# Role of Microfinance in Building a $5 Trillion Economy

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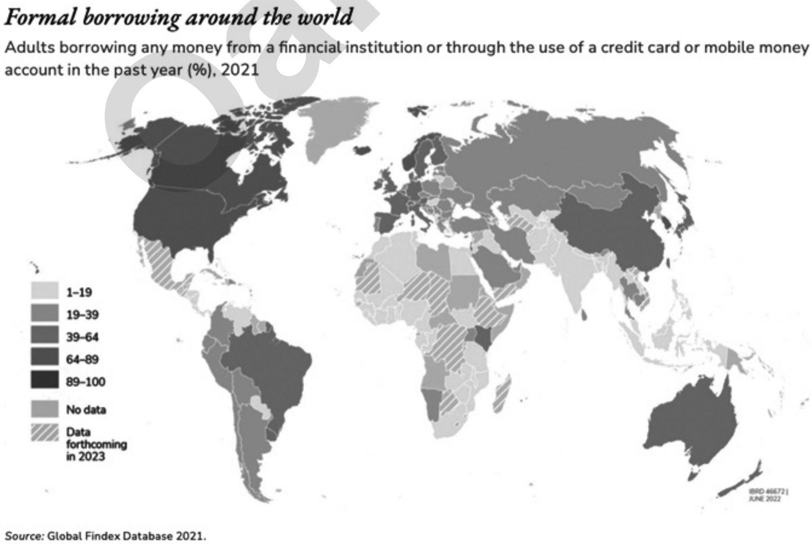
## 1. INTRODUCTION

The role of financial development and deepening in catalysing financial activity is widely accepted. Access to credit encourages the borrowers at the bottom of the pyramid to invest in entrepreneurial ventures or to strengthen their existing livelihood. Such businesses offer them the possibility of earning a higher income as compared to the alternative option of employment at low wages (Banerjee and Newman, 1993). Easier access to credit also helps newer segments of the population to avail the services of formal financial institutions. Multiple research studies have established the positive impact of credit availability on poverty reduction, women empowerment, household health, children's education and other human development indicators (Honohan, 2004; Beck et al., 2007; Demirguc-Kunt et al., 2008; Sahay et al., 2015; Ghosh and Vinod, 2017).

**Figure 1:** *Formal Borrowing Around The World*



Despite the progress made in improving financial inclusion, in 2021 only about 53 per cent of adults worldwide reported borrowing any money over the past 12 months (Global Findex Database 2021). In developed countries, borrowing from formal sources was pre-dominant. The percentage of adults borrowing from formal sources in developing countries continues to be low though it has increased from about 16 per cent in 2014 to 23 per cent in 2021.

## 2. ACCESS TO CREDIT IN INDIA

Providing easy access to credit to the poor sustainably has been an important goal for the policymakers in India, since independence. In 1951, the total population of India was 361 million, around 82.72 per cent of the total population lived in rural areas, and out of which nearly 60 per cent were poor. From 1950 to mid-1960s, efforts to expand credit availability to the poor focussed on the existing network of cooperative banks in rural areas and private commercial banks in semi-urban and urban areas. However, institutional constraints of cooperatives and the preoccupation of private commercial banks with the industrial and service sector proved to be a bottleneck.

Tardy progress in credit delivery resulted in a significant policy response which started with the nationalisation of private commercial banks in 1969 and lasted up to the early 1990s. This phase, euphemistically termed "social banking", saw a broad swathe of measures starting from the nationalisation of existing private commercial banks, massive expansion of branch network in rural areas, mandatory directed credit to priority sectors of the economy, subsidised rates of interest and creation of a new set of rural banks at the district level and an apex bank for agriculture and rural development namely National Bank for Agriculture and Rural Development (NABARD) at the national level. The increase in banking network and volume of credit was supplemented by directions on interest rate regulation and provision of subsidies under various government programmes routed through the banking structure.

Such a decisive policy push did yield impressive quantitative results with the average population per bank branch falling tenfold from about 140 thousand to 14000 (Burgess & Pande 2003) between 1961 and 2000 and the share of institutional agencies in rural debt increasing from 7.3 per cent in 1951 to 66 per cent in 1991(RBI 1954; GOI 1992). However, the quality of formal sector penetration posed serious issues.

