



Report on MSMEs' Access to Finance and Timely Payments



Foreword



The global economic environment has become increasingly uncertain and volatile. Geopolitical shifts and increasingly restrictive trade policies means the external environment is no longer benign.

In this context, the contribution of the external sector to India's economic development proves to be less reliable. However, despite these shifts, there is still optimism for our ambitions to become a developed nation by 2047 due to the strength and resilience of our Micro, Small and Medium enterprises (MSMEs). They anchor India's growth in a strong foundation and occupy a central role as creators of employment, innovators of production, robust drivers of regional growth and a vat of immense potential. Therefore, for India to sustain its progress toward becoming a developed economy, MSMEs must be able to sustain their momentum and grow, modernize, and integrate more deeply into formal financial and supply chains. In this regard, timely access to capital and finance remains critical for this transformation.

Over the past few years, the government has undertaken several measures to ease financial frictions, from enhancing credit guarantees and promoting digital public infrastructure to operationalizing platforms such as TReDS and MSME Samadhaan. Yet, just as it is with any policy initiative, addressing every issue at once remains impossible. Thus, gaps remain between policy intent and the on-ground flow of capital. Addressing these will require continued coordination between policymakers, regulators, financial institutions, and industry bodies. This report, "MSMEs: Access to Finance and Timely Payments", provides valuable evidence on the scale of these challenges and identifies actionable areas for reform. Its analysis offers timely insights that can help strengthen financial resilience and improve payment discipline. If implemented, the recommendations made in this report have the potential to enable MSMEs to contribute more fully to India's growth ambitions.

I commend FISME, C2FO, and GAME for their collaborative effort and for advancing a conversation that will significantly aid India's inclusive and sustainable development journey. Their contributions are invaluable, and their efforts are greatly appreciated.

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Acknowledgement

The Report on ‘MSMEs Access to Finance and Timely Payments’ delves into the issues raised at the National and Regional Roundtables organized by Federation of Indian Micro and Small & Medium Enterprises (FISME), C2FO and Global Alliance for Mass Entrepreneurship (GAME). These organizations, in association with regional MSME bodies, organized a series of regional consultations in Kolkata, Mumbai and Bengaluru to elicit views and suggestions from the ground. This report would not have been possible without the insights provided by government officials, regional associations, industry associations and bodies, representatives of PSUS, Banks, NBFCs, credit rating agencies, TReDS platforms, experts from the field of finance, law, during the roundtable discussions. We wish to express our sincere gratitude to Mr. S C L Das, Secretary, Ministry of MSME, Mr. Manoj Pandey, Additional Secretary, Ministry of Corporate Affairs, Ms. Anuja Bapat, Deputy Director General, DC - MSME, Dr. Sumantra Pal, Economic Advisor, Public Procurement, Mr. Manoj Muttathil Ayyappan, Joint Secretary, Department of Financial Services (DFS), Mr. Ateesh Singh, Joint Secretary, Ministry of Micro Small Medium Enterprises (MoMSME) for their invaluable guidance and support.

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Executive Summary

Micro, Small and Medium Enterprises (MSMEs), numbering 6.4 crore, are the backbone of India's economy. Yet, their potential is throttled by two entrenched challenges: delayed payments and restricted access to formal credit. Together, these issues trap an estimated ₹25 lakh crore in unmet credit demand and ₹8.1 lakh crore in delayed receivables—equivalent to 4.6% of India's GVA in FY24. For micro enterprises, the impact is especially severe, with payment delays 2–3 times longer than larger firms, often affecting household consumption and survival.

Government initiatives like TReDS, Section 43B(h) of the Income Tax Act, the MSME-1 disclosure form, and the Samadhaan portal have created useful platforms, but weak enforcement, low uptake, and institutional bottlenecks dilute their impact. Credit policies such as Priority Sector Lending and Mudra loans have widened coverage but fall short of closing the gap due to rigid bank practices, information asymmetry, and punitive SMA/NPA classification norms.

This report highlights six priority actions to unlock MSME growth:

1. **Enforce timely payments** through strict use of Section 43B(h) and public disclosure of chronic defaulters.
2. **Scale TReDS** as the default rail for MSME payments, integrated with GST and Udyam data.
3. **Strengthen dispute resolution** by expanding Facilitation Councils, introducing fast-track arbitration, and ensuring finality of awards.
4. **Reform SMA/NPA classification** to prevent viable firms from being strangled by rigid norms.
5. **Expand digital credit models** using GSTN and UPI data to build cash-flow-based scoring and accelerate low-ticket loans.
6. **Reorient Samadhaan** with automation, standard contract templates, and public disclosure of award and appeal data.

If implemented, these measures can release locked capital, expand formal credit, accelerate tax collection, stabilize household incomes, and add up to 1–1.5% to India's GDP growth. The pieces already exist, the task is to enforce, connect, and scale them with political will and institutional accountability. This report synthesizes insights with respect to the issue of access to finance from regional roundtable discussions held across major Indian cities, culminating in the New Delhi roundtable of September 2024.

Access to Finance:

In the context of India's growing economy, enhancing MSMEs access to affordable formal financing has become increasingly crucial. However, lending institutions often maintain a cautious stance regarding the commercial viability of MSME loans. This hesitancy, combined with significant information asymmetry, frequently results in delayed fund disbursement. Consequently, MSMEs facing urgent financing needs often resort to alternative, typically informal, sources of credit. Recent trends indicate a shift toward lower ticket size loans, with public sector and private banks reporting reductions of 21% and 7% respectively in their average loan sizes.

The Reserve Bank of India (RBI) has consistently prioritized the inclusion of MSMEs in the formal financial system through various targeted measures. A key initiative has been the Priority Sector Lending (PSL) guidelines, which mandate a sub-target of 7.5% of banks; adjusted net bank credit for micro enterprises. However, over the past two decades, the definition of Priority Sector has considerably broadened, leading banks to favor less risky options like housing loans based on historical data rather than considering MSME loans that rely on future projections.

Delayed Receivables:

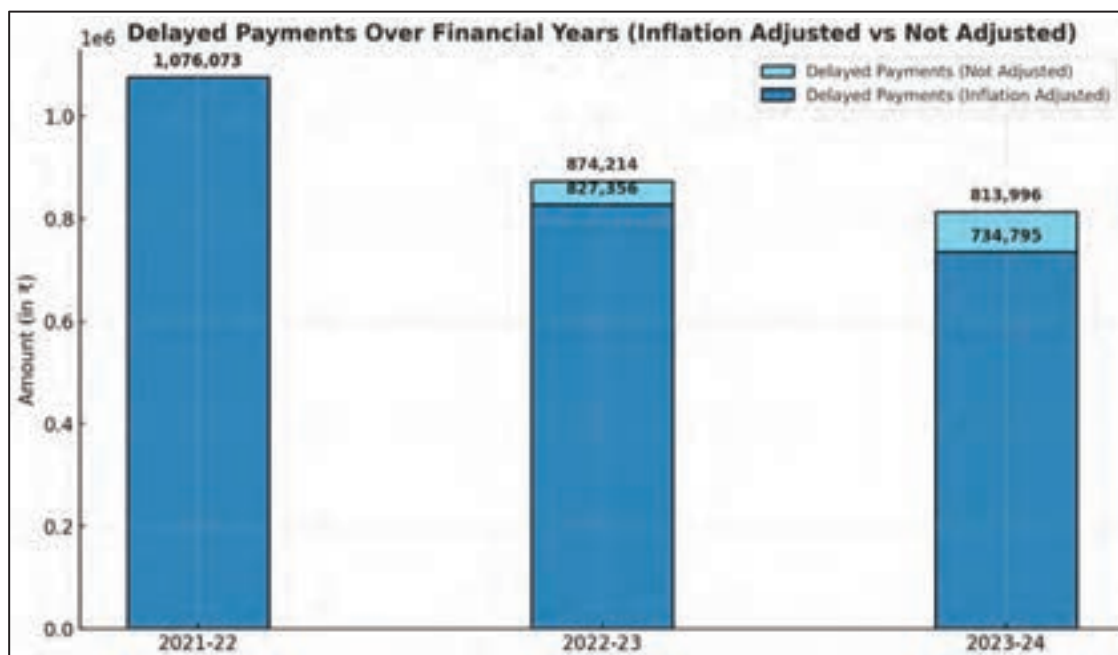
The importance of prompt payment to MSMEs has been the focus of the Government of India, RBI and other stakeholders. In this regard, GAME came out with our first report in May 2022 which highlighted the causes of delays in payments and the way forward. Most importantly, for the first time we estimated the quantum of delayed payment to MSMEs be around ₹10.70 lakh crore. In the second report the focus was on highlighting suitable solutions to address the problem.

In the current report, we have revisited the quantum of delayed payments and have observed a decreasing trend in the quantum of delayed payments in the system. The quantum as at the end of March '23 and March '24 is ₹8.74 lakh crore and ₹8.13 lakh crore respectively. This when inflation is adjusted, is ₹8.27 lakh crore and ₹7.34 lakh crore. This report examines these issues in detail, evaluates the current policy frameworks, and proposes actionable recommendations to address these systemic gaps.

The fact that delayed payments represent over 4.6% of India's total economic output in FY 2023-24 underscores the substantial macroeconomic impact of this issue. Given that

India's GVA for FY 2023-24 is ₹159.4 lakh crore, this percentage translates to a significant amount of economic value that is temporarily locked up due to payment delays.

Chart 1: Delayed Payments Over Financial Years



This percentage signifies that a considerable portion of the value generated within the Indian economy is not readily available due to overdue payments. Such a large amount of capital being held up in delayed payments can have far-reaching consequences, affecting not only the businesses directly involved but also the broader economic environment. It can constrain investment, slow down economic growth, and negatively impact the financial health and operational efficiency of businesses across various sectors, particularly smaller enterprises that are more vulnerable to cash flow disruptions. Addressing the issue of delayed payments has the potential to unlock a significant amount of capital within the economy. This freed-up capital could then be reinvested, leading to increased economic activity, and potentially boosting the overall growth trajectory of the nation. Policies and initiatives aimed at fostering a prompter payment culture and reducing the incidence of delayed payments can therefore have a positive impact on the Indian economy.

The data reveals a clear inverse relationship between the size of the revenue segment and the average time taken to receive payments. The smallest businesses (Up to ₹5 crore revenue) face the longest payment delays, with an average debtor period more than double that of the next larger segment and almost triple that of the largest segment. This suggests that smaller enterprises often lack the negotiating power to enforce favourable payment terms and are more susceptible to delayed payments from their clients, which can severely

impact their cash flow and overall financial stability. This extended payment cycle can create significant challenges for the operational efficiency and sustainability of these smaller businesses, potentially hindering their growth and development. Conversely, larger companies (₹50 to ₹250 crore revenue) appear to have more leverage in ensuring timely payments, possibly due to stronger contractual agreements or more efficient internal processes for managing their receivables. The marked difference in average debtor days across revenue segments underscores the vulnerability of smaller businesses to prolonged payment delays. This situation calls for policy interventions specifically designed to improve cash flow and financial resilience of smaller enterprises. Such measures could include promoting adoption of shorter payment terms, facilitating access to invoice financing options, or strengthening enforcement of contracts to ensure timely payments. The repercussions of protracted capital cycles occur in the form of delayed tax and revenue for the government, business opportunities and cycles forgone, snowballing delay in payments down the value chain and in extreme circumstances has direct impact on wages. After having tracked this issue systematically over the last couple of years we believe that we should aim to lower the delayed payments to GVA ratio and continue to target solutions for the micro and small category to ameliorate systematic asymmetries. A lower ratio efficiently hastens capital cycles and thereby delivers manifold gains in terms of quicker tax collections, healthy working capital, and growth. The issue of delayed payments lies at the intersections of ensuring fairer systems of economic participation and unlocking growth by addressing systemic inefficiencies.

Roundtable Discussions:

Federation of Indian Micro and Small & Medium Enterprises (FISME), C2FO and Global Alliance for Mass Entrepreneurship (GAME) in association with regional MSME bodies organized a series of regional consultations in Kolkata, Mumbai and Bengaluru to elicit views and suggestions from the ground. Federation of Small & Medium Industries (FOSMI), Chamber of Small Industry Associations (COSSIA), Thane Small Scale Industries Association (TSSIA) and Federation of Karnataka Chambers of Commerce & Industry (FKCCI) were partners in organizing regional roundtables. The final roundtable in this series was held in New Delhi on 28th September 2024. It was presided by Shri S.C.L. Das, Secretary, Ministry of MSME, GoI. The discussions and suggestions put forward are expected to contribute to future policy decisions and initiatives aimed at strengthening the MSME sector in India.

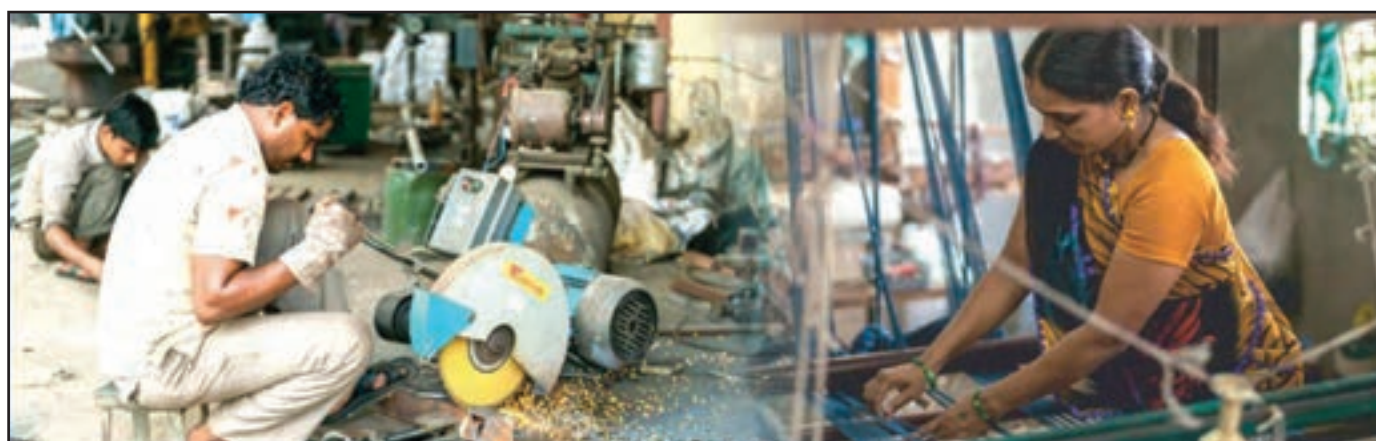
Context - MSMEs in India

Based on the sixth Economic Census, there are around 6.4 crore MSME enterprises with approximately 2 crore units (31%) engaged in manufacturing. This number can be taken as the size of the formal manufacturing sector, given that nearly 1.65 crore units operate from households in approximately 400 industrial (usually urban) and approximately 3,000 artisanal (largely rural) clusters; factories employing more than 10 workers number 2.5 lakhs (ASI data) and the rest can be termed as unorganized.

The table below contextualizes MSMEs in India:

Table 1: MSMEs Segmentation

S. No	Enterprise Segment	Numbers (crores)	Data set/source
1.	All enterprises (being termed as MSMEs)	6.40	Economic Census
2.	Manufacturing MSMEs	2.00	31% of Economic Censes/Udyam
3.	Manufacturing MSMEs formal	0.35	Industrial Power Connections
3.	MSMEs/Organized sector	0.25	ASI/Factories Act; units employing >10 workers
4.	Informal & Unorganized	1.65	(2)-(3)
5.	Manufacturing Medium Enterprises	0.025	Estimated, based on ASI data



Chapter 1: Access to Timely Payments

1.1 Background

MSMEs are the backbone of the Indian economy driving job creation and employment generation. However, their growth is restricted by the persistent issue of delayed payments from larger corporations and state/central Public Sector Enterprises (PSEs). Mostly micro and small enterprises (MSEs) have been at the receiving end of the delayed payment crisis due to the power asymmetry between smaller suppliers and large buyers. Specifically, around 80% of the annual delayed payments amount is owed to Micro and Small Enterprises (MSEs). According to a report launched by Global Alliance for Mass Entrepreneurship (GAME) and analytics company Dun & Bradstreet (D&B), ₹10.7 lakh crores (USD 130 Bn) are stuck in delayed payments owed to MSMEs in India. This translates to 6% of India's Gross Value Added (GVA). By withholding payments (or trade payables) beyond the agreed credit periods, buyers essentially get access to free cash to finance their own working capital cycles, at the cost of their deprived sellers.

