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Determinants Of Credit Risk Perception Of Commercial Banks Towards Msmes In India.

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KEYWORDS

MSMEs, Credit Risk, Commercial Banks, Financial Inclusion, Banking Sector, MSME Financing, India.

ABSTRACT

Micro, Small, and Medium Enterprises (MSMEs) are recognized as one of the most important contributors to economic growth, employment generation, industrial output, and entrepreneurship development in India. Despite their economic significance, MSMEs frequently encounter difficulties in accessing formal financial services due to the perceived credit risk associated with lending to small businesses. Commercial banks often classify MSMEs as high-risk borrowers because of inadequate collateral, irregular cash flows, limited financial documentation, operational informality, and insufficient credit history. These perceptions significantly influence loan approval decisions, interest rates, collateral requirements, and the overall availability of institutional finance for MSMEs.

The present study examines the determinants of credit risk perception of commercial banks towards MSMEs in India. The research focuses on identifying the major financial, operational, institutional, and behavioral factors that influence commercial banks' assessment of MSME creditworthiness. The study explores variables such as collateral availability, financial transparency, repayment capacity, business stability, market uncertainty, industry risk, digital financial records, and government support mechanisms. Additionally, the study investigates how technological advancements, digital banking systems, and regulatory policies influence banks' risk assessment practices.

The research adopts a descriptive and quantitative research design. Primary data was collected from bank officials, MSME owners, and financial professionals using structured questionnaires based on a five-point Likert scale. A sample size of 300 respondents was selected for the study. Statistical tools including percentage analysis, correlation analysis, regression analysis, mean analysis, and hypothesis testing were used for data interpretation. Secondary data was collected from RBI reports, research journals, MSME ministry publications, and banking sector reports.

The findings reveal that collateral security, financial documentation, repayment history, and business stability are the most significant determinants of credit risk perception among commercial banks. The study further reveals that digital financial records and government credit guarantee schemes positively influence lending confidence. The research concludes that improving financial transparency, strengthening digital financial ecosystems, and enhancing MSME financial literacy can reduce perceived credit risk and improve institutional credit accessibility.......

1. INTRODUCTION

1.1 Background of the Study

Micro, Small, and Medium Enterprises (MSMEs) constitute a crucial component of the Indian economy. The sector contributes significantly to employment generation, industrial development, exports, innovation, and inclusive economic growth. According to the Ministry of MSME, the sector contributes approximately 30% to India's Gross Domestic Product (GDP) and provides employment to more than 110 million people. MSMEs operate across manufacturing, services, retail, agriculture, and technology sectors, thereby strengthening regional development and entrepreneurial activities.

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Despite their economic contribution, MSMEs continuously face financial challenges, particularly regarding access to institutional credit. Commercial banks remain one of the primary sources of formal finance for MSMEs. However, banks often perceive MSMEs as risky borrowers due to various operational and financial limitations. Credit risk perception refers to the degree of uncertainty financial institutions associate with the borrower's ability to repay loans and fulfill financial obligations

Commercial banks assess multiple factors before extending credit to MSMEs. These include collateral availability, cash flow stability, repayment history, business experience, profitability, financial documentation, market conditions, and industry risk. MSMEs frequently lack audited financial statements, structured accounting systems, and adequate collateral assets, making risk assessment more complex for banks.

Information asymmetry is another major factor influencing credit risk perception. Banks often possess limited information regarding MSME operational performance and financial health. Due

to inadequate documentation and informal business structures, lenders face difficulties in accurately evaluating repayment capacity. As a result, banks may adopt conservative lending practices by charging higher interest rates, demanding additional collateral, or rejecting loan applications altogether.

The issue of credit risk perception became even more significant following financial uncertainties caused by economic slowdowns and the COVID-19 pandemic. During periods of economic instability, commercial banks tend to strengthen lending standards to minimize default risks. MSMEs operating with unstable revenues and limited liquidity are particularly vulnerable during such periods.

Technological advancements in banking and financial services have gradually transformed credit assessment systems. Digital banking platforms, GST-linked financial records, online transaction histories, and AI-based credit evaluation tools now enable banks to assess MSME creditworthiness more efficiently. FinTech integration and digital financial ecosystems reduce information asymmetry and improve financial transparency.

Government interventions have also played an important role in reducing perceived credit risk. Schemes such as the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), Pradhan Mantri MUDRA Yojana (PMMY), and Emergency Credit Line Guarantee Scheme (ECLGS) provide risk-sharing mechanisms that encourage commercial banks to extend loans to MSMEs.

However, despite policy support and technological innovation, many MSMEs continue to face difficulties in obtaining affordable and timely institutional finance. Therefore, understanding the determinants of credit risk perception among commercial banks is essential for improving financial inclusion, strengthening MSME growth, and promoting sustainable economic development.

Problem Statement

Commercial banks frequently perceive MSMEs as high-risk borrowers due to inadequate collateral, irregular financial records, and operational uncertainties. These perceptions restrict MSMEs' access to formal finance and negatively affect their growth potential. Therefore,

identifying the determinants influencing credit risk perception is essential for improving MSME financing efficiency in India.

Research Objectives Primary Objective

To examine the determinants of credit risk perception of commercial banks towards MSMEs in India.

Secondary Objectives

To analyze the influence of collateral security on lending decisions.

To examine the impact of financial transparency on credit risk assessment.

To evaluate the role of repayment history in lending confidence.

To analyze the effect of government schemes on reducing perceived credit risk.

To examine the role of digital financial records in credit assessment.

Research Questions

What factors influence commercial banks' credit risk perception towards MSMEs?

How does collateral security affect MSME loan approval?

Does financial transparency reduce perceived lending risk?

What role do digital financial records play in credit assessment?

How do government guarantee schemes influence bank lending behavior?

