*Welcome to India: State of the Indian Economy, Banking Sector and Factoring Services**

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Mr. Gerhard Prenner, Chairman, International Factors Group (IFG); Mr. Pramod Bhasin, Founder & Vice Chairman, Genpact Limited; Mr. Sanjay Chamria, Co-founder & CEO, Magma Fincorp Limited; Mr. Ravi Gupta, Managing Director, Blend Financial Services Ltd.; delegates to the conference, ladies and gentlemen! It gives me great pleasure to welcome you all, especially the foreign delegates, to India and to this historic city of New Delhi for IFG's Annual Conference. It is heartening to note that IFG, the global association for commercial finance with 150 members from more than 60 countries, has chosen to hold its annual conference in India, signifying the growing interest of the global financial institutions in India. At the outset, let me thank Mr. Ravi Gupta and Ms. Margrith Lütschg-Emmenegge, two people, who influenced me to enter into the realm of factor financing while I was serving as the Chairman and Managing Director of Punjab National Bank. In fact, together with FIMbank, which Ms. Margrith represented, we jointly laid down the foundation of a factoring company in India. So, when Mr. Gupta requested me to speak at this conference, I could not refuse the invitation.

2. I have been asked to speak today on the topic "Welcome to India" – which, of course, I have already done! So, what next? I am told that the participants are interested in learning about the state of the Indian economy, the barriers, opportunities and expectations for the near future as well as the central bank's views on banking, SME financing and factoring. Therefore, during my address today, I intend to give you a brief lowdown on the prospects of the Indian economy, the structure of banking sector and the Reserve Bank of India's perspectives on the issues and challenges faced by the Micro, Small and Medium Enterprises and the factoring sector in India.

A. State of the Indian Economy – barriers, opportunities and expectations

3. Over the years, the Indian economy has gone through phases of remarkable transformation. After witnessing the Hindu rate of growth for the first three decades post-independence, the Indian economy got its first "big push" with the first phase of economic reforms in 1980s while the second major push came post 1991, following liberalisation of the economy, which helped it to move on to a sustainable higher growth trajectory. India made a radical break in 1991 from its past policies of inward orientation and started a process of opening up to trade and foreign investment. The growth response emerged a decade later as the cumulative impact of the gradual reforms began to be felt on the investment environment. India's GDP growth was of the order of eight-plus per cent per annum during 2001-11. In the five years, prior to the global financial crisis of 2008, the Indian economy had averaged 9 per cent annual GDP growth. In the aftermath of the crisis, there has been a slowdown and a question on the minds of most observers is whether this slowdown is temporary or is the economy moving to a lower growth rate in the medium term. While the RBI estimates that the trend/potential growth rate of the Indian economy, which averaged around 8.5 per cent during 2005-06 to 2007-08, dipped gradually thereafter and presently stands at about 7 per cent, the draft Twelfth Five Year Plan (2012-17) document prepared by the Government of India indicates that India's full growth potential remains around 9 per cent.

4. Like the other emerging market economies, the Indian economy is also facing certain challenges: inflation is high, growth is down, investment is slowing down, current account deficit is above the sustainable

* Opening Address by Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India at International Factors Group's Annual Conference on October 7, 2013 in New Delhi. Assistance provided by Smt. Lily Vadera is gratefully acknowledged.

levels, fiscal deficit is high, and the exchange rate is under pressure. While, global slowdown is an important factor, the domestic factors are no less important.

5. At the macro level, there are concerns. But we need to separate noise from signal. The fundamentals of the economy remain strong. An important point to note is that in the more recent period, growth has become more broad-based across the many states of India, poverty has declined but financial inclusion has emerged as a major concern. There has been much more spending on inclusion and social protection.

6. Going forward, there are challenges – some old, some new. The ongoing challenges are: (i) providing world-class infrastructure for a rapidly-growing economy, particularly in telecom and power sectors, and (ii) macroeconomic management involving fiscal reform and monetary policy in an open economy context.