The data on delayed payments reported on Samadhaan portal also paints a grim scenario. Delayed payments to MSMEs continue to be a major issue, with the MSME Samadhaan portal reporting a staggering ₹21,108 crores in outstanding dues. State governments are the largest defaulters, owing MSMEs ₹3,170 crores. Central public sector undertakings follow closely, with ₹2,191 crores in unpaid bills. Over 2 lakh micro and small enterprises have sought relief through the portal, highlighting the urgent need for timely payments to support these crucial economic drivers. The true cost of delayed payments to MSMEs, however, transcends monetary figures. It restricts their ability to raise capital and get access to technology.

The legal system, particularly the arbitration process, can be characterized by its complexity and lengthiness. For MSMEs, navigating these intricacies can be challenging due to limited resources and time constraints. While legal counsel provides invaluable guidance, the arbitration process, even with the advent of online platforms, remains a time-consuming endeavor involving multiple stages. While the Samadhaan platform is a commendable initiative, its execution has encountered certain challenges. Issues such as OTP (One Time Password) delays and a lack of system transparency hinder its effectiveness. To foster a conducive environment for entrepreneurship, it is imperative to instill confidence in MSMEs regarding the timely resolution of their outstanding payments. The government's

support, including through the Samadhaan portal, plays a pivotal role in addressing these concerns. The government must reassure MSMEs of its commitment to facilitating the recovery of their stuck payments.

The issue of delayed payments starts right from the stage of contract formulation. In government procurement, three years of experience with PSUs is required. Unless an MSME starts doing some business they are not able to participate in any of the government tenders. The current policy of requiring final pending payments to be made by March 31st presents several challenges. The auditor of the company is responsible for putting payments-related data on the balance sheet. This extended timeline allows for potential delays and disputes throughout the year, impacting the financial stability of businesses.

1.2 Government Initiatives to Address Delayed Payments to MSMEs:

i. Introduction of the Trade Receivable e-Discounting System (TReDS) portal:

Introduced in 2016, TReDS has become one of the most successful interventions in addressing the problem of delayed payments to MSMEs. It is a simple, easy to use, electronic platform for discounting of bills of MSMEs for supplies to large corporations. There are presently four TReDS platforms operational in India: Receivables Exchange of India Ltd (RXIL), C2treds, M1xchange and Invoicemart. TReDS enables MSMEs to secure financial assistance digitally at competitive terms without any collateral security, based on the invoices / bills for supplies to large corporations. The testament to the success of this initiative is that in March 2025, over ₹30,000 crore worth of bills were discounted across the four licensed TReDS platforms.

Public policy has also played a major role in contributing to the success of TReDS. CPSEs and corporations with over ₹250 crore of turnover have been mandated to register on TReDs. Financier pools have been expanded to introduce NBFC factors. Trade credit insurance is now a possibility which has the potential to enable discounting of receivables for entities that are not as well rated. Government in the recent budget revised the definition of MSMEs, increasing the turnover thresholds to ₹10 crores, ₹100 crores and ₹500 crores for micro, small and medium enterprises respectively, a step that will enable a larger base of companies to avail benefits of TReDS portal.

- ii. **Amendment of Section 43B of the Income Tax Act:** The central government has introduced a new regulation - Section 43B(h) of the Income Tax Act, 1961. This amendment, effective from Assessment year 2024-25, mandates companies to clear payments to MSME vendors within 45 days of accepting goods or services. Section 43B(h) is intended to promote regulatory compliance in financial transactions. By having a regulatory provision that mandates timely payments, MSMEs gain leverage when negotiating payment terms with larger corporations. However, payments to Micro or Small enterprises (MSEs) can only be claimed as expenses in the year of payment. If paid within the time limit specified in Section 15 of the MSMED Act, the expense can be claimed in the year of incurrence. However, if paid after the time limit, the expense can only be claimed in the year of payment, regardless of the ITR due date. This is because the first provision to Section 43B(h) does not apply to payments to MSMEs.
- iii. **MSME-1 Form:** To address the long-standing problem of delayed payments to MSMEs, the government introduced MSME-1 form in January 2019. This form requires companies to report outstanding payments exceeding 45 days. To further strengthen this initiative, the government revised the form in July 2023, seeking additional details from defaulting companies, including the amount due, the due date, and reason for the delay. The July 2023 revision of the MSME-1 form aims to enhance transparency and accountability in payment practices. In addition to the reason for delay and outstanding amount, the form now requires companies to provide specific details on payments made within 45 days through TReDS or other modes, payments made after 45 days, and the amount outstanding for both periods. The form also mandates the inclusion of the MSME supplier's name and PAN.
- iv. **Strengthening Dispute Resolution under the MSMED Act:** The Ministry of MSME has been holding stakeholder consultations with Industrial bodies and associations to incorporate suggestions for proposed amendments in the MSMED Act. The Ministry has also ramped up efforts to strengthen the facilitation councils, establish clearer guidelines for their functioning, and provide flexibility to state governments. The emphasis of improving dispute resolution mechanisms would be on improving the efficiency of adjudication, implementation, and other support systems, including online platforms. In this context, it is recognized that Online Dispute Resolution (ODR) mechanisms offer significant advantages in terms of

time and cost savings. To ensure finality of arbitral awards by Micro & Small Enterprises Facilitation Councils (MSEFCs), Guidelines for Arbitration and Mediation in Contracts of Domestic Public Procurement were released by the Department of Expenditure, Ministry of Finance. The guidelines stipulate that in cases where there is a decision against the government departments or PSUs, the decision to challenge/ appeal should not be taken routinely but only when the case genuinely merits being challenged/appealed and there are high chances of winning in the court/higher court.

1.3 Challenges MSMEs Face in Securing Timely Payments

1.3.1 Unequal bargaining power of MSMEs

Most of the delayed payment issues that MSMEs face are related to their supplies to large corporates, state and central Public Sector Enterprises (PSEs). Larger entities often dictate payment terms that may include longer credit periods, delayed payments, or complex payment mechanisms. MSMEs are unable to submit the invoice for various reasons, including the purchaser has not confirmed the receipt of goods. Many MSMEs face issues of delayed payments due to discrepancies in invoices and payments. This reconciliation process can be time-consuming and frustrating for businesses.

Software solutions often focus on invoice numbers, amounts, and payment details, but they may not be able to resolve disputes or other complex reconciliation challenges. Many Public Sector Undertakings (PSUs) enter contracts with one-sided payment terms that lack clarity and transparency. This ambiguity often leads to delays in payments due to the excessive authority granted to engineers and purchase managers to verify invoices, supplies, and the timely completion of work. Due to the lack of bargaining power, MSMEs supplying to Central Public Sector Enterprises (CPSEs) and large corporations are left with no alternative other than accepting one-sided payment terms of the contract.

The following table highlights the delayed payment status as per Samadhaan portal.¹

Table 2: Delayed Payment Status as per Samadhaan

S. No	Respondent Category	Applications Filed by MSEs	Amount payable as per applications filed (₹Crores)	Total no of pending (Application + Cases)	Pending Amount (Pending + Cases) (₹Crores)
1.	Central Ministries	1463	629	451	220
2.	Central Dept.	2847	1083	907	445
3.	Central PSU	7070	5538	2201	2177
4.	Railway Zone	1066	233	391	87
5.	Railway div.	955	228	367	104
6.	State Govt.	11937	6449	4630	3009
7.	State PSU	3750	2960	1549	1758
8.	MSME Unit	17179	2778	7032	1115
9.	Individual	9683	738	4226	292
10.	Proprietorship	54013	4228	26719	1964
11.	Other	102891	22297	42413	9638

Source: MSME SAMADHAAN – Delayed Payment Monitoring Portal – Pending Amount Report (<https://samadhaan.msme.gov.in>)

As per the data from MSME Samadhaan portal for delayed payment, central and state governments, departments and central and state PSUs account for nearly 40% of delayed payments for which applications have been filed on the Samadhaan portal.

Procurement processes may not always be transparent, making it difficult for MSMEs to understand the criteria and requirements for bidding on contracts. An excessively tedious process for participation poses severe barriers to MSMEs' participation in public procurement tenders. The lack of transparency can create challenges for MSMEs in participating in the procurement process. Not just that, but the imposition of a three-year PSU experience requirement for government tenders poses a significant challenge for new entrepreneurs, limiting their ability to participate in government tenders and secure contracts.

¹ <https://samadhaan.msme.gov.in>

Emerging firms are contingent upon the approval of designated authorities within relevant departments to be enlisted on approved vendor lists. These firms are required to go through lengthy administrative and procedural requirements. Even when MSMEs overcome these obstacles, upon securing contracts, they often encounter challenges in ensuring timely payments, as the sanctity of the contract is not upheld.

1.4 Dispute Resolution Framework Under MSMED Act

The MSMED Act is a beneficial legislation that aims at facilitating the promotion, development and enhancing the competitiveness of micro, small and medium enterprises. The Act includes a dispute resolution mechanism that allows parties to refer disputes to the Micro and Small Enterprises Facilitation Council (MSEFC). The MSEFC can then conduct conciliation or refer the matter to an alternate dispute resolution center. The Act provides for a legal framework to ensure relief to suppliers who are micro or small enterprises. However, there are issues regarding dispute resolution and execution mechanisms. Some of the issues discussed at the regional and national roundtables are presented below.

1.4.1 ‘Works Contract’ and date of registration under MSMED Act:

Payments are being stalled by PSUs on grounds of ‘Works Contract’ not being defined under the Act and the date of registration of MSME supplier. So, without a proper notification from the ministry stating that payments for Works Contract and whatever items are covered under the National Industrial Classification (NIC) codes are payable under the MSMED Act, MSME suppliers are being denied the benefits of the Act. Additionally, the requirement for mandatory MSME registration prior to contract submission is unclear. While the MSMED Act does not explicitly state this requirement, some PSUs are stalling payments based on the date of registration, even though the supplies were after the date of registration. Section 8 of the Act currently gives prospective effect and only those micro and small enterprises can file the case under Chapter V who had submitted the memorandum at the time of dispute. This position was also settled in the *Silpi Industries* case. In the *Silpi Industries* case, for the applicability of the MSMED Act, the date of supply of the goods and services was held to be relevant.

So, MSMEs not registered by submitting the memorandum under section 8 of the MSMED Act on the date of supply of goods and services are unable to avail relief under the Act. The mandatory registration provision on the date of supply of goods and services under Section 8 is not in line with the objective of MSMED Act. This legislation was enacted to ensure speedy disposal of the cases which involve MSMEs. However, going by the above ruling, now the unregistered MSMEs would have to go through regular court proceedings to secure their claims. Furthermore, Section 8 of the MSMED Act employs the phrase “may, at his discretion,” thereby vesting enterprises with the discretion to opt for registration or not.

Government of India, through *Notification No. 2(3)1/2007-MSME Pol (Pt.) dated August 1, 2007*, explicitly clarified that the filing of a memorandum is voluntary for enterprises and there is no time limit for the same. Thus, mere non-compliance of a discretionary provision deprives MSMEs of their substantive right to secure payments conferred by this welfare legislation.

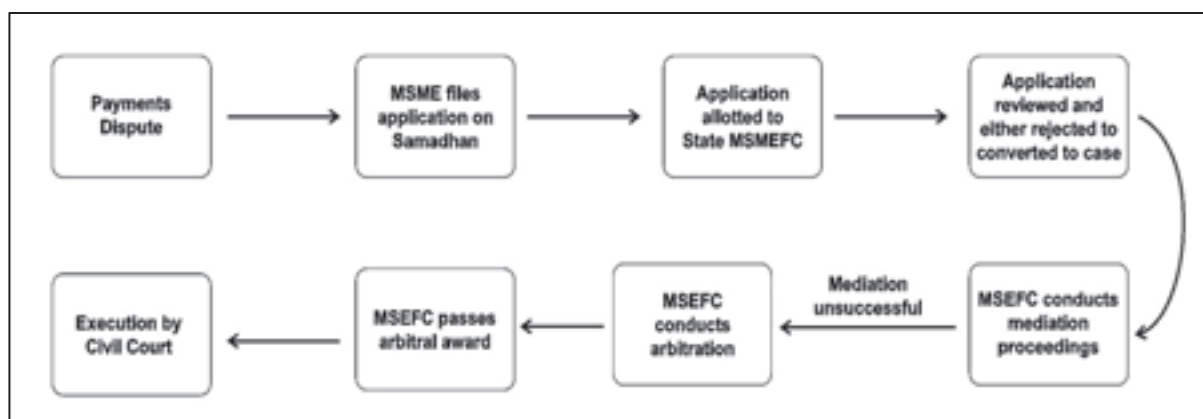
Works Contracts ought to be included within the scope of the Act, thus requiring legislative overruling of the judgement of the Supreme Court in *Silpi Industries* case. The words ‘or any combination thereof’ may be inserted at the end of the provision to include contracts which pertain to both goods as well as services. An explanation may be inserted after section 2(e) to explicitly provide that Works Contracts fall under the scope of this clause. Alignment with National Industrial Classification will be necessary as this currently does not provide for Works Contracts.

1.4.2 Proceedings of MSEFCs

Section 18 of the MSMED Act provides for dispute resolution by MSEFCs. The facilitation councils first initiate mediation proceedings, and if no settlement is reached, the MSEFCs either conduct arbitration proceedings themselves or refer the dispute for institutional arbitration. Many MSMEs at the roundtable highlighted the inefficiency and uncertainty in the adjudication process. A crucial issue identified was the gap between legislation and implementation, with a major challenge being adherence to stipulated timelines. Under the Mediation Act, the time limit for mediation proceedings is 120 days. However, MSMEs report that the facilitation councils often lack the capacity and infrastructure to complete mediation proceedings within the stipulated timeframe. Furthermore, delays are exacerbated when central or state government departments or PSUs are the respondents.

Even in cases where the payment liability is clearly established, settlements are not always reached through mediation.

Chart 2: Dispute Resolution Framework Under MSMED Act:



The dispute resolution process under the MSMED Act typically involves three stages: Mediation (formerly conciliation), Arbitration, and Execution.

During the mediation stage, the seller often initiates the process through the facilitation council, while the buyer may be less proactive. In the execution stage, traditionally, the Civil Courts handled the process after the award. However, some states have begun treating decrees from facilitation councils as land revenue arrears, allowing government channels to handle execution. While this approach can be faster than traditional Civil Court procedures, challenges remain in tracking the progress of execution through government channels.

Personal experiences from MSME suppliers at the Roundtable highlight the difficulties in monitoring case status after submission to District Magistrate (DM). A more robust mechanism is needed to enforce decrees related to land revenue arrears, as delays can undermine the system's effectiveness. Delays in the process can undermine the effectiveness of the system. The Act recommends that conciliation and arbitration processes be completed within 90 days, but this is often not achieved. Even for conciliation, multiple dates are usually scheduled. With the passing of Mediation Act 2023, conciliation has now been subsumed under mediation. However, this has not led to faster disposal of cases by facilitation councils.

There is also a potential conflict of interest under Section 18 provisions, whereby both mediation and arbitration proceedings are conducted by the same council. Under the MSMED Act, once a reference is made u/s 18, the MSEFC conducts mediation

proceedings. If mediation fails to result in a settlement, the same council then adjudicates the payment dispute as an arbitral tribunal. This creates a conflict with the Arbitration and Conciliation Act, as the same body that conducted mediation should not then adjudicate the same matter as an arbitral tribunal. However, the MSMED Act has not addressed this lacuna.

The legal soundness and quality of the award passed by the facilitation council is also affected by the lack of adequate number of legal experts in the council's composition. This makes the Council's award prone to challenge in High Courts. Despite these flaws and scope for improvement, the institution of facilitation council has demonstrated effectiveness in states such as Tamil Nadu and Goa. Therefore, rather than mandating institutional arbitration for all disputes, a more prudent approach would be to focus on capacity building and strengthening these Councils.

Another concern pertains to the composition of the council. The current provision for industrial representation on the facilitation council aligns with the interests of MSMEs. The requirement under Section 21 for the inclusion of the Director of Industries and one or more office bearers or representatives of industry associations is deemed acceptable by MSMEs, as it ensures balanced representation and facilitates the effective addressing of their concerns during proceedings. However, the 5-member facilitation council poses another problem, as meetings can be delayed when a member is unavailable.