Government interventions through directed credit, state-owned Rural Financial Institutions (RFI) and subsidised interest rates increased the tolerance for loan defaults as credit was perceived as a dole from the state. Loan waivers by the government added to the problem. It weakened the structure financially and certain common trends became visible across the banking sector during the early 1990s. Two major problems were: (a) high incidence of loan default leading to an increase in risk cost and reduced ability to recycle funds and b) high transaction cost in retailing rural credit, yet lending at concessional rates causing insufficient financial spread (Misra 2008). The All India Debt and Investment Survey of 1991 showed the wide gap in formal sector share in rural household debt across income categories. The households in the bottom 3 deciles of household income had ~40 per cent share of the formal sector in cash debt, while the top household income decile had a high 81 per cent share from the formal sector. The inadequacies of a supply-driven, subsidised and normal banking-oriented approach in undertaking last-mile inclusion were evident- it was neither reaching the poor nor was it sustainable over the long term.

## 3. THE EVOLUTION OF MICROFINANCE IN INDIA: MICROFINANCE VERSION[1]

The evolution of microfinance in India coincided with the global development in microfinance and the evident shortcomings of the existing structure to meet the credit needs of the low-income clients. It found a supportive ecosystem on account of financial sector reforms ushered in 1991 in India.

In many developing countries, directed and subsidised rural credit programmes suffered from similar institutional weakness, cornering of subsidies by the better off and the exclusion of the needy from the reach of financial services. Microfinance projects began to take hold globally in the relatively dissimilar contexts of Bangladesh, Bolivia, and Indonesia as a reaction to these limitations of the formal sector. Professor Muhammad Yunus's ground-breaking work in Bangladesh in the late 1970s was followed by PRODEM in the 1980s in Bolivia and Bank Rakyat Indonesia (BRI) to provide financial services to the poor. In both the scope of their outreach and ability to recover costs, these interventions demonstrated techniques for lending to the poor that were more effective than previous approaches (Rhyne 2001; Robinson 2001). This laid the foundation for the evolution of the concept called 'microfinance' in late 1980s or early 1990s.

The contextual and design differences of various interventions are noteworthy. For example, BRI used individual lending while the Grameen Bank in Bangladesh used group lending and the Bolivian approach was characterised by commercial operations as against the subsidised operations of Grameen. However, the unifying message of these diverse innovations was that "appropriately designed financial products and services enable many poor people to expand and diversify their economic activities, increase their incomes and improve their self-confidence" (Robinson 2001). Above all, this dispelled the myth that the poor

1. Promotion and Development of Microenterprises (PRODEM) was created in 1986 in Bolivia as a non-profit financial institution.

are not creditworthy. In addition, the unifying thread of these interventions lies in their similar principles, such as reliance on character rather than collateral as primary loan security, use of social capital, positive incentives for repayment, interest rates that approached or covered costs and focus on sustainability which have guided the movement till now (Rhyne 2001).

The impetus for microfinance interventions in India in the early 1990s can be attributed to multiple factors: the realisation of the inability of the formal banking system to reach the poor sustainably, the beginning of financial sector reforms in the early 1990s and the success of microfinance interventions across the world especially in Asia and India by NGOs (Task force 1999; Thorat 2006). NABARD, as the apex agency for rural development, began to search for alternative models of reaching the rural poor. It was found that the poor tended to come together in a variety of informal ways to pool their savings and dispense small, unsecured loans at varying costs to the group members based on their need. This concept of self-help was discovered by social-development NGOs in the 1980s. The democratic nature of these groups, flexible operations and prudent use of savings and loans were impressive. The only constraining factor was the limited financial resources available to such groups- NABARD took the lead in linking the self-help groups (SHGs) with banks to overcome the financial constraint. The success of the programme was evident in high recovery rates of SHG loans (99 per cent) as compared to poor recovery rates under conventional rural finance. The increasing involvement of banks in the programme was another redeeming feature and by March 2005, SHG-Bank Linkage Programme (SBLP) covered 1.6 million groups.

Parallel to the SHG model of microfinance, many donor-funded NGOs started group-based savings and credit activities. As this work was taken up by the existing NGOs working in a range of developmental areas, the microfinance component was an add-on to their existing activities. The next phase of this approach had two features: the separation of microfinance as a separate vertical and reducing dependence on donor funds.