7. The new challenge are: how to bridge the gap between a growing demand for different skills as the economy resumes its journey on a high-growth path, and their supply. The demographic opportunity needs to be turned into a dividend – Today, 50 per cent of India's population is under 25 years of age. Aspirations are rising. The demographic opportunity is increasing for India because the percentage of population of working age will continue to increase for another 40 years. This needs to be harnessed with greater focus on skill building, higher education, innovation, knowledge creation, and knowledge sharing. The Government of India's National Skill Development Initiative uses public-private partnership to address this challenge. India is uniquely placed for attracting investments in education because there is a hunger for education in emerging economies and a strong commitment to education at the family level. Global educational institutions will have to look at building a presence in India as they will have to gravitate where human resources are available.

8. In the coming years, millions of people in India are expected to move out of the agricultural sector and that jobs will have to be provided for them. India, therefore, needs to increase its manufacturing capability. Though in the recent past, the growth of the manufacturing sector has generally outpaced the overall growth rate of the economy, at just over 16 per cent of GDP, the contribution of the manufacturing sector in India is much below its potential. Every job created in manufacturing has a multiplier effect of creating two to three additional jobs in related activities. Therefore, a thrust on manufacturing is integral to the inclusive growth agenda of the Government. The National Manufacturing Policy announced by the Government of India proposes to increase the sectoral share of manufacturing in GDP to 25 per cent over the next decade.[1]

9. As we capitalise on these strengths, I see India delivering on the aspirations of a young and growing middle class. And we will do so while increasing our integration with the world. India is now closely integrated with the rest of the world both by way of financial integration and trade integration. It is the intent and objective of the Government of India to attract and promote foreign direct investment in order to supplement domestic capital, technology and skills for accelerated economic growth. While India can look at an 8 per cent growth based on domestic opportunities, for a 9-10 per cent growth to occur the external environment has also to be hospitable.

B. Banking structure in India

10. The existing banking structure in India has evolved over several decades. It is elaborate and has been serving the credit and banking services needs of the economy. The Indian banking sector has come a long way since independence, more so since the nationalisation of 14 major banks in 1969 and 6 banks in 1980. In the post financial sector reforms (1991) phase, the performance and strength of the banking

[1] National Manufacturing Policy 2011, Department of Industrial Policy & Promotion, Ministry of Commerce and Industry, Government of India.

structure improved perceptibly. Over the years, the reach of banking has widened significantly to include relatively under-banked regions, particularly in rural areas. Commercial bank credit as per cent of GDP picked up steadily from 5.8 per cent in 1951 to 56.5 per cent by 2012. The population per bank branch came down from 64,000 in 1969 to 12,300 in 2012 (RBI, 2013). The key feature that distinguishes the Indian banking sector from the banking sectors in many other countries is the fostering of different types of institutions that catered to the divergent banking needs of various sectors of the economy. Credit cooperatives were created to cater to the credit, processing and marketing needs of small and marginal farmers organised on cooperative lines. Cooperatives expanded also in urban and semi-urban areas in the form of urban cooperative banks to meet the banking and credit requirements of people with smaller means. Regional Rural Banks were created to bring together the positive features of credit cooperatives and commercial banks and specifically address credit needs of backward sections in rural areas. Further, there was an experiment of establishing Local Area Banks, *albeit* on a smaller scale, to bridge the gap in credit availability and strengthen the institutional credit framework in the rural and semi-urban areas.

11. While fostering a multi-tier structure, the regulatory effort has been to ensure stability and soundness by addressing weaknesses as and when they arose. The soundness of the system was evident from the way it withstood the recent financial crisis rather well, even as the banking systems in many countries across the world were adversely affected.

12. Notwithstanding the growth in number of branches opened by banks, Indian banking sector is yet to reach the desired level of banking penetration and inclusion as witnessed in most advanced and some of the emerging economies. It is estimated that rural India had only 7 branches per 1,00,000 adults in 2011 in sharp contrast with most of the developed and even BRICS economies having over 40 branches. Regionally, north-eastern, eastern and central regions are more excluded in terms of banking penetration. Given the fact that there is a large unbanked population in the country and a large informal sector that still does not have access to the formal banking sector, there is considerable scope for the expansion of India's banking sector. This would also require greater presence of private entities at national and local levels. The assessment and comparison with other economies brings to the fore the need for imparting dynamism through expanding the commercial banking system in terms of its size and number of banks; need for expanding smaller banks in unbanked and under banked areas; need for focus on consolidation; need to relax barriers to entry for improving competition; and the need for enhancing operational efficiency.

