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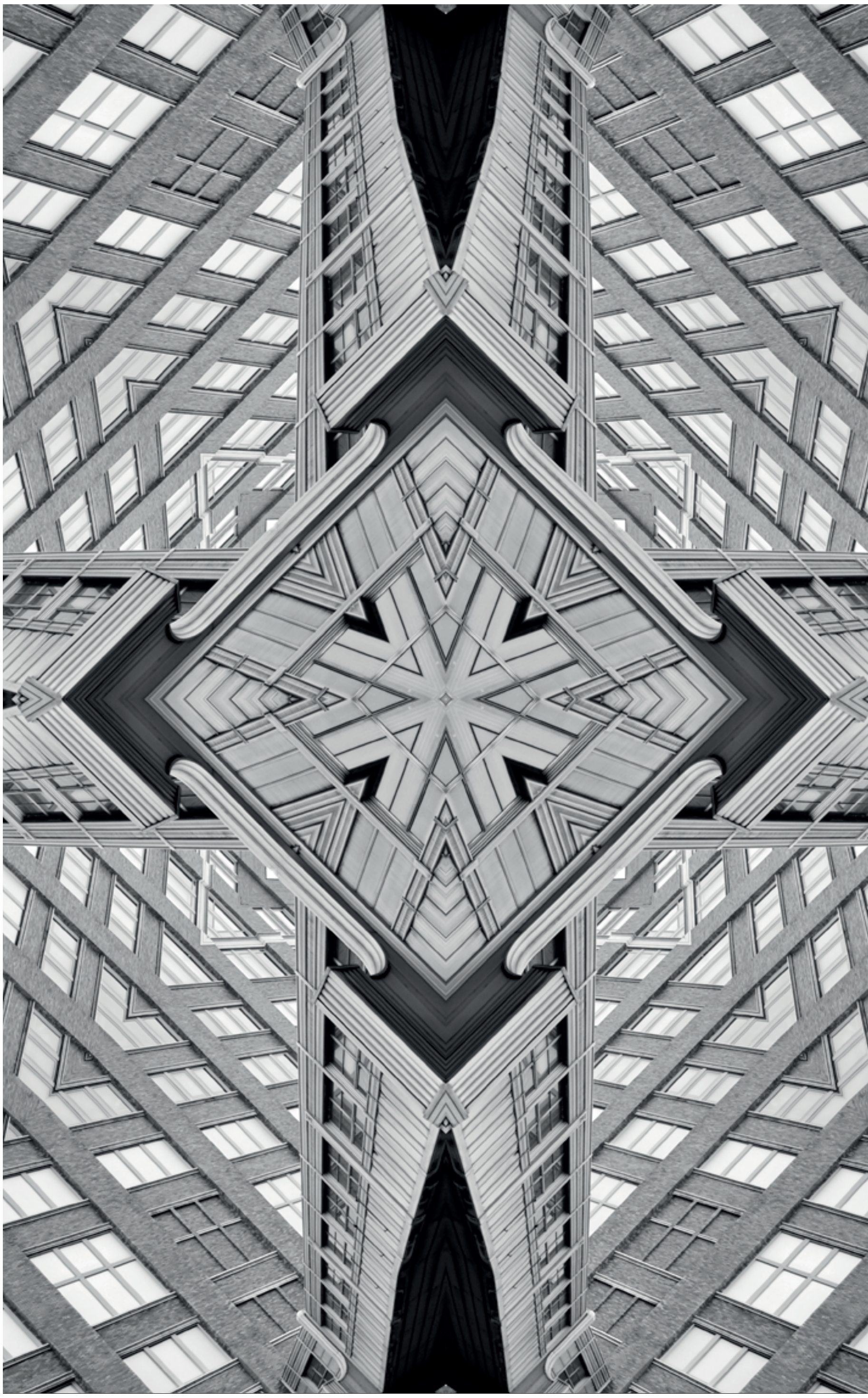

Public Credit Guarantee for Small Enterprises in India: An Explainer

Labanya Prakash Jena

Abstract

In many parts of the world, including India, Public Credit Guarantee Programmes (PCGP) improve access to credit for small enterprises that are unable to obtain assistance from mainstream financers. This brief discusses the relevance of PCGPs in India, their mechanisms, features, and efficiency. Although these programmes have improved access to credit for MSMEs (micro, small and medium enterprises), there are concerns regarding their efficiency and sustainability. The analysis finds that the success of a PCGP depends on its structure, on whether it aligns with the interests of the borrowers, lenders, and guarantors, and fully considers positive externalities.

