

## IMPACT OF DEMONETIZATION ON MSMEs

In the recent past there have been unprecedented debates and discussions regarding the demonetization move that shook the nation on 8<sup>th</sup> November 2016. Although demonetization as a cleaning exercise has generated numerous benefits to the economy. However at the same time, it has created unavoidable income losses to the MSME sector which is basically a cash based sector and where incomes are based on their daily work. Moreover inadequate liquidity has caused gross disruption in all sectors of the economy and in India the digital transaction culture has yet to catch up with all sections

Following demonetization the Indian economy is totally bereft of liquidity as 86% of the cash in the system is withdrawn without any speedy replacement. According to sources there are 8.58 lakh crores of Rs. 500 notes and 6.86 lakh crores of 1000 notes resulting in a total of 15.44 lakh crores being taken out of the system causing an acute liquidity dehydration.

SMEs usually function with unsecured loans from friends and associates which has now started drying up, Because of greater reliance on cash, sales of MSMEs is expected to be impacted. MSMEs play a predominant role in the Indian Economy and accounts for nearly 40% of the total economic activities in the country besides being the largest contributor towards employment.

Also most of the micro enterprises belonging to the unorganized / informal sector are facing an adverse impact in their day-to-day operations and close to 40 per cent of them could end up closing down in the second half of the current financial year.

MSMEs affected the most relate to textiles, agricultural products, consumer durables, steel, infrastructure and automobiles – all of which are basically small and micro industries and rely heavily on cash transactions and about 33% of their manpower is casual labour and daily wage earners.

India risks its position of being the fastest growing largest economy, this can already be seen by the landslide in business activities by atleast 25% which may reduce India's GDP growth as the liquidity impact itself may last three -four months and recovery specially for the MSMEs will take a much longer time

India is predominantly a cash based economy and the proportion of black money is estimated to be rather inconspicuous as compared to the total cash. Also what one should note is that only a small portion of black money is actually stored in the form of cash. Generally, black income is converted to physical assets like gold, land, buildings etc.

The Micro, Small & Medium Enterprises (MSME) sector plays a pivotal role in India's economic development making significant contributions to GDP, employment and exports. It is estimated that in terms of value the sector accounts for about 45% of the manufacturing output and around 40% of the total export of the country. It is, only appropriate that public policy accords high priority to this sector in order to achieve balanced, sustainable, more equitable and inclusive growth in the country.

Demonetisation is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters. The question that arises is why demonetisation was required at this point of time and how does it plan to regain lost ground

**To counter the effects of demonetization and assist MSMEs regain their growth we recommend the following:**

1. The trade credit sector in the banking industry has seen a steep rise in financial infirmities and NPAs and needs attention. The main reason, for this issues not being in the center stage of deliberations is due to the non-availability of correct and reliable data on TC distortions due to the huge size of the informal economy in the country. Thus, there is an urgent need for RBI intervention on a priority basis before the issue transforms into a major crisis. Currently, the Indian economy is in a trend is to institutionalize vital policy changes and this presents the most opportune time to ring in reforms in the trade credit sector too.
2. The Indian banking system is interlinked with each and every Development Agenda of the Indian Government. Government's initiative on Make in India, Ease of Doing Business, Start Ups and Digital India needs special dispensation and boost from financial sectors to achieve its optimum purpose to boost economic growth, employment and exports.
3. Finance policies have been formulated but their reach to the beneficiaries is still restricted. In event of same a pro policy structure can be adhered to and ways and means be devised to aggressively fund the manufacturing, SME and Infrastructure sector and thus ensure the much needed growth in economy.
4. With the near failure of SDR scheme, there is no other way but to subsidize potential infrastructure and manufacturing projects by availing them lower interest rate for repayment or fifty percent reduction in interest load. A similar process had already been implemented in 2009-2014, at the time of policy paralysis and no growth in manufacturing and infrastructure sector.

The Indian inflation has been on control at the cost of growth, however this will again lead to policy paralysis if this strategy remains in vogue for a longer time.

