEs.

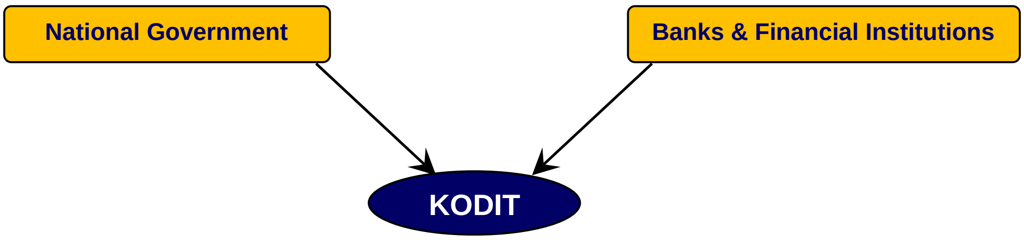
The Credit Guarantee Fund

The Korean Credit Guarantee System consists of three well-established funds, Korean Credit Guarantee Fund (KODIT), Korean Technology Credit Guarantee Fund (KOTEC) and Korea Federation of Credit Guarantee Foundations (KFCGF). While KODIT is the largest fund with the widest coverage, KOTEC focuses on high-risk high-tech SMEs. The outsourcing of credit data by KODIT and KOTEC has resulted in the formation of a new company known as the Korea Integrated Data Co Ltd which is the world’s largest comprehensive credit information database.

Due to the wide presence and large size of KODIT, and its coverage of SMEs in general, D&B India has focused its study on KODIT, among the three funds of the Korean Credit Guarantee System.

The capital fund of South Korea is the second-largest in the world, after the credit guarantee fund of Japan. The capital is contributed by the National Government and the banks and financial institutions as per the Korea Credit Guarantee Fund Act. The rate of contribution of financial institutions was originally 0.5% (of loans made) per annum, which was reduced to 0.3% per annum in 1979 and to 0.2% per annum in 1989 through amendments of the Act.

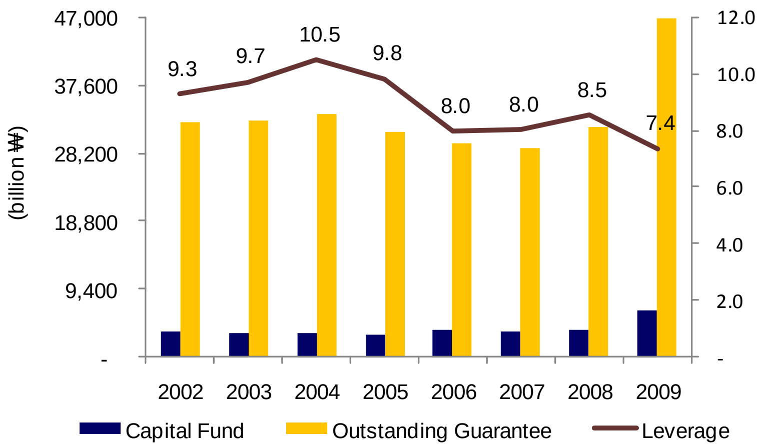
Contributors to Capital Fund



Source: KODIT, South Korea

In 2008, the government made a contribution of ₩92.5 billion (`366 Crore) to the capital fund of KODIT and the banks contributed ₩780.4 billion (`3,088.8 Crore) to KODIT. The total capital fund of KODIT and the outstanding guarantee is given in the chart below. The leverage for this period has ranged from 7 to 11 times.

Capital Fund and Leverage



Source: KODIT, South Korea

In the year 2009, the size of capital fund of KODIT stood at ₩6,376 billion (`25,236 Crore), and the amount of outstanding guarantee stood at ₩46,913 billion (`185,681 Crore), as shown in the chart above.

The Credit Guarantee Product

KODIT offers a variety of services and covers a large number of SMEs all over the country. It has supported SMEs during financial crisis by introducing various special guarantee schemes and has acted as an important stabilizing tool for the government.

The services offered by KODIT are listed below:

1. General Credit Guarantee Services can be categorized into 4 broad types:
    a) Guarantee for Indirect Financing
        i. Guarantee for Bank Loans
        ii. Guarantee for Payment Guarantee of Bank Loans
        iii. Guarantee for Loan from Non-Banking Financial Institutions
        iv. Guarantee for Leases
        v. Guarantee for Acceptance of Trade Bills
    b) Guarantee for Direct Financing
        i. Guarantee for Bond Issuance
    c) Guarantee for Credit Transaction between Enterprises
        i. Guarantee for Commercial Bills
        ii. Guarantee for Performance
        iii. Guarantee for Transaction Liabilities
    d) Guarantee for Tax Payment
        i. Guarantee for Tax and Duty

    Consequently, the various creditors that come under the purview of the general credit guarantee services of KODIT are banks, non-banking financial institutions, leasing companies, bond holders, notes holders, government institutions, public institutions, enterprises and tax office.

2. Special Credit Guarantee Services were introduced in 2000 to facilitate corporate financing at lower cost in the aftermath of the financial crisis:
    a) Primary Collateralized Bond Obligation (P-CBO) Guarantee
    b) Collateralized Loan Obligation (CLO) Guarantee

3. Electronic Credit Guarantee Services, that have been developed by KODIT to promote the safer e-commerce transactions, are divided into two categories:

a) E-commerce Loan Guarantee

b) E-commerce Liabilities Guarantee

4. Credit Insurance, introduced to prevent chain reaction bankruptcies, where KODIT insures SMEs against non-payment of trade receivables by their buyers, the cover being up to 80%:

    a) Bill Insurance Service

    b) Receivables Insurance Service

5. Infrastructure Credit Guarantee, to help private investment corporations obtain funds for infrastructure construction projects

6. Management Consulting, which consists of consulting services performed by independent experts, training programs for owners as well as employers of SMEs, and issuing of several publications such as newsletters and information booklets

7. Guarantee Combined Investment, to provide venture companies (that are innovative and have potential) with capital by purchasing shares or underwriting bonds, which not only helps these companies gain access to long-term capital, but also helps KODIT to realize extra capital gains

8. Management of Credit Information, such as the CRETOP launched in 1992, containing database of credit information on SMEs which KODIT has collected in the process of credit investigation

The various features of the credit guarantee product provided by KODIT is as under:

PARAMETERS	FEATURES	
% of loan amount covered (based on credit rating)	Upto 85%	
Credit Rating:	**Less than 10 year***	**Over 10 years***
KS1	50%	50%
KS2-KS3	70%	65%
KA1-KA4	75%	70%
KB1-KB3	80%	75%
KB4-KE3	85%	80%
Fee Structure (risk-based, sliding scale)	Basic = 0.5-3%, additional 0.5% for a large company	
Ceilings on guarantee	**General**	**Special**
	₩3 billion (`11.87 Crore)	₩7 billion (`27.7 Crore)
Collateral	No collateral required by KODIT	
Partial Collateral	Allowed in some cases, but not often[80]	

* Tenure of usage of credit guarantees by the company

[80] Via email response from Jiyun Paik, Asst Manager, International Affairs, KODIT

The Credit Guarantee Process

The credit guarantee process under KODIT involves three parties: the applicant firm, the lender institution and KODIT. The process can be broken into the following major steps:

- **Application for guarantee:**

  The applicant firm, after consultation of a loan with a bank, applies for a credit guarantee to KODIT. The firm can submit the application to KODIT either through Web Application (on the Cyber branch of KODIT's Website) or through direct application (by visiting an office of KODIT).

- **Consultation**:

  Under this process, KODIT conducts a preliminary inspection by KODIT to check the adequacy of the application and the credit status of the applicant. The process is conducted through a KODIT staff member's visit to the applicant, teleconsultation or when the applicant visits a KODIT branch office. If the applicant does not qualify the preliminary requirements (for e.g., due to a conflict with internal regulations of KODIT), KODIT may decline the application for guarantee service.

- **Credit Investigation:**

  KODIT conducts credit investigations on the applicant by reviewing all the documents and information submitted by the applicant or collected through other sources. KODIT personnel conduct an onsite visit to inspect the applicant's firm, to confirm the information submitted, and to collect additional information, such as the employee's morale, etc. A report on the applicant's credit status is then compiled, containing information on business, credit record, financial status, etc.

  When KODIT itself conducts credit investigations, the procedure is known as direct guarantee, and is used in most cases of the credit guarantees (In 2005, 97% of the guarantees were issued through this method). On the other hand, when KODIT entrusts banks with all the operations of guarantees such as credit investigations, the procedure is known as indirect guarantee.

- **Credit Evaluation:**

  Credit Evaluation is the stage where KODIT decides whether to extend guarantee and the guarantee amount to be extended. The process involves conducting an overall evaluation of the applicant's credit, and three different methods exist to perform the evaluation, based on the type and amount of guarantee.

- **Approval and the issuance of The Letter Of Credit Guarantee:**

  After a series of approval procedures, which takes three to nine working days, KODIT makes a credit guarantee agreement with the client, the client pays the guarantee fee to KODIT, and

KODIT issues The Letter Of Credit Guarantee to the bank, and the bank extends loan to the applicant. For guarantees for bonds issuance, acceptance of trade bills, and commercial bills, KODIT stamps its signature on the face of the bond or the bill instead of issuing a letter of credit guarantee.

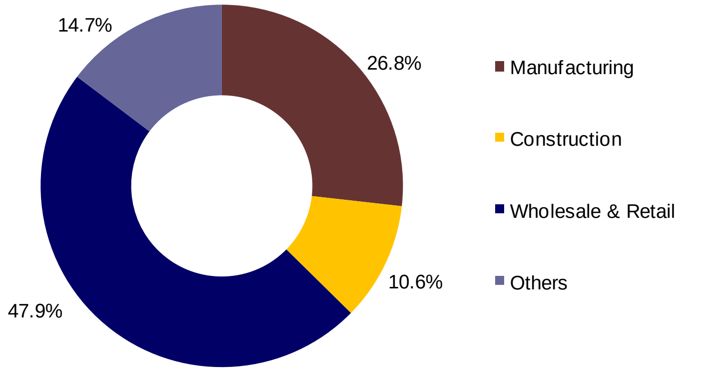
Overview of the Performance of the Credit Guarantee System

1. Coverage:

The estimated proportion of SMEs using the services of KODIT is around 13%. In the year 2009, KODIT extended guarantees (including all 11 guarantee products) totaling ₩39.25 trillion (`155,352 Crore), an increase of 29% over last year[81].

A break-up of sector-wise number of guarantees by KODIT by the end of 2009 is provided below:

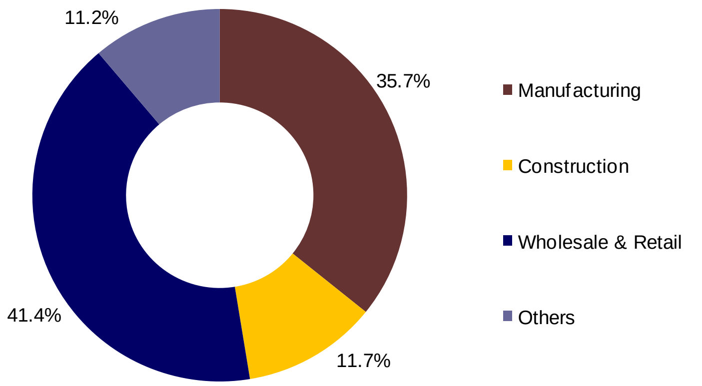
Sector-wise number of guarantees (2009)



Source: Annual Report 2009, KODIT

A break-up of sector-wise amount of guarantees by KODIT by the end of 2009 is provided below:

Sector-wise amount of guarantees (2009)



[81] Annual Report 2009, KODIT

Source: Annual Report 2009, KODIT

2. Leverage:

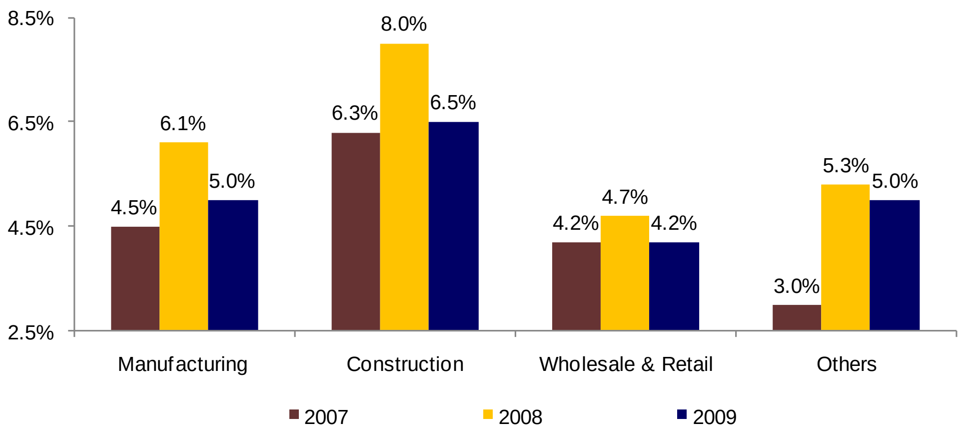
The leverage of the credit guarantee fund has ranged from around 7 to 11 times in recent years. The upper prescribed limit for the leverage is 20 times. In the last decade, KODIT achieved the highest leverage in 2007, when the extended guarantee was 10.5 times the capital fund, and the lowest in 2009, when it was 7.4 times the capital fund.

3. Default Rate:

At the end of 2009, KODIT recorded a gross default rate of 4.8%, and a net default rate of 4.4%. The default rate had increased significantly in the second-half of 2008, and it peaked in the first-half of 2009. The gross default rate and the net default rate in 2008 were 5.6% and 5%, respectively, and the gross default rate in 2007 was 4.4%.

Gross default rate recorded by KODIT by type-of-industry for the period 2007-09 is provided below:

Sector-wise default rate (2007-09)



Source: Annual Report 2009, KODIT

4. Rate of guarantee payment relative to default amount:

In 2008, KODIT paid 85.49% of the amount of loans in default. Also, in 2009, it paid 97.68% of the amount of loans in default.

5. Recovery Rate:

KODIT maintains a target recovery rate of 16.7%, in spite of the unfavorable financial conditions and increased bankruptcies. In 2009, it achieved and surpassed its target recovery rate by realizing ₩719 billion (`2,845.8 Crore) in collection, with respect to the payment of ₩1,854 billion (`7,338 Crore) for guarantees in default, representing a recovery rate of almost 39%.

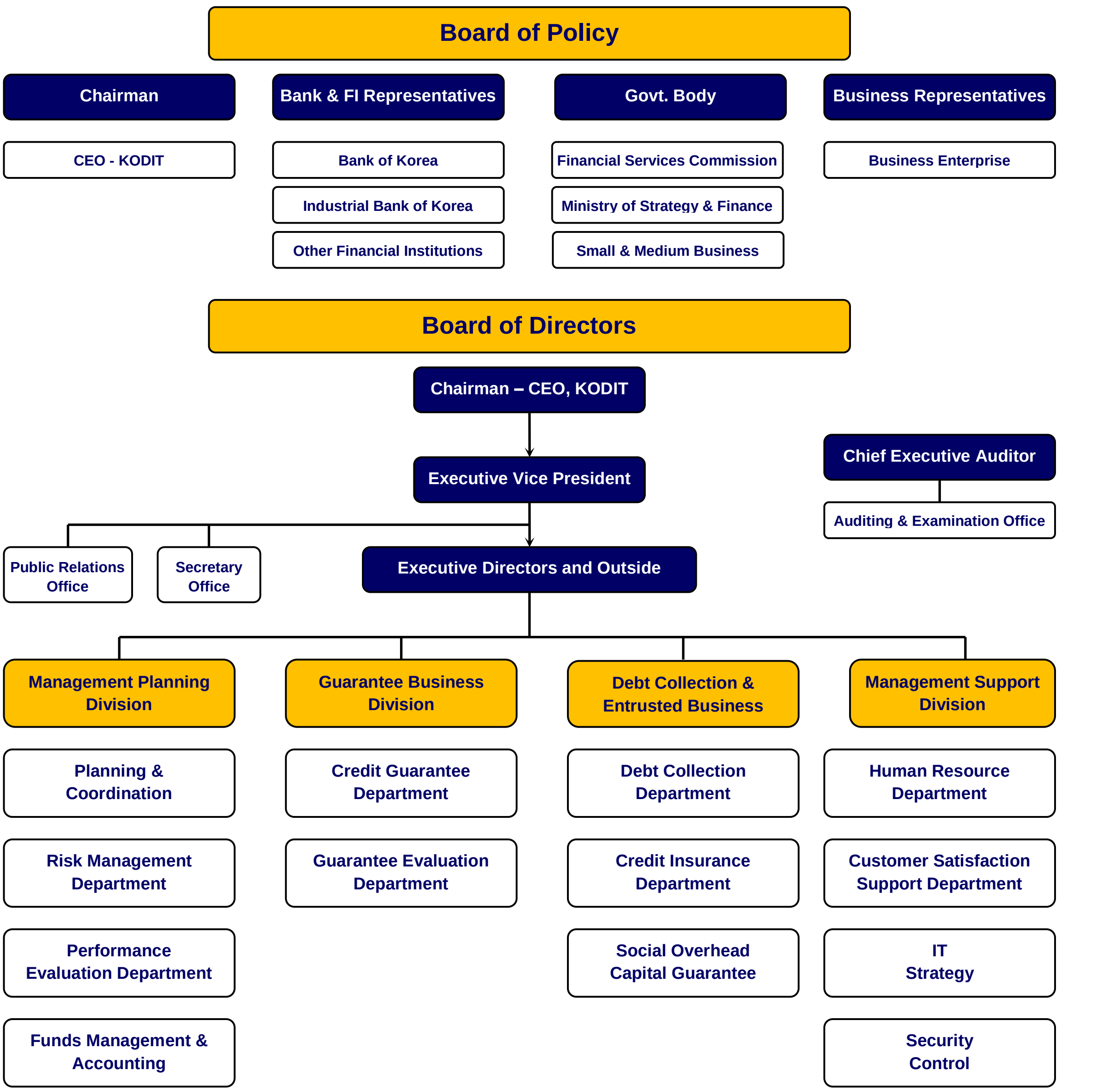
6. Awareness Levels:

KODIT and its guarantee products are now publicly known to SMEs in South Korea. The organization makes frequent PRs through the media to increase awareness among SMEs across the nation regarding its credit guarantee products and services.[82]

Organizational Structure

The organizational structure of KODIT is provided in the chart below:

Organizational Structure (as on March-end 2010)



Source: KODIT, South Korea

[82] Via email response from Jiyun Paik, Asst Manager, International Affairs, KODIT

The Board of Policy, which decides on major policies of KODIT, consists of the CEO of KODIT, who is appointed by the Financial Services Commission (FSC) and chairs the board, and representatives of various organizations and bodies, as mentioned in the chart. The Board of Directors, which makes important decisions regarding the operations of KODIT, comprises of the CEO of KODIT, and other executives who are appointed by the FSC in consultation with the CEO.

The CEO of KODIT serves a term of three years, and the other members of the Board of directors, and the Chief Executive Auditor of KODIT (who is appointed by the FSC), serve a term of two years.

The Head Office of KODIT consists of four main divisions, 12 departments and three offices. The business network of KODIT consists of eight Business Headquarters, 26 Debt Collection Teams, 86 Branches and 13 Offices. The number of branches and offices is spread over the eight business headquarters, as provided below:

Business Headquarter	No of Branches	No of Offices
Seoul West Business Headquarters	11	1
Seoul East Business Headquarters	10	3
Seoul South Business Headquarters	12	0
Gyeongin Business Headquarters	13	2
Busan & Gyeongnam Business Headquarters	13	0
Daegu & Gyeongbuk Business Headquarters	10	2
Honam Business Headquarters	10	1
Chungcheong Business Headquarters	7	4

Institutional Structure

The Korean Credit Guarantee Fund is known to have extensive supervision and inspection. KODIT is internationally known for being a well-managed and effective system and has been successful in achieving its objectives, the most important one being enhancing access of SMEs to bank credit. The fund is also supported by a sound and extensive database and credit information sharing system, and possesses a well-integrated risk-management system. The institutional structure of KODIT is illustrated in the chart below.

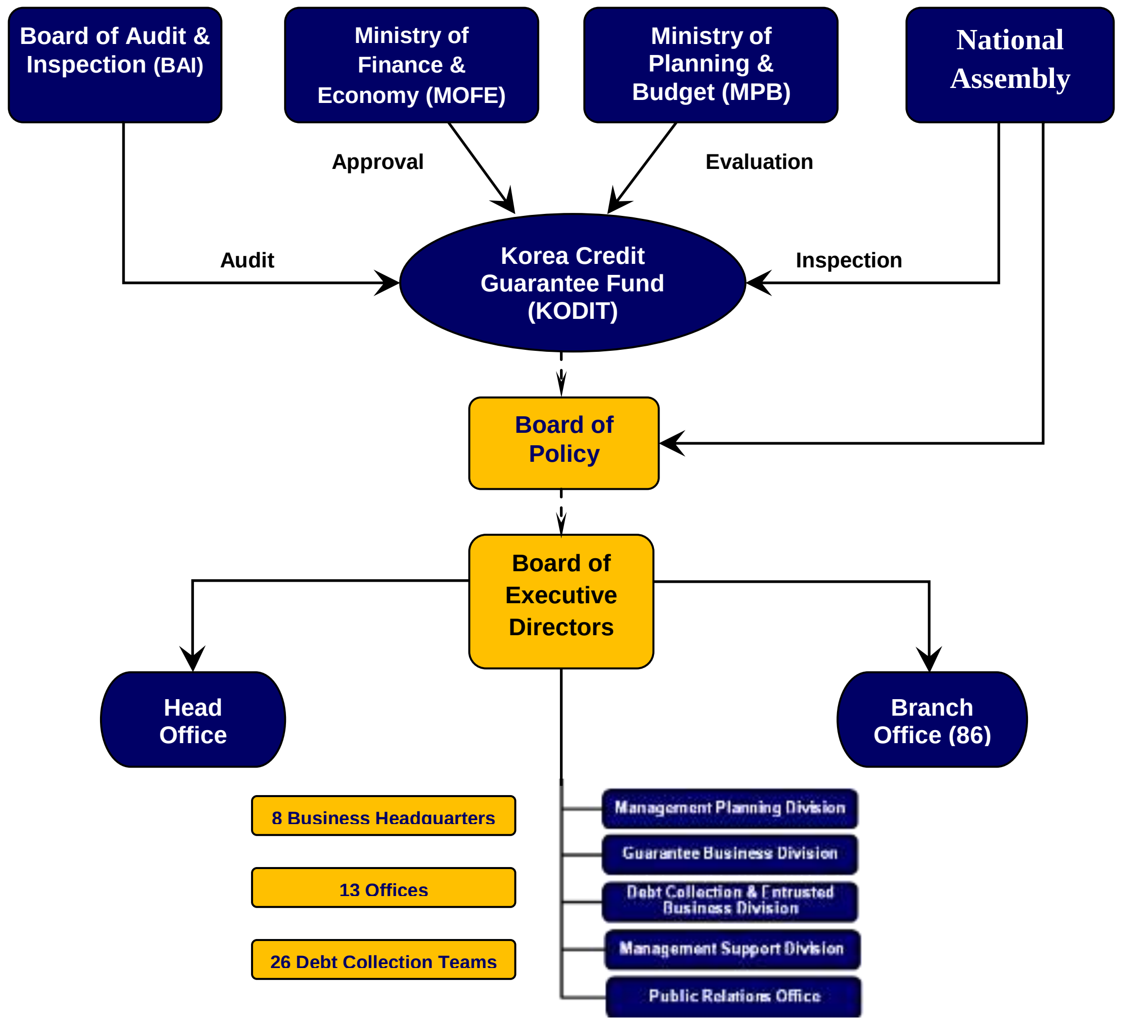
1. **Role of Board of Executive Directors:**

   Executive Directors are the decision making body for the internal stakeholders of KODIT. They set yearly business plans of KODIT and approves internal regulation. They delegate their decision making power to relevant department heads to ensure autonomy and increase efficiency. The internal auditor of the fund, belonging to the fund's Audit and Examination Office, and appointed by MOFE is responsible to the Board of executive Directors.