Section 21 of the Act empowers state governments to establish procedures for the discharge of functions by members of MSEFCs. This has led to variations in fee structures across different states. In the UPMSEFC, for dispute amounts up to ₹5 lakhs, the fee is ₹3,000, while in Haryana MSEFC, for disputes below ₹2 lakhs, the fee is around ₹5,000. While the fee structures for dispute resolution in UPMSEFC and Haryana MSEFC vary, they highlight the need for a standardized and equitable approach, particularly for micro and small enterprises. Even within the graded fee structure, the maximum fee limit should be prescribed for micro and small enterprises. While, for micro enterprises, the reference fee to MSEFC should not exceed ₹2500 irrespective of the dispute amount.

1.4.3 Execution and Enforcement of Award

In 2022, in the matter of *Delhi Airport Metro Express Private Limited vs Delhi Metro Rail Corporation Ltd.*, the Supreme Court categorically observed that India cannot aspire to be an international arbitration hub without effective enforcement of arbitration awards. For

MSMEs, obtaining a favorable award from the MSEFC represents only half the battle; the real struggle begins when the decree-holder (the MSME) approaches the executing court. In *Rahul S. Shah v. Jinendra Kumar Gandhi* (2021), a three-judge bench of the Supreme Court directed that executing courts must dispose of execution proceedings within six months of filing, extendable only by recording written reasons for the delay. This position was reiterated by a two-judge bench of the apex court in 2022. However, execution delays persist, denying MSMEs the benefits of awards granted by the MSEFC.

But the question is: why do MSE suppliers have to go through so much struggle to execute what has already been granted in their favor in the proceedings of the facilitation council? The flaw can be attributed to both procedure and system. While the arbitral award of the MSEFC ought to be executed, the rules framed under certain MSEFCs state that the execution of the award should be carried out by the Collector. As per Rule 10, of Haryana MSEFC, *the award of Council is to be executed by the Collector of the District where the property of Judgement Debtor (JD), i.e. the buyer is located*. However, recent judgments by several High Courts and observations made by the Supreme Court have established that an arbitral award, whether from institutional arbitration or passed by the MSEFC, shall be executed as a money decree. Therefore, it is to be executed either by attachment and sale of JD's property or by Civil Imprisonment of JD. Nevertheless, buyers frequently invoke the provisions of State Facilitation Councils, which empower District Collectors to execute awards, to prolong the enforcement process.

1.4.4 Finality of Award of MSEFC

Another issue in execution is the lack of finality of arbitral award due to appeals against it. Most of the payments disputes that are referred to facilitation councils involve payments made by Micro and Small suppliers to CPSEs, State PSUs or departments of Central/State governments. Despite the legal framework of the Mediation Act, which makes a mediated settlement binding on the parties, MSMEs have found it difficult to reach a mediated settlement when the other party is a state or central government enterprise or department. Under the Arbitration and Conciliation Act, the decisions of arbitrators are final and grounds for challenge are very limited (Section 34 of the Act). However, in practice, the benefits of finality have not been fully realized. Finality ought to have been an expected benefit for MSMEs, to develop trust in the Alternate Dispute Resolution (ADR) mechanisms.

The system of decision-making in government involves accountability to Parliament, with multiple levels of scrutiny before and after decisions are made. Despite the finality envisaged in theory, government departments frequently demonstrate reluctance to accept adverse decisions, opting instead to pursue legal remedies. Acceptance of an adverse award when recourse to appeal to courts is available is perceived as inefficient by various departments. Government officers may have differing approaches to compliance. While some may adopt a conciliatory approach toward mediated settlements, others may see compliance with facilitation council awards as indicative of procurement process inefficiencies, leading them to challenge such awards, even when liability is established.

Expectation that challenges to arbitral awards would be rare and on concrete grounds, has not been realized in practice. Therefore, instead of reducing litigation, it has become virtually an additional layer and source of more litigation, thereby delaying final resolution. As a result, the objective of alleviating the burden on courts has not been achieved. An arbitral award passed by facilitation council without any provision for its speedy disposal is an anathema to arbitration proceedings. A fundamental re-evaluation of both the legislative framework and procedural mechanisms is therefore required.

To address the issue of finality in MSME laws, it may be helpful to establish guidelines from the Apex Court. This could provide a framework for resolving disputes without being constrained by constitutional restrictions. Article 226 of the constitution grants High Courts broad powers, which can sometimes lead them to circumvent legal limitations. The decision to initiate an appeal against an adverse arbitral award involving a government department or undertaking should not be solely vested in the subjective discretion of the concerned official in charge of the department. Decisions regarding appeals should be made pragmatically, considering both long-term public interest and the legitimate claims of MSME suppliers.

In cases where a decision goes against the government or PSUs, the decision to challenge or appeal should not be routine but based only on cases that genuinely merit such action, with a high chance of success. The introduction of a threshold limit for challenging arbitration awards could mitigate the subjectivity inherent in the appeal process. *Guidelines for Arbitration and Mediation in Contracts of Domestic Public Procurement* released by Department of Expenditure, Ministry of Finance also emphasize the finality of arbitral awards, stating that government departments/entities/agencies should settle as many disputes as possible

using available mechanisms. States could consider seeking an advisory opinion from the Supreme Court to address the finality of arbitration awards. This could help protect MSMEs and promote economic development.

Another issue impacting the finality of the award is the territorial jurisdiction of the MSEFC. The current practice of conducting final contract execution in the customer's location places an unnecessary burden on suppliers, particularly those located in different regions. This process often involves additional costs and logistical challenges, further hindering the timely receipt of payments. To streamline the process and reduce supplier burdens, it is recommended that the final execution of contracts take place in the vendor's town or city. For buyers located outside the territorial jurisdiction of MSEFC that passed the award, the award should be permitted to be executed by the MSEFC under whose territorial jurisdiction the buyer is located.

Given its beneficial nature, the MSMED Act should incorporate provisions for execution and enforcement of arbitral awards by MSEFCs. The regulation of such execution and enforcement should be explicitly addressed within the Act itself. It is also essential to undertake necessary amendments to the Code of Civil Procedure, particularly in relation to execution jurisdiction. These modifications will necessitate specialized attention within the domain of Civil law. To expedite the disposal of awards, increasing the number of benches dedicated to such matters could be considered, as repeatedly urged by the Supreme Court. Additionally, consideration should be given to streamlining the procedural framework outlined in the Code of Civil Procedure, particularly with respect to the enforcement of arbitral awards. With the establishment of specialized commercial courts, High Courts should also consider creating distinct benches to handle commercial disputes. Recent developments, such as the enactment of the Mediation Act, 2023, have necessitated a re-examination of the government's approach to ADR mechanisms like arbitration and mediation. Mediated settlement agreement carries the force of a decree and is binding on the parties. MSMEs should not be required to approach courts for its execution.

1.4.5 Admissibility of Appeal u/s 19

There are concerns about the admission criteria for appeals under Section 19 of the MSMED Act. The provision requiring a 75% deposit is sometimes not strictly enforced by courts. Even when this amount is deposited, it is not always paid to the MSME supplier. Rulings by the Allahabad and Calcutta High Courts, which have upheld that compliance

with Section 19 of the MSMED Act is mandatory for seeking a stay of an award. The High Courts have held that pre-deposit is a condition precedent for a buyer to seek setting aside of an award under the MSMED Act, and without it, the application for stay would be stillborn. The delayed payments result in MSME cash flow being blocked.

While the 75% deposit could be considered in three installments, depositing less than 75% of the award amount by the buyer is detrimental to MSMEs. To address this, it is suggested to incorporate a more structured process for assessing admissibility and ensuring consistent application of the deposit requirement. Additionally, the 75% deposit should be provided directly to the MSME supplier to alleviate their financial burdens, rather than through a bank guarantee. This would ensure that MSME suppliers do not suffer business losses while the appeal against the award is being adjudicated upon by the court.

1.4.6 Capacity of MSEFCs

The Micro and Small Enterprises Facilitation Council (MSEFC), commonly referred to as the MSME Court, is a state-level institution established to resolve payment disputes between Micro or Small suppliers and buyers. The MSEFC examines claims filed by MSME suppliers for delayed payments and directs buyers to fulfill their payment obligations, including applicable interests. The MSMED Act provides authority to MSEFCs to decide upon the payments dispute under Section 18 of the Act. MSMEs face procedural difficulties in making a reference to MSEFCs. For the dispute resolution process to be initiated by MSEFCs, the application filed by the supplier on the Samadhaan portal must first be converted into a regular Reference Petition/Claim case. Under the Samadhaan scheme, MSEFCs are tasked with adjudicating these cases. These councils are often staffed by part-time officials, and there is simply not enough manpower to effectively handle these cases.

The process, which involves filing of an application, its conversion into a formal case, and subsequent resolution through either mutual agreement or arbitration, is often protracted. To ease the burden on the MSEFCs, zonalization of MSEFCs can be considered to address capacity needs. The state governments under Section 20 of the MSMED Act are empowered to constitute additional councils. Currently, if there is no action on an application, the concerned MSEFC must be contacted after filing the application online on Samadhaan portal. The primary cause of delay often lies with the MSEFCs themselves, as they may take considerable time to initiate proceedings. Moreover, there is no alternative

authority to which MSMEs can appeal if the facilitation council fails to address their complaint.

Even in cases, where buyer has not raised objection within stipulated time and the payment liability on part of buyer is clearly established, supplier is required to furnish additional documents within fifteen days of announcement to MSEFC. Furthermore, the petitioner (supplier) is needed to send a copy of the reference to the buyer against whom the reference is directed. This additional documentation creates time and cost burdens, especially for micro units with limited resources.

A recommendation to expedite the process at MSEFCs could be incorporation of documents-only arbitration through the procedure given in S.29B (Arbitration & Conciliation Act, 1996) for smaller claims. For claims of small amounts, summary proceedings could be conducted for dispute resolution. However, incorporation of fast-track procedure under Section 29B of Arbitration Act has its own constraints. The fast-track procedure outlined under Section 29B stipulates a sole arbitrator to decide the dispute. Allowing referral of cases by MSEFCs to sole arbitrators has the potential fallbacks of increased fees and partiality of sole arbitrators. Arbitration/ Arbitrators could be introduced to expedite arbitration. However, impartiality and independence of the process must be ensured.

Incorporating documents-only arbitration, as outlined in Section 29B of the Arbitration and Conciliation Act, 1996, for smaller claims where payment liability is clearly established, could be a viable option to expedite proceedings at MSEFCs. Additionally, for disputes exceeding a specific threshold or involving complex matters, suppliers could be granted the option of either referring the matter to MSEFC for arbitration or opting for institutional arbitration.

Another concern MSMEs have with the proceedings of facilitation councils is non-compliance with stipulated timelines and legal quality of the award. Upon receipt of a reference, the Chairperson of MSEFC examines the buyer's responsibility for delayed payment. The facilitation council will first conduct mediation proceedings for each reference placed. The buyer and supplier are required to appear for verification. According to the MSMED Act, mediation proceedings by Councils are to be conducted as per the Mediation Act, 2023, in which the period for arriving at a mediated settlement is 120 days extendable to a maximum of 180 days. The requirement for oral hearings can lead to procedural delays, particularly when the buyer fails to attend.

Furthermore, the principle of mutual consent inherent in the mediation process can impede resolution when the buyer refuses to accept their payment obligation. If mediation does not lead to settlement of dispute, the MSEFC either acts as an arbitrator or refers the case for institutional arbitration. MSMEs have found that the 120-day timeline is rarely adhered to. To expedite the dispute resolution process, it is imperative to make adherence to timelines mandatory rather than discretionary. Furthermore, the imposition of penalties on buyers for unjustified delays could serve as a powerful incentive for prompt action. In instances where buyers deliberately delay the process by raising frivolous objections or deny claims that are supported by verifiable documents, penalties could be imposed in addition to interest, if the award of facilitation council is in favor of the supplier.

Composition of MSEFC is also closely linked to the capacity of MSEFC. The current composition under which MSEFCs can have minimum of three and maximum of five members allows for industrial representation. As per Section 21 of the Act, one or more office-bearers or representatives of micro or small industry associations in the state must be members of the council. A two- or three-member bench can be proposed for composition of MSEFC, while retaining the representation of industrial bodies/associations.

The absence of adequate legal experts in facilitation councils results in awards that are not legally sound and are vulnerable to challenges under Section 34 of the Arbitration & Conciliation Act. Since Section 34 has already been narrowed, MSEFCs must be upskilled to enhance the quality of awards so that Section 34 applications are not routinely entertained by High Courts. For complex cases or claims involving large amounts, where liability is not clearly established, industry experts could be appointed as *Amicus Curia* and their recommendations could be taken into consideration for deciding disputes.

A regulatory and supervisory board could be established in every state as a governing body for MSEFCs, with responsibilities including providing data on delayed payments by both public (government and PSUs) and private buyers, as well as capacity building for MSEFCs. In cases where suppliers perceive undue delays on part of buyers or arbitrary rejections by facilitation council without providing reasons or there has been a long delay in conversion of application to a case, the supplier must be allowed to approach the Board for intervention.

1.4.7 Conflict between MSMED Act and Arbitration & Conciliation Act

The issue at hand is the interplay and dichotomy between the provisions as stipulated in the MSMED Act and the Arbitration and Conciliation Act, 1996 ('Arbitration Act'), and analysis into the possible impacts which the recently enacted Mediation Act, 2023 ('Mediation Act') is likely to have on the paradigm.

In India, arbitration agreements are primarily governed by the Arbitration and Conciliation Act. This Act empowers parties to include arbitration clauses in their contracts, thereby enabling them to resolve disputes through arbitration proceedings. On the other hand, Section 18 of the MSMED Act empowers the facilitation council to either act as an arbitral tribunal to settle such dispute or refer it to an arbitration Centre or institution provided that the mediation proceedings started before it as per Section 18(2) of the said Act stands terminated.

The Hon'ble Supreme Court has analyzed the interplay between the MSMED Act, and the Arbitration Act in a very detailed manner in the *Gujarat Civil Supplies case* and categorically held that "Chapter V of the MSMED Act, 2006 would override the provisions of the Arbitration Act, 1996. The usage of non-obstante clauses in Part V of the MSMED Act highlights the legislative intent of giving preference to the Act.

It is evident from the judicial trend in India that the nature of the MSMED Act is prospective in nature. The most important aspect of the prospective nature of the Act is registration under Section 8 on the date of delivery of goods or services to claim benefits of the Act. Prospective application of a beneficial legislation is impracticable as it prevents parties from invoking claims arising out of contracts entered by them before they were registered as a supplier under the MSMED Act based on two grounds. Firstly, this approach is inconsistent with the objectives and purpose of the MSMED Act. Secondly, a small proportion of MSMEs in India are formally registered, this approach would deprive the majority of MSMEs of an effective remedy.

However, the question that which statute would be given preference becomes contingent on the fact that which statute is invoked first in case of a payments dispute. Buyers could circumvent the facilitation council by initiating arbitration proceedings pursuant to the arbitration agreement. This could potentially undermine the remedial measures available to MSMEs under the MSMED Act.

Another issue is related to potential bias in the proceedings of MSEFCs as it plays the role of both mediator and arbitrator in deciding the dispute. Under the MSMED Act, once a

reference is made u/s 18, the MSEFC conducts mediation proceedings. If mediation fails to arrive at a settlement, the same Council then adjudicates the payment dispute as Arbitral Tribunal. This conflicts with the Arbitration and Conciliation Act as the same body that did mediation, or conciliation cannot then adjudicate the same matter in the capacity of an arbitral tribunal. To a certain extent, this conflict was addressed by the Supreme Court. The Court opined that since the MSMED Act overrides the provisions of the Arbitration Act, and the said provision under Section 80 cannot be a bar for the facilitation council to act as conciliator and arbitrator. The bar on the same body to act as mediator and arbitrator placed in section 80 of the Arbitration Act was to prevent the emergence of bias and ensure a fair arbitration procedure. While conciliation has been subsumed under mediation, the potential for bias remains, particularly when the facilitation council assumes dual roles as both mediator and arbitrator.

If there exists any degree of bias during mediation, it may impact the impartiality of the arbitrators as well since they are the same entity. Moreover, challenges to the appointment of such arbitrators on grounds of bias could lead to additional litigation, thereby defeating the intended purpose of the MSMED Act. The facilitation council's dual role in both mediation and arbitration increases the likelihood of arbitrary awards, which may be subject to legal challenges in High Courts. Having a separate panel for mediation and arbitration proceedings by the facilitation council can be an effective strategy to minimize the potential for bias. However, this measure must be carefully considered in light of the existing delays in the facilitation councils' proceedings.

