Pradhan Mantri MUDRA Yojana
A Critical Analysis and a Call for Change

DEEPTI GEORGE

The Pradhan Mantri MUDRA Yojana is the government's flagship refinance and guarantee scheme aimed at providing access to credit for non-corporate and informal enterprises. Analysing the available data, the performance of the PMMY against its objectives is assessed, and it is observed that the PMMY has not altered secular trends in lending to the target segments. The current scheme design for its ability to create the level of impact needed is questioned, and some ideas on how to accelerate impact are also discussed.

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The Pradhan Mantri MUDRA Yojana (PMMY) is the flagship refinance and guarantee scheme of the Government of India, targeted at making access to inexpensive and suitable credit a reality for the universe of India's non-corporate and informal enterprises. The scheme is administered through a non-banking financial institution registered with the Reserve Bank of India (RBI) called the Micro Units Development and Refinance Agency or MUDRA Bank. While not a banking company, as the name would suggest, the MUDRA Bank, first introduced in the union budget of 2015–16, was allotted a corpus of ₹20,000 crore, and a credit guarantee corpus of ₹3,000 crore.[1] It is currently a wholly-owned subsidiary of the Small Industries Development Bank of India (SIDBI) and enjoys access to deposits under priority sector shortfall from banks to the tune of ₹5,000 crore in 2015–16 and ₹3,125 crore in 2016–17,[2] which is in addition to budgetary allocations made annually. We analyse, using available data, the performance of this scheme against the objectives for which it was established, and put forth some ideas on how to accelerate its impact.

Characterising the Beneficiaries

The PMMY has defined the target beneficiaries as entrepreneurs and businesses, and this comprises the entire spectrum of the micro, small and medium enterprises (MSME). However, it has stopped short of using the MSME definition to keep borrowers within or outside the purview of the scheme. Instead, the qualification for availing refinance is defined at a loan level as loans to the target borrowers that are within an absolute limit of ₹10 lakh. This is an inclusive definition. Irrespective of the nature or size of the enterprise, whether registered or unregistered, tax-paying or not, it would be eligible for availing a loan under the PMMY. This naturally keeps out large enterprises for whom loans below ₹10 lakh would be inefficient to avail. The enterprises can be any from among a broad and expansive set of eligible businesses, and loans can be used for working capital needs, business expansion and purchase of equipment such as machinery and vehicles for the business, and therefore cover most funding requirements for businesses. Loans for agricultural purposes, land improvement, irrigation, and canals would not qualify for the PMMY. However, businesses linked to agriculture, such as poultry, animal rearing, dairy, fisheries, or agro-processing units, are eligible under the scheme.

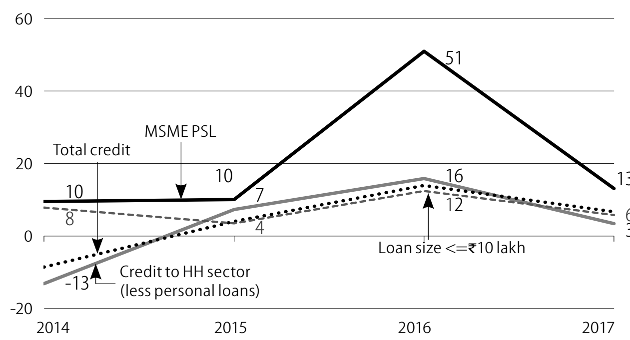
While the entrepreneur is the final intended beneficiary, the institutional beneficiaries are RBI-regulated financial institutions lending to these entrepreneurs. These Member Lending Institutions (MLIs) comprise all scheduled commercial banks (SCBs), including 27 public sector banks (PSBs), 18 private sector banks, 31 regional rural banks (RRBs), 14 cooperative banks, 47 non-banking financial companies–microfinance institutions (NBFC–MFIs; also includes some that converted to small finance banks [SFBs]), and 31 non-MFI NBFCs.[3] The scheme has also shortlisted 26 MLIs not regulated by the RBI (these are either Section 25 companies, trusts, or societies).

There are three key benefit features that the PMMY has provided so far that are aimed at addressing specific constraints in the supply of institutional credit to the MSME sector and that directly or indirectly impact beneficiaries. The performance of MUDRA with respect to these features is discussed in the next section.

