

## Mudra Loan NPAs: A Crisis in the Making

Amit Melkani\*, Dr. Nandan Singh Bisht\*\*, Dr. Rajnish Pande\*\*\*

### Abstract:

The Mudra Loan scheme represents an effort to extend financial inclusion to the domain of business credit. It intends to make it easier for small (non-corporate) business owners to get access to bank loans at reasonable rates of interest without needing to offer collateral. Though it was conceived with the best of intentions, the scheme is beginning to run into problems as reflected in the unusually high level of Non Performing Assets (NPAs) among Mudra Loans. The paper argues that the worsening asset quality of Mudra Loans is due to the inherent drawbacks of lending carried out at the government's prompting. It also contends that the scheme is another example of the mistaken over-reliance on credit as a vehicle of growth and job creation.

**Keywords:** Mudra Loans, Non-Performing Assets, Asymmetric Information, Financial Inclusion

### Introduction:

The Pradhan Mantri Mudra Yojna (PMMY) was launched in 2015 with the goal of providing collateral-free loans to micro and small enterprises, as part of the government's larger push for financial inclusion. The scheme was billed as a vehicle for enabling small businesses to access formal bank credit, something they were often excluded from in the past. However, recent reports about soaring Non-Performing Assets (NPAs) among Mudra Loans offer a chance to reassess both the concept and the execution of the scheme (Verma (a)).

The paper looks at recent stress in Mudra Loans within the conceptual framework of asymmetric information. It then examines the operational problems and accountability issues that arise with loan schemes such as this. Finally, it highlights the larger problem with the way we think of bank credit as an instrument of promoting growth, and how that relates to Mudra loans.

### Mudra Loans – The Background

PMMY was introduced in 2015 as the credit component of the government's financial inclusion project. The government had earlier launched the Jan Dhan Yojana to facilitate the opening of “zero balance” savings accounts, the Pradhan Mantri Jeevan Jyoti Yojana (PMJJY) and Pradhan Mantri Suraksha Beema Yojana (PMSBY) to provide life and accidental insurance cover at nominal premiums, and the Atal Pension Yojana (APY) to create old age pension. All these were aimed at ensuring that banking, insurance and funded pension plans were made available to large sections of India's population that found it hard or impossible to access such services. The Mudra Loan scheme aimed to extend the logic of financial inclusion to credit (*Important Schemes*).

Mudra Loans are essentially small loans given by banks, micro-finance institutions and other institutional lenders to non-corporate borrowers to start a new business, expand an existing business or to meet the working capital needs of the business they are currently running. The loans are divided into three categories depending upon size, with an upper cap of Rs 10 lakh (*Important Schemes*).

The key distinguishing feature of these loans is that they are meant to be collateral-free. What this means is that apart from the assets created using the loan, borrowers are not required to offer any other asset (or third-party guarantee) as security. This is important because the inability to put up collateral – such as land or residential property – is often why small businesses are unable to borrow from banks.

The two principal institutional pillars of PMMY are the Micro Units Development and Refinance Agency (MUDRA) Ltd, which offers refinance to lending institutions that give Mudra Loans (*Annual Report – 2015-16*) and the Credit Guarantee Fund for Micro Units (CGFMU) which provides partial guarantee cover for

---

\* Research Scholar, Department of Economics, DSB Campus, Kumaun University, Nainital

\*\* Asst. Professor, Department of Economics, DSB Campus, Kumaun University, Nainital

\*\*\* Professor & Head Department of Economics, DSB Campus, Kumaun University, Nainital

the loans (*Notification*). The guarantee provided by CGFMU is meant as a substitute for the collateral that banks usually insist on when lending to businesses. Originally, the guarantee was for 50% of the amount in default with a cap of 15% of the total loan portfolio, subject to the lender bearing the first loss of 5% of the outstanding loan portfolio. Since March 2021, however, the cover amount has been raised to 75% of the amount in default, with the cap remaining at 15% of the total portfolio. The first loss to be borne by the lender has also been reduced to 3% of the amount in default ("Govt increases loss coverage for micro loan defaults to 75% from 50% earlier").

