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PRIORITY SECTOR LENDING THROUGH MFIs:AN ANALYSIS OF NPA OF FEW BANKS IN INDIA

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Abstract
RBI guidelines on priority sector aim to ensure that adequate finance reaches the agricultural and generally weaker sections of the society, mainly in rural India to provide them with economic opportunities. Spurred by the crisis in Andhra Pradesh, RBI reassessed their policies regarding banks providing finance to Micro Finance Institutions(MFIs). After much deliberation the new norms eased bank lending to MFIs and tried to provide a win-win proposition for banks, MFIs and the beneficiaries in priority sector.

This paper tried to access whether the updated norms supported the bank in meeting their PSL targets. At the same time, by looking at various annual reports, the paper studied the effect of PSL lending through MFIs on NPAs performance of three private sector banks namely ICICI, Axis and Yes bank and two public sector players namely SBI and PNB. Smaller private banks, like Yes Bank, with limited infrastructure in rural areas immediately capitalized on this and started lending via MFIs reducing their PSL NPAs to nearly zero. Overall, all banks (apart from major public banks) showed a decrease in priority sector lending NPAs.

Key Words: Priority Sector, MFIs,NPAs Performance.

1. Introduction to Microfinance and MFIs

Microfinance is a source of financial services for entrepreneurs and small businesses lacking access to banking and related services. Microfinance is an initiative whose objective is "a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high-quality financial services, including credit, savings, insurance, and fund transfers."

Microfinance institutions, or MFIs, come in all shapes and sizes. They can differ in scale, experience, legal statute, strategy and budget. What lies at the heart of the microfinance system is the issue of reliability. Reliability determines how smoothly an MFI operates.

Firstly, microcredit cannot exist without microfinance institutions. These organizations provide hard-to-find financial services to local individuals and groups. MFIs aim to promote economic activity among low-income earners, for whom access to official banking services is impossible or nearly so.

Microfinance is a way to promote economic development, employment and growth through the support of micro-entrepreneurs and small businesses and micro finance institutions helps in achieving this by means of providing finance to disadvantaged segments of society. This paper aims to gain insight of MFI’s and how it is a benefit for the poor by fulfilling their credit needs.

Further, it is important to understand the structure of MFI’s, major risks and various opportunities associated with MFI’S in India. Further, we will try and enumerate various benefits of Micro Finance Institutions and a few limitations which hamper in serving the MFIs’ objectives.

2. Introduction to Priority Sector lending

Priority Sector refers to those sectors which may not get timely and adequate credit in the absence of this special dispensation. This includes poor borrowers in rural areas who need credit to develop opportunities for employment. PSL is an important role given by the Reserve Bank of India (RBI) to banks for providing a specified portion of the bank lending to few specific sectors like agriculture (and allied activities), micro and small enterprises (SMEs), poor people for housing, students for education and other low income groups and weaker sections. This is done keeping in mind an all-round development of the economy as opposed to focusing only on the financial sector.

2.1 Categories of Priority Sector

(i) **Agriculture and Allied Activities (Direct and Indirect finance)**: Direct finance to agriculture shall include short, medium and long term loans given for agriculture and allied activities directly to individual farmers, Self-Help Groups (SHGs) or Joint Liability Groups (JLGs) of individual farmers without limit and to others (such as corporates, partnership firms and institutions) up to Rs. 20 lakh, for taking up agriculture/allied activities. This is very crucial to this dissertation as

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This distinction between direct and indirect agriculture is dispensed with. Instead, the lending to agriculture sector has been re-defined to include (i) Farm Credit (which will include short-term crop loans and medium/long-term credit to farmers) (ii) Agriculture Infrastructure and (iii) Ancillary Activities.

(ii) **Small Scale Industries (Direct and Indirect Finance):** Direct finance to small scale industries (SSI) shall include all loans given to SSI units which are engaged in manufacture, processing or preservation of goods and whose investment in plant and machinery (original cost) excluding land and building does not exceed the amounts specified in various regulations. Indirect finance to SSI shall include finance to any person providing inputs to or marketing the output of artisans, village and cottage industries, handlooms and to cooperatives of producers in this sector.