2. **Role of Board of Policy:**

Board of Policy is the decision making body for the outside stakeholders and the highest decision making authority. It sets the policy direction of KODIT and decides on all important matters related to the operations of KODIT.

Institutional Structure



Source: KODIT, South Korea

3. Role of Ministry of Finance and Economy (MOFE):

The Ministry of Finance and Economy (MOFE), along with the National Assembly, grant approval on the yearly business plan and budgeting of KODIT. MOFE provides primary oversight to the fund, performs supervision and inspection, and makes recommendations to Ministry of Planning and Budget on the size of annual government contributions to KODIT. The inspection performed is not annual, but from time-to-time. The inspection criteria includes operational appropriateness, verification of policies, soundness of financial affairs, financial plans and performance data, outstanding credit guarantee supplied, capital funds, subrogation and recovery rates, and leverage.

4. Role of National Assembly:

The National Assembly grants approval as well as inspects the functioning of KODIT. It formally makes decisions on amendments to laws, decrees, and regulations and approves government contribution to KODIT.

5. **Role of Board of Audit and Inspection (BAI) of Korea:**

   The Board of Audit and Inspection inspects KODIT's accounting and performance, with emphasis on identification of illegal transactions.

6. **Role of Ministry of Planning and Budget:**

   A board of fund operation evaluation, commissioned by the Ministry of Planning and Budget (MPB), evaluates the operation results of the fund and business performance of KODIT each year. The Ministry monitors all the three credit guarantee funds through evaluation committees and allocates government funding contributions.

Tax Structure

Korea credit Guarantee Fund (KODIT), was established as an independent legal entity in 1974, by the enactment of the Credit Guarantee Fund Act. It was given the status of trust company under the Trust Business Act. According to the Act, the fundamental property of the Fund consisted of contributions from the government, banking institutions, commercial enterprises, and other sources, which is treated as the capital stock of the organization.

The Fund submits a budget indicating total estimated revenues and expenditure each fiscal year, and the Ministry of Finance and Economy approves it. It represents its accounts based on the corporate accounting standards. The Fund prepares and submits statements of accounts, balance sheets, profit and loss statements and the fundamental property statement covering each fiscal year to the Minister of Finance and Economy within two months following the end of the relevant year. As a state-owned financial institution with majority of government funding, the organization enjoys the status of a not-for-profit entity, and its earnings are exempt from Income Tax as well as Value-Added Tax.

Conclusion

The Credit Guarantee Fund of South Korea (KODIT) provides various services apart from credit guarantee, such as credit insurance services, management consulting, etc. Within credit guarantee services, it provides as high as 11 different types of credit guarantee products. It is one of the largest credit guarantee funds of the world, and implements a thorough credit risk assessment procedure, leading to low default rates over the years. Some of the learning aspects identified by D&B India from KODIT are as under:

- Credit Investigation Procedure

  The credit guarantee fund of South Korea, KODIT, employs a detailed credit investigation process before extending the guarantee for an SME loan. The process involves various steps such as consultation (preliminary inspection), credit investigations (onsite visits, review of documents, etc.), credit evaluations (overall evaluation of SME), and finally the approval.

The high employee strength of KODIT relative to the average number of approvals per year makes the process of individual inspection of SMEs before approval of guarantee application feasible in South Korea. The detailed credit assessment has led to low default rates witnessed by KODIT over the years.

In India, the assessment of the MSE borrower is done by the bank / financial institution. The CGTMSE approves the guarantee based on inputs provided by the bank. D&B India believes that CGTMSE can increase its participation prior to the approval of the loan and the guarantee, which would lead to better usage of the guaranteed loan and less default rates. Most of the successfully running credit guarantee organizations have very high employee strength, spread across many regionally located offices across the nation, which enables the organization to conduct thorough assessment of applications before approving a guarantee. The employee strength of CGTMSE needs also to be expanded to deal with the various functions of the organization, and manage the increased scale of operations. Moreover, a dedicated team in the organization could be appointed for the task of conducting preliminary credit risk assessment before approving the guarantee. The credit check could include personal visit by CGTMSE staff in order to assess the MSE borrower's product capabilities, to confirm the details furnished in the application, and to assess other details such as the borrower's integrity and morale. Alternatively, a Review Committee within the organization may take up the task of assessing capabilities and credibility of borrower MSEs to which the guarantee has already been approved, for MLIs with high default rate.

- Variable Coverage in terms of Number of Years of usage

KODIT offers risk-based guarantee fee ranging from 0.5-3%, and also a variable extent of coverage, ranging from 50-85%, based on credit rating. Moreover, the extent of coverage for a firm with less than 10 years of usage of guarantee product is more than a firm with more than 10 years of usage. This not only ensures greater coverage of risk for a relatively new firm, but also allows itself to cover lower proportion of risk for a firm with good track record.

In India, more than 15% of MSEs[83] are less than five years old. In order to support new firms and encourage start-ups, a preferential scheme could be adopted, with more guarantee cover / less guarantee fee for start-up firms. Special features in the scheme could be adopted to encourage innovative entrepreneurs with new ideas in certain important sectors to provide easy access to finance.

- Guarantee Combined Investment

KODIT provides venture companies capital by purchasing shares and underwriting bonds, which helps such companies get long-term capital. Such investment also helps KODIT realize extra capital gains, and ensures that the fund of KODIT generates high returns. However, the scale of operation and acceptability of such a product is still low in South Korea.

[83] RBI

United Kingdom

Introduction

SMEs in the U.K. contribute to around 99% of businesses, 50% of private-sector turnover, and 60% of private-sector employment. There were around 4.8 million SMEs in the U.K. at the beginning of 2008, employing 23 million people and generating turnover of around £3,000 billion. Most of the SMEs in the U.K. consist of sole proprietorships and partnerships comprising only the self-employed owner-manager(s), and companies comprising only an employee director.[84] Almost 96% of the SMEs in the U.K. have 0-9 employees, and contribute to around 22% of employment. SMEs in some industries such as agriculture, business activities and construction account for a higher proportion of employment than in other industries. The SMEs contribute to the U.K economy as originators of new ideas, technologies and innovation, links in supply chain promoting technical advances, and sources of specialized goods and services for large enterprises. The largest proportion of SMEs belong to the Business Services sector, followed by the Wholesale, Retail & Repair sector, Construction sector, Manufacturing sector and Hotels & Restaurants[85].

Definition of SMEs

According to U.K Law, SMEs under Companies Act 1985 and 2006 are defined by qualification of 2 of the following 3 thresholds for 2 years in a row:

Category	Employees not more than	Turnover not more than	Balance Sheet not more than [86]
Small	50	£6.5 million (`47.7 Crore)	£3.26 million (`23.9 Crore)
Medium	250	£25.9 million (`190 Crore)	£12.9 million (`94.7 Crore)

According to EU definition (adopted on 1st January 2005), an enterprise can be classified as the following if it satisfies either the turnover ceiling or the balance sheet ceiling, in addition to the headcount ceiling. The definition applies to all Community policies applied within the European Economic Area in favor of SMEs, except in the area of company accounting and reporting where a different set of thresholds are set out in the European Company Law Directive.

[84] Department for Business, Innovation and Skills

[85] Small Business Service, Research Unit

[86] Based on eight-day average exchange rate of August, as on August 12, 2010

Category	Employees of maximum	Turnover of maximum	Balance Sheet of maximum[87]
Micro	9	€2 million (`12.18 Crore)	€2 million (`12.18 Crore)
Small	49	€10 million (`60.88 Crore)	€10 million (`60.88 Crore)
Medium	249	€50 million (`304.4 Crore)	€43 million (`261.78 Crore)

Statistics by Department of Business, Innovation and Skills uses the following definition for enterprises based on the number of employees alone:

Category	Micro	Small	Medium	Large
Number of Employees	0-9	0-49	50-249	250 or above

Financial Support to SMEs

An estimated 23% of SMEs are estimated to have sought external finance in 2006, and only 70% of them were successfully able to attract finance in their first attempt. Hence, there was a market gap of almost 135,000 businesses. Moreover, the failure rate of start-up firms is more than 75%, and that of loans to start-up firms is around 25%[88]. Borrowing of SMEs through loan represents 72% of overall SME financing, and the rest is represented by overdraft / credit line. 25% of loans mature at less than 3 years, around 13% at 3-5 years, and 62% at more than 5 years.

The Wilson Committee Report of 1979 had identified that since SMEs were considered to be more risky, they were faced with higher interest charges, more severe conditions, shortage of start-up capital, equity development capital for expansion, and various other market failures in supply of finance to SMEs in the U.K. A study[89] conducted in the years 1987-89 on small and large U.K. companies reveals that the long-term loans as a percentage of total loans for manufacturing SMEs was 20.5% and for non-manufacturing SMEs was 29.4%. On the other hand, the long-term loans as a percentage of total loans for manufacturing Large Firms was 61.7% and for non-manufacturing Large Firms was 72.9%. That is, most of the SMEs relied on sources of short-term finance for all their needs. A variety of policy measures were consequently designed by the government to tackle these problems, such as, the Loan Guarantee Scheme (LGS) and the Business Expansion Scheme (BES) in the 1980s, SMART and SPUR to support investment in hi-tech and innovative businesses, and the Enterprise Investment Scheme and Venture Capital Trusts to boost finance for investment in SMEs.

[87] Based on eight-day average exchange rate of August, as on August 12, 2010

[88] Asian Development Bank Project, Antony Stark

[89] Business Monitor MA3 Company Finance: Various Issues

A 2004 Survey[90] on U.K. SMEs revealed that while 50% of SMEs use overdraft facility for working capital needs, around 7% need it for purchase of fixed assets. Also, while 66% of SMEs use invoice finance for working capital needs, as high as 27% use it for business acquisition and / or expansion. Only 3% of the SMEs use equity finance, and the major sources of equity finance are directors, business associates, friends and family. Besides, there are various sources of grants such as Regional Grants, Enterprise Grants, Agricultural Grants and Business Support Schemes.

History of Credit Guarantee System

In Western and Central Europe, national governments support the SME sector through regulations, as well as fiscal support. Many countries have highly localized small mutual guarantee associations, and others have government-sponsored guarantee schemes. United Kingdom, on the other hand, has developed several highly-subsidized government-guaranteed programs operating through banks.

U.K. Small Firms Loan Guarantee Scheme (SFLGS) was the first scheme started by the national government in 1981, to support SMEs through loan guarantees. It worked through local banks, and provided a standard 75% government loan guarantee to banks and other financial institutions for small enterprises that had viable business proposals but were unable to get conventional loans due to lack of security. The scheme went through major reforms in 1989, 1993, and 2003 as it had somewhat failed to pick up with banks, who preferred all available collateral (personal collateral was forbidden) than government guarantees. The scheme also incurred high operating costs (including net losses) to as high as 15% of amount of loans guaranteed and required ongoing large government subsidies. The average net default rate of the scheme was at around 20% (prior to taking into account the fees and recoveries, the default rate of small businesses under SFLGS was 30-35%)[91]. On the other hand, the scheme was successful in supporting start-up businesses to a great extent, 70% of whom, after being rejected by commercial banks, survived, and thereafter thrived.

Enterprise Finance Guarantee (EFG) was launched on 14th January 2009 to replace the SFLGS, and provided a larger facility and a broader scope than previous guarantee schemes. It also provided 75% guarantee on individual loans to viable businesses, and planned to enable £1.3 billion (`9,539.6 Crore) lending up to 31st March 2010, and £500 million (`3,669 Crore) lending from 1st April 2010 to 31st March 2011.

[90] Survey by Centre for Small and Medium-Sized Enterprises, Warwick Business School

[91] Asian Development Bank, Project PRC-4350

The Credit Guarantee Product

Main Features of Small Firms Loan Guarantee Scheme (SFLGS) operational from 1981-2008 and Enterprise Finance Guarantee (EFG) operational since 2009 are given in the tables below:

Parameters	Features of SFLGS		
Source of Capital Fund	100% government		
% of loan amount covered	75%		
Fee Structure	2% on outstanding guarantee		
Eligibility for borrower:	**Sales less than:**	**Loan Amount between:**	**Term between:**
Manufacturing	£5.6 million (`42.6 Crore)	£5,000 to £250,000 (`3.67 Lakh to `1.8 Crore)	2-10 years
Non-Manufacturing	£3.5 million (`25.7 Crore)		
Tenure of existence	Up to five years		
Sectors	All excluding transport, agriculture, coal and steel		
Businesses	All excluding export and replacement of existing finance		
Other conditions	• Viable business plan with projections, showing the need for finance up to aforementioned limit • No personal asset used as guarantee • Should not be already indebted to their bank, for example, with a debenture in place on their assets		
Guarantee Ceiling	£75,000 (`55 Lakh) if operating for up to two years £187,500 (`1.38 Crore) if operating for more than 2 years		
Collateral	No collateral required by SFLGS, No personal guarantee		

Parameters	Features of EFGS		
Source of Capital Fund	100% government		
% of loan amount covered	75%		
Fee Structure	2% on outstanding guarantee		
Capital Fund	£59 million (`433 Crore)		
Outstanding Guarantee	£700 million (`5,137 Crore) from January 2009 to March 2011		
Eligibility for borrower:	**Sales less than:**	**Loan Amount between:**	**Term between:**
Manufacturing	£25 million (`183.5 Crore)	£1,000 to £1,000,000 (`73,382 to `7.34 Crore)	3 months-10 years
Non-Manufacturing			
Sectors	All excluding transport, agriculture, coal and steel		
Businesses	All excluding export and replacement of existing finance		
Eligibility for lender	Have been lending to SMEs for at least 3 years		
Guarantee Ceiling	£75,000 (`55 Lakh) if operating for up to two years  £187,500 (`1.38 Crore) if operating for more than 2 years		
Collateral	No collateral required by SFLGS, No personal guarantee		

Other features of the EFG Scheme:

1. Types of loan covered:

There are various types of loans covered by CfEL for loan guarantee, such as:

a) New Terms loans

b) Refinancing of existing term loans as a result of deteriorating value of security or cash flow difficulties leading to inability to make loan repayments

c) Overdraft Financing

d) Invoice Financing to support an agreed additional finance

e) Term loans with partial guarantee

f) Overdraft refinancing or increased overdraft financing for firms experiencing short-term cash flow difficulties

g) Existing overdrafts converted into term loans to release capacity, in order to meet overdraft working capital requirements

It is to be noted that CfEL has set a target of 20%[92] of overall loan portfolio of EFG scheme for refinancing or debt consolidation facility. Also, EFG places particular emphasis on access of small and medium firms to working capital, as implied by the fact that the scheme covers outstanding overdrafts converted into loans to release capacity in overdraft.

2. Default rate 'Cap':

CfEL has defined a cap on default rate of portfolio under guarantee for all banks. For defaults that exceed that cap, CfEL does not provide guarantee. The current default cap imposed on each bank is 13%[93] (defined by EU in June 2008). Within the overall cap on portfolio, there is cap on different types of loans mentioned above. This cap on default rate addresses many issues in the credit guarantee mechanism:

a) It ensures that bank does credit risk assessment before extending loans even under guarantee, and does not simply pass off bad loans to the government.

b) Its also caps the maximum possible guarantees to be purchased by CfEL (75% of 13%, i.e. 9.75% of each bank's portfolio under the loan guarantee scheme).

c) The maximum possible guarantee levels enables CfEL to arrive at an appropriate guarantee fee in accordance with the expected default that the organization needs to purchase. Since the guarantee fee to ensure break-even of the fund turned out to be around 3.5%, which was very high proportion of interest rate levels, CfEL decided to make it to 2%[94], and the deficit in the fund was provided for by the government. This state aid was considered to achieve the

[92] Basis inputs by D&B India from meeting with CfEL, United Kingdom

[93] Basis inputs by D&B India from meeting with CfEL, United Kingdom

[94] Basis inputs by D&B India from meeting with CfEL, United Kingdom

social objective of helping a number of SMEs in generating GDP and employment in the economy.

d) The cap also drives banks to extend higher amounts of loans with good credit standing (in case the default rate of small loans turns out to be very high), in order to ensure that the default rate does not exceed the cap. This increases the base portfolio of CfEL, enabling more premiums and helping the fund to eventually become self-financing.

3. Guarantee Premium Rate

The small and medium borrower firms pay the premium for guarantee (guarantee fee) directly to CfEL through an automated process (through direct debit of account). The frequency of payment is quarterly, and the fee is paid on reducing balance. The higher frequency of payment enables CfEL to keep a track of the health of the account, as any delay in payment will signal default risk to the organization at an earlier stage.

4. Partial Collateral:

CfEL also allows partial collateral for guarantee of loans in cases where the borrower in only able to offer small amount of collateral relative to the size of the loan. In turn, the guarantee may be extended only to the non-collateralized portion of the loan, enabling the borrower to pay smaller premiums on small amount of loan rather than the whole loan size. On the other hand, if the bank is not certain of the future market value of the collateral, it may insist on guarantee coverage on the whole loan size, despite the guarantee.

<u>The Credit Guarantee Process</u>

1. Objective and rationale for providing the scheme:

The main reason for extending guarantee is the inability of a small or medium firm borrower to provide collateral against loan. The borrower should have a viable business proposition in order to obtain guarantee. The main objective of providing guarantee under the scheme is to enable finance to small and medium firms with viable business prospects but lack of collateral. The area of emphasis of the scheme is the availability of working capital through terms loans and consolidation of overdrafts.

2. Guarantee Process[77]:

The lender initially discusses with the business its financing requirements and considers the possibility of commercial lending before considering EFG. If the proposition is sound and only if the security is inadequate or there is a lack of track record does the lender proposes government guarantee on the loan. In case where the borrower specifically asks for EFG, the lender will still assess the option of commercial lending, and if the project is viable but commercial lending is not possible, it will decide on extending the scheme under EFG.

3. Collection process of premium:

   The collection of premium is outsourced by CfEL to a collection agency, which is responsible for collection of premium by all small and medium firms, and for keeping a track on timely payment of premium.

4. Non-payment of premium:

   In case of non-payment of premium, CfEL notifies the respective bank of the borrower, and the bank is responsible for recovering the premium amount to be paid to CfEL within 6 months of scheduled payment date. If the borrower fails to pay the fee within the grace period, the guarantee on the loan becomes invalid.

5. Recovery process:

   The recovery process by the bank needs to be completed by the bank within 18 months of the date of default.

6. Purchase of default loan:

   The CfEL pays guarantee on the defaulted loan within 3 months of the date of guarantee invocation.

7. Review of performance of lenders:

   An independent auditor conducts scrutiny of banks by sampling few default cases from different banks. The auditor with CfEL associates visit each lender and review the case. The sample contains larger number of cases from banks with higher rate of default. Also, lender gets a score on the basis of default rate of loans under the scheme. Based on the score, the number of cases to be scrutinized and the frequency of review for banks with better scores are reduced, and those for banks with bad scores are increased. Hence, the scrutiny process by the independent agency ensures review by CfEL on lending practices of banks under the loan guarantee scheme, and keeps a check on banks with poor record of loans under EFG.

8. Risk assessment and processing of loan:

   The credit risk assessment of loans extended under EFG scheme is undertaken by the bank itself. The borrower is required to provide information to the bank related to the current business plan, financial projections, historical trading figures, statutory and management accounts, etc. in order to assess the viability of the project.

   In terms of time taken in the processing of the loan, while during the initial phase of the EFG scheme, the time taken by the bank for the loan to be processed was around 3 months, it is now around an average of 1 month for most of the cases. The processing target for EFG loans given to all major lenders is 20 working days, starting from the date when the application including all relevant information has been received by the lender, and the due-diligence has been conducted by the lender, to the date when the lender has made the offer to the borrower, or provided a letter declining the application. In case this limit of 20 working days has been exceeded by the lender, the latter is answerable to BIS and has to provide explanation for the same.

Overview of the Performance of the Credit guarantee System

1. Extent of coverage of EFG scheme among small and medium businesses:

   The average loan size under EFG was around £100,000 (`73.4 Lakh) in FY10. In terms of number, around 30,000 applications were received by CfEL in FY10, and out of them, 11,500 were found to be eligible, and 9,000 of them were covered under the scheme. EFG is expected to account for 1-2% of total lending to SMEs in the U.K.

   Out of the total number of facilities offered by CfEL under EFG Scheme, about 85% were drawn by SME units to avail the guaranteed loans. The proportion of different types of loans that were availed is as under:

Type of Loan	% of total number of loans	% of total value of loans
New Term Loan with No Security	34.4%	27.6%
New Term Loan with Partial Security	55.0%	57.3%
New term Loan for Overdraft Refinancing	8.0%	11.6%
New Term Loan for Debt Consolidation or Refinancing	1.5%	2.6%
Overdraft Guarantee Facility	0.8%	0.7%
Invoice Finance Guarantee Facility	0.3%	0.2%

2. Awareness of scheme:

   In terms of awareness of the scheme, most of the small businesses know about the scheme prior to approaching the lender. In case of firms consulting independent sources of advice and using accountants, the awareness level about the scheme is even higher. Moreover, the borrowers are well aware of the facilities they are entitled to under the scheme, seek to obtain the same, and complain to the relevant authority in case any guideline (such as processing time of 20 working days) has not been followed by the lender or any other organization.

