Making MUDRA work

Without credit insurance, just like directed lending

On the face of it, getting PSU banks to lend to micro and small enterprises is a win-win idea since these firms typically borrow from unofficial sources at rates as high as 30%; once the loan rates fall to around 10%, the logic is, these firms will be much more viable and will easily be able to repay their loans. Since India has around 6 crore such enterprises that employ around 11 crore people, such targeted intervention will go a long way in creating the jobs the economy so desperately needs. That, in a nutshell, is the idea behind the Pradhan Mantri MUDRA (Micro Units Development and Refinance Agency) scheme that finance minister Arun Jaitley has said will disburse ₹1.2 lakh crore this year to around 1.25 crore small businessmen—₹24,000 crore has been disbursed to 27 lakh small businesses so far. But there is a catch: typically, large banks do not really cater to this segment of borrowers, so how are the NPAs that will probably get created be funded, and isn't this better done by MFIs and small banks who, in any case, target precisely this kind of customer and know better which unit to lend to and which not to? Indeed, since the government claims there are no calls being made by officials any more to bankers on their lending practices—the government even wants to distance itself from appointments of PSU chiefs through the proposed Banking Board—doesn't this run contrary to the philosophy?

At the centre of the plan lies the credit guarantee scheme run even today under CGTMSE, to provide insurance for banks in case the loans to micro and small enterprises go bad. In that sense, this is similar to the crop insurance schemes the government is pushing—the government pays the premium for crop insurance and, in case of a crop failure, the farmer gets a basic level of protection. The problem with CGTMSE, and this is where MUDRA with its ₹20,000 crore corpus needs to come out with a better scheme, is that it covers only the principal lent—at even a 10% interest rate, a ₹100 loan is worth ₹161 after 5 years; so, the current insurance is leaving a large part of the bank's exposure uncovered. CGTMSE doesn't cover frauds either; so, it becomes cumbersome for banks to get their claims in case there is a dispute on whether the default was deliberate or not. Also, since the principle of sound lending is to align interest rates with risk—the riskiest loans carry the highest interest rates—it defies economic logic that MUDRA envisages banks lending to micro and small enterprises at the base rate; more so since the loans are without any collateral. If the government wants lower rates for a section of enterprise, it makes more sense to give a direct interest subvention. If MUDRA does not address this set of issues, the ₹1.2 lakh crore of lending becomes just another form of directed lending that has contributed to the NPA mess banks are in right now. The real test of how well MUDRA works will be when MFIs and small banks start availing of it while lending to micro and small enterprises.