We strongly suggest in overall view and support of the MSME, Infrastructure and other sectors a more compliant and innovative policy catering to different economic scenarios needs to be addressed and formulated so that the stakeholders do not have to wait in lurch given the fact that all being part of the growth agenda.

### **Financing and Credit**

MSMEs primarily rely on bank finance for their operations and as such ensuring timely and adequate flow of credit to the sector has been an overriding public policy objective. In a highly competitive environment, finance is needed not only for running an enterprise and operational requirements but also for modernization/upgradation of technology, capacity expansion,

marketing etc. Inadequate access to finance is the root cause of poor technological and marketing performance of MSMEs.

Moreover, high collateral requirements and complex procedure followed by banks in lending, MSMEs prefer to use own funds or borrow from informal sources. In few regions cooperative banks have been very active in lending to MSMEs, but the higher rate of interest charged by these banks pushes the cost of production.

### **Suggestions**

- Atleast 20 per cent of banks lending must be reserved for the MSME sector
- A ceiling on the interest rate on bank lending to MSMEs should be implemented

### **Credit Guarantee Trust Fund for Micro and small Enterprises (CGTMSE)**

CGTMSE is a good step towards the growth of this sector as the scheme aims to provide credit to Micro and Small enterprises for loans up to Rs. 100 lacs without collateral or third party guarantees.

#### **Suggestion:**

The government should consider sanctioning loans to startups to meet their individual needs and can be categorized as follows

- Production Purchase Fund up to Rs. 100 lacs
- Market Promotional Fund up to Rs. 100 lacs
- Expansion Fund up to Rs. 100 lacs
- Upgradation Fund up to Rs. 100 lacs
- Research Fund up to Rs. 10 lacs - A common research center can be an initiative in clusters that will offer research data on market, customer and competitors. As well as conduct market surveys on customer demand, needs and wants of the market.
- Start-up Fund up to Rs. 200 lacs - The government should consider sanctioning of loan on the PPP Model (Public Private Partnership Model) for setting up the enterprise, purchase machineries and setting up the plants. The concern authorities should monitor the progress of the startups.

### **Equity Fund**

Keeping in mind the need of the SMEs a special Equity Fund could be created with an initial corpus of around Rs 50,000 crores. Contribution to the fund could come from the PSU Banks, and the management of the same could also be with the PSU Banks.

The purpose of the Equity Fund would be to provide capital to SMEs through equity stake in companies up to 25 percent. This would provide SMEs with long term funding as well as meet their margin money requirements.

For most scholars, small industry policies have typically meant narrow sector-oriented policies such as reservation, duty concessions, directed credit, and government regulation, controls, and extension. The major impact of macroeconomic policies both monetary and fiscal on the sector has been almost entirely missed in both government's discussion of policies and academic debate.

And as such many specific macroeconomic policy-induced distortions work against the small-scale sector.

### **Tariff Inversion**

Tariffs are not entirely free from inversion, that is, higher rates on inputs like steel, plastics, energy, and metals semi-manufactured than on finished products. This inversion which, since the reform was at its peak in the late 1990s, has declined but not disappeared. Inversion particularly hurts small firms since they do not have a comparative advantage in manufacturing in its original sense. Additionally, the very high uncompensated costs of energy, especially electricity and petroleum - based energy, which are not vetted even for export industries, impose large costs on location of manufacturing.

### **Exchange Rates**

Exchange-rate policies have been particularly hurtful to small firms, especially in areas dominated by SMEs, like textiles. The effective exchange rate of the rupee has been higher than the value that prevailed at the end of the stabilization period.

If it can move back to those values the small firms of export can rise, as can manufactured goods production. It is worth remembering that export-led growth economies greatly under-valued their currencies for long periods to prime the export engine.

