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Structural, Operational and Credit Risk Bottlenecks in Institutional Financing of MSEs in Bihar: An Integrated Policy Review

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ABSTRACT

Despite targeted interventions like the Priority Sector Lending (PSL) guidelines and the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), the credit gap remains a steep hurdle. Financial institutions operate under severe constraints including cash-driven transactional behaviors, structural credit conversion friction, and high processing costs. Furthermore, banking operations are heavily restricted by high Non-Performing Assets (NPAs), mounting legal recovery bottlenecks (Certificate Cases), and deep-seated "Moral Hazard" behaviors where collateral-free guarantee lines are misinterpreted by borrowers as non-repayable welfare grants. This paper examines these integrated challenges from both system-wide operational frameworks and ground-level bank official perspectives to advocate for a transition toward data-validated, cash-flow-based digital underwriting paired with optimized recovery mechanisms.

1. Introduction

The Micro, Small, and Medium Enterprise (MSME) sector serves as an indispensable economic engine in India, driving nearly 30% of the national GDP and 45% of manufacturing output. Within Bihar, where the primary sector still employs 54% of the labor force, according to the *Bihar Economic Survey 2025-26*, modernizing the MSE ecosystem is essential for structural economic transformation. However, expanding sustainable credit flows is not merely an issue of liquidity. Lending structures in Bihar face dual pressures: 1. Supply-side hurdles**:** High operational costs, documentation vacuums, and acute information asymmetry and 2. Systemic risk barriers**:** Elevating default pools (NPAs), aggressive government targets that distort asset quality, severe staff accountability policies that discourage bank credit officers, and structural issues in legal claim settlements under credit guarantee setups.

The specific goals of this integrated study are to examine structural, financial, and credit risk bottlenecks slowing down MSE capital deployment in Bihar, evaluate empirical indicators, local credit flow trajectories, and the rising patterns of financial defaults or legal recoveries and formulate balanced, data-driven frameworks to improve systemic credit delivery, guarantee sustainability, and recovery management.

3. Research Methodology

This study combines institutional and descriptive data. The secondary data frameworks integrate structural inputs from the National Institute of Public Finance and Policy (NIPFP), performance tracking from the Ministry of MSME, operational insights from the Small Industries Development Bank of India (SIDBI), and financial indicators from the State Level Bankers' Committee (SLBC) Bihar. To capture ground-level realities, these macroeconomic data points are validated by a dedicated primary field survey of bank officials (predominantly experienced branch managers from Public Sector Banks, tracking structural inputs on appraisal standards, moral hazard loops, and operational policy friction.

4. Literature Review & Systemic Baseline

Recent literature underscores that credit constraints are fundamentally structural rather than volume-driven.

- **Informality Hurdles:** Unit-level data evaluations from the Annual Survey of Unincorporated Enterprises (ASUSE) highlight that Bihar shows a deeply entrenched informal credit dependence gap compared to leading industrialized regions.
- **Information Asymmetry:** Research emphasizes that basic operational gaps—poor bookkeeping habits and an absence of standard historical records—exclude micro-enterprises from clearing modern algorithmic credit underwriting setups.

- **The Liquidity Squeeze:** Post-GST working capital adjustments have created structural pressures. Small units encounter lengthy Cash Conversion Cycles (CCC), where cash gets trapped in receivables, leading to technical regularisation delays that traditional risk frameworks misinterpret as active default warning flags.
- **The Sustainability Matrix:** World Bank frameworks outline that a healthy Credit Guarantee Scheme (CGS) must balance operational outreach with fiscal sustainability. This requires monitoring structural leverage levels (the ratio of active guarantees to fund capital) and containing structural default exposures to ensure long-term coverage viability.

5. Credit Flow Trajectories vs. The Burden of Non-Performance

While policy interventions have achieved a steady path of nominal capital deployment inside the state, a deep disconnect remains between credit expansion and active risk control. The following table contrasts absolute MSME credit progress with systemic asset quality degradation.

Table 1: Credit Flows vs. Non-Performing Assets (NPAs) in Bihar

Financial Year	Total Credit Disbursed (in ₹ Crore)	YoY Credit Growth (%)	Banking Sector MSME NPA (%)	Active Certificate Cases (No.)	Outstanding Cert. Amount (in ₹ Crore)
FY 2019-20	20,277.00	—	14.12%	674,266	5,131.05
FY 2020-21	13,729.71	-32.29%	12.84%	763,548	5,995.51
FY 2021-22	24,481.52	+78.31%	12.99%	807,274	6,646.37
FY 2022-23	33,966.04	+38.74%	9.87%	875,378	7,505.22
FY 2023-24	47,101.21	+38.67%	7.76%	909,269	8,017.23

Source: Consolidated from Ministry of MSME Data, Reserve Bank of India State Reports, and SLBC Bihar Publications (FY 2019 - FY 2024).