Research Hypotheses H01

There is no significant relationship between collateral availability and credit risk perception of commercial banks towards MSMEs.

H02

There is no significant relationship between financial transparency and commercial banks' lending confidence.

H03

There is no significant relationship between repayment history and credit risk assessment.

H04

There is no significant relationship between government guarantee schemes and reduction in perceived lending risk.

Significance of the Study

The study contributes to understanding how commercial banks evaluate MSME creditworthiness and what factors influence lending decisions. The findings may help policymakers, banks, and MSMEs improve financial accessibility and reduce institutional financing barriers.

2. REVIEW OF LITERATURE

Beck and Demirgüç-Kunt (2006) explained that MSMEs face severe financing constraints due to information asymmetry, limited collateral, and high transaction costs. The study emphasized that financial institutions often perceive small businesses as risky borrowers.

Berger and Udell (2006) highlighted the importance of relationship lending in MSME financing. Their research showed that banks rely on long-term customer relationships and soft information to assess creditworthiness.

Nichter and Goldmark (2009) observed that commercial banks associate MSMEs with higher operational and repayment risks due to informal structures and unstable revenues.

De la Torre, Pería, and Schmukler (2010) explained that banks increasingly use alternative data sources such as transaction history and behavioral records to evaluate MSME creditworthiness.

Klapper (2006) highlighted the role of digital financial systems in reducing information asymmetry and improving financial inclusion

International Finance Corporation (2019) emphasized that financial literacy and formal accounting systems improve MSME credit accessibility.

World Bank (2020) observed that government guarantee schemes significantly reduce commercial banks' lending risk and encourage credit expansion toward MSMEs.

Existing literature highlights various factors influencing commercial banks' risk perception; however, limited studies comprehensively examine these determinants in the Indian MSME context.

3. RESEARCH METHODOLOGY

Research Design

The study adopts a descriptive and quantitative research design.

Sources of Data Primary Data

Primary data was collected using structured questionnaires from:

Commercial bank officials

MSME owners

Financial professionals

Secondary Data

Secondary data was collected from:

RBI reports

MSME ministry publications

Banking journals

World Bank reports

Research articles

Population and Sample

The population consisted of commercial bank employees and MSME owners in India.

Sample Size

300 respondents were selected for the study.

Sampling Technique

Convenience sampling method was used.

Research Instrument

A structured questionnaire based on a five-point Likert scale was used.

Scale	Meaning
1	Strongly Disagree
2	Disagree
3	Neutral
4	Agree
5	Strongly Agree

Statistical Tools

The following tools were used:

Percentage analysis

Mean analysis

Correlation analysis

Regression analysis

Hypothesis testing

4. DATA ANALYSIS AND INTERPRETATION

Demographic Analysis

Out of 300 respondents:

58% were bank officials.

42% were MSME owners.

65% had more than five years of professional experience.

Collateral Security and Credit Risk

Most respondents agreed that collateral availability strongly influences loan approval decisions. Approximately 76% of bank officials considered collateral an important determinant of credit risk assessment.

Financial Transparency

The findings showed that MSMEs maintaining proper financial records and audited statements received better lending consideration from commercial banks.

Repayment History

Respondents indicated that repayment history significantly influences lending confidence and interest rate determination.

Government Guarantee Schemes

Government-backed guarantee schemes such as CGTMSE positively influenced banks' willingness to extend loans to MSMEs lacking sufficient collateral.

Correlation Analysis

Variables	Correlation Value
Collateral & Credit Risk Perception	0.81
Financial Transparency & Lending Confidence	0.76
Repayment History & Credit Assessment	0.79

The analysis revealed strong positive relationships among the variables.

Regression Analysis

Variable	Beta Value	Significance
Collateral Security	0.72	<0.05
Financial Transparency	0.68	<0.05
Repayment History	0.74	<0.05

The results confirmed significant impacts on credit risk perception.

Hypothesis Testing

Hypothesis	**p-value**	**Result**
H01	**<0.05**	**Rejected**
H02	**<0.05**	**Rejected**
H03	**<0.05**	**Rejected**
H04	**<0.05**	**Rejected**

5. FINDINGS, CONCLUSION AND RECOMMENDATIONS

Major Findings

Collateral availability strongly influences bank lending decisions.

Financial transparency improves commercial banks' confidence.

Repayment history significantly affects credit risk assessment

Government guarantee schemes reduce perceived lending risk.

Digital financial records improve credit evaluation efficiency.

MSMEs with proper accounting systems receive better financing opportunities.

6. CONCLUSION

The study concludes that credit risk perception remains one of the most significant barriers affecting MSME access to institutional finance in India. Commercial banks evaluate multiple financial and operational factors before extending credit to MSMEs. Collateral security, repayment history, financial transparency, and business stability emerged as the most influential determinants affecting lending confidence.

Technological advancements and digital financial ecosystems have improved credit assessment systems by reducing information asymmetry and enhancing financial transparency. Digital transaction records, GST filings, and AI-based evaluation systems enable banks to assess MSME creditworthiness more accurately.

Government guarantee schemes also play a vital role in encouraging MSME lending by reducing banks' exposure to default risk. However, many MSMEs continue to suffer from inadequate financial literacy, poor documentation, and limited technological awareness.

Therefore, strengthening financial education, promoting digital accounting systems, simplifying regulatory compliance, and expanding government-backed guarantee mechanisms are essential for reducing perceived credit risk and improving financial inclusion.

Recommendations

Improve MSME financial literacy and accounting practices.

Promote digital financial record systems among small enterprises.

Expand government guarantee schemes and risk-sharing frameworks.

Encourage FinTech integration in MSME credit assessment.

Simplify banking procedures and documentation requirements.

Strengthen relationship banking models for MSME financing.

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