Since the Act was last amended in 2006, many of the pain points expressed will need to be addressed through legislative changes. The focus must be on strengthening the institution of facilitation councils, providing flexibility to state governments, and establishing clear guidelines for the functioning of these councils. This includes improving the efficiency and certainty of the adjudication process. Another crucial area is reducing the gap between adjudication and implementation.

1.5 Challenges With Samadhaan Portal

MSME Samadhaan is a mechanism introduced by the Government of India to facilitate the resolution of delayed payment disputes for MSMEs. It provides a platform for MSMEs to file applications and seek redressal for delayed payments from both government and private sector buyers. Samadhaan portal holds significant importance for MSMEs as it

provides a legal framework to address delayed payment issues and ensure timely receipt of payments.

As of now, over two lakh applications have been filed on the portal, with a total amount of delayed payments standing at ₹47,000 crores. Despite the potential of Samadhaan portal, the actual case disposal rates remain poor. The following table shows the pendency of cases by MSEFCs.

Table 3: Applications & Case Status of Micro and Small Units (MSEs)²

No.	Category	Status (No.)
1	Total No. of Applications filed by MSEs	2,14,371
2	Applications mutually settled	20,000
3	Applications pending (yet to be viewed by MSEFCs)	50,916
4	Applications rejected by MSEFCs	59,629
5	Application converted to cases and disposed by MSEFCs	43,287
6	Cases pending (under consideration by MSEFCs)	40,539

Source: <https://samadhaan.msme.gov.in/>

51% of the applications filed by MSEs are in the application stage. They have been either rejected or are yet to be converted to cases. Only 39% of the applications that have been viewed by MSEFCS have been either mutually settled or converted into cases and disposed of. Out of the 83,826 applications converted into cases, about 48% remain pending and under consideration at MSEFCs. These figures clearly demonstrate the capacity limitations of the MSEFCs. It could take several years before the pending applications are disposed of.

Experiences shared by MSMEs during the regional and national roundtable discussions shed light on the various difficulties faced in filing on Samadhaan portal. To file a case for delayed payments, the process needs to start on the Samadhaan portal. One issue is the delayed receipt of OTPs, which are required within a 30-minute time limit. This ongoing

² <https://samadhaan.msme.gov.in/>

issue needs to be addressed to improve the effectiveness of the Samadhaan portal. Further complications arise as MSMEs are required to upload various documents to support their claims, including signed contracts, work orders, invoices, and proof of delivery.

In most cases, MSMEs don't have proper documents to begin with. They often supply goods to buyers based on informal agreements, rather than formal written contracts. This is especially true for micro units, which may not have proper documentation such as purchase orders or invoices or may lack the necessary legal formatting. Even when documents are available, the paperwork is often extensive, leading to incomplete submissions and rejections. Another issue is the delay in filing applications, as MSMEs often struggle to track payments due, resulting in significant gaps between payment due dates and filing. Timeliness is crucial in MSME Samadhaan cases. Delaying the filing of applications can hamper MSMEs chances of recovering the delayed payments.

MSME Samadhaan portal's procedures require adherence to specific regulations, and failing to follow these can lead to errors in the application process. It therefore becomes crucial for MSMEs to familiarize themselves with the requirements and adhere to them diligently. After filing an application under MSME Samadhaan, it is essential to actively follow up and track the progress of your case. Failure to do so can result in delays or missed opportunities for resolution, forcing MSMEs to divert limited resources from core business operations.

There is also no record of pending arbitration cases involving central or state government departments or enterprises. Even though the Samadhaan MSME portal maintains data on pending applications and cases at MSEFCs, it is not segregated by public and private buyers. It is crucial to gather data on appeals pending in courts against awards passed by MSEFCs. Public sector enterprises at both the state and central levels should be mandated to disclose data regarding arbitral awards passed against them, including the number of awards, appeals filed, and appeals pending. A central regulatory board could be established to collate such data and make it publicly available.

There is a need to reorient the Samadhaan portal and make it more accessible and user friendly for Micro and Small suppliers. One step could be to provide standardized contract templates covering all types of transactions, available in both English and vernacular languages. MSMEs could then be encouraged to find the most appropriate template as applicable to their business and transactions. Standardizing contracts would significantly streamline the dispute resolution process for MSME councils, enabling them to expedite

the disposal of cases related to delayed payments. Raising awareness among MSMEs about both the functioning of the Samadhaan portal and best practices in business documentation is crucial. The digitization and automation of the entire Samadhaan system, from application initiation to final resolution, would significantly expedite the process, offering much-needed relief to MSMEs.

1.6 Online Dispute Resolution

Online platforms are particularly suitable for mediation, especially in the context of commercial disputes where forensic evidence is often not required. Many arbitration proceedings can also be conducted online, offering significant time and cost savings, which is especially important for MSMEs.

According to NITI Aayog ODR handbook 2021, the adoption of ODR has the potential to contribute approximately ₹1,99,000 crores to GDP. However, for Online Dispute Resolution (ODR) to be successful, clear guidelines need to be laid out. Digital penetration is critical in ensuring uptake for ODR. Digital technology has not yet permeated all corners of the country. There are many concerns that MSMEs have for the ODR process. Some of these concerns are:

- i. Dehumanization of human-centric processes
- ii. Lack of digital literacy, insufficient confidentiality
- iii. Secrecy of proceedings
- iv. Risks to confidentiality when using third party applications
- v. Inability for technology to handle the varying complexity of legal cases
- vi. Difficulty for the advocate in building rapport with parties

Many of the nations including India do not have robust digital infrastructure which is the first and foremost requirement of ODR. There is also a growing talk of incorporating Artificial Intelligence and Machine learning Models within ODR. However, algorithmic technology can be biased, and this bias can be further amplified in the algorithms themselves. While a shift towards ODR seems inevitable, clear regulatory guidelines, accountability, and data security are essential for its effective implementation. Despite the drawbacks, ODR platforms will continue to evolve and have the potential to enhance, rather than replace traditional ADR methods.

1.7 Key Recommendations For Addressing Delayed Payments

Some of the key recommendations to strengthen the dispute resolution mechanism under the MSMED Act as emerged from the regional and National Roundtables are summarized below:

- i. **Inclusion of Works Contract under MSMED Act:** Works Contracts ought to be included within the scope of the Act. The words ‘or any combination thereof’ may be inserted at the end of the provision to include contracts which pertain to both goods as well as services. Alignment with National Industrial Classification will be necessary as this currently does not provide for Works Contracts.
- ii. **Date of Registration under Section 8, MSMED Act:** It is suggested that the Section 8 may be given retrospective effect to include those enterprises who have obtained the registration after the dispute has taken place.
- iii. **Expediting the proceedings at MSEFCs:** Incorporation of documents-only arbitration through the procedure given in S.29B (Arbitration & Conciliation Act, 1996) for smaller claims where payment liability is clearly established could be an option that can be considered. Additionally, for disputes exceeding a specific threshold or involving complex matters, suppliers could be granted the option of either referring the matter to MSEFC for arbitration or opting for institutional arbitration.
- iv. **Ensuring Finality of Award:** To address the issue of finality, it might be helpful to establish guidelines from the Apex Court. This could provide a framework for resolving disputes without being constrained by constitutional restrictions. The introduction of a threshold limit for challenging arbitration awards could mitigate the subjectivity inherent in the appeal process.
- v. **Admissibility of appeal under Sec 19:** It is recommended to incorporate a more structured process for assessing admissibility and ensuring consistent application of the deposit requirement. Additionally, the 75% deposit should be directly provided to the MSME supplier to alleviate their financial burdens, rather than through a bank guarantee.
- vi. **Database on pending Arbitration cases:** All PSEs, both at the state and central levels, should be mandated to disclose data pertaining to arbitral awards passed against them related to payments to suppliers. This data should include the number of awards, the number of appeals filed against these awards, and the number of such appeals

currently pending. The central regulatory and supervisory board could be assigned as the nodal body for collating such data and making it available in public domain.

- vii. **Making Samadhaan portal more user friendly:** There is a need to reorient the Samadhaan portal and make it more accessible and user friendly for Micro and Small suppliers. To begin with, various standardized contract templates that cover all types of transactions could be made available on the portal in English and vernacular languages. Raising awareness among MSMEs about both the functioning of the Samadhaan portal and best practices in business documentation is crucial.



Chapter 2: MSME's Access to Credit

2.1 Background

MSMEs have long been a cornerstone of India's economic growth. A persistent challenge faced by MSMEs, despite their pivotal role in India's economy, is the difficulty in securing timely and sufficient formal credit, hindering their ability to thrive. A 2022 report by the Lok Sabha Standing Committee on Finance stated that the credit gap in the MSME sector is to the tune of ₹25 lakh crores, with about 47% of the MSME credit demand remaining unmet. Among the 64 million MSMEs in the country, only 14% have access to credit. A study by the International Finance Corporation (IFC), every USD 1 Million loan to MSMEs created an average of 16 additional permanent jobs when compared to firms that did not have access to finance.

In the context of a growing economy, increasing MSMEs' access to affordable formal financing is crucial. However, lending institutions often remain cautious about the commercial viability of loans to MSMEs. This, coupled with information asymmetry, can significantly delay the disbursement of funds. As a result, MSMEs with urgent financing needs may resort to alternative, often informal, sources of credit. It's also interesting to note that an increasing number of MSME borrowers are availing loans of lower ticket sizes. Recent reports also reveal that the loan ticket size at public sector and private banks have reduced by 21% and 7% respectively.

On its part, the Reserve Bank of India (RBI) has consistently prioritized the inclusion of MSMEs in the formal financial system through a range of targeted measures. One of the key initiatives is the Priority Sector Lending (PSL) guidelines, mandating a sub-target of 7.5% of banks adjusted net bank credit for micro enterprises, and all loans made to MSMEs coming under PSL. However, over the past two decades the definition of Priority Sector Lending has been considerably widened and banks find it much easier to grant housing loans based on history rather than consider lending to MSME based on future projections.

2.2 Status of MSME Credit

The government has increased the lending target for scheduled commercial banks and Non-Banking Financial Companies (NBFCs) to MSMEs this financial year by ₹1.54 trillion, aiming for a credit flow of ₹5.75 trillion in 2024-25. The target has been

subsequently increased to ₹6.21 trillion and ₹7 trillion for 2025-26 and 2026-27, respectively.

Table 4: Credit low target to MSMEs:³

FY	In INR Lakh Crores	In USD Billion
2024-25	5.75	68.12
2025-26	6.21	73.57
2026-27	7.00	82.93

Table 5: Growth in Outstanding loans over last 2 FYs

Type of Lending Institution	Growth
Public Sector Banks	9.2%
Private Sector Banks	25%
NBFCs	39%

Table 6: Status of Mudra Loans

Growth of loans to MSMEs	20.1% year on year as on March 2024
NPAs on Mudra loans for PSBs	3.4 %
NPAs on Mudra loans for Private Sector Banks	0.95%

2.3 Challenges For Access to Credit

RBI and Government of India have taken several initiatives to enable MSMEs access to formal credit. Some of these initiatives include incorporation of MSMEs under Priority Sector Lending and credit guarantee-based lending schemes. Two important measures related to access to credit announced in the budget included a new assessment model for MSME credit rating based on digital footprints of MSMEs in the economy and reduction of turnover threshold of buyers for mandatory onboarding on the TReDS platform from ₹500 crores to ₹250 crores. Despite these initiatives, many issues and constraints in

³ 'Credit for growth: Enhanced credit flow to boost MSME investment, growth'- Business Standard 12 Nov 2024

securing formal credit persist for MSMEs. Some of these issues were deliberated at the regional and national roundtables and are summarized below.

2.3.1 Mechanism for SMA classification

According to the SMA classification policy, banks are required to put accounts with exposure of ₹5 crores (fund plus non fund) into three categories: SMA-0 (if account showed signs of incipient stress even if principal/ interest not overdue for more than 30 days); SMA-1 (if principal/ interest payment overdue for 31-60 days) and SMA-2 (if principal/ interest payment overdue for 61-180 days).

It is reported that a red flag is raised even if principal/ interest payments get delayed by 30 days. Once an account is flagged as SMA, the account becomes a pariah, and the bank brings even the normal banking operations to a grinding halt. The objective of bringing in SMA framework was that if there is any incipient sickness, it will be addressed, and the unit would be made viable again. However, the approach relies heavily on the judgment of bank managers, who often rely on spreadsheets and credit ratings to assess the viability of businesses. However, this reliance on quantitative data may overlook qualitative factors that are essential for accurately evaluating a company's financial health and potential for recovery.

Box 1: Challenges in SMA Classification

We present the following two cases to highlight how the SMA classification process is impacting SMEs.

Case-1: Jaipur based MSMEs having a small plant in China got its operations severely hampered post Covid closure of China. The company consistently got export awards but after eth SMA grind turned into NPA and was forced to close-down. Properties sold to settle dues.

Case-II: Bangalore based MSME, among the top three global manufacturers of granite pickling tanks for Steel plants got into headwinds because Covid led disruptions in Steel industry. Russia-Ukraine crisis exacerbated the crisis. SMA strangled the running industry and forced it close.

Now, as the health of the account starts falling, the tendency is instead of being tender, banks start adopting a tough stance. Threatening severe action on the account becoming

NPA. The first step taken by banks is to increase the rate of interest, causing further burden on the borrower. The worst situation is once the account slips into the NPA category, banks show reluctance and do not undertake quick restructuring.

Prompt payment delays can exert significant pressure on promoters. A more borrower-centric approach is necessary. While certain RBI directives may be advisory in nature, others are mandatory, often leading to inconsistencies. The current 90-day NPA classification period may be too stringent, especially when compared to the 180-day period common in advanced economies, particularly for high-risk sectors. It is recommended that accounts should not be flagged as Special Mention Accounts (SMAs) or Non-Performing Assets (NPAs) until a thorough evaluation of any rehabilitation proposal is conducted. Such premature classifications can have detrimental effects on the industry.

The current system for determining the amount of financial assistance provided to sick businesses is based on a predetermined percentage, such as 10% of the guaranteed amount. To improve the effectiveness of financial assistance programs, it is recommended that a more comprehensive evaluation process be implemented, incorporating both quantitative and qualitative factors. This would allow for a more nuanced assessment of a company's situation and ensure that financial assistance is provided to those businesses that are most likely to benefit from it.

The original intent of the SMA classification was to provide a corrective measure, not a punitive one. However, there have been instances where it has been misused, such as placing businesses in the OPD instead of providing necessary support. RBI and Ministry of Finance have recognized this behavioral issue and taken steps to address it. While some procedural changes have been implemented, further action is needed to ensure proper implementation. RBI's SMA classification policy is meant to be an early warning of NPAs. RBI's last circular for SMA classification guidelines and criteria for identification of incipient stress came out in 2015. Since then, the framework for Revival and Rehabilitation has not been revised/updated. The SMA framework should be immediately reviewed and also a liberal restructuring option be given to MSMEs affected by Covid and geo-political turmoil. (*Refer Annexure for RBI Circular FIDD.MSME & NFS.BC.No. 21/6.02.31/2015-16 dated 17th March 2016*). Clarification should be issued for guidelines for identifying incipient stress. Unless bankers examine the rehabilitation proposal, the account should not be flagged SMA or NPA. Such flagging is counter-productive and affects the industry. Banks

should be directed not to discontinue normal banking facility to MSME unit that has been flagged as SMA.

MSMEs have expressed concerns regarding the 30-day period for classifying accounts as Special Mention Accounts (SMA-0). This timeframe may not realistically reflect the financial stability of a unit, as external factors beyond the unit's control can impact timely payments and cash flows. Once an account is classified as SMA, banks often adopt a more conservative lending approach, potentially limiting future financing options for the affected MSME. Hence an MSME unit that had the potential of financial recovery is rather pushed to further distress. Classification of MSME Unit as SMA within 30 days for reasons which are beyond the control of unit is contrary to the policy of SMA framework which was brought to identify incipient stress and facilitate corrective action for restructuring or rectification.

Therefore, the number of days for which principal and interest payment becomes due and the account gets flagged as SMA should be revised to 60, 61-90 and 91 to 120 for SMA-0, 1 and 2 respectively. Once a customer becomes an SMA due to reasons beyond their control (like delayed payments from corporate clients, accidents, or business interruptions), the possibility of creating a guarantee scheme to support banks should be explored. This would help banks mitigate risk and allow for more flexibility in dealing with these situations.

