International Journal for Multidisciplinary Research (IJFMR)
E-ISSN: 2582-2160 ● Website: www.ijfmr.com ● Email: editor@ijfmr.com

Governance, Moral Hazard, and Accountability in MSME Credit Guarantee Schemes: A Critical Study of CGTMSE and Rising NPAs in India

Melson D'Silva[1], Dr Nagaraja V[2]

[1]Student, School of Legal Studies, Reva University
[2]Professor, School of Legal Studies, Reva University

Abstract
Micro, Small and Medium Enterprises (MSME) are a key pillar of the Indian economy and see an increase in their revenues contribute toward employment creation, industrial development, export, entrepreneurship and inclusive development. Despite the many advantages of taking out a formal loan, many MSMEs struggle to access credit from financial institutions because of the absence of collateral security, lack of financial records and high risk of lending. To overcome these problems the Government of India has established a Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) which is a promotional institution for lending with partial guarantee cover to borrower default. The objective of the scheme is to boost financial inclusion, and make credit access more readily available for MSMEs.
But there have been some concerns about the manner of operation of the credit guarantee that have spurred governance-related issues such as governance gaps, weak institutional oversight, irregularities in procedures, and poor accountability systems. In some cases, the guarantee protection has led to a lessening of credit assessment and repayment discipline, causing a moral hazard in guaranteed lending systems. The weaknesses are now seen in the growing rate of Non-Performing Assets (NPAs) in guaranteed MSME loans. This study critically analyses the governance and accountability structure of CGTMSE and ascertains the possibility of achieving rule of law and discipline in access to credit with financial inclusion and long term financial stability under the CGTMSE.

Keywords: MSME Sector, CGTMSE, Credit Guarantee Schemes, Non-Performing Assets (NPAs), Governance, Moral Hazard, Accountability, Credit Risk, Financial Inclusion

1. Introduction

Job creation, industrial growth, export contribution, entrepreneurship and inclusive development are defined as roles for contribution to which the Micro, Small and Medium Enterprises (MSME) sector make a significant contribution in the Indian economy.[3] MSMEs also contribute to the balanced development of the region and develop and foster innovation, local manufacture and activities along the value chains. Despite these significance, many of the MSMEs face problems in getting appropriate institutional credit

[3] Ministry of Micro, Small and Medium Enterprises, *Annual Report 2023* (Government of India 2023).

because of the lack of collateral security, financial record of very limited extent and high perceived lending risk of financial institutions.[4] Therefore, many companies rely on informal and expensive sources of finance.

To overcome the above problems, the Government of India initiated credit guarantee plans, such as Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) which has been launched to promote collateral free lending, under which the Credit Guarantee Fund Trust guarantees a programme motivating bankers to give loans without the necessity of collateral.[5] The scheme is designed to increase the financial inclusion and credit accessibility for MSME's. But the issue of a surge in the Non-Performing Assets (NPAs) in guaranteed MSME-loans has emerged. There is evidence of financial stress in guaranteed lending portfolios due to poor credit appraisals, ineffective monitoring, and some procedural issues and governance failures that have been uncovered in regulatory reports and audit results.[6] This paper reviews the governance and accountability mechanism across the organization of CGTMSE and its linkage with the increased NPA problem in the MSME financing segment.

2. Conceptual Framework

2.1 Governance in Financial Schemes

Governance in financial schemes means the system of rules, policies, institutional controls and accountability systems which govern the operation of public financial institutions and schemes.[7] Good governance ensures responsible, transparent and lawful use and management of financial resources in line with legal and policy goals. In public credit schemes, governance is very important to keep the schemes operational, to prevent that these funds are misused and to ensure good supervision of the lending and recovery process.

Good governance structures support information, accountability and good decision making by financial institutions. They also contribute to some extent to minimizing features of corruption, procedural irregularities and financial risks.[8] "Good governance" is crucial to ensure good financial discipline, guard public resources and sustain the scheme long term and credibly in the context of Credit guarantee schemes.

2.2 Moral Hazard in Credit Systems

In financial credit systems, moral hazard means that borrowers and/or lenders have a tendency to take more risk when they are less liable for any actual financial losses.[9] In an assured crediting arrangement, institutional safety can lessen the need for deliberated monetary habits and credit rating self-discipline.