By reducing the credit risk of lenders, the guarantee cover is expected to encourage banks to be generous with giving loans to otherwise eligible borrowers who don't have any collateral to offer.

### **Movement of NPA:**

Ever since PMMY was rolled out in 2015, the quality of lending under it has been a subject of interest. The barely disguised pressure from the government on banks to step up lending under the scheme created a natural worry that they may be pushed into making poor lending decisions which would reflect in high NPAs (It may be noted here that the NPA rules governing Mudra Loan are the same as those that apply to normal loans. So a default of 90 days or more leads to a Mudra Loan being marked as NPA, as is the case for regular loans.)

Up until recently, though, the worry seemed unjustified, as Mudra Loans did not, on average, appear to do any worse than other loans extended by commercial banks. However, the catch here was the relative lack of transparency around the performance of these loans. So while MUDRA has widely publicised the disbursements made under the scheme, it has not been regular in reporting the NPA position with respect to these loans. In the six annual reports it has published since 2015-16, MUDRA has revealed the NPA percentage under PMMY only once, in March 2018 (*Annual Report - 2017-18*), when Mudra NPA stood at 5.48% against the overall NPA figure of 11.2% for all Scheduled Commercial Banks (SCBs) and 14.6% for Public Sector Banks (PSBs) (*Report on Trend and Progress on Banking in India 2017-18*). While 5.48% may not seem that alarming against the backdrop of the overall NPA level for that year, it should be pointed out that as of March 2018 the Mudra Loan scheme had been running for barely three years.

In the years since, though, there has been an unmistakable deterioration in asset quality of Mudra Loans. While neither MUDRA nor the RBI has presented data on how these loans are doing, Right to Information (RTI) queries have revealed that as of March 2021, Mudra Loan NPAs stood at 11.98% of total Mudra Loans outstanding (Bose). This should be seen in the context of an overall NPA level of 7.3% for SCBs and 9.1% for PSBs on the same date (*Report on Trend and Progress on Banking in India 2020-21*). In absolute terms, the amount of NPA under PMMY stands at Rs 34, 090 crore against total outstanding of Rs 2.84 lakh crore (Bose).

On one level, the abnormally high stress in Mudra loan could be straightforwardly attributed to the strained finances of Micro, Small and Medium Enterprises (MSMEs) in the wake of the Covid-19 pandemic. As has been well documented in the media, MSMEs have been particularly hard hit by the pandemic (Bose). But naturally, this would reflect in greater loan defaults and higher NPAs. If anything, the Mudra Loan NPA figure could be an underestimate of the true extent of the financial distress faced by MSMEs, since the RBI launched restructuring scheme for MSMEs loans could have helped make the NPA figures seem better than they otherwise would have been. As a public sector banker told the Indian Express, among Public Sector Banks, PMMY NPA in the June 21 quarter could be as high as 20% of the loan portfolio (Verma (b)).

What is even more concerning is that the problems with Mudra Loans probably pre-date the pandemic, as there were reports that up to 20 % of SBI's Mudra Loan portfolio was NPA in March 2020 (Adhikari). With SBI being the country's largest Public Sector Bank, the poor health of its portfolio indicates deeper problems with the scheme as whole.

Another point worth highlighting is how the government has been cagey about sharing NPA details of Mudra Loans. Government data, as and when it is shared, tends to report Mudra NPAs as a percentage of total loans disbursed in a given year. This is contrary to the standard practice of reporting NPAs as a percentage of total loans outstanding (Adhikari). Since loans may not necessarily turn NPA in the year in which they are sanctioned and disbursed, looking at total NPA as a percentage of total loan amount disbursed in a given year may convey a distorted picture of the asset quality of loans.

