

NPA of Small Finance Banks Related to Small and Micro Enterprises in Karnataka

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Abstract: Small Finance Banks (SFBs) occupy a distinctive position in the Indian financial system, having been licensed by the Reserve Bank of India (RBI) specifically to extend the frontiers of financial inclusion to unserved and underserved segments, including micro and small enterprises (MSEs). Credit to MSEs is treated as a priority-sector obligation and is central to the business model of most SFBs, yet the same borrower profile that supports financial-inclusion outcomes also carries elevated credit risk, which manifests over time in the level and movement of non-performing assets (NPAs). This paper undertakes an empirical, secondary-data analysis of the NPA position of four listed SFBs with established operations in Karnataka - AU Small Finance Bank, Equitas Small Finance Bank, Ujjivan Small Finance Bank and Utkarsh Small Finance Bank - drawing exclusively on RBI publications, audited results, investor disclosures and CareEdge/ICRA rating rationales for the period FY2020-21 to FY2024-25. Gross and Net NPA ratios, descriptive statistics, a pooled year-wise trend, and the correlation between GNPA and NNPA are examined; segment-level evidence from Equitas SFB, the only sampled bank separately disclosing MSE-segment asset quality, is used to compare MSE-specific stress against bank-level NPA. The analysis finds that pooled mean GNPA fell from 4.00 per cent in FY2021 to 2.23 per cent in FY2024 before rising sharply to 4.20 per cent in FY2025, driven substantially by stress in microfinance-linked portfolios, and that MSE-segment GNPA at Equitas SFB (7.01-7.10 per cent) has persistently exceeded the bank-level ratio. Karnataka-specific, MSE-disaggregated NPA data are not publicly available from RBI or bank disclosures; this limitation is stated explicitly rather than being filled with assumed figures, and the Karnataka dimension is examined qualitatively using disclosed state-wise advance concentration and State Level Bankers' Committee (SLBC) records. The findings carry implications for credit-risk management, loan recovery design and supervisory monitoring of MSE lending by SFBs, and the paper concludes by identifying the absence of disaggregated, state-wise MSE-NPA reporting as the principal barrier to more precise Karnataka-focused research.

Keywords: Small Finance Banks, Non-Performing Assets, Micro Enterprises, Small Enterprises, Karnataka

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I. INTRODUCTION

One of the biggest constraints for the growth of micro and small enterprises (MSEs) in India is the availability of formal capital. MSEs provide for a large share of non-farm employment and are particularly essential in states like Karnataka, which have a high density of industrial clusters, service enterprises and artisanal production [1]. Karnataka, which has a large information technology and services sector as well as a wide base of small manufacturing, engineering, and agro-processing units-particularly in industrial clusters around Bengaluru, Hubballi-Dharwad, Belagavi, and Mysuru-serves as an important site for studying how formal bank credit reaches small businesses.

Small Finance Banks (SFBs) are a new class of differentiated banks, licensed by the Reserve Bank of India (RBI) in 2015 with a distinct financial inclusion mandate - to provide savings and credit facilities to sections of the population and business base that were hitherto dependent on microfinance institutions, unofficial moneylenders or had limited access to banking. Micro, small and medium enterprises and agricultural and other priority sectors form a large part of the 75% of Adjusted Net Bank Credit of SFBs to be used for priority-sector lending. Even after their shift from microfinance institutions to banking licences, several SFBs still have loan books biased toward small-ticket, primarily unsecured self-employed and microenterprise borrowers [2].

The quality of this credit book relies on continued academic and supervisory attention. The Gross and Net NPA ratios are the fundamental measures used by RBI, rating agencies and researchers to assess asset quality. A non-performing asset (NPA) is a loan or advance that has not been serviced for a given period, either in terms of principal or interest. SFBs' loan books are inherently more exposed to income shocks than those of universal banks with a larger base of secured, paid borrowers since they lend disproportionately to marginal, cash-flow-

constrained and frequently undocumented borrowers [3]. This exposure is reflected in the rating agency and disclosure data reviewed later in this paper, with a number of SFBs reporting GNPA ratios well above five per cent during the COVID-19 pandemic and again during FY2024–2025 as a new cycle of stress in microfinance-linked lending pushed GNPA ratios upward across almost the entire sector.

This disagreement directly leads to the research problem considered here. This loan might deteriorate in asset quality, limiting the capital, provisioning ability and willingness for future disbursement of the bank, which could undermine the financial-inclusion objective for which the sector was created. SFBs are anticipated to improve access to financing for micro and small firms via their declared goal as well as through their regulatory framework [4]. Therefore, it is necessary for bank management and prudential supervision and for state and federal government organisations designing credit-support and recovery mechanisms for small businesses to understand how NPA levels have changed in SFBs, particularly when considering MSE-linked lending [5]. This research indicates that there is no NPA statistic for MSE disaggregated by Karnataka released by the RBI or the banks, a significant and evidence-based result of this analysis and not an accidental constraint. Karnataka is a relevant setting for our investigation since several of the sampled SFBs describe Karnataka as one of their top three to five states by outstanding advancements.