Restructuring during Covid-19 could be a good lesson to learn. Only due to clear guidelines of RBI, accounts could be restructured without down gradation into NPA during Covid-19 times. Without clear RBI guidelines, restructuring of loans would not have taken place.

2.3.2 Approach of banks while lending to MSMEs

A crucial consideration is to accurately assess the specific financial requirements of the industry. Underfinancing can lead to a loss of potential value, while overfinancing exposes the investment to unnecessary risk. The optimal approach involves providing the precise amount of financing needed to support business's growth and operations. This requires a careful and realistic evaluation of the company's financial health, historical performance, and future prospects. Given their expertise and insights into the industry, bankers are well-positioned to conduct such assessments and make informed lending decisions.

Another critical factor to consider is the impact of uncontrollable circumstances. For instance, a fire incident can lead to significant losses, including the destruction of valuable

inventory. In such situations, banks may fail to provide adequate support, opting instead to pursue recovery measures, such as property attachment. This approach often disregards potential insurance claims and can have severe consequences for the affected business. The increasing dominance of private sector banks in the industry may further exacerbate this issue.

Many MSMEs are facing Non-Performing Asset (NPA) or Special Mention Account-2 (SMA-2) classifications due to delayed payments from their customers, often PSUs and government departments. Given that these delays are beyond MSME's control, banks need to adopt a more lenient approach, avoiding immediate classification as SMA-1 or SMA-2 and granting additional time. Banks often treat accounts as overdue after only 10-15 days, especially in the current market conditions. This can lead to pressure to recover funds quickly.

Banks tend to prioritize shareholder interests over loan security. They are concerned that changes in transaction numbers could negatively impact a unit's credit rating. For instance, if a unit with a ₹5 crore turnover acquires additional business from another entity, a decrease in this additional turnover could potentially lower the unit's credit rating. However, banks, should primarily focus on the security of the loan extended by them rather than the financial performance of unrelated entities.

It is the Public Sector Banks which lend to the MSME sector, especially to those borrowers who require loans beyond Mudra threshold. Private Sector Banks' unwritten policy is not to entertain prospective borrowers till they show three years of profitable financial performance. This problem gets compounded because private sector banks chase the prospects for opening Current Account. However, they do not support if the same customer wants credit support.

Underfinancing often results in mortality. If the working capital cycle is not adequately financed, the borrower finds it difficult to run the business. If he manages to get a large order, his first concern becomes how will he meet additional fund requirements. The banks and the regulator have become strict on short term spike funding for the fear that it may give rise to evergreening. In the process, genuine borrowers suffer. A simple example is one can press the accelerator of the vehicle only if there is fuel in the tank. Adequate & need based funding is key to the progress of MSME. In the absence of lending support from banks, the entrepreneur borrows from informal sources / NBFCs which are costlier.

As to working capital finance for MSME, banks still demand Credit Monitoring Analysis (CMA) reports, which the small entrepreneur is unable to provide. When confronted with the Nayak committee recommendations, lenders say that they have their own norms. The Nayak committee recommendations are a much simpler tool to assess working capital requirements and easy to understand by the entrepreneurs. Further, GST returns help in tracking actual performance. It should be emphasized that for Working Capital requirements of the MSME borrowers, a simple formula suggested by the Nayak committee should be the norm. Only if the borrower is demanding more, then a detailed CMA data be sought.

Banks have interpreted 2016 RBI circular guidelines regarding diversion of funds in an impractical manner. In this regard, provisions related to diversion of funds in the RBI circular are very subjective. The line between a legitimate use of funds and a diversion of funds can be blurred, often hinging on one's perspective. When in adequate surplus the borrowers take decisions such as to: Withdraw funds for personnel use such as building home, daughter's marriage children's education, investing in diversified product, new venture, paying unsecured loans, paying to outgoing partner, settling family partition where few members are not willing to continue in business. Such events are common occurrences in business and are not exclusive to those having any financial exposure. The banker should object at the time of the event or when they have first knowledge of the matter. Maybe if this is done, the borrower goes to some other banker. The events happening 3-4 months before post submission of 3 monthly stock statements and/or post review / renewal of exposure should not form the basis of declaring diversions of funds.

A significant number of entrepreneurs in the unorganized sector face challenges in accessing formal banking services due to complex documentation requirements. The government's Goods and Services Tax (GST) initiative provides a valuable database that could be utilized by banks to simplify the loan approval process. However, a prevailing fear of repercussions for non-performing loans among bank managers, particularly in Public Sector Banks (PSBs), continues to hinder the disbursement of loans, even after the implementation of simplified procedures. To effectively implement government schemes like Mudra, it is imperative to sensitize ground-level bank staff to the importance of these initiatives and to address their concerns.

2.3.3 Lack of awareness and inadequate capacity among MSMEs

While there are various funding opportunities available for MSMEs, many entrepreneurs remain unaware of these options. Despite the significant amount of funding raised through these channels in the last two and a half years, there is a lack of awareness among MSMEs regarding the guidelines and procedures established by regulatory bodies like SEBI. To address this gap, targeted outreach initiatives are necessary to educate MSMEs about the available funding options and guide them through the application process.

The reason for failure of many projects is heavy debt burden caused by term loans taken for land, building as well as for machinery. Inadequate knowledge about ability to service debt causes such debt traps and bankers seek more collateral security to justify risk from higher debt. The banks need to educate the borrowers that the cash flow from the project should service their debt and not sale of assets. While the banks support such high debts by asking for additional collaterals (calling it risk mitigant), they are miserly when it comes to working capital funding and quick in enforcing the securities.

MSMEs should prioritize financial discipline by carefully selecting credit products that align with their specific needs and cash flow. Understanding various options like term loans, working capital loans, overdrafts, and invoice discounting is crucial for making informed borrowing decisions. It's essential to match borrowing to business cycles and avoid excessive debt. By comparing terms across lenders and negotiating favorable interest rates and repayment plans, MSMEs can secure affordable and timely credit. It is also important to use the bank funds for the purposes for which it was borrowed. Sometimes, however, it is noticed that working capital funds are diverted for other purposes which may not be a deliberate diversion of funds on part of the buyer. Nevertheless, unplanned and underfunded expansions can still strain MSMEs, impacting credit history and relationships with banks.

MSMEs also need to invest in capacity building to enhance their operational and financial management skills. Financial literacy programs can empower entrepreneurs by providing knowledge of credit appraisal processes, banking regulations, and government support schemes. Leveraging the ecosystem, including industry bodies, trade associations, incubators, and accelerators, can offer MSMEs access to mentorship, funding, market connections, and training opportunities.

Micro and Small Business also face challenges in preparing a financially sound CMA report. A CMA report is a report exhibiting a company's projected and past performances in

financial terms. It includes an in-depth study of a loan applicant's actual and expected financial matrices. It illustrates a firm's creditworthiness that represents a company's ability to repay. The banks review the company's CMA document before approving the loan. The loan might not even be approved if the statement is not satisfactory. For CMA, banks consider different variables, such as a company's current operation, credit background, current assets and liabilities, income statement.

An accurate and well-prepared CMA data report can increase the chances of loan approval. However, to prepare a well-structured CMA report, buyers have to rely on the expertise of financial experts. Many micro and small Businesses don't have robust data on financial reporting indicators necessary to secure a loan. The accuracy of the data is crucial when preparing a CMA report. Inaccurate data can lead to incorrect financial ratios and metrics, which can affect the eligibility of funding for seeking credit. Taking the services of financial experts is also a significant cost to the resource constrained MSMEs.



2.3.4 Third Party Credit Rating System

Regarding credit assessment, the importance of branch managers' discretion is an important aspect. The banks can look to develop digital products that focus solely on digital data for credit assessment. Government is exploring digital footprints like GST data and UPI transactions to do informed credit assessments. Banks are working on products that move away from traditional balance sheet and collateral-based lending. These innovative underwriting models could include credit risk ratings. This could be a significant development in the lending landscape for MSMEs.

While external credit ratings are sometimes considered, banks typically only require them for larger exposures exceeding ₹25-50 crore. If a bank is demanding a credit rating for MSMEs, it's often due to a lack of awareness on the part of the banker. If exposure of banks to an MSME account is beyond a threshold, Banks insist on getting a third-party rating known as Bank Loan Rating (BLR) from RBI/ SEBI approved rating agencies. The

trigger according to RBI was Basel-II norms but has been later clarified that it was not mandatory, but an advisory for banks to use external rating agencies till they have capacity to develop their own risk assessment models.

Credit ratings are primarily based on Return on Investment (ROI) rather than assessing a company's safety. These ratings are not definitive but rather reflect the questions and concerns raised by rating agencies. The focus is on the shareholder's perspective, with repeated inquiries about ownership and its relevance over time. The questions asked by credit agencies such as the company's share in the market is an irrelevant question to ask to a manufacturing enterprise. For unlisted medium industries, credit ratings should be assessed differently than for listed companies. The current form for credit assessment is primarily designed for listed companies based on shareholding and not on credit worthiness of the company.

Third party credit rating system restricts MSMEs capacity to raise capital for expansion. Hardly any MSMEs got investment grade rating which means higher interest rates and demand for additional collateral security. Third party rating has no role in short solvency needs of banks. The budget mentioned a new credit assessment model to be initiated by Public Sector Banks for MSME credit based on the scoring of digital footprints of MSMEs in the economy. The new assessment model proposed is expected to be a significant improvement over the traditional assessment of credit eligibility based only on asset or turnover criteria and will also cover MSMEs without a formal accounting system. The adoption of the new method of credit assessment by private sector banks remains to be seen. Data from TReDS act as an alternative data source for credit-building mechanisms for MSMEs, giving banks and NBFCs invoice-backed transaction data to assess creditworthiness.

2.3.5 Unethical Lending Practices by Banks

The banks and MSME relationship is an uneven one, with the balance of power heavily tilted in favor of the bank. Lack of competition in the banking sector, weak regulatory institutions and a near defunct grievance redressal mechanism (office of Banking Ombudsman) all coalesce into an unsatisfactory experience for an ordinary small businessman in dealing with the banks whether private or public.

A major issue faced by MSME borrowers is the imposition of prepayment penalties by banks. These charges, often ranging from 2% to 4% of the loan amount, restrict the

financial freedom of MSMEs and prevent them from switching banks or prepaying loans, even when they are entitled to do so under RBI guidelines and the Code for MSMEs. Foreclosure charge is levied on prepayment of loan or when the borrower wants to change the bank due to unsatisfactory service. The charges are a coercive tool used by banks to thwart buyers' choice to change the bank.

What is even more disturbing is that such practices are in violation of the RBI facilitated code for MSEs that all Scheduled Commercial Banks are signatory which advises Micro and Small Enterprises to be spared of such penalties. SIDBI and NBFCs have not even ratified the code. Except ICICI, no bank has announced a policy for not charging foreclosure/prepayment charges despite signing on the code. In addition to foreclosure charges, many commercial banks levy non-compliance charges when an MSME borrower insists on changing banks. Non-compliance is not notified by the bank during periodic inspection reports or at the time of annual renewals, but it is raised if the distraught customer expresses interest in changing bank. These charges are arbitrary.

As per the RBI guidelines, banks and NBFCs are not allowed to charge foreclosure charges and prepayment penalties on loans obtained by individual borrowers on a floating rate of interest. RBI in October 2024 announced to include MSME loans in these guidelines. Similarly, the Bank Code for MSEs does not allow banks to impose foreclosure charges on customers falling under the category of MSMEs.

During the 27th Standing Advisory Committee of RBI, held in December 2022 in Kolkata, RBI had informed all banks that the Bank Code for MSEs was valid. Its violation by any way could call for a complaint with the Banking Ombudsman. Several cases were reported to Federation of Indian Micro and Small & Medium Enterprises (FISME), where several banks had imposed prepayment/foreclosure charges, if the borrower wished to change the bank from where it had borrowed the loan. Post this, several private sector banks, namely ICICI Bank, followed RBI circular on waiver of foreclosure charges for MSMEs, and dropped pre-payment charges altogether.

The prepayment charges restrict the ability of MSMEs to secure better terms of finance as sometimes the prepayment penalties or foreclosure charges while transferring loans to another bank/lender is more than the interest payable. The lack of awareness among MSMEs also contribute to commercial banks exploiting MSME customers with ambiguous terms and agreements at the time of loan disbursal. Business loan agreements are not read

carefully, and the terms are not explained by bankers at time the customer approaches the bank.

MSMEs during the roundtable discussions emphasized that RBI, being the regulator of all commercial banks, needs to take lead in ensuring that unethical lending practices are stopped. Firstly, adherence to the code for MSME needs to be ensured in letter and spirit. RBI should consider bringing in stricter regulations against banks that impose excessive fees, withhold NOCs, or obstruct the transfer of property. It is an irony that SIDBI which is exclusively meant to cater to MSMEs is not even signatory to the Code nor the hundreds of NBFCs financed by it all of which levy hefty penalties on MSMEs with impunity the moment an MSME borrower wants to switch.

Regarding the RBI's decision to include MSME loans in guidelines that prohibit foreclosure or prepayment charges on floating-rate term loans given to individuals for non-business use, draft circular should be issued for public consultation. MSMEs also need to ensure that terms and conditions of business loan agreements are read carefully. Industrial associations such as FISME have taken initiatives in this regard. A banking grievance redressal portal has been launched by FISME. The portal is a dedicated online platform designed to address the banking-related concerns and grievances of MSMEs.

RBI also announced on April 15, 2024, that all the banks are required to provide a Key Facts Statement (KFS) detailing key facts of a loan agreement, in simple and easy to understand language, provided to the borrower in a standardized format. Mandatory provision of KFS to all prospective borrowers to help them take an informed view before executing the loan contract, is indeed a welcome step. The RBI circular also stated that any fees, charges, etc. which are not mentioned in the KFS, cannot be charged by the Regulated Entities (REs) to the borrower at any stage during the term of the loan, without explicit consent of the borrower. These directives are expected to provide some relief to MSMEs when dealing with banks, but RBI must enforce adherence to these guidelines.

2.3.6 Grievance Redressal Mechanism

MSMEs banking related grievances are left unaddressed at multiple levels. Bankers are completely unaccountable for excessive delay and resort to absurd/ illegal actions, even suspending banking services to borrowers. The institution of Banking Ombudsman has not brought relief to MSMEs as the awards of Ombudsman are invariably in favor of banks.

One of the most important lacunas of the Banking Ombudsman scheme as highlighted by MSMEs during the roundtables, is that it is not mandatory for the Ombudsman to deliver reasoned /speaking orders. This is in complete contravention with the provisions under Section 12 of the Banking Ombudsman scheme which clearly states that the award of the Ombudsman shall state briefly the reasons for passing the award. Due to this, cases are dismissed arbitrarily without giving reasons. In the developed countries like UK, Australia, Canada and even Sweden from where the concept of Ombudsman originated, Ombudsman is required to give speaking orders.

There needs to be an overhaul of the Banking Ombudsman scheme as it has not served the purpose of providing redressal of grievances against deficiencies in banking services, concerning loans and advances. The improvement in the Banking Ombudsman scheme ought to start from the procedure for filing complaints to the Ombudsman. Current procedure as outlined in the scheme calls for too much documentation. The grounds for rejection of complaints by the Ombudsman are wide and, in many instances, the complaints are rejected arbitrarily.

The discretion of the Ombudsman to reject a complaint if in his opinion, no loss or damage or inconvenience has been caused to the customer is vague and subjective. The Ombudsman also has authority to reject a complaint at any stage of proceedings if in its opinion, the complaint requires consideration of elaborate documentary and oral evidence. The decision of the Ombudsman in rejecting the complaint is final and binding. MSMEs have raised concerns that the Banking Ombudsman's discretionary powers are being misused to dismiss legitimate complaints, thereby defeating the scheme's intended objectives.

RBI has asked regulated entities to enhance their internal grievance redress mechanisms. While directing banks to strengthen their internal grievance redressal systems is indeed a welcome step, without a time bound grievance redressal system and an escalation matrix, it will not yield desired results. RBI directives are interpreted at the operating level in a subjective manner. RBI guidelines which are in favor of customers are often considered by bankers as recommendatory while those in their (bankers) interest as mandatory.

