

**ASIAN DEVELOPMENT BANK**

**TAR: IND 36345**

**TECHNICAL ASSISTANCE**

(Financed by the Government of the United Kingdom)

**TO**

**INDIA**

**FOR**

**PREPARING**

**SMALL AND MEDIUM ENTERPRISE FINANCE**

**SECTOR DEVELOPMENT PROJECT**

**November 2004**

## CURRENCY EQUIVALENTS

(as of 25 October 2004)

Currency Unit	–	Indian rupee/s (Re/Rs)
Re1.00	=	\$0.0219
\$1.00	=	Rs45.62

## ABBREVIATIONS

BDS	–	business development services
DEA	–	Department of Economic Affairs
DFID	–	Department for International Development
FI	–	financial intermediary
GTZ	–	Gesellschaft für Technische Zusammenarbeit
KfW	–	Kreditanstalt für Wiederaufbau
MOF	–	Ministry of Finance
NPL	–	nonperforming loan
RBI	–	Reserve Bank of India (the Central Bank)
SFC	–	state financial corporation
SIDBI	–	Small Industries Development Bank of India
SME	–	small and medium enterprise
SSI	–	small-scale industry
TA	–	technical assistance
TOR	–	terms of reference

## TECHNICAL ASSISTANCE CLASSIFICATION

<b>Targeting Classification</b>	–	General intervention
<b>Sector</b>	–	Finance, industry, and trade
<b>Subsector</b>	–	Financial sector development and reforms Small- and medium-scale enterprises
<b>Themes</b>	–	Sustainable economic growth Governance Private sector development
<b>Subthemes</b>	–	Promoting economic efficiency and enabling markets Financial and economic governance Policy/institutional/legal/regulatory reforms Catalyzing private sector investment

## NOTES

- (i) The fiscal year (FY) of the Government of India ends on 31 March. For example FY 2003 ended on 31 March 2004.
- (ii) In this report, "\$" refers to US dollars.

This report was prepared by R. Hartel and V.V. Subramanian.

## I. INTRODUCTION

1. In its National Common Minimum Program, the Government of India (the Government) emphasized the importance of small and medium enterprises (SMEs) for economic growth, employment generation, and poverty reduction. The Government requested the Asian Development Bank (ADB) for technical assistance (TA)<sup>1</sup> to prepare a project to support the development of SME finance in India. The TA and the ensuing project are confirmed in the Country Strategy and Program Update 2004–2006. ADB support will complement assistance being provided by other development partners to enhance competitiveness of SMEs by improving the enabling environment, facilitating access to commercial finance, and providing business development services (BDS). The Department for International Development (DFID) of the United Kingdom, the German Government through Gesellschaft für Technische Zusammenarbeit (GTZ) and Kreditanstalt für Wiederaufbau (KfW), and the World Bank Group are contributing to this effort. ADB TA implementation will be closely coordinated to avoid duplication of effort. An ADB Fact-Finding Mission met in May 2004 with the Government—the Ministry of Finance (MOF), Ministry of Small Scale Industries, Small Industries Development Bank of India (SIDBI), selected state financial corporations (SFCs), the Reserve Bank of India (RBI)—and other key stakeholders and agreed on the objectives, scope, and implementation arrangements of the TA. This report reflects the agreement reached with the Government.

## II. ISSUES

2. India has a vibrant SME sector. Currently, there is only an official definition for a small-scale industry (SSI) unit. While most SSIs are defined as enterprises with investments in plant and machinery of up to Rs10 million (\$219,000), the Government is now considering defining the threshold for SMEs of up to Rs100 million (\$2.19 million) for the same criteria.<sup>2</sup> The SSI subset of the SME sector consists of about 12 million enterprises, of which only 20% are registered. Despite the large proportion of unregistered SSIs, the informal sector accounted for only 23% of gross national income in 2003, indicating far higher productivity and profitability of registered units. Registered SSIs constitute 95% of all manufacturing enterprises, and in FY2002, accounted for 40% of industrial output (\$165 billion), 35% of export revenues (\$18 billion), and 45% of formal industrial employment (19 million).<sup>3</sup>

3. Since India's independence, the Government has developed policies and a large public sector infrastructure to support SSIs. At the heart of the SSI promotion policies were production protection, preferential conditions, tax exemptions, subsidized support schemes, priority sector lending, and a large network of public sector business service providers and banks. During the peak of protection in the mid-1980s, about 900 products were reserved for SSI production.<sup>4</sup> Protection policies have been essentially targeted for producing enterprises, especially those whose products were targeted for the domestic market, while exporting and trading units have been more exposed to competition. BDS for the SME sector are provided mainly through a large network of public sector agencies, both at central and state government levels, for entrepreneurship development, training, marketing, export, technology transfer, and

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<sup>1</sup> The TA was first listed in *ADB Business Opportunities* (Internet edition) on 28 June 2004.