In summary, it is clear that the health of the Mudra Loan portfolios of banks is much worse than the health of their overall loan portfolios, something that should lead to a review of the design and implementation of the scheme as a whole.

### **Asymmetric Information and Bank Lending - The Case of Mudra Loans**

In economic theory, asymmetric information refers to a situation where one side of a transaction/contract is better informed than the other (Pindyk and Rubinfeld 627). While many real world situations meet the definition of asymmetric information, it is especially relevant to loans. This is because with almost every form of lending, the borrowers are always better informed about their likely future income (and therefore their capacity to repay) than the lenders.

One way for lenders to overcome the asymmetry is to undertake a thorough appraisal of the borrower, and all banks do in fact have elaborate appraisal systems in place for this very purpose. In addition, even after a loan has been sanctioned and disbursed, lenders continue monitoring it until it is repaid in full.

Despite all the care, however, some loans do turn bad. While this is partly due to the inherent uncertainty and the unavoidable risks that come with lending (and business loans in particular), the role of information asymmetry cannot be discounted. Since it is reasonable to assume that despite detailed appraisals and monitoring, borrowers still know more than lenders about their intent and capacity to repay, it may well be impossible to entirely eliminate the information asymmetry in the context of loans.

The existence of asymmetric information impedes the smooth functioning of a market in two main ways: by causing adverse selection and by introducing moral hazard. Adverse selection arises when a market gets dominated by poor quality products because one of the transacting parties is unable to separate high quality products from low quality products (Pindyk and Rubinfeld 630). On the other hand, moral hazard arises when an agent has a reduced incentive to guard against risk as it is protected against any possible loss (Pindyk and Rubinfeld 639). With schemes such as the Mudra Loan, both consequences of asymmetric information are on display.

Over and above the risk of adverse selection that is always present with any loan, Mudra Loans come with their own added challenges. Since the loan is meant to specially cater to small business owners who aren't otherwise deemed credit worthy by banks, it should come as no surprise that the demand for these loans comes disproportionately from relatively high-risk borrowers who are more likely than average to default. Moreover, as Mudra Loans are partially covered by the credit guarantee cover extended by CGFMU, the lending institutions have a reduced incentive to be diligent with loan sanction and monitoring. Both these factors, i.e. the predominance of high-risk borrowers and the sharing of credit risk with an outside agency, increase the likelihood of default.

Therefore, loan schemes that require lending to take place on any grounds other than the intrinsic creditworthiness of borrowers (and where the lenders' risk is mitigated by external guarantees) are almost certain to see higher defaults than regular commercial lending.

### **Accountability, operational burden and low impact**

Since there is always a subjective element in any loan appraisal, accountability issues are relevant to most forms of lending. These become even more pronounced with government backed loan schemes because credit officers can easily blame future defaults on the liberalized appraisal standards that usually accompany such schemes. This means that loans could be sanctioned with the full knowledge that they are unlikely to be repaid. And since low-quality borrowers are well-aware of their poor creditworthiness, they are willing to bribe bank officers to get their loans approved (“Rising NPAs in Mudra loan cause of worry for banks”).

The potential for corruption aside, loan schemes like the Mudra pose other difficulties at the operational level as well. Even though the loan amounts are relatively small, the documentation and paperwork are almost as onerous as those involving large loans. Also, at least in the initial stages of the scheme, individual branches were given targets for the number of loans sanctioned rather than for the loan amounts sanctioned or disbursed. Consequently, branches got swamped with a large number of small loans that still required as much documentation as regular loans. This naturally crowded out other – more high-value – business.

The small loan amounts, in turn, also raise questions about the efficacy of the scheme. Between April 2015 and September 2021, about 310 million Mudra Loans were sanctioned, with a cumulative disbursement of Rs 15.86 lakh crore. This comes down to an average of approximately Rs 51,000 per beneficiary, far below the upper limit of Rs 10 lakh (Rao). One can well wonder whether loan amounts in that range make any real difference to the fortunes of an average small business owner.