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Introduction

Micro, Small and Medium Enterprises (MSMEs) play an essential role in both developed and developing economies, primarily by generating employment. In India, there were 48.8 million MSME units in 2016, collectively providing 111.4 million jobs.[1] The contribution of MSMEs to the Indian economy is 7.7 percent of the total manufacturing output and 27.4 percent of the overall service sector. MSMEs generated more than 20 percent of total jobs in 2016.[2] They have also helped expand industrialisation in rural areas, thereby reducing regional imbalances in development.[3]

Even as the MSME sector contributes to the economy, however, it receives limited institutional support from the government as most facilities are directed to large corporations. For example, these businesses have access to institutional capital at better terms than what is accorded to MSMEs. In more recent years, various governments have sought to pay attention to the MSME sector as job growth in large corporations have started to shrink. For example, MSMEs can avail credit from the Small Industries Development Bank of India (SIDBI). Support for the MSMEs are in various forms, including low-interest loans, collateral-free loans, and upfront capital subsidy for technology upgrade.

In a 2019 study of the MSME sector, the Reserve Bank of India (RBI)[4] identified its various challenges. The key weaknesses are in the areas of infrastructure, adoption of new technologies, skill level of workforce, access to markets and inputs, payment cycles, access to credit, and reliable capital. This brief focuses on the challenge of access to credit. Without credit, the growth of MSMEs is limited as they cannot, for example, set up a large plant that will give them economies of scale, nor can they invest in new technology to become more competitive.

Banks and debt capital markets are the two most common sources of debt financing for large corporations. For MSMEs, it is a difficult challenge to access capital from these two sources to meet their capital expenditure and working capital requirements. A 2018 report from the International Finance Corporation (IFC) suggests that mainstream financers contribute only 22 percent of the capital needs of the MSME sector; the rest are provided by other informal sources. There are several reasons for the low levels of formal credit flow to the MSME sector in India. The key barriers are related to the requirement for collateral or guarantee, the rigid lending policies of banks, high cost of borrowing due to high real or perceived risks, cumbersome procedures, and the borrower's limited financial knowledge.

Formal lenders view MSMEs as high-risk borrowers due to high transaction costs, limited historical record, absence of a collateral market,[5] little lending relationship with borrowers,[6] and higher reserve capital requirements.

Introduction

A study by the RBI[7] found that the lack of transparency in financial reporting, and non-professional business practices, are restricting MSMEs to access alternative financing sources such as private equity, venture capital, and secondary market financial instruments.[8] Moreover, another RBI study has also revealed the other constraints that keep MSMEs from being able to access formal financing: high due diligence cost,[a] asymmetric information, high non-performing assets (NPA), limited equity capital in the balance sheet, and insufficient technology adoption.[9]

Several governments, non-profit organisations, and national and multilateral development banks have developed various solutions and instruments to address the financing challenges faced by the MSME sector. These financial instruments can be broadly categorised into four categories: equity; loan; risk management instruments; and grants or technical assistance. Empirical evidence suggests that risk management instruments such as guarantees can maximise public capital use, compared to equity or loan capital.[10]

This brief examines the utility of Public Credit Guarantee Programmes (PCGPs) in a developing country like India. The use of guarantee instruments is quite extensive in global financial markets and covers various financial obligations, including loans, bonds, receivables, and swaps. The credit guarantee's two primary goals are: strengthening the credit profile of at least one of the participants in a financial transaction; and attracting new sources of financing, thereby lowering the expectation on the banking system to deliver the capital. Several studies have found that credit enhancement provides financial aid by increasing the availability of credit and improving borrowing terms.[11] These studies examined the design issues of Public Credit Guarantee Programmes (PCGPs) in developed economies; few studies on PCGPs in developing countries like India have been conducted.

> "India's MSME sector contributes 7.7% of total manufacturing output; it generated more than 20% of all jobs in 2016."