3. Impact of the scheme:

   An early stage assessment of EFG carried out by BIS[95] from survey of recipient firms in the period

[95] Basis report provided by BIS on "Early Stage Assessment of the Impact of the Enterprise Finance Guarantee (EFG) on Recipient Firms"

Sep-Oct 2009 shows the following results:

a) Most of the firms under the study believed that EFG had been critical in realizing the primary objective for which the finance had been sought.

b) Many firms also said that the EFG loan had led to wider additional benefits such as, increased chances of survival, healthier prospects for growth, improvement in cash flows, increased sales, introduction of new products and processes, better employee productivity, reduced costs, etc.

c) EFG loan aided in avoiding closure or redundancies of many businesses thereby saving numerous jobs, estimated to be around 31.7% of workforce across micro, small and medium enterprises. In addition, the scheme was estimated to have created jobs to the tune of 6% of workforce across the 3 categories. In terms of numbers, By Sep-Oct 2009, EFG had saved or created around 31,600 jobs, and was expected to save or create an additional 8,400 jobs in near future.

Organizational Structure

Overall, 5 individuals manage the loan guarantee programs of CfEL. There are 3 leaders, 1 statistician responsible for developing the forecasting model, and 4 members in the portfolio management team that are responsible for receiving and settling claims[96].

Institutional Structure

United Kingdom's Department of Trade and Industry (also known as Department for Business, Enterprise and Regulatory Reform after 2007) introduced the U.K. Small Firms Loan Guarantee Scheme (SFLGS) in 1981. It was in existence to enable small businesses with a viable business plan, but lacking security, to borrow money from approved money lenders. The U.K. government merged its research and skills department with its business department in 2009, and consequently, Department for Business, Enterprise and Regulatory Reform and Department for Innovation, Universities and Skills came together to form Department for Business, Innovation and Skills (BIS) The Enterprise Finance Guarantee (EFG) was launched under BIS through its subsidiary CfEL in January 2009. The scheme was replaced by Enterprise Finance Guarantee Scheme (EFGS) in January 2009, and is scheduled to run until March 2011.

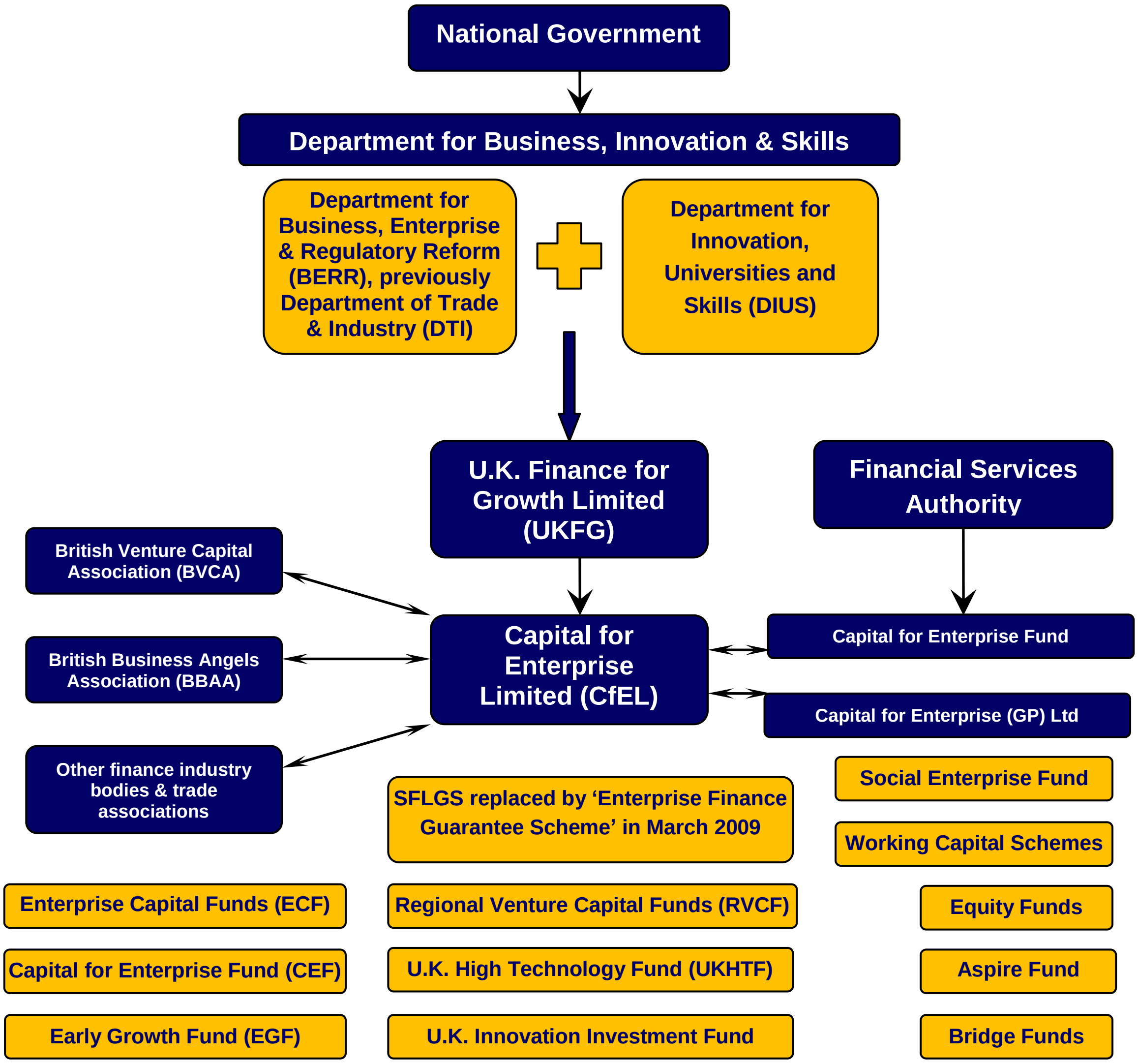
Below is the institutional structure of various schemes run by British government through the organization 'Capital for Enterprise Limited' (CfEL) to support SMEs:

1. Role of BIS (formerly BERR):

[96] Basis inputs by D&B India from meeting with CfEL, United Kingdom

The main function of BIS is to foster a competitive U.K. economy and promote sustainable economic growth. BERR had transferred the responsibility for the operation of Small Firms Loan Guarantee Scheme (SFLGS) to its wholly owned subsidiary Capital for Enterprise Limited (CfEL) in April 2008. In January 2009, SFLGS was replaced by Enterprise Finance Guarantee (EFG).

Institutional Structure



Source: D&B India Literature Study

2. Role of UKFG:

UKFG is a new public company, established to manage BIS's SMEs finance schemes and oversees all publicly funded VC schemes. UKFG is responsible for bringing together the BIS portfolio of SMEs finance schemes managed by CfEL. UKFG provides a range of services to design schemes for Government organizations and to monitor their performance. Government organizations proposing new financial interventions for SMEs will have to consult UKFG for advice. UKFG also provides oversight for all publicly funded venture capital schemes, to throw light on SME finance initiatives. In the long term, UKFG is expected to raise capital from institutional investors, providing a credible channel for those institutions to invest in the U.K. SMEs.

3. Function of CfEL:

CfEL was set up in April 2008 to deliver and manage the U.K. government's financial interventions in the SME sector. It is a Non-Departmental Public Body (NDPB) that operates under a contract with BERR. It also operates a number of other funds such as the Enterprise Capital Fund (ECF) and the Social Enterprise Fund (SEF).

It is currently funded grant-in-aid from BERR against which any income from third parties is offset. The fund operates in such a way so as to achieve a break-even.

The company formed two subsidiaries called Capital for Enterprises Fund Managers Ltd and Capital for Enterprises General Partners Ltd for implementation of its Capital for Enterprises Fund introduced in 2009.

CfEL manages and monitor's BERR's all fund investments and effectively managed the loan guarantee programs, particularly the Enterprise Finance Guarantee Scheme (EFGS).

Tax Structure

CfEL is a limited company wholly owned by the U.K. Government, through the Department for Business, Innovation and Skills (BIS). The strategic aim of the company is to manage the Government's financial interventions in the SME sector, such as the Government's venture capital investments and loan guarantee programs. The company complies with the Companies Act and the Treasury's Government Financial Reporting Manual (FReM). It performs quarterly reporting to the parent organization, the BIS.

There is no corpus fund with the company for loan guarantee purposes. CfEL forecasts number of loan guarantees and default rate, and arrives at an estimated default rate and guarantee fee. The organization has capped the maximum default rate for lending institutions (currently at 13%), and hence its maximum liability towards claims. However, for the estimated claim amount, the guarantee fee to make the operating revenue equal the operating cost is around 3.5%, which is very high relative to the interest rates for borrowing in the U.K. Hence, it has kept the guarantee fee at 2%, and the deficit is financed by the Government.

CfEL does not operate on a commercial basis with a view to realize profits, and operates on central grant in aid funding. Hence, income generated from its mainstream activities is not taxable. However, CfEL is currently liable to corporate tax on the investment income. Also, the profit after tax is attributable to the equity holder, which is the parent organization.

Conclusion

The Enterprise Finance Guarantee (EFG) Scheme offered by CfEL (and launched in January 2009) covers a wide variety of type of finance extended to SMEs, and intends to provide a broader scope in loan guarantees than the previous guarantee schemes. It is managed by a small team, but has various features that ensure the increased acceptability as well as smooth-running of the loan guarantee scheme. D&B India has identified several features of CfEL (in terms of guarantee product as well as organizational structure) that can be adopted by CGTMSE:

- Fee Structure

  The guarantee fee charged under EFG is based on the outstanding loan amount rather than the complete loan amount. This helps reduce the burden of fee on SME borrower in later years of the term-loans, when the outstanding amount of loan is very low, and the fee charged is in-line with the amount of loan remaining.

  Moreover, the fee is charged on a quarterly basis rather than a yearly basis, which helps the organization track the health of the SME, as well as recover greater portion of fee earlier in a financial year.

  D&B India believes that a similar fee structure can be adopted by CGTMSE. The fee payable on outstanding amount will decrease the cost of funds to borrower MSE, and will help increase the acceptability of the scheme among the MLIs and SMEs, leading to wider coverage base of scheme. The increased frequency of payment of service fee will bring similar advantages to CGTMSE, as it does to CfEL. D&B India has discussed this point in detail in the section 'Structure of RSF-II Scheme.

- Partial Collateral

  Allowing partial collateral under the scheme not only helps the increased coverage of scheme amongst borrowers with insufficient collateral, but also enables the borrower pay lower fee and obtain guaranteed loans.

  A similar practice by CGTMSE would greatly enhance the coverage of the scheme, as it would be in the interest of the MLI as well as the borrower. While the MLI will have some collateral against the loan, which would lead to increased recovery rates of loans under default, it would decrease the cost of funds to borrower, who would have to pay guarantee fee on only the unsecured portion of the loan. Moreover, several MSEs with insufficient collateral, who would have otherwise been unwilling to opt for the scheme due to the high amount of fee on complete value of loan, would now be willing to opt for a scheme with partial collateral due to lower amount of fee.

- Collection Agency

  CfEL outsources its fee collection activity to a collection agency. D&B India believes that a separate team dedicated to the task of collecting guarantee fee and service fee would help in the smooth running of the guarantee mechanism, in light of change in fee structure in terms of frequency and amount. Such a team would ensure the accurate determination of amount of fee payable (on outstanding loan amount) and also ensure timely payment of fee by MSEs, leading to limited rejection ground of claims by CGTMSE. It would also help in better communication and enhanced information dissemination among the various stakeholders of the scheme, regarding various aspects of the scheme.

- Cap on Default Rate and Review of Performance

CfEL defines a cap on default rate of each bank beyond which the claims by the bank will not be guaranteed by the organization. The various benefits of such a cap, including limiting the risk of CfEL, have already been discussed.

With increased acceptability of the existing scheme, CGTMSE can review the default rates of MLIs basis a defined cap. It may also ensure that the credit guarantee fund of CGTMSE does not run in deficit, and might eventually become self-sustainable.

United States of America

Introduction

SMEs in the U.S. contribute to approximately 75% of net jobs added to the economy and employ 50% of the private workforce, representing 99.7% of all employer firms. They contribute to around half of the nation's private sector output. Most of the SMEs are very small in size, with around 50% being home-based, and around 75% having no employees.

SMEs are important for the American economy as they fill the niches in input and output markets, innovate, and contribute to the dynamism in the American industries, and the the U.S. economy as a whole[97]. The gross movement in number of business and employment is very large, contributing significantly to a continuous flow of new firms entering the market (due to large number of births and deaths of such firms) to ensure an adequate number of startups in the U.S. economy which grow on to become fast-growing businesses.

Definition of SMEs

The definition of small businesses is set by Small Business Administration (SBA) for each individual NAICS[98] coded industry. This variation is intended to better reflect industry differences. SBA's Office of Size Standards develops and recommends small business size standards to the Administrator of SBA. Size standards are either the average annual receipts or the average employment of a firm. The most widely used size standards are $7 million in average annual receipts for most non-manufacturing industries, and 500 employees for most manufacturing and mining industries. The definition of a small business concern and the size standards as specified by SBA for some of the most common sectors are provided below:

Definition of a small business concern:

A small business concern is organized for profit; has a place of business in the United States; makes a significant contribution to the U.S. economy through payment of taxes or use of American products, materials or labor; is independently owned and operated; is not dominant in its field, on a national basis; and is no larger than SBA's small business size standard for its industry.

Size Standards:

The size standards of SBA for some of the common sectors:

[97] SBA Research

[98] North American Industry Classification System Codes

Sector	No. of employees	Average annual receipts[99]
Construction		
General building & heavy construction		$33. 5 million (`152 Crore)
Specialty trade construction		$14 million (`63 Crore)
Land subdivision		$7 million (`32 Crore)
Dredging		$20 million (`91 Crore)
Manufacturing		
75% of industries	500	
Small balance	1,500	
Few others	750 / 1,000	
Mining		
All industries except mining services	500	
Retail Trade		
Most industries		$7 million (`32 Crore)
Grocery stores, departmental stores, etc.		$35.5 million (`161 Crore)
Services		
Most units		$7 million (`32 Crore)
Computer programming, data processing,		$25 million (`133 Crore)
Engineering & architectural services		$4.5 million (`20 Crore)
R&D, Environmental remediation, etc.	500	
Wholesale trade	100	
Agriculture, transportation, etc.		$0.75 million (`34 Crore)
Source: SBA		

Financing Patterns of SMEs in the U.S.

SMEs in the U.S. use a variety of financial sources for different purposes. About 55% of the businesses use traditional loans, and about 71% use non-traditional loans, such as owner's loans and credit cards. 46% of the small businesses use personal credit cards, 34% use business credit cards, 28% use credit lines, and 21% use vehicle loans. Other major sources of finance for small businesses are mortgage loan, equipment loan, lease etc.

[99] Rupee figures as per exchange rate on September 24, 2010

Among the various financial institutions, banks account for 38% of small businesses, owner's loans account for 14.2%, and finance companies account for 13.3% of such businesses. However, there is significant variation in the pattern for different sizes of SMEs. For example, for the smallest businesses with no employees and 1-4 employees, only 17% and 31% borrow from commercial banks, whereas for small firms with more than 100 employees, 77% borrow from commercial banks. Also, the smallest category of SMEs depend more on personal credit cards, whereas the larger ones depend on business credit cards. In case of other sources of finance, the pattern doesn't vary much for the small and large SMEs.

The small business loan market in the U.S. has been very competitive due to continued presence of a large number of community banks in regional and local markets as well as entry of large national and regional banks. Therefore, for many years, there had been little concern within small firms over the availability of credit.

However, during the recession of 2008, lending to small businesses decreased, and since small businesses are more dependent on credit from banks than large firms (which also have access to external finance), the former were more severely hampered. In the year 2009, total small business lending by banks in the U.S. decreased by 11.6%. Partly, supply side factors such as non-willingness of bankers contributed to the decline, but majorly, demand side factors of deteriorating credit quality of borrowers, resulting from the effects of recession led to contraction in availability of credit to small firms. Even the terms of credit cards and other non-traditional lines of credit worsened to a great extent during this period.

However, since the commencement of the year 2010, major banks have decided to increase their lending to small businesses in the year. For example, Bank of America planned to extend $5 million more in 2010 than in 2009, Wells Fargo planned to increase lending to small firms by 25%, and JPMC planned to extend $4 million more than the previous year.

History of Small Business Administration

The U.S. Small Business Administration (SBA) was established on July 30, 1953 for the assistance of small businesses. There were a number of organizations in place before the establishment of SBA, such as the Reconstruction Finance Corporation (established in 1932 to help large and small businesses hurt by the Great Depression), the Smaller Was Plants Corporation (established in 1942 to help small businesses in war production), and the Small Defense Plants Administration (established during the Korean War, 1950-53, to address small business concerns). The Reconstruction Finance Corporation was abolished in 1952, and to continue the important functions of the earlier agencies, Small Business Administration was established in 1953. The main functions of the SBA since 1954 were making direct loans to small businesses, guaranteeing bank loans to small businesses, making loans to victims of natural disasters, working to get government procurement contracts for small businesses, and providing owners of small businesses technical and managerial assistance and business training.

Since its inception, the SBA has extended or guaranteed more than $211 billion business loans. Also, it had approved over 1.8 million disaster loans for over $47 billion. The organization has played a crucial role in enabling several entrepreneurs to become leaders in their field, such as Federal Express, Sun Microsystems, and Hewlett Packard.

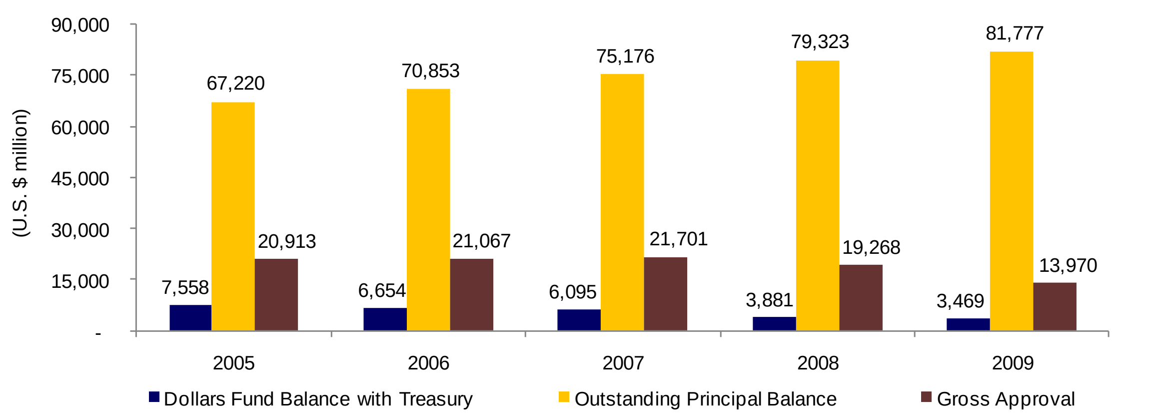
Capital Fund of SBA

Each year, the SBA estimates the scale of the program, and arrives at a fee structure based on lenders' demand for guarantee cover and tenure of guarantee, such that the fund becomes self-sustained. That is, the fee is such that it is able to cover for the defaults that are estimated using an econometric model, for the identified guarantee cover. Also, the fee receipts for any guarantee program are used only to cover the cost of the program, and not other costs such as employee salary[100].

During recession, the actual defaults were much higher than the estimated levels, and hence the government had to provide funds to pay the guaranteed amounts. However, the target is to make the fund self-sustained through appropriate fee structure and guarantee cover levels.

The treasury fund available with SBA for the period 2005-2009, the outstanding guarantee and the gross approval in each year, is provided in the chart below:

Treasury Fund and Outstanding Balance of SBA



Source: D&B India Literature Study

The Credit Guarantee Product

SBA's Guaranteed Loan Programs

SBA's primary program is the 7(a) Loan Program, which offers start-ups and existing small businesses with loan guarantees for loans made by participating lending institutions for a variety of business purposes. Lending partners need to execute an SBA Form 750, Deferred Participation Agreement, which establishes the terms for loan guarantee by SBA. While applying for guarantee, the

[100] Via telephonic discussion with SBA

lender needs to certify that it would not make the loan if the SBA doesn't guarantee it. That is, SBA guarantees loans for only those borrowers who have officially been turned down by lenders because of lack of collateral. SBA then decided whether to make a guarantee based on the information provided to it in the loan application.

Under an SBA guarantee, there are certain conditions imposed on the lender (related to administration and closure of account) and the borrower (related to business or owners).

There are a variety of methods for applying for guarantee on proposed loans. The differences in the methods pertain to the levels of authority and responsibility that the lender and SBA share between them in making decisions about the loan. The better the past performance of the lender in administrative functions of the loan, the more is the authority given to the lender.

In case of a default, the lender may request SBA to purchase the guaranteed portion.

- **7(a) Loan Program**

  7(a) Loan Program is SBA's primary and most flexible loan program which guarantees loans for a variety of general business purposes extended by commercial lending institutions. It is designed for startups as well as existing small businesses. The major types of 7(a) Loan Programs are Express Programs, Export Loan Programs, Rural Lender Advantage Programs, and Special Purpose Loan Programs.

  Some of the basic features of SBA's 7(a) Loan Program is given below.

Features of 7(a) Loan Program	
Parameters	**Features**
% of loan amount covered	75-85%
Collateral	Collateral taken by banks, Personal guarantees required by SBA from large shareholders
Maximum Maturity of 7(a) Loans	For Working Capital: 7 years; For Term-Loan: Economic life of asset or 25 years, whichever is less
Maximum Loan Amount	$2,000,000 with SBA's exposure being $1,500,000 (75%)
Guarantee Fee	2-3.5% of guaranteed portion depending on loan size
Annual Service Fee	0.55% of outstanding balance of guaranteed portion
Interest Rate	Under 7 yrs, max prime 2.25%, above 7 yrs, max prime 2.75%, below $25,000: -2%, from $25,000-50,000: -1% can be added
Prepayment Penalty	5% of amount of prepayment during 1st year after disbursement, 3% during 2nd year, 1% during 3rd year
Eligibility	Must be operated for profit; meet SBA size standards; show good character, management expertise, & commitment & show ability to repay; may not be involved in speculation or investment
Source: SBA	

7(a) loans are the most basic and most commonly used loans as they can be used for a variety of purposes such as working capital, machinery and equipment, furniture and fixtures, land and building, debt refinancing etc. Most of the American banks and non-bank lending institutions participate in the program, and agree to structure the loan according to SBA's requirements.