(iii) **Small Business / Service Enterprises:** shall include small business, retail trade, professional & self-employed persons, small road & water transport operators and other service enterprises as per the definition given in Section I and other enterprises that are engaged in providing or rendering of services, and whose investment in equipment does not exceed the amount specified in Section I, appended.

(iv) **Micro Credit :** Provision of credit and other financial services and products of very small amounts not exceeding Rs. 50,000 per borrower to the poor in rural, semi-urban and urban areas, either directly or through a group mechanism, for enabling them to improve their living standards, will constitute micro credit.

(v) **Education loans:** Education loans include loans and advances granted to only individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad, and do not include those granted to institutions;

(vi)**Housing loans:** Loans up to Rs. 28 lakh in metropolitan cities where population is above 10 lakh and Rs. 20 Lakh at other centers for construction/purchase of a dwelling unit per family provided total cost of the unit in metropolitan centers and at other centers does not exceed Rs. 35 Lacs and Rs. 25 Lacs respectively. (excluding loans granted by banks to their own employees) and loans given for repairs to the damaged houses of individuals up to Rs.5 lakh in metropolitan centers and Rs. 2 Lakh at other centers.

The paper is divided into following section. Section 3 talks about Outreach and Loan Portfolio, Section 4 talks about RBI Policy Formulation in the context of Andhra Pradesh Microfinance Crisis, Section 5 analysisFive Banks and their NPA Performance Section 6 finally concludes the paper.

3. Outreach and Loan Portfolio

Microfinance institutions (MFIs) have become an important channel for banks' lending activities. Poor demand from traditional priority sectors and the fact that PSL is going to be monitored strictly by the Reserve Bank of India has led to unprecedented growth in loans to this sector. Further, MFIs have also become a lot more trustworthy after putting in place tight due diligence processes.

The following quote by UCO Bank chairman and managing director ArunKaul sums up the outlook in banks, "There is a large opportunity for collaboration between banks and MFIs" There are about 48000 bank branches in 6.5 lakh villages. The gap is being filled in the MFIs. Banks cannot penetrate to these pockets because of structural rigidity."

Under such circumstances, banks are trying to reach out to the economically under-privileged lot through MFIs and self-help groups. In fact, MFI business emerged as one being funded mostly by bank loans.

A statistic shows that between October and December 2014, MFIs received a total of Rs 9070 crore from banks and other financial institutions, showing 162% growth as compared to Q3 FY14. Most of this (about 77%) of the funding came from banks, according to Microfinance Institutions Network (MFIN).

Further, many bankers share the belief that lending to MFIs help banks in dispersing credit risk. Banks provide loans to MFIs for onlending and micro credit to the poor borrower is historically known for over 90% recovery record.
Further, all effort is made to ensure that the poor borrowers get micro loans for taking up economic activities only. In fact, banks lend to MFIs always with a clause that the onlending should be for helping the poor to create opportunities and do business and not simply for conspicuous consumption. Banks with gaps in priority lending invest in pass through certificates from MFIs wherein underlying loans are priority sector-compliant. Banks also purchase loan receivable pools from MFIs directly meet the target.

3.1 Trends in Rural – Urban Share of MFI Borrowers

The figure 1 below shows the trends in the urban and the rural share of MFI Borrower from the year 2012 to 2015. We observe the sharp fall of 23% in 2015 and 11% in 2014 in the share of MFI borrowers in rural sector. But the case of the share of the urban MFIs has seen the tremendous growth between 2014 and 2015 i.e 11% and 23% respectively in the years.

