RBI's new battle for responsible microfinance

Mains: *GS-III- Economy*

Why in news?

The RBI is pushing for "responsible microfinance" by ensuring borrowers give informed consent, understand loan terms, and are protected from excessive debt, even as the industry seeks more flexible lending norms.

What is Microfinance's footprint?

- **SIDBI-Equifax Microfinance Pulse Report** – It covers June 2026, showing that the outstanding microfinance portfolio fell 12% year-on-year (YoY) to Rs. 2.69 lakh crore.
- **Large borrower base** – The sector had 7.15 crore active loan accounts.
- **Increase in loan disbursement** – Disbursements during April-June 2026, however, grew 17% YoY to Rs. 62,302 crore.
- **Sa-Dhan Quarterly Microfinance report** – It gives a somewhat broader picture, with the industry's outstanding portfolio at Rs. 3.26 lakh crore in June 2026, down 7.6% YoY.
- **Microfinance Institutions Network (MFIN) data** – Banks' direct microfinance portfolio was about Rs. 83,080 crore in June 2026, accounting for one-fourth of the industry's portfolio; it represented less than 0.4% of total scheduled commercial bank credit.
- **Economic impact** – Direct financial footprint is relatively small, but microfinance's influence on rural consumption, women's entrepreneurship, informal businesses and household livelihoods is substantial.
- **Growing contribution** – The sector's cumulative contribution to India's Gross Value Added (GVA) was 2.03% in 2018-19, projected to rise to 2.7% by 2025-26.
- **Loan repayment** – Industry-wide early-stage delinquency (30-179 days past due) fell to 1.9% in June 2026 from 6.1% a year earlier.
- However, loans overdue by more than 180 days were high at 17.4%, implying the extent of legacy stress.
- **Stresses responsible lending** – The firm stance of the RBI on the microfinance industry has sent out strong messages that financial inclusion cannot be at the cost of household over-indebtedness and responsible lending begins even before a loan is sanctioned.
- **Sign of recovery** – After two years of contraction, stability appears to have returned in the country's microfinance sector -- which primarily targets unbanked or underbanked individuals, informal workers, and rural households living below or near the poverty line -- but recovery remains fragile.

What are the industry demands?

- **Raise the eligibility limit** – One of the key demands is an upward revision of the Rs. 3 lakh annual household income threshold, which was introduced in 2022.
- According to the MFIN, the threshold does not adequately reflect increases in wages, household incomes and inflation.
- Consequently, borrowers whose incomes improved marginally may be out of the regulatory definition, although they may continue to require small-ticket credit.
- **Review of the 50% FOIR norm** – Another demand is on the 50% fixed-obligation-to-income ratio (FOIR) as the industry seeks a rational review from the banking regulator as they view that a uniform 50% repayment ceiling may not adequately capture regional differences in household income, consumption expenditure, cost of living and repayment capacity.
- **Need for regulatory clarity** – The industry warns that uncertainty over FOIR norms, income eligibility criteria, and lending practices could discourage fresh investments and capital inflows into the microfinance sector.
- **Concerns over informal lending** – It also could push financially vulnerable households towards informal moneylenders, potentially exposing them to higher interest rates.
- **Flexible repayment obligations** – The microfinance industry wants certain repayment obligations to be assessed more flexibly, including proposals to consider only the interest component of some loans rather than the entire principal and interest repayment.
- **Concerns** – The industry has been flagging concerns about inconsistent classification of microfinance loans in credit-information company databases; MFIN wants all eligible loans to be consistently reported under the microfinance category.

What did the RBI say?

- **RBI oppose relaxing FOIR** – On FOIR, the RBI instead viewed excluding principal repayments as understating actual household indebtedness.
- **Repayment from income** – In this regard, it cites a study that showed an average microfinance borrower spends just 18.7% of her monthly household income on loan repayment, while about two-thirds goes towards consumption.
- **Better lending practices** – On the threshold, the RBI's sights are on industry developments, hinting that regulatory flexibility will depend on demonstrable improvements in
    - Household income assessment,
    - Credit reporting and
    - Responsible lending.
- **Call for stronger industry standards** – It is imperative for the industry to strengthen its lending practices, uphold responsible credit standards and build greater resilience to withstand emerging challenges.
- **RBI's balancing challenge** – For the RBI, it is a tightrope walk, balancing financial inclusion and due diligence.
- It has to ensure that tighter credit discipline does not become a barrier to financial inclusion. At the same time, it shouldn't undermine the purpose of microfinance.

What is Pseudo consent?

- **Pseudo consent** – It occurs when borrowers sign loan documents without fully understanding the loan terms, costs, repayment obligations, or conditions attached to the loan. The consent is technically given, but it is not truly informed.
- **RBI calls for informed consent** – Lenders must provide the Key Facts Statement (KFS), explain its contents in a language understood by the borrower and obtain an acknowledgement that the borrower understands the commitment.
- **Concern in the digital lending era** – With expanding digital lending, instant personal loans, credit cards and other retail products, pseudo consent could become a wider banking-sector problem.
- **Need for borrower protection** – Addressing pseudo consent has now become an urgent issue amid heightened geopolitical uncertainties, rising household expenditure and growing demand for credit.
- **Factors reduce household disposable income** – Elevated crude oil prices, costlier transportation and high inflation in essential commodities can squeeze household disposable incomes, which translate into additional borrowings.
- In such a scenario, financial inclusion could inadvertently deepen household indebtedness, turning credit into a source of financial distress rather than economic resilience.

Is there a conflict of interest?

- **Potential conflict of interest** – The two RBI-recognised Self-Regulatory Organisations (SROs) -- MFIN and Sa-Dhan -- are industry associations whose members are also the institutions they are expected to monitor.
- This creates a potential conflict of interest, as the organisations are responsible for monitoring the same entities they represent.
- **Sale of additional financial products** – MFIs may market additional financial products such as insurance, savings-linked products and other services alongside microcredit, creating a potential conflict between the borrower's actual financial needs and the institution's revenue-generating interests.
- **Profit motive vs borrower welfare** – MFIs are established to provide affordable credit to financially underserved households, but the thrust on profitability and expansion of loan portfolios can lead to aggressive lending.

What's the underlying ethos?

- The RBI's June 2026 directions on advertising, marketing and sale of financial products seek to prohibit deceptive practices and ensure explicit customer consent. These requirements are scheduled to take effect from January 1, 2027.
- The era of pursuing loan growth at the expense of borrower protection must end, implying that the MFIs' success rests on the financial resilience of borrowers, not the volume of credit disbursed.

Reference

The Hindu | Pseudo consent, real debt: RBI's new battle for responsible microfinance



SHANKAR
IAS PARLIAMENT
Information is Empowering