<sup>2</sup> Various industries and product lines have special SSI thresholds; the largest threshold is Rs50 million for investment in machinery and equipment. Unlike other countries, business turnover and employment size are not criteria used for defining an SSI/SME in India. Recently, the Ganguly Committee has recommended the following thresholds by business turnover: (i) up to Rs20 million—tiny units, (ii) up to Rs200 million—SSI units, and (iii) up to Rs500 million—medium-sized units.

<sup>3</sup> Since 80% of the SSIs operate in the informal sector, the real significance for employment is much higher.

<sup>4</sup> Currently there are 675 reserved items and a further reduction by 85 items has been recommended.

consultancy. Despite the significant policy and institutional support, the public sector BDS providers have been unable to extend their outreach beyond 1% of the SSI units.

4. In the 1990s, the Government recognized that the previous interventionist approach was no longer suitable and embarked on significant market-based reforms in the enterprise and financial sector. Most bank deposit and lending rates have been liberalized, prudential norms and supervision improved, and priority sector lending has been reduced. India's banking sector consists of 295 commercial banks, most of which are publicly owned, though 67 are privately owned. Public sector banks control three quarters of banking system assets and account for about 90% of lending to SSIs. The State Bank of India (SBI) and its eight associates alone account for about 30% of the banking system assets and loans to SSIs. About 80% of bank lending is targeted to urban markets. The rural segment is served by the 19 nationalized banks (52%), SBI (27%), and the 196 rural banks (14%). Private banks play a marginal role.

5. The banking system directed about 12% of its overall net lending to SSIs during the 6 years since 1997. While the aggregate SSI loan portfolio increased by 8% annually, it grew far below the 14% annual growth of commercial credit during the same period. Since SSI output growth consistently exceeded the growth of the overall private sector, it is obvious that financial intermediaries (FIs) do not recognize the significance of SSIs for their business growth. With higher credit growth, the contribution of SSIs to growth could have been more significant.

6. The low growth in SSI lending demonstrates that priority sector lending to SSIs did not produce the desired results. Saddled by high nonperforming loans (NPLs) in the SSI segment (about 15–21% of public sector banks' loans to SSIs), priority sector lending is largely viewed by the banks as a social liability and many institutions do not recognize the large potential of the SME market as a business. Other reasons for the weak growth of SME credit are (i) the large number of unregistered enterprises, which require different lending and risk management techniques, processes, and skills; (ii) lack of fixed collateral among SMEs that banks typically require; (iii) lack of a secured transactions law to regulate assignment and registry of movables; and (iv) the difficulty and high cost of registering property<sup>5</sup> and enforcing contracts. Despite high liquidity, banks still focus on narrow market segments such as consumer and home loans that are perceived to be less risky and more profitable. RBI statistics show that about 420,000 accounts represented 17% of outstanding loans in the range of \$10,000–100,000 in 2000 for SMEs. Given India's large number of SMEs, this is a very small coverage. Market-based approaches to credit for SMEs need to be developed to tap this large potential.

7. Recognizing the importance of SMEs for growth and employment in the economy, the Government views the growing financial resource gap as a major concern, estimating the term credit needs for SMEs at Rs634 billion (\$13.9 billion) for the 10<sup>th</sup> Plan period (FY2002–2007), and working capital needs at Rs1,230 billion (\$27 billion) during the final year of the Plan. It announced an Rs100 billion (\$2.2 billion) credit package to SMEs for FY2004–2006. To address the credit gap to SMEs, the Government established SIDBI in 1990 under an Act of Parliament. SIDBI lends through FIs, essentially banks and SFCs, and more recently directly to SMEs. As of 31 March 2003, FI lending comprised 92%, and direct lending only 8%, of its loan portfolio; SFCs form the largest part of SIDBI's FI lending operations with Rs44 billion (\$0.95 billion) or 31% of FI loans outstanding.

8. Eighteen SFCs were established under the SFC Act of 1951 (amended in 2000), to finance SSIs at the state level. While SFCs were an important source of medium-term credit

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<sup>5</sup> A recent World Bank survey states that registration in India costs double the regional average. This undermines the use of property for collateral purposes. For more details, see <http://rru.worldbank.org/DoingBusiness>.