In order to avail for SBA's 7(a) Loan Program, the small business needs to approach the lender with loan application. The lender reviews the application and decides whether to extend the loan or whether additional support of SBA is required. In case the lender is not willing to extend the loan in spite of SBA guarantee, the latter cannot force the lender to extend the loan. There are several credit factors that are assessed by the lender as well as the SBA while assessing the creditworthiness of the small business. Some of the factors are adequate equity investment, healthy cash flows from the business, payment history of existing credit relationships, available working capital, adequate collateral (as 20% personal collateral of owner is required by SBA), and character and managerial capacity.

- **Other Guaranteed Loan Programs**

  Other Guaranteed Loan Programs of SBA are CDC / 504 Loan Program for long-term fixed financing to acquire fixed assets for expansion or modernization, Microloan Program for small businesses and not-for-profit child care centers delivered through specially designed intermediary lenders, and Disaster Assistance Loan Program to provide low-interest loans in case of declared disasters to affected parties such as home-owners and businesses of all sizes.

The Credit Guarantee Process

Application Process:

SBA guarantees loans to borrowers only if they have been denied all sources of finance due to non availability of collaterals. The application process for obtaining the guarantee loan program involves extensive documentation to evaluate the loan request. Along with the SBA form, other details in the form of documents required are as under:

- Loan documents
- Executive summary
- Business Profile
- Management Experience
- Loan repayment schedule along with cash flow and budget estimates
- Collateral
- Personal Financial Statement
- Business Financial Statement
- Propose business
- Projections
- Other items such as lease, franchise agreement, purchase agreement, articles of incorporation, plans, specifications, copies of licenses, letters of reference, letters of intent, contracts, and partnership agreement

Moreover, by Law, SBA may not guarantee a loan if a business can obtain funds on reasonable terms from a bank or other private source. Hence, the applicant needs to try to get private financing before approaching SBA, and needs to identify the lender that he would be approaching after obtaining the SBA loan guarantee.

Fee Payment:

The fee on a guaranteed loan is charged to the lender financial institution[101]. The lender may or may not pass on the fee as a part of interest payments to the borrower. The borrower is usually willing to pay the higher interest rate as the loan would not be possible without the SBA guarantee.

Guarantee cover as Call Option:

The guarantee cover offered by SBA in its various guarantee programs acts as a call option for the lenders. This is because the lenders have an option of either claiming the guarantee after a loan defaults, or recovering their default from the borrower. Based on risk involved in extending loan to a borrower (after borrower approaches SBA and obtains an in-principal approval for guarantee cover), lender can purchase an option from SBA by selecting a suitable guarantee cover and loan tenure. In case of a default in the loan account, the lender can either claim the guarantee from SBA or initiate the recovery proceedings by considering the cost-risk-benefit analysis and time involved in both the options. In case a lender exercises the option, SBA purchases the guaranteed amount in default (principal and outstanding interest) from the respective lender. Hence, the guarantee program in the U.S. helps the lenders to maximize their returns by acting as a risk mitigation instrument.

Credit Risk Management:

The Office of Lender Oversight of SBA is responsible for the credit risk management function. SBA conducts onsite reviews once in two years for about 8% of the lenders which are responsible for about 85% of dollar guarantees of SBA[102]. Besides, the Office of Lender Oversight regularly monitors the portfolio of guarantee through leading indicators and quarterly credit scores provided by a credit rating agency, and conducts monthly reviews of the programs.

<u>Overview of Performance of the Credit Guarantee System</u>

Performance of SBA

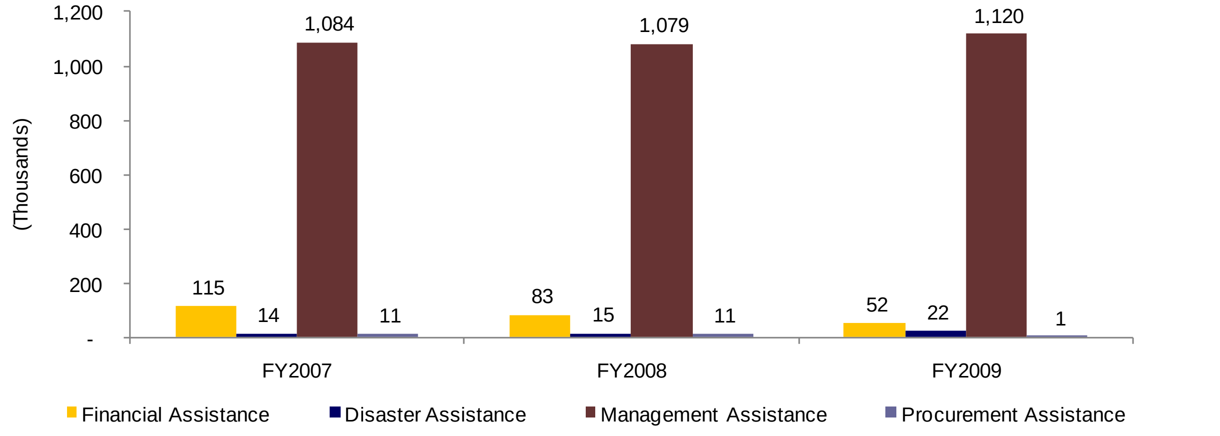
The performance of SBA over the period FY2007-FY2009 in terms of extent of coverage is given below. While the financial assistance and disaster assistance are measured in terms of number of new loans approved, management assistance is measured in terms of number of small businesses

[101] Via telephonic discussion with SBA

[102] Via telephonic discussion with SBA

assisted, and procurement assistance is measured in terms of number of small businesses assisted for 8(a) Program and number of Final Bonds Guaranteed under Surety Bond Program. It is to be noted that management assistance represents a substantially high figure compared to other areas of assistance in terms of number of small businesses covered.

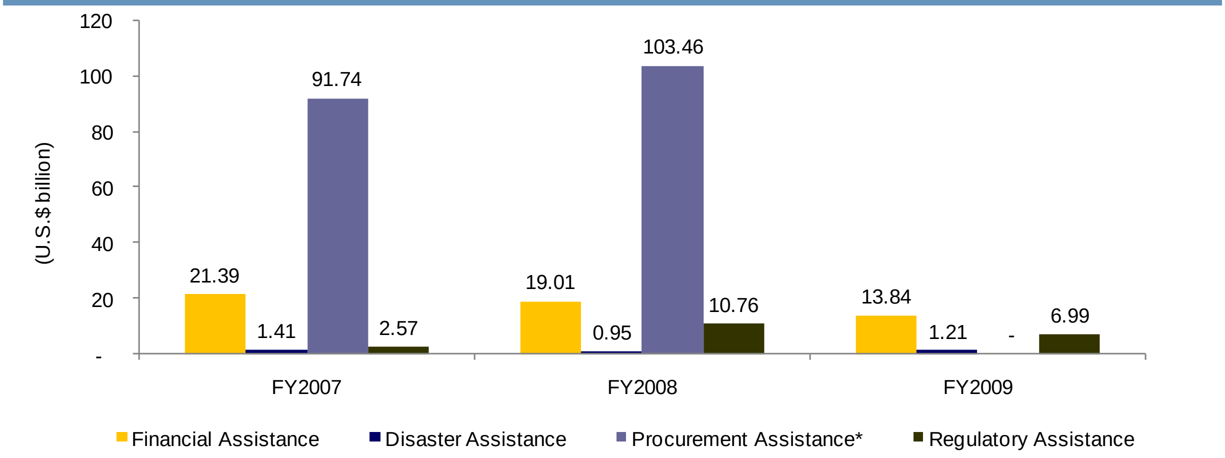
Performance of SBA in terms of numbers



Source: SBA

In terms of Dollar value of assistance, figures for financial assistance and disaster assistance represent dollar value of loans approved, figures for procurement assistance represents value of federal contracts (for Prime Contracting and HubZone programs), and figures for regulatory assistance represents regulatory cost savings. It is to be noted that the Dollar amount of loans approved in case of financial assistance, specifically for 7(a) Regular Loans and 504 Regular Loans, is about 15% higher than the disbursement / funded loans. Also, Dollar amount of Disaster Loans is around 46% higher than disbursement / funded loans as many potential borrowers get declined after being approved in case they receive insurance payments, grants, or decide not to rebuild.

Performance of SBA in terms of Dollar value

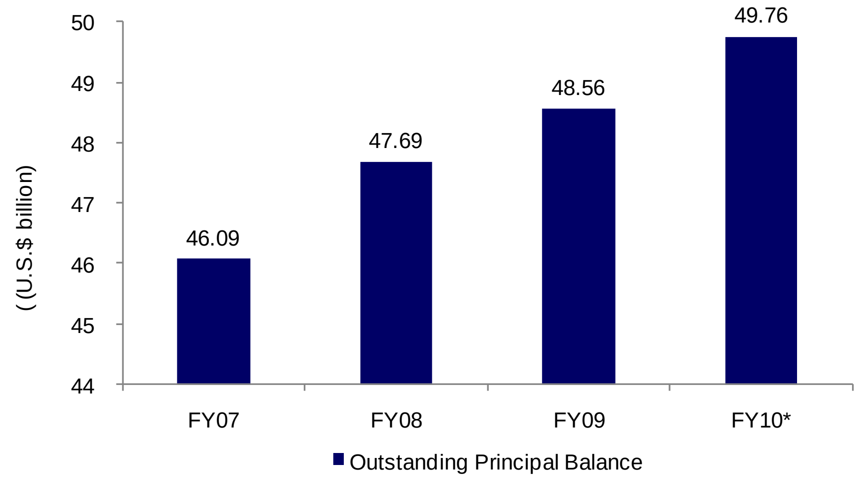


Source: SBA
*excludes FY2009 data which would be available from federal agencies by 4th quarter of FY2010

Performance of 7(a) Loan Program

The figure below represents the outstanding principal balance of 7(a) loans for the past few years which have not been charged off as of the end of the year. It is comprised of the guaranteed as well as non-guaranteed portion of the loan.

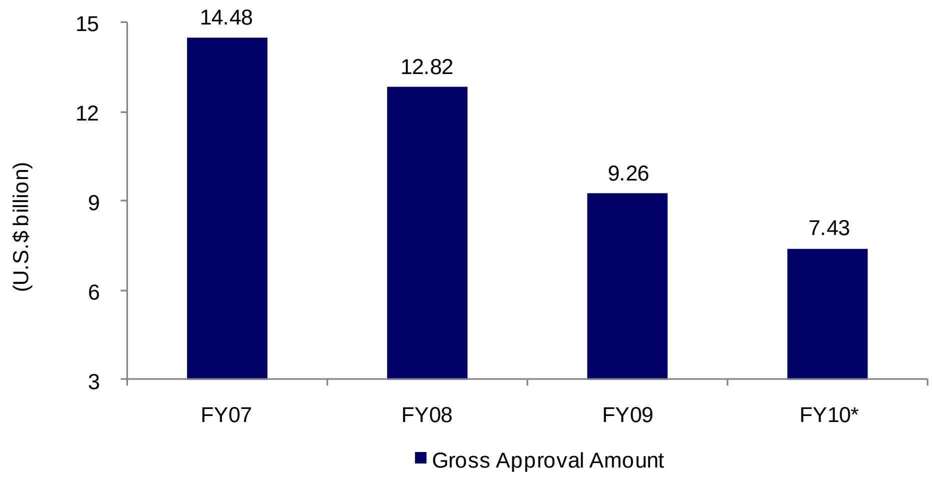
Outstanding Principal Balance of 7(a) Loan Program



Source: SBA
*For FY10, data only till March 2010

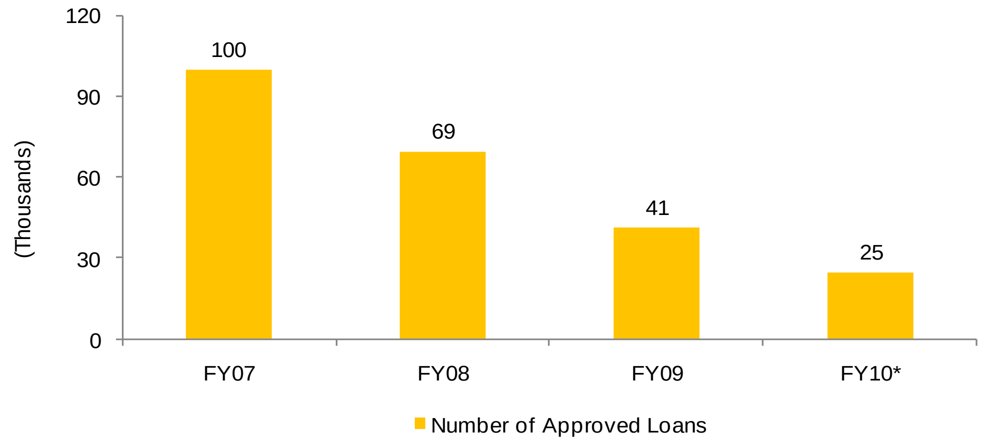
Gross Approval Amount includes the dollar amount of approved loans (guaranteed as well as non-guaranteed portion) during a given year and subsequent loan increases that occur during that year. It also includes loans that may have subsequently been cancelled. The figures below represent the dollar amount of approved loans as well as the number of loans approved for the years FY07-10.

Gross Approval Amount of 7(a) Loan Program



Source: SBA
*For FY10, data only till March 2010

Gross Number of Approvals of 7(a) Loan Program

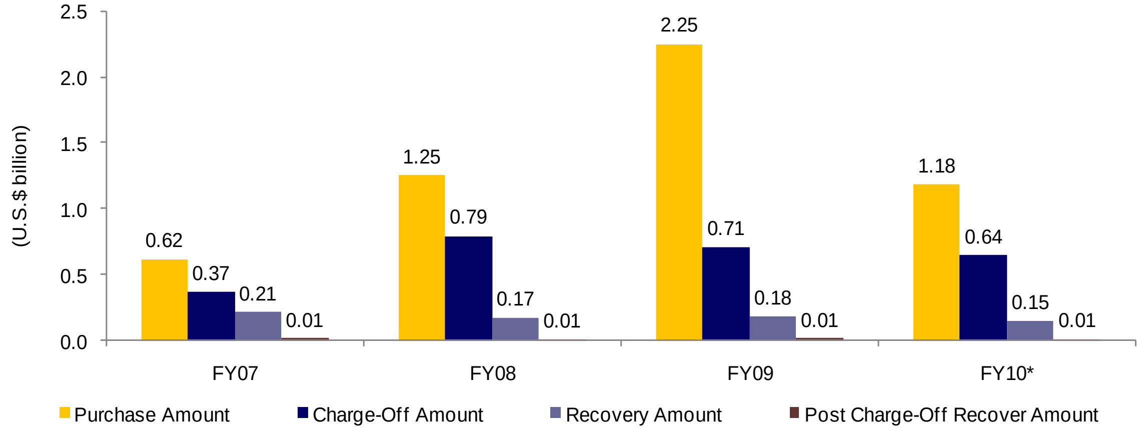


Source: SBA
*For FY10, data only till March 2010

Default Rates

The defaults under any loan guarantee program are the amount of purchases for the program. That is, there are negligible cases for which the guarantee payment is denied. Purchase Amount is the dollar amount of principal and interest purchased by SBA on the guaranteed loan in default. It is net of pre-purchase lender recoveries and related costs, but not net of post-purchase recoveries and related expenses. It excludes the non-guaranteed portion of the loan in default.

Purchase and Recovery Amounts of 7(a) Loan Program



Source: SBA
*For FY10, data only till March 2010

The purchase rate for 7(a) Loan Program (equal to 12 month purchases / outstanding guarantee) was about 2% in July-August 2007, and rose to 7-8% in June-July 2010, which was the highest in the history of the Loan Program[103].

[103] Via telephonic discussion with SBA

Organizational Structure

Restructuring of SBA in the year 2002

United States' Small Business Administration went through an organizational restructuring in the year 2002 to make the federal agency more result-oriented, market-based and citizen-centered.

Prior to the 2002 restructuring, the SBA contained 10 regional offices, 70 district offices, 16 branch offices, 6 area offices, 9 loan service centers, and 1100 centers such as Small Business Development Centers. As a part of the restructuring plan, the six area offices and three certification and eligibility centers were consolidated under the agency's regional offices.

It was realized that the agency had too many political appointees, which led to bloated bureaucracy, and the need to replace / support them with career officers was recognized. The post of chief operating officer was suggested to be replaced by career civil servants instead of political appointees, and few posts under it were advised to be combined into it. Also, in the 1993 round of restructuring of SBA, a lot of power was shifted from regional offices to district offices which had resulted in cumbersome communication between the head quarter and the field units. Hence, in the 2002 restructuring, some power was restored to regional offices. The regional offices were back as the link between the headquarters and district offices. The district offices shifted their focus on marketing and outreach whereas the back-office functions such as loan processing and servicing was transferred out of these offices.

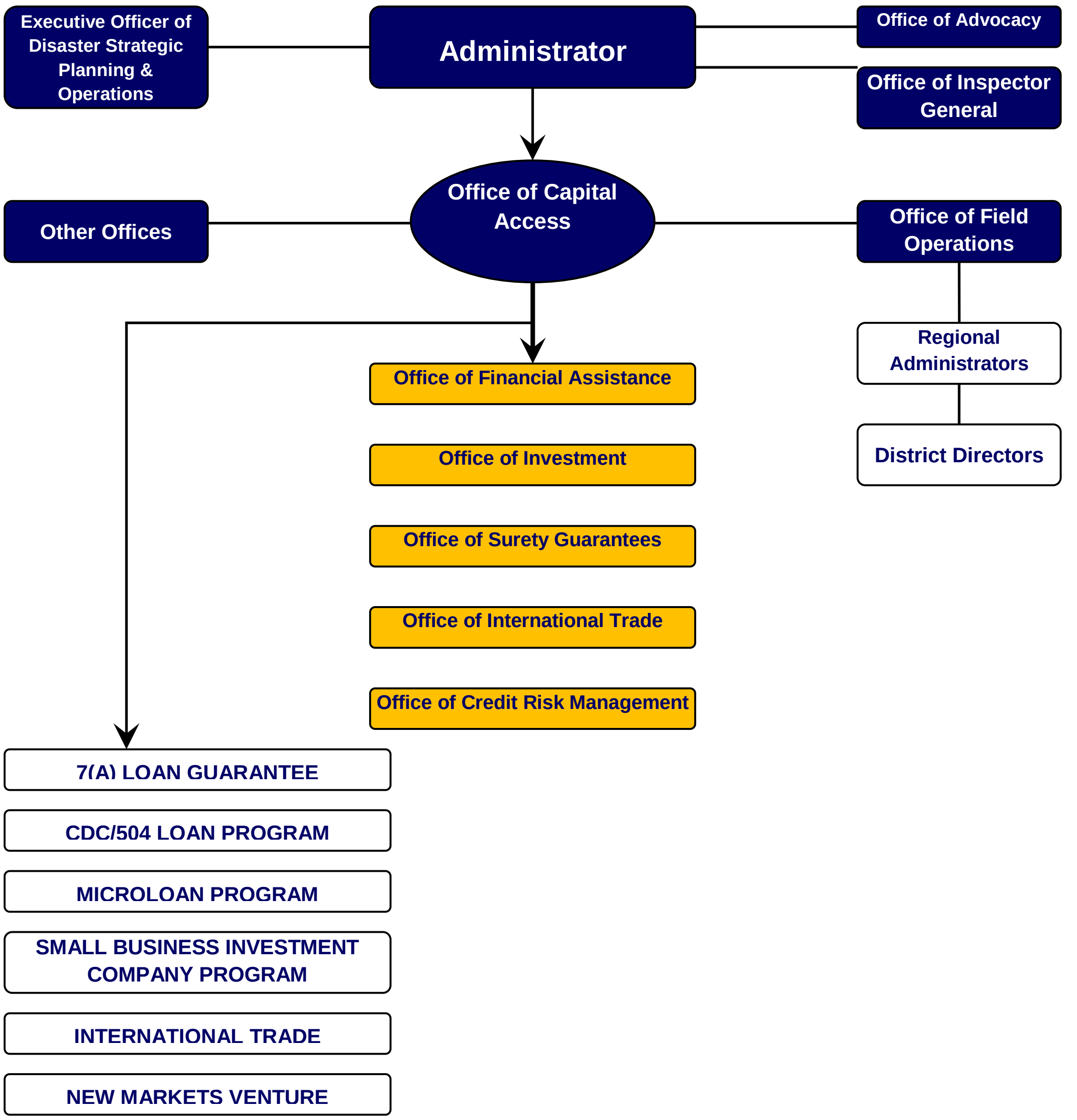
Also, prior to the restructuring, banks were regarded as the primary customers of SBA by employees of district offices. This attitude was changed and an emphasis on small businesses as primary customers was put forward. A workforce transformation process was taken up and employee training was considered a key component of the program.

Current Organizational Structure of SBA

The SBA Headquarters are located in Washington DC, and there are 10 Regional Offices, 70 District Offices, various Offices of Field Operation, and over a thousand resource partners nationwide. While the Regional Offices and District Offices primarily perform marketing and promotional activities in respective regions, the Offices of Field Operations function parallel to the Regional and District Offices. The management structure of SBA is relatively flat in headquarters, with 19 offices reporting to the Office of Administrator. The 5 functional areas of SBA are Financial Assistance, Procurement Assistance, Management Assistance, Disaster Assistance, and Regulatory Assistance.