Performance of the PMMY

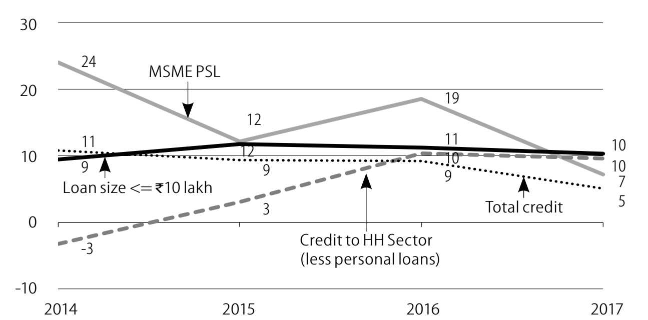
The tagging of eligible loans under the PMMY: The first feature of the PMMY is the origination and reporting by MLIs of eligible loans under ₹10 lakh as the PMMY loans against annual targets placed on them by MUDRA. This tagging of eligible loans is intended as a first step towards availing refinance by the MLI, but such tagging does not automatically qualify

Figure 1: Annual Growth Rates in No of Loans by Banks (%)



HH: Household; MSME: Micro, small and medium enterprise; PSL: Priority sector lending.
Source: Author's calculations.

Figure 2: Annual Growth Rates in Credit O/s of Banks (%)



HH: Household; MSME: Micro, small and medium enterprise; O/S: Outstanding;
PSL: Priority sector lending.
Source: Author's calculations.

the loan for this benefit. The MLI enters into a separate refinance contract with MUDRA as discussed later. For the purposes of loan-tagging, the PMMY requires MLIs to classify loans as Shishu (up to ₹50,000), Kishor (₹50,000 to ₹5 lakh), or Tarun (₹5 lakh to ₹10 lakh). Since the PMMY's inception, the central government has set targets on MLIs for outreach of the MUDRA scheme at ₹1.8 lakh crore for 2016–17,[4] ₹2.44 lakh crore for 2017–18,[5] and ₹3 lakh crore for 2018–19.[6]

Table 1 provides an analysis of the PMMY loans by category. Annual growth rates in scheme coverage of loans have been quite uniform across the three loan categories, and in the ranges of 24% to 35%, attributable to the natural increase in the number of MLIs that MUDRA has been able to shortlist since inception. This is determined by both capacity (constraints) within MUDRA to carry out assessments of MLIs based on the eligibility criteria, and a willingness of lenders to participate.[7] Roughly, 69% of the PMMY-tagged loans (by value) were originated by banks (excluding SFBs), while about 31% originated by MFIs and SFBs. Shishu loans, comprising 92% of

Table 1: Category-wise Analysis of the PMMY-tagged Loans (₹ crore)

Category	No of Loan Accounts in FY 2016–17	Loan Amounts Sanctioned (FY 2016–17)	% Annual Growth in Loan Sanctioned
Shishu	3,64,97,813 (92)	85,100.74 (47)	35
Kishor	26,63,502 (7)	53,545.14 (30)	24
Tarun	5,39,732 (1)	41,882.66 (23)	33
Total	3,97,01,047 (100)	1,80,528.54 (100)	31

Figures in parenthesis are percentages.
FY: Financial year.
Source: Reproduced from MUDRA Bank (2016–17: 49).

the PMMY-tagged loans by number of loan accounts and 47% by value for 2016–17, have been originated principally by the SFBs and MFIs (66% of the amount).[8] At an average loan size of ₹23,317 for a Shishu loan in 2016–17, the SFB/MFI channel sanctioned 60% of all the PMMY loans in the given year. Driven by the characteristics of this channel that largely lends to women-only groups, Shishu loans formed 98% of all the PMMY loans to women and 78% of Shishu loans were to women in 2016–17 (MUDRA Bank 2016–17: 52).

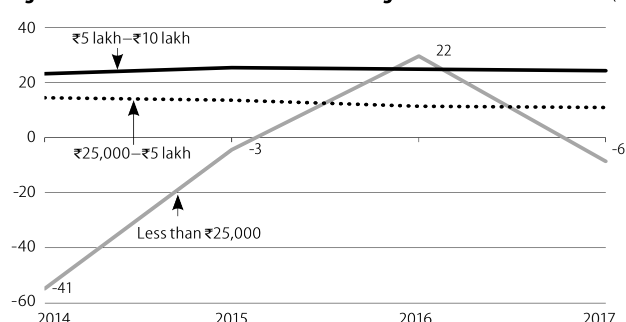
To understand[9] whether target-driven origination of eligible loans has led to increased lending and/or lending to new borrowers by MLIs, especially banks, we look at trends in banking-sector data published by the RBI. There is no single data set that can help us study the flow of credit to non-corporate enterprises and households engaged in non-agricultural business activities, especially because the borrower cannot be characterised by a cap of their extent of borrowing, which is the ₹10-lakh limit. However, the RBI has three relevant data sets from which we can assemble trends in lending to the target segments of interest for MUDRA. These are outstanding banking credit data for different loan sizes,[10] for MSME loans that qualify as priority sector lending (PSL),[11] and for loans to the household sector.[12] Loans to the household sector include lending to proprietary concerns and partnership firms, and we remove personal loans from this data set as they are for consumption purposes. All three of these data sets comprise both loans that qualify under MUDRA and those that do not, and therefore, these cannot directly inform the effects of the PMMY. However, in combination, they can provide a good picture of overall trends. Since absolute numbers are growing, we compare relative annual growth rates to tease out differences (Figures 1 and 2).