during the 1970s and 1980s, lending fell drastically from 1998 to 2000 with aggregate annual disbursements to SSIs dropping from 38% to 20% of the net credit increment of the banking sector to SSIs during that period. Intervention by state governments and, consequently, lack of independence of SFC management, as well as poor underwriting and loan management have contributed to high NPLs. Further, SFCs have been weakened by frequent changes of management, high cost of funds, business restrictions under the SFC Act, and absence of effective powers for prudential regulation and supervision by RBI and/or SIDBI. To address the SFCs' insolvency, the Government established the Gupta Committee, which estimated in early 2001 that the 18 SFCs have an aggregate negative net worth of Rs33.3 billion (\$0.7 billion). However, the committee felt that 14 SFCs continued to be relevant and would require about Rs24.5 billion (\$0.5 billion) to recapitalize. The recommendations have not been fully accepted as the committee proposed that the Government, RBI, and SIDBI take over two thirds of the restructuring/recapitalization cost, while the concerned states as principal owners would bear only one third of the cost. The committee was also less specific about the operational restructuring aspects that are normally prerequisites for successful restructuring. In 2004, RBI established the Ganguly Committee<sup>6</sup> to study means to (i) improve the flow of credit to the SSI sector and (ii) revive SFCs as a conduit of funds to SMEs. That committee recommended the following: (i) repeal the SFC Act, (ii) restructure commercially viable SFCs as vehicles for FIs for funding SMEs, (iii) facilitate SFC restructuring by NPL transfer to asset reconstruction companies, (iv) the state government stake in SFCs may be taken over by SIDBI or banks, and (v) reconstitute individual or groups of SFCs under the Companies Act. SIDBI signed agreements with nine SFCs requiring compliance with financial and operational targets in exchange for providing financial support. However, a holistic approach is required to put SFCs on a sound basis.

9. There is also a need for an integrated policy and institutional framework for SME development including (i) defining the role of the Government and the private sector in providing BDS, (ii) identifying underwriting and management processes for enhancing the commercial outreach of lending to SMEs, (iii) identifying appropriate policy packages and institutional support for access to export markets, and (iv) developing effective credit enhancements in addition to the credit guarantee fund. A comprehensive SME strategy and effective collaboration of the Government, FIs, and BDS providers is necessary to realize the targets of the 10<sup>th</sup> Plan.

10. The development partner efforts aim at improving policies for SME finance, building capacity, mitigating credit risk, and meeting financing needs. While the World Bank and KfW will provide credit lines for lending by commercial banks, DFID and GTZ will provide TA to enhance capacity for SME finance, BDS, and the business environment. The ADB support will complement this initiative and arrangements will be put in place to ensure good coordination.

### **III. THE TECHNICAL ASSISTANCE**

#### **A. Purpose and Output**

11. The TA is to prepare an SME project aimed at improving SME growth and competitiveness and at developing SME finance in collaboration with the Government and other key stakeholders. The TA will (i) review effectiveness of past approaches in support of SME finance; (ii) identify solutions for improving service delivery, commercial viability, and appropriate prudential supervision of SFCs; (iii) identify broad policy issues to be addressed for

<sup>6</sup> The mandate of the Ganguly Committee, established by the Governor of RBI, covered a broad range of issues and institutions to facilitate the flow of credit to SSIs. The terms of reference and the findings can be viewed at <http://www.rbi.org.in/sec21/53524.pdf>.

improving the business environment and SME access to market-based financial services, including credit and BDS; and (iv) developing a strategy and incentive framework for FIs, including SFCs, for providing financing to SMEs on a sustained basis. The TA puts particular emphasis on institutional reforms successfully tested elsewhere and will (i) examine the financial and operational status of the FIs, especially the SFCs, at the national and state levels, (ii) identify SFCs with turnaround potential and draw up strategic and operational plans, (iii) examine how SIDBI's role can be enhanced in responding to the changing needs of the SMEs, (iv) review the current legal and regulatory framework to remove constraints and facilitate SME access to credit and BDS, and (v) identify enhancement of SME creditworthiness. As set out in the project framework (Appendix 1) and detailed in the outline terms of reference (Appendix 2), the TA comprises three components, developed in a consultative process.

12. Component 1 will review effectiveness of past government and FI-led approaches to SME financing, identify gaps in development of the sector, and provide solutions for improving the policy and enabling environment, including incentives, market-based financial services, and BDS, based on lessons learned in India and elsewhere.

13. Component 2 will identify detailed options, sequencing, and implementation plans for the turnaround and commercialization of SFCs; assess the state governments' commitment to the recommended reforms; and identify the SFCs' role, including business and restructuring strategies and plans. This component will also examine SIDBI's role in light of the needs of SFC restructuring and the changing SME business environment. This entails both direct lending and indirect lending to commercial FIs and SFCs at acceptable portfolio quality, and further enhancing SIDBI's capacity as apex body for SME finance and oversight of the SFCs. It also includes reviewing RBI's policy and practice in regulating and supervising SFCs.

14. Component 3 will examine the potential and scope for institutional and product-based credit enhancements, and for building capacity among FIs to improve SME access to credit.

## **B. Methodology and Key Activities**

15. As detailed in Appendix 2, the TA will be implemented in three phases commencing by February 2005.<sup>7</sup> The first (diagnostic) phase entails a full review as indicated under component 1, and analysis and detailed implementation plans for components 2 and 3. Within 6 weeks of commencement of the TA (by end-March 2005) stakeholders will review the findings and agree on the scope for designing the SME loan.