The current organizational structure of SBA is provided below:

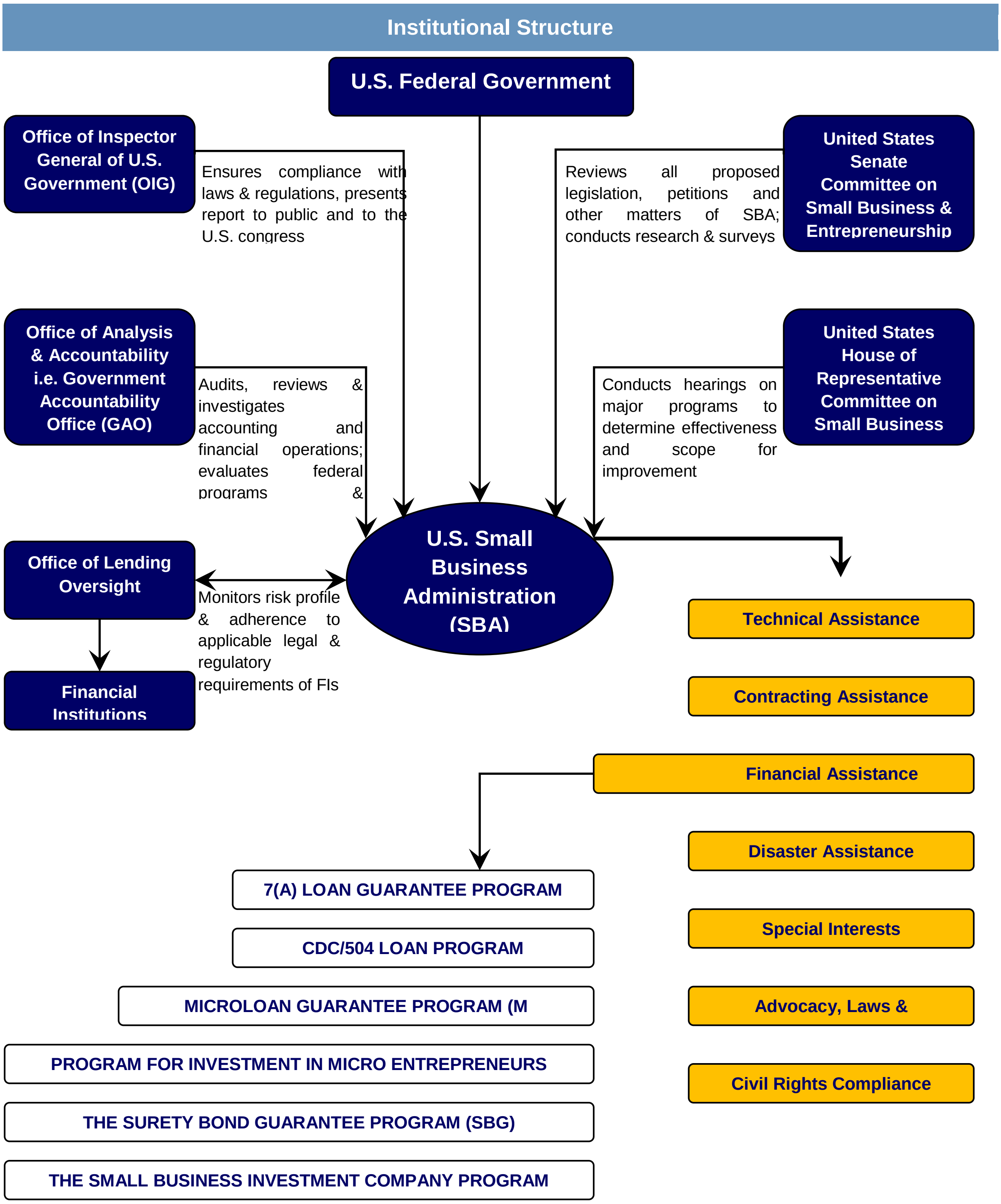
Organizational Structure



Source: D&B India Literature Study

Institutional Structure of SBA

SBA is an agency of the U.S. Federal Government, which, under the U.S. federal legislation, provides various kinds of assistance to small businesses, such as technical assistance, financial assistance, disaster management, counseling, online training, assistance on legislation and regulation, special minority programs, contracting opportunities etc. Within financial assistance, the agency provides various investment programs, loan guarantee programs, bond guarantee program, micro loan program, venture capital etc.



Source: D&B India Literature Study

1. Role of the Office of Inspector General (OIG):

The Inspector General of the U.S. Government ensures SBA's compliance with laws and regulations. The Office of the Inspector General (OIG) has the authority to provide policy direction for audits, investigations and examination and to supervise and coordinate them. It has access to all information of the SBA and is required to make its report available to public and also to submit semiannual report to the U.S. Congress covering the significant activities.

2. **Role of Government Accountability Office (GAO):**

The GAO is the investigating arm of the U.S. Congress and has the statutory authority of the Controller General of the U.S. to audit, review and investigate the accounting, financial and other related operations of all Federal Government agencies. It evaluates federal programs, audits federal expenditures and issues legal opinions. The body is very crucial for the government as its recommendations lead to laws and acts that improve government operations. GAO reports its inspections to the management of SBA in cases where there are deficiencies and initiates corrective actions and follow-up communications by the SBA.

3. **Role of Office of Lender Oversight**

This office is maintained by the SBA to identify, monitor and assess the risk profiles of financial institutions and their adherence to applicable legal and regulatory requirements. It conducts quarterly off-site reviews and on-site examinations once in 3 years.

4. **Role of the U.S. Senate Committee on Small Business and Entrepreneurship**

The Senate Committee reviews all matter relating to SBA such as legislation, petitions, memorials etc. It also conducts research and surveys into problems faced by small businesses in the U.S.

5. **Role of the U.S. House of Representative Committee on Small Business**

The House of Representative Committee conducts hearings on all major programs of SBA to determine their effectiveness and provides possible ways of improvement. It oversees SBA’s performance in carrying out its statutory mandated roles, such as its internal financial management, and ensures that SBA remove any improper payments and receives a green score card under the Administration’s Programs Assessment Rating Tool. The Committee also monitors reporting requirements on gifts, co-sponsorships and co-operative agreements received or entered into by SBA with the private sector.

<u>Tax Structure</u>

SBA, being a government organization, is exempt from paying income tax and value-added tax.

<u>Conclusion</u>

- Self-sustained capital fund

Although SBA has a treasury fund in place, it has been constant over the years 2005-07 as shown in the chart “Treasury Fund and Outstanding Balance of SBA” in the sub-sections “Capital

Fund of SBA". The fund decreased in value due to the recession and the unanticipated higher rates of default which were paid for through the treasury balance. Nevertheless, the loan guarantee program is designed in such a way that the guarantee fees charged pays for the guarantee payments in case of defaults. Other operating expenses such as employee salaries are paid by SBA's own fund.

D&B India believes that once the committed capital of the settlers of CGTMSE scheme are infused as capital fund, the fund should aim to be self-sustained where the expected amounts of default can be forecast and the guarantee fee collected should be able to pay for the guarantee payments. Settlors can step-in to contribute to the capital fund, only if there is any shortfall in the corpus required for meeting the guarantee obligations.

- Flexibility in product structure

SBA designs its guarantee product every year based on forecasted defaults according to lender requirements on tenure and extent of coverage.

CGTMSE can look at providing customized guarantee products to the lenders based on the tenure of coverage required and the extent of guarantee cover. Also, D&B India has discussed the issue of risk-based pricing with MLIs. With a uniform credit assessment system in place, CGTMSE can include the risk assessment in the pricing of the guarantee product. Also, D&B India has recommended a Review Committee in the section "Institutional Structure of CGTMSE" for performance evaluation of MLIs based on default rates. Through this, MLIs with impressive track of low default rate can be rewarded with rebate in guarantee fee.

- Guarantee cover as call option

SBA provides guarantee cover as call option, where lenders can either claim the guarantee or recover the defaulted amount from the borrower based on cost-risk-benefit analysis and time involved in each process.

Based on the recommendations regarding partial collateral, CGTMSE can provide flexibility regarding extent of partial collateral relative to guarantee cover to the lender at the time of approval of the guarantee. Since the program has not reached the maturity stage where it can forecast defaults and arrive at option pricing, this flexibility can be provided at the time of taking the guarantee rather than choosing it at a later stage.

- Credit Risk Management

The credit risk management function is performed by the Office of Lending Oversight of SBA. While a thorough credit risk assessment is performed before approving the guarantee cover, regular credit checks are performed on the borrower.

D&B India believes that with the expanding organizational structure of CGTMSE, the organization can look into conducting extensive checks on the borrower through documents related to financial statements, purpose of loan, business projections, etc. before approving a credit guarantee.

Moreover, the credit guarantee portfolio can be regularly reviewed through onsite visits, credit scores, and other instruments and indicators.

- Function of Regional and District Offices

With increased centralization of operations of SBA, the responsibilities of Regional and District Offices in the loan guarantee function has decreased overtime. However, the existing infrastructure and database of such offices is used for marketing and promotional activities extensively in the respective regions.

CGTMSE can also have robust infrastructure specially dedicated to understanding the local needs of the diversified regions of India. The offices can conduct awareness programs and marketing activities, and also understand the needs and concerns of various regions / sectors and provide feedback to the Head Office, which will enable the organization to come up with better products with wider coverage that are more suited to the needs of all stakeholders.

Malaysia

Introduction

Contribution of SMEs in Malaysian economy is crucial as they provide a significant input to various economically diverse activities, create more jobs per unit of capital employed than the large enterprises (SMEs are mostly labor-intensive), serve as a training background for developing and upgrading of skills of industrial workers, technicians, managers and entrepreneurs, reduce import requirements and hence improve Balance of Payments position, and provide impetus to inter-firm linkages in the domestic economy. By 2010, SMEs in Malaysia are expected to contribute to 37% of GDP, 57% of total employment, and 22% of total exports. Their contribution is most significant in the manufacturing sector, with 97.7% of total manufacturing establishments belonging to the SME segment.

Since the main source of financing for SMEs in Malaysia is the owner's credit, or that of family and friends, the sector contributes significantly to the overall saving and investment rate of the Malaysian economy. They also contribute to regional development and create a more equitable income distribution in the economy.

Definition of SMEs

In Malaysia, various agencies adopt different definitions of SMEs depending on their business interests. However one common definition is that provided by the Small and Medium Industries Development Corporation (SMIDEC). According to the common definition, SMEs in Malaysia are defined on the basis of either number of full-time employees, or total sales / revenues generated by the business in a year. A business unit has to qualify either

Definition of SMEs based on number of employees			
	Primary Agriculture	Manufacturing Sector (including agro-based and manufacturing-related services)	Services Sector (including information and communication technology)
Micro	Less than 5	Less than 5	Less than 5
Small	Between 5 and 19	Between 5 and 50	Between 5 and 19
Medium	Between 20 and 50	Between 51 and 150	Between 20 and 50
Source: SME Corp Malaysia website			

Definition of SMEs based on sales / revenue			
	Primary Agriculture	Manufacturing Sector (including agro-based and manufacturing-related services)	Services Sector (including information and communication technology)
Micro	Less than RM200,000 (`29 Lakh)	Less than RM250,000 (`36.6 Lakh)	Less than RM200,000 (`29 Lakh)
Small	Between RM200,000 (`29 Lakh) and less than RM1 million (`1.47 Crore)	Between RM250,000 (`36.6 Lakh) and less than RM10 million (`14.7 Crore)	Between RM200,000 (`29 Lakh) and less than RM1 million (`1.47 Crore)
Medium	Between RM1 million (`1.47 Crore) and RM5 million (`7.33 Crore)	Between RM10 million (14.7 Crore) and RM25 million (36.6 Crore)	Between RM1 million (`1.47 Crore) and RM5 million (`7.33 Crore)
Source: SME Corp Malaysia website *Rupee figures are based on eight-day average exchange rate of August, as on 12 August, 2010			

Government Initiatives for SMEs

The areas in which the government of Malaysia assists SMEs can be classified in four categories, namely, tax incentives, grant assistance (such as those for technical assistance and skill upgradation), loans, credit and equity participation (such as government direct financing, credit guarantees, equity financing, venture capital, minimum lending guidelines), and infrastructure and supporting services. The government has put in place a number of ministries and agencies which have designed a number of grants, incentives and other programs to aid SMEs and to support them in various critical areas.

The **Small and Medium Industries development Corporation** (SMIDC) operates several programs for SMEs such as those to help SMEs penetrate overseas market, to create critical industrial linkages, to enable new and attractive product packaging designs, to enhance technical and managerial skills of employees, to provide advisory services, and to recognize achievements of home-grown companies and promote them. The **Ministry of Entrepreneur and Co-operative Development** (MECD) provides training and advisory services to entrepreneurs and helps them create franchises and enter foreign markets, and engages in business linkages programs. **Federal Agriculture Marketing Authority** (FAMA), **Ministry of Science, Technology and Innovations** (MOSTI), **Department of**

Standards Malaysia, **Perbadanan Kemajuan Kraftangan Malaysia** are among the various other government ministries and agencies that assist SMEs in the country in various ways.

Financing of SMEs in Malaysia

There are various tailored-made products by few SME-focused banks for micro and small enterprises. A brief summary of various SME-focused products offered by three popular SME banks is given below. The SME Bank, besides providing the following types of loans to SMEs at competitive rates (subject to term of funds and risk ratings), also provides advisory services, business acceleration services, information services, promotional and business matching services, and performance evaluation services.

<table>
<tr><th colspan="6">SME Focused Banks and their products</th></tr>
<tr><th colspan="2">SME Bank</th><th colspan="2">CIMB Bank</th><th colspan="2">RHB Bank</th></tr>
<tr><td>SME Start-Up</td><td>For Start-ups with viable business plan</td><td rowspan="2">Fund for Small and Medium Industries</td><td rowspan="2">Government aided scheme in conjunction with Bank Negara</td><td>Automatic Standby OD</td><td>Immediate supply of cash against FD</td></tr>
<tr><td>SME Professional</td><td>For existing SMEs wishing to expand in domestic and foreign markets</td><td rowspan="3">Business Growth Package</td><td rowspan="3">Includes Term Loan, Overdraft, Trade Financing, Bank Guarantee, Foreign Exchange Line to help business grow</td></tr>
<tr><td>SME Franchise</td><td>Aimed at franchises</td><td rowspan="2">Small Entrepreneur Guarantee Scheme</td><td rowspan="2">Not government aided, and focuses on Micro enterprises</td></tr>
<tr><td>SME Procurement</td><td>Aimed at Vendor SMEs</td></tr>
<tr><td>SME Global</td><td>Aimed at SMEs expanding market overseas</td><td>Flexi Cash</td><td>Personal Loans at hefty interest rates</td><td>Business Loans</td><td>For conventional and Islamic financing</td></tr>
<tr><td></td><td></td><td></td><td></td><td>Equipment Loans</td><td>Long-term immediate financing for a broad range of equipments</td></tr>
</table>

				Property Loans	To finance commercial property

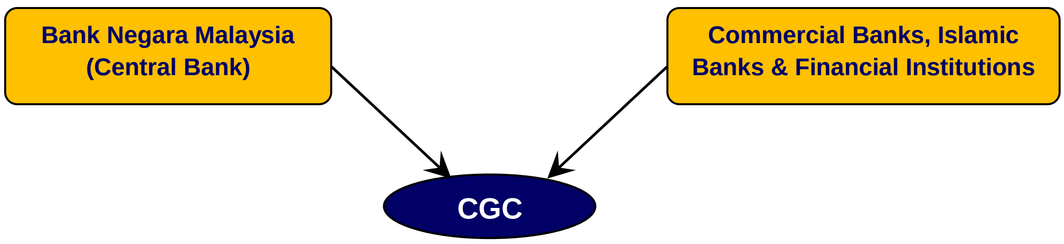
Source: D&B Literature Study

In spite of various SME focused government schemes and bank loan products, the sector faces various constraints in relation to access to finance. According to the Census of 2005, 13.1% of SMEs faced the constraint due to lack of adequate documents, 10.7% of SMEs faced the problem of lack of financial records, 9.8% faced long loan-processing time, and 5.3% of SMEs were declared to not have a viable business plan. However, as high as 55.2% of SMEs faced constraint in financing due to lack of adequate collateral. Hence, the Credit Guarantee Corporation of Malaysia has a vital role to play to alleviate this problem faced by SMEs in Malaysia.

The Credit Guarantee Fund

The Credit Guarantee Corporation (CGC) of Malaysia was established in the year 1972 to assist SMEs with no or inadequate collateral with access to finance from financial institutions. The shareholders of the CGC are Bank Negara Malaysia with a holding of 79.3% and Commercial Banks and Financial Institutions of Malaysia with a holding of 20.7%. The capital fund of CGC Malaysia stood at RM2.3 billion (`3,371 Crore[104]) including reserves set-aside for certain government backed schemes and Islamic schemes.

Contributors to Capital Fund



Source: CGC Malaysia

The Credit Guarantee Product

Currently, the CGC offers 11 different types of schemes for SMEs. The major details of the schemes are provided below[105]:

- **Eligibility Criteria:**

  The eligibility criteria for lenders and borrowers are based on individual scheme guidelines. In

[104] Based on eight-day average exchange rate of August, as on 12 August, 2010

[105] Basis e-mail response from CGC Malaysia

principle, lenders who are eligible to participate in the guarantee schemes are all commercial and Islamic banking and development financial institutions licensed in Malaysia. Eligible borrowers are SMEs that come under the definitions of SMEs. They must also have a viable business and have no adverse record.

- **Types of loans covered:**

  Depending on the individual guarantee schemes and its suitability to business operation, facilities covered include both the conventional and Islamic facilities such as Overdraft (normal), OD / Invoice / PO, Term Loan, Revolving Credit and Trade lines (LC, TR, BA, SG, BG, etc).

- **Other details:**

  The guarantee fees range between 0.50% to 5.75%[106] and are payable annually on the complete loan amount. Upon claim approval, the claim payment can either be immediate payment or deferred payment (depending on the schemes). For some schemes, claim is approved conditionally. The payment of claim will is made if it has met the terms & conditions set by CGC. In case of partial collateral-based guarantee, the coverage offered on secured portion is between 30-90%.

  The various parameters of the major guarantee products offered by CGC Malaysia are given below.

Guarantee Products of CGC Malaysia				
Parameter	**Direct Access Guarantee Scheme (DAGS)**	**Direct Access Guarantee Scheme-i**	**Small Entrepreneur Guarantee Scheme (SEGS)**	**Direct Bank Guarantee Scheme (DIRECT BG)**
Loan Financing Amount	RM0.05-3 million (`7.3 Lakh to `4.4 Crore)	RM0.05-3 million (`7.3 Lakh to `4.4 Crore)	RM0.01-0.05 million (`1.5-7.3 Lakh)	RM0.05-3 million (`7.3 Lakh to `4.4 Crore)
Tenure	WC: 5 years TL: 10 years	WC: 5 years TL: 8 years	5 years	Corresponding to specific bank guarantee
Interest Rate	1-1.75% + BLR	1-1.75% + BLR	Max 1.5% + BLR	0.6%, min = RM 50

106 Basis e-mail response from CGC Malaysia

Guarantee Coverage	30-100%	30-100%	Bumiputra: 100% Non-Bumi: 80%	Up to 100%
Guarantee Fee	Secured: 0.5-3% Unsecured: 0.75-3.5%	Secured: 0.5-3% Unsecured: 0.75-3.5%	Secured: 3% Unsecured: 3.5%	Secured: 0.5-3% Unsecured: 0.75-3.5%

Source: CGC Malaysia website

Guarantee Products of CGC Malaysia (Contd.)

Parameter	**Credit Enhancer-i Scheme (ENHANCER-i)**	**Credit Enhancer Scheme (ENHANCER)**	**Franchise Financing Scheme**	**Flexi Guarantee Scheme**
Loan Financing Amount	Up to RM10 million (`14.7 Crore)	RM0.05-10 million (`7.3 Lakh to `14.7 Crore)	RM7.5 million (`11 Crore)	RM0.05-5 million (`7.3 Lakh to `7.3 Crore)
Tenure	Varied	OD: 3 years TL: Maturity Date	5 years	5-7 years
Interest Rate	Determined by FI	Determined by FI	1.5% + BLR	4-6%
Guarantee Coverage	30-90%	Secured: 30-90% Unsecured: 30-80%	Secured: 90% Unsecured: 80%	30-80%
Guarantee Fee	Secured: 1-2.45% Unsecured: 1.5-3%	Secured: 2.1-2.7% Unsecured: 2.4-3%	0.5-1%	Secured: 0.5-2.15% Unsecured: 0.5-1.85%

Source: CGC Malaysia website

The Credit Guarantee Process

- **Application of guarantee:**

  A potential business firm can either apply directly for guarantee to CGC or can approach a financial institution with loan application. In the former case, the client can walk in or apply online to CGC, after which the CGC will evaluate the loan application to check whether the business plan is viable or not and accordingly forward the application to the bank with a recommendation letter. Thereafter, if the bank agrees to extend the loan, the client will be granted credit facilities. In the latter case, the client will request to a financial institution for a loan, which will assess the business proposal and forward the paper work to CGC to obtain guarantee.

- **Risk Assessment:**

  The CGC conducts risk assessment in a similar procedure to that of banks and emphasis is given on the industrial, performance and credit risks of each SME. The parameters assessed are based on the credit principles i.e. capital, character, capacity, condition. Less emphasis is given on collateral. The procedure is the same for direct proposals received by CGC and those received via banks.

- **Collection of Fee:**

  Guarantee fees are collected through the lender bank. It is payable annually in advance, within 30 days from invoice. The Loan Administration Department of CGC is in charge of fee collection and supervision of payment.

- **Monitoring of Performance of Financial Institution and SMEs:**

  CGC monitors the performance of financial institutions closely and regular, and holds discussions for remedial actions, if needed, with the institutions with high default rates. CGC monitors various aspects related to the participation of the financial institutions, such as their extent of participation in the guarantee schemes, monitoring of loans, guarantee fee collection, loan quality (NPL) and loan recovery.

  For SMEs that avail financing via CGC branches, CGC itself undertakes close monitoring of the SMEs.

- **Default and Recovery:**

  In case of default, CGC proceeds with legal process when all attempts to recover the loan have failed. The organization also considers restructuring and rescheduling options to recover the loan.[107]

<u>Overview of Performance of the Credit Guarantee System</u>

- **Coverage:**

  Since its establishment, CGC has cumulatively guaranteed more than 400,000 loans valued at close to RM45 billion (`65,956 Crore).

[107] Basis e-mail response from CGC Malaysia

- **Leverage:**

  The capital fund of CGC as on Dec 2009 was RM2.30 billion (`3,371 Crore) and the amount of outstanding loans as on December 2009 was close to RM19 billion (`27,848 Crore). The leverage was approximately 8 times and the average net guarantee reserve ratio was 5 times.

- **Acceptance of Claims:**

  CGC accepts almost all the claims received by it unless they are in non-compliance of the scheme guidelines.

- **Awareness:**

  There is high level of awareness of CGC among SMEs. CGC regularly promotes its products and services via various promotional and marketing activities including media advertisement, participation in relevant road shows, exhibitions and expos nationwide.