### **Erroneous Sickness Data**

In reporting the data on lending to small firms banks include loans made out under many sop programs of the Planning Commission. Most of these are giveaways at best. Naturally, this magnifies the scenario of overall sickness of and loans outstanding against small firms. In reality, the nonperforming loans outstanding against small firms are much smaller than in lending to medium and large firms.

### **Exit System**

Considering the volatile market situation in India, businessmen particularly in the MSME sector are walking a tight financial rope. Amidst uncertainties, entrepreneurs need government help in exiting a business when it is no longer financially viable or at least after he has spent his last rupee to keep it running.

About a third of small industries at the all India level are classified as "sick." These are units that have entered the books of the financing institutions. There are many who did not borrow but fell sick. They have assets like the land and machinery, which are locked for decades without remedy. A rough estimate of such assets in the industrial estates alone would be 5-6% of the GDP!!

The acknowledged problems common to small enterprises as a whole persisting for over four decades include: lack of demand, lack of access to finance, non-availability of raw material, inadequate and high cost infrastructure, low capability for technological up-gradation etc.

The direct intervention in the credit market for SMEs did some good, but it has also engendered the growth due to the banks lending to some sectors that lead to avoidable portfolio risks. Banks carry now as much as 30-35% in the unacknowledged sick industries portfolio. RBI Annual Reports on sickness and rehabilitation, despite redefining sickness and reformulating guidelines for rehabilitation, indicate that the banks are averse to take on rehabilitation.

The absence of a clear exit policy is hurting many entrepreneurs. It is easy to start a small scale or micro unit but it is difficult to run it and almost impossible to close it.

### **Suggestion:**

There is a need for a vital, proper and single point of exit in case of corporate failure, provision of second chance in case of insolvency and bankruptcy, need to reform in the judicial system of corporate exit, rivalry issue, harassment by money-lenders, and the most importantly, need to change the mindset of the borrower.

There should be a structured exit policy, taking into account the length of time the unit functioned before going "sick." It was suggested, for settlement of all labour disputes in tribunals or courts within six months, closure of all accounts related to taxes and duties within three months and creation of social security for entrepreneurs who had been generating employment for 20 years and more. Framing a suitable exit policy will ultimately benefit the MSME sector.

While there were number of studies in the past and limited attempts on the part of the RBI resulting in formulation of certain guidelines for reviving the sick but potentially viable enterprises, they all remained largely on paper. The banks, in the meantime, as part of the reform process, have moved to revised asset classification according to which the units that fall in arrears of payment of either principal or interest for 90 days or more will be treated as NPAs.

Assets locked up in sick SEs should be released within the quickest possible time after identifying them as sick or potentially viable so that the factor productivity does not become negative. Therefore, the future policy focus has to be not merely on certain key issues for sustained growth like raising total factor productivity and price competitiveness, ensuring quality standards and facilitating export growth, but also on providing a safe exit route for unviable enterprises.

There should be basic recognition that enterprises have their inevitable failures (even the top 500 companies in the world were never the same every year). There is a need to understand that the failed entrepreneurs have an urge to restart their enterprises with a new agenda or in a new shape after drawing lessons from their failure.

Legally, bankruptcies among the SEs would need recognition to facilitate exit route. All developed nations have bankruptcy laws that define exit rules giving honor and dignity to failed entrepreneurs to make an honorable living.

## **Skill Development**

India is the largest MSME country and ranks 2<sup>nd</sup> in the world for MSMEs. Yet MSMEs face a number of hurdles and challenges, many of them do not have the knowledge of connecting with markets or branding their products due to lack of guidance.

### **Suggestion:**

A skill development scheme for the MSMEs should be introduced towards skilling the MSMEs on market information, industry, research and advice related to financial support, use of various marketing techniques and ways to attract and retain customers.

Short term courses should be designed for entrepreneurs and practical training should be given on various enterprises.

## **MSME Finance and Credit Policies**

### **Adequate and timely finance**

The MSMEs should have access to adequate and timely credit. An effective regulator of banks should check and ensure compliance to the instructions and guidelines given by RBI.