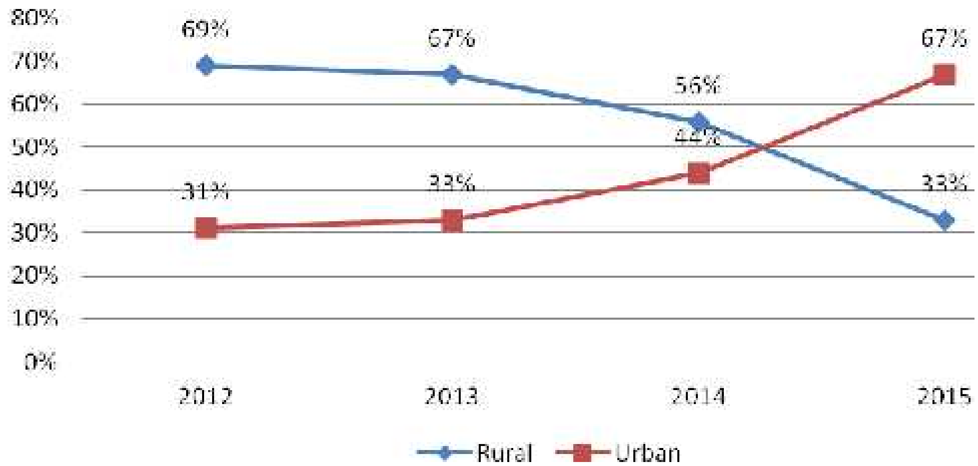

Figure 1:Regional Breakup of client out reach of MFIs

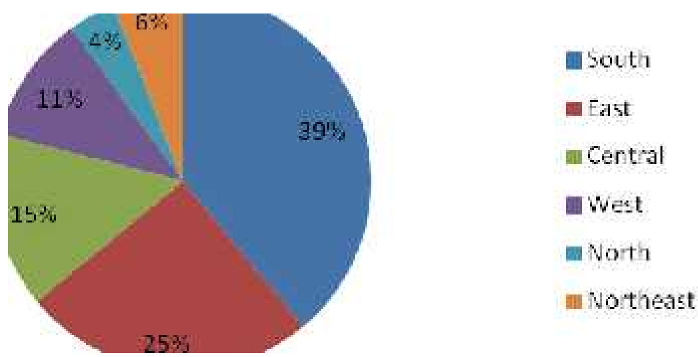

Figure 2: District wise penetration of Portfolio Outstanding of MFIs

When we study the district wise access in figure 2 we found that 39% is the penetration in the south and 25% in the east which covers the major share of portfolio outstanding of MFIs. The central, west , north and north east shares 15%, 11%, 4% and 6% respectively.

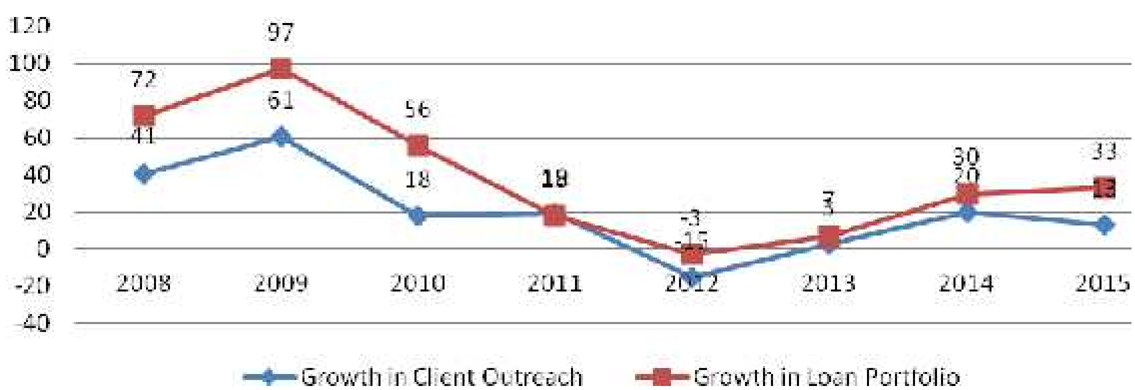

Figure 3: Growth Fluctuations in Outreach and Loan Outstanding

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During the study of the fluctuations in the outreach of client and the loan portfolio (loan outstanding) from the year 2008 to 2015 in figure 3 the data plot shows that the pattern of both the categories is more or less similar. Initially it had a upward movement during 2008 than a very sharp dip has been spotted from the year 2009 to 2012 from 97 to -3 and from 61 to -15for loan portfolio and client outreach respectively. Prior to 2012 a rising trend has been observed as the client outreach has a growth -3 to 33 and growth in loan portfolio recorded a change -15 to 20 in 2014 and again declined from 20 to 13 in 2015.