16. The second (design) phase will develop the detailed design solutions, strategies, and operational plans for each component; a draft development policy matrix; and implementation arrangements. Within 20 weeks of the commencement of the TA, stakeholders will review findings and agree on final design and implementation arrangements for the ensuing SME loan.

17. The third (final design) phase will aim to ensure full support of stakeholders, completion of the policy matrix, detailed action plans for meeting reform objectives, and finalization of implementation arrangements for the SME loan within 28 weeks of the commencement of the TA. To facilitate a smooth transition to implementation, about 10% of the TA resources will be utilized based on an agreed plan at the end of the final design. The TA will be completed by June 2006 and TA accounts will close by December 2006. The consultant will submit reports as set out in Appendix 2.

<sup>7</sup> The time schedule is tentative and depends on the timely effectiveness of the TA, recruitment of consultants, and effective stakeholder feedback. The stakeholder feedback ensures adequate building of ownership and addressing any relevant poverty and social issues. The initial poverty and social analysis is in Appendix 3.

### **C. Cost and Financing**

18. The cost of the TA is estimated at \$1 million equivalent, of which \$610,000 is in foreign currency and \$390,000 equivalent is in local currency. ADB will finance \$800,000, including the entire foreign exchange cost and \$190,000 equivalent in local currency. The Government will contribute the remaining \$200,000 equivalent in kind, which will include office expenses and counterpart staff remuneration. The TA will be financed on a grant basis by the Government of the United Kingdom. The Government has been advised that financing of the TA does not commit ADB to financing the ensuing project. Details of the cost estimates are in Appendix 4.

### **D. Implementation Arrangements**

19. MOF will be the Executing Agency, while SIDBI will be the implementing agency. In addition to stakeholder reviews, a steering committee will provide strategic guidance. It will be chaired by MOF secretary (financial sector) and will include representatives from MOF Banking Division, Department of Economic Affairs, the Department for SSIs, SIDBI, and once determined, each of the state governments in which SFCs have been selected for restructuring. For stakeholder feedback, TA reports will be posted on SIDBI's web site. A separate panel of both international and domestic experts will peer review the TA findings. Tripartite review meetings involving the steering committee, consultants, and ADB will be chaired by MOF.

20. An international firm will be recruited to provide a team of consultants of about 35 person-months, of which about 65% international and 35% domestic experts will have expertise in SME policy, and finance; FI restructuring, commercialization, and business strategy; SME credit; financial sector regulatory and governance; and BDS. The consulting services require an innovative approach to SFC restructuring including strategies, and business plans; prudential supervision by a financial apex intermediary and RBI, awareness building at the stakeholder level, and identification of SFCs and state-level government commitment. There is no standardized approach for service delivery and the task of developing restructuring solutions including systems, lending processes, and procedures is complex technically and falls into the political domain and thus requires a high level of specialized technical and communication skills. Developing solutions with a number of stakeholders with different interests requires a significant degree of flexibility in the allocation of expertise as well as management of the design process. For these reasons, the consulting firm will be recruited under quality-based selection. The consultants will be engaged by ADB in accordance with the *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for the engagement of domestic consultants.

## **IV. THE PRESIDENT'S DECISION**

21. The President, acting under the authority delegated by the Board, has approved ADB administering technical assistance not exceeding the equivalent of \$800,000 to the Government of India to be financed on a grant basis by the Government of the United Kingdom for preparing the Small and Medium Enterprise Finance Sector Development Project, and hereby reports this action to the Board.