2.3.7 Credit Guarantee Based Lending

Setting up of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) has been a major structural intervention by the Ministry of MSME and one of its biggest

success stories. However, keeping in view of the unmet demand and the proof of concept already established, there is a need to expand the Credit Guarantees through public and private sector. Although a significant number of banks are members of CGTMSE, many still require entrepreneurs to demonstrate a profitable financial history before extending credit, even when the loan is backed by a CGTMSE guarantee. This makes CGTMSE membership largely symbolic, rather than a practical solution for new entrepreneurs. To incentivize Public Sector Banks (PSBs) to assume greater risk, additional financial incentives may be required.

Consequent to recent changes, the credit guarantee cover has been enhanced for micro and small enterprises from ₹5 crores to ₹10 crores, estimated to facilitate an additional ₹1.5 lakh crore in credit over the next five years. Startups will benefit from a doubled guarantee cover of ₹20 crores, with a reduced 1 per cent guarantee fee for loans in 27 priority sectors. Export-focused MSMEs will receive term loans up to ₹20 crores, accompanied by enhanced guarantee covers.

The eligible lending institutions are required to enter a "one time" agreement with CGTMSE for becoming Member Lending Institutions (MLIs) of the Trust. MLIs can then apply for guarantee cover in respect of eligible credit facilities sanctioned to any eligible borrower. The MLIs can apply for guarantee cover in respect of credit proposals anytime during the tenure of Loan.

Each bank follows its own guidelines about eligibility and pricing. Despite their names appearing as MLI under CGTMSE, many MLIs do not entertain a loan application under CGTMSE under different pretexts. So, an aspirational entrepreneur does not get formal bank credit support. Not all registered MLIs extend credit for a green field first generation entrepreneur. They are willing to entertain only after some years of profitable operations. CGTMSE has no control if an MLI does not give credit support but remains a passive member. A review of the current enrollment criteria and the status of the MLI is necessary. The premium charged by banks to CGTMSE is often unclear, varying based on internal bank policies and performance. This lack of transparency makes it difficult for borrowers to compare costs and choose the most affordable option. If premium rates were publicly available, borrowers could select the bank with the lowest fee. CGTMSE should disclose any discounts or premiums on its website to help borrowers make informed lending decisions.

Pricing pattern of loans is normally determined by the banks' axiom "higher the security cover (primary plus collateral), lower the spread". The weightage for the government guarantee is not clearly defined for charging spread. Thus, the borrowers end up paying higher interest rates because it is never explained how government guarantee is viewed by the lender. Presumably, the government guarantee reduces the capital charge for the bank, so banks need to set aside lower capital. However, while banks save on capital charge for such loans, they charge higher spreads to the micro and small borrowers. It is suggested that the CGTMSE declares the claim settlement ratio for every bank. A superior ratio would indicate the lenders' robust system.

To address the issue of lender bias, which can be influenced by factors such as gender, social status, region, class, age, or education, the promotion of specific credit guarantee schemes could be considered. Such schemes could help alleviate the risk perception of lenders, encouraging them to extend credit without significantly increasing systemic risk. Engaging in a constructive dialogue with RBI and Department of Financial Services (DFS) could pave the way for the creation of a diverse range of credit guarantee schemes.

Despite government support through CGTMSE, banks often impose stringent debt-to-equity ratio requirements on loans. This can undermine the purpose of the scheme, especially in cases where the government provides substantial guarantees of 90% for women, 80% for 'Z' certified businesses, and 70% for others. To address this issue, RBI could consider issuing guidelines to encourage banks to adopt more flexible debt-to-equity ratio requirements.

Bank branch managers, who may not possess specialized expertise, often face the challenge of evaluating the viability of project reports submitted by entrepreneurs. To address this issue, the involvement of industry experts from relevant associations could be considered. This would not only improve the quality of project evaluations but also enhance the capacity of CGTMSE staff to support young entrepreneurs in accessing finance.

Despite government guarantees (90% for women, 80% for "Z" certified, and 70% for others) under the CGTMSE scheme, banks often impose a restrictive 1:1 debt-to-equity ratio, undermining the scheme's purpose. RBI should establish clear guidelines for banks on this ratio. Furthermore, project report evaluations, currently left to potentially unqualified branch managers, should be handled by expert industry bodies. This would improve CGTMSE's effectiveness and facilitate financing for young entrepreneurs, crucial for achieving a USD 5 Trillion economy.

2.3.8 New Credit Guarantee Scheme for SMA accounts and project financing:

Government has designed two credit guarantee schemes for 2024-25.

a) Credit Guarantee Scheme for SMA accounts

Under this scheme it is proposed to provide one-time funds to MSME accounts marked as SMA 1 and SMA2 on a particular date, to be announced in due course. The maximum amount of loan is proposed to be 10 % of the outstanding sanctioned amount on the reference date and it will be collateral free with full guarantee coverage by the credit guarantee trust. The duration of the loan will be for 4 years including moratorium period and with an upfront guarantee fee of 1%. Loanes contribution will be 10% of the loan sanctioned and it can be utilized only to extinguish outstanding dues.

Suggestions:

- i. As the very reasons of SMA classification are problems in cash flows due to various reasons, the fund under the scheme should address this problem and provide finance for meeting the cash flow gap. Leveraging GST data and incorporating cash flow-based financing, the scheme should provide funds to bridge immediate cash flow gaps, up to a certain limit.
- ii. The scheme leaves interest rate to be charged to Banks. When the loan amount is fully covered under the guarantee, banks cannot be left to charge any risk premium, and the interest rate should be pegged to External Benchmark Lending Rate (EBLR).
- iii. The timing and speed of implementation of the scheme is crucial. As majority of the SMA accounts stare at the risk of slipping to NPA classification, banks should be highly proactive in releasing the guaranteed fund. In this regard the Covid era Emergency Credit Line Guarantee Scheme (ECLGS) may be a model to consider.

b) Credit Guarantee Scheme for Manufacturing:

The scheme focuses on manufacturing MSMEs and only funds collateral free new and expansion projects. Under the scheme it is proposed to provide guarantee cover to the extent of 60% of the project cost up to an amount of ₹100 Lakh with a repayment period of 10 years including moratorium period of 2 years. The significant aspect of the scheme is charging 5% of project costs upfront to the trust fund, with a provision of mutual credit

guarantee. The interest rate is linked to EBLR, and the guarantee amount will initially be 1.5% and then 1%.

Suggestions

- i. The demise of State Finance Corporations (SFCs) has left MSMEs without adequate funding for growth. While banks are cautious, and SIDBI's reach is limited, this scheme, with its significant guarantee coverage, can provide a much-needed boost to new and existing entrepreneurs.
- ii. With limited presence in the project financing of MSMEs, banks need to do a lot of self-priming to implement the scheme. Firstly, developing a cadre for project appraisal for MSME projects which are way different from corporate projects with only entrepreneur's own fund to meet the funding gap.
- iii. With only 60% guarantee coverage, banks require reasonable equity from entrepreneurs. To expedite the process, banks should empower specialized teams in MSME clusters and manufacturing districts.
- iv. The 5% upfront cost and 1.5% guarantee fee could hinder project viability. The government should ensure the trust fund is managed prudently, relying on guarantee fee income and preserving the fund's principal.

Contribution to Trust Fund: A significant aspect of the scheme is allocation of 5% of the project cost to the guarantee trust fund, to fortify it. The burden of 5% upfront cost along with 1.5% guarantee fee on the project viability will be a big question. Secondly, the Government should see that the operations of the trust fund is run judiciously from the guarantee fee incomes and the trust fund accumulations remain untouched.

2.3.9 Equity Based Financing

Equity financing is essential for both the establishment of new enterprises and the expansion of existing businesses. A significant number of first-generation entrepreneurs who have successfully launched their ventures in recent decades received substantial equity support from State Financing Corporations from 1960s to 1980s.

To facilitate equity financing for MSMEs, particularly in the manufacturing sector, there is an urgent need for a dedicated institution or mechanism. Given the inherent risks associated with equity investments, the government could consider establishing a CGTMSE-like institution to provide equity guarantees for greenfield and brownfield projects. To incentivize banks to participate in this initiative, they could jointly contribute

to an Equity Guarantee Fund (EGTMSE). The guarantee coverage should eliminate the need for collateral security.

SME exchanges continue to face challenges related to liquidity and market making, which hinder the robust price discovery mechanism for SME stocks. To address this issue, it may be prudent to consider a regulatory mandate requiring banks, financial institutions, and insurance companies to invest a small percentage, ranging from 0.5% to 1% of their equity exposure in SME exchanges. This strategic intervention could significantly enhance the liquidity of SME exchanges and pave the way for MSMEs to raise equity capital through public offerings.

2.3.10 Penal Interests Charges by Regulated Entities (RE)

Allowing operational autonomy to the REs under the Board approved policy, has potential of misuse. Letting the RE Boards to fix penal charges for different defaults/non-compliances is a grey area which is bound to be misused in the absence of any clear-cut guidelines from the RBI.

Fair compensation should be estimated and allowed to the REs in case of transgression by the borrowers by way of defaults/non compliances etc. However, to hope REs to inculcate a sense of discipline amongst borrowers is not likely to happen. No doubt credit discipline is essential but MSMEs operate in a highly volatile environment which is the main cause for 'credit indiscipline' among the borrowers. Here the penal interest will only address the result not the cause. Along with 'credit discipline for borrowers', 'Work Discipline' be also asked from the REs.

There is no sense of urgency amongst the staff that deal with the accounts of MSMEs. The staff is not sensitized to the fact that the pace of business has increased so much that unless the borrowers and the REs operate in tandem, the customer is exposed to huge risks which is obviously going to jeopardize the interest of both the RE and the borrower MSME.

REs have been restrained from tweaking relevant regulatory instructions for determination of interest rates on credit facilities including conditions for reset of interest rates. With such a high standard of objectivity set by the RBI in the most important aspect of pricing of loan and all efforts being made to bring in greater transparency, we submit that the conditions for pricing loans may also be made available on RBI website for the information of the borrowers. Asking the REs to claim penal charges and not penal interest for violation

of the loan conditions, will provide relief to the borrowers. Restricting levy of penal charges in proportion to the default and only beyond a threshold, could be another important step. Globally, defaults are analyzed by the banks and default accounts are put into different buckets, namely, willful defaults, defaults due to external conditions, due to delayed payment, due to sudden regulatory burdens, due to endemics etc. and differential rates of penalty are imposed according to the reasons of default. Same approach needs to be followed in India and RBI should start the ball rolling. Hefty penal charges for closure of loan account or shifting of accounts from one bank to another is an archaic rule.

As working capital accounts are practically perpetual, closure of such accounts anytime will call for penal charges in the present regime, putting the borrowers in perpetual bondage. Logically, banks should not charge any penalty if the loan accounts are closed after a certain period, say two years, as followed for many personal loan accounts. Here also immediate advisory from RBI is needed. 'Non-compliance charges' is another set of arbitrary penalties imposed on borrowers. Firstly, other than payment of interest and installments, penal charges should not be levied retrospectively. Secondly, in case of non-compliance the borrower should be served a notice to adhere to compliance within 15 days failing which a pre-disclosed charge could be levied prospectively.

2.3.11 Insurance Surety in lieu of Bank Guarantees

It is estimated that the size of public procurement in India is almost one third of its GDP. For MSMEs, it assumes even greater importance because 25% procurement is mandated in Central Government purchases from them. MSMEs participating in such procurement are required to furnish Bank Guarantee (BG)/ Performance Guarantee (PG) as part of bid requirement.

Banks charge huge sums against service from MSMEs (margin money, collateral & service charges for period of use). Unlike large companies, whom banks offer BG/ PG at a nominal price, for MSMEs it locks up working capital and stymies their growth. FISME consistently highlighted global practice of furnishing BGs through Insurance Companies which neither insist on margin money nor demand collateral security but charge for usance period.

At present, the insurance companies are offering Bid & Performance Guarantee Bonds. They are one of the most cost-effective ways to finance contract security options and enable ease of doing business. As on 31.8.2024, Insurance Surety Bond amounting to

₹6,390 crores have been issued, out of which Performance Bonds comprise of ₹1,400 crores. *(Circular by Department of Financial Services, Ministry of Finance)*. The Insurance Regulatory and Development Authority of India (IRDAI) had also issued guidelines in 2022 to promote and regulate surety insurance business in India.

Insurance Surety offers the benefit of freeing up working capital, which is otherwise locked up as collateral in lieu of obtaining BGs. However, the option of replacing BGs with Insurance Surety is restricted to NHAI projects only. One can imagine the magnitude of the problem that on the GeM portal alone there are over 8.5 lakh MSMEs registered all of whom suffer from the inefficient and outdated BG/PG regime.

The development of Surety Bond market in India will require certain clarifications on the ambiguity pertaining to the recourse available to insurance companies in case of default. IRDAI (Surety Insurance) Guidelines, 2021 (issued on September 8, 2021), expressly provided for securing Security Bonds through personal guarantees of the promoters. However, the provision has been omitted from the final draft of the Surety Guidelines. Insurance Surety should be allowed to be accepted in all government purchases in lieu of Bank Guarantee (BG) or Performance Guarantee (PG).

2.4 Key Recommendations For Securing MSMEs Access to Finance

Some of the key recommendations to secure MSMEs access to credit as emerged from the Regional and National Roundtables are summarized below:

- i. **SMA classification guidelines:** The SMA framework should be comprehensively reviewed, and a liberal restructuring option be given to MSMEs affected by long Covid and geo-political turmoil. Clarification should be issued for guidelines for identifying incipient stress. Banks should be directed not to discontinue normal banking facility to MSME unit that has been flagged as SMA.
- ii. **Capacity building of MSMEs:** Financial literacy programs can empower entrepreneurs by providing knowledge of credit appraisal processes, banking regulations, and government support schemes. Targeted outreach initiatives are necessary to educate MSMEs about the available funding options and guide them through the application process.
- iii. **Alternate Credit Rating System:** BLR rating has inhibited the growth of enterprises from micro to small and small to medium and should completely be

done away with. For unlisted medium industries, credit ratings should be assessed differently than for listed companies.

- iv. **Fair Lending Practices by Banks:** RBI has decided to include MSME loans in guidelines that prohibit foreclosure or prepayment charges on floating-rate term loans given to individuals for non-business use. A draft circular should be issued for public consultation in this regard. Stricter regulations against banks that impose excessive fees, withhold NOCs, or obstruct the transfer of property.
- v. **Grievance Redressal Mechanism:** RBI should encourage stakeholders to file complaints u/s 35A of BR Act in cases of serious default by bankers and take suitable action as per rules and regulations. This will bring much needed accountability in the system. A review of the institution of Banking Ombudsman is required. A grievance redressal mechanism must be strictly time-bound for it to be efficacious. Besides, an escalation matrix be created enabling that the matter is sorted at higher level where knowledge of regulations is expected to be better. Quality audit should be made a part of the grievance redressal mechanism.
- vi. **Credit Guarantee Based Lending:** Keeping in view of the unmet demand and the proof of concept already established, there is a need to expand credit guarantee through public and private sector. Specific Credit Guarantees could be promoted to cushion the risk perception of lenders. Cap on pricing loans guaranteed by CGTMSE should be considered.
- vii. **Insurance Surety in Lieu of Bank Guarantee:** Insurance Surety should be allowed to be accepted in all government purchases in lieu of Bank Guarantee or Performance Guarantee. Concerns raised by the insurers that they should have recourse to recovery at par with the banks need to be addressed.



Chapter 3: Securing Payments Through Trade Receivables

Discounting System (TReDS)

3.1 About TReDS

The Trade Receivables Discounting System (TReDS) platform is a digital ecosystem designed to facilitate the financing of trade receivables in India. It aims to provide a seamless and efficient way for businesses, particularly MSMEs, to access working capital by leveraging their receivables. The TReDS platform allows sellers to discount their trade receivables through an auction-based process, offering an alternative to traditional financing methods. The platform connects buyers (large companies), sellers (SMEs), and financiers (banks and financial institutions), creating a transparent, secure, and fast channel for liquidity.

