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| 10:02 AM   21 NOV<br><b>MARKET STATS</b> ▼ | SENSEX<br><b>25,993</b> ▼ -157.02 | NIFTY 50<br><b>8,018</b> ▼ -56.10 | GOLD (MCX) (Rs/10g.)<br><b>28,970</b> ▼ -161.0 | USD/INR<br><b>68.15</b> ▲ 0.02 | <b>CREATE<br/>PORTFOLIO</b> | <b>Download ET<br/>MARKETS APP</b> | CHOOSE<br>LANGUAGE<br>ENG |
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# View: Why small finance faces a big wipeout

By Swaminathan S Anklesaria Aiyar, | Nov 20, 2016, 11.32 AM IST

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The media generally believes that [demonetisation](#) has been a political success, that it has put opposition parties on the back foot, and won the hearts of millions who think Modi is the only politician willing to take tough decisions to hit black money. Middle-class folks standing in long queues mostly seem willing to suffer a bit for a great cause.

On the other hand, much has also been written about people dying for want of cash for medical care, of some people committing suicide, of farmers unable to sell their produce, of traders unable to function, of jewellers shuttering shops, and of substantial distress in the 70% of India that is rural and functions almost entirely on currency notes.

What the media and sundry pundits seem scarcely aware of is the carnage occurring in the small-finance sector. This has low visibility, but is absolutely vital for financing the vast majority of small businesses, who have little or no access to the formal banking system. The financiers who reach these millions of small businesses are called non-banking finance companies (NBFCs). They range from big corporates like Bajaj Finance and Shriram Transport Finance to small microfinance institutions. They are able to reach grassroots businesses that banks cannot, and so play a vital but little-appreciated role in greasing the wheels of medium, small and micro enterprises.

Of India's 100 million shopkeepers, barely 2% have the machines to accept credit and debit cards: the rest are cash-based. Much the same is true of a horde of other small businesses, transporters and traders. These small folk have all suffered a sharp drop in business. Many are parts of value chains, starting from raw material producers and ending at the retail level. All are reeling under a shortage of currency notes. On the one hand, customers have reduced spending for want of currency notes. On the other hand, businesses do not garner enough currency notes to make cash repayments of loans. If their current problems last just a few weeks, they will recover. If the problems continue for two months, the damage will be substantial and could spark a mini-financial crisis among the small lenders that keep the economy moving.

NBFCs borrow from banks and lend to small businesses, using the last-mile reach that they have and banks do not. Lending institutions have only a little of their own capital, and borrow the rest, so they are fragile creatures that cannot afford significant defaults. Industrial businesses may be able to withstand significant defaults from customers and recover, because they have a substantial cushion of their own money, and are not so dependent on borrowings. But the capacity of banks and NBFCs to manage defaults is far less because they have small equity cushions and are heavily dependent on borrowed funds.

For lending institutions, loan defaults of 2% are normal; of 6% spell crisis; and of 10% spell potential bankruptcy. So, while most small businesses will survive a month or two of tribulations caused by demonetisation, defaults of no more than 10% can spell disaster for their financiers. Many small businesses cannot repay loans from NBFCs on time because of a drop in business. Many others want to repay but lack the currency notes to do so.

These are not actually defaulters. They are willing to pay but cannot because of bungled demonetisation. Yet the immediate impact on NBFCs is the same as wilful default.

NBFCs are reporting a sharp spike in non-payments. One top transport finance company says that only 60% of normal payments are coming in. Some of the smallest microfinance loans, entailing a weekly repayment of a few hundred rupees, are being repaid because the women borrowers are able to garner notes worth Rs 300-400. But larger borrowers who need to repay instalments of over Rs 1,000 say they cannot find the currency notes to do so.

The RBI lays down strict rules for finance companies, which have to classify loans overdue beyond a point as dubious or bad loans, and set aside money to cover the gap. If these set-asides are no more than one-eighth of all loans, that can wipe out the net worth of many finance companies. That in turn will mean a financial crisis for the small business sector.

The RBI must immediately relax its rules for financial provisioning, and create ample space and time for small businesses and small finance to recover. What look like defaults should be formally recognised as exceptional events arising out of demonetisation, not as inability to pay. Existing RBI rules will kill small finance, so an immediate relaxation of rules is essential.