Figure 4: Loan Disbursement over the years

In figure 4 the loan disbursement i.e the amount released or distributed in parts towards the loan had followed the similar trend as observed in the above figures. 2010-11 had a rising graph but again in 2011-12 it has fallen to 22635 . After 2012 is has an increasing trend and reached to the level of 56860 in 2015.

4. RBI Policy Formulation in the context of Andhra Pradesh Microfinance Crisis

Andhra Pradesh Microfinance Crisis and its Repercussions on Microfinancing Activities in India

Microfinance institutions, once considered as a tool for long term sustainable development, are today themselves struggling with the issues of their own sustainability. The Andhra Pradesh Microfinance Crisis in 2010 endangered the existence and viability of Microfinance Institutions' (MFIs) operations in India. The Andhra Pradesh Microfinance Institutions (regulation of money lending) Act, 2010 badly stifled the operations of MFIs. Under this Act, provisions related to recovery caused loan repayment to fall from 99 per cent to a meager 10 per cent. Further, an attempt has been made to trace the repercussions of Andhra Pradesh Crisis on other general activities of MFIs. Analysis from the data gathered from the various reports like State of Sector Reports on Microfinance by NABARD, ACESS, MCRIL Review Reports and Microfinance Information Exchange data etc., have found that loan disbursement, cost efficiency, clients served and operational sustainability etc. of MFIs has been greatly hampered by the crisis. However reprieved Microfinance Bill if passed can bring optimistic change in the sector (as it did happen after the 2011 and 2015 RBI circulars). Further, credit bureaus are also playing an important role to counter the problems that caused the emergence of the crisis in 2010.

Most MFIs provide credit to a very specific set of high risk borrowers. Further, loan recovery is not easy in some cases leading to reasonable bad debt. To compensate for the same, the MFIs charge high interest rates (24% – 36 %) and sometime even turn to use of coercive recovery practices. In October 2010, allegations were made on MFI's that their coercive practices led to a spate of suicides in Andhra Pradesh. In response to this state governments began to put increased regulations on MFIs. This lead to a slowdown in the loan recovery process, hitting the financial health of the microfinance sector. It was further aggravated by the reluctance of banks to provide support to MFIs.

To study the issues and concerns being faced by the sector a Sub-Committee of the Central Board of Directors of Reserve Bank of India under Y. H. Malegam submitted a report to the Governor, RBI on January 19, 2011. The following recommendations were suggested

The reasons for the increasing dominance of the MFI Group vis-à-vis bank linkage need to be examined. Five possible reasons have been suggested.

a) First, it is believed MFIs have been able to achieve a deeper reach as they tend to have a more informal approach as opposed to banks which still operate through traditional branches.

b) Second, MFIs are said to be more aggressive in securing business as they use more of the local population as field workers which gives them better access to borrowers as opposed to banks which still largely use traditional staff.

c) Third, the procedures used by MFIs are said to be simpler and less time consuming whereas the procedures used by banks tend to be bureaucratic and laborious.

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d) Fourth, bank loans to SHGs have a longer repayment period and during that period if SHG members need loans, they approach MFIs.
e) Finally, it is believed that banks find it easier to use MFIs to meet their priority sector targets. This is particularly true near the year end where banks invest in securitized paper issued by MFIs to meet targets.
The final recommendation of the committee was that "Bank advances to MFIs shall continue to enjoy "priority sector lending" status. However, advances to MFIs which do not comply with the regulation should be denied "priority sector lending" status. It may also be necessary for the Reserve Bank to revisit its existing guidelines for lending to the priority sector in the context of the Committee's recommendations". The same points were echoed by Dr. D. Subbarao, Governor, RBI in his Monetary Policy Statement 2011-12 on May 3, 2011.

