



## Microfinance Sector

**For Prelims:** [Microfinance](#), [Marginalized groups](#), [Women empowerment](#), [Micro Finance Institutions \(MFIs\)](#), [Self Help Groups \(SHGs\)](#), [Poverty alleviation](#), [Reserve Bank of India \(RBI\)](#), [Pradhan Mantri MUDRA Yojana](#), [Indian Micro Finance Equity Fund \(IMEF\)](#), [E-Shakti initiative](#), [Regional Rural Banks \(RRBs\)](#), [Cooperative societies](#)

**For Mains:** [Role of Microfinance Sector in Financial Inclusion](#)

The microfinance sector is a crucial component of financial inclusion, offering small-value loans, savings, insurance, and other services to underserved populations. It plays a transformative role in poverty alleviation, women's empowerment, and fostering entrepreneurship in developing economies.

### What is Microfinance?

#### ▪ About:

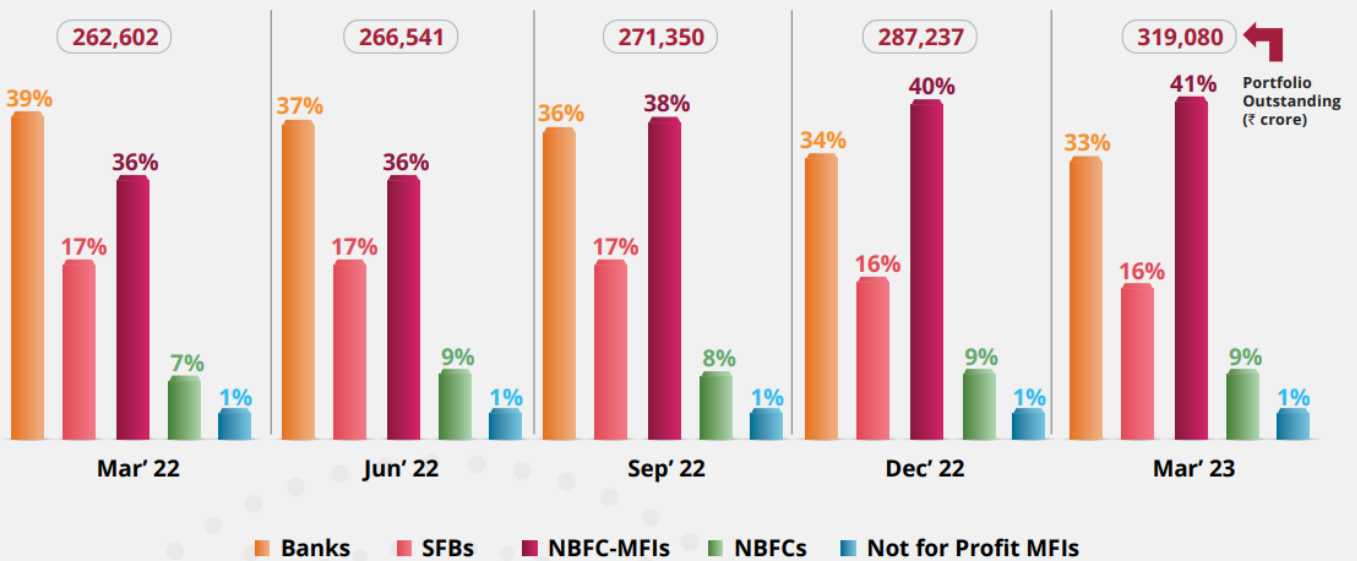
- [Microfinance](#) refers to providing **financial services**, including **small-value loans**, to households, small businesses, and entrepreneurs who **lack access to formal banking services**.
- It is an effective tool for [financial inclusion](#), enabling [marginalized](#) and low-income groups, particularly women, to achieve **social equity and empowerment**.
- In India, the [microfinance sector](#) has experienced significant growth, with 168 Micro Finance Institutions (MFIs) operating across 29 States, 4 Union Territories, and 563 districts.
- These MFIs serve over 3 crore clients with an outstanding loan portfolio of Rs. 46,842 crore.

