A Brief Commentary on RBI guidelines for Rehabilitation of Sick MSEs

The current economic scenario with stagnating demands and increasing costs has been affecting the profitability of most business ventures. SMEs, owing to their low scale of operations and limited financial muscle, are more susceptible to down cycles in the business environments. Given the large number of enterprises, their role in employment generation and contribution to the country's production and exports, their financial health and sustainability is very important for the economy. As such, there is a strong need to address the problem relating to sickness in the sector and to proactively support SMEs at the incipient stage itself, to avoid them from becoming sick and also rehabilitate potentially viable sick SMEs before it is too late. Past studies and efforts to rehabilitate sick but potentially SMEs have not been very successful, as statistically visible from the RBI mandated study carried out by a working Group in 2007. The RBI constituted Working Group recommended measures to avoid sickness at the incipient stage itself and rehabilitate the potentially viable sick Micro and Small Enterprises (MSEs). RBI has come out with guidelines for banks aimed to address the problem. The measures suggested, *inter alia*, include recognising sickness at an early stage, faster decision with regard to potentially viable MSEs, and nature of facility that can and should be provided. While the measures are welcome, there are some areas which have not been touched, like not addressing similar problems for the medium sector and nature of handholding at the incipient stage itself.

CA. Rajesh Dubey

(The author is a member of the Institute. He can be reached at hrajyagorca@gmail.com)

Background

Rehabilitation schemes for SMEs from RBI can be traced since 1987-89 period when the restructuring of loans along with some concessions on the debt servicing formed the basis of the rehabilitation efforts. The first study report on the subject was submitted by a Committee constituted by RBI in February 1987 under the Chairmanship of Shri A. Hasib, the then ED of RBI. The era is remembered as one of protected environment not only for the SMEs but also for the banks. Banks were directed to disburse loans through loan melas dictated out of a desire for gaining political dividends for the party in

power. Also, the banks' financial statements did not reveal much on their financial health as provisions were hidden under net income and net assets. The recognition of loans as 'bad' or 'non-performing' could be delayed as much as possible as there was no direct involvement of public investors. Banks were owned by GOI, either through direct holding of shares or through RBI. The norms for greater disclosures and capital adequacy for the banks were introduced in 1992. With the introduction of these norms for banks, SMEs found it difficult to access debt from the banks as SMEs were perceived to be riskier than loans to large entities. The perception of the banks' has also to do with the low recoveries made out of loans granted during the loan melas where loans were disbursed to 'SMEs' without giving regard to the genuineness of the borrowers and thus was not inherently linked with the risk characteristics in the SME sector alone.

In the recent past, a Working Group (WG) was constituted to look into the issues of sickness in the SME sector and suggest remedial measures so that potentially viable sick units can be rehabilitated at the earliest. The WG was set up under the Chairmanship of Dr. K. C. Chakraborty, the then CMD of Punjab National Bank and currently Dy. Governor of RBI, with representatives from SIDBI and SBI as its members. The WG reviewed the data of sick SSI and medium units as at March 2007 and found that only 4.7% of the identified sick SME units were considered as potentially viable by the banks and only about 0.53% of the SMEs were considered for rehabilitation and nursing plan. It, *inter alia*, suggested:

a) Changing the definition of sick micro and small enterprises (MSEs) to include MSEs who have become NPA for 3 months or more, or erosion in the net worth due to accumulated losses to the extent of 50%. It also recognised insipient sickness in the MSE sector as, wherever
   (i) There is a delay in commencement of commercial production for more than 6 months or
   (ii) The enterprise has incurred losses in the past 2 consequent years or cash loss for one year or during the period for which such losses were anticipated in the financial projections while evaluating the project, or
   (iii) The capacity utilisation in terms of quantity or sales value is less than 50% of the projected level;
b) Early commencement of rehabilitation process, preferably at the incipient sickness stage itself and in any case not later than 3 months from the date when the enterprise becomes sick, in order to avoid a scenario where it is too late for rehabilitation;
c) Decision regarding viability/rehabilitation or decision that the enterprise is not viable should have the approval of the next higher authority. The next higher authority should take decision with regard to unviability of an enterprise after giving an opportunity to the promoters to present their case. Also the decision regarding unviable projects should be communicated within 7 days from the date of such decision;
d) Rehabilitation package to provide for -
   a. Waiver of penal interest from the beginning of the accounting year in which the account is classified as NPA,
   b. Nil interest on funded interest term loans (or FITL in short – that portion of interest on loans which have not been paid by the borrower and is converted into a separate loan account with a repayment schedule drawn to enable payment in the future assessed on the future cash flow generating capacity of the enterprise),
   c. Allowing for staggered or ballooned repayment/payment of principal/interest matching the cash flows of the enterprise,
   d. Margin of 40% for funding of losses,
   e. Clauses for 'recompense' in favour of lenders to enable them recover the sacrifice after the unit turns-around. Even new lenders stepping-in be permitted to convert debt into equity or mezzanine capital, etc.