PRELIMINARY PROJECT FRAMEWORK (To be revised during Implementation)<sup>a</sup>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Risks
<p><b>Goal</b> Enhance growth and competitiveness of the SME Sector</p>	<ul style="list-style-type: none"> <li>• Growth of SME exports</li> <li>• Growth of SME exporters</li> <li>• Growth of SME manufacturing value added</li> <li>• Growth of SME sales turnover</li> <li>• Growth of SME employment</li> <li>• Growth of formal credit to the sector</li> </ul>	<ul style="list-style-type: none"> <li>• RBI annual report</li> <li>• SIDBI annual report</li> <li>• TA reports</li> <li>• TA review meetings</li> <li>• Economic survey report of the Government</li> </ul>	
<p><b>Purpose</b> Improve the SME Sector's access to formal credit on a sustained basis</p>	<ul style="list-style-type: none"> <li>• Policy reform agenda and action plans for improving SME finance and incentive framework</li> <li>• Agreed policy reform and action plan for improving enabling environment</li> <li>• Reform and action plans for improving BDS</li> <li>• Institutional reform and action plans for FIs engaged in SME finance at national and state levels</li> <li>• Credit enhancement and other risk mitigation measures</li> <li>• Policy matrix and detailed implementation arrangements</li> </ul>	<ul style="list-style-type: none"> <li>• TA steering committee meetings</li> <li>• Tripartite reviews</li> <li>• Consultant reports</li> <li>• Stakeholder feedback and consensus on reforms</li> <li>• Special committee reports</li> <li>• ADB review missions</li> </ul>	<ul style="list-style-type: none"> <li>• Continued government commitment to economic reforms, employment generation, and poverty reduction</li> </ul>
<p><b>Outputs</b> <b>Component 1:</b></p> <ul style="list-style-type: none"> <li>• Review Government and FI-led approaches to SME finance</li> <li>• Identify gaps to improve the policy and enabling environment, financial services, and BDS through market-based mechanisms</li> </ul> <p><b>Component 2:</b></p> <ul style="list-style-type: none"> <li>• Identify options, sequencing, and plans for commercialization of SFCs</li> <li>• Assess state governments' commitment to SFC reforms</li> <li>• Identify SFC business role, strategies, and plans</li> <li>• Develop solutions for SFC resolution</li> <li>• Examine SIDBI's role in light of the changing needs of the environment</li> </ul> <p><b>Component 3:</b></p> <ul style="list-style-type: none"> <li>• Examine scope for credit enhancements facilitating SME finance</li> </ul>	<p><b>Phase 1—Diagnostic:</b></p> <ul style="list-style-type: none"> <li>• Full diagnostic review of component 1, and analysis and detailed options for components 2 and 3</li> <li>• Meetings with stakeholders in the Government, FIs, chambers of commerce, and SME associations</li> <li>• Stakeholder seminar within 6 weeks of TA commencement (by end-March 2005)</li> </ul> <p><b>Phase 2—Design:</b> Develop detailed design, strategies, and operational plans for each component</p> <ul style="list-style-type: none"> <li>• Draft policy matrix and implementation arrangements within 16 weeks of TA commencement</li> <li>• Stakeholder meetings within 20 weeks of TA commencement (by latest end-June 2005) to agree on final design and implementation arrangements</li> </ul> <p><b>Phase 3—Final Design:</b> Buy-in of stakeholders, completion of policy matrix, detailed reform action plans, and implementation arrangements within 28 weeks of TA commencement</p> <ul style="list-style-type: none"> <li>• About 10% of the TA resources will be utilized based on an agreed plan at the end of the final design. TA completed by end-June 2006</li> </ul>	<ul style="list-style-type: none"> <li>• Consultant reports</li> <li>• Tripartite meetings</li> <li>• Restructuring plans and reports</li> <li>• Action plans for resolving NPLs</li> <li>• ADB review missions</li> <li>• A separate advisory panel comprising international and domestic experts to carry out a peer review of the TA findings</li> </ul>	<ul style="list-style-type: none"> <li>• Continued thrust on SME development and poverty reduction by all stakeholders</li> <li>• Business climate does not deteriorate</li> </ul>
<p><b>Inputs.</b> About 35 person-months, comprising 65% international and 35% domestic experts. Total cost \$1 million, ADB financing \$800,000.</p>	<ul style="list-style-type: none"> <li>• Selection of consultants by end-January 2005</li> <li>• Commencement of services by February 2005</li> <li>• Adherence to schedule and consultative design process</li> </ul>		<ul style="list-style-type: none"> <li>• Qualified consultants are fielded in time</li> </ul>

ADB= Asian Development Bank, FI=Financial Intermediary, BDS=Business Development Services, NPL=nonperforming loan, RBI=Reserve Bank of India, SFC=State Financial Corporation, SIDBI=Small Industries Development Bank of India, SME=Small and Medium Enterprise, TA= Technical Assistance

<sup>a</sup> The time schedule is indicative, and will be updated based on the effective fielding of the consultant, conclusion of phases, and clarification of work plans for subsequent phases.

## OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. **Context.** The Government has sought Asian Development Bank (ADB) technical assistance (TA) to prepare a small and medium enterprise (SME) finance sector development loan in 2005. Concurrent with this initiative, the Government will be supported by a number of development partners including the World Bank Group, Kreditanstalt für Wiederaufbau (KfW), Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), and Department for International Development (DFID) in developing the sector. Arrangements are currently being finalized and it is critical that the evolving design for the ADB-supported initiative is grounded in the overall effort, and duplication of effort is avoided. The Ministry of Finance (MOF) and the Small Industries Development Bank of India (SIDBI) are the executing and implementing agencies for the initiatives.

2. **Key Agencies and Institutions.** Involved in the design of the ADB initiative are (i) the federal Government, represented by MOF, and the Ministry of Small Scale Industries; (ii) the state governments in which state financial corporations (SFCs) operate; (iii) Reserve Bank of India (RBI); (iv) SIDBI; (v) the SFCs; (vi) commercial banks; (vii) chambers of commerce; and (viii) trade and industry associations. The Government has established steering committees for the multi-development partner initiative and the ADB TA to ensure timely guidance and feedback. In addition, the ADB TA will ensure feedback from the private sector and independent experts to ensure that the design reflects the needs of the beneficiaries and embodies relevant lessons learned in India and internationally. It is critical that the consulting services are implemented in a consultative and evolutionary manner, seeking stakeholder support and feedback for solutions, while highlighting important design issues, benefits, and risks in a clear and concise manner. The outputs of the TA will serve as the basis for the Government and ADB in finalizing the objectives, scope, and implementation arrangements for the SME program.