#### ▪ **Evolution of the Microfinance Sector in India:** The development of the microfinance sector in India occurred in four main phases:

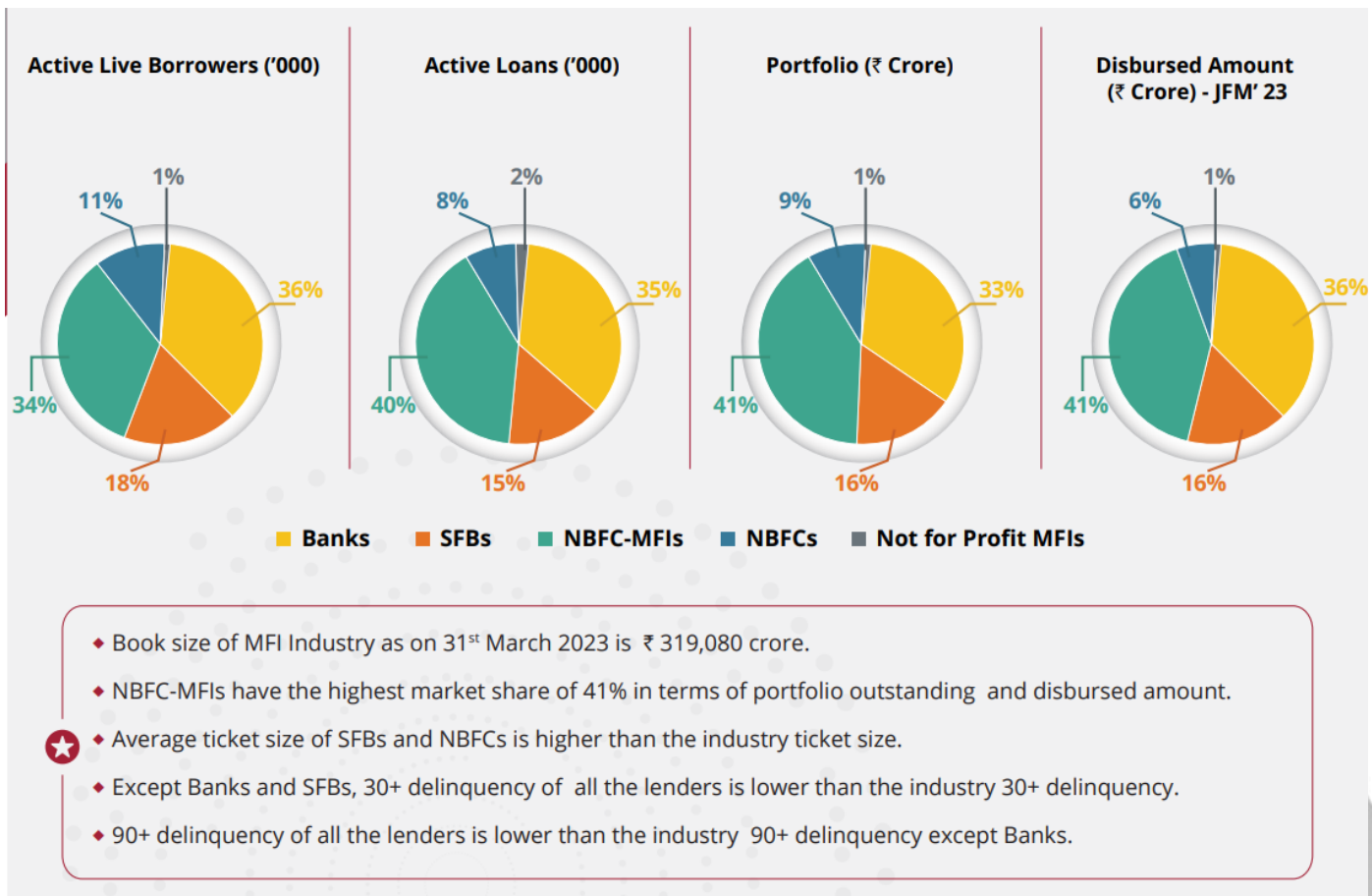
- **Initial Period (1974-1984):**
  - **1974:** Shri Mahila Sewa Sahakari Bank was established to provide financial services to **women in the unorganized sector**.
  - **1984:** [NABARD](#) advocated [Self Help Group \(SHG\)](#) linkage as a tool for [poverty alleviation](#).
- **Change Period (2002-2006):**
  - **2002:** Norms for unsecured lending to SHGs were aligned with other secured loans.
  - **2004:** The [Reserve Bank of India \(RBI\)](#) included microfinance within the priority sector, recognizing MFIs as a tool for financial inclusion.
  - **2006:** Allegations of high interest rates and **unethical recovery practices** led the government to shut down branches of some MFIs.
- **Growth and Crisis (2007-2010):**
  - **2007:** Private equity players entered the market, leading to rapid growth in the MFI loan book (INR 35 billion).
  - **2009:** The [Microfinance Institutions Network \(MFIN\)](#) was formed, allowing [NBFC-MFIs](#) to become members.