The PMMY was introduced in April 2015, and during the relevant time period of financial years (FY) 2014 to 2017, the banking system saw a decline in the overall annual growth in credit, from 11% to 5%. During the time, PSL credit to MSMEs showed a spike in FY 2016 due to loans to medium enterprises being given PSL status from April 2015 onwards.

An analysis of loan sizes within the sub–₹10 lakh range was carried out for cash credit, overdrafts, demand loans, packing credit, and medium- and long-term loans (Figures 3 and 4, p 33).

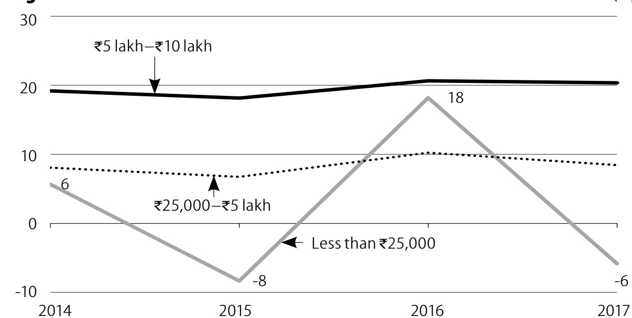
Only for the category of loans less than ₹25,000 was there a steady growth in FY 2016. Since it is possible that a majority of these loans would qualify as Shishu loans under the PMMY, this effect could well be due to the PMMY and can be considered as possible evidence for the PMMY having an impact, at least in this category. However, this momentum was not sustained, as seen by the decline in the opening of new accounts in this category in FY 2017. We conclude that the increase in the PMMY targets for banks may not have translated into sustained increases in lending to this sub-category of enterprises. We observe a similar increase in both number and quantum of credit to the household sector during FY 2015 and FY 2016 and a subsequent decrease in 2017, indicating that there might be some positive effect of the PMMY that has not been sustained.

Figure 3: Annual Growth Rates in Outstanding Credit of Banks (%)



Source: Author's calculations.

Figure 4: Annual Growth Rates in Loan Accounts of Banks (%)



Source: Author's calculations.

The banking sector (excluding SFBs) had a sub-target of ₹1.14 lakh crore set by the PMMY for 2016–17 that it was able to achieve. The target amounts to 69% of fresh disbursements in loans upto ₹10 lakh, and 67% of loans to the household sector for the year (we assume a simple difference of year-end outstanding is net of repayments and is hence a good indicator of fresh disbursements). The targets themselves therefore do not require any ramping up of existing lending operations of banks, and they cannot be expected to drive any substantial increase in lending to the borrower of interest. The year-on-year growth in such PMMY-tagged loans is heavily linked to the expansion of the scheme since 2015 and the inclusion of an increasing number of lenders—actual increases in tagging can become clear once all enrolment efforts are completed.

We can conclude that so far, it is unlikely that the PMMY has significantly altered secular trends in lending to the target segments. However, while such tagging of eligible loans does not automatically provide any benefits to the borrower or the lender, it can help to monitor the additional flow of credit arising from the PMMY, to understand the relative responsiveness of different institutions or channels to the efforts of MUDRA officials, and to study the changing patterns in financial access and financial depth as a result.

The refinance facility: The second scheme feature is the provision of refinance[13] funds by MUDRA to MLIs, conditional on their willingness to pass this on as lowered interest rates to borrowers. In refinance, MUDRA lends to MLIs against debt held on the books of the MLIs such that the funds from such a loan can be further on lent to target segments, thereby increasing the reach of bank credit to credit-starved enterprises. The terms of refinance require that the underlying loans be priced within a specified margin on MLIs' cost of funds. For SCBs, this is currently no higher than the base rate/marginal cost of funds based lending rate (MCLR) while lending to microunits, not more than 3.5% above the PMMY refinance rate for RRBs and cooperative banks, and not more than 6% above the PMMY refinance rate for NBFCs.[14] During 2016–17, MUDRA provided refinance to the tune of ₹3,525.94 crore to 11 PSBs, 20 MFIs, four non-MFI NBFCs, and an unreported number of RRBs.[15] This marked a 5.6% increase in disbursed amounts since the previous year. However, this represents less than 3% of the ₹1,23,000 crore PMMY loans sanctioned by SCBs and RRBs (excludes SFBs) in the year. Refinance in the current form therefore does not appear to have any significant impact on the funding needs of the intended beneficiaries.