3. **Objective.** The goal of the loan is to enhance growth and competitiveness of the SMEs and to help fulfill the Government's objectives for exports, economic growth, employment, and poverty reduction as stated in its 10<sup>th</sup> Plan. The immediate objective of the TA is providing the basis for designing the ensuing SME loan, based on lessons learned in India and elsewhere.

4. **Scope.** ADB and the Government agreed on the following scope and structure:

- (i) **Component 1.** Review effectiveness of past government and FI-led approaches to SME assistance and financing, identify policy reforms gaps, and in close collaboration with the Government and other development partners, recommend reforms to further improve the enabling environment for SME growth, including appropriate incentive structures, market-based financial services, and business development services (BDS).
- (ii) **Component 2.** Analyze institution-specific issues adversely affecting the operations of SFCs, after discussion with state governments and SFCs, and after specific analysis of SFCs propose SFCs for restructuring to MOF and SIDBI; identify detailed options, sequencing, and implementation plans for the turnaround and commercialization of selected SFCs; assess the state governments' commitment to the recommended reforms; identify the SFCs business role, including business strategies and plans, and operational and financial restructuring plans. Examine the current loan underwriting and management processes with particular emphasis of credit risk, and environmental and social safeguard risks, and recommend improvements.

Examine options for resolving nonperforming loans, and unviable SFCs such as merger, takeover, disinvestment, sale to the private sector, and liquidation, and develop detailed solutions in consultation with the stakeholders. Examine SIDBI's operations and strategy in light of the needs of the changing SME business environment. This entails analysis and recommendation of appropriate solutions of its (i) direct lending operations, including its potential for further expanding its apex functions by lending to commercial FIs and SFC, (ii) ability to improve portfolio quality and improve effective supervision of borrowing SFCs, and (iii) perspective for building its apex function for SME finance. It also includes reviewing RBI's policy and practice in regulating and supervising SFC, and review of the SFC act.

- (iii) **Component 3.** Examine the potential and scope for institutional and product-based credit enhancements facilitating SME access to credit, including but not limited to the outputs of the ongoing TA on secured transactions reform.<sup>8</sup>

5. **Consultative Implementation Process.** The Consultant will implement the terms of reference in three phases in a consultative process commencing by February 2005.<sup>9</sup>

- (i) The first (diagnostic) phase entails a full review as indicated under component 1 and analysis and detailed options for implementing the remaining components during the second phase. Specifically it includes the selection of SFCs and a proposed set of actions for SIDBI, RBI, and the Government to be implemented during the design phase. Assisted by SIDBI, the consultants will organize meetings and workshops with stakeholders in the Government, FIs, and the private sector including chambers of commerce and SME associations and a stakeholder seminar within 6 weeks of commencement of the TA (by end-March 2005) to review the findings and agree on the scope for designing the SME loan.
- (ii) The second (design) phase will, based on a detailed plan agreed between the Government and ADB at the end of the diagnostic phase, develop the detailed design solutions, strategies, and operational plans for each component, as well as the draft development policy matrix and implementation arrangements logically organized in outcome and key results areas, within 16 weeks of commencement of the TA. Assisted by SIDBI, the consultants will organize meetings and workshops with the stakeholders mentioned above within 20 weeks of commencement of the TA (latest by end-June 2005) to review the findings and agree on final design and implementation arrangements for the ensuing SME loan.
- (iii) The third (final design) phase will ensure support of stakeholders of the SME loan and completion of the policy matrix, detailed action plans for meeting reform objectives, and the cost of reform and finalization of implementation arrangements for the loan, within 28 weeks of commencement of the TA. To facilitate a smooth transition to implementation and to ensure continuity of effort during the period of loan approval and beginning of loan implementation, about 10% of the TA resources will be earmarked and utilized, based on a plan to be

<sup>8</sup> ADB. 2002. *Technical Assistance to India for Secured Transactions Reform*. Manila.

<sup>9</sup> The time schedule is indicative, will be updated based on the effective fielding of the consultant and effective conclusion of phases and clarification of work programs for subsequent phases.

agreed on at the end of the final design. The TA will be completed by end-June 2006 and TA accounts will close by December 2006.

6. **Policy Guidance and Quality Enhancement.** In addition to stakeholder reviews, a steering committee will provide overall strategic guidance, and a separate advisory panel comprising both international and domestic experts will carry out a peer review of the TA findings at the three stages of TA implementation. Tripartite reviews involve the steering committee, consultants, and ADB, and will be chaired by MOF.