4.1 Relevance to Banks
RBI guidelines require banks to lend 40.0% of their adjusted net bank credit, or credit equivalent amount of off-balance sheet exposure, whichever is higher, to certain specified sectors called priority sectors. The definition of adjusted net bank credit does not include certain exemptions and includes certain investments and is computed with reference to the outstanding amount at March 31 of the previous year. Priority sector includes small enterprises, agricultural sector, food and agri-based industries, small businesses and housing finance up to certain limits. Out of the 40.0%, banks are required to lend a minimum of 18.0% of their adjusted net bank credit to the agriculture sector and the balance to certain specified sectors, including small enterprises (defined as enterprises engaged in manufacturing/production, processing and services businesses with a certain limit on investment in plant and machinery), small road and water transport operators, small businesses, professional and self-employed persons, all other service enterprises, micro credit, education loans and housing loans up to INR 2.0 million to individuals for purchase/construction of a dwelling unit per family.

The implications of this were summarized by Bandhan Finance's (Indians biggest MFI) model, which lends at 24% interest on average, keeps around 13%, while the bank that buys loans makes 11%. Repayment of microfinance loans is at 99% and returns, too, are considered good.

5. Five Banks and their NPA Performance
To study the effects of PSL through MFIs, we shall now look at the NPA statistics and overall orientation of 3 private sector players – ICICI, Axis and Yes bank and two public sector majors – SBI and PNB.

5.1 ICICI Bank
In 2011, ICICI bank was in the news as the financials reported increased loans to MFIs. n March, nearly at the end of the financial year, micro-finance companies managed a windfall of credit from banks as many of them — including ICICI Bank — failed to meet their annual priority sector lending (PSL) targets. To prevent a shortfall, they invested into securitisation deals and term loans of close to Rs 1,500 crore to micro-finance companies.

MFIs acknowledged that they benefited from banks falling short of Priority Sector Lending targets (40% of gross advances). Securitisation deals became very popular means of investment for banks during the 2011 financial year end.

The following tables show the Net NPA for the whole bank and NPAs in priority sector advances for ICICI over a 7 year period (2009 to 2011). It can be easily observed that there was a major change in net PSL NPA in 2011 to 2012. This coincides with the RBI guidelines stating clearly that loans to MFIs can be categorized as PSL.

Bank NPA Details				
Year	Gross NPA	Net NPA	Net customer assets	Net NPA %
2009	98.03	46.19	2358.24	1.96%
2010	96.27	39.01	2091.22	1.87%
2011	101.14	24.58	2628.16	0.94%
2012	95.63	18.94	2628.16	0.62%
2013	96.47	22.34	3517.62	0.64%
2014	105.54	33.01	4037.08	0.82%
2015	152.42	63.25	4516.34	1.40%

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Priority Sector Details			
Year	Priority Sector Loan	PSL NPA (Gross) %	PSL NPA (Net)%
2009			
2010	539.77	5.62%	3.05%
2011	534.02	7.61%	3.00%
2012	592.86	4.78%	1.25%
2013	597.94	3.60%	0.75%
2014	645.52	2.29%	-
2015	762.09	2.14%	-

5.2 Axis Bank
On August 13, 2011, similar to other major banks, Axis Bank decided to step up lending to micro-finance institutions sector. Other external factors also played a part in deciding the bank's lending inclination. "So far, we have been going slow on lending to the MFIs because of the fiasco, which took place in Andhra Pradesh," Managing Director and CEO of Axis Bank Shikha Sharma.

With the regulations for MFIs fortified, the bank decided to scale up lending to the priority sector, adding that they would also consider lending directly to Microfinance Self-Help Groups.