In this context, the availability of MUDRA refinance (or indeed, any other interventions by MUDRA to lower MLIs' cost of funds) could serve to either lower costs on the current size of lending or enable fresh lending. These outcomes can be realised at scale once the take-up of these facilities improves and the interest rate benefits indeed get passed on to these enterprises. There is no information available that can serve as evidence for studying this. It is to be noted that the pricing caps for loans enjoying the refinance benefit should not in any way change the credit risk premiums that lending institutions charge based on their assessment of the riskiness of the borrower.

The credit guarantee facility: The third feature of the PMMY is the provision of a credit guarantee facility for unsecured loans less than ₹10 lakh, intended to encourage uncollateralised lending to new or "thin-file" clients. Such credit guarantees are provided by the Credit Guarantee Fund for Micro Units (CGFMU), which in turn is managed by the National Credit Guarantee Trustee Company (NCGTC) of the Government of India. The CGFMU is one of five credit-guarantee funds that the NCGTC manages. While the MUDRA balance sheet does not house any such credit guarantees, MUDRA facilitates guarantees for loans that get tagged under the PMMY.

The CGFMU is a portfolio-guarantee facility extended to eligible MLIs on unsecured loans lower than ₹10 lakh. All MLIs are eligible to transact with CGFMU, subject to the loans to microunits being eligible according to the eligibility checks published on the NCGTC website.[16] The eligibility criteria include a requirement that Shishu loans must not have interest charged to customers above 12% per annum, while no such requirement applies on Kishor and Tarun loans. This would indicate that NBFC–MFIs, which originate the bulk of Shishu loans, and, most likely, all other NBFCs originating Shishu loans will be ineligible to obtain credit guarantee under CGFMU.

The NCGTC credit guarantee is currently available at a uniform fee described as standard basic rate (SBR) of 1% of the sanctioned amount. This is expected to be replaced with a risk-based guarantee fee structure in the future, which would be pivotal to making this fee economical to all MLIs (for instance, NBFC–MFIs, whose expected loss numbers are typically below 1%, would find the guarantee fee of 1%

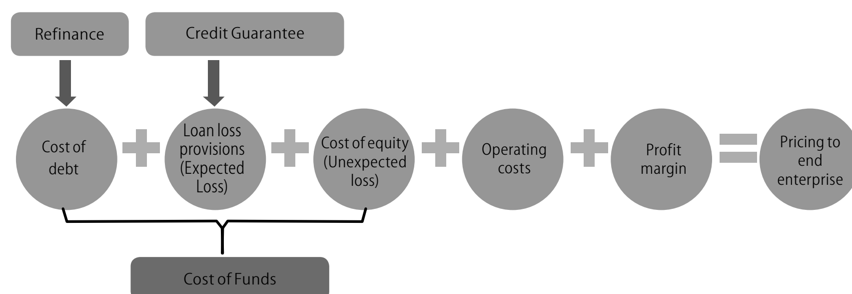
to be uneconomical). While the first 5% of losses on the portfolio are to be borne by the MLI, CGFMU compensates 50% of the amount in default in the portfolio, subject to a maximum cap of 15% of the portfolio (NCGTC 2017). This facility can be expected to have multiple effects. First, the availability of credit guarantee could encourage lenders to expand their size of lending to MSMEs and extend loans with confidence to riskier borrowers and thin-file clients. Second, to the extent that the credit guarantee lowers the cost to MLIs of managing credit risk, it could also lower the risk premiums embedded in loan pricing (Ghatak 2010). Used in this manner, the credit guarantee could ultimately serve to increase MLIs' resilience to local or sector-specific shocks, and increase market stability.

According to the NCGTC Annual Report 2016–17 (NCGTC 2016–17), a total of 48 MLIs of the PMMY had registered under the CGFMU, and a total of ₹3,224.1 crore was sanctioned to nine MLIs, all of which were either PSBs or RRBs, indicating that no NBFCs have availed this facility so far. The MUDRA Annual Report states that, of the 46 MLIs registered with NCGTC, 13 MLIs had transacted on the SURGE online platform, and this involved about 6.69 lakh loan accounts covering ₹6,910 crore (MUDRA Bank 2015–16). Shishu loans comprised 70% of the loan accounts and 25% of the loan amounts. Since microfinance loans were not eligible or applicable for availing CGFMU, 67% of these loans (and 77% of outstanding credit) enjoying the credit guarantee were disbursed to men (NCGTC 2016–17: 18). At least half of all exposures were in South India, and nearly 70% of all exposures were in South and West India, implying a significant regional skew (NCGTC 2016–17: 18).

Current Scheme Design

Refinance is not a new policy lever in the history of sector-specific development policies of the Government of India. MUDRA joins a long list of Indian development financial institutions (DFIs)—such as National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB), and SIDBI—which provide refinance to the banking system (Table 2). While SIDBI refinance has been in existence since the 1990s for the benefit of the same target beneficiaries, MUDRA is the latest entrant to the refinance market and is therefore very well-placed to incorporate learnings from past experiences to enhance the effectiveness of refinance.