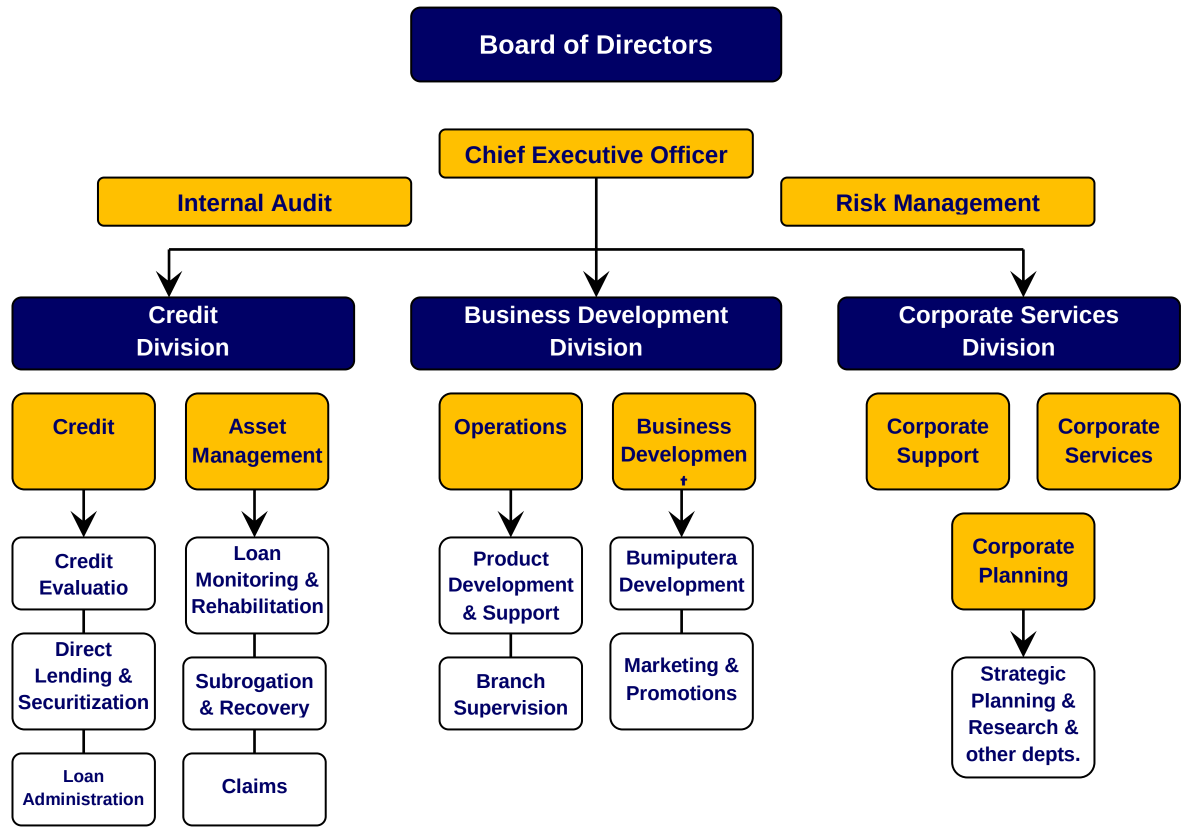
- **Portfolio Guarantee:**

  CGC has recently entered into a partnership with Standard Chartered Bank for portfolio guarantee. It is a part of CGC's efforts to expand its range of products and services for SMEs. Via portfolio guarantee, CGC is able to provide faster turnaround time and speedier disbursement of loans for customers. It also enables CGC to promote greater risk-sharing with the participating financial institutions.

Organizational Structure

The organizational structure of CGTMSE is provided in the chart below:

Organizational Structure



Source: CGC Malaysia

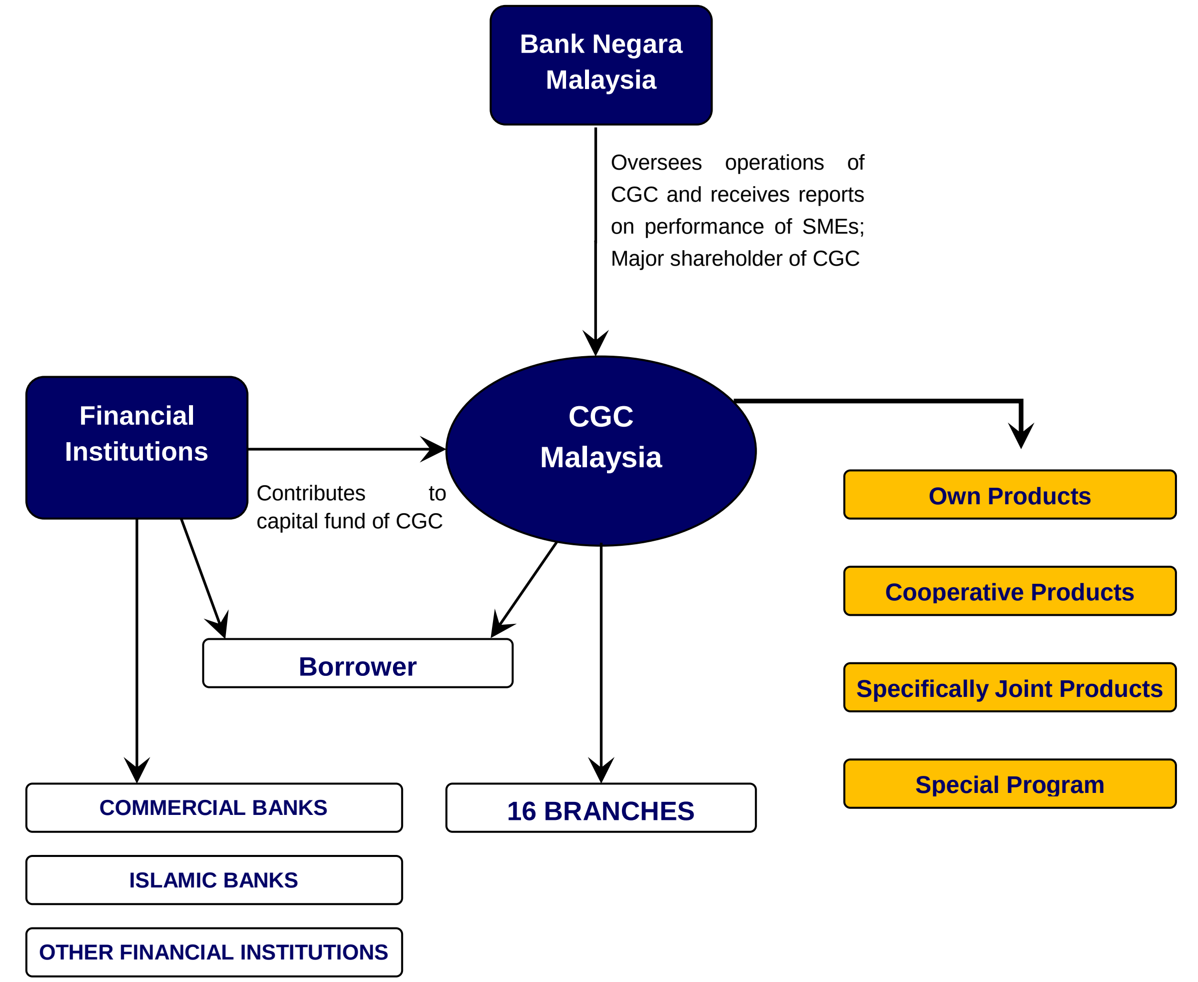
Institutional Structure

1. Role of Bank Negara Malaysia

The Central Bank of Malaysia, Bank Negara Malaysia, is the major shareholder of CGC. Therefore, periodic reports related to the development and performance of the SME financed through financial institutions and CGC needs to be submitted to Bank Negara.

Unlike commercial banks, BNM does not supervise CGC as CGC is not a regulated entity licensed under the banking legislation. However, as CGC is a subsidiary of BNM, the BNM oversees the operations of CGC and conducts inspection of the organization via its representation on the Board of CGC. The Deputy Governor of BNM is currently the Chairman of CGC Board.

Institutional Structure



Source: CGC Malaysia

2. Role of SME Credit Bureau established by CGC Malaysia

SME Credit Bureau (SMECB) provides comprehensive and credible credit information and credit risk ratings on SMEs to facilitate CGC's risk assessment of credit guarantee applications. Since credit guarantee applications may be from numerous financial institutions with different internal credit ratings, SMECB's reports and rating provides an independent assessment for CGC to measure SMEs credit worthiness from the different institutions

Further to this, credit information from SMECB goes beyond the traditional banking information, i.e. the availability of SMEs non-banking transactions with trade partners, telcos and utilities companies. This provides further means to evaluate SMEs credit standing beyond banking information.

3. Role of National Audit Department

Audit of CGC Malaysia is conducted by National Audit Department as well as external auditors.

Tax Structure

All income of CGC Malaysia (including the investment income) is exempt from tax for a period of 10 years from year of assessment 2002. This is provided for under section 127 (3) (b) of the Income Tax Act 1967 (Act 53).' It states that "The Minister may by statutory order exempt any person or class of persons from all or any of the provisions of this Act, either generally or in respect of any income of a particular kind or any class of income of a particular kind".

Conclusion

The credit guarantee fund of Malaysia is a result of the contribution of the Central Bank of Malaysia, Bank Negara Malaysia, and Commercial Banks and Financial Institutions, unlike other countries, where the government is the main contributor. There are various credit guarantee products offered, with varied eligible loan amounts, extent of coverage, guarantee fee, etc. Some of the features identified by D&B India that can be adopted by CGTMSE are:

- Monitoring of Performance

  CGC Malaysia monitors the performance of financial institutions and holds discussions for remedial actions. For SMEs that avail financing via CGC branches, CGC itself undertakes close monitoring of the SMEs.

  In the event that CGTMSE witnesses high default rates consistently, a regular monitoring procedure can be adopted by a Review Committee which may include penalty measures for MLIs with high default rates, or alternatively, discussions for remedy and counseling could be adopted to ensure low default rates by MLIs. The monitoring would also include review of performance of MSE beneficiaries, to assess the impact of the scheme on MSEs.

- Portfolio Guarantee

  CGC Malaysia's recent venturing into portfolio guarantee helps expand range of products and services for SMEs, and provides faster turnaround time and speedier disbursement of loans for borrowers. It also enables CGC to promote greater risk-sharing with the participating financial institutions.

In the scenario that CGTMSE decides to provide portfolio guarantees, it may lead to benefits such as high volumes, lower operational costs, and simplified process of guarantee approval.

However, D&B India believes that the following considerations should be looked into prior to introducing portfolio guarantee system with any MLI:

i. The quality of borrower may be low in portfolio guarantee structure as compared to individual guarantee mechanism, hence it should be implemented only after the individual guarantee system for the concerned MLI has been existent for a few years, and the past performance of the MLI is good

ii. CGTMSE should have full confidence in the appraisal techniques of the MLI

iii. It should regularly monitor the MLI's performance

iv. The eligibility criteria of borrowers should not be too broad, there should be limits such as turnover, number of years, etc,

v. There should be limit on the maximum size of the portfolio / leverage

vi. The portfolio of loan guarantees of CGTMSE should be well-diversified.

Summary

The summary of main features of Credit Guarantee Funds in various countries is as follows:

Criteria	Japan	South Korea	U.K.	Malaysia	U.S.	India
Size of Capital Fund	`1,19,739 Crore	`25,236 Crore	`13,209 Crore	`3,371 Crore	`16,070 Crore	`1,754 Crore
Leverage	25.9	7.4	12	8	N.A.	2.75
Guarantee Fee	0.5-2.2%	0.5-3%	2%	0.5-5.75%	2-3.5%	1.5%, 0.75%
Coverage	up to 80%	up to 85%	75%	30-100%	75-85%	50-80%
Default Rate	2.3-3.9%	4.4%	N.A. (cap of 13%)	N.A.	4.82%	0.2-3.1%
Rate of Acceptance of Claims	N.A.	85-98%	N.A.	Almost all	Almost all	36%
Recovery Rate	44%	17%	N.A.	N.A.	23%	N.A.
% of SMEs covered	38-48%	13%	1-2%	N.A.	N.A.	N.A.
Legal Status	Not-for-profit entity	Not-for-profit entity	Limited Company	Not-for-profit entity	Not-for-profit entity	Not-for-profit entity
Tax Status	Exempt from Income Tax and Value-Added Tax	Exempt from Income Tax and Value-Added Tax	Operating Income exempt from tax, Investment Income taxed	Exempt from tax for 10 years from assessment year 2002	Exempt from Income Tax and Value-Added Tax	Exempt from tax for 5 years from assessment year 2001

Institutional Structure of CGTMSE

Current Structure of CGTMSE

Introduction

The Ministry of Small Scale Industries and Agro and Rural Industries of the Government of India introduced the "Credit Guarantee Fund (Scheme) for Small Industries" in the year 2000. The Ministry ("government"), through this fund, aimed to provide effective credit guarantee to small industries by guaranteeing loans and advances by Scheduled Commercial Banks and few well-performing Regional Rural Banks without collaterals and / or third party guarantees. The government along with the Small Industries Development Bank of India (SIDBI), together known as "settlors" created a "Trust" known as Credit Guarantee Fund Trust for Small Industries for the above mentioned purpose.

Several changes were incorporated in the scheme over the following years, especially following the MSMED Act of 2006 (which gave a definition to Micro, Small and Medium Enterprises - MSMEs) and the merging of the Ministry of Small Scale Industries and the Ministry of Agro and Rural Industries into the Ministry of Micro, Small and Medium Enterprises in 2007. The scheme came under the purview of the newly formed Ministry of MSMEs in 2007, with change in the scope of activities and coverage. The name of the Trust also underwent change and became to be known as the "Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)". The representative of Reserve Bank of India (RBI) in the Board of Trustees was replaced by that of Indian Banking Association (IBA).

Offices of the Trust

The registered office of the Trust is located in Mumbai, and 10-12 offices are located in various locations across India.

Capital Fund of the Trust

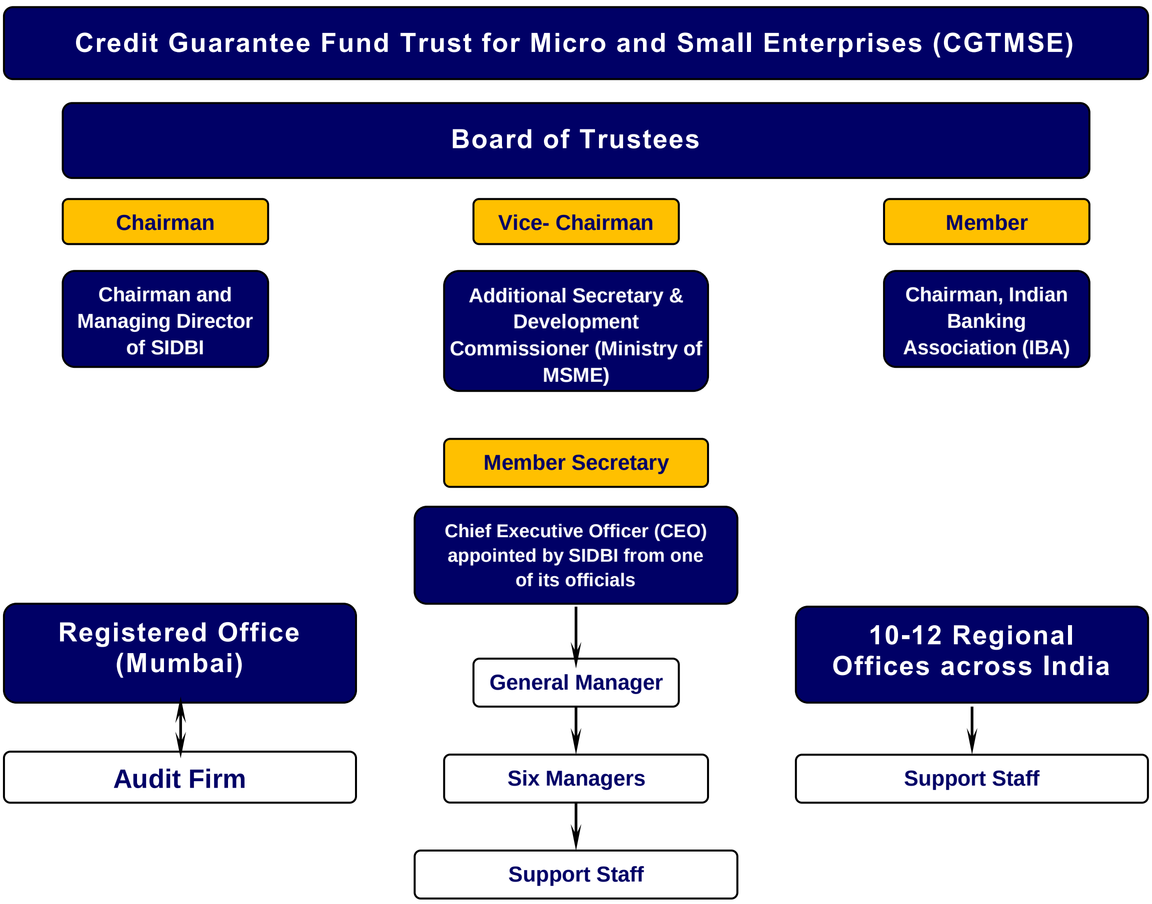
The corpus fund of the Trust was at `1740 Crore by the end of FY2009. The contribution of the government was around `1389 Crore whereas that of SIDBI was around `351 Crore. According to the Trust deed, any deficit in the overall operation of the scheme was to be met by the government, thereby limiting the liability of SIDBI to the extent of its contribution to the fund. Also, all assets, as well as rents, profits and income, and stocks, funds and properties representing the same are held by the Board of Trustees for the objects and purposes of the Trust, subject to the powers of the Board. Income from investments is to be spent towards fulfilling the objectives of the Trust, and the savings are transferred to the corpus fund. The implementation cost of the fund was provided for by SIDBI and the operational cost is borne out of the income of the Trust. The Trust invests in fixed deposits with banks and in LIC under FAS.

Organizational Structure

The Trust is managed and administered by a Board of Trustees consisting of 4 members, the Chairman, the Vice-Chairman, the member and the member secretary (the CEO), as shown below. The Board manages and administers the affairs of the Trust and has supervision of all matters of the Trust. The Chief Operating Officer, assisted by other SIDBI officers carries out the functions of the Trust and manages its day-to-day affairs, keeping in mind the objectives of the Trust.

The accounts of the Trust are audited every year by a firm of Chartered Accountants appointed by the Board of Trustees on the recommendation of Comptroller and Audit General of India.

Structure of CGTMSE



Source: CGTMSE

Staff

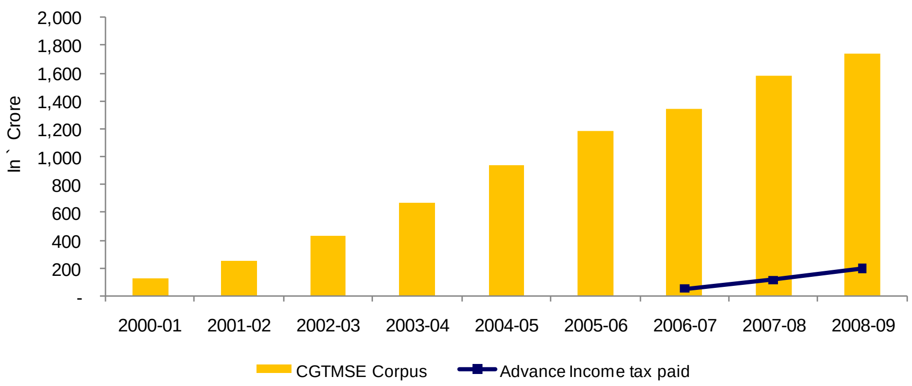
Currently, the organization has around 25 people, including the 4 Board members, the GM, the six officers working under the CEO at the Registered Office in Mumbai, 10-12 support staff at the Registered Office, and another 10-12 staff at various offices of CGTMSE across the country.

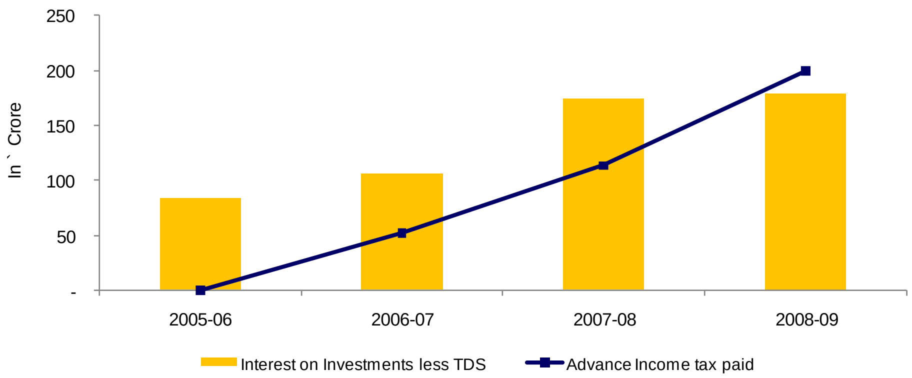
Tax Structure

The main objective behind formation of CGTMSE, in the year 2000, is to provide impetus to Micro and Small Enterprises by minimizing their lending constraints due to lack of collateral securities and / or third party guarantees. The trust is formed to provide credit guarantees for MSE (formerly SSIs) loans extended by various lending institutions. It was specified in the trust deed that *"all income arising out of the investments of the corpus fund shall be spent towards fulfilling the objectives of the trust, and the savings effected in any year shall be transferred to the corpus fund"*.

As CGTMSE is a not-for-profit organization, it was exempted from payment of income tax for the first five years of its operations under sub-section 23EB u/s 10 of Income Tax Act, 1961 (Incomes not included in total income). The tax exemption came to an end in FY 2005-06 and has not been extended for future period. The increase in corpus of CGTMSE in the period between FY 2001-10 and advance tax paid from the year 2006-09 is as follows:

Advance Income Tax Paid





Source: CGTMSE

Based on opinion obtained from a tax consultant, CGTMSE has started claiming the exemption u/s 11 (Income from Property held for charitable or religious purposes) and 12 (Income of trusts or institutions from contributions) of Income Tax Act, 1961 starting from the assessment year 2008-09. Accordingly, the trust has filed for refund of advance income tax paid (starting from the FY 2007-08) with the Income Tax department.