13. With a view to ensuring that the banking system grows in size and sophistication to meet the needs of a modern economy and improving access to banking services, the Reserve Bank of India is considering giving some additional banking licences to private sector players subject to their meeting our eligibility criteria as announced by the Union Finance Minister in his Budget speech for the year 2010-11. Consequently, the Reserve Bank of India released the Guidelines for Licensing of New Banks in the Private Sector[2] on February 22, 2013. The RBI is in the process of issuing new bank licenses consistent with the highest standards of transparency and diligence. Further, the Reserve Bank has recently (on August 27, 2013) released a Discussion Paper on 'Banking Structure in India - The Way Forward'[3] which is placed on the website for comments from stakeholders. The document explores the possibility of differentiated licences for small banks and wholesale banks, the possibility of continuous or "on-tap" licensing, and the possibility of converting large urban co-operative banks into commercial banks.

[2] Guidelines for Licensing of New Banks in the Private Sector released by Reserve Bank of India on February 22, 2013 and accessed fromhttp://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=28191.

[3] Discussion Paper on 'Banking Structure in India - The Way Forward' released by Reserve Bank of India on August 27, 2013 and accessed fromhttp://rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=713.

We propose to carry forward these ideas and come up with a detailed road map of the necessary reforms and regulations for freeing entry and making the licensing process more frequent after we get comments from stakeholders.

14. As the real economy is dynamic, it is imperative that the banking system is flexible and competitive to cope with multiple objectives and demands made on it by various constituents of the economy. From the financial inclusion perspective too, there is a pressing need to extend the reach of financial services to the excluded segments of the society. Viewed from this perspective, today's banking structure in India has both the need and scope for further growth in size and strength. With a view to strengthen the banking structure in India, based on the lessons from the global crisis, to cater to the needs of a growing and globalising economy as well as deepening financial inclusion a Discussion Paper on 'Banking Structure in India - The Way Forward' has been placed on our website as mentioned earlier. The discussion paper has identified certain building blocks for the revised banking structure with a view to addressing various issues such as enhancing competition, financing higher growth, providing specialised services and furthering financial inclusion. It also emphasises the need to address the concerns arising out of such changes with a view to managing the trade off for ensuring financial stability.

15. As the Indian economy expands with increasing focus on manufacturing and infrastructure, the credit intensity is higher and more resources will be needed for supporting the growth process. In order to support an annual economic growth of 8 per cent, as envisaged by the 12th Five Year Plan, banking business needs to expand significantly to an estimated ₹288 trillion by 2020 from about ₹115 trillion in 2012. Expansion of the existing banking business requires additional capital support. Indian banking is dominated by the public sector, which accounted for about 73 per cent of total assets of the banking sector at end-March 2012. Hence, an important way to achieve an expansion in capital of the banking sector, while managing fiscal consolidation, would be to widely distribute the ownership stake in banking.

16. India also has a number of foreign owned banks, many of whom have been with us a long time and helped fuel our growth. They have been in the forefront of innovation, both in terms of improving productivity, as well as in terms of creating new products. We would like them to participate more in our growth, but in exchange we would like more regulatory and supervisory control over local operations so that we are not blindsided by international developments. The RBI will encourage qualifying foreign banks to move to a wholly owned subsidiary structure, where they will enjoy near national treatment. We are in the process of sorting out a few remaining issues so that this move can be made[4].

C. MSME Financing

17. The critical role and place of the MSME sector in employment generation, exports and economic empowerment of a vast section of the population in the Indian economy cannot be overemphasised. As per estimates released by the Ministry of MSME, there are about 36.1 million enterprises in this sector employing nearly 80.52 million people[5]. The sector accounts for 45 per cent of manufactured output and 8 per cent of the GDP. MSMEs contributed close to 40 per cent of all exports from the country.