### **Suggestion:**

The future credit policy for this sector should aim at providing a level playing field with others in the domestic and global market. Reduction in the cost of credit to the extent possible within the overall condition of the economy. The government should make an endeavour to bring it at par with other countries particularly those with whom we have to compete. To begin with, the cost of credit could be made identical for both small as well as large units.

Availability of higher amounts of loan without insistence on collaterals and third party guarantees. This however, depends to a great extent on the experience under the Credit Guarantee Fund Scheme.

## **Working Capital**

A large segment of MSMEs particularly those who are part of supply chains face working capital shortages due to unpaid or delayed bills. In majority of the cases the delay is greater than 180 days. The NPA norms classify a bank a/c as NPA after 90 days (extended to 120 days now), whereas the payment cycle is 180 days and beyond.

### **Suggestion:**

The impediments in the use of factoring should be addressed and should be promoted among the MSMEs.

## **Term Loans**

Many progressive companies that went for expansion or started a new unit during boom period (last 4-5 years) are finding extremely difficult to service periodic re-payments as market conditions have suddenly reversed. In current situation neither top line nor bottom line targets could be met by borrowers. Therefore repayment plans have gone awry and defaults become imminent.

### **Suggestion:**

A Moratorium for one year is needed for the affected MSMEs. There is also need for more sensitive restructuring guidelines having strict time frames.

The Banks should clearly spell out their restructuring norms as branch managers remain clueless and MSMEs are unaware what they could expect.

## **Interest rate and service charges**

MSMEs get a raw deal in interest rate and are made to pay higher charges for all types of chargeable services particularly non-fund based limits such as bank guarantees.

The interest is supposed to be charged based on performance of the borrower. The process of judging is internal, non-transparent and subjective. The findings are never shared with the borrower. Over the years, if there is improvement on some parameters, values are changed to keep the borrower under higher slab of interest.

### **Suggestion:**

The RBI should benchmark maximum services as is done by TRAI and make continuous efforts for their reduction.

There is a need to improve transparency, internal credit rating/ scoring report must be shared with the borrower.

## **Collateral**

RBI should constitute a Committee for issuing guidelines on extent of collateral. Collateral greater than 100% (besides mortgage of plant and machinery should be refunded).

## **Third Party Credit rating**

The third party credit rating requirement under BASAL II for loans portfolio above Rs. 10 Cr. has unnecessarily burdened SMEs. There is need to review their efficacies of credit rating models and fee structure and service quality. Moreover, these conditions be withdrawn for unlisted SMEs.

## **Subsidies/Credit**

- The SME sector is not given any subsidies, incentives or tax exemption as given in case of large scale sector.

- Creation of a widespread institutional network for credit rating for SME projects at affordable cost to them.
- Introduction of newer and more innovative finance schemes such as factoring services and venture capital supported by incubation centers for new entrepreneurs. The policy measures required for popularizing venture capital concept may be initiated by Ministry of SME & ARI.
- In order to mitigate the post sale problems of SME, there is a need to encourage bills culture, without recourse, to SME. In this context, Government of India be requested to help creating conducive climate for development of factoring services through appropriate policy prescriptions/legislative changes to ease the problems relating to stamp duty, registration fee, assignment of debt, etc. A task force should be appointed to look into these problems.
- Strengthening of the financial/capital base of the SFCs, the institution that has played important role in the development of the SME sector by providing fixed capital. The respective state governments, SIDBI and IDBI would have to play a major role in revamping the SFCs.
- There is a need for continuous and rigorous monitoring of the guidelines/directions issued by the RBI to the banks and other financial institutions for improving the flow of credit to SME sector.
- Commercial banks may be instructed by RBI not to take all future fixed assets of assisted units for securing its existing advances. This will help units going in for technology upgradation, modernization, etc. to avail assistance from financial institutions for such programmes without difficulties.
- The Credit Guarantee Trust Fund Scheme may be extended from Rs. 50 Lakhs to Rs. 1 crore but most of the banks are not considering the proposal under the scheme and the SME entrepreneurs are not benefiting from the scheme.
- There is a need for a change in the attitude and orientation of commercial bank staff in their lending to the SME sector.
- RBI may take up the matter with the banks for sub-allocating the overall limits sanctioned by banks to such large borrowers specifically for meeting the payment obligations in respect of purchases from SMEs either on cash basis or bill basis.
- SIDBI should promote financial intermediaries as venture capital funds, equity funds, marketing consortia, co-operative industrial banks, incubators, consultancy services at national, state and district level to be operated by different agencies including industrial associations.
- Commercial banks should fulfill priority sector lending targets by lending directly to SME sector instead of adopting soft approaches like subscription to bonds of SFCs/NABARD etc.
- Within the amount earmarked for SMEs, sub targets may continue to be fixed for lending on incremental basis to micro, tiny and other SME units.



