SUMMARY OF RECOMMENDATIONS

Ingredients of the Textile Package

1.1 Extend the unbroken CENVAT chain to the entire Textile sector.

1.2 Discontinue CENVAT credit on deemed basis.

1.3 Apply an 8% CENVAT for the entire Textile sector starting at the yarn stage for a period of 3 years for enabling modernization of the sector.

1.4 On synthetic filament yarns – PFY, POY and PTY – reduce excise rates from 32% to 24% in first year and 24% to 16% in second year. CENVAT on polyester-cotton and viscose-cotton blended yarn be brought at par.

1.5 Continue the present excise exemptions to the genuinely disadvantaged sectors. Retain the SSI excise exemption / CENVAT exemption to the sectors like fabrics woven on handlooms, khadi, silk yarn, hand processing totally without the aid of power whose details are contained in the Report.

1.6 Retain CENVAT at 16% on all man-made / synthetic fibres.

1.7 Reduce customs duty from 25% to 5% on capital goods of man-made / synthetic fibre / yarn industry and similarly on certain garment sector machinery.

1.8 Domestic production of such machinery be exempted from CENVAT whose import is exempted from CVD. Weaving preparatory and critical garment machineries be exempted from CVD / CENVAT (Details in the Report).

1.9 Reduce customs duty on intermediates of synthetic fibres and yarns (DMT / PTA / MEG / Caprolactum) from 20% to 15%.

1.10 Reduce customs duty on apparel grade wool and flax fibre from 15% to 5%.

1.11 In view of our comfortable foreign exchange position, permit the Textile industry to access External Commercial Borrowing for purchase of indigenous machinery by a suitable modification in the FEMA for implementation of projects under the TUF scheme.

1.12 Announce the constitution of a Textile Industry Reconstruction Fund with a Corpus of Rs.3000 crores for financial restructuring of the Textile industry.

INVESTMENT AND GROWTH IN TEXTILE INDUSTRY

INTRODUCTION

2.1 Textiles and clothing sector is the largest employer after agriculture and its importance in India's economy is recognised for its contribution to industrial production and export earnings. With the phasing out of the Multi Fibre Arrangement by 2005 and the removal of Quantitative Restrictions and scheduled dismantling of tariff barriers by the end of 2004, the industry will be required to achieve a competitive strength for its survival in the global environment. In the globally integrated scenario new opportunities will emerge for the Indian textile industry while challenges in the form of credible threat of imports would also arise. The key to success will be a transformed mindset of the industry to get rid of technological obsolescence and pave way for modern industrial base.

2.2 **The National Textile Policy 2000 was announced in the context of the need for accelerated growth in the sector.**

2.3 During a presentation made to the Prime Minister on 23rd October, 2001 the importance of the textile sector in the national economy and the need to take urgent, time-bound steps to attract investments and encourage growth in the textile sector was emphasised and a High Powered Steering Group, with Prime Minister's approval, was set up to examine all the issues concerning investment and growth in the textile industry and to suggest an action plan for growth.

Setting Up of a Steering Group on Investment and Growth in Textiles

2.4 In the above context, a Steering Group under the chairmanship of Shri N K Singh, Member, Planning commission was set up to:

- Review and monitor the implementation of policies and programmes outlined in the National Textile Policy 2002 and devise further measures necessary for attracting requisite investment and growth in textile sector;
- Review export scenario and identify measures to enhance export competitiveness of Indian textiles in the changing global scenario, particularly, in the post 2004; and
- Evolve a growth oriented fiscal policy for integrated development of the textile industry covering all its segments.

2.5 The constitution of the Steering Group and the terms of reference are at **Annex – I**.

FISCAL DUTY STRUCTURE

INTERIM REPORT

CENVAT

3.1 In view of the urgency of reforms required to attract investment in this sector, the Steering Group submitted an interim report (extracts **Annex-II**) on fiscal policy for textile industry in January 2002 to enable the Government to consider fiscal policy changes in the Budget 2002-03. A comparative statement of recommendations of the Group and changes announced in the Budget 2002-03 is at **Annex-III.** As could be seen some of the recommendations were accepted but large number of them still remain to be implemented. While submitting the fiscal policy for textile industry, the Group in its report emphasised "*these recommendations need to be accepted as a package. Selective application of the elements of this package will lead to further distortion and hence not recommended*".

3.2 In the meeting of the Group held at Mumbai on September 17, 2002 industry, banks and financial institutions also endorsed that credit flow to textile industry is a function of profitability, which requires removal of fiscal distortions and creation of a level playing field.

3.3 A copy of the record note of the meeting is **Annex-IV**.

Task Force suggestions

3.4 The Task Force on Indirect Taxes set up by Ministry of Finance under the Chairmanship of Adviser to Minister of Finance and Company Affairs with the objective to review the Customs and Central Excise Law and procedures and make recommendations on their simplification, reducing cost of compliance, facilitating voluntary compliance, etc. have in its Consultation Paper, pointed out that the present tax structure with its plethora of duty exemptions in the textile sector distorts the production pattern. The Task Force has suggested that as a general policy, the textile sector should be subjected to the standard rates of duty. The salient suggestions made by the Task Force about fiscal structure in the textile sector are:

- A number of duty exemptions available in the textile sector should be removed without having any adverse impact on the industry. It has suggested withdrawal of around 105 product/sector specific exemptions. The excise exemption in respect of 16 items be retained and continued – list annexed at **Annex - V**
- Withdrawal of sector specific exemptions has been emphasised in the Consultation Paper.
- A single CENVAT rate of 16% be achieved in the textile sector by the year 2005-06 except Polyester Filament Yarn, on which the reduction in duty from 32% to 16%

has been suggested to be achieved in a phased manner by 2006-07.