Credit guarantee schemes have a behavioural impact on both borrowers and lenders. Both borrowers and lending institutions may relax their obligations in repayment as a result of guarantee support, except that lending institutions may lower the intensity of the credit appraisal, monitoring and risk evaluation. This can result in sub-optimal accountability systems and risk incentive lending.[10] The absence of control can

---

[4] Reserve Bank of India, *Report on Trend and Progress of Banking in India 2023* (RBI 2023).

[5] Credit Guarantee Fund Trust for Micro and Small Enterprises, *Scheme Guidelines and Annual Reports 2023* (CGTMSE 2023).

[6] Reserve Bank of India, *Report on Trend and Progress of Banking in India 2023* (RBI 2023).

[7] World Bank, *Credit Guarantee Schemes for SME Lending: Lessons Learned* (World Bank 2018).

[8] Hyman P Minsky, *Stabilizing an Unstable Economy* (Yale University Press 1986).

[9] Joseph E Stiglitz and Andrew Weiss, 'Credit Rationing in Markets with Imperfect Information' (1981) 71 *American Economic Review* 393.

[10] Thorsten Beck, Leora F Klapper and Juan Carlos Mendoza, 'The Typology of Partial Credit Guarantee Funds around the World' (2010) *Journal of Financial Stability*.

lead to higher Non-Performing Assets (NPAs) and decline in financial stability of guaranteed credit systems as the case of moral hazard.

2.3 Accountability Mechanisms

Accountability mechanisms are those systems that provide financial institutions with means of oversight, reporting, monitoring and institutional responsibility to ensure they comply with the laws and regulations. In public financial schemes, transparency, efficiency in operation and responsible decision making are ensured with accountability. For credit guarantee schemes, accountability mechanisms are vital for good credit appraisal, tracking loan use, adherence to the scheme rules and recoveries. They help curb unauthorized use of guarantee protection, avoid unwanted procedural irregularities and enhance institutional discipline of lenders and borrowers.[11] They also ensure responsible use of public money and hold the financial institutions to account for negligence and failure to comply. There are thus, in need, strong accountability systems that must be in place to ensure financial stability, control Non-Performing Assets (NPAs) and continue to maintain the credibility of the guarantee schemes.

3. Overview of CGTMSE Scheme

The Government of India and the Small Industries Development Bank of India jointy created Credit Guarantee Fund Trust, for Micro and Small Enterprises to ensure credit accessibility to micro and small enterprises.[12] The purpose of the scheme is to incentivize the banks and financial institutions to extend credit facilities to MSMEs by offering guarantee cover to banks/financial institutions to repay the loan on the event of default by the borrower.

CGTMSE functions on the basis of risk sharing mechanism, which provides partial guarantee protection to the eligible lending institutions on approved loans.[13] The micro and small enterprises, which have insufficient security in the form of collateral, are covered under the scheme. The role of banks and financial institutions is pivotal in the appraisal, disbursement, monitoring and recovery of loans. The government policies that promote financial inclusion, entrepreneurship and development of the MSMEs support the scheme.

4. Governance Challenges in CGTMSE

There are different governance-related issues that impact the quality and sustainability of guaranteed lending that arise as limits in the functioning of the CGTMSE framework. Several limits are raised in the functioning of the CGTMSE framework because of governance issues, which negatively impact the quality and sustainability of guaranteed lending.[14] Despite the weak monitoring and supervision in lending institutions, loan utilisation and financial stress is not often monitored and are identified late. Credit appraisal processes can also be inefficient, resulting in risk assessment being done incorrectly and loans being sanctioned to the less financially sound borrower.