Further, the CSR wing of Axis (Axis Bank Foundation), also tied up with Bandhan finance (a major MFI) for 5 years to offer grants to around 50,000 marginalized people.

Axis foundation along with Bandhan would also set up a fund of Rs 100 crore for the purpose (from which Rs 75 crore would be contributed by the former and the rest by the latter). As a five year plan, Axis Foundation would work to provide sustainable livelihoods in the most needy and excluded districts of our country, including ensuring that at least 60 per cent of the beneficiaries are women. The initiative aimed to help in financial inclusion of the people who are not credit-worthy.
Further, it can be observed that the gross NPA of Axis Bank has gradually reduced from 2010 to 2012.

Bank NPA Details			**Priority Sector Details**	
	Gross NPA %	Net NPA %	Priority Sector Loan	PSL NPA (Gross) %
2009				-
2010	1.13%	0.36%	299.4	-
2011	1.01%	0.26%	412.89	-
2012	0.94%	0.25%	484.79	-
2013	1.06%	0.32%	484.98	-
2014	1.22%	0.40%	633.07	1.29%
2015	1.43%	0.46%	702.8	1.21%

5.3 Yes Bank
Yes Bank has been traditionally strong in meeting its priority sector lending targets and generally expects its priority sector lending to continue to see zero defaults as well as yield positive margins.

According to the RBI, banks should extend at least 40 per cent credit to the priority sector, which includes agriculture, micro and small enterprises, education and housing. These sectors have huge potential, but defaults remain a big risk.

SomakGhosh, group president of the corporate finance and development banking at Yes, commented in 2010 that the bank had regularly exceeded the levels set by the RBI for the priority sector in the past four years. The bank's non-performing assets in the development banking have also been zero. The business is also expected to remain viable.

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"We have one of the lowest NPAs in the industry. In the development banking or PSL, our NPAs are zero and we expect them to remain at that. Further, the bank will continue to make modest money in the development banking business,'' Ghosh said.

Further, Yes Bank has made good profits in priority sector with the Net interest margin (NIM - the difference between interest earned and interest paid) of 3.2 per cent while generally the NIM in priority sector lending is around 1.5 per cent.Ghosh said that risk management techniques and the business development processes contributed to the bank's success in areas like micro-financing and farm lending, despite a lack of a large branch network. "We have followed a partner-led model which has two implications — it results in zero defaults and allows us to keep our costs low,'' he said.

Yes Bank claims to focus on development banking because of the huge potential it sees in the sector. "It's not only about meeting the priority sector targets or the RBI regulatory norms. Close to 80 per cent of the rural households catered to have no access to banking services. There is a huge potential in offering financial products and services to these under-banked households,'' Ghosh added.

"Buying loans from MFIs is certainly more cost-effective than lending directly to the priority sector," said SomakGhosh, Yes Bank Ltd's group president for corporate finance and development banking. "What is more, there is almost no risk in buying these assets because there is almost no delinquency."

In fiscal 2010, Yes Bank bought loans worth at least Rs300 crore from Share Microfin and SKS Microfinance Pvt. Ltd. It has been buying such loans for at least two years.

To streamline the process of buying loans from MFIs, Yes Bank has, in partnership with credit rating agencies Crisil Ltd and Icra Ltd, developed a mechanism to evaluate the quality of loans, according to Ghosh. Microfinance loans are normally unsecured, or are not backed by mortgages, so understanding credit quality is paramount.

It is expected that micro-finance via MFIs will continue to account for 10-12 per cent of the bank's priority sector portfolio.

Bank NPA Details				**Priority Sector Details**	
	Gross NPA	Gross NPA %	Net NPA %	Priority Sector Loan	PSL NPA (Gross) %
2009	-	0.68%	0.33%	-	-
2010	-	0.27%	0.06%	44.91	-
2011	-	0.23%	0.03%	90.36	-
2012	-	0.22%	0.05%	98.45	-
2013	-	0.20%	0.01%	105.21	-
2014	1.749	0.31%	0.05%	145.77	0.15%
2015	3.134	0.41%	0.12%	189.76	0.31%

5.4 State Bank of India

Like every bank, SBI also welcomed the RBI norms on priority sector lending in 2011. The updated priority lending norms will lead the banks to lend 7 per cent of their total advances to small and marginal farmers.