- Establishing a complete CENVAT chain in the textile sector with credit of duty on actual basis and removal of deemed credit. Even traders to pay duty and get credit on document basis.
- The production of unprocessed woven and knitted fabric as well as yarn be covered under the Small Scale Duty Exemption Scheme.
- To continue the exemptions for handlooms, the processing of handloom fabrics can be given the benefit of Small Scale Duty Exemption Scheme. In case, a unit processing handloom fabric is thus required to pay duty, it should be given a transparent subsidy as in the case of hank yarn.

3.5 **The Steering Group endorses the suggestions made by the Task Force in respect of removal of sector specific and other duty exemptions, establishing a complete CENVAT chain, a uniform duty rate, withdrawal of deemed credit, etc.** Effective implementation of these suggestions towards rationalisation of fiscal duty structure in the textile sector would go a long way in providing a level playing field and holistic growth of the textile sector.

3.6 **The Group strongly reiterates:**

- Continuation of the excise exemptions to the genuinely disadvantaged sectors.
- Need to evolve an effective mechanism to ensure that the benefits of such exemptions are not taken by the unintended sectors.
- Policy initiatives taken by the Government in this direction should not be reversed as has happened in the case of duty exemptions provided to the processing sector for carrying out certain processes with the aid of power. The number of such exemptions was reduced from 12 in the case processing of cotton fabrics and from 7 for processing man-made/blended fabrics to 3 in the Budget 2002-03. Subsequently, the pre-budget position was restored by the Government. The Group feels that such policy decisions shake the very confidence of the industry and tend to give indication of instability in policy making process.
- No product or sector specific duty exemptions be given.

SSI - Exemptions

3.7 The fiscal and other tax incentives given in the past to the SSI sector have led to fragmentation of the textile industry. Besides, the misuse of such benefits also created market distortions by unfair competition to the units in organised sector. This has also largely attributed towards uncompetitiveness in the sector, as the units in SSI sector preferred to remain within the SSI investment limit and consequently no worthwhile investment could flow to the sector. This in turn adversely affected modernisation and setting up of large scale production capacity so as to achieve economies of scale. The Group feels that the excise duty concessions/exemptions to major spinning, fabric producing segments and processing segments not only make the tax base extremely narrow but also break the taxation in value addition chain creating distortions and inequities. SSI exemption to cotton yarn spinning has already been withdrawn. Therefore, the benefits of SSI Excise Exemption Scheme wherever available presently should be withdrawn and the Scheme should be confined only to meet the larger social development objective and should not be extended to all sectors of the textile industry, such as spinning, weaving, knitting, power processing, garmenting, etc. **The Group recommends that the SSI Excise Exemption Scheme be given to the handloom, silk, wool and hand processing segments of the textile industry in the manner indicated below:**

(i) Fabrics woven on handlooms should be exempted from CENVAT. No deemed credit be given if such handloom fabrics are processed with any aid of power. However, processing of handloom fabrics by totally hand processing units should also be exempted from CENVAT.

(ii) The hand processors (working totally without aid of power) can also be given SSI exemption upto a turnover of Rs.50 lakhs per year, subject to the condition that they should be registered as SSI unit with concerned authorities.

(iii) Silk yarn spun from silk waste and manufactured without the aid of power.

(iv) Yarn of carded wool and combed wool manufactured without the aid of power and

(v) Fabrics woven on handlooms, and certified as 'Khadi' by KVIC and processed with or without the aid of power.

Recommendations

3.8 The differential and discriminatory duty structure on processed fabrics has impeded the growth, profitability and competitiveness of the high-tech process houses. With a view to pave the way for attracting large investments in this sector thereby improving the quality, it is imperative that a non-discriminatory CENVAT credit system be put in place. Currently, the dual system of CENVAT credit – document based and deemed credit creates unfair competition within the sector. **The Group strongly recommends that CENVAT credit on deemed basis should be abolished and a single system of CENVAT credit on actual basis (document based) be implemented.**

3.9 It is reiterated, while the policy of the Government is to move towards single CENVAT rate, textile sector need to be considered on a different footing, particularly, in view of the present difficult situation, criticality of investment in technology upgradation by 2005, the need to clothe 1 billion people and the opening of the global textile market

3.10 In order to move further in the direction adopted in the Budget 2002-03, **a merit rate of CENVAT at 8% is reiterated for the textile sector starting at yarn stage.** Encouraged with the results from the withdrawal of CENVAT exemption to the mills on production of hank yarn and replacing it with direct subsidy to handloom weavers, a revised CENVAT regime on the following lines is recommended:

(a) While there are arguments in favour of a uniform CENVAT rate across the board, clothing needs to be placed in a different category. In the textile sector, cotton yarn attracts only 8% duty, grey fabrics are exempt and there are concessions at various stages of processing. Also, the duty on processed fabrics is 8% CENVAT and 4% AED. When AED gets transferred to the States, fabrics will be left with 8% CENVAT.

(b) The Group also noted with concern that the profitability in the textile sector has gone down considerably and investment sentiments are largely adverse. Keeping in mind the need to encourage investment and growth in the textile sector and realising the fact that the investments will be driven by profits, the Group considered it appropriate to recommend a merit rate of 8% for the textile sector in general (with a few exceptions) for a period of 3 years i.e. with a sunset clause upto 1.3.2005. The sector could then move to a uniform rate of CENVAT as may be applicable to similar sectors.

(c) The current description under 5206.12 enables blending of Viscose Staple Fibre up to 49% and clearing the yarn at Cotton Yarn basic duty of 8%. However, even if 1% Polyester Staple Fibre is blended with Cotton, the yarn attracts basic duty of 16%. The tilt towards any specific blend be removed and Polyester-Cotton and Viscose-Cotton blended yarns be treated at par.