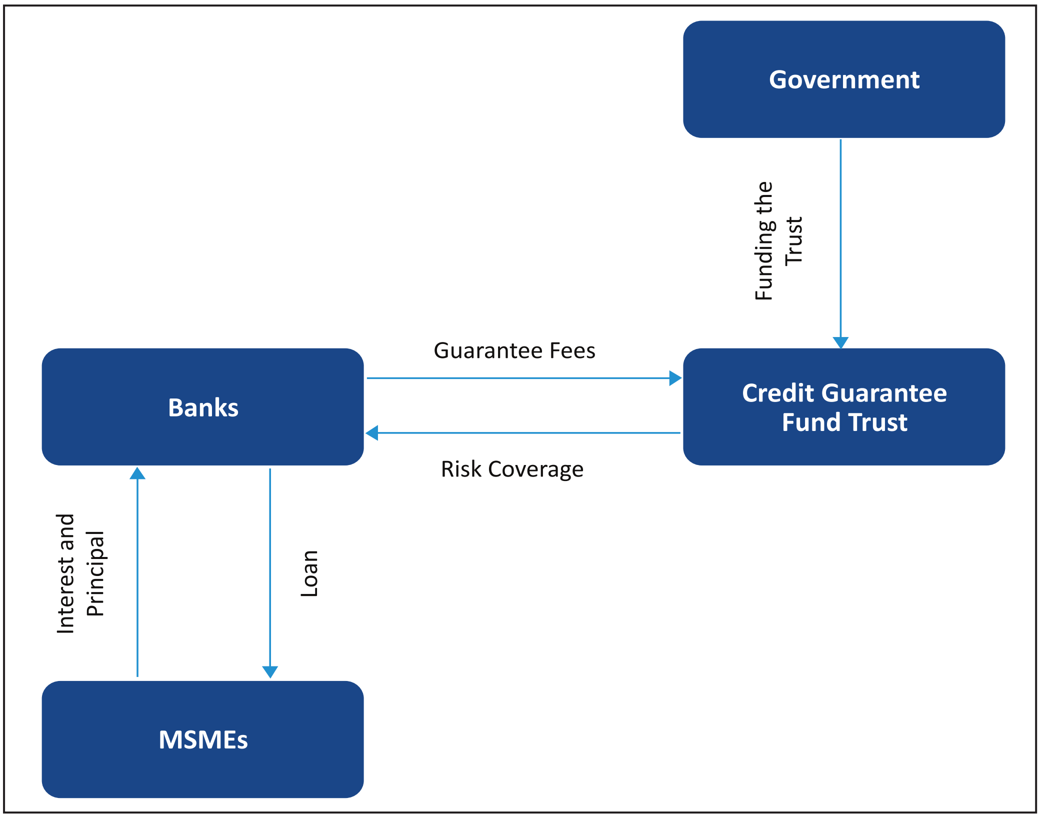
a Cost of analysing a borrower/investee before taking an lending/investment decision

Public Credit Guarantee Mechanism: An Overview

In a public credit guarantee scheme, a third party—a credit guarantee trust—plays the key role: it covers a certain percentage of risk coverage in case of default by the borrower, and in return, the credit guarantee trust charges the guarantee fee to the lender. The partial or full default risk coverage of the loan reduces the lender's exposure to credit loss–even when there is no change in the amount of default nor even a probability of default. The credit loss risk coverage acts as default insurance for the lenders. The decrease in expected credit losses pushes the lenders to reduce the collateral loan requirements as the recoverability of the loan portfolio increases. Moreover, the scheme encourages the lender to offer credit to corporations that would otherwise not get credit without the credit guarantee. With a credit risk coverage, an MSME would get credit with preferred terms such as lower interest rate, long duration, and higher amount of loans.

Figure 1

Framework for a Public Credit Guarantee Mechanism



Source: OECD[12]

Credit guarantee schemes have been around since the 19th century and were accepted as a mainstream financial mechanism in the 1990s.[13] Since then, these schemes have evolved to meet the changing demands of their beneficiaries. By 2015, nearly all countries across the world had started using public guarantee schemes.[14] Their use expanded rapidly after the 2007-08 financial crisis, and during the first year of the ongoing COVID-19 pandemic, whose economic fallout has severely affected MSMEs.[15]

The following paragraphs outline the key features of a credit guarantee scheme. This brief uses Yale University's Public Credit Guarantee Database to derive the key features of various PCGPs implemented around the world.[b,16]