Figure 5: Pricing of Credit to End Enterprise



Source: Author's representation.

To answer the question of what MUDRA can do better, we need to understand the route through which MUDRA's schemes of refinance and credit guarantee can be expected to reduce loan pricing to the end borrower.

Figure 5 depicts the various constituents of loan pricing to a borrower. Any lending institution would incur a cost to borrow funds (which is denoted as the cost of debt) as well as a cost to execute the transaction, typically what is characterised by operating costs. In addition, when engaging in risky lending (as opposed to investing in government debt), lending institutions have to account for two potential losses from credit risk. The first is expected losses, which are losses that can be expected based on past performance of the same type of credit risk/asset class and can be managed through pricing. When lending to new asset classes (in this case, new borrowers or existing borrowers in previously underserved regions or segments), it is difficult to ascertain the expected losses due to the absence of previous credit performance histories, and therefore, lenders price in a higher provisioning requirement to counter this uncertainty. The second is unexpected losses, which are losses that the loan book can incur that are in excess of the expected losses, and for which the lender needs to keep economic capital that can absorb these losses (equity cushion of the lender). In addition to these, the credit risk premium may or may not comprise the profit margin and, for the sake of completeness, this component is shown separately.

Table 2: Outstanding Refinance Book of DFIs to Lending Institutions (₹ crore)

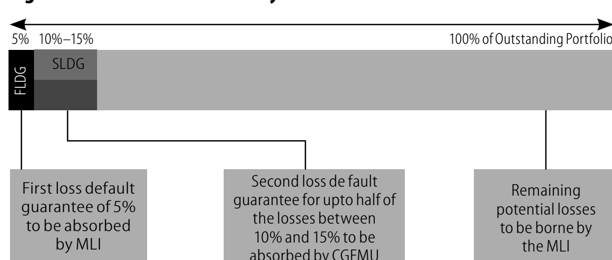
	2013–14	2014–15	2015–16	2016–17
SIDBI (net of provisions)	46,302	43,756	57,476	63,630
NABARD	1,02,345	1,21,578	1,19,281	1,27,898
NHB*	39,657	44,532	–	–
MUDRA (disbursement)	–	–	3,287	3,526

MUDRA: Micro Units Development Refinance Agency; NABARD: National Bank for Agriculture and Rural Development; NHB: National Housing Bank; SIDBI: Small Industries Development Bank of India.
* More recent reports for 2015–16 and 2016–17 are unavailable online (when last checked on 1 September 2018).
Sources: SIDBI (2013–14, 2014–15, 2015–16, 2016–17); NABARD (2013–14, 2014–15, 2015–16, 2016–17); NHB (2013–14, 2014–15); MUDRA Bank (2015–16, 2016–17).

A refinance contract involves an advance made by the DFI to the lender at a specified interest rate. This loan becomes an additional source of borrowing for the lender. The usefulness of refinance as a policy lever hinges on the assumption that MLIs face a paucity of lendable funds due to limits on their ability to raise current account and savings account (CASA) and other borrowings, and that the banking system is well placed to carry out robust credit risk assessments for these enterprises.

Whether or not refinance is indeed useful to the lender depends on the rate at which the lender is able to borrow from the DFI, and net of transaction costs, this should be less than the blended cost of debt incurred by the lender on its own. The refinance contract can require this difference to be passed on as reduced interest cost either to existing borrowers or to new borrowers the lender brings on board since availing the refinance (the latter is usually the preferred route). Therefore, for a lender who has already originated say ₹100 of loans, every ₹1 of refinance funds availed from the DFI can

Figure 6: Portfolio Guarantee by CGFMU



CGFMU: Credit Guarantee Fund for Micro Units; FLDG: First loan default guarantee; MLI: Member Lending Institution; SLDG: Second Loan Default Guarantee.
Source: Author's representation.

create ₹1 worth of new loans to eligible borrowers. By design, the refinance route will not be able to bring about reductions in credit risk premiums charged by the lender because of the riskiness of the borrower. In other words, the ₹3,526 crore refinance disbursements that MUDRA made in 2016–17 will enable recipient MLIs to create additional ₹3,526 crore worth of new loans to eligible borrowers. This is only a drop in the ocean and does not create any serious dent to meeting the demand for credit by enterprises in India.[17] Also, since pricing is not risk-based, this provides no incentive to well-performing entities to build their book. It also does not reach lower-rated entities struggling to get cheaper funds for their operations, many of which would be small.[18]

A credit guarantee contract, on the other hand, is a contract between the lender and the DFI which, in return for a reasonable guarantee fee, takes on the role of a guarantor to provide full or partial guarantee to a loan originated by the lender with exposure to the underlying borrower (the enterprise, in this case). If the borrower were to default, the guarantee will pay out an amount to the lender that will partially or fully cover the extent of losses depending on the guarantee features. The usefulness of the credit guarantee relies on the assumption that lending institutions have adequate lendable funds that they are unable to deploy because of high credit risk that would be unmanageable on own balance sheets. For banks, this inability to manage credit risk on own balance sheets primarily stems from an inability to underwrite due to a high degree of informational asymmetry regarding the borrower and, to a lesser extent, due to inadequate equity cushions.