18. As availability of timely and adequate bank credit without the hassles of collateral and third party guarantees is of essence to small first generation entrepreneurs, the Reserve Bank of India had enjoined upon banks to provide collateral free loans to Micro and Small enterprises with credit limits up to ₹1 million. The Credit Guarantee Fund Trust for Micro and

4 Statement by Dr. Raghuram Rajan, Governor, Reserve Bank of India, on taking office on September 4, 2013 and accessed fromhttp://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=29479

5 Annual Report 2012-13 of Ministry of Micro, Small and Medium Industry and accessed from http://msme.gov.in/ANNUALREPORT-MSME-2012-13P.pdf

Small Enterprises (CGTMSE), set up by the Government of India operates the "Credit Guarantee Scheme" (CGS) which guarantees grant of collateral-free and/or third party guarantee-free credit facilities to Micro and Small Enterprises by banks.

19. The 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. Over the years there has been a significant increase in credit extended to this sector by the banks. As at the end of March 2013 the total outstanding by all Scheduled Commercial Banks (SCBs) to the micro and small sector (MSE) stood at ₹6,847.96 billion as against ₹5,276.84 billion in March 2012, ₹4,785.27 billion in March 2011 and ₹3,622.91 billion in March 2010. Despite the increase in credit outstanding to the sector, availability of timely and affordable credit is still one of the issues for the MSME sector. Recognising the important role played by MSMEs in economic development and its sizeable contribution to employment and GDP, and realising that financial access is critical for MSMEs growth and development, the Government and the Reserve Bank of India are taking the lead in supporting initiatives that improve access to finance.

20. A number of measures have been taken by the Reserve Bank to facilitate credit growth to the sector. As the level of financial exclusion is high in the micro and small enterprises sector (93 per cent as per the Fourth Census of small enterprises), drive to universal financial access, including MSME finance, is no longer a policy choice but a compulsion. With an objective of ensuring uniform progress in provision of banking services in all parts of the country, banks were advised to draw up a roadmap to provide banking services through a banking outlet in every unbanked village having a population of over 2,000 by March 2012. Banks have successfully met this target and have covered 74,398 unbanked villages. In the second phase, Roadmap has been prepared for covering remaining unbanked villages *i.e.,* with population less than 2,000 in a time bound manner. About 4,90,000 unbanked villages with less than 2,000 population across the country have been identified and allotted to various banks. The idea behind allocating villages to banks was to ensure availability of at least one banking outlet in each village. The Reserve Bank advised banks that such banking services need not necessarily be extended through a brick and mortar branch but could be provided also through any of the various forms of Information and Communication Technology (ICT) – based models, including Business Correspondents (BCs).

21. The Government of India also set up an Inter-Ministerial Committee to boost exports from the MSME sector[6] (Chairman: Shri R. S. Gujral, Finance Secretary). The Committee has since submitted its report which is being examined by the Government.

22. As the incidence of sickness in the sector is high, timely identification of sick micro and small enterprises and their rehabilitation is critical. In order to hasten the process of identification of a unit as sick, early detection of incipient sickness, and to lay down a procedure to be adopted by banks before declaring a unit as unviable, the revised guidelines for rehabilitation of sick units in the MSE sector have been issued for rehabilitation of sick units in the MSE sector.

23. A structured institutional mechanism has been set up at the Reserve Bank, both at the Central office and Regional Office level, to monitor the issues concerning the sector. A Standing Advisory Committee has been constituted at the Central Office level and an Empowered Committee functions at the Regional Offices of the Bank with all stakeholders as members. These Committees examine issues relating to improving of credit to the MSME sector, difficulties/constraints being experienced and steps being taken to overcome them, *etc.*

[6] Report of the Inter-Ministerial Committee for boosting exports from the MSME sector by Ministry of Finance, GoI and accessed fromhttp://dgft.gov.in/exim/2000/imc-EXPORT-sme.pdf

24. Further, a large section of Micro and Small Enterprises need handholding. The lack of financial literacy represents a formidable challenge for MSE borrowers underscoring the need for facilitation by banks in these critical financial areas. To effectively and decisively address these handicaps, Scheduled commercial banks have been advised to either separately set up special cells at their branches, or vertically integrate this function in the Financial Literacy Centres (FLCs) set up by them, as per their comparative advantage. With a view to spreading financial literacy in the MSE sector and more so for the new entrepreneurs in this sector, we have made an endeavour to take out a guide book which answers some basic questions for a budding entrepreneur and the advantages of linking themselves with the formal banking sector. This, we hope, will be used by banks in their MSME camps and by the industry associations to circulate to new entrepreneurs.