7. SIDBI will establish a counterpart team at its office in Mumbai, which will oversee the SFC operations to manage the TA, and counterpart teams will be established at those SFCs that participate in the TA.

8. **Consulting Services and Expertise.** An international consulting firm will be engaged to provide the services in a well-coordinated manner. Using the terms of reference, short-listed consulting firms will prepare full technical proposals reflecting discussions with key stakeholders in India, and reflecting a proposed concept approach to implement the TA. The consulting firm will be responsible for (i) the effective implementation of the proposed approach as reflected in the technical proposal and the consulting contract; (ii) suitability of the specialists in terms of cultural sensitivity and communication skills, technical expertise, and ability to produce analysis and solutions in a clear concise way relevant to the legal, regulatory, and operational environment in India; and (iii) flexibility in addressing the stakeholders' and ADB's concerns. The consultant is free to bundle certain specializations in one suitable individual and rearrange the responsibilities as deemed appropriate. The consultant will have substantial backstopping facilities to provide quality review, alternative personnel, and systems support at short notice, and home support in the region is desirable.

9. The consultative and evolving nature of the TA will require of the consultant a high level of flexibility in assigning the expertise resources. However, given existing information available the following utilization of overall TA resources is indicated: Phase 1: 20%; Phase 2: 50%; and Phase 3: 30%, of which 10% will be reserved to accommodate implementation preparation for the SME loan in the period between government and management approval and start of operations. It is estimated that an overall 35 person-months are required to implement the TA, of which about two thirds will be international expertise and one third domestic expertise. The person-months and the above indicative resource allocation provide a broad idea of the possible workload in each phase. While the consultant is free to modify the level of input of the individual experts, the total amount of services may not exceed the budgeted and subsequently contracted cost.

10. The consulting firm will have a proven track record in managing policy and institutional change, and product development in developing countries and more advanced economies, with a strong presence in South Asia. The consultant will be familiar with the current financial and SME support system in India and international best practice and will assign a project manager for home office support.

11. The consultant will also assign a senior project team leader from among the individual experts to coordinate the outputs of the consulting team with the various stakeholders. The team leader will have excellent communication skills, and a proven track record of effectively negotiating and implementing reforms with stakeholders from government and the private sector. The team leader will have a bank restructuring/change management background with significant exposure to policy dialogue and a perfect understanding of the needs of the SME

environment. The expertise for the assignment will be in the following areas: (i) change management and restructuring of financial institutions; (ii) policy and business analysis, and associated strategy modeling and implementation; (iii) legal, regulatory, and institutional reform in the financial sector, with particular experience in the SME sector; (iv) capacity building for SME finance in financial institutions, especially design and implementation of sound credit underwriting and management; (v) market analysis and product development strategy and implementation, with particular focus on credit enhancements outside a banks credit process; and (vi) market-based BDS to SMEs. The team leader will have at least 8 years of experience in the relevant field, especially in managing similar assignments, and all individual experts will have at least 5 years of relevant experience in their respective field of expertise, have tertiary degrees, and be proficient in oral and written English. The consultant may associate with other firms under the lead of one firm. In the proposals, the firms will need to demonstrate the back-office arrangements in terms of quality review of the outputs and mobilization of additional expertise at short notice.

12. The consultant will submit the following reports in paper and electronic format:
- (i) a draft diagnostic report within 4 weeks of beginning the services,
  - (ii) a draft design report within 16 weeks of beginning the services, and
  - (iii) a draft final design within 28 weeks of beginning the services;
  - (iv) final reports within 1 week of completion of stakeholder seminars highlighting the findings and the agreed way forward;
  - (v) brief bimonthly interim reports highlighting key issues and milestones; and
  - (vi) a final report at TA completion.

## INITIAL POVERTY AND SOCIAL ANALYSIS

### A. Linkages to the Country Poverty Analysis

<p><b>Is the sector identified as a national priority in country poverty analysis?</b></p> <p style="text-align: right;"><input checked="" type="checkbox"/> Yes <input type="checkbox"/> No</p>	<p><b>Is the sector identified as a national priority in country poverty partnership agreement?</b></p> <p style="text-align: right;"><input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p> <p>Though there is no country poverty partnership agreement, the SME sector has been identified as critical for poverty reduction in India's 10th Five-Year Plan, the National Common Minimum Program, and the Country Strategy and Program (2002–2006).</p>
<p><b>Contribution of the sector or subsector to reduce poverty in India:</b></p> <p>The small and medium enterprise (SME) sector is vital to the Indian economy as it constitutes 95% of all industrial units and contributes 40% of industrial output and 45% of formal industrial employment. In the emerging economy of India, SMEs are the prime drivers of new employment. The development of the SME sector will enhance the economic structure and income- and employment-generating activities, reduce income disparity, and contribute to overall macroeconomic stability and poverty reduction. The 10th Five-Year Plan has placed great reliance on small enterprises for attaining the overall economic growth and employment targets set for the plan period.</p> <p>Given its high multiplier effect on the national economy, the SME sector is critical for financing and policy intervention to support the growth rate of the economy. The Project will support the Government's recognition of the significant role SMEs can play in achieving national development goals and its efforts to attain the 10th Plan objectives of 8% growth, 10% industrial growth, and 1 million jobs a year.</p>	