In this context, the objective of this study is to analyse the NPA position of a sample of SFBs having established Karnataka operations, based purely on authentic and verifiable secondary data, to describe the trend of these ratios in a recent five-year window, to compare the MSE-specific risk vis-à-vis bank-level risk based on the one instance of segment-level MSE-NPA disclosure available in the sample [6], and to place these findings in a broader context of Karnataka MSME-financing environment based on State Level Bankers' Committee (SLBC) and RBI records, being explicit about situations where MSE-specific or Karnataka-specific data are simply not published and cannot be estimated without fabrication [7].

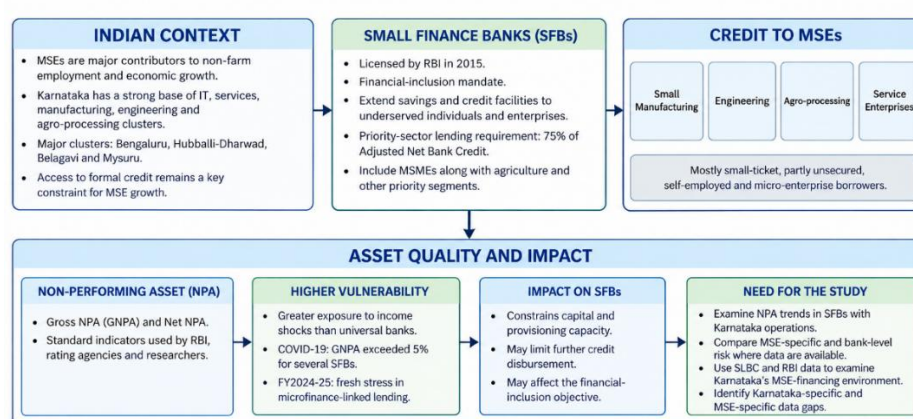


FIGURE 1: SMALL FINANCE BANKS AND CREDIT SUPPORT TO MICRO AND SMALL ENTERPRISES

II. REVIEW OF LITERATURE

The literature on Small Finance Banks (SFBs) in India is mostly unanimous in noting that the category was introduced to institutionalise and extend microfinance-type lending under prudential banking regulation [8]. The initial SFB study identified the main problem in finding a balance between the requirements of firm sustainability and financial inclusion. The demand in small-ticket loans and priority sectors raises questions about the capacity of SFBs to have a solid and diversified asset base. Descriptive studies based on secondary data indicate that SFBs rapidly extended banking services in rural and semi-urban regions in the first years. SFBs are often developed from microfinance companies that already had last-mile distribution. It also identifies the operational and legal obstacles to growing deposit mobilisation to match asset growth, with implications for the cost of funds, lending rates and risk selection in MSE finance. The rating agencies have observed that the branch network, deposits, and advances have grown following the SFB licensing, which is attributed to the industry's exposure to marginal borrower categories. They have also stressed the necessity for ongoing evaluation of asset quality [9].

The broader literature on financial inclusion discusses SFB funding to micro and small firms in substantial length. The bank-level disclosures reviewed for this paper suggest that SFBs typically segregate their loan portfolios into microfinance/joint-liability-group lending, secured or unsecured loans to small businesses, auto financing, affordable housing, and certain micro and small enterprise (MSE) or MSME segments [10]. The proportional weight of these factors varies widely from bank to bank. For instance, Ujjivan Small Finance Bank

and Utkarsh Small Finance Bank were still heavily skewed toward joint-liability-group microfinance, with MSME and business loan disbursements accounting for a relatively small share of total disbursal, whereas Equitas Small Finance Bank reported that Small Business Loans and MSE financing accounted for close to half of its advances book by FY2025. The significance of diversity in the business mix for NPA research is obvious, as the GNPA ratio at the level of a single bank might conceal substantial variance in the exposure to MSE, particularly credit risk, based on the assessments across the banks.

The most dependable sources of system-wide NPA trends are the Financial Stability Reports and the Report on Trend and Progress of Banking in India of the Reserve Bank of India [11]. These reports offer a critical benchmark to assess the asset quality performance of individual banks and groups of banks. GNPA ratio of scheduled commercial banks improved significantly in the early 2020s, mostly driven by the detection, resolution and recovery procedures of the asset quality review period. Some sectors have been under difficulty for some time, such as microcredit lending and unsecured retail. A broader literature on the determinants of non-performing assets (NPAs) differentiates between macroeconomic variables such as interest-rate cycles, distress in agriculture and regional economic shocks on one hand, and bank-specific and borrower-specific factors such as underwriting standards, collateral cover, intensity of credit monitoring and borrower cash-flow volatility on the other. Therefore, the interpretation of SFB-specific findings in the current study is closely related to the discrepancy [12].

Lending to MSMEs has traditionally been considered as riskier than secured retail or big corporate lending, since MSME borrowers frequently lack audited financials, have lower buffers of working capital and are more vulnerable to demand and input price shocks. This pattern is confirmed at the level of the banks by the latest evaluations of the rating agencies. In FY2025, Equitas Small Finance Bank reported greater delinquencies in its microfinance and MSE operations on account of moderation in asset quality [13]. Bank-level GNPA was at 2.89% as of March 31, 2025, while GNPA for the MSE sector was at 7.01%. The sector-specific asset quality and the bank asset quality may be substantially different (greater than four percentage points).