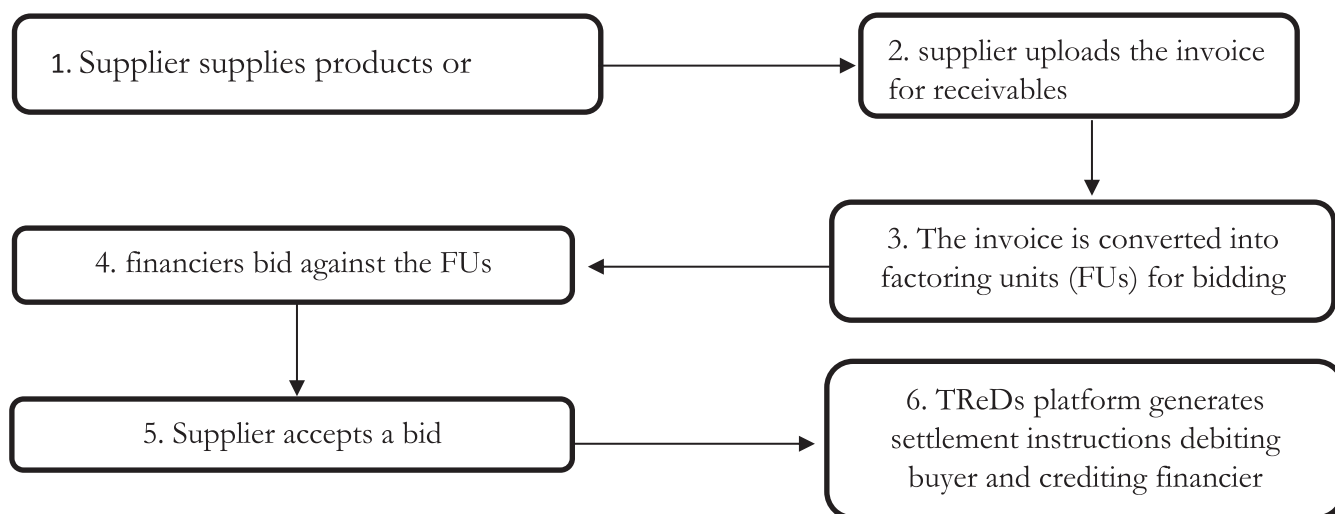
The TReDS platform aims to address the challenges faced by MSMEs in obtaining timely payments and working capital. By allowing these businesses to unlock the value of their receivables, TReDS helps reduce dependency on informal funding sources and encourages formal financing solutions. Additionally, it supports the Indian government's initiatives to promote ease of doing business, financial inclusion, and economic growth. With the involvement of reputable banks and financial institutions, the platform ensures reliability and trust, making it a vital tool for improving the financial health of MSMEs.

3.2 How TReDS Works

TReDS involves factoring and reverse factoring. Both traditional and reverse factoring rely on invoice verification between buyers and suppliers, which allows financiers to offer funding. In traditional factoring, the supplier initiates the process, while in reverse factoring, the buyer does. TReDS enhances traditional factoring by giving suppliers the power to choose their financing partners based on factors like transparency, confidentiality, and cost. In both cases, once a bid is accepted by the supplier (after verification in reverse factoring), payment is typically processed within 48 hours.

The following processes happen during financing or discounting through TReDS.

Chart 3: TReDS Process



- **Creation of Factoring Unit (FU):** In the TReDS system, invoices and bills of exchange are standardized as "Factoring Units" (FUs), representing confirmed obligations from corporate or government buyers. MSME sellers initiate factoring by creating the FU, while corporate buyers initiate reverse factoring by doing the same.
- **Acceptance of the FU by the counterparty:** Before proceeding, the FU must be accepted by the counterparty, that is, either the buyer or the seller.
- **Bidding:** Financiers submit bids, and then either the seller or the buyer selects the most favorable offer.
- **Crediting the supplier:** Payment made by the financier (of the selected bid) to the MSME seller is done at the agreed rate of financing or discounting.
- **Crediting the financier:** Finally, payment is made by the buyer to the financier on the due date.

3.3 Issues Pertaining to TReDS

The government has recognized the value of TReDS platforms in addressing the issue of delayed payments, particularly for MSMEs. While TReDS provides a platform for MSMEs to receive timely payments, it is grappled with several hurdles and constraints. Some of these issues deliberated at the roundtable discussion are outlined below.

3.3.1 Uptake of TReDS among PSEs and large Corporates

While the turnover threshold of buyers for mandatory onboarding on the TReDS platform has been reduced from ₹500 crores to ₹250 crores, mandatory transactions through TReDS have not yet been implemented. While TReDS platforms have gained significant traction among corporates, its adoption by Central Public Sector Enterprises (CPSEs) remains limited. Analysis indicates that only 10% of the total transaction volume on TReDS is attributable to CPSEs. The primary challenge lies in the ambiguity of the gazette notification, which mandates registration but does not explicitly require new transactions to be conducted through TReDS.

Successful implementation of TReDS platform has been observed in states of Goa and Tamil Nadu, demonstrating its potential benefits. Government should actively encourage larger corporates to adopt TReDS platform, as their participation is crucial for driving growth and expanding the platform's reach. Analysis indicates that the current usage of TReDS is significantly below its potential, with only 2-3% of annual transactions being conducted through it. To fully realize the benefits of TReDS and promote its adoption, concerted efforts are needed to increase awareness, address challenges, and incentivize participation from a wider range of businesses.

3.3.2 TReDS is a buyer dependent portal

While TReDS offer a valuable solution for timely payments, there are challenges related to the requirement for buyer acceptance and the potential recourse implications of the second window mechanism. Currently, the buyers are not interested in transacting through TReDS platform because they have a leeway for making payments as per their convenience. To address these concerns, it is essential to explore alternative approaches that minimize the need for buyer acceptance while maintaining the benefits of recourse-free discounting.

The implementation of TReDS depends on the specific arrangements between buyers and sellers. While some buyers may choose to upload invoices independently, others may involve suppliers in the process. Suppliers should also be given the option to upload invoices on TReDS. This would enable a wider range of transactions to be processed through TReDS, expanding its benefits to a larger segment of businesses. In cases where suppliers upload invoices, reverse factoring can be utilized, allowing suppliers to receive early payments at a discounted rate. However, the feasibility of reverse factoring depends on the commercial agreement between buyer and seller.

Additionally, the government should evaluate the effectiveness of current onboarding limit for TReDS, considering the number of companies already onboarded and the volume of transactions being conducted through TReDS. Based on this assessment, the onboarding limit can be adjusted accordingly to maximize the benefits of TReDS for MSMEs. So instead of lowering the turnover limit for companies to get on-boarded on the TReDS platform, the government should be monitoring how many transactions the onboarded companies are doing through the TReDS platform.

3.3.3 Creditworthiness and Insurance: Key Concerns for TReDS Expansion

Large Indian corporations are yet to participate in TReDS at scale, with many leveraging alternative receivables financing models such as dynamic discounting and supply chain finance. These mechanisms, when deployed responsibly, can also facilitate timely payments to MSMEs by enabling early access to working capital at market-linked rates. TReDS provides a regulated and transparent marketplace for invoice discounting. However, other buyer-led programs represent complementary instruments that can coexist within India's evolving working capital ecosystem. Together, they have the potential to deepen MSME liquidity access and promote financial inclusion across the supply chain.

A company's creditworthiness, typically represented by its credit rating, significantly influences its access to financing through TReDS. Lower-rated companies face greater difficulty in securing funding due to the higher perceived risk. While lowering the threshold for TReDS participation from ₹500 crores to ₹250 crore is expected to attract more companies, their creditworthiness for banks remains a concern.

Although sandbox testing was conducted approximately three years ago, and IRDA issued a circular in 2022 permitting insurance companies to participate on the platform (following RBI regulations in 2021 and platform access in 2022), insurance companies have shown limited engagement. This is primarily because they prefer portfolio-based financing rather than the invoice-based model of TReDS.

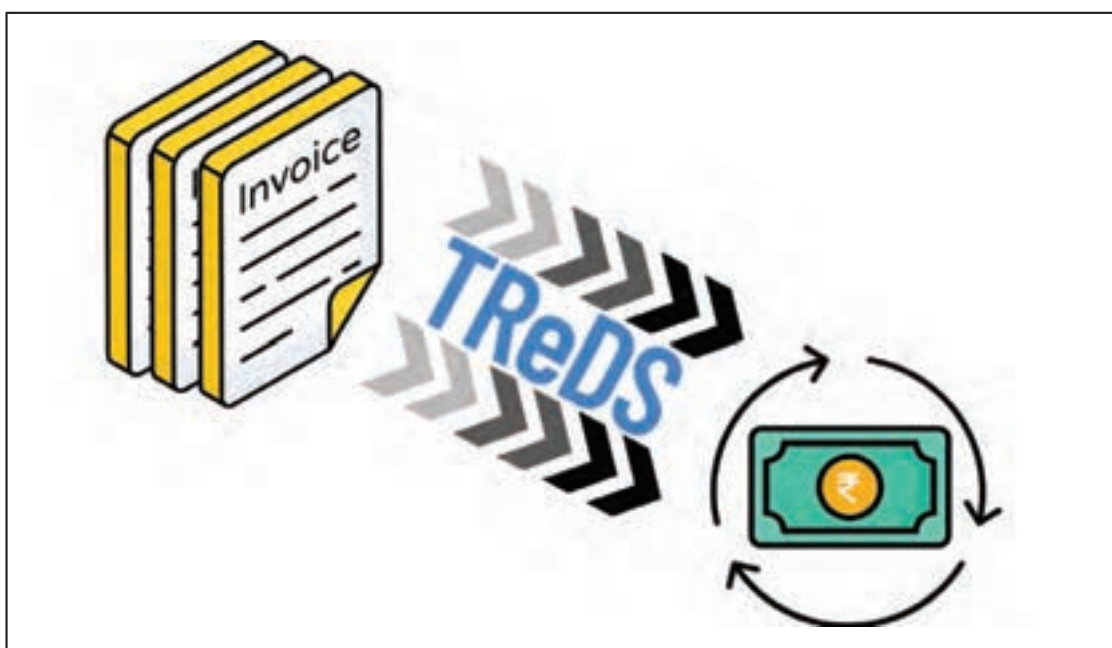
Globally, factoring is often supported by credit insurance, a feature currently unavailable to financiers in India. Policymakers and Insurance Regulator need to reconsider this position and explore the possibility of allowing credit insurance specifically for financiers supporting MSME participants on TReDS portal. This would significantly empower TReDS to become a true enabler of working capital finance for MSMEs.

3.4 Suggestions to Improve TReDS Portal

- i. **Integration of TReDS with GST:** The Standing Committee on Finance has recommended that all invoices uploaded to the GSTN portal be automatically routed to TReDS portal, facilitating a smoother and more timely payment process. To ensure timely settlements, it is recommended that government mandate the automatic exchange of information between the GSTN portal and TReDS portal. Integration of GST with TReDS would also eliminate the need for manual verification and reduce the potential for delays caused by buyer reluctance to accept the invoice.
- ii. **Incentivizing TReDS as a payment portal:** The RBI in 2023 had proposed the expansion of scope of TReDS with an aim to further ease operation of the TReDS, including: (a) introduction of insurance facility; (b) permitting all entities eligible under the Factoring Regulations Act, 2011 (“FRA”) to enter TReDS transactions; and (c) enabling secondary market operations on TReDS platform. The RBI had also stated that all entities eligible to do factoring business under the Factoring Regulation Act will be permitted to participate as financiers on TReDS as the transactions fall under the ambit of factoring business. The central bank had also allowed secondary market operations on TReDS for the transfer of invoices or factoring units (FUs) within a particular TReDS platform to bring in more liquidity on the platform.
- iii. **TReDS guidelines changes:** The proposed changes to the TReDS Guidelines are a positive step towards simplifying transacting through TReDs. Notably, the introduction of a secondary market and insurance facilities addresses concerns related to creditworthiness, especially for buyers with lower ratings. While the secondary market for discounted Factoring Units (FUs) is a welcome development, the eligibility criteria limiting participation to entities governed by the Transfer of Loan Exposures (TLE) Master Directions is restrictive. This exclusion prevents other entities from accessing the secondary market.
- iv. **Incentivizing large corporates to boost TReDS Adoption:** Efforts should be made to incentivize companies with a turnover above ₹250 crores to make transactions through TReDS. Non-fiscal incentives can be provided to corporates who transact through TReDS. To incentivize the adoption of TReDS platforms, it

is recommended that credit rating agencies consider incorporating the use of this portal into their evaluation criteria. Businesses that consistently transact through TReDS could potentially benefit from improved credit ratings, reflecting their commitment to timely payments and responsible financial practices. This incentive would encourage more companies to utilize TReDS, thereby contributing to a more efficient and transparent payment ecosystem.

- v. **Linking TReDS adoption with ESG performance:** Large corporations such as Dabur, Granules, and Sun Pharma are increasingly expressing interest in improving their Environmental, Social, and Governance (ESG) ratings. These companies have recognized that delayed payments can negatively impact their ESG performance, leading to concerns among stakeholders and potential investors. As demonstrated by the proactive approach of NTPC, which highlighted the connection between delayed payments and ESG ratings, there is a clear opportunity to leverage TReDS to enhance ESG performance. By incorporating TReDS usage into ESG evaluation criteria, the government can incentivize companies to adopt these platforms, contributing to improved payment practices and overall sustainability goals.



Chapter 4: GST's Potential to Ease MSME Payment Challenges

Delayed payments and defaults on inter-firm or Trade Credit (TC) have become a widespread and persistent issue, particularly for non-corporate businesses, including MSMEs. Recent research by Dun & Bradstreet and the Global Alliance for Mass Entrepreneurship (May 2022) estimates that ₹10.7 lakh crore is tied up annually in overdue payments to MSMEs, with micro and small units accounting for 80% of this amount.

In FY 2021, micro units faced median payment delays of 195 days beyond the 45-day regulatory period, while small units experienced delays of 68 days. This data indicates a worsening trade receivables situation for these businesses following demonetization and the implementation of GST. An RBI study of select public limited companies reveals a sharp increase in the receivables-to-sales ratio for companies with turnover under ₹25 crores, rising from 36% in FY 2019 to 60% in FY 2021. This indicates that payment delays and defaults are having a ripple effect throughout the payment system.

The government has taken multiple legal, regulatory and promotional measures to overcome the payment problem. These measures include prompt payment laws, promotion of bills discounting, factoring, TReDS, and Samadhaan platform. However, significantly extended payment periods, large receivable backlogs, and increasing strategic defaults in recent years suggest that current measures have limited effectiveness. Past events like demonetization, GST implementation, and the COVID-19 pandemic have demonstrated how quickly repayment behavior, business trust, and liquidity can deteriorate, severely impacting the trade credit ecosystem and undermining payment practices, business conventions, and credit discipline. Power asymmetry between small suppliers and large purchasers and fear of losing business in case of late payment complaints enable large firms to manipulate date schedules relating to challan, invoice, purchase order, or goods acceptance. Despite the best efforts of the government, these problems continue. However, a system driven digital platform can overcome these. The GST Network (GSTN), now recognized by the RBI as an account aggregator network, offers a valuable resource. By incorporating new input fields and triggers, the GSTN digital platform can be leveraged to monitor and automate actions against delayed payments and defaults in B2B transactions. The input fields and action triggers include:

- **Due date** of repayment and payment receipt date to be mentioned on GST invoice.
- **Automatic raising of red flag** in GST account of TC debtor after 10 days overdue, and if repayment amount is less than 90% (to take care of discounts etc.)
- **Raising of second red flag** if account remains overdue for 20 days; third red flag on 30th day with the provision of digital reporting of late payment to borrower's bank, CIBIL, Ministry of Corporate Affairs (corporate eases) and stock exchanges (listed companies); fourth red flag after 60 days and suspension of GST account or imposition of monetary penalties if overdue persist above 90 days.
- **Linking of bank payment systems to update payment receipts in GSTN system.** To ensure accurate payment records, the bank payment system should be linked to the GSTN system. Until this integration is complete, the payer can update the payment date, which the seller can then validate.
- **In case of disputes,** a government-accredited industry forum will provide time-bound resolution or arbitration. During this interim period, the red-flagging process will be suspended.

Initially, this system could be implemented for firms with annual turnovers of ₹100 crores or ₹500 crores and above. A lenient approach to initial delays may be necessary as trade credit and repayment flows stabilize. This should pose minimal challenges for large corporations, as their average working capital utilization is around 50% of their sanctioned limit.

This inclusive approach extends beyond MSMEs, recognizing the interconnectedness of bank credit risk and B2B payment flows. Currently, CIBIL's credit risk analysis is limited to banks' and NBFCs' transactions, omitting the unknown risks associated with a firm's trade credit operations. Integrating trade credit operations into credit analysis provides a more complete picture, giving banks insights into their clients' cash flow matrices. This facilitates cash-flow based lending, improved account monitoring, and better stock financing. Faster payment cycles enhance liquidity and encourage the formalization of business dealings, which benefits both revenue and growth.