The CGFMU is a loan portfolio-level guarantee that pays out claims based on the defaults occurring at the portfolio level. The working of the CGFMU guarantee is covered in Figure 6.

The total guarantee of ₹3,224.1 crore, sanctioned by CGFMU till 31 March 2017 can provide a 100% guarantee cover of about ₹161.2 crore of losses in the event that the entire portfolio faces a gross non-performing asset (GNPA) level of 15% or more. This would mean that the universe of sanctioned PMMY loans amounting to ₹1,80,529 crore would require a credit guarantee fund that has the wherewithal to pay out ₹9,026.4 crore in the event the portfolio GNPAs were to jump to 15%. Guarantees can have a multiplier effect on the quantum of credit that can be galvanised to the end borrower of interest. However, this portfolio-level guarantee does not increase or improve (cost of) loanable funds for the MLIs if the guarantee does not translate into rating upgrades for the MLI or for its borrowings. In the event of default, losses above the first 5% are not diversified out from the lenders' books beyond that which gets covered under CGFMU.

We therefore question whether the current design of refinance and guarantee delivers the best route to maximise impact, and we propose an alternative in the next section.

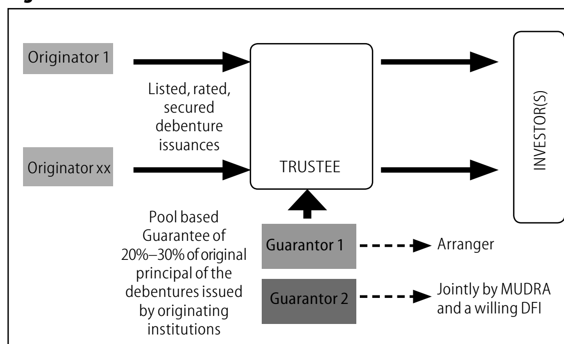
A Strategic Role for MUDRA

It is to be acknowledged that bank-led models of origination have traditionally been characterised by features such as a branch-based, high-cost, high-risk approach to origination, an extensive originate-to-hold mandate of PSL policy prerogatives and associated restrictions on differentiating on business models, as well as inadequate risk management capabilities. Additionally, the MSME sector, similar to other underbanked sectors, has a paucity of underwritable business information, which has in turn led to an over-reliance on collateralised lending by traditional financial institutions. Traditional underwriting has seen MSMEs needing to meet eligibility criteria, such as minimum vintage of business, the availability of high levels of equity at the level of the promoter to provide assets in the form of collateral and personal guarantees, and an ability to absorb cash-flow shocks to business from expected (volatilities due to seasonality, delays by corporate buyers to settle bills within stipulated time) and unexpected events (climatic shocks, commodity price shocks, political uncertainties). All these severely limit the extent to which fresh loans to first-time formal finance borrowers in the MSME sector can be enabled through the SCB route, and these borrowers form a significant part of the target for the MUDRA's refinance and credit guarantee facilities.

There is therefore a need to dramatically improve the origination strategies that have traditionally been employed to target enterprises. India is too diverse a country, and within that the MSME sector is too diverse a segment, to have any single blueprint. In order to achieve the vision of full financial inclusion and financial deepening in a manner that enhances systemic stability, there is a need to move away from a limited focus on any one model to an approach where multiple models and partnerships are allowed to emerge, particularly between national full-service banks, regional banks of various types, NBFCs, fintech firms, and financial markets. The financial architecture must seek to encourage partnerships between specialists, instead of focusing only on the large generalist institutions, such as national full-service banks. We propose the following steps in regard.

Focus on enabling growth of specialist lenders: There is a need for strengthening existing and creating many more specialist institutions that focus on the provision of credit for different types of MSMEs. There are already a number of NBFCs and MFIs serving MSMEs, and the financial system needs to ensure that such institutions, as long as they are able to do so in a high-quality manner, grow and multiply. These differentiated institutions have a strong understanding of individual sector needs, an ability to

Figure 7: Credit Enhancement in Pooled Bond Issuances



DFI: Development Financial Institution; MUDRA: Micro Units Development Refinance Agency.
Source: Author's representation.

assess risk appropriately, typically through proximity-based strategies, and an ability to customise their offerings to suit specific needs. Examples of such banking institutions in other markets include the MSME-focused Planters Development Bank (now merged with China Bank) in the Philippines and Bank Rakyat of Indonesia. Differentiated institutions are, however, ill-equipped to hold local, systematic risks relating to rainfall or commodity price fluctuations, and therefore, they must be given the ability to link with and transfer such risks to large diversified institutions that have the capability to hold and manage such risks, in return for liquidity that can be used for growth.