- **2010:** The **Andhra crisis** unfolded, involving coercive debt collection practices that led to borrower suicides. The government issued an **Ordinance**, that significantly curbed MFI activities.
- **Consolidation and Maturity (2012-2015):**
  - **2012:** The **Malegam Committee** recommended changes, and RBI implemented new regulations.
  - **2014:** RBI issued a **universal banking license** to Bandhan Bank, the largest microlender. MFIN was recognized as a self-regulatory organization (SRO).
  - **2015:** The government launched **MUDRA Bank** to finance small businesses.
- **Status of Microfinance in India:**
  - Microfinance contributes about **130 lakh jobs and 2% of our GVA**, as per a National Council of Applied Economic Research (NCAER) study.
  - It has the potential to reach all the 6.3 crore unincorporated and **non-agricultural enterprises**. The RBI recently defined microfinance as collateral-free loans given to households having annual incomes up to Rs. 3 lakh.

Market Share Trends by Lender Type



- ◆ Microfinance industry grew by 22% from March 2022 to March 2023 and witnessed Q-o-Q growth of 11% from December 2022 to March 2023.
- ◆ NBFCs witnessed highest Y-o-Y growth of 51% from March 2022 to March 2023.



## Business Models in Microfinance:

### Self-Help Groups (SHGs):

- SHGs are informal groups of 10–20 members, mainly women, who pool their savings and become eligible for credit from formal banking institutions under the [SHG-Bank Linkage Programme \(SHG-BLP\)](#). NABARD plays a key role in developing and supporting SHGs.

### Microfinance Institutions (MFIs):

- MFIs provide micro-credit and other financial services like savings, insurance, and remittances. Loans are typically provided through **Joint Lending Groups (JLGs)**, informal groups of 4–10 members engaged in similar economic activities who jointly repay loans.

## Categories of Microfinance Lenders:

- Non-Government Organizations (NGO-MFIs):** Registered under the [Society Registration Act 1860](#) or [Indian Trust Act 1880](#), these NGOs extend micro-credit.
- Co-operative Societies:** Registered under relevant laws, co-operative societies such as [Primary Agricultural Credit Societies \(PACS\)](#) offer microfinance services.
- Section 8 Companies (Formerly Section 25 of Companies Act 1956):** These are non-profit entities that extend micro-credit under the [Companies Act, 2013](#).
- Non-Banking Finance Companies (NBFC-MFIs):** NBFC-MFIs raise funds from their own resources or bulk loans from banks to lend to JLGs. This category, **introduced by the RBI in 2011**, accounts for 80% of the microfinance market.