(d) The Group also felt that in the case of PFY, POY and PTY a reduction in excise duty from 32% (16% CENVAT + 16 SED) to 8% may not be feasible. Therefore, Group recommends the existing standard rate of CENVAT of 16% for PFY, POY and PTY. If revenue considerations so warrant, the reduction in CENVAT rate instead of one year could be carried out in two years in stages of 24% and 16%. The Group felt that ideally all synthetic/man-made fibres should also have a merit rate of CENVAT at 8%, but appreciating the revenue implications of going back upto the raw-material stage, CENVAT for all synthetic/man-made fibres may continue at 16%

(e) The Group is also of the view that no positive credit should be given at any stage in the textile chain and therefore, capping of the CENVAT credit is recommended wherever necessary. In view of the above the following recommendations are made:

Sr. No	**Product**	**Existing CENVAT rate**	**Recommended CENVAT rate**
1.	Cotton Yarn (in cone and hank form)	8%	8%
2.	All Yarns i.e. Spun and Filaments (except POY/PTY/PFY)	16%	8%
3.	POY/PTY/PFY	32%(CENVAT 16%+SED16%)	16% (CENVAT 8% + SED 8%)
4.	Woollen yarn	16%	8%
5.	All man-made/synthetic fibres	16%	16%(no change)
6.	Grey woven fabrics of all fibres	Optional @ 12% (Basic 8% + AED 4%)	8% (Basic)
7.	Processed woven fabrics of all fibres	12% (Basic 8% + AED 4%)	8%
8.	Grey knit fabrics of all fibres	Optional @ 12% (Basic 8% + AED 4%)	8%
9.	Processed knit fabrics of man-made, blended, woollen	12% (Basic 8% + AED 4%)	8%

10.	Processed knit fabrics of cotton	Optional @ 12% (Basic 8% + AED 4%)	8%
11.	Knitwears of all fibres	Optional 12% (Basic 8% + AED 4%)	8%
12.	Garments (woven)	12%(Basic 8% + AED 4%)	8%
13.	Silk	Exempt	No change (from the existing exemption)

3.11 In the above recommendation, the CENVAT rate for man-made/synthetic fibres is higher than the CENVAT rate of yarn (except POY/PFY/PTY). The CENVAT credit at yarn stage should be limited to the actual CENVAT incidence at yarn stage. In case of filament fabrics, CENVAT credit should be capped at the level of actual CENVAT incidence at fabric stage. No positive credit would be admissible at yarn or fabric stage

3.12 **The above recommendations are not revenue negative. In fact, even without considering buoyancy in the sector, they will yield more revenue than the present levels (a calculation sheet is at Annex-VI). Further, lowering of CENVAT rate would result into consequent reduction in the revenue outflow by 1/3rd on account of drawback disbursement.**

Textile Machinery

3.13 The Steering Group, in its interim Report, recommended reduction in cost of machinery as a critical intervention to encourage investment in modernization and technology upgradation. While majority of the recommendations of the Steering Group have been implemented in the Budget 2002-03, **the following recommendations need to be implemented further:**

- CENVAT exemption has already been given to automatic shuttle looms. Similar exemption should also be extended to necessary weaving preparatory machinery to complete the production chain – list annexed at **Annex – VII.**

- CVD exemption has been given on 11 textile machinery items for imports. In order to provide a level playing field to the indigenous manufacturers, the domestic production of such machinery should also be exempted from CENVAT – list annexed at **Annex – VIII.**

- 31 machinery items of the garment sector **(Annex - IX)** have been allowed for import at concessional customs duty of 5% and 7 machinery items **(Annex - X)** at 25% normal customs duty. Imports of these machinery items either at concessional customs duty or with normal duty has not been found economical since such import also attracts CVD and SAD. The import of these critical 38 machinery items be allowed at par with import of 40 textile machinery items, the import of which have been permitted at 5% customs duty without CVD and most of which (29 items) have also been exempted from CENVAT.

- The import of capital goods of synthetic fibre / yarn industry has been allowed under normal customs duty of 25%. This is a capital-intensive industry. The capital cost is one of the major critical factors in determining the cost of items manufactured from such capital goods. The prices of our synthetic fibres / yarns are far higher than available internationally. In order to make the availability of raw materials to the textile sector at reduced prices, it is necessary to bring down the capital cost by way of reduction in customs duty from 25% to 5% on capital goods of man-made/synthetic fibre/yarns (subject to end use) as per the list given by Department of Chemicals and Petro-Chemicals –**Annex -XI.**

Customs Duty

3.14 To enhance the competitiveness of the textile industry and to make clothing affordable to the poorer sections of the society, the cost of raw materials needs to be brought down in a few segments like synthetic and man-made fibre, wool, etc. With the phasing out of MFA, there is urgent need to enhance the competitiveness of our industry by making available raw materials to Indian textile industry at equivalent price at which they are available to our competitors. **Therefore, the following recommendations are made for changes in customs duty:**

- Reduction in customs duty on apparel grade wool and flax fibre from 15% to 5%.
- Exemption from 4.2% Special Additional Duty of Customs (SAD) on import of Rayon Grade Wood Pulp.
- Reduction in customs duty on intermediates of synthetic fibres and yarns (DMT/ PTA/ MEG/ Capralactum) from 20% to 15%.
- Duty free import of specialty filament yarns which are not being manufactured indigenously –list attached **(Annex - XII).**

3.15 The Group reiterates its earlier recommendations for acceptance of the recommendations as a package.

CREDIT REQUIREMENT FOR INVESTMENT AND GROWTH

4.1 The textile industry is a labour intensive industry and next only to agriculture, contributes to about 28 percent of the industrial work force. With a growth in textile production, the employment in this sector is expected to grow at the rate of 1.74 per cent. Majority of them are weavers, artisans and craftsmen including those from the socially and economically weaker sections dependent on textiles and textile based activities. It is expected that as against an estimated employment of 82 million in this sector, the sector will provide to 91 million by the end of 2006-07.