- The various committees appointed from time to time like the Nayak Committee, Kapur Committee, Ganguly Committee have given their recommendations to Reserve Bank of India (RBI) and many of these have not been implemented till date which should be looked into and necessary follow-up action for implementation should be taken by the Government to meet the adequate and timely financial need of the SME Sector.

### **Systematic Reforms for MSME Growth**

#### **Business Laws:**

The current legal system does not recognize failure of business as a possibility. There is a need to evolve Insolvency and Bankruptcy Codes.

#### **SEBI Norms on Delisting**

The Securities Laws (Amendment) Act 2005 allowed delisting of securities, necessitating the creation of a delisting framework. Even after repeated announcements, simplified delisted names have not been announced as yet.

#### **Suggestion:**

The de-listing norms for SMEs should be announced without delay as it is causing enormous burden on such SMEs that have applied for de-listing.

### **Affordable credit to MSMEs**

- Banks must adhere to the recommendations of Task Force on MSME and provide 60 per cent of the MSE credit to micro enterprises. The Committee should closely track the flow of credit to micro enterprises and advise the Ministry of MSME, if shortfall in 60 per cent sub-target falls short;
- Micro enterprises may also be provided with interest subvention on their loans as recommended by the Task Force. The Committee may discuss the ways and means of providing interest subvention to the micro enterprises;
- The Industry Associations be provided fund for appropriate guidance and consultancy to the micro enterprises for resolving problems faced by them in preparation of balance sheet, maintain a proper accounting practices as also bringing up awareness towards importance of credit rating, benefits of CGTMSE and advantages of the same. Creating awareness on credit guarantee trust for micro and small enterprises at grass roots levels is particularly important;
- As regards other segments of the MSME sector, regular monitoring is necessary to ensure strict adherence by the banks of the stipulated target of lending to MSME sector within the next banking credit;

- With a view to increasing the level of lending to MSMEs, the banks may go in for simplification of procedures and delegation of adequate powers to the Branch Officials;
- As present collateral is invariably insisted upon. The Banks need to be asked for not insisting upon collateral if the loan has guarantee coverage of CGTMSE. Further the quantum of collateral free loan may be mandatory upon the level of Rs.10 lakhs.
- Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) has been very helpful for the MSME sector. However to make it stronger and support more and more MSMEs, the corpus of the CGTMSE may be extended so that all loans could be adequately covered. This might also help in bringing down the rate of interest. At present higher interest rate dampens and inhibit the MSMEs endeavours.

### **Delayed Payment**

Despite Government directions to expedite payment to the sector that supplies goods and services, MSMEs face innumerable hurdles for getting payments against their supplies to Corporates and PSUs. Due to delayed payments, the units are defaulting on bank loans, which are being declared as non-performing assets. Specific steps are needed to ensure timely payment to MSMEs against supplied made by them to Corporates. It is suggested that the delayed payment provision under the MSMED Act i.e. payment should be made within 45 days should be strictly enforced;

### **Venture/Risk Capital**

Presently Venture Capital availability to SMEs is not widespread due to various reasons like limited opportunities of third party or IPO exits, absence of corporatization, high handling and monitoring cost, act. This is considered very critical especially for the knowledge-based MSMEs, since India has large pool of budding entrepreneurs with rich professional and technical experience and innovative business ideas. This area needs attention.