25. While a number of initiatives have been taken a lot more needs to be done especially in the area of access to equity finance, delayed payments, technology upgradation, skill building *etc.*

26. Access to equity capital is a genuine problem. At present, there is almost negligible flow of equity capital into this sector. Absence of equity capital may pose a serious challenge to development of knowledge-based industries, particularly those that are sought to be promoted by the first-generation entrepreneurs with the requisite expertise and knowledge. Such firms typically look for venture capital to provide them with the financing they need, to expand, break into new markets and grow faster. Thus, the ability of MSMEs (especially those involving innovations and new technologies) to access alternative sources of capital like angel funds/risk capital needs to be enhanced considerably to encourage and develop entrepreneurship. In the Union Budget 2012-13, the Finance Minister has announced to set up a ₹50 billion India Opportunities Venture Fund with SIDBI to enhance the availability of equity to the MSME sector. Based on the recommendations of the PM's Task Force on MSMEs, the Bombay Stock Exchange and the National Stock Exchange have also set up a separate dedicated exchange/platforms for listing and trading of shares of SMEs, making it easier for them to raise equity capital.

27. Timely payments from customers will help SMEs in reducing their working capital requirements leading to lower interest costs, improved profitability and a positive impact on the long-term health and sustainability of India's SME sector. Delays in settlement of dues adversely affect the recycling of funds and business operations of the SME units. It is, therefore, critical to ensure that the small entities are able to raise liquidity against their receivables. This problem can be institutionally tackled by factoring, which provides liquidity to SMEs against their receivables and can be an alternative source of working capital. World over, factoring is a preferred route of accessing working capital for SMEs and even larger organisations. Some banks and financial institutions in India have already launched factoring services and I would urge more banks to offer such services, particularly for the MSMEs. To provide a legislative framework for factoring services, the Parliament has recently passed the Factoring Regulation Bill that would address delays in payment and liquidity problems of micro and small enterprises.

28. With the increasing competition, globalisation and the uncertainty due to the global downturn, SMEs will have to continuously incorporate the latest technology into their production processes as well as in their marketing and management functions, to cut costs, gain efficiency and consistency. The Prime Minister's Task Force on MSMEs recommended several measures having a bearing on the functioning of MSMEs, *viz.*, credit, marketing, labour, exit policy, infrastructure/technology/skill development and taxation.

29. The ability of SMEs to adjust to the competitive pressures that come with trade liberalisation and globalisation will depend on the level of skills available domestically. Given the growing requirements of the

MSME sector and the huge 'demographic capital' we possess, significant efforts are still needed to enhance the skill and entrepreneurship development. Investment needs to be made in a big way on skill and entrepreneurship.

D. Factoring in India and role of the Reserve Bank

30. Factoring service, which is perceived as complimentary to bank finance, enables the availability of much needed working capital finance for the small and medium scale industries especially those that have good quality receivables but may not be in a position to obtain enough bank finance due to lack of collateral or credit profile. By having a continuous business relationship with the factoring companies, small traders, industries and exporters get the advantage of improving the cash flow and liquidity of their business as also the facility of availing ancillary services like sales ledger accounting, collection of receivables, credit protection *etc.* Factoring helps them to free their resources and have a one stop arrangement for various business needs enabling smooth running of their business.