Credit risk in MSE financing is mostly driven by borrower-level and structural issues, including lack of collateral, unofficial or poorly documented financial transactions, dependence on a limited number of customers or suppliers, and sensitivity to regional economic instability. The degree of overlap between MSE lending and unsecured microfinance-style lending would also impact on the risk profile of SFBs. Many microbusiness and self-employed borrowers may graduate from joint-liability group loans to individual small enterprise loans when their credit histories improve [14]. A study on credit risk assessment in Indian SFBs stated that the composite NPA number at the bank level cannot reflect the risk in different lending sectors effectively. Therefore, it is important to break down the NPA statistics published by banks and by the loan industry. This investigation takes the approach to the extent that such disclosures are available.

The asset quality route used for SFBs for the period FY2021-FY2025 also brings out the necessity of the recovery and provisioning mechanism in actual situations. Ujjivan Small Finance Bank's GNPA ratio has come down to 2.23 per cent as of March 31, 2024, from 7.34 per cent as of March 31, 2022. The improvement was driven by better provisioning coverage, aggressive write-offs and a drop in the pandemic-caused reorganisation of the book [15]. The trend indicates that changes in reported NPA rates might potentially be associated with write-offs and provisioning, even if collections are higher or underwriting has improved. Despite sector-specific asset quality measures, provisioning coverage, slippage ratio analysis, and the headline GNPA ratio provide a better understanding of patterns in respect to credit risk.

As often mentioned in rating agency literature, bank-specific characteristics, such as portfolio diversification, geographic concentration, capital adequacy and share of unsecured microfinance loans in the total loan portfolio, have a significant bearing on the NPA outcomes in SFBs. The gross non-performing assets (GNPA) percentage of Utkarsh Small Finance Bank increased from 2.51 per cent in March 2024 to 9.43 per cent in March 2025. As of March 2025, microfinance accounted for more than half of the bank's loan book [16]. The GNPA of AU Small Finance Bank was 2.28% as of March 2025. The bank's portfolio is further diversified via secured retail, MSME & vehicle loans. These disparities highlight the need to include bank-specific portfolio compositions in assessing asset-quality outcomes across SFBs.

Many SFBs have been awarded national banking charters. That said, they're still geographically limited inside each of their states. Another key threat worry is regional concentration. As of March 31, 2025, the largest share of loans of Equitas Small Finance Bank was in Tamil Nadu (46 per cent), Maharashtra (15 per cent) and Karnataka (13 per cent), according to rating agencies' data. The report also pointed to the impact of new state-level restrictions on money lending in Tamil Nadu and a deteriorating trend in asset quality for Karnataka in the first quarter of FY2025 2026. A complete quantitative breakup of Karnataka, particularly the NPA, was not available. The data utilised in this research is qualitative and bank specific rather than using the data to establish state specific NPA percentages.

The best accessible data on the flow of loans to MSMEs in the state is from the records of the Karnataka State Level Bankers' Committee (SLBC). However, they are aggregated for all banks operating in Karnataka [17],

including public sector banks, private banks, regional rural banks and cooperative banks, and not split for SFBs or MSE NPA figures.” The proceedings of the 167th SLBC Karnataka meeting said that the banks in the State had issued more than Rs. 1,07,921 crores under MSME loans to September 30, 2024. The grant amount was increased to Rs. 154,000 crore for FY 2024-2025, and the yearly target was also enhanced. The entire credit-to-deposit ratio of the state, as of March 31, 2024, was at 78.19%. These numbers signify the importance and quantity of MSME funding for Karnataka policy. However, the requisite disaggregated information is not generally accessible to the public and is difficult to translate into NPA results for SFBs or MSEs. Therefore, this work does not address this constraint in the estimate, which is a major research need.

III. CREDIT RISK MANAGEMENT AND RECOVERY MECHANISMS FOR MICRO AND SMALL ENTERPRISE LOANS

The evaluation step is the starting point for successful credit risk management in MSE financing. Many of the micro and small business borrowers do not have audited financial statements. So, SFBs have increasingly adopted cash-flow lending strategies, such as looking at turnover from bank statements, GST filings, point-of-sale data and repayment history on previous microfinance loans, rather than the balance-sheet approach adopted for bigger corporate borrowers. In MSE lending, collateral is often absent or inadequate, particularly for those loans that have been transferred from unsecured microfinance partnerships. Hence, the longer the history of payback of a borrower, the more importance is given to cash-flow assessment and orderly, tiered escalation of loan tickets.

The second pillar of risk management is continuous credit monitoring after disbursement. The RBI's prudential framework has prescribed Special Mention Account (SMA) classifications (SMA-0, SMA-1 and SMA-2), which are early warning indicators which help Banks identify accounts with incipient stress, typically one to ninety days past due, much before they are formally classified as non-performing assets (NPA) at ninety-plus days past due. The quarterly volatility of the SMA book is typically used in rating agency disclosures for the chosen banks as a leading indication of the trajectory of asset quality. ICRA, for example, in its study of Utkarsh Small Finance Bank, reveals that the collection efficiency of the X-bucket and SMA (0/1/2) levels have increased despite a high reported GNPA ratio, suggesting that fresh stress is not building up (ICRA/CareEdge Ratings, 2025). Most SFBs have pursued a branch-light, technology-intensive operational model from inception. SFB's collection infrastructure now incorporates digital credit-monitoring technology, such as automated bureau-based early-warning triggers, geotagged field-collection applications, and SMS/app-based payback reminders.