### **NPA**

Banks classify a borrower as non-performing assets when any commercial loans for which interest or repayment of principal or both remain outstanding for a period of 90 days. In view of the inordinate delay in receiving payments even from the PSUs and demand slump in the market, it is submitted that 90 days time-frame be enhanced to 365 days with immediate effect.

### **Securitization and Reconstruction of Assets**

The Securitization Act allows lenders to take over the assets of defaulting companies and auction them to recover their dues or take over the management of companies after serving a notice for a

period of 60 days. It is suggested that recovery of loan under the Securitization Act is extended to Rs.1 crore from the existing limit of Rs.1 lakh.

### **Debt Recovery Tribunals**

Debt Recovery Tribunals be converted into SME Rehabilitation Tribunals. Rehabilitation Committee be formed at national, state and district level and they should be empowered to perform. The performance of these committees should be monitored on monthly basis.

### **Rehabilitation of Sick Units**

The Unit should be identified at pre-sick stage and timely action should be taken before they fall sick. Investment upto Rs. 10 lakh in sick units should be exempted from Income Tax for at least five years and the Income Tax Authorities should not harass investors.

Identified at the incipient stage itself and appropriate measures taken to avert the sickness. Sick units viable for rehabilitation, contingency loan assistance need to be arranged at concessional rate of interest with longer moratorium for start-up, repayment to pressing creditors, working capital requirement, etc. There should be a time bound special package for easy exit policy for the non-viable sick units without cumbersome procedures together with a Social Security Scheme for all the sick units.

### **Timely /Adequate Availability of Credit**

The adequate /timely availability of credit has been a long standing issue confronting the vibrant sector of economy. Various committees were set up in 90s by RBI/Govt. such as P.J. Nayak Committee, S.L. Kapoor Committee to address the issue. P.J. Nayak Committee had recommended that 20% of sales achieved should be provided bare minimum & banks were liberty to justify/verify, if additional working capital is required. It is an admitted fact that since Nationalization in 1969, banks were conservative in sanctioning the working capital limits. Banks were reluctant to provide 20% of sales achieved. The recommendations were not implemented in letter & spirits.

The Task Force was constituted in Sept., 2009, which has recommended 60% of MSE credit to Micro Enterprises, which is to be achieved in stages. The fact that 50% was to be achieved in 2010-2011 (both manufacturing & Service sector).Needless to mention that the focus of Nationalized banks is on SMEs & not on Micro Enterprises/service enterprises.

### **Collateral Free Loan**

The limit of collateral free lending to MSEs has been enhanced from Rs.5 lacs to Rs.10 lacs and banks are mandated not to accept collateral security. The limit of collateral free lending of Rs.10 lacs of RBI as per nationalized Banks is not mandatory. No loan is being sanctioned without collateral guarantee. The Branch Managers need to be trained/educated to implement the

mandated directions of RBI to be implemented in to. The branch level functionaries don't encourage availing the credit Guarantee Scheme Cover and demand for collaterals.

### **Securitization Act, 2002**

The Act was enacted to bring around defaulters/big fishes, but, unfortunately, the banks have exploited clause 13(2) as limit was Rs.1 lakh and the banks issue 60 day's notices under 13 (2). It is high time that limit should be raised to Rs.10 lacs instead of Rs. One lakh at present. No relaxation is being granted to Small borrowers by Banks, where the value of collateral security is much more and the commercial banks are quite rigid in the case of MSEs.

### **Uniform Rate of Interest**

It was noticed that no uniform rate of interest is being charged by the banks for SMEs. It was noticed that differential rate of interests are being charged even by State Bank of India, which was the only bank, which provided loans to SSI, under a pilot scheme in 1956. The higher rate of interest is being charged by other Public sector banks from the Micro/Small Enterprises.