The economic research department of SBI mentioned that the move will ensure a 40 per cent rise in credit flow to the under-funded segment (mainly small and marginal farmers) at Rs 85,000 crore in that fiscal year.

In the revised guidelines on the priority sector lending (PSL) the Reserve Bank had asked for a staggered increase in lending to the small and marginal farmers under the compulsory credit outgo to weaker sections of the society. It is important to note that, at that time, events like the unseasonal rains in central and northern states had aggravated the stress among the farmers.
In this background, the "small and marginal farmers" was a newly-introduced segment which became a part of the overall 18 per cent credit allocation for agriculture. It is crucial here to note that RBI had dispensed away with the earlier distinction between direct and indirect lending making lending simpler and less risky for banks.

"Overall, the new rules are positive and could be a game changer for banks with more focused and inclusive lending," a note by SBI economic research department said.

After the most recent (2015) Priority Sector Lending reforms by RBI, SBI chairman Arundhati Bhattacharya had the following comments on new rules and what it means for banks in general, "Definitely banks will be better able to achieve the target mainly because a few things have been tweaked. The distinction between direct and the indirect has been taken away. A number of new things have been added such as renewables, social infrastructure, food processing, so, that again gives us a lot more capability to do these things. The amount that you can take for housing loans also has been increased. It has gone up to Rs 35 lakh and Rs 25 lakh for the project cost. So, that again brings quite a large chunk of our lending into priority sector norms. So, overall I think a number of positives are there and we are very happy that these things have happened because we believe we haven't done the numbers as yet, it will take a little time for us to run it and see where we are coming but we believe we will be able to better achieve targets now."

Bank NPA Details				**Priority Sector Details**	
	Gross NPA	Gross NPA %	Net NPA %	Priority Sector Loan	PSL NPA (Gross) %
2009	-	-	1.79%	-	-
2010	-	3.05%	1.72%	1705.68	-
2011	253.26	3.28%	1.63%	2315.97	-
2012	396.76	4.44%	1.82%	2501.77	-
2013	511.89	4.75%	2.10%	2643.12	-
2014	616.05	4.95%	2.57%	2808.19	6.56%
2015	567.52	4.25%	2.12%	2889.52	6.85%

Further, the NPA figures of SBI also fall in line with the common trend followed by private banks. The net NPA reduced from 1.79% in 2009 to 1.63% in 2011. Then it rose to 2.57% in 2014 only to fall back to 2.12% by the end of FY 2015. The trend roughly matches with the expected trend of NPA changes due to PSL norms. At the same time, it is interesting to note that PSL NPA actually rose from 2014 to 2015 (6.56% to 6.85%) which suggests low correlation. This can be due to other factors influencing the gross bank NPA (as also discussed in the limitations later).

5.5 Punjab National BankPNB

In April 2011, K.R. Kamath, chairman and managing director of state-owned Punjab National Bank made the following comment, "The time and energy required to make small loans in the priority sector is huge,"
Buying loans from microfinance lenders is an easy way of fulfilling priority sector lending obligations, he added. Commercial banks mostly buy agricultural loans from MFIs, according to Chandra ShekharGhosh, managing director of Bandhan.

For banks, the annualized return on these assets is around 11-12%. MFIs, which typically lend at 24-36% interest, keep the rest for managing and recovering the loans, according to industry officials.

As can be seen from the table below, PNB continues to have one of the higher net NPAs in the industry. Being a public sector bank, it does have the strength to support such defaults. Further, it has not ventured too deep into the PSL through MFI model as it has its own rural network and makes direct lending available to priority sector too.