4.2 After analysing the capacity and technology levels in various segments of textile industry and the need for modernisation, funds required for various segments have been estimated as below. The detail of the working is at **Annex- XIII.**

Sl.No.	Segment	Investment (Rs.in crore)
1.	Ginning & Processing	1,800
2.	Spinning	10,600
3.	Weaving	22,950
4.	Knitting	3,150

5.	Woven Processing	25,800
6.	Knit Processing	8,550
7.	Clothing	24,000
8.	Jute	500
9.	Silk, Wool	1,200
	Total	98,550

4.3 The new investment is expected to improve not only the technological upgradation but also HRD skills of large number of workers who are living below or just above the poverty line. This will help a large number of women and members of weaker section of society to join the workforce and improve their quality of life. This investment would also enable the Indian textile industry to meet the global challenge that it is going to face once the multi fibre arrangement come to an end by 2005. In order to encourage investments and improve credit flow, the initiatives taken by the Textile Ministry and related issues which need to be addressed are following:

Technology Upgradation Fund Scheme (TUFS)

4.4 At present, the only scheme through which Government can assist the industry is the Technology Upgradation Fund Scheme (TUFS) which provides for reimbursing 5% interest on the loans/finance raised from designated financial institutions for bench marked projects of modernisation. IDBI, SIDBI, IFCI have been designed as nodal agencies for large and medium small scale industry and jute industry respectively. They have co-opted 148 leading commercial banks/cooperative banks and financial institutions like State Finance Corporations and State Industrial Development Corporation etc.

4.5 While formulating the TUF Scheme, man-made fibre/yarns industry {except Viscose Filament Yarn (VFY)} were not covered under the scheme since it was generally considered that this sector is comparatively modernised and does not require TUFS assistance. In view of the growing importance of this sector, **the Group recommends that machinery (including the ancillary facilities) required for manufacture of synthetic/man-made yarn onwards (including filament yarn) be allowed for benefits under TUFS. Other value addition processes including weaving, processing and garmenting of synthetic/man-made filament/spun yarn are already covered. Production facilities upto the polymerisation stage, which is basically the chemical process, need not be given support under the TUF Scheme.**

4.6 A brief analysis on the progress of implementation of TUFS in various segments during last three years as well as last eight months is at **Annex-XIV**.

Implementation of the Scheme by co-opted PLIs

4.7 Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) and Industrial Finance Corporation of India (IFCI), the Nodal Agencies of the scheme for non-SSI textile sector, SSI textile sector and jute sector respectively have coopted a total of 148 banks/financial institutions consisting of 18 SFCs, 17 SIDCs, 11 Twin function IDCs, 82 Scheduled Commercial Banks, 12 Co-operative Banks, 5 All India Financial Institutions, EXIM Bank, NCDC and NSIC for implementation of the scheme. However from the feedback received, only 51 co-opted PLIs have actually implemented the scheme, 33 PLIs that have intimated 'Nil' progress are virtually not implementing the scheme, whereas there is no intimation whatsoever from the remaining 64 PLIs.

Rigid attitude of Nodal Agencies with regard to financial norms etc.

4.8 Nodal Agencies have agreed that co-opted PLIs under direct finance may fix their own prudential norms without affecting technology norms under TUFS and can interpret bankable project in their own way. However, in actual practice, Nodal Agencies are not covering some of the applications disbursed by the PLIs stating that the projects do not meet the financial norms as laid down in the scheme.

Though IMSC has discussed it, IDBI needs to be requested that such cases needs to be taken unless it feels there is gross violation of certain norms that requires to be brought to the notice of Central Government.

TUFS proposals in conjunction with other schemes

4.9 SIDBI is the nodal agency for TUFS as well as operating agency of National Equity Fund Scheme (NEF) and promoter of Credit Guarantee Fund Trust Scheme (CGFTS). However, SIDBI directly is not covering TUFS proposals in conjunction with NEF and CGFT. The TUFS proposals should be considered in conjunction with NEF and CGFTS provided the projects are meeting the norms of all the three schemes. It may be impressed upon SIDBI to accept such cases.

Rejection of applications under TUFS

4.10 As per the details furnished by Nodal Agencies / PLIs in respect of applications under TUFS rejected by them, it is observed that many cases are rejected on unsustainable grounds such as :- 'the unit is not banking with them at present', 'promoters new entrant to the industry hence not experienced', 'past performance not satisfactory', 'not found support worthy as operations are marginal', 'green field projects', 'proposed products are highly competitive', 'company not in a position to provide security', 'promoters were engaged only in marketing activity and had no industrial experience', 'performance of many of the similar assisted existing units not satisfactory', 'promoters were taking up too many projects at the same time' etc. All these issues require to be sorted out in consultation with nodal agencies / PLIs in order to make the scheme more progressive.

Co-option of banks which have already implemented the TUF scheme.

4.11 Textile Ministry has been receiving representations from textile industrial units as well as the banks including co-operative banks stating that they have already disbursed finance to industrial units under TUFS for the projects, which are TUFS compatible. However, since the banks have not been co-opted by the Nodal Agencies, units are not in a position to claim the interest reimbursement. Such units should not be deprived of the benefits under the scheme due to the only reason that the banks are not co-opted. This office has requested IDBI / SIDBI from time to time regarding co-option of such banks by forwarding / recommending their representations. The nodal agencies particularly SIDBI should co-opt. such banks to increase the coverage of TUFS.