In the recent past, a Working Group (WG) was constituted to look into the issues of sickness in the SME sector and suggest remedial measures so that potentially viable sick units can be rehabilitated at the earliest. The WG was set up under the Chairmanship of Dr. K. C. Chakraborty, the then CMD of Punjab National Bank and currently Dy. Governor of RBI with representatives from SIDBI and SBI as its members. The WG reviewed the data of sick SSI and medium units as at March 2007 and found that only 4.7% of the identified sick SME units were considered as potentially viable by the banks and only about 0.53% of the SMEs were considered for rehabilitation and nursing plan.

e) Where rehabilitation is not possible, early exits through one-time settlement (OTS) providing for haircuts on principal amount as well could be considered.
f) All loans below ₹2 lakh given for self-employment should be excluded from the data relating to sickness and incipient sickness in the SME sector, as the riskiness of such loans is higher and the same can distort the overall picture with regard to riskiness in the SME sector.
g) Setting up of a Rehabilitation Fund with a corpus of ₹1,000 crore with an intention for rehabilitation of sick MSMEs, to provide support in the nature of promoters' contribution wherein soft loan at concessional rates of interest, say 5-6% or quasi equity up to 50% of the required promoters' contribution subject to a maximum of ₹75 lakh can be provided.

In addition to suggestion on rehabilitation of sick MSEs or insipiently sick MSEs, the WG also made other recommendations relating to improving the ecosystem and support mechanism for the SME sector, ranging from training to banks in credit assessment, development of model projects with a cluster approach, reintroduction of national equity fund, capitalisation of SFCs, improving market access to the SMEs, etc. aimed at reducing chances of sickness in the SME sector, which have been forwarded by RBI to GOI, State Level Inter Institutional Coordination Committees, SIDBI for consideration and necessary implementation as they deem fit.

Guidelines for Rehabilitation of Sick MSEs

The Reserve Bank of India's Governor, in his II Quarter Review of Monetary Policy of 2012-13, mentioned that guidelines would be issued, laying down procedures for assessing the viability of sick units. Accordingly, RBI issued guidelines on the subject on 1st November, 2012. RBI has accepted some of the suggestions made by the Dr. Chakraborty Working Group and the guidelines issued have the following welcome features:

RBI issued guidelines on 1st November, 2012 wherein it has accepted some of the suggestions made by the Dr. Chakraborty Working Group. However, while the changes to guidelines are welcome, there a few issues which still remain to be addressed for the scheme to be more successful in the present economic scenario. One point is that the guidelines address sickness or insipient sickness and rehabilitation in MSE sector only; the sickness malaise in medium enterprises has not been addressed.

1. Handholding stage has been defined as scenarios where –
   a. The commencement of commercial production is delayed by 6 months, for reasons beyond the control of promoters (relevant for new projects or expansion/diversification projects of MSEs), or
   b. The MSE unit incurs cash loss for 1 year or losses for 2 years beyond the accepted timeframe, (mostly relevant for new projects or expansion/diversification projects of MSEs), or
   c. The capacity utilisation is less than 50% of the projected level in terms of quantity or value.

   The guidelines provide for timely and adequate assistance, stating that the same should commence at the handholding stage, viz., within 2 months from the time when MSE is identified as one which would require a handholding support.

   During holding operation i.e. when the rehabilitation or nursing package is being drawn and finalised, MSEs be allowed to draw from their cash credit account, amounts equivalent to the sales proceeds credited/deposited to the account.
2. The Sickness definition has been widened to cover
   a. All MSEs that become and remain NPA for more than 3 months (as against 9 months stipulated earlier), or the net worth is eroded to the extent of 50% on account of accumulated losses (as against the earlier stipulation that the net worth erosion should be on account of cash losses)
   b. All MSEs, irrespective of whether they have commenced commercial operations or not (as against earlier stipulation that the unit should have been commercially operating for a minimum period of 2 years).
3. A maximum timeframe of 3 months from the date when the unit becomes sick, has been stipulated to decide on the viability or otherwise of the MSE unit (the earlier guidelines were silent on this).
4. The decision of identification of viable or unviable units would have to be undertaken by
   a. Branch Manager without viability study for: micro (manufacturing) enterprises with investment in plant and machinery ≤ ₹5 lakh,

micro (service) enterprises with investment in equipments ≤ ₹2 lakh.

b. Sanctioning authority and next higher authority with the support of viability study for all other entities.

A procedure for declaring a unit as unviable has been stipulated, including giving a chance to the promoter of the unit to present his case before the decision making authority has been stipulated (the earlier guidelines were silent on this).