Evolving into a sector-focused provider of credit enhancements: We propose that the strategic focus of MUDRA be shifted away from taking senior exposures in securitised paper to one where it plays the role of a guarantee institution for the lending institutions serving the MSME sector. In this role, MUDRA can provide a whole suite of specialised products and investment approaches, such as the following, to boost risk-taking by MLIs in previously underserved regions and sectors:

(i) Credit enhancements in the form of partial or full second loss guarantees in securitisation transactions involving loans to the MSME sector;

(ii) Credit enhancements in the form of co-guarantees on second loss in securitisation transactions involving loans to the MSME sector, along with other guarantors such as DFIs and NBFCs;

(iii) Credit enhancements in the form of partial or full second loss guarantees in pooled bond issuances by MLIs (Figure 7);

(iv) Credit enhancements in the form of co-guarantees on second loss in pooled bond issuances by MLIs, along with other guarantors such as DFIs and NBFCS; and

(v) Investment in pass-through certificates (PTCs) representing junior tranches in securitisation transactions involving loans to the MSME sector.

Credit enhancements have an effect of directly reducing the loss given default of the underlying portfolio of loans or bonds for the investor, and in turn increase overall credit ratings and lower interest costs for lending institutions and ultimately the end borrowers. This is because, irrespective of the rating of the originator, their non-convertible debenture (NCD) issuances can now aspire for higher ratings with the support of guarantees from MUDRA and bring in new investors who want exposure to the sector, but who would do so only with improved ratings of the NCDs. This serves to hand-hold smaller high-quality originators operating in difficult regions or segments such as the North East and the East. By adopting such a strategy, MUDRA can serve MLIs that engage with this sector by directly impacting cost and the volume of funds available to the end customer. It can also catalyse a new base of capital markets investors as well as partial guarantors for these assets which are otherwise fairly dominated by banks. In contrast to the current PMMY credit guarantee design, here, losses beyond the first loss arising from local systematic risks arising from concentrated operations of specialist lenders can be diversified out of their balance sheets.

The guarantee institution structure will enable the use of resources allotted to it by the Government of India to create a significant multiplier effect in terms of total volumes of financing and enabling high-quality institutions to differentiate themselves in the market, while having a significant downward impact on lending rates to the sector. This will also enable the creation of a high-quality market for these assets and the evolution of strong intermediaries who can originate for the sector.

There are several factors that make MUDRA well poised to become this guarantee company. Being a non-deposit-taking NBFC registered with the RBI, even if it were required to maintain a regulatory capital adequacy level of 15% and keep 100% risk weights on all financial guarantees it makes in the form of products listed above, ₹2,000 crore Tier 1 equity allocation from Government of India would allow MUDRA to enable as much as ₹13,000 crore (of full second loss default guarantee) of financing to the MSME sector.[19] This strategy therefore creates more than six times the impact in the form of mobilising credit to the sector, as would have obtained by following a direct refinance strategy. Going forward, it may also provide additional liquidity to these securities guaranteed by it through market making. MUDRA has already indicated interest in products, such as the partial guarantee for bond issuances of originators, as captured in their Annual Report 2015–16.[20]

MUDRA has indicated an interest in considering a role for itself in securitisation transactions involving eligible loans, in providing credit enhancements in NCD issuances of financial institutions, participating in alternative investment funds as well as in providing partial second loss guarantees in securitisations of eligible loans and NCD issuances. However, MUDRA has not yet partaken in any of these alternative routes, except through investing in securitised paper.[21] Direct investment in highly rated securitised paper only brings in MUDRA as an investor in the least risky tranche of PTCs and does not in any way assist in bringing down the risk to the other parties in the securitisation transaction, including investors in the lower tranches. Our recommendation therefore is to make the provision of guarantees the primary focus of the institution. MUDRA would need to build risk management capabilities and information technology (IT) platforms required for taking on this role and function.

Conclusions

Government interventions in credit must be restricted to ensuring allocational efficiency (across regions and sectors) without prescribing firm-level strategies.

An institution-level target-driven approach adopted thus far by MUDRA is aimed at tagging eligible loans and has not translated into tangible increases in lending to the MSME sector, let alone to underserved regions or segments. India needs a diverse set of financial institutions that can cover the length and breadth of the country, and the PMMY can be put to best use to nudge, incentivise, or make possible avenues for them to serve previously underserved beneficiaries. In the long term, credit pricing to the end borrower should move towards ordinality in risk (that is, lower risk customers receiving lower prices, and vice versa). Our proposal to convert MUDRA into a guarantee company for high-quality originators serving the enterprises sector takes these factors into due consideration.