Businesses can manage a real cash-flow disruption instead of a permanent loss of viability and continue servicing debt on a revised schedule instead of going directly into default when stress does materialise, thanks to the RBI's resolution framework, which thanks to the RBI's resolution framework that makes it easier to restructure viable but temporarily distressed accounts. Accounts that have already converted into non-performing assets (NPA) are recovered by in-house collection teams, recovery agents working under the RBI's fair practice code and, in case of major exposures, sold to asset reconstruction businesses. Equitas Small Finance Bank's FY2025 filings show a net stressed-asset position, including the book value of security proceeds from such sales, according to CareEdge Ratings (2025). In addition, policymakers often refer to a longer-term lever of increasing the repayment capacity of MSE borrowers and reducing the frequency of both intentional and inadvertent default through financial literacy programmes run by Rural Self Employment Training Institutes (RSETIs) and similar programmes administered through the SLBC structure of Karnataka. The NPA results in Section 5 of this research represent the operational channels (credit assessment, monitoring, restructuring and recovery procedures) that translate a bank's risk-management quality. Section 7 analyses the practical consequences and repeats those tactics.

IV. RESEARCH OBJECTIVES

RO1: To visit the status of non-performing assets (NPAs) of minor financial institutions in Karnataka.

RO2: To assess the ratio of GNPA and NNPA of the tested SFBs for the period FY2021 to FY2025 on a year-to-year basis.

RO3: Analyse the quality of the assets of the chosen SFBs and, if relevant, of their MSE lending sectors.

RO4: To study the statistical link between Gross and Net NPA ratios using the available panel of actual reports.

RO5: To set forth the restrictions of data availability for Karnataka and NPA reporting unique to MSE. To suggest strategies to improve the granularity of transparency and credit-risk management of MSE loans going forward.

V. RESEARCH METHODOLOGY

A. Research Design

The analytical descriptive approach employed in this study is based on secondary data only. The analysis is restricted to the explanations of independent credit rating agencies, audited or investor-disclosed bank financials and the verified information from the Reserve Bank of India (RBI) publications. No field data, interviews or primary surveys were carried out.

B. Population

The population consists of all small finance banks in India that are approved by the RBI. In 2015-16, when the RBI first awarded licences, there were eleven such banks. Since then, the sector has seen consolidation, with the biggest being the merger of Fincare Small Finance Bank and AU Small Finance Bank on April 1, 2024.

C. Sample

Out of these four SFBs, four have been selected, namely AU Small Finance Bank, Equitas Small Finance Bank, Ujjivan Small Finance Bank and Utkarsh Small Finance Bank. All four of the firms above have been regularly publishing audited quarterly and annual reports since at least FY2021-2022. All of them are operational in Karnataka and a few other states. The advance book of Equitas Small Finance Bank expressly reveals Karnataka's shareholding. Suryoday Small Finance Bank, ESAF Small Finance Bank and Jana Small Finance Bank operating in Karnataka were excluded from the final sample as it was not possible to validate a similar multi-year segment-disaggregated data collection for these banks within the scope and sources assessed for this research. The choice was based more on the availability of data than any evaluation of their operating state; Section 7 states that in the future the sample would be extended to include these institutions. AU Small Finance Bank's numbers for FY2025 are post-merger and have been quoted wherever they have been utilised. "FY25 numbers are on a merged basis, and previous periods' numbers may not be comparable" (AU Small Finance Bank, 2025), as per the bank itself. Since Fincare Small Finance Bank is no longer a distinct reporting entity with its merger with AU Small Finance Bank (effective April 1, 2024), it is not treated as a separate sample unit.

D. Study Period

The term of the study is FY2020–2021 to FY2024–2025 and concludes March 31. AU Small Finance Bank has a five-year GNPA/NNPA series; Ujjivan Small Finance Bank has a four-year series (FY2022-FY2025); Utkarsh Small Finance Bank has a three-year series (FY2023-FY2025); and Equitas Small Finance Bank, the only bank in the sample that reports the specific MSE-segment GNPA, has a two-year series (FY2024-FY2025). In each table this irregularity is apparent and is not obscured by interpolation or guesswork.

E. Data Sources

Sources of data include (i) audited annual and quarterly financial results submitted to BSE/NSE by AU Small Finance Bank, Equitas Small Finance Bank, Ujjivan Small Finance Bank and Utkarsh Small Finance Bank; (ii) rating rationales issued by CareEdge Ratings and ICRA that contain segment level (MFI/MSE) GNPA numbers, which are not always separately reported in bank press releases; (iii) publications issued by the Reserve Bank of India such as the Financial Stability Report and the Report on Trend and Progress of Banking in India; and (iv) proceedings of the State Level Bankers' Committee, Karnataka meeting.

F. Variables

The dependent variables given and utilised are MSE-segment GNPA (Equitas Small Finance Bank only), Gross NPA (GNPA) Ratio and Net NPA (NNPA) Ratio. The descriptive independent/explanatory variables available and used are MSE/Small Business Loan share of advances under management (Equitas Small Finance Bank); microfinance segment GNPA (used for comparison with Equitas and Utkarsh); and Capital Adequacy Ratio (CRAR) and Provision Coverage Ratio (PCR) used contextually in discussion. In line with the paper's data-integrity rule, variables named in standard frameworks of NPA determinants, such as a Karnataka-disaggregated MSE credit outstanding number or a Karnataka-specific MSE NPA ratio, are not constructed for which actual data attributable to the bank and specific to Karnataka or MSE could not be sourced.