### **Trade Credit**

Indian exporters are facing constraints on several fronts such as a lack of trade credit, hard bargaining by buyers for steep discounts, payment defaults as well as the rising costs or a lack of credit insurance. This has led to payment cycles being stretched and an excessive build-up of inventory. As for factoring, availability of credit insurance is an issue. Even when it is available, the costs are high.

Trade credit is a finance cushion though with limited extent to the worth of goods. Trade credit is economically significant from both the micro- as well as a macroeconomic perspective. Trade credit is one of the most important sources of working capital for firms, not only in advanced economies, but in India as well. Trade credit accounts for roughly 11% of the external finance for large firms in India. In the case of SMEs, this proportion is nearly double at around 20%. Globally, the extant evidence appears to suggest that, on average 19.7% of all investment financed through external sources is via trade credit. Trade credit is the single most important source of external finance for firms and is used as a hedge for financing needs.

It appears on every balance sheet and represents more than one half of businesses' short term liabilities and a third of all firms' total liabilities with about 60% of all international trade transactions being financed via trade credits.

Following the slowdown and credit crunch globally, insurers are not willing to take the risk. With the recent collapse in international trade, credit availability has had its relative impact on SME exporters. Given the importance of SMEs in job creation, as well as the problems emanating from the chronic trade deficits, the extent to which SME exporters are adversely affected by frictions in the credit markets is an important public policy issue. In particular, the small firm share of the dollar volume of total exports is adversely affected by deterioration in bank health, and the

adverse impact is more pronounced for firms in industries that are more reliant on external finance, such as chemicals and textile mill products. Small exporting firms are affected more by deterioration in bank financing than are larger exporting firms.

In fact, given that there is reason to believe that exporting firms are more sensitive to bank financing compared with firms producing for the domestic market, a program supporting credit to smaller exporting firms may provide the greatest “bang per buck” among focused small business lending guarantee programs when bank financing weakens and the availability of credit is impaired.

In contrast to large firms small, illiquid firms with little access to outside finance pass liquidity shocks on to their suppliers by defaulting on trade credit. If the supplier is also small and illiquid and cannot raise fresh funds on short notice, a substantial portion of the shock is likely to be passed on further down the trade credit chain. Large liquid firms with access to outside finance ultimately tend to absorb at least some of these shocks and hence inject new liquidity into the system.

In this way credit constrained firms avoid having to liquidate assets. Trade credit default chains can serve a useful role in allocating liquidity to credit constrained firms. SMEs increasingly depend on handholding by the banks to meet their credit requirements.

Persistently sluggish industrial growth despite strong fundamentals, influx of FDI, implementation of a string of policy reforms in the last 4-5 years has led to clustering of delays/defaults in TC payment aiding the already present acute working capital crisis leading to growth crisis for large number of businesses. Trade credit flow system was based on trust and confidence .However, deterioration of same has led to fall in credit culture making the credit-based segment of the payment system increasingly vulnerable.

### **Suggestion:**

There is a need to relook at the NPA Norms for MSME and infrastructure projects and also moratorium on earlier loans and interest for 2-3 years to move forward as the industries as a whole is facing liquidity crunch which needs to be addressed on priority, this shall resolve the pending issues and economy shall get impetus for better growth.

### **NPA Environment**

Despite various NPA recovery mechanisms, sale of NPAs to asset reconstruction companies, write-offs and concerted recovery efforts, NPAs are steadily increasing. Financial sickness as reflected in banks’ NPA data is only a small portion of the aggregate of bad loans in the economy if cases of bad loans in private credit are taken into account. Bad loans situation is worse in private credit as banks at least have some security and various legal back-ups for recovery.

On the other hand, the rights of private creditors are less protected. Cases of willful defaults, strategic debtors, delayed payments and opportunistic behavior are on the rise in the TC network

in the recent years. These do have demonstrably adverse effects on confidence channel in TC. However, such data is not compiled and discussed in public domain. Trade creditors generally suffer silently as legal remedies are costly and long-drawn with uncertain outcome.