Another ineffective aspect of the institutional coordination is between banks, guarantor institutions and authorities. Likewise, regulatory and administrative issues such as the time delays, non-uniformity in practices and weak enforcement procedures make the scheme less effective as a whole.[15] It can bring about

[11] Government of India, *Micro, Small and Medium Enterprises Development Act 2006*.
[12] Credit Guarantee Fund Trust for Micro and Small Enterprises, *Scheme Guidelines and Annual Reports 2023* (CGTMSE 2023).
[13] Government of India, *Micro, Small and Medium Enterprises Development Act 2006*.
[14] World Bank, *Credit Guarantee Schemes for SME Lending: Lessons Learned* (World Bank 2018).
[15] Reserve Bank of India, *Report on Trend and Progress of Banking in India 2023* (RBI 2023).

several governance issues such as overuse of guarantee protection, increasing Non Performing Assets (NPAs) and lack of financial discipline in the MSME credit system.

5. Moral Hazard and Behavioural Concerns

Guarantee protection within the CGTMSE structure can lead to moral hazard and behavioural distortion on lenders and borrowers side.[16] This can lead to lending institutions making excessive risk-taking decisions, or to abating of their credit appraisal and monitoring. This could provide a prime opportunity for weakening due diligence and hasty lending. From the borrower's perspective, guarantee can lower their incentive to repay and engender opportunistic behaviour, especially when monitoring and recovery regimes are lax. Some borrowers can abuse the credit resources or pay intentionally with the assumption of institutional protection. Such behavioural issues erode the discipline in credit, elevate the Non-Performing Assets (NPA) risk and impact the sustainability and effectiveness of the credit guarantee framework in the long run.

6. Rising NPAs in MSME Credit

Recently, financial stress in small enterprise lending has risen with Non-Performing Assets (NPAs) of a significant magnitude in the sector are seen over the years.[17] In some situations, owing to poor credit appraisal, lax credit monitoring and involving banks in orchestrating credit discipline, it is CGTMSE's promise of re-payment that has been responsible for this trend.

The distribution of NPAs differs in varieties and levels across sectors and regions, influenced by the economic condition, industrial performance, and financial infrastructure in the region. Areas of the economy that are sensitive to economic shocks and changing market conditions tend to see higher default rates.[18] Economic slowdown, inflation, policy changes, business operation disruptions etc. have their impact on repayment capacity of MSMEs as a matter of external factors. Are guaranteed lending frameworks monitoring their risks and/or establishing adequate governance to deal with high NPAs?

7. Linkages Between Governance Failures, Moral Hazard, and NPAs

Poor governance and the moral hazard are interconnected in the guaranteed lending mechanism and play an important role in increasing Non Performing Assets (NPAs).[19] Risky lending may occur as a result of poor supervision, which can generate poor credit appraisals and inadequate accountability frameworks. Meanwhile, ensure protection can compromise repayment dynamics of borrowers and the due diligence processes of lenders, introducing a moral hazard into the credit system.

Further, the credit risk is accentuated by the credit weaknesses in the credit life cycle—from loan sanction to monitoring to recovery to claim settlement—from government- and NGO-backed banks. A lack of coordination amongst financial institutions and guarantor agencies may also limit the efficiency of operations and supervision.[20] Together, these systemic problems exacerbate asset quality deterioration and

[16] Joseph E Stiglitz and Andrew Weiss, 'Credit Rationing in Markets with Imperfect Information' (1981) 71 *American Economic Review* 393.
[17] Reserve Bank of India, *Report on Trend and Progress of Banking in India 2023* (RBI 2023).
[18] Ministry of Micro, Small and Medium Enterprises, *Annual Report 2023* (Government of India 2023).
[19] Thorsten Beck, Leora F Klapper and Juan Carlos Mendoza, 'The Typology of Partial Credit Guarantee Funds around the World' (2010) *Journal of Financial Stability*.
[20] Hyman P Minsky, *Stabilizing an Unstable Economy* (Yale University Press 1986).

not only hinder the effectiveness and sustainability of credit guarantee schemes like CGTMSE, but they also squander opportunities for institutional investors to provide financial resources and expertise.

8. Institutional and Policy Implications

A drop in banking sector confidence and stability can impact when there are governance failures and the presence of rising Non-Performing Assets (NPAs) in guaranteed MSME lending.[21] The financial condition of the lending institutions and the risk of the credit system could suffer due to the weak economic recovery and rising rating problems.