NOTES

1 Union Budget of India, 2015–16, p 8, https://www.indiabudget.gov.in/budget2015-2016/ub2015-16/bs/bs.pdf (accessed on 1 September 2018).

2 Section V, "Indebtedness: Of the Company Including Interest Outstanding/Accrued but Not Due for Payment," Form No MGT 9, MUDRA Bank (2015–16, 2016–17).

3 From the "List of Lending Institutions Shortlisted to be Partners of MUDRA," https://www.mudra.org.in (accessed on 4 July 2018).

4 Union Budget of India, 2016–17, https://www.indiabudget.gov.in/budget2016-2017/ub2016-17/bs/bs.pdf (accessed on 1 September 2018).

5 Union Budget of India, 2017–18, https://www.indiabudget.gov.in/budget2017-2018/ub2017-18/bs/bs.pdf (accessed on 1 September 2018).

6 Union Budget of India, 2018–19, https://www.indiabudget.gov.in/budget2018-2019/ub2018-19/bs/bs.pdf (accessed on 1 September 2018).

7 "Eligibility Criteria for Availing MUDRA Refinance/Loan," https://www.mudra.org.in/offerings (accessed on 4 July 2018).

8 Author's calculations based on figures from MUDRA Bank (2016–17).

9 This analysis was also covered in an op-ed by the author (see George and Srinivas 2018).

10 Author's calculations from data compiled from Table 4.6, Size of Credit Limit and Type of Account-wise Classification of Outstanding Credit of Scheduled Commercial Banks, March 2013 to March 2017, Basic Statistical Returns of SCBs in India, Time Series Publications, Database of Indian Economy (DBIE), RBI, https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications (accessed on 1 August 2018).

11 Author's calculations from data compiled from Table 17, Distribution of Outstanding Advances of Scheduled Commercial Banks to Priority Sector, March 2013 to March 2017, Statistical Tables Relating to Banks in India, Time Series Publications, DBIE, RBI, https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications (accessed on 1 August 2018).

12 Author's calculations from data compiled from Table 5.2, Organisation-wise Classification of Outstanding Credit of Scheduled Commercial Banks According to Occupation, Basic Statistical Returns of SCBs in India, Time Series Publications, DBIE, RBI, https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications (accessed on 1 August 2018).

13 The rate at which MLIs avail refinance is linked to the average cost of funds from the Rural Infrastructure Development Fund (RIDF), with a mark-up of up to 0.75% for banks and 3% for non-banks (Dvara Research and IFMR LEAD 2018: Section 1.1).

14 "The MUDRA Pricing," https://www.mudra.org.in/Offerings (accessed on 9 July 2018).

15 Since 17 banks received refinance in the year, according to page 55 of the MUDRA Annual Report 2016–17 (MUDRA Bank 2016–17), and since 11 of these were public sector banks, according to page 32 of the same report, we can conclude that six RRBs received refinance.

16 "Eligibility Checks for Micro Units Loans Input File," National Credit Guarantee Trustee Company (NCGTC) website, http://www.ncgtc.in/sites/default/files/cgfmu_one_pager_about_eligibilty_checks.pdf (accessed on 5 July 2018).

17 The Economic Census 2013–14 (CSO 2016) reports only 11.8 lakh enterprises (2% of all enterprises enumerated) with institutional loans as a major source of finance, and a further 3.12 lakh (0.53%) with self-help group (SHG) loans as their major source. The National Sample Survey Office (NSSO) 67th Round Survey on Unincorporated Non-Agricultural Enterprises estimated that in 2010–11, only 4.5% enterprises had outstanding formal loans, including loans from Central and state government lending institutions (NSSO 2012).

18 The eligibility criteria for availing the PMMY refinance/loan indicates that even Tier III MFIs (with less than ₹50 lakh book) can be eligible for refinance provided that, among others, they have a minimum Mfr-5 grading on capacity assessment. "Eligibility Criteria for Availing MUDRA Refinance/Loan," https://www.mudra.org.in/offerings (accessed on 23 July 2018).

19 Assuming that MUDRA provides a 50% second loss guarantee cover for losses incurred between 20% and 30% of the loan/bond pools, with the initial 20% loss being covered between the originator and the arranger. Capital adequacy calculated as [Tier I and II Capital/risk-weighted assets] > = 15%.

20 See MUDRA Bank (2015–16: 28).

21 This has been to a cumulative tune of ₹320 crore (₹49 crore in 2015–16 and ₹271 crore in 2016–17), involving NBFCs and NBFC–MFIs as originators of enterprise loans; sources: MUDRA Bank (2015–16, 2016–17).

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