5. The nature and extent of reliefs that can be provided to viable/potentially viable units can be decided by the respective Boards of the banks. Similarly, the OTS for non-performing loans can be decided by the banks, duly approved by their Boards.

Comments and Observations

While the changes to guidelines are welcome, there a few issues which still remain to be addressed for the scheme to be more successful in the present economic scenario:

1. The guidelines address sickness or insipient sickness and rehabilitation in MSE sector only; the sickness malaise in medium enterprises has not been addressed.
2. The requirement of a viability study has been done away with, only in the case of micro (manufacturing) and micro (service) enterprises having investment in plant and machinery not exceeding ₹5 lakh and equipment not exceeding ₹2 lakh, respectively. It could have been suggested for credit exposures of up to ₹2 crore to speed up the process for a large portion of enterprises. The past experience of viability study is not available and especially when the exclusion rate for consideration for rehabilitation rate being very high, need for adopting a different approach is very much warranted.
3. The guidelines are not very clear on the nature of financial support that can be provided during the handholding period i.e. during the stage of insipient sickness. The same has been left for the respective banks to decide. It could be clarified that it could be on similar lines as for the nursing packages such as rescheduling the loans to match the cash flows, staggering or ballooning the loan repayments, funding of interest, relaxation in margin requirements for operating on cash credit accounts, etc.
4. The number of potentially viable MSEs identified from the sick MSEs has been very small in the past, as also observed by Dr. Chakraborty Working Group. The reasons of low recognition have not been ascertained even after 4½ years since the WG submitted its report. The main reasons that can be attributed for the low recognition are-

a. Coverage of less than ₹2 lakh loan given for self-employment generation where the delinquency rate is much higher, making the overall picture distorted. RBI could consider disclosing separate statistics excluding the loans up to ₹2 lakh to assess accepting MSE accounts as viable/potentially viable.

b. Inability of promoters in bringing the margin money of about 40 – 50% required from the banks' point of view for turning around the business,

c. Conservative outlook of the lenders for assisting units in sickness/insipient sickness stage; as it requires an additionally proactive outlook and approach compared to while taking other credit decisions,

d. Relatively safe approach of OTS or recovery through invoking security in case the credit exposure is adequately collaterally secured with fixed assets.

Dr. Chakraborty Working Group suggested setting up a rehabilitation fund with a minimum corpus of ₹1,000 crore. There couldn't be a better time for the introduction of the rehabilitation fund than now for a revival of the SME sector and possibly making the growth in economy more sustainable and to withstand even severe shocks.

5. While speed of decision-making in terms of recognising the MSE units as insipiently sick/ sick and the communication of the decision has been addressed, the possibility of recognising potentially viable units as unviable, has not been addressed. The same could have been addressed by adding a check in the form of taking up at least 10% of the MSE units identified as unviable by an independent Committee comprising of representatives of banks and industry representatives. The existing District Consultative Committees can be broad-based to include industry representatives and the same can be considered as a check-body for the purpose. Bank officials who have identified the units as unviable and the respective affected units' promoters may also be called to separately present the case before the Committee. This process can act as a check on the selection or identification process adopted by the banks in identifying the potentially viable MSE units. Wherever banks are found to be very conservative, necessary guidance and training can be provided. The objective of the exercise should not be considered as an effort to castigate the banks but to enhance their capability in assessing potentially viable units. If need be, the findings in respect of individual banks need not be disclosed. Only aggregate data for all banks should be disclosed to assess the fruitfulness and effectiveness of the selection exercise adopted by the banks.
6. The rehabilitation or nursing packages call for additional funds' infusion from the promoters and the lenders. Even though the amount of promoters' contribution is lower than the funds infused by the banks, many a times it is difficult for the promoters to bring in his contribution. Many potentially viable projects are not considered favourably by the lenders in the absence of promoters' capability towards adequate infusion of funds. It is a rather uneasy situation for the insipient or sick SMEs, as most of the SMEs are trapped into sickness for want of risk capital, an essential bloodline when the business is tagnating or where the pressure is high on the bottom-line due to increased costs or falling revenues. The current economic scenario reflects all these symptoms. Dr. Chakraborty Working Group suggested setting up a rehabilitation fund with a minimum corpus of ₹1,000 crore. There couldn't be a better time for the introduction of the rehabilitation fund than now for a revival of the SME sector and possibly making the growth in economy more sustainable and to withstand even severe shocks. ■

Wherever banks are found to be very conservative, necessary guidance and training can be provided. The objective of the exercise should not be considered as an effort to castigate the banks but to enhance their capability in assessing potentially viable units. If need be, the findings in respect of individual banks need not be disclosed. Only aggregate data for all banks should be disclosed to assess the fruitfulness and effectiveness of the selection exercise adopted by the banks.