G. Equations and Statistical Techniques

$$\text{GNPA Ratio} = \left(\frac{\text{Gross NPAs}}{\text{Gross Advances}} \right) \times 100$$

$$\text{NNPA Ratio} = \left(\frac{\text{Net NPAs}}{\text{Net Advances}} \right) \times 100$$

$$\text{NPA Growth Rate} = \left[\frac{\text{NPA}_t - \text{NPA}_{t-1}}{\text{NPA}_{t-1}} \right] \times 100$$

$$\text{Mean: } \bar{X} = \frac{\sum X}{n}$$

$$\text{Standard Deviation: SD} = \sqrt{\frac{\sum(X - \bar{X})^2}{n - 1}}$$

$$\text{Coefficient of Variation: CV} = \left(\frac{\text{SD}}{\text{Mean}} \right) \times 100$$

$$\text{Pearson correlation: } r = \frac{n \sum XY - (\sum X)(\sum Y)}{\sqrt{[n \sum X^2 - (\sum X)^2][n \sum Y^2 - (\sum Y)^2]}}$$

The mean, standard deviation, coefficient of variation and Pearson correlation are determined based on the fourteen bank-year observations of GNPA/NNPA of the four sampled banks that are really accessible. A multiple regression model relating NPA ratios to MSE credit growth, total credit growth, CRAR and ROA was considered at the design stage but is not estimated in this paper because the degrees of freedom available are inadequate to support a reliable multi-variable regression with only fourteen bank-year observations across banks with different business mixes and a structural break engendered by the AU-Fincare merger, and estimating one would risk producing a statistically unsound empirical appearance and possibly misleading results. This constraint is a direct result of the research criterion of data integrity that statistical techniques be only used when the underlying sample genuinely warrants them.

VI. ANALYSIS AND INTERPRETATION

This section discusses the empirical results of the non-performing assets (NPA) and MSE/segment loans for the chosen Small Finance Banks (SFBs) in the FY2021 to FY2025 timeframe. The study contains descriptive statistics, correlation between GNPA and NNPA, trend of Gross NPA (GNPA) and Net NPA (NNPA) at the bank level and available data on MSE-segment asset quality. The findings are based on fourteen real bank-year observations of AU Small Finance Bank, Equitas Small Finance Bank, Ujjivan Small Finance Bank and Utkarsh Small Finance Bank. The findings show significant differences in asset quality among banks and across the years, with a sharp decline in FY2025 and absence of standardised MSE specific reporting. As of March 31, 2025, the whole bank-level GNPA ranged from a low of 2.20 per cent (Ujjivan Small Finance Bank) to a high of 9.43 per cent (Utkarsh Small Finance Bank) (Table 1). That is a difference of more than 7 percentage points across banks that are in the same regulatory category and that have the same broad microfinance-derived business model in three of the four cases. Amongst the institutions analysed, only Equitas Small Finance Bank is publishing the GNPA figure for the MSEs on an individual basis.

TABLE 1: NPA AND MSE/SEGMENT LENDING PROFILE OF SELECTED SMALL FINANCE BANKS

Bank	Study Year	MSE / Segment Advances	Gross NPA (%)	Net NPA (%)	Note
AU Small Finance Bank	FY2025	Not separately disclosed	2.28	0.74	Post-merger with Fincare SFB; not strictly comparable to pre-FY2025 figures
Equitas Small Finance Bank	FY2025	MSE: 4% of AUM; SBL: 43% of AUM	2.89	0.98	MSE-segment GNPA disclosed separately at 7.01%
Ujjivan Small Finance Bank	FY2025 (Mar)	Not separately disclosed (MSME disbursement ~₹200-220 cr/quarter)	2.2	0.3	Book remains microfinance (JLG)-dominated
Utkarsh Small Finance Bank	FY2025	Not separately disclosed	9.43	4.84	Sharp deterioration driven by microfinance segment (~50% of book)

This directly contributes to Research Objective 3. This result (7.01 per cent) is more than two and a half times bigger than the bank's own overall GNPA ratio (2.89 per cent). This is in line with the pattern established in the literature research that the risk of the MSE sector is higher than the risk of the bank's blended book. For three of the four banks, MSE Advances/segment data is noted as "not separately disclosed", an empirical finding related to Research Objective 5. This means that the absence of uniform segment reporting in the SFB sector is a more important constraint to the study of MSE credit and NPA in Karnataka than any lack of MSE loan activity. AU Small Finance Bank's comparatively lower GNPA is on a hybrid balance sheet with a higher-risk book picked up from Fincare Small Finance Bank and the current secured retail-heavy portfolio. This combination probably underestimates the hazard of each book considered in isolation and is thus mentioned rather than presented unqualified.