Key Structural Contrast: Although targeted MSME credit deployment scaled up significantly to ₹47,101.21 crore by the close of FY 2024-25, the volume of active legal recovery claims (Certificate Cases) scaled upward to 909,269 cases, locking down over ₹8,017.23 crore in litigation. This creates serious balance sheet pressures that constrain risk appetite for new credit extensions.

6. The Core Institutional Bottlenecks

6.1. High Reliance on Informal Finance

According to data from the National Institute of Public Finance and Policy (NIPFP), Bihar channels only 61.30% of its active unincorporated enterprise debt through formal bank pipelines, trailing significantly behind states like Jharkhand (92.66%) and Odisha (85.05%). The remaining 38.70% relies on high-interest informal lenders, preventing borrowers from establishing the structured credit footprints needed for bank credit scoring.

6.2. Ground-Level Bank Perspectives & "Moral Hazard" Risks

Data gathered directly from credit officers points to an institutional design challenge: the Moral Hazard dilemma under collateral-free programs (CGTMSE and PMMY).

- **Borrower Misconception:** Credit surveys reveal that significant shares of MSE borrowers actively choose collateral-free routes even when they hold personal assets. This stems from a flawed mindset that views government-backed guarantee programs as non-repayable public welfare grants.
- **Weak Settlement Realization:** This challenge is exacerbated by administrative hurdles, with bank officials noting that only 50% to 70% of default claims submitted under guarantee setups clear final institutional settlement stages smoothly.

6.3. Distorted Credit Quality via Campaign-Driven Lending

A substantial majority of surveyed bank officials (73.5%) highlight that high-pressure government lending drives (e.g., rapid "Loan Melas") lower credit underwriting quality. Forcing rapid credit allocation within compressed timelines prevents proper verification of borrower integrity, increasing default rates down the line.

6.4. Severe Staff Accountability and HR Friction

Unlike private banks or Small Finance Banks (SFBs)—which report low or near-zero certificate cases—Public Sector Banks and Regional Rural Banks (RRBs) carry the main burden of state-backed priority financing. Credit officers face strict institutional accountability guidelines. When a loan goes bad due to systemic issues or borrower fraud, bank officials face lengthy internal investigations, disciplinary actions, or formal charge sheets. This risk-heavy environment creates an understandable hesitation to approve new, unsecured small-ticket portfolios.

6.5. Prohibitive Operational Costs and Underwriting Delays

Processing small-ticket loans across rural areas involves multi-layered administrative workflows which generates high transaction costs relative to asset yield, making widespread lending difficult without policy-driven operational shifts.

7. Policy Implications and Strategic Interventions

To bridge the credit gap while safeguarding banking stability in Bihar, the financial ecosystem must transition from rigid, manual processes to a technology-enabled framework:

- **Transition to Cash-Flow-Based Underwriting:** Credit institutions must move past traditional collateral-dependent models. By integrating automated API checks via the Account Aggregator (AA) platform and the *Udyam Assist Portal*, banks can verify real-time operational inflows and business activity, bypassing the need for extensive formal tax histories.

- **Strengthen Legal Recovery Support:** The Government of Bihar should provide structural support to help banks recover non-performing assets. Resolving the rising backlog of Certificate Cases requires setting up fast-track credit tribunals and dedicated state recovery mechanisms to protect the health of public lending channels.

- **Balance Policy Priorities with Strategic Sourcing:** While financial campaigns expand outreach, credit allocation must prioritize a borrower's business viability and integrity over rigid volume metrics.

8. Conclusion

The credit bottleneck in Bihar’s MSE sector is shaped by two distinct challenges: a high level of economic informality on the borrower side, and systemic credit risk pressures on the institutional side. Addressing this requires a clear shift in perspective. Credit guarantee models like the CGTMSE can achieve long-term sustainability only if moral hazard risks are contained through better borrower selection and stronger digital checks. By replacing outdated asset-backed verification with cash-flow-driven fintech scoring, simplifying land asset registries, and setting up efficient recovery mechanisms, the financial sector can safely support sustainable industrial growth across Bihar.

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