Microfinance

***Mains:** GS2 – Governance*

GS3 – Economic development | Inclusive growth and issues arising from it

What is microfinance?

- **Microfinance –** It is a form of financial service which *provides small loans and other financial services* to poor and low-income households.
- **Enhance access to financial services** – Microfinance represents banking services for low-income individuals or groups who otherwise would not have access to financial services.
- **Working** – Like conventional lenders, microfinanciers charge interest on loans and institute specific repayment plans
- **Safe lending practices** – Microfinance allows people to take on reasonable small business loans safely and consistent with ethical lending practices.
- **Data management** – Microfinance client disbursement and recovery data is updated daily with Credit Information Companies (CIC), ahead of the 15-day regulatory requirement.
- **Financial operations** – Microfinance Institutions (MFIs) operate with thin profit margins.
- These institutions offer loans without collateral with small interest rate increases (e.g., 0.15%) attract significant attention.
- **Globally influential** – Most microfinancing operations occur in developing nations, such as Bangladesh, Cambodia, India, Afghanistan, the Democratic Republic of Congo, Indonesia, and Ecuador.
- **In India –** all *loans that are below Rs. 1 lakh* are considered as microloans.
- Based on the recommendations of **Malegam Committee**, RBI introduced a comprehensive regulatory framework for NBFC-MFIs in 2011.

What are its contributions?

- **Increases banking penetration** – Serves 75 million low-income clients across 720 districts including 112 aspirational districts.
- **Last-mile financial service –** Microfinance institutions frequently deliver loans and related financial services directly to borrowers' homes or villages, especially in rural and remote areas.
- This "last-mile" servicing involves substantial expenses such as travel costs, field staff salaries, logistics, and time.
- **Generates employment** – Contributes 2.03% to India's Gross Value Added (GVA) and

generates employment for 13 million people (based on 2021 NCAER study with 2018-19 data).

- **Empowers women** – Promotes women's empowerment, builds digital capabilities, and helps curb urban migration.
- **Enhances accountability** – The sector maintains transparency by publicly disclosing minimum, maximum, and average interest rates.

How they are regulated in India?

- **Lending limits –** The microfinance Industry Network (MFIN) restricts lending so that a borrower can have loans from no more than three regulated entities.
    - Additionally, the combined loan amount from all lenders cannot exceed ₹2 lakh, protecting borrowers from excessive debt.
- **Repayment limits –** The Reserve Bank of India (RBI) mandates that microfinance borrowers' total repayment obligations must not exceed 50% of their household income.
- This rule ensures borrowers retain enough income for daily expenses, preventing financial distress and promoting sustainable borrowing.
- **Periodical monitoring –** To enforce these protections, MFIN conducts quarterly reviews of Credit Information Company (CIC) data.
    - This ongoing monitoring helps ensure responsible lending practices and reduces risks of over-indebtedness among low-income borrowers.

Current Status of Microfinance Progress
• Portfolio at Risk (1-90 days) is now improving, currently at 4%. • Only 4% of the total loan amount disbursed by microfinance institutions is currently overdue by between 1 and 90 days. • This relatively low PAR suggests that the majority (96%) of loans are being repaid on time or within an acceptable margin. • Out of total credit outstanding is ₹3.55 lakh crore, *representing 2% of India's total banking sector credit flow*. • **Borrower profile** – The majority of borrowers (95.6%) maintain relationships with fewer than three lenders, ensuring controlled debt exposure. • Additionally, 84% of these borrowers have outstanding loans below ₹1.2 lakh, indicating moderate borrowing levels and reduced risk of over-indebtedness.

> ***Portfolio at Risk (1-90 days)*** *is a key metric used in microfinance to assess the quality of loan portfolios. It represents the percentage of a microfinance institution's outstanding loan portfolio that is overdue or at risk of default by 1 to 90 days. A lower PAR percentage indicates better portfolio health and effective recovery of loans.*

What are the issues?

- **Gaps in KYC process** – After the 2017 Supreme Court ruling, regulated entities (such as microfinance institutions) were *prohibited from storing or reporting Aadhaar numbers* to Credit Information Companies (CICs).

- This limits effective customer identification and verification in microfinance.
- To comply, institutions use alternative IDs like voter ID as these are less reliable and prone to inaccuracies.
- Increasing risks of duplicate or fraudulent borrower records.
- The inability to fully use Aadhaar undermines the potential for seamless and accurate borrower verification in the sector.
- **Funding crunch** – Despite abundant liquidity in the banking system, bank funding to Non-Banking Financial Company-Microfinance Institutions (NBFC-MFIs) fell by 54%.
- **Lending restrictions** – This has restricted NBFC-MFIs' ability to lend, resulting in nearly 7 million low-income clients losing access to formal microfinance services.
- **Pricing perception** – Public discussions often ignore key factors like interest rate benchmarks, the costs of offering doorstep services, and the risks of unsecured loans.
    - Comparing a single institution's rates in isolation can be misleading; rates must be viewed relative to overall sector benchmarks to understand if they are reasonable or excessive.
    - This incomplete understanding muddies perceptions about fair loan pricing.
- Informal finance still accounts for 31% of rural loans, indicating the ongoing need for well-regulated microfinance.

What lies ahead?

- To keep helping low-income communities, it's important to make regulations clearer, improve Know Your Customer (KYC) processes, and tackle funding issues.
- Pricing talks may be more responsible and take into account the challenges and risks faced by microfinance providers, which are essential for financial inclusion.

Reference

[The Economic Times| Microfinance]