TABLE 2: DESCRIPTIVE STATISTICS OF GNPA AND NNPA RATIOS OF SELECTED SMALL FINANCE BANKS, FY2021-FY2025 (POOLED BANK-YEAR OBSERVATIONS)

Variable	N	Mean (%)	Median (%)	Std. Deviation	Minimum (%)	Maximum (%)	CV (%)
GNPA Ratio	14	3.34	2.52	2.26	1.66	9.43	67.6
NNPA Ratio	14	0.93	0.53	1.25	0.03	4.84	134.7

Table 2 is based on fourteen valid bank-year GNPA/NNPA observations of four selected banks, five observations for AU Small Finance Bank, two observations for Equitas Small Finance Bank, four observations for Ujjivan Small Finance Bank and three observations for Utkarsh Small Finance Bank. The average GNPA ratio is 3.34 per cent, and the median is 2.52 per cent. The distribution is right-skewed, with most bank-years between 1.6 per cent and 3.2 per cent, but a few observations, especially the FY2022 number for Ujjivan Small Finance Bank (7.34 per cent) and the FY2025 number for Utkarsh Small Finance Bank (9.43 per cent), are pulling the mean higher. In the case of banks like Ujjivan Small Finance Bank, the NNPA ratio is near nil with a provision coverage ratio as high as 98% in FY2023, with a mild GNPA. As of March 2025, Utkarsh Small Finance Bank has a substantially lower provision coverage of 51%, which leads to a much larger pass-through of NNPA from a given GNPA. This is the reason why the coefficient of variation of NNPA (134.7%) is substantially higher than GNPA (67.6%). This is consistent with research on credit risk management that recognises provisioning policy as a lever apart from underwriting quality.

TABLE 3: TREND ANALYSIS OF POOLED MEAN NPA INDICATORS OF SELECTED SMALL FINANCE BANKS, FY2021-FY2025

Year	Banks Reporting (n)	Mean GNPA (%)	Mean NNPA (%)	GNPA Growth over Prior Year (%)
FY2021	1 (AU SFB)	4.00	2.18	Not applicable (first year in panel)
FY2022	2 (AU, Ujjivan)	4.67	0.56	+16.8
FY2023	3 (AU, Ujjivan, Utkarsh)	2.58	0.29	-44.7
FY2024	4 (AU, Equitas, Ujjivan, Utkarsh)	2.23	0.50	-13.6
FY2025	4 (AU, Equitas, Ujjivan, Utkarsh)	4.20	1.72	+88.3

The count of participating banks varies year to year (from 1 in FY2021 to 4 from FY2024 onwards); hence, the year-on-year comparison should be seen as indicative of sector trend, not a constant composition index. Table 3 shows the pooled mean of the GNPA and NNPA ratio of all the chosen banks reporting in a certain year. With that caveat, we observe the trend.” The pooled mean GNPA jumped by 88.3% in FY2025 over FY2024, the highest single-year change in the panel, after a gradual fall in the period FY2021 to FY2024 in the wake of the post-pandemic recovery, aggressive write-off policy and high provisioning coverage stated in Section 2.6. The FY2025 decline is mostly attributable to microfinance-linked loan stress, independently validated by comments from Care Edge Ratings and ICRA for three of the four banks analysed. The decline comes at a time when Equitas Small Finance Bank has specifically cited “weak asset quality trends in Karnataka” as a rationale for higher slippages. The FY2025 dip is a mix of a fresh macro/borrower-level income shock in the microfinance industry and a structural move (merger of Fincare in the case of AU Small Finance Bank). Thus, one should not see the trend as a sign of a simple cyclic pattern. Section 7 demonstrates that the available data do not allow an identification of the cyclical and structural components.

TABLE 4: RELATIONSHIP BETWEEN GNPA AND NNPA, AND QUALITATIVE COMPARISON OF MSE-SEGMENT VERSUS BANK-LEVEL ASSET QUALITY

Analysis	Basis	Result
Pearson correlation, GNPA vs NNPA	n = 14 pooled bank-year observations, FY2021-FY2025	$r \approx 0.77$ (strong positive association)

Analysis	Basis	Result
MSE-segment GNPA vs bank-level GNPA	Equitas Small Finance Bank, FY2024-FY2025 (n = 2)	MSE-segment GNPA (7.01-7.10%) exceeds bank-level GNPA (2.52-2.89%) by 4.1-4.6 percentage points in both years
MSE credit growth (MSME portfolio) vs asset quality	Equitas Small Finance Bank, FY2025 (single-year disclosure: 41% YoY MSME portfolio growth)	Insufficient time-series length to compute a correlation coefficient; reported qualitatively only

Unsurprisingly, the Pearson correlation of around 0.77 between GNPA and NNPA for the pooled fourteen observation panel shows that the two ratios move together since NNPA is arithmetically derived from GNPA net of provisions. This relationship is stated for the purpose of completeness but is not considered an economically significant conclusion for MSE loans. We make no claim of causation. The sample size ($n = 2$) is too small for a formal significance test. The comparison of MSE-segment GNPA with bank-level GNPA at Equitas Small Finance Bank, the sole example in the sample where it is possible, is much more important for Research Objective 4. The best quantitative evidence of the fact that MSE lending carries far greater credit risk than SFB's blended book is the consistent four- to five-percentage-point gap throughout the two years for which we have data. Only one of the banks studied provides MSE segment data at all, and even for that bank only two years of comparable segment disclosure can be obtained for that bank. As such, a statistically significant association between MSE credit growth and NPA ratios across various banks and years as envisioned in the study goals could not be calculated. This is presented as a data gap and cannot be filled by extrapolation of aggregate microfinance or overall-book figures from other banks, which would misrepresent risk specific to MSEs.