Risk-sharing

The sharing of risks between borrowers, lenders, and guarantors is key to the success of a credit guarantee scheme. An improper credit guarantee structure can increase the moral hazard among borrowers and lenders. For example, very high coverage of default risk induces borrowers to default since the loss in the form of collateral would be rather small in the event of default. Meanwhile, a very low credit-risk coverage increases the risk of the lenders as a large portion of default risk will be borne by the lender. Similarly, a very high credit-risk coverage encourages lenders to take excess risk, as most of the risk is borne by the credit guarantee fund. The moral hazard and credit rationing problem will arise as the lender knows that its loan is heavily guaranteed by the public guarantee fund. Researchers have found that the credit risk coverage of 60–70 percent is most effective,[17] and it should not be more than 80 percent to align with the interests of lenders.[18] There will be moral hazards and no credit rationing if there is 100-percent credit guarantee coverage.

However, at a time of crisis, many countries resort to increasing risk coverage up to 100 percent. The UK Government's Enterprise Finance Guarantee (EFG), for example, increased coverage from the standard 75 percent to 82 percent in 2012–2013 during the Eurozone debt crisis. Similarly, Korea, Japan, and Thailand increased risk coverage up to 100 percent during the 2008 Asian financial crisis. Several countries in Europe, as well as India, have also increased risk coverage up to 100 percent in response to the COVID-19 crisis.

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b The database has covered 78 PCGPs across developed and developing countries. The PCGPs were implemented over 2002-2020, hence covered both stable economic cycle (before-crisis period) and unstable economic cycle (after-crisis period, which covers the credit and financial crises of 2007 and 2008, the Euro Zone crisis, and the COVID-19 pandemic).

Size of the guarantee

Most of the public credit guarantee funds have placed a cap on the total amount of borrowing. However, some interesting features were found in the schemes that can generate social welfare. The Austria Gwirtschafts Service (AWS) scheme's guaranteed capital is based on the number of employees of the company. Italy's credit guarantee fund, meanwhile, caps the maximum borrowing up to the yearly wage expenses of the borrower. Since employment generation is one of the primary objectives of a public credit scheme, linking the borrowing to the number of employees working in a company make credit flows more accessible to companies that absorb the workforce.

Guarantee staff

It is crucial that the guarantee fund scheme be designed by an experienced staff. They must have experience in loan underwriting and recovery processes. A proper structure can optimise the fund's capital. The staff also plays a critical role in negotiating scheduled repayments from the creditors. They also need to monitor the creditors and underwriting process – the creditors and borrowers may conspire to default the loan.

Guarantee fees

The guarantee fee is an essential component of the credit guarantee structure. The guarantee fee size should be small enough for creditors to participate in the scheme, and high enough for the financial sustainability of the guarantee fund. A credit guarantee whose fees are too high discourages creditors from joining as the net income from the loan would decrease. On the other hand, credit fees that are too low may make the guarantee fund financially unsustainable since default cost could be higher than guarantee fees. Theoretically, the credit guarantee fee should at least cover the credit risk of the guaranteed loan portfolio, cost of paid-up capital, and administrative cost of the fund. However, in the case of the public guarantee fund, the guarantee fee is not commensurate with the credit risk since there are positive externalities involved in PCGPs such as employment generation by saving the enterprise from bankruptcy, helping a particular industry of national importance, and aiding new and small firms to compete with large corporations. The guarantee fee varies across country, depending on the prevailing interest rate and credit profile of the MSMEs. The guarantee fee is fixed for some schemes irrespective of the credit risk of the enterprise.[19] In a time of crisis, the government also does not charge any guarantee fees. However, the government should avoid subsidising the guarantee fees heavily that it would end up helping only the private lenders; the lenders might not pass on the benefits of lower guarantee fees (interest cost) to the borrowers.

Administration

The quality of administration of the credit guarantee fund has a significant influence on the success of the scheme; excessive administration is one of the key obstacles that discourage creditors from participating. There is a cost involved in constant engagement with the guarantor to recover the guarantee. The creditors complain of burdensome paperwork requirements, multiple loan followups and delay in settlement of claims—they all increase the cost of operation.[20] From the perspective of the lender, a quick settlement of claims would decrease their cost of operation and capital cost. Chile's FOGAPE scheme, for example, makes the full payment within 15 days of a claim being made, which implies quick settlement of claims by the fund. The swift processing of claims reduces the cost of operation and capital of the lender. The lender does not have to spend resources to settle the claims and its capital is not stuck with the guarantee fund.