4.12 **Realising the urgency and difficulties in the operation of TUF Scheme because of its rigid norms certain new initiatives on the following lines may be**

considered for decentralised as well as organised sector:

Decentralised Sector

4.13 Recognising the criticality of the weaving sector to the entire textile value chain, and its lack of preparedness to meet the challenge of the global market, Government announced in the Union Budget 2001-02 a special programme for modernizing weaving capacities by induction of 50000 shuttleless and 2.5 lakh semi automatic/ automatic looms in the decentralized powerloom sector, with TUFS as the main credit instrument. Facilitation machinery was put in place and modifications were carried to the guidelines and parameters of TUFS to enable greater access to capital to the sector.

4.14 Despite this, the pace of modernisation has failed to improve. Loans sanctioned and disbursed to the small-scale powerloom sector under TUFS are still less than 1% of the total. As on August 2002, only 118 units out of 3.7 lakh powerloom units (0.03%) have stepped forward to modernize.

4.15 The major reason is the inability to access bank credit due to an absence of books of account; size of credit requirement are too small to meet the TUFS norms for minimum project size; the existence of a large number job work units with neither the need nor capacity to meet the requirements of bankers for loans; and the bankers' reluctance to extend credit to the unorganized sector.

4.16 Taking cognizance of these issues, **it is recommended that a new scheme be launched that enables small scale units to access funds from any source, including sources other than banks, by giving them a direct capital incentive, in the manner of the Cotton Technology Mission, linked to their fulfilling certain specified criteria of modernisation. The capital incentive should be limited to the NPV of the concession currently available under TUFS.** Considering that the introduction of the scheme will reduce the off-take under TUFS by the amount envisaged for this sector, funds be made available out of the total allocation for that scheme in the 10th Plan.

<u>Organised Sector</u>

4.17 Under TUF Scheme existing Rupee Term Loan (RTL) can be converted into LIBOR linked foreign currency loan (FCL) with over all repayment period not exceeding 10 years. However, after conversion, instead of 5% per annum interest reimbursement on RTL, the borrower will be eligible for coverage of exchange rate fluctuation limited to5% per annum as admissible to FCL.

Existing provisions of Foreign Exchange Management Act (FEMA)

4.18 As per present guidelines of FEMA, External Commercial Borrowing (ECB) in foreign exchange upto US$ 50 million or its equivalent by an Indian entity for general corporate purposes with average maturity of not less than 3 years is permissible under automatic route with the stipulation that such funds should not be utilised for investment in stock market or in real estate business. RBI Notification No.FEMA 3/2000-RB dated 3.5.2000 read with A.P. (DIR Series) Circular No.10 dated 5.9.2000 attached as **Annex - XV** . As such the textile units can resort to ECB upto US$ 50 million to implement projects under TUF Scheme with repayment period of around 5-7 years.

Current impediments under FEMA

4.19 Normally, overseas lenders who extend funds under ECB insist for bank guarantee for repayment of the loan. Under present provisions of FEMA, an authorised dealer can give a guarantee in respect of debt or other liability incurred by a person resident in India and owed to a person resident outside India, in the following cases, namely:
where the debt, obligation or other liability is incurred by the person resident in India –

- As an exporters, on account of exports from India (or)

- As an importer, in respect of import on deferred payment terms under RBI's approval.

RBI Notification No.FEMA 8/2000-RB dated 3.5.2000 - attached as **Annex - XVI.**

4.20 In other words, the authorised dealer cannot issue a Foreign Letter of Guarantee (FLG) in respect of FCL utilised for purchase of indigenous machinery. In absence of such bank guarantee, normal borrowers are unable to go for ECB for their projects under TUF Scheme and thereby deprived of cheaper funds.

Suggested alternatives

4.21 Government of India may encourage foreign currency loan on regular basis to meet credit requirements under TUF Scheme as:

- Total cost of funds to borrower under RTL & FCL will almost be equivalent or sometimes FCL may be cheaper than RTL (average interest on RTL under TUF Scheme is about 13-14% p.a. and after 5% interest subsidy from GOI, net interest to the borrower works out to 8-9% p.a.; in case of FCL, the average interest would be LIBOR + 2.5% i.e. 4.25% approx. + forward premium of around 4% in which case the net cost to the borrower under FCL would be around 8.25%).

- Export units will have natural hedge against exchange rate fluctuation and need not go for forward cover which shall further reduce the cost of FCL (due to saving of forward premium cost) which shall be around 4.25% to 4.50% p.a. approx. besides the guarantee commission payable to commercial banks.

- Under FCL, the cost of exchange fluctuation risk is borne by the borrower and even after that, the total cost of funds will be either equivalent or lower than that of RTL. In the process, GOI would save 5% p.a. interest subsidy payable by the Government and also 5% p.a. subsidy towards exchange rate fluctuation may not be warranted as the latter can be borne by the borrower under FCL without any additional interest burden. This would result in saving of financial burden of GOI.

- GOI may establish a Reserve Fund in which savings under TUF Scheme could be passed on to the benefit of Indian textile industry. Using this Fund, GOI may offer Letter of Comfort or counter guarantee to the Indian banks in respect of FLGs given by such banks under TUF Scheme towards repayment of loans raised by the borrower through ECB.

4.22 **Recognising the comfortable foreign exchange reserve position, it is recommended that FEMA may be**

amended suitably so as to permit authorised dealers to issue FLG favouring overseas lenders even if such overseas funds are used for purchase of indigenous machineries by the domestic textile sector for implementation of projects under TUF Scheme. This would provide Indian textile industry better access to the latest technology through international competitive credit terms. This would also improve the overall competitiveness of Indian textile industry in international markets and also domestically in terms of quality and price.