Chapter 5: Recent Developments Since the Preparation of Report

5.1 Directive on Efficient and Effective Management of Litigation by Government of India

Department of Legal Affairs, Ministry of Law and Justice, has framed the 'Directive for the Efficient and Effective Management of Litigation by Government of India', which is an integrated approach in reinforcing the goal of good governance and ensuring public welfare and timely dispensation of justice. The directive acknowledges that the litigation process is seen to be time-consuming, complex, and influenced by various external factors, resulting in significant delays in resolving disputes. These delays contribute to uncertainty of outcome, undermine system accountability, and increase the financial burden on the parties or the public exchequer. The directive seeks to achieve the following objectives:

- i. Streamline the administrative processes involved in the conduct of litigation
- ii. Reduce litigation of recurrent nature
- iii. Reduce anomalies/inconsistencies in statutory or non-statutory notifications and administrative orders
- iv. Reduce unnecessary appeals against orders of the Court
- v. Put in place a sound Knowledge Management System (KMS)
- vi. Streamlined and effective management of contract-related issues where Ministries/Departments are party

The directive also states the approach to be followed towards Alternative Dispute Resolution (ADR) Mechanisms. Recourse to Alternative Dispute Resolution (ADR) mechanisms as a means for resolving disputes needs to be promoted, wherever feasible, taking the following aspects into consideration.

- **Resolution of Disputes through Mediation:** The nature of disputes which can be resolved through mediation may be identified and a scheme/guideline for resolution of such disputes through mediation in accordance with the relevant provisions of the Mediation Act, 2023, may be rolled out.
- **Approach to Arbitration:** While resorting to ADR mechanism leads to faster settlement of disputes, inclusion of arbitration clauses in Government contracts

should be considered on a case-by-case basis, with such clauses specifically designed to ensure public accountability and judicial oversight.

- **Promotion of Institutional Arbitration:** Wherever a recourse to arbitration is deemed necessary, institutional arbitration may be preferred over ad-hoc arbitration.
- **Periodic review of all arbitration cases involving the Union of India as a party:** A periodic review of all arbitration cases, whether domestic or international, should be conducted at the level of the Secretary or any Senior officer of the concerned Ministry/Department. The significant outcomes of such an assessment be communicated to the Department of Legal Affairs (DoLA), for record and reference.
- **Establishment of Government Arbitration Portal:** An Arbitration Portal shall be created by DoLA on the lines of National Judicial Data Grid, to collate the data on arbitration matters involving the Government and monitor the progress of arbitration cutting across Ministries/Departments of the Central Government or its attached and subordinate offices and the autonomous bodies. Each department should regularly upload all required details pertaining to each arbitration, including amount under dispute, on the portal.
- **Litigation Management of the State Governments:** The State Government(s) may also consider adopting this Directive for the efficient and effective management of litigation involving them.

5.2 Guidelines on MSE Scheme on Online Dispute Resolution for Delayed Payments

The Ministry of MSME has envisioned the development of a new Online Dispute Resolution Portal built on the principles of efficiency and speedy disposal of disputes which is a cornerstone of any robust and modern legal system. MSME Samadhaan ODR Portal can help in dispute avoidance, dispute containment and dispute resolution and will enable the ease of access to justice in timely and cost-efficient manner.

Components and Features of the Scheme

- **Development of MSME Samadhaan ODR Portal:** To promote and support the end-to end digitization of the delayed payments applications by creating a digital public infrastructure.
- **Support to MSEFCs for Online Dispute Resolution implementation:** To support the Micro and Small Enterprises Facilitation Councils (MSEFCs) in establishing the state- of art IT infrastructure for the effective implementation of the Scheme.
- **Financial Assistance for Legal Support:** To reduce the additional financial costs borne by MSEs during dispute resolution process, the Ministry of MSME will support the enterprises by providing financial assistance for documentation, application fees charged by MSEFCs, mediation, arbitration, and legal aid advocate to the maximum grant of ₹50,000 per case
- **Automated Case Management:** The portal allows parties to track live status of the case and view daily orders passed by MSEFC. The ODR portal provides for rights-based visibility so the mediator/conciliator cannot access documents that are accessible to arbitrators.
- **Analytics:** The ODR portal provides data analytics, MSEFC wise progress report, average disposal time, enforcement of settlement orders, arbitral awards. It also provides for secured repository of case documents by providing centralized access to parties and adjudicators only.
- **Pre-MSEFC Stage for Dispute Resolution:** The new MSME SAMADHAAN ODR Portal will provide two-fold solutions to delayed payments applications filed by Micro and Small Enterprises in two stages: (i) pre-MSEFC, and (ii) MSEFC. The pre-MSEFC stage is a voluntary, out of court solution which shall be undertaken based on consent provided by both the parties. The entire pre-MSEFC stage shall be completed within a period of fifteen (15) days from the date of filing of delayed payment application.

5.3 Important Supreme Court Judgements on MSMED Act and Alternate Dispute Resolution

- **Limited Power to Modify an Arbitral Award:** Five-judge Bench in *Gayatri Balasamy v ISG Novasoft Technologies Ltd* held that courts have a limited power to modify an arbitral award under Section 34 of the Arbitration and Conciliation Act. Limited powers to modify an arbitral award can only be exercised under the following circumstances: (i) when the award is severable, (ii) correcting clerical, computational, or typographical errors, (iii) modifying post-award interest, in limited circumstances, (iv) with respect to Article 142 of the Constitution.
- **Conciliators powers to arbitrate under MSMED Act:** In *Tamil Nadu Cements Corporation v Micro and Small Enterprises Facilitation Council*, the key question before the Court was whether members of the Micro and Small Enterprises Facilitation Council (MSEFC), who conduct conciliation under Section 18 of the MSMED Act, can subsequently act as arbitrators. A three-judge bench of Supreme Court noted that there existed conflicting judicial interpretations of whether MSEFC members who act as conciliators can subsequently serve as arbitrators.
- **Arbitrator's power to grant pendente lite interest:** In *Ferro Concrete Construction (India) v State of Rajasthan*, a Division Bench comprising Justices P.S. Narasimha and Joymalya Bagchi held that a contractual bar on payment of interest does not stop an arbitrator from awarding pendente lite interest with the arbitral award unless the contract expressly prohibits it.
- **Limited Scope of Appeal:** In *Somdatt Builders NCC-NEC v National Highways Authority of India*, the Supreme Court held that Court cannot consider the merits of the case while hearing a Section 37 appeal. It emphasized the limited scope of interference under Section 37 of the Arbitration Act.
- **Need for a new Law:** In *ASF Buildtech v Shapoorji Pallonji and Company*, Justice J.B. Pardiwala, highlighted the delays and procedural hurdles in arbitration despite multiple amendments to the 1996 Act. He noted that uncertainty in arbitration law was “an anathema to business and commerce.” The Bench urged the Ministry of Law and Justice to take a serious relook at the arbitration regime.
- **Benefit of MSMED Act to non-registered MSME:** In *NBCC (India) Ltd. v. The State of West Bengal & Others (2025 IN SC 54)*, the Hon'ble Supreme Court of India

reiterated the overriding nature of MSMED Act and held that the definition of supplier in section 18 is broader and allows even the non-registered MSMEs to participate in dispute resolution mechanisms under section 18 of MSMED Act.

5.4 RBI Draft Circular- Responsible Lending Conduct – Levy of Foreclosure Charges/ Pre payment Penalties on Loans

- Reserve Bank's supervisory reviews have indicated divergent practices amongst Regulated Entities (REs) with regard to levy of foreclosure charges/ pre-payment penalties in case of loans sanctioned to MSEs which led to customer grievances and disputes.
- REs, other than Tier 1 and Tier 2 Primary (Urban) Co-operative Banks and Base Layer NBFCs, shall not levy any charges/ penalties in case of foreclosure/ pre-payment of floating rate loans granted to individuals and MSE borrowers, with or without co-obligant(s), for business purpose. For MSE borrowers, however, this directive shall apply only up to an aggregate sanctioned limit of ₹7.50 crores per borrower.
- REs shall permit foreclosure/ pre-payment of loans without stipulating any minimum lock-in period. REs shall not levy any charges/ penalties in cases where foreclosure/ pre-payment is affected at the instance of the RE.



Annexure 1: Proposed recommendations for Amendments in MSMED Act

Provision	Relevant Section	Brief description of issue	FISME's Suggestions
Inclusion of Medium Enterprises and 'Works Contract'	Section 2(n)	● Inclusion of medium enterprises within scope of the Act ● 'Works Contract' not defined in the Act	● Medium Enterprises should be covered under the act. The number of Medium Enterprises is approx. 10,000-15,000 and addition of medium enterprises under the act will not overburden the MSEFCs. ● The words- '<i>or any other combinations thereof</i>' shall be added in Section 2(e) to incorporate 'works contract'
Procedure of MSEFCs	Section 18	Allowing referral of cases by MSEFCs to sole arbitrators	Mediation and Arbitration proceedings under MSMED Act should be conducted by MSEFC and not delegated to any other institution/Centre or referred to sole arbitrator. If required, in complicated cases, Council can make a reference to an Industry Expert.
	Section 18	Incorporation of documents-only arbitration through the procedure given in S.29B (Arbitration & Conciliation Act, 1996) for smaller claims	● For claims of small amount, summary proceedings should be conducted for dispute resolution. ● For claims of large amounts or complicated cases where MSEFCs lack capacity, Industry Experts can be appointed as <i>Amicus Curia</i> whose recommendations can be taken cognizance of in resolving the dispute.

			● The fees of the <i>Amicus Curia</i> to be borne by both the parties after taking into consideration the dispute amount.
Composition of MSEFCs	Section 20	Zonalization of MSEFCs to address capacity needs; pecuniary jurisdiction to be assigned to District MSEFCs.	The Act should stipulate the provision of an appellate tribunal to hear appeals against award of MSEFC.
	Section 20, 21	Composition of MSEFC (links closely to the capacity of MSEFC and prevents frivolous appeals under s. 34)	The MSEFC should comprise five members and there should be adequate representation of Industrial experts, Industrial bodies and Associations. The existing provision that MSEFC shall consist of not less than three but not more than five members should be retained
Regulatory Board		Central Regulatory and Supervisory Board	The Board should be made responsible for the following: ● Furnishing data on delayed payments cases for both Public (Govt., PSUs) and Private buyers ● Capacity Building of MSEFCs

Annexure 2: List of Officials at National Roundtable

S. No	Name	Designation
Government Officials		
1	Shri SCL Das	Secretary, MoMSME
2	Shri Manoj Pandey	Additional Secretary, MCA
3	Ms. Anuja Bapat	Deputy Director General, DC (MSME)
4	Dr. Sumantra Pal	Economic Adviser, Public Procurement
5	Shri Manoj Muttathil Ayyappan	Joint Secretary, DFS
6	Shri Ateesh Singh	Joint Secretary, MoMSME
FISME		
1	Mr. S.K Jain	President
2	Mr. Rakesh Chhabra	Vice-President
3	Mr. Neeraj Kedia	Chairman, Banking & Finance Committee
4	Mr. Dinesh Singhal	Past President
5	Mr. Anil Bhardwaj	Secretary General
Global Alliance for Mass Entrepreneurship (GAME)		
1	Mr. Ketul Acharya	President
2	Mr. Ramesh Dharmaji	Ex CGM- SIDBI, Senior Advisor - GAME
3	Mr. Dhruvil Jakasaniya	Manager
C2FO		
1	Mr. Vishal Narwal	Vice President

Annexure 3: Profile of Participants at Regional Roundtables

1. Regional Industry Associations

- Federation of Small & Medium Industries (FOSMI)
- Chamber of Small Industry Associations (COSSIA)
- Thane Small Scale Industries Association (TSSIA)
- Federation of Karnataka Chambers of Commerce & Industry (FKCCI)

2. Banks

- HDFC Bank
- State Bank of India
- Bank of Maharashtra
- SIDBI
- TJSB Sahakari Bank Ltd
- State Level Bankers Committee, Kolkata

3. MSMEs

- R K Dutt Concerns
- Dipti Corrugating industries Pvt. Ltd.
- Sun Connect Solar Pvt. Ltd.
- Noel Engineering Private Limited
- Kajay Remedies Pvt. Ltd.
- Shubham Specialty Products Pvt Ltd

4. Government Representatives

- MSME & Textiles Department, Govt. of West Bengal
- Directorate of Industries - Government of Maharashtra
- Joint Director & HOD, MSME-DFO

5. TReDS Platform

- RXIL
- Invoicemart
- C2treds

6. Buyer Organizations

- Pitambari Products Pvt Ltd
- Network Techlab India Private Limited
- Ashida Electronics Pvt Ltd
- Garden Reach Ship Builders & Engineers Ltd.
- Balmer & Lawrie Ltd.

7. Professionals

- Charter Accountants
- Lawyers
- Consultants

Annexure 4: National Roundtable- New Delhi, 28th September 2024



Annexure 5: Regional Roundtables At A Glance

Kolkata-3rd May 2024



Mumbai-14th May 2024



Bengaluru- 17th May 2024



About GAME

Global Alliance for Mass Entrepreneurship (GAME) is a social impact organization launched in 2018. GAME was conceived as a catalyst for national change, aiming to shift societal perceptions around entrepreneurship and cultivate a vibrant entrepreneurial ecosystem that drives job creation and economic growth. By tackling multifaceted challenges—such as access to finance, market entry, and regulatory hurdles—GAME orchestrates collaborative action across the financial, educational, and policy landscape to create enabling conditions for entrepreneurs.

Serving as an ecosystem enabler, GAME's work is distinguished by its systemic approach: fostering consensus among diverse stakeholders, aligning strategic efforts, and facilitating collaborative breakthroughs that unlock the potential of mass entrepreneurship. Central to its initiatives are program development, policy advocacy, in-depth research, and capacity building, with a particular emphasis on supporting women entrepreneurs and enabling MSMEs through targeted, place-based interventions.

In addition to its ecosystem-building mandate, GAME runs several pioneering programs aimed at empowering entrepreneurs and strengthening the MSME sector. Notable programs include access-to-finance initiatives such as NBFC Growth Accelerator Program (NGAP) that helps NBFCs avail of loans from formal institutions, thereby enhancing flow of credit to MSMEs. Further, GAME, along with NRLM /SRLM, enabled thousands of rural women entrepreneurs to access bank credit directly and grow their businesses, in a few districts across Rajasthan, Madhya Pradesh and Maharashtra.

As part of the organization's focus on place-based interventions, GAME partners with regulators and state governments to work together on district entrepreneurship missions. These pilots, launched in locations like Nagpur, Visakhapatnam, and Lucknow, focus on tailoring support ecosystems to local needs, including capacity building, mentorship, community engagement, and market access improvement.

Driven by belief in collective impact, GAME leverages partnerships across the entrepreneurship spectrum, focusing on creating meaningful opportunities for sustainable livelihood generation. (<https://massentrepreneurship.org/>)

About FISME

FISME- a national federation of MSME associations originated from the National Alliance of Young Entrepreneurs (NAYE) established in 1967 when Indian government started monumental initiatives for small industry promotion. In 1995, NAYE was reorganized and rechristened as FISME which came into being as a Federation of geographical and sectoral associations of MSMEs in India. FISME focuses primarily on trade and market access issues and reforms with the twin objective of establishing entrepreneurial and competitive environment at home and greater market access for Indian SMEs in India and abroad. (<https://fisme.org.in/>)

Thematic work areas

The key thematic areas of work at FISME constitute:

- Securing market access for MSMEs in India and abroad and ensuring competitive functioning of factor-markets
- Advocating for reforms in regulatory environment and promotional policies to enhance competitiveness of SMEs vis-à-vis their larger domestic counterparts and foreign firms through research and dialogue
- Executing MSME development projects supported by Indian government as well as by all major multilateral and bilateral bodies in India such as UNIDO, ILO, UNCTAD, DFID, GIZ among others.

About C2FO

C2FO is the world's on-demand working capital platform, providing businesses with fast, flexible, and equitable access to low-cost capital. C2FO enables trust and transparency in working capital finance through its suite of solutions using patented Name Your Rate® technology that enables companies to be paid sooner by the world's largest enterprises. Currently serving hundreds of thousands of business customers globally, the platform has delivered more than \$445 Bn+ in risk-free capital since its inception. Founded in 2008 and headquartered in Kansas City, USA, with offices around the globe, C2FO's mission is to ensure every business has the capital needed to thrive. To learn more, visit (<https://c2fo.com/>)

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