VII.RESULT AND DISCUSSION

The empirical findings give an overall understanding of the relationship between asset quality and the increase in lending to micro and small enterprises (MSEs) in the context of Karnataka's credit environment for select Small Finance Banks (SFBs) in India. The analysis combines asset quality disclosures at the segment level, bank-level GNPA comparisons, pooled gross and net non-performing asset (NPA) trends, and changes in small business and MSE credit exposure to examine whether the growth in credit to small businesses has been accompanied by commensurate changes in credit risk. Figures 2–5 show three important features of the analysis: the trend in overall asset quality across the tested SFBs; the rise of MSE-orientated lending; and the differences in asset-quality outcomes across MSE, microfinance and overall bank-level metrics. Most of the chosen banks do not provide the levels of NPA, particularly for Karnataka; hence, the quantitative results are often accepted as all-India SFB proof. However, we individually investigate state-specific insights for Karnataka using publicly available state-level banking and MSME information. This gap is maintained throughout the argument because sufficiently disaggregated information at the state level is lacking, preventing the explicit presentation of asset quality outcomes at the national level for Karnataka.

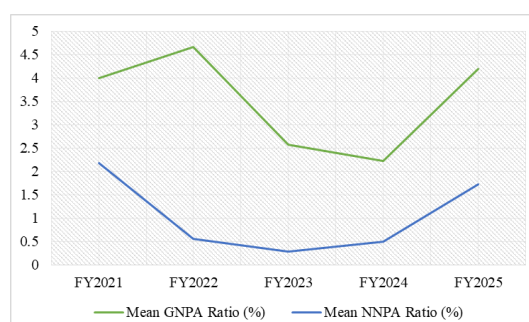


FIGURE 2: TREND OF POOLED GROSS AND NET NPA RATIOS OF SELECTED SMALL FINANCE BANKS, FY2021-FY2025

The pattern of Table 3 is displayed in Figure 2. The most important empirical conclusion of this study is the V-shaped pattern, which is characterised by a sharp spike in FY2025 after dropping from FY2021 to FY2024. It states that the asset-quality improvements The study indicates that SFBs' asset-quality improvements during FY2022–FY2024 will face challenges from a fresh revenue shock in the microfinance-linked sector in FY2024–2025. Rating agencies tend to ascribe these benefits to write-off-led clean-up and substantial provisioning rather than to a fundamental change in underwriting for marginal borrowers. This system-wide decline is of direct

relevance for MSE borrowers even in cases where a bank does not separately report an MSE-segment NPA figure. MSE lending at several sampled banks (especially Ujjivan and Utkarsh Small Finance Banks) Several sampled banks, particularly Ujjivan and Utkarsh Small Finance Banks, continue to closely associate MSE lending with microfinance-style, small-ticket unsecured lending.

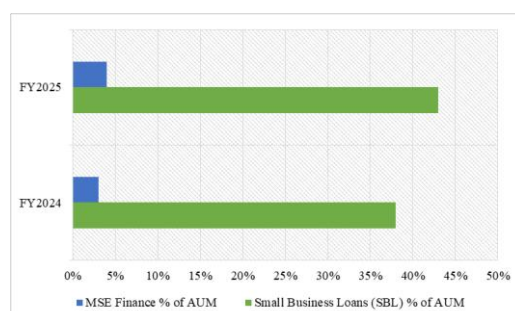


FIGURE 3: GROWTH OF SMALL-BUSINESS AND MSE CREDIT SHARE, EQUITAS SMALL FINANCE BANK

Figure 3 This is the only multi-year MSE/small-business credit share data in the sample. The share of Small Business Loans (SBL) at Equitas Small Finance Bank in advances-under-management climbed from 38% (FY2024) to 43% (FY2025) along with a 41% growth in the MSME portfolio announced at the FY2025 results. Further, its separately categorised MSE financing share too climbed to 4% from 3% during the same time (Equitas Small financing Bank, Q4 FY2025 results call). This growing MSE/SBL exposure occurred in the same year that the bank's MSE-segment GNP A remained persistently high at 7.01 per cent, highlighting the practical tension referred to in the Introduction: According to this bank's own data, limiting MSE-specific asset-quality risk and increasing MSE credit access are not necessarily compatible outcomes.

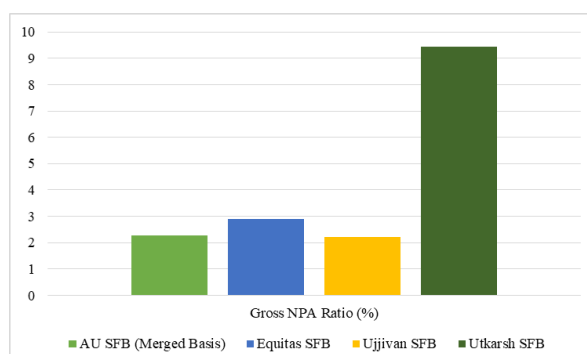


FIGURE 4: COMPARATIVE GNPA POSITION OF SELECTED SMALL FINANCE BANKS, 31 MARCH 2025

Figure 4 compares the GNPA ratios of the four banks assessed for FY2025 against the unofficial sub-3% GNPA threshold associated with RBI's eligibility criteria for SFBs seeking to move to a universal banking licence, as per rating agencies. Utkarsh Small Finance Bank's 9.43 per cent GNPA takes it safely away from this barrier, whereas three of the four banks evaluated – AU, Equitas and Ujjivan Small Finance Banks – stayed at or near it. This analysis shows there are substantial differences in asset-quality outcomes across SFBs even when they are in the same regulatory cohort and have a broadly comparable starting business plan. That disparity is more a reflection of each bank's residual dependence on unsecured microfinance-style lending than of any single economy-wide macroeconomic reason.