FINANCIAL RESTRUCTURING OF VIABLE AND POTENTIALLY VIABLE TEXTILE MILLS

5.1 Many units in the textile sector have become sick owing to various internal & external factors. This is not confined to any specific segment of the industry and all components spinning, weaving, processing and composite units suffer from financial sickness. For purposes of rehabilitating the industry as a whole, financial support is necessary. Given the current status of the bulk of the industry, the companies are not received positively by the capital or debt market and are unable to access funds. Many of the textile units are under purview of financial institutions as they have defaulted in their repayment obligations. Hence a specific initiative by the Government for addressing the concerns of the organised textile sector would be necessary for reviving the prospects of this sector.

5.2 Units in this sector can be subjected to an ABC analysis. The A units are those which are capable of profits and can take a debt burden. The debt is for expansion, reorganization or consolidation. The B units work on thinner margins and could benefit from lower cost of capital and may require management strengthening. The C units are those which are not likely to turn around in the near future and may therefore be left to themselves unless coupled with borrowed strength from the A or B units.

RECONSTRUCTION FUND

Options for finance

5.3 Financial institutions have lent funds and are unable to recover them. They have the option of taking control of the assets from the borrowing units or persuading such units to take appropriate rehabilitation measures. A key factor to rehabilitation is low cost of capital. For the purpose funds could be made available from several sources. Without limiting their origins they can be (a) an allocation from the existing infrastructure fund, (b) working through specialized lines of credit with the help of financial institutions in the international market, (c) approaching specific lending institutions (d) approaching international associations like the ADB (e) approaching the market for collecting funds through the issue of bonds or (f) effective utilization of the unavailed portion of the Technology Upgradation Fund (TUF)

5.4 If the financial institutions work in coordination with the government, the government may consider to swap the existing lending with funds available from funds like the infrastructure funds. This would retire the expensive debt and make available cheaper finance as the cost to be borne by the institution would be lesser than its existing cost of capital. In addition, the companies would require funds for working capital assistance and cost reduction measures such as rightsizing of manpower and power conservation initiatives. If the market has to be approached, financial institutions can work towards specialized lines of credit from Multilateral and bilateral agencies such as KFW, Germany, Asian Development Bank (ADB) etc. The cost of these funds will have to carry an additional spread burden for the risk on re-lending to the A, B or C units. International cost of capital is low and if such funds are available the line of credit for international borrowing can be cost effective. Apart from specified lines of credit, the matter may also have to be approached from a tax effective point of view and borrowings made from such institutions which enjoy a tax exempt status. Alternatively, the possibility of extending such tax facility may be considered. Institutions like ADB may also be agreeable to make a government lending. The repayments can have long periods or could be in the nature of grants. The last of the above sources of funds is bonds. There have been instances in the past where the government has been instrumental in providing seed finance on the strength of which borrowings have been made upto six times or eight times such seed capital.

5.5 Considering the overall state of the industry at present, tax sops may be necessary for the purposes of providing incentives to investments. At present there are provisions in Indian Income tax act facilitating business reorganizations. The tax law permits carry forward and set off of accumulated loss and unabsorbed depreciation allowance in cases of "amalgamation" and "demerger" of companies; conversion of a proprietary concern or a partnership firm into a corporate entity.

Role of the Financial Institutions

5.6 The financial institutions could play a pivotal role by assisting the government in appropriate utilization of competitive capital derived from the above sources. Professional bodies could be associated with the financial institutions for ensuring that the deployment of funds is for such purposes and in compliance with such conditions that the financial institutions may impose. The financial institutions have a first hand feel of which category a borrowing unit may fall. This prima facie opinion can be confirmed by professional bodies such as Asset Management Companies (AMCs) set up for the purpose. It would go without saying that such AMCs would be multi-locational with available expertise in the textile industry to be able to decide the extent and ultimate possibility of revival of the defaulting units. They would also play a part in encouraging and promoting the performing units keeping in mind the focus of the industry and the ultimate goals to be achieved in the short, medium and long term.

5.7 A set of criteria would have to be established for ensuring that the deployment of funds is to eligible units as long as there is a genuineness of the promoter exhibited by a contribution of a minimum (say 25% of the total fund needs) from the borrowers private sources. The disbursement of the FIs can be a two-stage exercise. At stage one, a swap would eliminate the NPA status of the borrower, which would have a direct impact on the working performance of the institution. This may entail a one-time settlement with the borrower. In coming to a suitable settlement the FI would consider the possibility of mergers or suitable M&A exercises. The character of the borrower would help the institution to decide whether it needs to avail of the special power it enjoys under specific legislation such as the Sick Industrial Companies Act or the Asset Reconstruction Law. It would also have the ability to deal with listed and unlisted companies separately. For the purpose of implementing this scheme and the responsibilities the FIs undertake, government may consider compensating them by introducing legislation. Essentially it would be tax legislation.

- **For example Sec.36(i)(viii) permits a deduction for a special reserve created by a financial corporation engaged in providing long-term finance for industrial development or development of infrastructure facility. A comparable tax sop can be provided. It could be limited to the extent of the loss suffered by the institution in the one time settlement.**

- **In the event that an FI does not wish to avail of funds but seeks a counter guarantee from the government an additional sop may be granted to the institution for purposes of incentivising them for not utilizing available funds, which can be deployed for other economic alternatives.**
- **In course of time, the provision of the Sick Industrial Companies Act may also be modified to provide that financial institutions may on their own agree to provide required monetary assistance subject to their terms and conditions. In that event all textile units presently under BIFR could stand discharge from that legislation. Such of the units that remain under the BIFR would then have to face the strong possibility of being wound up. The BIFR or any such other appropriate authority would exercise that as first option. This would help in reducing matters pending before the BIFR and encourage a suo moto resolution of NPAs and sick units.**

Specific Issues related to the role of the Financial Institutions

5.8 The lending, which will be made by the FIs, would be in substitution of the existing facilities or by way of additional facilities. The security for the lending in the case of a substituted facility would continue to remain the same.