Loan recovery

In the case of loan default, the proceeds from recovery are shared between guarantor and lenders, which is based on the risk-sharing principle. Since the credit guarantor has limited access to the borrower, the banks are responsible for recovering the dues from the borrower as much as possible. Usually, banks always take some credit risk until completing the recovery process, which incentivises the banks to pursue recovery efforts. Mostly, lenders' claims processing only starts after the lenders initiate legal recovery proceedings; otherwise, lenders might be too quick to write off a loan after default.[21] Generally, a credit guarantee covers the credit institution's net loss after recoveries so that the lender is incentivised to recover the maximum of debt. However, Greece's credit guarantee scheme, for instance, which was operational during the financial crisis, covers the first call of default to incentivise lenders to accelerate credit flows during times of stress. For its part, Japan's Special Credit Guarantee Programme gives the guaranteed loans equal priority to both secured and unsecured loans in the event of default, to align with all debt financers' interests.

Eligibility

Eligibility is one of the most critical constraints to MSMEs. The eligibility criteria include both financial and non-financial measures. The financial measures are the company's net worth, size, profitability, historical default record, and transparency in financial reporting. Japan's Special Credit Guarantee Programme (SCGP), for example, has rejected companies with significant negative net worth, tax delinquency, default, outstanding loan, or a history of dishonest financial behaviour. Greece's Credit Guarantee Fund of Small and Very Small Enterprises (TEMPME SA), meanwhile, considers only those profitable companies over the past three years. The UK'S EFG scheme makes it mandatory for borrowers to show that they were denied financing outside of EFG to discourage good companies that can borrow without the guarantee scheme's support. Malaysia's Working Capital Guarantee Scheme is only available for companies majority-owned by Malaysians. At the same time, financial criteria are considered for eligibility to address adverse selection and moral hazard, while non-financial measures were brought to leverage public funds. Chile's FOGAPE scheme also added eligibility criteria for the lender to discourage bad lenders. FOGAPE scheme's lender criteria set a minimum lender's default ratio – if a lender exceeds a specific limit, it is excluded from participating in the guarantee scheme for a specified timeframe.

Loan evaluation

Credit evaluation is a crucial component of a credit guarantee scheme to rationalise the guarantee. Some CGSs do credit appraisals themselves before offering any guarantee, while others rely on the lenders' evaluation. The evaluation of loan practices varies across countries. In countries like Romania and Korea, the guarantee fund, and not the lender, evaluates the loans. In Chile, lenders do credit evaluation of borrowers. The evaluation of loans both by lenders and guarantee fund is duplicated and generally not cost-effective. When the guarantee fund evaluates the loans, it appoints a credit specialist firm to assess the loan. The fund itself does not have the necessary capacity to assess credit risk. Moreover, a portfolio-level loan evaluation is more cost-efficient than an individual loan evaluation.[22] However, portfolio-level evaluation is often found to be substandard and carries a high default risk. A loan performance-based mechanism can be introduced, which can incentivise the lenders to originate high-quality loans.

Use of guarantee

The use of a guarantee fund is another vital element of the public guarantee fund. Malaysia's SME Assistance Guarantee Scheme allows guaranteed loans to be used for working capital, project financing, or capital expenditure, not refinancing existing credit facilities. The UK's EFG scheme allowed for the conversion of overdraft into a loan.

Financial regulation

Banks are required to set aside some amount of capital based on the riskiness of the loans. To incentivise the lenders, financial regulators reduced the capital requirement of guaranteed loans. In Chile, the central bank temporarily reduced banks' capital requirements on loans guaranteed by the credit guarantee scheme. In Japan and Italy, loans secured by public guarantee funds were treated as zero-percent risk-weighted capital.

Credit guarantee addresses three financing challenges: information asymmetry, risk management, and collateral needs.[23]

Information asymmetries

The information asymmetry between the borrower and lender is one of the critical financing barriers for MSMEs. The companies in the MSME sector do not follow modern financial reporting and disclosure practices. Also, there is a long time-lag between the financing reporting, and the auditing of reports. As the MSMEs are mostly informal, a significant portion of the business is not reflected in their financial reports,[24] making them less reliable. This discourages banks and other mainstream financers from lending to them. Moreover, since many transactions are not reported in the financial statements, banks cannot evaluate the real creditworthiness of MSMEs. Even creditworthy projects end up being considered non-bankable.