### B. Poverty Analysis

#### Targeting Classification: General Intervention

<p><b>What type of poverty analysis is needed?</b></p> <p>SMEs enhance competition and entrepreneurship and hence have external benefits on economy-wide efficiency, innovation, and aggregate productivity growth. This will help exploit the social benefits from greater competition and entrepreneurship, lead to more productivity, and boost employment, as SMEs operations are more labor intensive. The Government recognizes the important potential of SMEs for job creation.</p> <p>The state financial corporations (SFCs) were created for supporting entrepreneurial development, employment generation, poverty reduction, and reduction in regional disparities. Since SFCs have been conceived as institutions of national importance in the rural and backward regions of the states, the Government requested assistance to support the restructuring those SFCs that have the potential to become commercially viable. Because of the nature of the institutional reforms, the impact on poverty will be indirect.</p>
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### C. Participation Process

<p><b>Is there a stakeholder analysis?</b></p> <p style="text-align: right;"><input checked="" type="checkbox"/> Yes      <input type="checkbox"/> No</p> <p>The social assessment is integral part of the technical assistance (TA) implementation and will involve iterative consultation with the following stakeholders: SME entrepreneurs, SFCs, Small Industries Development Bank of India (SIDBI), related state governments, the central Government, financial intermediaries (FIs), and industry chambers and associations. The focus will be on (i) cost-effective SME credit delivery, which includes SMEs operated by women; (ii) improved financial services of FIs; and (iii) enhanced access of SMEs to credit through policies and incentives.</p> <p><b>Is there a participation strategy?</b></p> <p style="text-align: right;"><input checked="" type="checkbox"/> Yes      <input type="checkbox"/> No</p> <p>Stakeholder participation is a key element of the design and implementation arrangements for the TA. Stakeholders will be consulted during the three phases of the TA and views will be consolidated and validated at the end of each phase to ensure that policy reforms have been adequately discussed and agreed upon. Through improved viability of FIs, SME stakeholders will be able to participate more in contributing to economic growth, jobs, and income generation.</p>
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**D. Gender Development****Strategy to maximize impacts on women:**

Among the priorities under SME development is the objective of improving knowledge about female entrepreneurship and understanding specific needs and developing customized solutions for this segment of SMEs. The TA will analyze lending products, processes, and monitoring of FIs with respect to women entrepreneurs and identify solutions to improve women's SMEs' access to credit.

Has an output been prepared?  Yes  No

**E. Social Safeguards and other Social Risks**

Item	Significant/ Not Significant/ None	Strategy to Address Issues	Plan Required
<b>Resettlement</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	Since the Project emphasizes policy reforms and institutional capacity building there will be no resettlement issues.	<input type="checkbox"/> Full <input type="checkbox"/> Short <input checked="" type="checkbox"/> None
<b>Affordability</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	There will be no affordability-related issues. In contrast, the credit delivery at competitive rates along with the productivity improvements will result in a more competitive SME sector that will not be dependent on government subsidies.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Labor</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	A positive labor impact is expected as a result of extended credit outreach and expanded business activities.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Indigenous Peoples</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	Since the Project emphasizes policy reforms and institutional capacity building there will be no resettlement issues.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Other Risks and/or Vulnerabilities</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	No other adverse issues are anticipated.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No

**COST ESTIMATES AND FINANCING PLAN**  
(\$ '000)

Item	Foreign Exchange	Local Currency	Total Cost
<b>A. Government of the United Kingdom Financing<sup>a</sup></b>			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants	520.0	78.0	598.0
ii. Domestic Consultants	0.0	52.0	52.0
b. International and Local Travel	30.0	21.0	51.0
2. Seminars and Workshops	0.0	16.0	16.0
3. Surveys	0.0	5.0	5.0
4. Representative for Contract Negotiations	5.0	0.0	5.0
5. Contingencies	55.0	18.0	73.0
<b>Subtotal (A)</b>	<b>610.0</b>	<b>190.0</b>	<b>800.0</b>
<b>B. Government of India Financing</b>			
1. Office Accommodation and Transport	0.0	150.0	150.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	50.0	50.0
<b>Subtotal (B)</b>	<b>0.0</b>	<b>200.0</b>	<b>200.0</b>
<b>Total</b>	<b>610.0</b>	<b>390.0</b>	<b>1,000.0</b>

<sup>a</sup> Administered by the Asian Development Bank.  
Source: Asian Development Bank estimates.