## Regulatory Framework:

- The **Reserve Bank of India (RBI)** regulates MFIs in India through the **Non-Banking Financial Company-Micro Finance Institutions (NBFC-MFIs)** framework, issued on 01.07.2014.
- The guidelines cover aspects like **eligibility for registration, client protection, prevention of borrower over-indebtedness, privacy, and pricing of credit**. MFIs generally comply with these regulations, contributing to stakeholder confidence in the sector.

## What are the Government Measures for the Development of Microfinance

## Institutions (MFIs)?

- **Indian Micro Finance Equity Fund (IMEF):** To address liquidity challenges, the Government of India introduced the [Indian Micro Finance Equity Fund \(IMEF\)](#) in the **Union Budget of 2011-12**, with an initial allocation of **Rs. 100 crore**.
  - Operated through the [Small Industries Development Bank of India \(SIDBI\)](#), this fund was aimed at strengthening the capitalization of smaller, socially oriented MFIs, particularly in underserved areas.
- **Role of NABARD:** NABARD's Micro Credit Innovations Department facilitates access to financial services for the unreached poor in rural areas through various microfinance innovations.
  - **Self Help Group - Bank Linkage Programme (SHG-BLP):** SHG-BLP is a **cost-effective model** linking poor households to formal financial institutions.
  - **NABARD Financial Services Ltd. (NABFINS):** NABARD established NABFINS as a **model microfinance institution**, focusing on governance, transparency, and reasonable interest rates.
  - **Micro Enterprise Development Programmes (MEDPs):** Skill training for SHG members to enhance production activities.
  - **E-Shakti Initiative:** The [E-Shakti initiative](#), launched by **NABARD**, is a major technological advancement for the microfinance sector. The project focuses on **mapping existing Self Help Groups (SHGs)** and uploading both financial and non-financial information on a dedicated website.
    - This digitization of SHGs improves [transparency](#), enables better access to data, and facilitates more efficient financial inclusion efforts.
- **Pradhan Mantri MUDRA Yojana (PMMY):** Launched in **2015**, the [Pradhan Mantri MUDRA Yojana \(PMMY\)](#) was introduced to enhance credit flow to small businesses, an essential component of financial inclusion.

## How does Microfinance Contribute to Financial Inclusion?

- Despite the significant achievements of the microfinance sector in recent years, there are numerous opportunities for further growth and development.
  - **Poverty Alleviation:** Microfinance serves as a vital tool for [alleviating poverty](#) by providing access to financial services for low-income individuals and families.
    - Studies have shown that microfinance can **help lift people out of poverty**, enabling them to diversify their income sources and improve their living conditions.
  - **Impact on Health, Social Capital, and Economy:** Microfinance has a positive effect on various aspects of life, including health and education, which can subsequently influence economic development.
    - For example, research indicates that providing mothers with access to credit can **increase their children's school enrollment rates** by approximately **1.9%** for girls and **2.4%** for boys, as observed by the [Grameen Bank](#).
  - **Microfinance as a Development Tool:** Microfinance can act as a buffer against unexpected crises, such as business risks or supply disruptions.
    - Studies indicate that microfinance is **relatively resilient to national and global economic fluctuations**, offering a reliable support system during difficult times.
  - **Opportunity for Commercial Banks:** With many Microfinance Institutions (MFIs) providing a limited range of microfinance products, there is an opportunity for commercial banks to develop **innovative offerings** in this sector.
    - Research shows that microfinance products can have high recovery rates and profitability.
  - **Women Empowerment:** Microfinance provides women with the opportunity to **start and grow their businesses**.
    - Many MFIs, particularly in countries like [Bangladesh](#), prioritize lending to women due to their higher repayment rates.