Further, with the general increase in payment cycle, funding of liquidity is becoming difficult. Increasing number of firms' financials are sliding. A large number of them are struggling to survive.

As credit from different sources being fungible and form the financial resource base of any unit, bad-debts and credit-constraints in TC do impact the bank-debt repayment capacity of a unit. In India bank financing and restructuring of NPA proposals, particularly in MSMEs, have incomplete or very little information/idea about the quantum, cost and credit terms in respect of trade payables/receivables and private loans. These make various financial projections in credit appraisal or restructuring proposals less real. Such projects carry higher NPA risk and lower revival chances in case these slide to stressed asset category.

The interconnectedness that exists between TC and banks exposes the system to contagion risks under stress scenarios. The stress situation for a large number of firms is worsening as fresh injection of funds in TC is on decline. Result is an unprecedented loss in growth momentum in credit-intensive manufacturing sector and spurt in NPAs. The problem of NPAs in banks cannot be solved without addressing bad credit and liquidity problems in TC. However, the real concern is that this fact is little understood as all analytics confine to bank credit and bank NPAs. Focus on a part of financial system [bank credit] can obscure vulnerabilities arising from infectious liquidity crisis in TC and eventually may prove perilous for banks and the economy.

Even lowering of interest rates may not help much in increasing credit flows as banks/trade creditors' tight lending standards make liquidity funding conditions shaky. Top down use of monetary transmission mechanism alone is inadequate to counter the problem of micro-level credit constraints. Easy monetary policy may lead to credit-push through large ticket loans which could end-up in large cash/liquid investment on the balance sheet of high-end corporate or money market instruments.

**Suggestion:**

Any loss of faith in credit based payment system would result in more cash-based and fewer credit-based transactions, thereby reducing efficiency in payment mechanism, economic activities and flow of transactions. TC deleveraging and liquidity constraints remain a major headwind for NPAs in the coming period.

Feedback from trade and industry show that liquidity problem is becoming more serious day by day and widespread. This has created an environment of pessimism in TC network. Collective

feeling of pessimism has cascading effect in driving down liquidity in trade and industry. The interconnectedness that exists between TC and banks does expose the banking system to contagion risks of NPAs. As such, greater understanding of the financial networks and their relations with real sector activities are essential to identify fault-lines along which financial shocks propagate.

Under these conditions, trade finance intervention is required to: i] mitigate the problems of micro liquidity problems and ii] facilitate availability of trade finance along the supply chain to absorb liquidity shocks and prevent closure of illiquid/credit constrained but solvent firms. Following the Lehman crisis, liquidity in global financial market dramatically dried up. This had immediate and huge impact on global trade.

Under these circumstances, IFC, G-20 countries, development finance institutions, etc., supported/resorted to trade finance interventions on emergency basis. Additional liquidity was provided to facilitate trade transactions which did help in containing depression in world trade. Without TC intervention, even higher public expenditure, monetary easing, measures to increase bank credit and lower interest rates to stimulate economic growth may not have the desired level of outcome as ultimately the credit travels through the TC chain.

Policy intervention including legal measures are also required to strengthen quality of accounting information to ensure reliability about the value of receivables and its efficient realization. These will make receivables as attractive and effective collateral against bank credit and factoring. This will scale-up availability of working capital and factoring services. Secondly, it is essential to strengthen creditors' rights and legal system for quicker and cost-effective private credit recovery which encourage higher TC flows.

To maintain integrity/discipline and engender transactional trust in TC eco-system, self-regulation, collective action by industry bodies against willful defaulters/opportunistic behaviour, creation of credit directories for private credit, etc., are required. In these matters industry associations' role become critical.

An integrated approach based on above factors to address the problem of NPAs in both banking and non-bank financial markets can work efficiently and effectively. Partial remedial measures confining to bank NPAs may not cure the NPA malady cost-effectively, efficiently and wholesomely.