31. The Kalyanasundaram Study Group set up by the Reserve Bank of India in January 1988 to examine the feasibility and mechanics of starting factoring organisations in the country paved the way for provision of domestic factoring services in India. The Banking Regulation Act, 1949 was amended to include factoring as a form of business in which the banks might engage. The Reserve Bank of India issued guidelines permitting the banks to set up separate subsidiaries or invest in factoring companies jointly with other banks. However, it was generally felt that absence of Factoring Law was one of the major impediments in the growth of factoring business of the country including the heavy stamp duty over assignment deed, ambiguity in the legal rights of Factors in respect of receivables *etc.*

32. The Government of India enacted the Factoring Act, 2011 to bring in the much needed legal framework for the factoring business in the country. It has provided definitions for the terms factoring, factor, receivables and assignment. The Act also specifies that any entity conducting factoring business would need to be registered with the RBI as NBFCs; while exempting banks, government companies and corporations established under an Act of Parliament, from the requirement of registration with the RBI for conducting factoring business. The Act, thus, gave clarity to the activity of assignment of receivables and also granted exemption from stamp duty on documents executed for the purpose of assignment of receivables in favour of Factors thereby making the business more viable. The Act also envisages that all transactions of assignment of receivables shall be registered with the Central Registry established under the SARFAESI Act, 2002 to reduce the possibility of frauds and for strengthening the due diligence process for the clients.

33. The Act has given powers to the Reserve Bank to stipulate conditions for 'principal business' of a Factor as also powers to give directions and collect information from factors. Subsequent to the passing of the Act, the Reserve Bank has created a separate category of NBFCs *viz.*, NBFC-Factors and issued directions for their regulation. The prudential norms as applicable to NBFCs engaged in lending business, has also been extended to the NBFC-Factors. Further, bank finance to factoring companies and the factoring business conducted by banks are also regulated by the RBI.

Challenges faced by factoring sector

34. Though the enactment of the Factoring Regulation Act has potentially removed all the major impediments that the factoring sector faced in the country, nevertheless, the sector has few other items on its wish list, the primary among which are introduction of credit insurance in the factoring business and extending the scope of SARFAESI Act to cover NBFCs for speedy enforcement of security interest[7]. As regards credit

[7] Factors impending Factoring- Why is factoring not picking up in India post enactment of the new Act?' by Nidhi Bothra and Shampita Das, Vinod Kothari & Company accessed from http://india-financing.com/Factors_impending_factoring_why_is_factoring_not_picking_up_in_India_ post_enactment_of_the_new_act.pdf.

insurance, the Finance Minister in the Union Budget 2013-14 has made an announcement for setting up a Credit Guarantee Fund with SIDBI for factoring, with a ₹5 billion corpus. As far as extension of the provisions of the SARFAESI Act to NBFC is concerned, the final call rests with the Government of India.

35. Low penetration of factoring business in the country still remains a challenge which could be on account of lack of awareness among the users. With the necessary law now in place, sincere attempts need to be made by the industry through its associations and other fora for articulating the benefits of factoring as not just an alternative source of finance but also an avenue for providing a bouquet of financial services *vis-à-vis* traditional finance to small scale industries. They should be able to identify the untapped potential clientele, especially in various SME industry sectors, and create awareness on how the higher cost of factoring *vis-à-vis* the traditional finance is justifiable and cost effective for the businesses in the long run. Factoring companies should also constantly endeavour to upgrade their expertise on both technological front as also on the operational level for offering cost effective services to their clientele.

36. I thank the IFG for holding its annual conference in India as I sincerely believe that organising more such events would have two-pronged benefits of one, creating general awareness about the potential benefits that the factoring services holds for the businesses in general and more so for the SME segment and more importantly, helping the Indian companies learn from the experiences of their counterparts in the developed economies where factoring business is well entrenched. I hope that the deliberations during the two day conference would throw up some practical ideas on increasing the penetration of factoring services in the country. I am quite sure that the distinguished speakers would bring a lot of valuable inputs to the table about what could be the most appropriate and cost-effective delivery model for the factoring services in its nascent stage in India. However, it is imperative that the domestic factoring industry works hard to take the momentum generated by this conference forward by implementing the ideas emanating from the conference in right earnest. Only then will the gains from the conference be truly realised.

I once again thank the organisers for inviting me and giving me an opportunity to share my thoughts on the subject. Thank you!