MUDRA LOANS IN THE EYE OF THE STORM

Ten years back, the collapse of Lehman brothers with its trillion dollar balance sheet nearly took down the global financial system with exotic financial products like credit default swaps and collateralized debt obligations contributing to the debacle. A decade later, Raghuram Rajan, the former governor of the Reserve Bank of India has raised the prospect of fresh trouble for the Indian banking system from a much more humble source, micro loans up to Rs 10 lakhs. Dubbed Mudra loans, these are under the aegis of the Pradhan Mantri MUDRA Yojana (PMMY) scheme.

The loans are provided to non-corporate, non-farm small/micro enterprises and are sanctioned by Commercial Banks, Regional Rural Banks, Small Finance Banks, Cooperative Banks, Micro Finance Institutions and NBFC's. Data reveals that lenders are predominantly public sector banks and micro finance institutions. Private sector banks have small size portfolios except for one well known Kolkata head quartered bank which has origins in micro finance. This bank has built up a significant Mudra loan portfolio.

The targeted beneficiaries are from the non–corporate small business segment comprising of proprietorship / partnership firms running small manufacturing units, service sector units, shopkeepers, fruits / vegetable vendors, truck operators, food-service units, repair shops, machine operators, small industries, artisans, food processors and others, in rural and urban areas.

The objectives of the scheme are laudable. The burgeoning salary earning middle class with corporate jobs and cozy retirement nest eggs, often forgets that the unorganized sector provides the livelihood for the vast majority of the population though lacking formal sources of financing. The Mudra portal has several success stories of micro businesses benefiting from this scheme.

Rajan's voice is highly respected in the Indian and global financial community. Tucked away in a small corner of his recent 17 page note to the estimates committee of Parliament on bank NPA's, is an almost passing reference to Mudra loans, exhorting the need for closely examining them for potential credit risk, and in that context also seeking urgent attention to the "growing contingent liability" emanating from The Credit Guarantee Scheme for MSME run by SIDBI. Despite taking up just a couple of lines in an otherwise lengthy report, the media has given wide publicity to this part of Rajan’s report.

So why should tiny loans less than Rs 10 lakhs to the likes of shopkeepers and autorikshaw owners attract so much attention? The numbers tell part of the story. Even since the PMMY scheme was launched in 2015, the amount disbursed has grown by leaps and bounds to Rs 6.5 lakh crores, with a CAGR of about 35%. While this may constitute circa 5% of the asset size of Indian banking, potential high levels of defaults and a growing loan portfolio of the Mudra loans, may add to the current pile of non-performing loans (NPA) of more than Rs 10 lakh crores. In all fairness, NPA figures for the Mudra loans are not available thus far in the public domain. But Rajan having been at the helm of the banking regulator, must be basing his concerns on solid grounds.

Applying the traditional risk parameters for assessing corporate loans or the credit score based risk assessment for consumer loans pioneered by Fair and Isaac of FICO score fame, does not serve the purpose for Mudra loans.

Similar to commercial loan proposals, assessing "project viability" for Mudra loans is emphasized by lenders. Recently SIDBI called for "credit counsellors" to be empaneled by it to help small businesses in

preparing project reports. At the other end of the spectrum, the disastrous fate of the multibillion dollar projects appraised by the capital markets arm of India's storied public sector bank staffed by top business school graduates, is well known. Project appraisal needs to go much beyond an exercise in number crunching in a spread sheet.

The Mudra loan scheme excludes seeking collateral from borrowers. Only the assets financed by the lenders can be taken as security. What criteria do banks then adopt? The eligibility criteria for the Mudra scheme loans available in the portal of the largest commercial bank in India is pretty basic: potential borrowers should be residing in the same locality at least for the last two years, should not be a defaulter to any financial institution, and should have undergone some training.

Significantly, Mudra loans by banks are covered under the Credit Guarantee Fund for Micro Units (CGFMU) with the premium cost to be borne by the borrower. The fund comes under National Credit Guarantee Trustee Company, set up by the Government of India, thereby shifting the significant part of the credit risk to the tax payer.

Here are some salient details of the credit guarantee coverage for Mudra loans. Based on the amount in default,
a. First Loss to the extent of 5% will need to be borne by the lender
b. Out of the balance portion, the ‘extent of guarantee’ will be to a maximum extent of 50% of ‘Amount in Default’ in the portfolio, subject to maximum cap of 15% of the portfolio.

While banks are not entirely off the hook, public sector banks account for nearly half the Mudra loans, thereby shifting losses on account of future potential NPA's back to the tax payer.

Here, Rajan laments about the growing contingent liability for the Government's credit guarantee fund. The contingent liability to the tax payer would get fructified sooner or later in the event of large scale defaults. The number of Mudra loans sanctioned thus far is nearly 14 lakh crores. While this may not translate into the exact number of beneficiaries, the numbers are still mind boggling. It would be a political disaster as well as a nightmarish process for public sector banks to collect the defaulted loans back from the vast numbers of these tiny borrowers. Are they then essentially a handout from the Government masquerading as loans?

Herein lies the nub of the issue. The vast majority of the current NPA's of about Rs 10 lakh crores is on account of lending to corporates. Gold plating of projects in the form of over invoicing of costs, alluded to by Rajan as well, means that there is very little, and often negative equity from well-connected promoters in bank financed projects, which have turned NPA's. These few elite promoters continue to lead tax payer funded lives of luxury either in India or in safe havens abroad, away from the reach of the Enforcement Directorate, the CBI and Indian courts. Would it not be ironic if tax payers also need to pony up for NPA's in the tiny Mudra segment where borrowers numbering in crores, are from the poorest strata of society?

Which segment of the tax payers is ultimately picking up the tab for defaults from the corporate promoters and potentially from the Mudra scheme borrowers? It is the few honest corporate tax payers and the vast segment of the middle class salary earners who have no choice in paying taxes on account of it being deducted at source. Maybe the middle class too should figure out a way of going hat in hand to the government for tax payer funded handouts, thereby balancing the scales now heavily tilted towards both crony capitalists and tiny borrowers at the opposite ends of the spectrum!