Bank NPA Details			**Priority Sector Details**	
	Gross NPA %	Net NPA %	Priority Sector Loan	PSL NPA (Gross) %
2009	1.60%	0.17%		-
2010	1.71%	0.53%	666.15	-
2011	1.79%	0.85%	756.52	-
2012	2.93%	1.52%	958.98	-
2013	4.27%	2.35%	910.76	-
2014	5.25%	2.85%	1205.38	5.58%
2015	6.55%	4.06%	1358.12	7.49%

Other factors affecting NPA

One limitation of this paper is that it assume that NPAs of banks are majorly contributed by the bad debt / default acquired by priority sector lending. Even though default is the biggest reason for NPAs, most of the time, especially in larger banks such as SBI and PNB, gross NPA of the bank is affected by other factors as well like economic conditions, mis-management, diversion of funds etc.

To counter this, we have tried to study the trends in Non-Performing Assets in Priority Sector Lending only wherever the data was available.

Extra costs incurred in PSL

Another limitation of this paper is that when banks do direct lending to priority sector, they incur higher costs. These costs are due to manpower, transportation or other infrastructure requirements for rural lending. These costs distort the overall financial expenses and affect the bank negatively. These costs are avoided when banks perform indirect lending through MFIs.

6. Summary and Conclusion

Overall the whole timeline related to priority sector lending can be divided into the following parts:

Period of uncertainty

This period is pre-2010 era. This is the period where banks were not sure whether lending to microfinance institutes can be considered under priority sector lending. Hence, banks were cautious and maintained a balance between direct lending and indirect lending.During this period there was very little correlation between bank NPAs and their PSL through MFIs.

Period of negativity

During the Andhra Pradesh farmer crisis, it was widely claimed that the coercive techniques used by many microfinance companies to get their loans reimbursed played a major role in causing farmer suicides. Further, the exorbitant rates charged by the MFIs (24-36%) were also questioned. In the heat of the moment, many considered the idea of closing down the MFIs or even withdrawing the support of the banks.

The Andhra government hugely regulated the MFIs and made it very easy for farmers to take loans and get a lenient treatment in case of default. This led to a sudden spike in bad loans for MFIs and they no longer were a low-risk option for banks.

On the other hand there were few committees and reports propagated the need to support MFIs and therefore de-regularize them, increase their funding from the banks while restricting their lending rates. During this period, most banks were meeting their 40% priority sector lending targets by lending directly to local SMEs and farmers. Due to limited reach and inadequate manpower and rural infrastructure, many banks experienced bad debt in this period. Without the support of MFIs (which aggregate the loans and have stronger capabilities to recover them as well) bank NPAs rose. In most cases discussed in this paper, net NPA and net PSL NPA of banks is very high in FY 2009.

Period of capitalization

In 2011, after RBI updated its priority sector lending norms, established once and for all that indirect lending via MFIs is categorized as priority sector lending, many banks and MFIs took a sign of relief. Almost every top banker in the country made statements about how this policy decision is a game changer for banks. Smaller private banks, like Yes Bank, with limited infrastructure in rural areas immediately capitalized on this and started lending via MFIs reducing their PSL NPAs to nearly zero. Overall, all banks (apart from major public banks) showed a decrease in priority sector lending NPAs which justified the recommendations of Malegam committee.

Further, as per guidelines, MFIs were asked to control their rate of lending which ensured that finance reached the weaker sections of the society at a low rate, limiting exploitation.The aim of RBI guidelines on priority sector was to ensure that finance reaches the agricultural and generally weaker sections of the society, mainly in rural India. By categorizing advances to MFIs as PSL, this aim is easier to reach. Further, by controlling the final lending rates, finance in available at a lower interests.

The banks capitalized on this guideline and began meeting the PSL norms. At the same time, many banks showed a decrease in bad loans, reflected in overall NPAs. Using strong infrastructure and reach capabilities of MFIs, the finance from banks continues to reach the weaker sections (priority sector) of the country much efficiently than before.

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