In certain cases it might be possible to strengthen the security by extending the charge over other assets not hitherto considered as a security. Units that substitute the original borrowing would be entitled to additional funding depending upon the added security, which such lender might be in a position to offer. Such funding could be towards providing working capital finance, modernization and cost reduction initiatives. Several units might be export oriented and availing of cheap export finance credit. These units could be recognized as being model units and encouraged to do better. The encouragement can be through available credit if such units are agreeable to take over management of the lesser performing units.

5.9 It is quite well known to the government and financial institutions that there are several state of art units which are in dire straits essentially because of bad management. The sickness has been compounded by having taken recourse to expensive funding during initial stages of sickness. These units could be offered cheaper credit and a onetime settlement by the lenders. In countries such as Sri Lanka, rehabilitation of such units is encouraged by treating the funds necessary for rehabilitation as being loans granted by the government for the purpose. A portion of the funds made available to the financial institutions can be earmarked for being treated as loans given by the government directly to such borrowing units. Comparable schemes are also in operation in India. For example, the deferred sales tax schemes introduced by several state governments are illustrations in point. Sales tax collected on sales effected are not required to be repaid to the government as in the case of other sellers. Units are entitled to retain the sales tax so collected for a specified period. This period is the loan period over which the unit is entitled to full flexibility regarding deployment. At the end of the deferred period the sales tax has to be paid to the government. Similarly, in the case of units taken over by healthy units funds can be granted with a moratorium for an initial period of a year or two with the ability to be able to repay the loan over a reasonable extended period of about seven to eleven years. Further encouragement can be granted by making the first few years (say three) having to bear an interest burden at a reduced rate.

5.10 It will have to be recognized that some units might default. A reasonable approximation of the extent of such defaults could help in working out an appropriate rate of lending by the institutions to the borrowing units. On the other hand if we accept that there is a cost to be borne for revitalizing the textile industry, the loss so suffered may be to the account of the government. In such a case the loss would be set off against the funds made available to the institutions. The energizing of the textile industry is likely to be a phased program. After the rehabilitation, emphasis may be on further modernization and up gradation. It may not be appropriate to go into the avenues of implementation but it may suffice to state that there will be need for large scale funds. The initial corpus of about Rs.3000-4000 crores sought to be made available at this stage would have to be augmented. The scheme outlined above would permit the conversion of the grant to a corporatised entity to be set up at an appropriate time by the financial institutions under the aegis of the government. The seed capital presently provided would be the seed capital of the new entity permitting augmentation through the bond route or any other route so as to make available additional funds for further expanding the textile industry.

5.11 The above proposal proceeds on the basis that financial institutions would work in tandem with the government; regulatory, compliance and reporting obligations being taken over by professional bodies.

Other Options

5.12 **As an alternative** to the above, the government could itself implement a similar scheme. For that purpose the government could set up a fund to which it would contribute the seed capital. A mutual fund can be set up under the existing guidelines for setting up of mutual funds or by specific legislation. For the present, the existing provision for the constitution, management, operation and taxation of mutual funds seems to be adequate. Under SEBI regulations a mutual fund is required to be set up as a trust to be settled by the settler which in this case could be the government. The operations of the trust are the responsibility of an asset management company. Such a company or companies (because there will be need for a geographical spread as mentioned above) can be constituted and manned by various regulatory bodies in the textile industry. Mutual funds are entitled to make loans. They would therefore extend financial assistance by either repaying the high costs debts availed by the borrowing units or by extending credit directly to them. There would be the question of security. In the event of the repayments, the security to existing lenders could stand automatically subrogated to the mutual fund. In the event that such subrogation is not possible, there could be a floating charge pari-passu with the existing lenders. The added facility in the case of exporters could be the securitisation of their receivables subject to the export credits availed of by such units. There would be no limitation on the fund accepting personal assets of the promoters for the purposes of granting the loans. The focus of the mutual fund would be the textile industry. The documentation therefore would have to proceed on that basis. Being a matter of procedural compliance, it does not require elaboration at present. The functions of the trustee company have been elaborated in the SEBI regulations.

5.13 To make reconstruction viable and attractive to Financial Institutions**, another option incorporating** a scheme for financial subsidy through Government and also through banks and financial institutions could be considered. Under this scheme, the Reconstruction Fund could provide 5% per annum interest subsidy on 80% of the secured debt on reducing balance basis. Secured debt to be defined secured by fixed or secured assets of the units. In addition, the lenders to the unit would provide subsidy to the extent of minimum of 2.5% per annum on the 80% secured debt of the unit. In this alternative, the sustainable debt (including secured as well as unsecured debt) would be the debt which the borrower unit can service and repay after considering the financial subsidy on the secured debt of the unit. The unsecured debt may be reconstructed on separate commercial terms and funds may be made available in the form of loan on commercial basis, wherein the Reconstruction Fund should get atleast 14% to 15% per annum yield. Under this scheme the reconstruction terms would need to be worked out, which would improve the prudential norms of the unit. Simultaneously, the borrower units would be required to provide for better monitoring mechanism as may be desired by the lenders. Inspite of giving subsidy, if a unit still have unsustainable debt portion it would have to bridge that gap by arranging fresh capital or by bringing equity from promoters or raising money through sale of surplus asset of the unit. The Scheme would help in keeping the balance sheets of financial institutions healthy as subsidy out go per year may be more attractive than one time write off under this option reconstruction worth Rs.15000 crore could be achieved by providing subsidy worth Rs.5000 crore over a period of 15 years.