Credit guarantee schemes also impose a fiscal burden on the government, because it is the government's responsibility to pay out the claims on the guarantees.[22] However, the sustainability of such schemes as CGTMSE can be threatened due to presence of a set of the elements where efficiency persists and the NPAs keep on increasing. Concurrently, poor implementation may have a negative impact on the goal of MSMEs growth and financial inclusion. Increasing the governance, accountability and risk management frameworks is critical for sustainable credit provisioning, stability of institutions and support for MSMEs.

9. Findings

The study reasons that there are some weaknesses in CGTMSE (existing framework) which include structural, operational and governance aspects, which are resulting in increase in the Non-Performing Assets (NPAs) in MSME lending. The following are some of the key observations: Poor credit appraisal systems, poor use of loan funds monitoring systems, procedural deviation from Standard Operating Procedure (SOP) and restricted institutional accountability for the lending institutions.

The paper also shows that in some cases, guarantee protection has led lenders and borrowers to become not as disciplined as they would otherwise be because of credit risk, which led to moral hazard problems. Financial institutions might be placing too much reliance on guarantee cover and borrowers may be showing less focus on the repayment activity. Furthermore, there are many risks and operational inefficiencies arising from the lack of coordination between regulatory bodies, banks and guarantor institutions. The overall increase of NPAs in the context of CGTMSE is attributed not just to economic issues, but governance failures, behavioural biases and institutional features of CGTMSE.

10. Recommendations

Building CGTMSE is much more effective and sustainable with enhanced governance and monitoring processes. Lastly, lending institutions need to introduce the strictest possible credit assessment criteria, regular monitoring and exercising of due diligence to minimize credit risk and reinforce asset quality.

Greater accountability should be applied by having clear reporting, institutional control and effective enforcement. A risk-based pricing mechanism and better assessment of loans' risk could limit excessive risk taking and moral hazard in guaranteed lending systems. Furthermore, there is a need for improved coordination amongst the banking sector, guarantor institutions and regulation institutions to enhance the operational efficiency and supervision.

The policy changes ought to prioritize the financial inclusion aspects along with financial discipline, which involves responsible lending and enhanced transparency and sustainable credit growth in the MSME

[21] Reserve Bank of India, Report on Trend and Progress of Banking in India 2023 (RBI 2023).
[22] World Bank, Credit Guarantee Schemes for SME Lending: Lessons Learned (World Bank 2018).

segment.

11. Conclusion

The study puts forth various governance, operational and behavioral issues in the CGTMSE framework that are responsible for the increasing Non-Performing Assets (NPAs) for MSME lending. Lending channels have not grasped their power of credit appraisal, number of monitoring, and have limited the accountability of institutions and increased financial risk in the MSME credit system, leading to the sub-optimal performance of the mechanisms of facility. Failing to comprehend the credit power, inadequate monitoring, small accountability of the institutions and high financial risk in the credit system of MSMEs have led to sub-optimal performance of the mechanisms for the facility.

CGTMSE has shown itself to be an effective local institution to foster financial inclusion and make credit more accessible to micro and small businesses, however those aspects are in need of strengthening over the long term through better governance, supervision and responsible lending. The study shows that financial inclusion should not come at the expense of discipline in the financial system and the stability of financial institutions.

To build a resilient credit ecosystem and ensure sustainable credit growth in the future, India needs a policy ecosystem that gives attention to transparency, accountability and risk management with greater focus on improved regulatory policy coordination.

References

1. Reserve Bank of India (RBI). (2023). *Report on Trend and Progress of Banking in India*.
2. Ministry of Micro, Small and Medium Enterprises. (2023). *Annual Report*. Government of India.
3. Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE). (2023). *Scheme Guidelines and Annual Reports*.
4. World Bank. (2018). *Credit Guarantee Schemes for SME Lending: Lessons Learned*.
5. Beck, T., Klapper, L. F., & Mendoza, J. C. (2010). *The typology of partial credit guarantee funds around the world*. Journal of Financial Stability.
6. Stiglitz, J. E., & Weiss, A. (1981). *Credit rationing in markets with imperfect information*. American Economic Review.
7. Minsky, H. P. (1986). *Stabilizing an Unstable Economy*. Yale University Press.
8. Government of India. (2006). *Micro, Small and Medium Enterprises Development Act*.