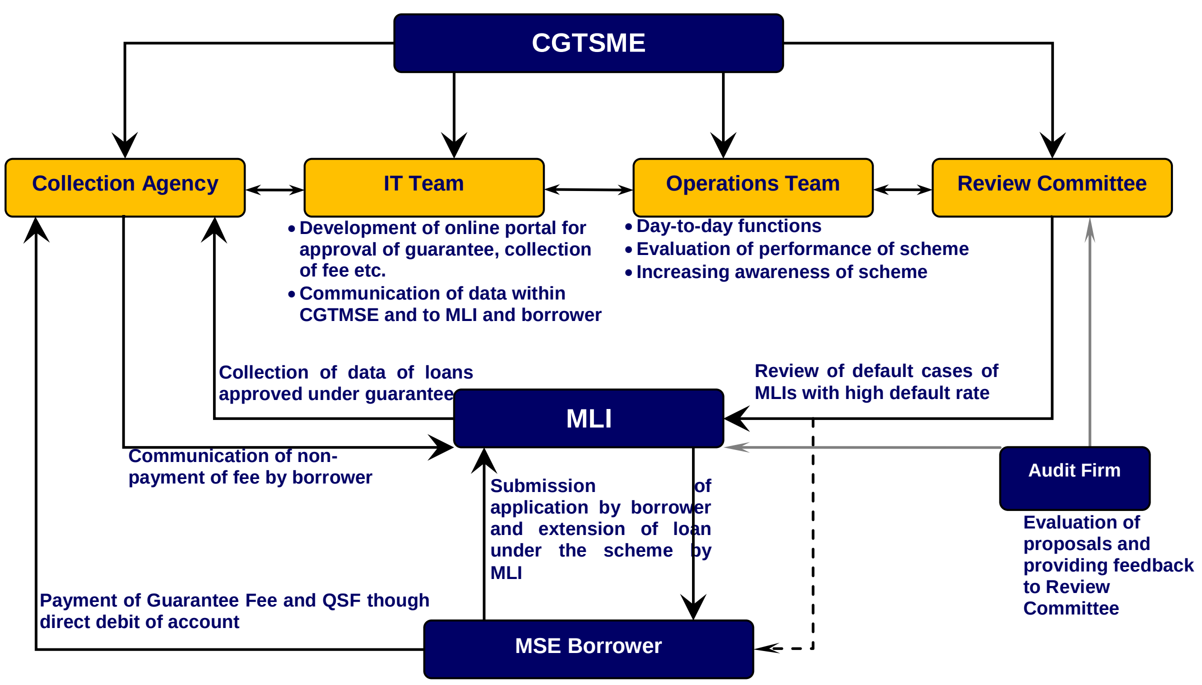
Propositions

Based on the study of structure of various international credit guarantee organizations, and in context of the various needs of the stakeholders of credit guarantee schemes in India, D&B India proposes that the current structure of CGTMSE be expanded in terms of headcount as well as functionality of various core departments. The expansion would enable better management of various critical functions of the organization, smoother functioning of the guarantee mechanism, increased adoptability of the guarantee product by stakeholders, and better supervision of the players benefiting from the scheme. The current headcount of the organization relative to the average number of guarantees approved per year is as low as 1:1400. This ratio is grossly inadequate as compared to that of successful international credit guarantee organizations such as South Korea and Japan. D&B India has identified that there is a need to expand the employee strength of the organization, into various departments, to be able to better manage the increased scale of functioning of CGTMSE, especially with the widening of scope of the scheme going forward.

Therefore, D&B India proposes the expansion of the organizational structure of CGTMSE with the following primary bodies to manage different functions of CGTMSE.

Proposed Organizational Structure

Proposed Structure of CGTMSE



Source: CGTMSE

The Board of Trustees may constitute the following Committees / Agencies to fulfill the following proposed functions of the organization:

Collection Agency

D&B India proposes the formation of a Collection Agency to track the calculations, monitoring and automation of payments of Guarantee Fee and Quarterly Service Fee. The agency could operate under CGTMSE or be an independent agency to which the collection process review would be outsourced. Consequently, the calculation of Service Fee would be done at MLI level, where the amount of total Service Fee would be notified to the Head Office of each MLI[108]. Moreover, the calculation of one-time Guarantee Fee would be done at branch level, where the Guarantee Fee for each approved case would be collected from the MLI branch itself.

On the basis of inputs obtained from primary study of Banks and Financial Institutions (MLIs) as well as that of Credit Guarantee Organizations in other countries, D&B India has arrived at the following two modifications in the current guarantee fee structure:

a) Increase the frequency of payment of service fee from annual to quarterly basis

   D&B India proposes to increase the frequency of service fee to be paid by the MSE for the loan guarantee from annual payments to quarterly payments. On the basis of inputs obtained from international study, D&B India observed that the quarterly payment of service fee on guaranteed loan has helped credit guarantee organizations to keep a better track of the health of the MSE borrower. Any deterioration in financial condition of the business unit can be detected at an earlier stage because of non-payment or delayed payment of service fee. Moreover, quarterly payment of service fee would enable CGTMSE to recover greater portion of fee earlier in the financial year. In case the MSE borrower defaults (and discontinues the payment of service fee), CGTMSE would have at least received a portion of the service fee payable for the running financial year, before paying out the guaranteed amount on the loan to the MLI.

b) Service Fee charged on outstanding amount rather than complete loan amount

   D&B India believes that the service fee payable should be charged on outstanding amount rather than the complete loan amount. A common concern brought out through discussions with various MLIs of CGTMSE in regard to fee structure was the amount of fee payable on the complete loan amount. The view of various MLIs and MSE participants of CGSMSE as well as RSF-I was that the service fee should not be charged on the complete loan in case of term-loans, as over the years the principal component of the loan decreases but the borrower continues to pay the fee on the complete loan amount, resulting in a significant burden on the borrower. Therefore, in order to mitigate the concern of the MLIs and decrease the burden of service fee on MSE borrower, and based on D&B India's analysis of the impact of change in fee structure of the credit guarantee

[108] This is in-line with the Circular No. 59 issued by CGTMSE on 11 March, 2010 where it has been made mandatory for all MLIs to make Service Fee payments through a single payment from the Head Office

product, D&B India proposes that the service fee should be charged on the outstanding loan amount of the term-loan, instead of the complete loan amount.

Based on discussions with existing MLIs, it was highlighted that there is a need for more communication from CGTMSE regarding the status of accounts and all the parties concerned should be imparted adequate information regarding any change in status. Therefore, D&B India proposes that the responsibilities of the Collection Agency should entail looking after the entire fee collection process as well as communicating all aspects of the process to relevant stakeholders, such as the MSE borrowers, the MLIs, and the other departments within CGTMSE such as the Operations Team, the Audit Firm and the Review Committee.

The functions for the Collection Agency should broadly encompass the following:

i. Collection of fee

ii. Information management

iii. Communication of all relevant information to the stakeholders

D&B India proposes the following steps to achieve above objectives of the collection agency:

Assigning unique codes to each approved case of RSF-II

A unique code should be assigned to each loan approved for guarantee under RSF-II by CGTMSE, in order to track all updates on the loan. The three crucial benefits of assigning unique codes to each loan are:

MLI Branch → **CGTMSE**

Information on status of outstanding loan, **change in loan payment schedule**, and other details in order to calculate the amount of fee payable in each quarter

CGTMSE → **MLI Head Office**

Information on amount of **service fee payable**, non-payment of fee from MSE, for the MLI to track the borrower to recover the fee within the grace period

MLI Branch → **MLI Head Office**

Information on cases approved under RSF-II scheme, amount of one-time guarantee fee payable, amount of service fee payable, and other details

A 14-digit code for RSF-II loans could be assigned in the following way:

i. The first two digits representing the loan-size bracket, for example, '09', '10', '11', and '12' for loan sizes `1.00-1.25 Crore, `1.25-1.50 Crore, `1.50-1.75 Crore and `1.75-2.00 Crore, respectively (as eight loan-size brackets are for loans under `1 Crore).

ii. The third digit could be an alphabet representing the sector that the MSE borrower's business belongs to, such as 'A' for Basic Metal Industries, 'B' for Beverages, Tobacco, etc., 'C' for Chemicals, etc. and so on.

iii. The fourth, fifth and sixth digit representing the serial number of the MLI, such as, 001 for Bank of Baroda, 002 for Bank of India, and so on.

iv. The next six digits representing the date on which the approval was granted for the loan, in ddmmyy format.

v. The last two digits representing the n^{th} loan approved by CGTMSE on the particular day.

Sector-wise coverage of the scheme, major loan size bracket availing the scheme, and such details can be obtained and analyzed through solely the codes, by all the parties with access to the codes (such as the CGTMSE Performance Evaluation Division and the MLI Head Office).

***Illustration**: Unique codes to loans approved by CGTMSE for RSF-II for MLI No. 004*					
Sector (Code)→ / Loan Size (Code)	Basic Metal Industries (A)	Beverages, Tobacco, etc. (B)	Chemicals etc. (C)	Cotton Textiles (D)	…and so on…
`1-1.25 Crore (09)	09A00408101012	09B00415051018	09C00426071013	09D00430061013	
`1.25-1.50 Crore	10A00419011016	10B00408031018	10C00406101022	10D00401081007	
`1.50-1.75 Crore	11A00423081012	11B00411021003	11C00428111009	11D00415121009	
`1.75-2 Crore (12)	12A00427111020	12B00419091001	12C00429121006	12D00410011011	

Presently, based on D&B India's discussion with MLIs, the following issues have been indentified at the centralized level of MLIs:

i. the Head Offices of MLIs do not have information on the details of loans approved under the CGTMSE scheme, hence, it is difficult to assess the performance of loans under the scheme in terms of primary sectors benefiting from the scheme, major loan sizes obtaining the scheme

ii. the MLIs depend on CGTMSE to track and calculate the amount of annual service fees, or even identify the loans which are covered under the credit guarantee scheme

Hence, there is a need to facilitate flow of information within the MLIs from the branch level to the Head Office, and vice-versa. This can be achieved providing a read-only access of all cases approved (through a drop-down list of all codes of cases falling under the corresponding MLI) to the Head Office of the corresponding MLI on the online portal. The unique code of each loan under RSF- would be a reference number for all details about the borrower, in the following table format:

Illustration: **Read-only access to MLI Head Office**													
NAME OF MLI													
LOAN CODE (drop-down list that can be sorted according to various criteria, such as branch, loan size bracket, etc.)	Date of sanction of loan	Date of approval of guarantee	Branch Location	Type of Loan	Name and Address of MSE Borrower	Category of MSE Borrower (General, Women, NER, etc.)	Purpose of Borrowing (New P&M, Expansion, etc.)	Credit Rating of Borrower (according to internal credit rating of MLI)	Interest Rate Charged	Value of Partial Collateral (if any)	Status of Loan (Closed, NPA, etc.)	AMOUNT OF ONE-TIME GUARANTEE FEE ***PAID***	AMOUNT OF QUARTERLY SERVICE FEE ***PAYABLE*** IN THE **NEXT** QUARTER (APR/JUL/OCT/JAN)
09A00408101012													
11B00411021003													
09D00430061013													
09B00415051018													
09C00426071013													
…and so on…													
GRAND TOTAL OF GUARANTEE FEE AND QUARTERLY SERVICE FEE: (Total amount will reflect any sorting performed)												**XXXXX**	**YYYYY**

The additional features that would be available in the online portal of CGTMSE to the authorized branches of MLIs are:

Illustration: Features accessible to authorized branch offices of MLIs					
NAME OF MLI					
NAME OF BRANCH LOCATION					
Module for lodging application	**Module for payment of Guarantee Fee**	**Module for guarantee maintenance**	**Module for change in loan payment schedule**	**Module for closure of account**	**Module for invocation of guarantee**
• Furnish all details of MSE • Apply for guarantee • Obtain the guarantee with the unique code	• Enter the unique code • Obtain the Demand Advice Notice (DAN) reflecting the amount of GF payable • Note the RP number and send the Demand Draft with the copy of the DAN to CGTMSE, Mumbai	• Enter the unique code • Update the status of the account, such as closure of account, date of classification of NPA	• Obtain approval from CGTMSE to gain access to the module to edit information • Enter the code and make the necessary changes in the loan repayment schedule (tenure, etc.)	• Provide the code of account to be closed • Send request for closure of account to CGTMSE	• Provide code of the account to be sent for claim • Enter information related to legal proceedings issued against the borrower

The additional features that would be available in the online portal of CGTMSE to the Head Office of MLIs are:

***Illustration**: Features accessible to Head Office of MLIs*		
NAME OF MLI		
Module for payment of Quarterly Service Fee	**Module for obtaining additional information from CGTMSE**	**Module for registering complaints or providing feedback**
• Obtain the Demand Advice Notice (DAN) reflecting the amount of GF payable • Note the RP number and send the Demand Draft with the copy of the DAN to CGTMSE, Mumbai	• In case of rejection of claims, enter unique code and send request for information • In case of other issues, provide details and send request for required information	• Provide reference code / branch location / other reference detail and provide complaint / feedback

Hence, through the read-only access to MLI Head Office, the MLI would be able to:

i. assess the total amount of quarterly Service Fee to be paid in the next quarter

ii. track the branch and obtain details on the accounts covered under the scheme through the unique code

In the event that CGTMSE decides to incorporate certain features of RSF-II, such as fee payable on outstanding amount into the existing scheme, unique codes can be attempted to be applied to all the loans under the existing CGTMSE scheme. The codes could be applied in a similar manner as for RSF-II, and timelines could be provided to each region of operation of MLI, to track the cases obtaining CGSMSE scheme, and to furnish all the details of the borrower, the loan, etc. in the online portal.

The main functions of the Collection Agency for RSF-II scheme can be segregated into information management and communication (with corresponding training requirement) in the procedural order as under:

S. No	Information Management	Communication	Training Requirements
1	**Assigning a unique code** to the loan approved by all MLIs, and including details (along with amount of loan and sector) on date of sanction, nature of loan, purpose of borrowing, credit rating of borrower, interest rate on loan, MLI branch location, value of partial collateral, etc.	**MSE → MLI branch → MLI Head Office → Collection Agency** Getting details of each loan approved for RSF-II from the MSE to the Collection Agency of CGTMSE	Imparting training to the branch level officer to **determine the nature of loan** according to which the loan will be assigned a code by CGTMSE through the online portal
2	Determining the **applicable *rate*** of guarantee fee and quarterly service fee based on the nature of the loan (loan size, extent of coverage, value of partial collateral, whether a women entrepreneur or an MSE operating in the NE region)	**Collection Agency → MLI → MSE borrower** Communicating the applicable *rate* of guarantee fee and quarterly service fee to the MLI and the MSE	Imparting knowledge to the MLI on **basis of determining the applicable fee rate**
3	Calculating the ***amount* of guarantee fee and quarterly service fee** for each quarter (based on payment schedule of loan) for each loan according to the code	**Collection Agency → MLI and MSE** Communicating the *amount* of guarantee fee and quarterly service fee to the MLI	Imparting knowledge on the **process for calculation of the quarterly service fee** MLIs
4	Generating a **Demand Advice Notice for each Guarantee Fee / Quarterly Service Fee** through the online portal and providing it to the branch office / Head Office and tracking the cases with non-payment of fee or delayed payment of fee Obtaining data from MLI Branch regarding any **change in loan payment schedule** and calculating the revised service fee, and reflecting it in the read-only access to MLI Head Office	**Collection Agency → MLI** Providing the code of cases with delayed payment of Guarantee Fee for issuing reminders to MSE at bank level, and providing the code for cases with non-payment of fee for recovery of fee from MSE by the MLI **MLI Branch → Collection Agency** Providing the details on change in payment schedule in the online portal	
5	Determining the **grace period** for cases with non-payment of fee and calculating the **amount payable at different intervals** within the grace period (including the penal interest rate for delayed payment of fee)	**Collection Agency → MLI** Communicating the grace period to MLI for each loan code, non-validity of guarantee cover in case of non-payment of fee within the grace period, and providing the amount payable at each interval within the grace period	Imparting guidelines and **norms** to MLI on **delayed payments and non-payments** of fee, **highlighting non-validity of guarantee cover** by CGTMSE in case of any lapse in payment, providing guidelines on recovering fee from MSE borrower within grace period, and basis for applicable penalty amount in the grace period
6	Recording date of eventual payment of fee and cases with non-payment and delayed payment of fee, **assimilating it at MLI level**	**Collection Agency → Review Committee and Operations Department** Providing MLI-wise data to the Performance Evaluation Div (Operations Dept) and Review Committee which would help them to assess the performance of MLIs and the scheme	

In the medium and long-term, the Collection Agency can take up the responsibility of collecting guarantee fee and quarterly service fee from the MSE borrowers for the existing CGTMSE scheme as well.

Review Committee

D&B India propose the formation of a Review Committee comprising of members of Board of Trustees of CGTMSE and persons representing Reserve Bank of India to review the performance of each MLI on yearly basis. An independent Audit Firm may be hired to conduct the evaluation of MLIs and conduct risk assessment of the default cases to check adequacy of credit check done by the MLI before granting the loan. The Review Committee would get data and evaluation report on each MLI through the Audit Firm and the Committee would carry out the following responsibilities:

i. Assessment of default rate of loans guaranteed by CGTMSE of each MLI based on data, evaluation report and feedback on credit check adequacy provided by the Audit Firm.
ii. Notification to MLIs with high default rate (above an acceptable limit) including inquiry of cases of default
iii. Study of a sample of cases of default of the chosen MLI selected out of the total default cases, across different sectors and loan sizes
iv. Assessment of the sample cases including project viability, cause of default, adequacy of risk assessment by lender MLI and providing opinion on the MLI's practices of extending loan under the guarantee
v. Proposing penalty such as reduced coverage of loan amount for guarantee for MLIs with consistently high default rates
vi. Among MLIs with acceptable levels of default rate, occasional review of default cases (to keep the MLI aware of CGTMSE's practice of reviewing cases of default and ensuring MLI's commitment towards conducting proper due-diligence of guaranteed loans at par with the bank's norms for all loans)
vii. Rewarding MLIs with impressive track of low default rate with rebate in guarantee fee or other incentives and rewards

Operations Department

D&B India recommends that an Operations Department may be put in place to assist the Managers of CGTMSE in day-to-day functions of the organization, along with various support staff at each office of CGTMSE to carry out various functions. The operations team would comprise of the following divisions to perform the following main functions:

a) Performance Evaluation Division:

i. It would be responsible for evaluating the performance of CGTMSE in terms of number and amount of loans guaranteed, major sector beneficiaries, major loan-size class under the scheme, major MLIs with increased participation, etc.

ii. The team would assess the adequacy of the guarantee product and monitor the general process of extension of guarantee through various MLIs

b) Fund Management Department:

i. It would be responsible for management of the corpus fund of CGTMSE

c) Customer Satisfaction Division:

i. It would conduct interactions through seminars with MLIs to understand their concerns and requirements, and provide feedback to the management to help formulate policies of CGTMSE based on the mentioned needs

ii. It would follow up the credit guarantee loans to understand their use and impact on the MSE borrower

d) Public Relations Division:

i. It would work towards increased awareness of the scheme among MLIs as well as MSEs through brochures, posters, workshops, etc. with tie-up with advertising agencies

ii. It would advice and guide MLIs to conduct awareness programs at MSE clusters with local branches of MLIs

iii. It would conduct training programs for bank staff to familiarize them with the credit guarantee product, the objective of the scheme, the mechanism of evaluation, etc

iv. It would conduct seminars in various locations across the country to impart knowledge and benefits of the scheme to industry and MSE associations

v. It would constitute a grievance redressal system to understand concerns of MLIs and MSEs, and their needs and concerns in times of financial downturns, and to address complaints

Awareness Programs

Besides imparting knowledge about the credit guarantee scheme through brochures and advertisements, the Public Relations Division of the Operations Team can familiarize CGTMSE's operations by advising and guiding MLIs to conduct awareness programs for the scheme in locations where their operation is in high concentration, and where they expect to have prospective clients.

A basic framework for such awareness programs that can be conducted through the support of **Public Relations Division** is provided below:

Awareness Programs conducted by MLIs for various beneficiaries of the scheme
Agenda:
• To familiarize branch offices, local MSE associations, prospective MSE beneficiaries about the credit guarantee scheme • To impart knowledge about the benefits and limitations of credit guarantee products, the advantages pertaining to various stakeholders through the product, and ways to utilize the facility to the best of the advantages of all stakeholders
Target Audience:
• Branch Officers • MSE units • Industry Associations • Local small industry associations • Consultants
Location
• Training centers / colleges located at areas of high concentration of MSEs, such as the clusters identified by Ministry of MSME

Training Requirements

Based on interactions with MLIs and MSE beneficiaries of CGTMSE, D&B India observed that many stakeholders (especially the MSE borrowers) do not have clarity over the features and benefits of the scheme. D&B India believes that there is need to impart training to bank / financial institutions officials through regional level workshops so that they are able to offer the scheme to the eligible and needy MSE borrowers with accurate knowledge of the scheme and its benefits, and give the MSE borrower details of the scheme, and ways of optimum utilization of the scheme (by providing partial guarantee, etc.). The officers can be distributed textbooks and complied course-books, which they can use as reference material in order to understand the various aspects of the scheme.

A basic framework for such workshops that can be conducted by the **Public Relations Division** of the Operations Department is provided below:

Workshop conducted by CGTMSE for training of bank / financial institution officials
Agenda:
• To provide the details of the features of the scheme • To provide the implications of features of the scheme • To impart training on interaction with MSE borrower (regarding features, benefits, implications, norms of the scheme) while suggesting / proposing the scheme • To impart training in order to use the website portal of CGTMSE, in terms of furnishing information, assigning the type of loan (size, sector), registering loans for approval, tracking the status of loan through the unique code • Conduct assessment of performance of loans under the scheme according to loan-size bracket, sector, etc.
Target Audience:
• Branch Manager and / or branch level officials who handle the loans under CGTMSE scheme
Location
• The workshop would be conducted on a state-level basis, and the concerned officials of all MLIs in all the branches of the state would assimilate in respective venues of each state to attend the workshop

Feedback Channels

Based on the assessment of existing scheme of CGTMSE and RSF-I, D&B India believes that a direct feedback mechanism between CGTMSE and the MLIs, and between MLIs and MSE borrowers is required in order to track the performance of the scheme.

- In order to manage the scheme at branch level, training needs to be given to branch level officials, who can address the concerns and issues of MSE borrowers, as discussed above. Also, seminars with MSE Associations can be conducted to understand the pain areas in MSE finance and major sectors / borrower groups in need of credit guarantee schemes
- In order to obtain feedback from MLIs, a more detailed mechanism should be put in place. The Customer Satisfaction Division of the Operations Department should assimilate the concerns and feedback of MLIs by holding annual / biannual seminars.