5.14 Textile Ministry will examine this options and finalize a scheme in consultation with Banks / Financial Institutions and participating industry.

Eligibility Norms & Selection Criteria

Logic of eligibility & selection

5.15 The primary principle of the selection process is to provide equitable opportunities to all units and not penalize performing companies by providing concessions to the "needier" units. The fund shall provide assistance to all companies in the organized textile sector comprising the spinning, weaving, processing and composite segments as per the eligibility norms and selection procedure detailed further in the report. The end-use shall be confined to takeover of existing high cost debt, provide working capital assistance, undertaking cost reduction initiatives, modernisation & consolidation. The fund shall not be used for expansion or forward/backward integration through green field projects.

Eligibility norms

5.16 The primary eligibility norms would be to review that the capitalisation is commensurate with installed capacity so that such companies that are over-capitalised do not have access to such funds. The norms for each segment of the sector will be developed and furnished in the overall package. The unit seeking funds under this package would also have to qualify through a selection procedure (financial template). A preliminary financial template is being suggested, details could be worked out in consultation with Financial Institutions.

- The unit's future financials (with a review to reasonableness and due diligence) shall be projected. The operating cash flows (prior to interest) for a period of say, 8 years, shall be assessed. Based on these cash flows the maximum sustainable debt at the current interest cost would be assessed. Simultaneously the actual total liabilities of the company (excluding normal working liabilities), both on and off balance sheet shall be computed. If the actual debt is lower than the serviceable debt, the firm automatically qualifies for participating in the package. It may be pertinent to mention that companies which qualify on this count are likely to be very good performers and have credit facility already at low rates of interest. In the interest of fairness and equity, it may be necessary to offer the assistance to such companies too.

- In the instance that the sustainable debt is lower than the actual liabilities at the current interest cost (say 17%) but would be higher than the actual liabilities at the fund's lending rate (say 11%), the company would also become eligible. In such an event the fund would enable repayment of the existing loan through a debt swap scheme and would become the primary investor in the participating company. It is likely that such companies are likely to be good performers but are not able to increase volumes or undertake fresh initiatives due to high cost of current debt and consequent inability to raise fresh capital.

- If the actual liabilities are greater than sustainable debt even at reduced interest rates, the cash flows are reassessed based on specific initiatives that the company has been unable to take up for want of capital. Such initiatives could include modernization, manpower rationalization, power cost reduction, etc. Needless to say, the disbursing entity shall review the reasonableness of the improved projected cash flows. Based on the reassessed cash flows, the sustainable debt is recomputed at the fund's lending interest rate. If the sustainable debt is now lower than the original liabilities + fresh loan borrowed for the initiatives, the company qualifies for availing the fund. The fund shall then takeover the existing liabilities, as well as provide capital for fresh initiatives. Companies that qualify at this point are likely to have been hampered by shortage of capital to undertake initiatives that would improve operating cashflows.

- Despite such initiatives and lower interest rates, if the actual debt is still greater than sustainable debt, the company is deemed ineligible unless the promoter offers to bridge the deficit through fresh funds infusion.

5.17 It would also be necessary to develop a priority lending mechanism to define the order of lending for various units, which may apply to avail the fund. The total funding shall not exceed the asset value of the borrowing entity. Further of the total capital requirement of the company, to ensure commitment of the promoters and preclude inflated request for funds, it is recommended that the promoter infuses fresh capital to the extent of 25% of the total capital requirement of the company. This shall be in addition to the eligibility deficit financing stated in the previous paragraph.

The Process of appraisal, disbursement & monitoring

5.18 Typically, a company seeking to avail this fund shall approach the fund (through the locally identified entity) with a coherent business plan for the next 8 years, including their statement of operations, projected financial statements with assumptions and rationale on an as-is basis without assuming any fresh capital infusion. This would form Plan A of the company.

5.19 The company shall also prepare an improved business plan (Plan B), which shall factor the improvements that the company would undertake if fresh funds were made available. As stated earlier, the improvements could be in the nature of a debt swap, additional working capital, modernization, cost reduction initiatives, etc. The investment required and the incremental benefits shall be clearly captured in Plan B of the company.

5.20 Firstly, the fund shall assess the capitalization of the company, based on specific norms that shall be evolved for each segment. Once the company qualifies on this eligibility count, the fund shall carry out a due diligence to review the reasonableness of the projections and the validity of the assumptions made in both these plans. If the fund is satisfied with the plans furnished by the company, the plans shall be subject to the financial template stated earlier.

5.21 Based on the outcome of the appraisal, the fund shall decide on the amount of capital required by the company and end-use of such capital, the end-use options having been enumerated in the earlier sections. Professional bodies could be associated with the fund for ensuring that the deployment of funds is for such purposes and in compliance in such conditions that the fund may impose. The investment shall be subject to 2 stipulations, namely, that the total volume of assistance shall not exceed the value of the assets of the company and that the promoter infuses 25% of the fresh capital needed. The interest rate shall be defined by the fund. The schedule of infusion (both the fund's and promoter's), moratorium and repayment schedule shall be decided by the fund on a case-to-case basis. The identified entity will also have the flexibility to lower interest rates in case of early repayment.

5.22 All the terms of the capital infusion shall be captured in a model agreement. The agreement shall also provide for conversion of the debt to equity in the event of default. Should such an instance occur, the fund shall explore option of sale or transfer of equity/ assets of the company.

5.23 The fund will also monitor the performance of the company on a regular basis and will be responsible for ensuring timely repayment. The identified entity shall be represented on the Board or in an equivalent forum. A mechanism with the assistance of professional bodies may also be defined to monitor performance and cash flows on a regular basis. Such a monitoring mechanism will ensure that the funds generated by the company during the course of business are retained and there is no "diversion". A system of escrow mechanism could also be explored.