At the same time, since banks can label all business loans of up to Rs 10 lakh as Mudra Loans, it is quite plausible that loans with larger ticket sizes are being given to those borrowers who could well have been able to avail such financing even before the scheme was launched (Rao).

To sum up, Mudra Loans may well be inadequate for those genuinely unable to access formal finance, while being superfluous for creditworthy small businesses that were already able to avail bank loans.

### **Bank Credit as a fiscal multiplier/welfare instrument:**

The Mudra Loan scheme is based on the belief that small scale credit can take the place of government spending both as an instrument of welfare and as a means of boosting aggregate demand. So what the government cannot deliver in the form of social spending, it hopes to be able to provide by making it easier for the underprivileged to get access to institutional credit. Similarly, if the government cannot shore up demand or create jobs through direct expenditure, it hopes that the same effect would be achieved by the disbursement of business loans.

On the face of it, the strategy has obvious appeal. First, it aligns with the desire of all governments to be seen to be pushing financial inclusion. Second, it reduces the government's own fiscal outgo. Third, it is not seen as a populist handout, but rather as an effort to help the poor become economically self-reliant. Finally, it helps rescue the poor from the clutches of informal moneylenders and their exorbitant interest rates.

However, a credit-reliant development/welfare strategy comes with several downsides. First, the very fact that so many people are unable to access credit through the normal route - because they cannot bring enough collateral - points to deeper problems of wealth distribution which cannot be papered over with supposedly easy loans.

In this context, the American experience with sub-prime lending in the early 2000s is instructive. In a bid to expand home-ownership, the US government tacitly encouraged banks to give home loans to borrowers who lacked a good credit-history and a reliable income, the so-called "sub-prime" borrowers. Through a complex sequence of events these sub-prime loans led to one of the biggest financial crises in world history (Blanchard and Johnson 204). The underlying problem there was wealth and income inequality, which was sought to be addressed through easy loans, with disastrous consequences all round.

Mudra Loans are essentially a similar attempt to use credit to expand access to business capital for micro-entrepreneurs. While it is perfectly normal for businesses to raise funds through debt, the probability of default rises significantly when the borrowing happens at the government's prodding and with a partial guarantee. The sharp spike in Mudra Loan NPAs demonstrates this point.

On a broader level, encouraging banks to lend more to support the economy is itself a risky strategy. Sure, bank finance plays a crucial role in meeting the working capital and term finance needs of businesses, especially for smaller firms that cannot access financial markets directly. But there is a huge difference between bank lending based on a careful assessment of the commercial viability of businesses and banks being forced to lend due to arbitrary targets from the government or due to irrational exuberance among senior management. Such reckless lending almost always ends in a banking crisis. This is evident from the Indian experience from the mid-2000s onwards, when a period of extremely high credit growth eventually led to a crash landing with soaring NPAs across the banking sector, but especially in public sector banks.

Now while the overall exposure of banks and other lending institutions to Mudra Loans isn't that large, it isn't insignificant either. If not managed properly, this could become a major source of trouble in the banking sector going forward.

Finally, it is worth mentioning that the government had reduced the target for Mudra Loan disbursements in the current financial year (Ohri). While that is to be welcomed, it does raise the larger point about the desirability of credit decisions being based on government targets in the first place.



## Conclusion

This paper makes the argument that the asset quality of loans given under PMMY is poor and getting worse. Though some of this could be attributed to the impact of the COVID-19 pandemic on the balance-sheets of micro and small enterprises, the factors specific to the loan scheme also need to be carefully examined. The combined effect of moral hazard and adverse selection as contributing factors in the rise of Mudra Loan NPAs deserves particular attention.

The paper points out that Mudra Loans impose a significant operational burden on banks and create avenues for unethical lending. Against this, the small average ticket size of the loans limit their capacity to make any real difference to businesses.

Last, the problems with the scheme are also an opportunity to reflect on the habitual tendency of governments to rely upon bank credit as a substitute for meaningful development.