A basic framework for such workshops to be conducted by the **Customer Satisfaction Division** is provided below:

Seminar for reviewing performance of CGTMSE scheme and obtaining feedback
Agenda:
• To gather inputs related to the experience of the MLIs with respect to the existing and pilot schemes • To gather qualitative inputs on profile of primary MSE borrowers who obtain the scheme • To understand the concerns and problem areas faced by MLIs at operational level as well as related to features of the scheme at centralized level • To provide a platform for discussions among MLIs regarding additional features and requirements in credit guarantee system
Target Audience:
• Regional Managers of respective MLIs • Officials of MSE Department at Head Office of respective • Government officials from finance ministries • Representatives of potential MLIs, including banks and various financial institutions • Policy researchers in MSE finance in India
Location and Venue
• The workshop would be conducted on a regional level basis, and the location would be chosen based on proximity of major participants • The venue would be selected on the basis of type of attendees, most likely, convention centers in five-star hotels

Information Technology (IT) Department

The IT Department may be expanded to accommodate for the increased scale of functioning of the automated system of fee collection, with change in structure from service fee payments on reducing balance method, as well as frequency from annual payments to quarterly payments. D&B India suggests the following functions for the IT Department in line with the modified credit guarantee product and mechanism.

i. It would establish a screening portal where the MSE borrower / MLI would check the eligibility of a case for extension of guarantee of loan by CGTMSE (based on financials of the borrower, amount of loan required and the eligibility criteria of CGTMSE for the scheme)

ii. It would develop the online portal better to be able to accommodate the large scale of usage of the online payment of guarantee fee, and ensure smooth functioning of new account entries and update of existing accounts

i. It would enable continuous access of the MSE borrower (through unique borrower number and password) to their status update on total fee payable and amount of fee paid, and details of basis of calculation of the same.

ii. It would also provide client summary of various accounts on an individual basis and overall statistics assimilated for each MLI

iii. It would require the borrower to update information with respect to name of the organization, purpose of loan, general information about business, etc.

iv. Moreover, it would enable online assistance / help features to borrowers as well as MLIs

v. The team would also be responsible for communication of delayed and non-payments from MSEs to the Collection Agency which would take further action in this regard

vi. Moreover, it would be responsible for providing default-related information of MLIs to the Audit Firm

Effectively, it would provide to the management, timely information and data, and will enhance communication among various departments, enabling them to carry out their core functions effectively as well as enabling the management to make strategic decisions.

Institutional Structure

Overview of Learnings

Based on study of institutional structure of various international guarantee funds and existing structure of CGTMSE, D&B India has explored the merits and limitations of the following institutional structures in detail (in the context of main objective for setting up of CGTMSE and its current operations):

- CGTMSE operating as a Trust
- CGTMSE operating as a public limited company

a. CGTMSE operating as a Trust:

Concept: All income arising out of the investments of the corpus fund will be spent towards fulfilling the objectives of the trust, and the savings affected in any year will be transferred to the corpus fund.

Merits of the structure:

- As the surplus generated is completely ploughed back into the business, CGTMSE is currently having a strong corpus fund. The corpus fund will be further strengthened in near future (once CGTMSE stabilizes and increase in scale of operations), which can in turn be utilized for benefit of MSEs:

- Augmenting its existing scale of operations through higher leverage ratio
- Aligning current fee structure based on dynamic requirements of MSEs
- Introduction of new sector-specific schemes (such as green-field projects, IPR or new generation technology areas such as nanotechnology, artificial intelligence etc.)
- Enhancing the coverage of the scheme (from fund based / non-fund based loans to various types of other securities)
- Exploring the opportunity of entering into various other products other than debt securities such as venture capital etc.

- As trusts are exempted from paying tax u/s 11 and 12 of Income Tax Act, 1961, the existing structure of paying advance tax and claiming refunds from Income Tax Department may continue. Alternatively, as proposed by the working group, Government may consider exempting both guarantee fee and the income on investments of the Trust from Income Tax Department.

Limitations of the structure:

- The sources of funding for CGTMSE will be limited.
- As a trust cannot distribute the profits in terms of dividends, Settlors might not receive any return on their investments. However, as the basic objective of setting up of CGTMSE is to benefit MSEs, the above concern might not be relevant.

b. CGTMSE operating as a Public Limited Company:

In this case, CGTMSE has to be incorporated as a public limited company under Companies Act, 1956. Current Settlors (Government of India and SIDBI) can be become equity holders in the newly formed company.

Concept: All income arising out of the investments of the corpus fund will be spent towards fulfilling the objectives of the trust, and the equity holders can distribute the savings affected in any year as dividends.

Merits of the structure:

- As a public limited company, CGTMSE can partner with a wide section of shareholders (such as financial institutions etc.) by issuing shares. In addition, the new structure will open up wide range of funding sources for CGTMSE, which might reduce the overall burden on current Settlors (Government of India and SIDBI).

- The new structure might provide a new perspective and focused approach in current operations of CGTMSE. This new approach might have a positive impact on operations of the fund:
  - Improving revenues by providing more guarantees thereby achieving economies of scale in operations
  - Improving profits by revamping the existing fee structure or introducing innovative products, or optimizing overall expenses of CGTMSE

  However, CGTMSE needs to ensure suitable measures / checks in place in order to adhere to its overall objectives.
- The equity holders can distribute the surplus generated in any year as dividends. In case of shortfall of funds in any year, equity holders can contribute to the corpus of the fund.

Limitations of the structure:

- CGTMSE needs to pay taxes on both revenue and capital incomes to the Income Tax Department.

Recommendations on Institutional Structure

D&B India suggests that CGTMSE should continue in its current Trust structure as the basic objective of the fund is to create impetus to MSE sector by providing guarantees to loans and advances extended by lending institutions. Any surplus generated by this fund should be completely ploughed back in to the business for benefiting a large section of MSEs instead of distribution of the same among equity holders.

The corpus fund available with CGTMSE in the year 2009-10 was `1,960 Crore against claims paid to the extent of `51.09 Crore in the same year. Thus, the corpus fund available was approximately 38.36 times the actual claims settled. Further, D&B India considered the worst case scenario of all the potential claims in the year 2009-10 devolving on the Trust (`148.24 Crore). The corpus fund available with CGTMSE is about 13.22 times the potential claims in the year 2009-10. D&B India believes that the current corpus fund of CGTMSE is sufficient to cover any claims that might arise in near future. Moreover, the lock-in period of 18 months for settlement of claims will provide sufficient duration to CGTMSE for fundraising from Settlors, in case of any shortfall in the funds. Hence, D&B India suggests that Settlors should only contribute to fund as and when required by CGTMSE.

With regard to the tax structure, D&B India concur with the Working Group's observations on tax exemption on CGTMSE's income. The Working Group argued that the income tax on guarantee fee and income on investment of any surplus should be tax exempted due to following reasons:

- Underlying objective / high public policy purpose of the credit guarantee fund

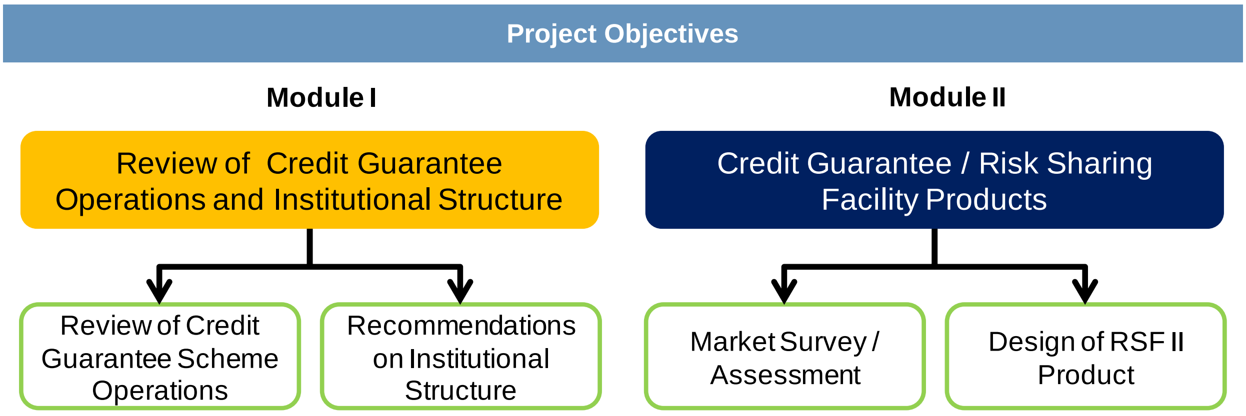
- The purpose of guarantee fee is to cover existing and potential claims, while the purpose of income on investment of any surplus is for meeting potential guarantee claims. The income on investment of corpus of the Trust increases the size of the Trust Fund and only furthers the public policy purpose of guaranteeing more MSE loans and / or reducing the guarantee fees thus ultimately benefiting only the MSE sector.
- As the Government is the major contributor to the corpus, in the extreme case of shortfall, the Government may have to replenish the same. Hence, it may not be appropriate to levy income tax on its own income.

D&B India agrees with the Working Group observations and its recommendation that the Government might consider exempting both guarantee fee and the income on investments of the Trust from Income Tax.

Annexure

Study Methodology

D&B India has deployed a mix of primary and secondary research for achieving the objectives proposed by SIDBI. Secondary research will involve study and analysis of the available literature and data whereas primary research will entail questionnaire based surveys and structured interviews with the relevant stakeholders.



Source: Tender Document, SIDBI

The methodology adopted for the study is briefly discussed below:

Secondary Research

The objectives of secondary research are:

- To understand guidelines, regulations provided by various regulatory bodies such as Reserve Bank of India to enable / enhance lending to MSE sector.
- To understand CGTMSE scheme related to various aspects such as eligibility criteria, extent of guarantee cover, fee structure and claim settlement.
- To study the performance of the scheme related to Capital Fund, NPA ratio and leverage ratio, Year-wise, MLI-wise, Slab-wise, Sector-wise details on MSE advances, NPAs, Claims received and Claims settled, etc.
- To identify the countries for conducting benchmarking study
- To understand various risk-sharing models for SMEs in these countries, appraise their merits, understand structure of these institutions and to explore the possibilities for replicating the same in India

D&B India analyzed the information available from databases and literature maintained by the Indian ministries, international credit guarantee funds and academic journals. The following are few information sources referred while conducting secondary research:

- RBI Website
- Scheduled Commercial Banks Websites
- IndiaStat Website
- CMIE and Bloomberg Databases
- RBI's report on Trend and Progress of Banking in India
- Ministry of Micro, Small and Medium Enterprises – Annual Reports
- SIDBI Annual Reports
- CGTMSE Annual Reports
- Websites and annual reports of International Credit Guarantee Institutions

Primary Survey

The objective of primary survey is mainly to acquire first-hand data and primary information from various stakeholders identified through secondary research and discussions with CGTMSE. D&B India has conducted primary survey on various active member lending institutions (MLIs) with CGTMSE, Federation of Indian Micro & Small and Medium Enterprises (FISME) and including beneficiaries of participants of RSF-I scheme in order to assess their views on suitability of RSF-I scheme and to understand the desired features of new credit guarantee scheme. The details of survey respondents are as follows:

Primary Survey Respondents	
	बैंक ऑफ इंडिया Bank of India Relationships beyond banking.
Canara Bank	Union Bank of India
AXIS BANK	IDBI BANK

Primary Survey Respondents	
ICICI Bank	BARCLAYS
FISME	SIDBI

Source: D&B India

Based on the primary survey of financial institutions, D&B India has obtained information related to:

- Overall MSE lending scenario of the bank
    - Apprehensions / constraints of financial institutions for MSE financing and underlying risk factors
- Experience of the bank lending institution with CGSMSE and RSF-I schemes
- Desired features of credit guarantee scheme such as eligibility criteria, limit for credit facility requirements, extent of guarantee cover, fee structure, and claim settlement procedure.

International Study

The objective of international study is to understand the MSE lending scenario in these countries, best practices followed by these funds, their institutional structure, and to explore the possibilities for replicating the same in India. D&B India has conducted primary survey on credit guarantee funds of five countries[109] such as Korea, US, UK, and Malaysia. The details of survey respondents are as follows:

International Study Respondents	
U.S. Small Business Administration SBA Your Small Business Resource Small Business Administration, U.S.A.	Capital for Enterprise Capital for Enterprise Limited, U.K.
KODIT KOREA CREDIT GUARANTEE FUND Korea Credit Guarantee Fund, South Korea	TOKYO GUARANTEE Credit Guarantee Corporation, Tokyo, Japan

[109] Identified based on secondary study and discussions with CGTMSE

International Study Respondents	
Credit Guarantee Corporation, Malaysia	

Source: D&B India

Based on the primary survey of international credit guarantee funds, D&B India has obtained information related to:

- SME scenario in the country
- Sources of finance to SMEs
- History and role of Credit Guarantee schemes in the country
- Key features of Credit Guarantee schemes
- Institutional structure of the Credit Guarantee Fund

Overview of the pilot scheme RSF-1

Background

The MSE Financing and Development Project (MSEFDP) is a SIDBI-implemented, World Bank-led project on the development of MSMEs. It is a multi-agency, multi-activity project with Department of Financial Services, Ministry of Finance, Government of India as the nodal agency, and the World Bank, Department for International Development (DFID) UK, KfW Germany and GTZ Germany as the international partners. The project has three major components: 1) Line of Credit from World Bank and KfW, 2) Risk-Sharing Facility, and 3) Technical Assistance.

Risk Sharing Facility Scheme entailed sharing of credit risk on a pari passu basis between a guaranteeing entity and Member Lending Institutions (MLIs). The objective of providing such a facility is to build up a track record of lending for banks and FIs, encourage them to scale-up lending to MSMEs, and to price these loans more appropriately, with sector-wide demonstration effects. RSF-1 was a pilot initiative launched by Credit Guarantee Trust Fund for Micro and Small Enterprises (CGTMSE) for this purpose.

RSF-1 was implemented through 8 Member Lending Institutions which signed an MOU with CGTMSE and ran through the period September-December 2008. The 8 MLIs were : SIDBI, State Bank of India, Bank of Baroda, Union Bank of India, Punjab National Bank, Bank of India, Canara Bank, and United Bank. Scaling up of the scheme and extending it to all MLIs in second phase f cxis planned after review of the pilot scheme.

The eligible loan amount under this scheme was `50-100 Lakh and the extent of guarantee cover provided by CGTMSE was 50% of the amount in default. The one-time guarante fee charged was 0.75% ans the Annual Service Fee was 0.375%. The lock-in period for the invocation of guarantee was 24 months. 75% of the claim was paid within 30 days of initiation of recovery proceedings by MLIs under due process of law, and the rest 25% was paid on conlusion of recovery proceedings.

Participation Details

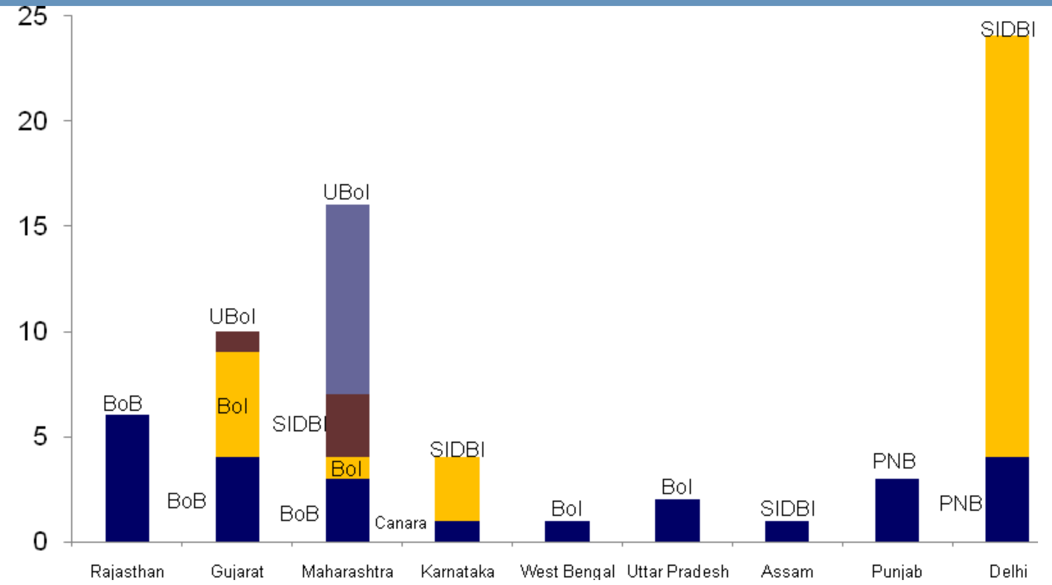
The eight MLIs that participated in RSF-1 are:

State-wise RSF-I Beneficiaries	
SIDBI	State Bank of India
Union Bank of India	Punjab National Bank
Canara Bank	Bank of India
United Bank of India	Bank of Baroda

Source: CGTMSE

64 cases for `47.54 Crore spanning over in 9 states were covered in the pilot project. The distribution of the projects over the 9 states vis-à-vis lending institutions is as follows. Within the states, the dominance of each of the MLI is also depicted. While SIDBI was the main participant of the high number of beneficiaries in Delhi, Union Bank of India contributed significantly to MSEs in Maharashtra.

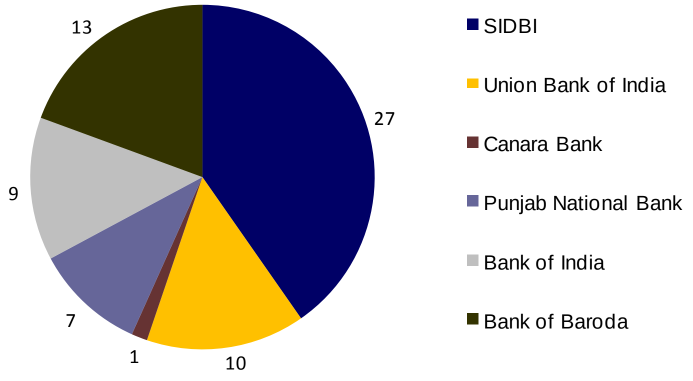
State-wise RSF-I Beneficiaries



Source: CGTMSE

Out of the 8 MLIs, 6 were active participants in the RSF-1 scheme. Bank-wise, the distribution of the number of loans disbursed under RSF-1 is as follows. The top MLI was SIDBI with the number of approved proposals at 30.

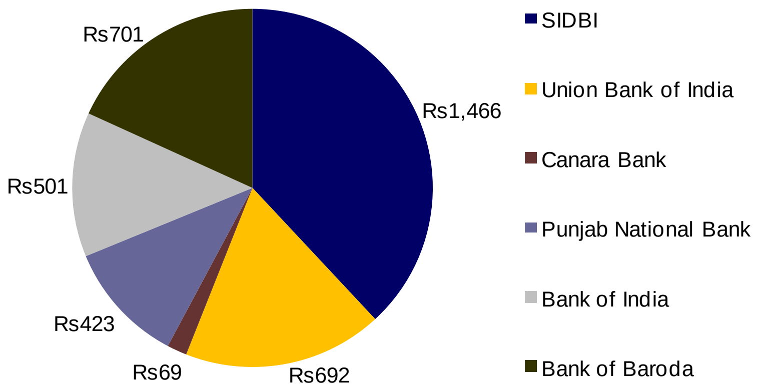
MLI-wise distribution of number of loans covered under the scheme



Source: CGTMSE

In terms of amount covered, the bank-wise distribution of loans is as follows.

MLI-wise distribution of loan amount (in ` Lakh) covered under the scheme



Source: CGTMSE

Charts and Tables

Coverage of MSE Advances of Public Sector Banks under CGTMSE Scheme as on March 2009

Name of the Bank	Number of MSE Accounts	Number of Accounts covered under CGTMSE	Total MSE Advances (In ` Crore)	Amount Covered under CGTMSE (In ` Crore)
State Bank Group	**1917000**	**40594**	**55057**	**1020.53**
State Bank of India	1255000	31239	34777	805.63
State Bank of Bikaner and Jaipur	53000	3321	2875	34.89
State Bank of Hyderabad	38000	1037	3279	44.17
State Bank of Indore	41000	207	4791	4.83
State Bank of Mysore	123000	540	2213	44.60
State Bank of Patiala	29000	318	4643	14.30
State Bank of Travancore	378000	3932	2480	72.10
Nationalized Banks	**2385000**	**102229**	**135911**	**3239.46**
Allahabad Bank	187000	3964	4593	94.29
Andhra Bank	86000	816	3341	27.13
Bank of Baroda	123000	2568	10839	189.35
Bank of India	218000	15844	15423	686.77
Bank of Maharashtra	57000	1465	2658	43.59
Canara Bank	304000	29291	16316	608.10
Central Bank of India	167000	3521	5600	189.38
Corporation Bank	36000	1558	3820	100.83
Dena Bank	48000	2176	3089	55.81
IDBI Bank Ltd.	27000	381	6794	39.48
Indian Bank	85000	3720	3844	79.80
Indian Overseas Bank	96000	2857	6488	102.68
Oriental Bank of commerce	54000	1017	5504	81.63

Name of the Bank	Number of MSE Accounts	Number of Accounts covered under CGTMSE	Total MSE Advances (In ` Crore)	Amount Covered under CGTMSE (In ` Crore)
Punjab National Bank	137000	17327	15658	321.23
Punjab & Sind Bank	34000	812	2139	18.93
Syndicate Bank	158000	2603	5722	148.24
Union Bank of India	193000	5600	9172	165.35
United Bank of India	164000	2756	3224	142.32
UCO Bank	113000	3254	7547	110.13
Vijaya bank	98000	699	4139	34.43
Total	**4302000**	**142823**	**190968**	**4259.99**

Slab-wise Advances of Schedule Commercial Banks (As on March 2008)

Size of Credit Limit	Number of Accounts	Outstanding Amount (In ` Lakh)
Up to `5 Lakh	15287360	85902.62
Above `5 Lakh and Up to `10 Lakh	570133	35114.85
Above `10 Lakh and Up to `25 Lakh	402053	53561.36
Above `25 Lakh and Up to `50 Lakh	122606	37223.62
Above `50 Lakh and Up to `1 Crore	74430	44150.39
Above `1 Crore and Up to `6 Crore	86658	176972.05
Above `6 Crore	39400	834979.89

Ratio of net NPA to net advances of Public Sector Banks

Name of the Bank	As on March 2008	As on March 2009
State Bank Group		
State Bank of India	1.78	1.76
State Bank of Bikaner and Jaipur	0.83	0.85
State Bank of Hyderabad	0.16	0.38
State Bank of Indore	0.73	0.89
State Bank of Mysore	0.43	0.50
State Bank of Patiala	0.60	0.60
State Bank of Saurashtra	0.91	
State Bank of Travancore	0.94	0.58
Nationalized Banks		
Allahabad Bank	0.80	0.72
Andhra Bank	0.15	0.18
Bank of Baroda	0.47	0.31
Bank of India	0.52	0.44
Bank of Maharashtra	0.87	0.79
Canara Bank	0.84	1.09
Central Bank of India	1.45	1.24
Corporation Bank	0.32	0.29
Dena Bank	0.94	1.09
IDBI Bank Ltd.	1.30	0.92
Indian Bank	0.24	0.18
Indian Overseas Bank	0.60	1.33
Oriental Bank of Commerce	0.99	0.65
Punjab and Sind Bank	0.37	0.32
Punjab National Bank	0.64	0.17
Syndicate Bank	0.97	0.77

Name of the Bank	As on March 2008	As on March 2009
UCO Bank	1.98	1.18
Union Bank of India	0.17	0.34
United Bank of India	1.10	1.48
Vijaya Bank	0.57	0.82

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