Adverse selection problem[c] originates from information asymmetry as the lender fails to distinguish the good borrowers from those who are not. This kind of uncertainty forces banks to increase the default rate for MSME loans, and consequently, the interest rate is pegged higher, too. The cycle is vicious: the higher interest rate discourages many good borrowers from turning to mainstream financers, and their pull-out increases the MSME loan portfolio's risk, which further increases the interest rate.[d] The high default rate makes the more prudent lenders such as banks wary of lending to MSMEs as they would want to maintain a good quality of loans in their books to minimise their non-performing assets (NPAs).

> "As MSMEs are mostly informal, a significant part of the business is not reflected in financial reports, making them less reliable for banks."

c Buyers and sellers have different information, e.g., about quality of a product

d Even if some good borrowers are crowded out, the stringent norms adhered to financial entities ensures that those who borrow are credit worthy and nor high risk.

Size

The operating and transaction costs (cost of originating loans, loan processing, and monitoring, and operation and maintenance services) in proportion to the loan value are relatively higher in MSME, given the average loan's smaller size. The high operating and transaction cost forces lenders to increase the interest rate on small loans, thus discouraging borrowers.[25]

Collateral requirements

Traditionally, banks ask for collateral for lending as the banks can sell the collateral to recover the dues in default. However, MSMEs do not have enough collateral, and MSME proprietors are not willing to collateralise their personal properties. Additionally, MSMEs are also asked to put up a proportionately higher amount of collateral compared to large corporations. Therefore, most of the MSMEs' loan applications do not pass the lending requirements of banks.

"MSMEs do not have enough collateral to present to banks, and proprietors are not willing to collateralise their personal properties."

Public Credit Guarantee Programmes in India

India started its public credit guarantee programme with the setting up of the Export Credit Guarantee Corporation (ECGC) in 1957. The programme was exclusively designed to offer credit insurance services to exporters. In 1971, RBI set up the Credit Guarantee Corporation of India (CGCI) to provide deposit insurance to bank depositors. Many years later, the government established the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) in 2000, the first of its kind. In 2014, the government set up the National Credit Guarantee Trustee Company Ltd (NCGTC), another public credit guarantee trust, to manage and operate multiple credit guarantee funds, including for small enterprises. This section outlines the features of credit guarantee schemes managed by CGTMSE and NCGTC.

Guarantee fees[26]

The CGTMSE credit guarantee programme was initially charging one to two percent of the loan as a guarantee fee from the lenders, depending on the size of the loan, kind of business, and borrower's location. Since the guarantee fee structure was not based on the borrower's creditworthiness, the member lending institution (MLI) was less concerned about the credit quality of the borrowers as the risk is tilted towards the guarantor, not the MLI. The MLI also started reporting a high level of NPAs. In 2016, CGTMSE introduced a risk-based pricing structure, which encouraged MLIs to originate quality loans and evaluate the loans properly. NCGTC's Credit Guarantee Fund for Micro Units (CGFMU) does not have a differential guarantee fee structure. Since the guarantee fee is not risk-based, the lenders have limited incentive to originate quality loans. Moreover, this flat pricing mechanism discourages good borrowers; they do not benefit from being better creditworthy borrowers as the cost of guarantee fees is passed on to all the borrowers in a uniform manner. The COVID-19 credit guarantee programme does not have any guarantee fee as it encourages MLIs to accelerate credit flows to small enterprises if they meet the eligibility criteria.

Administration

The credit guarantee trust (CGTMSE) reviews the lender's disbursement and recovery process; if any lapse is found, the lender is denied any reimbursement of guarantee coverage. Since the credit guarantee institutions review the lapses, they have incentives to identify lapses to delay guarantee coverage reimbursement. This process discourages the lender from offering credit to

MSMEs under the CGTMSE scheme. CGTMSE takes up to 30 days to pay 75 percent of the guaranteed amount to the lender, while NCGTC takes up to 60 days to pay lenders. Chile's FOGAPE – one of the most successful public credit guarantee schemes in the world – takes 15 days to make the full payment. The delay in the processing of payment discourages lenders from using public guarantees for lending to small enterprises.