## What is the Concept of Financial Inclusion?



- **About:**
  - **Financial inclusion** can be defined as "The process of ensuring **access to financial services** and timely, adequate credit, where needed, by **vulnerable groups** such as weaker sections and low-income groups, at an affordable cost."
- **Challenges for Low-Income Households:**
  - Low-income households often lack access to bank accounts and face difficulties such as:
    - Spending time and money on **multiple visits** to avail basic banking services
    - Difficulty in opening **savings accounts** or accessing loans
    - As a result, the **unbanked population** is largely disconnected from the banking system.
- **Financial Exclusion:**
  - Certain trends, such as **advanced customer segmentation technology**, have restricted access to financial services for specific groups.
    - This creates a divide, with high and upper-middle-income populations enjoying a wide range of personal finance options, while a significant portion lacks access to even basic banking services. This lack of access is termed "**financial exclusion.**"
- **Conventional Models Failure in Financial Inclusion:**
  - **Regional Rural Banks (RRBs):** The establishment of **Regional Rural Banks** in 1975 aimed to extend formal credit systems to the rural population.
    - The **RRB Act, 1976** emphasized providing adequate and timely finance to the rural sector.
    - Due to the predominance of the rural sector, RRBs have struggled with high levels of **Non-Performing Assets (NPAs)** and operational costs, resulting in heavy losses.
  - **Cooperatives: Rural credit cooperatives** were established to pool the resources of people with small means and provide financial services to the poor in urban and rural areas.
    - However, despite decades of cooperative efforts, private agencies continued to dominate the rural credit market, and cooperatives provided only **35%** of the total borrowing needs of farmers.

## What are the Challenges and Way Forward for India's Microfinance Sector?

Challenge	Way Forward
<b>High outreach costs</b> in remote areas.	Leverage technology, partner with local businesses, optimize field force
<b>Over-indebtedness</b> due to lack of proper assessment.	Strengthen risk assessment, provide financial education, <b>diversify loan products.</b>
<b>Competitive disadvantage</b> compared to mainstream banks.	Explore <b>alternative funding sources</b> , focus on value-added services, advocate for regulatory reforms.
Difficulty in acquiring <b>reliable data</b> for appraisals.	Develop <b>standardized valuation frameworks</b> , invest in data analytics, seek external validation.
<b>Limited reach</b> to the urban poor.	Tailor products and services, partner with <b>urban local bodies</b> , leverage digital channels.
Inadequate risk management practices and lack of collateral.	Enhance <b>credit risk assessment</b> , promote financial literacy, consider collateral requirements.
Difficulty in <b>accessing clients</b> in remote areas due to poor infrastructure.	Leverage <b>mobile technology</b> , partner with local agents, invest in infrastructure.
Limited <b>operational flexibility</b> and vulnerability to fluctuations in banking policies.	Explore <b>alternative funding sources</b> , build internal capacity, advocate for policy changes.
<b>Lack of awareness</b> regarding financial principles and services.	Conduct <b>financial literacy campaigns</b> , partner with schools and colleges, utilize digital platforms.

Limited product offerings, excluding low-wage workers from essential financial services.

Offer **microinsurance, introduce savings products,** explore digital payments.

## Conclusion

Micro Finance programme has played a significant role in the Indian economy. It has **proved its viability as a business model** as well as in its ability to reach out to a significant section of the population comprising the poor, the marginalised, and the unbanked. **Acting in complementarity to the banking system**, it has striven to provide sustainable microfinance services to the underprivileged, thereby providing **more inclusive development** and **economic parity** in the country.

## UPSC Civil Services Examination, Previous Year Question (PYQ)

### Prelims

**Q. Microfinance is the provision of financial services to people of low-income groups. This includes both the consumers and the self-employed. The service/ services rendered under microfinance is/are (2011)**

1. Credit facilities
2. Savings facilities
3. Insurance facilities
4. Fund Transfer facilities

**Select the correct answer using the codes given below the lists:**

- (a) 1 only
- (b) 1 and 4 only
- (c) 2 and 3 only
- (d) 1, 2, 3 and 4

**Ans: (d)**