## References

1. Adhikari, Anand. "20% of SBI's Mudra loans turn NPA; public banks' PMMY bad debt Rs 18,836 crore". *Business Today*, 10 November 2020, <https://www.businesstoday.in/latest/economy-politics/story/20-of-sbi-mudra-loans-turn-npa-public-banks-pmmmy-bad-debt-rs-18836-crore-278306>. Accessed 8 December 2021.
2. Annual Report (2015-16). MUDRA Ltd, 31 August 2016, <https://www.mudra.org.in>. Accessed 8 December 2021.
3. Annual Report (2017-18). MUDRA Ltd, 27 July 2018, <https://www.mudra.org.in>. Accessed 8 December 2021.
4. Blanchard, Olivier, and David R. Johnson. *Macroeconomics*. 6th Edition, Pearson, 2017.
5. Bose, Shritama. "Mudra NPAs rise as Covid hits MSMEs." *Financial Express*, 20 October 2021, <https://www.financialexpress.com/industry/banking-finance/mudra-npas-rise-as-covid-hits-msmes/2352779>. Accessed 8 December 2021.
6. "Govt increases loss coverage for micro loan defaults to 75% from 50% earlier", *Economic Times*, 17 February 2022, <https://economictimes.indiatimes.com/industry/banking/finance/govt-increases-loss-coverage-for-micro-loan-defaults-to-75-from-50-earlier/>. Accessed 17 February 2022.
7. Important Schemes. Ministry of Finance, 1 March 2022, <https://financialservices.gov.in/banking-divisions/ImportantSchemes#:~:text=Hon'ble%20Prime%20Minister%20announced,universal%20access%20to%20banking%20facilities>. Accessed 1 March 2022.
8. Notification. Ministry of Finance, 18 April 2016, <https://www.ncgtc.in/sites/default/files/cgfmugazette-notification.pdf>. Accessed 1 March 2022.
9. Ohri, Nikunj. "Govt cuts Mudra loans target in FY22, rules out fresh PSB merger proposal". *Business Standard*, 2 August 2021, <https://www.business-standard.com/article/economy-policy/govt-cuts-mudra-loans-target-in-fy22-rules-out-fresh-psb-merger-proposal-12108020>. Accessed 17 February 2022.
10. Pindyk, Robert, and Daniel Rubinfeld. *Microeconomics*. 8th Edition, Pearson, 2014.
11. Rao, PSM. "MUDRA: More hype than actual impact". *Deccan Herald*, 31 October 2021, <https://www.deccanherald.com/opinion/panorama/mudra-more-hype-than-actual-impact-1046109.html>. Accessed 17 February 2022.
12. Report on Trend and Progress on Banking in India 2017-18. Reserve Bank of India, 28 December 2018, [www.rbi.org.in](http://www.rbi.org.in). Accessed 8 October 2019.
13. Report on Trend and Progress on Banking in India 2020-21. Reserve Bank of India, 28 December 2021, [www.rbi.org.in](http://www.rbi.org.in). Accessed 17 February 2021.
14. "Rising NPAs in Mudra loan cause of worry for banks." *Lokmat*, 12 August 2021, <https://english.lokmat.com/aurangabad/rising-npas-in-mudra-loan-cause-of-worry-for-banks>. Accessed 8 December 2021.

15. Verma (a), Sunny. "As sanctions increase, Mudra loan NPAs nearly double during 2017-18". Indian Express, 2 January 2019, <https://indianexpress.com/article/business/banking-and-finance/as-sanctions-increase-mudra-loan-npas-nearly-double-during-2017-18-5519163/>. Accessed 8 December 2021.
16. Verma (b), Sunny. "Covid stress on small units:Mudra loan NPAs up in PSUBanks". Indian Express, 8 September 2021, <https://indianexpress.com/article/business/banking-and-finance/covid-stress-on-small-units-mudra-loan-npas-up-in-psu-banks-7495311>. Accessed 8 December 2021.