Loan recovery

CGTMSE and NCGTC only start reimbursing the lender after starting a legal proceeding to recover the loan – the absence of this clause would incentivise the banks to write-off the loans to claim disbursement quickly. CGTMSE pays 75 percent of the guarantee amount in the event of a default (after initiation of a legal proceeding to recover the loans); the remaining 25 percent is paid upon conclusion of the recovery proceeding. This payment mechanism mitigates the moral hazard issue as the banks' capital is still at risk, which forces banks to recover the loan from the defaulter as much as possible. Without this condition, banks would be putting effort into recovering the loan from the defaulter.

Eligibility

The eligibility of borrowers is based on the company's size, outstanding loans, and meeting the minimum legal and regulatory requirements. Before COVID-19, the scheme did not lay down any additional preconditions since the credit evaluation process is left to the lenders. This scheme's main drawback is offering subsidised credit guarantee facilities to creditworthy borrowers who would have been able to borrow without the credit guarantee; the public guarantee programme only subsidises their financing cost.

Since CGTMSE and NCGTC do not assess loans at the individual level, there is a possibility of compromising the quality of the lenders' loan portfolio guaranteed by CGTMSE and NCGTC. Since the risk of default is tilted towards the guarantor, the lender could take additional risks to improve its interest margin. The credit guarantor could provide certain conditions to guarantee loans, which would drive out bad borrowers from the guarantee portfolio. This will help the guarantor to minimise disbursement as the NPA of the guarantee portfolio would decrease.

The COVID-19 credit guarantee facility (managed by NCGTC) laid down additional criteria to mitigate adverse selection and moral hazard risks. The scheme offers up to 100 percent credit guarantee, collateral-free, and zero guarantee fee credit guarantee; it could create a moral hazard and credit rationing risks. The lenders would not conduct proper credit evaluation of loans as the loans are 100-percent guaranteed by the credit guarantor. NCGTC has made certain rules on the selection of borrowers to mitigate these two critical credit risks. The new borrowers, and the borrower whose loans are declared as NPA or delayed (by more than 60 days of non-payment of the loan) are not eligible to avail of this credit guarantee facility. These two conditions will not give a free hand to lenders on selecting the borrowers, thereby preventing moral hazard and credit rationing risks. As the loans are 100-percent guaranteed, the lenders do not have to bear any credit risk. Therefore, the lenders could not put sufficient effort in credit analysis of borrowers, which can lead to high default risk. However, the NCGTC has laid out clear conditions on the eligibility of borrowers; the lenders have limited discretion in selecting borrowers. This condition can prevent moral hazard and credit rationing risk to a certain extent.

CGTMSE and NCGTC have not laid down any conditions related to the eligibility of borrowers. Even the lenders who have high NPA in their books are eligible to avail the facility. The inclusion of bad lenders would increase the disbursement of the guaranteed amount to the lenders, which is not in the public credit guarantee programme's best interest. CGTMSE and NCGTC can set down eligibility criteria for lenders as well – they could include the barring of lenders who cross a certain NPA level against eligibility for the guarantee scheme.

Conclusion

Labanya *is a manager for Climate Finance at the Climate Policy Initiative, and a Doctoral scholar at XLRI, Jamshedpur. His primary research interests are in sustainable finance and public economics.*

Over the last few decades, state-funded credit guarantee schemes have become a popular policy prescription to help MSMEs, underserved by private financial intermediaries, to access credit. However, many questions remain about how these programmes work and their impact on the market. This analysis finds that there is considerable heterogeneity in the structure and features of schemes, and that the design and architecture of the guarantee scheme also change with time. The distinct features of the credit guarantee scheme make it difficult to conduct a comparative assessment. However, this brief offers the following concluding points, which should lead to further research on the subject.

Although public intervention is required in facilitating access to financing for small enterprises, the question arises on the limit of such intervention. While social welfare and equitable distribution of credit are two primary objectives of the credit guarantee, other government interventions are serving the same purposes. It can thus be argued whether or not public guarantee programmes can address the financing challenges of small companies.

Public credit guarantee schemes are an important tool for small companies to access commercial capital. However, the success of the public credit guarantee scheme hinges on its design. The right mechanism and risk management process, as well as efficient administration, can make the scheme financially sustainable and generate positive additionalities.ORF

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Endnotes

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20, Rouse Avenue Institutional Area,
New Delhi - 110 002, INDIA
Ph. : +91-11-35332000. **Fax :** +91-11-35332005
E-mail: contactus@orfonline.org
Website: www.orfonline.org