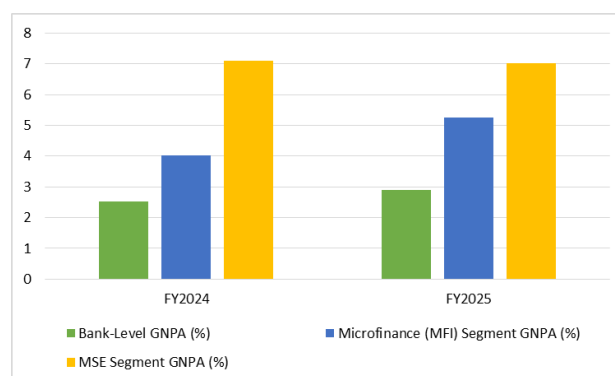


FIGURE 5: MSE-SEGMENT GNPA RELATIVE TO OVERALL BANK AND MICROFINANCE-SEGMENT GNPA, EQUITAS SMALL FINANCE BANK

Figure 5 shows the MSE-section GNPA of Equitas Small Finance Bank together with the overall GNPA and the GNPA of the microfinance sector of the bank for FY2024 and FY2025. The GNPA for the MSE sector (7.10 per cent in FY2024 and 7.01 per cent in FY2025) was higher than that of the microfinance segment (4.02 per cent and 5.24 per cent, respectively) in both years. This conclusion is somewhat at odds with the common perception that unsecured microfinance lending is the riskiest segment of an SFB's book, as shown in some of the material examined in Section 2. This result, based upon the only bank in the sample that reports both figures, should not be extended to the industry without corroborating information from other SFBs. However, it clearly addresses Research Objective 3 and supports the paper's broader claim that MSE-specific asset-quality analysis requires segment-level disclosure, which is presently rare throughout the SFB business.

❖ Discussion of Karnataka

The MSME ecosystem of Karnataka backed by the services and technology base of Bengaluru and major industrial and engineering hubs of Hubballi-Dharwad, Belagavi, Mysuru and Tumakuru requires term loans and working capital for the micro and small enterprises in the state. As to SLBC Karnataka statistics, banks in the state have disbursed more than Rs. 1,07,921 crores in MSME loans until September 30, 2024, against an expanded annual target of Rs. 1,54,000 crores for FY2024-25. The state-wide credit-deposit ratio was 78.19 per cent as of March 31, 2024, which shows a reasonably busy but not quite on-target credit-delivery environment. Karnataka is one of the top three to five states based on the number of outstanding loans in at least one of the small finance banks evaluated (Equitas Small Finance Bank, with around 13% of the bank's book as of March 31, 2025). The bank has linked the rise in slippages in the current quarter under review to Karnataka's unfavourable asset-quality trend in its FY2025-26 rating assessment.

It is important, however, to distinguish between the two types of evidence discussed in this study. The only Category A or truly Karnataka-specific evidence is the disclosed portion of the advances book of Equitas Small Finance Bank in Karnataka, the aggregate all-bank priority-sector and MSME lending data for SLBC Karnataka and the qualitative rating-agency note on weak asset-quality trends at that bank in Karnataka. The All-India category B SFB evidence includes almost all the GNPA, NNPA and MSE-segment data in Tables 1-4 and figures 2-5; none of this data was released on a Karnataka-disaggregated basis by a sampled bank, the RBI or SLBC Karnataka. The article does not mention an NPA % for Karnataka. In the case of Karnataka, it is merely Category A evidence. The all-India data for Category B is the closest verifiable approximation to the credit-risk environment in which borrowers of Karnataka-based SFBs, including MSEs, operate. State-level conditions could plausibly affect MSE credit risk through factors such as deficiencies in financial literacy, the high share of small businesses in Karnataka operating in the informal sector, and the state's own efforts to penetrate digital banking (as evidenced by SLBC's ongoing reviews of branch and business-correspondent coverage). However, the public domain currently lacks the disaggregated source data required to fully test this plausibility in Karnataka.

VIII.CONCLUSIONS

This paper covers the NPA scenario of Karnataka Small Finance Banks in Micro and Small Business Lending. We use only validated secondary data. The magazine has declined to compile Karnataka or MSE figures unless they are publicly accessible. The analysis of four listed SFBs, namely AU, Equitas, Ujjivan and Utkarsh Small Finance Banks, indicates that the pooled mean GNPA declined from 4.00 per cent in FY2021 to 2.23 per cent in FY2024 before increasing to 4.20 per cent in FY2025. The turnaround was driven by increasing stress in microfinance loans. The GNPA of the MSE section of Equitas Small Finance Bank was over 7% in FY2024 and FY2025, higher than the entire GNPA of the bank and even the microfinance segment. This gives clear, but not bank-specific, evidence that MSE lending is riskier than SFB mixed books.

The investigation shows that no source, including RBI, SLBC or banks, discloses MSE-specific Karnataka-disaggregated NPA data. The only information we have from Karnataka is SLBC's overall MSME loan disbursement, the credit deposit percentage, and a qualitative asset quality assessment regarding one bank's concentration of advances. This essay believes that this limitation is not a difficult but rather a big finding.

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