Just as NABARD had taken the leadership role for the SHG programme, Small Industries Development Bank of India (SIDBI) took a similar role for the MFI model which relied on making funds available to Micro Finance Institutions (MFIs) for lending to clients. Enabling fund flow to the MFIs also entailed more transparent financial operations, which expedited the process of separating microfinance operations with separate financial statements. Initially, SIDBI relied on lending directly as well as institutional strengthening through training and capacity development. To ensure linkage with the banking system for the flow of debt funds, SIDBI supported M-CRIL[2] in developing a rating

2. Micro-Credit Ratings International Ltd. (M-CRIL) is a microfinance rating agency working globally with focus on Asia. www.m-cril.com

tool for MFIs. This ushered in a new phase by providing a credible third-party assessment of performance and gaining the confidence of bankers. By 2005, the MFI model had transformed with the emergence of "microfinance only" organisations as against earlier clubbing of microcredit with other developmental activities. Though the model had moved to a system of external ratings for performance assessment, established linkages with the banking sector and also received the support of the apex institution in the form of SIDBI, it retained its ideology of client focus and had a modest outreach of 1.76 million (M-CRIL 2009). The sector was dominated by MFIs organised as societies and trusts and employed a variety of models (Grameen, Individual and SHG) to deliver credit services.

Both models were growing modestly but sustainably till 2005 in line with the approach of slow progress in building social capital and using social structures to undertake financial intermediation. Various studies across the globe provided support to the view regarding the positive effects of microfinance both under the SHG model and the MFI model. Spurred by these developments, the World Bank, the Asian Development Bank (ADB), the United Nations as well as practitioners hailed microfinance as the new panacea against poverty. Things changed post-2004 for both SBLP and MFI models.

## 3.1 Fast Growth & Lack of Customer Focus Lead to a Crisis

The period 2005-2010 saw a rapid increase in the expansion of the microfinance sector. Unfortunately, during this period, the focus on client engagement and understanding (core of the microfinance model) was lost in the pursuit of growth. By the end of 2010, almost every state was witnessing high competition, credit saturation, multiple borrowings and rising default rates. It was evident that something was going to break.

By 2005, a critical mass of SHGs had been established and its promise of providing a quick and easy means of promoting inclusion and poverty alleviation efforts caught the interest of the policy makers. Ambitious targets for linking an increasing number of SHGs by banks, NGOs and government agencies were not accompanied by a focus on quality (Misra 2008). A comprehensive study on Self Help Groups in India by EDA Rural Systems and APMAS in 2006 found that 40 per cent of groups had very weak records and another 39 per cent had moderate quality records (EDA & APMAS 2006).[3] The growth was not spread out- 2010 data on the cumulative number of SHGs credit linked shows 53 per cent share of the southern region, of which Andhra Pradesh alone accounted for 24.7per cent. Similarly, average loans disbursed per group jumped from low

3. The study covered 215 SHGs spread across four states of AP, Karnataka, Odisha and Rajasthan

levels of ₹46,800 in 2008 to ₹1,15,829 – nearly a threefold increase in two years. Alarming signs of repayments dipping to 80-85 per cent, poor quality of groups formed by government agencies, deficiencies in hand-holding support required to nurture groups and lack of motivation required to sustain a long-standing programme with such huge numbers from both NABARD as well as banks did not bode well (Srinivasan 2010). A study by CMF on access to finance in Andhra Pradesh showed pure consumption accounting for 49.9 per cent of loans (Johnson & Meka 2010).

Though spurred by different factors, a similar period of high growth was seen in the Joint Liability Group (JLG) model-based MFI lending. The linkage of MFIs with banks based on independent ratings led to the infusion of substantial sums of money into the system. To ensure financial discipline, banks relied on prudential norms like debt-to-equity ratio to have reasonable levels of leverage. MFIs registered as societies and trusts found it difficult to raise capital from external sources due to their legal form. This led the MFIs to transform into Non-Banking Finance Companies (NBFCs), the only legal route permissible and acceptable to equity investors. The transformation phase started around 2004 and by 2008, all major MFIs had transformed into NBFCs and dominated the sector accounting for 90 per cent of the market share by 2010. Since regulations did not allow NBFCs to take deposits, MFIs had to fulfil their funding requirements through private capital as equity or from banks as term loans. MFIs, to continue to be attractive to investors, went for aggressive growth. As a result, MFI outreach touched 26.7 million clients by March 2010.

Andhra Pradesh (AP) was the state where these fault lines converged. It accounted for a high 25 per cent share of the total SHGs linked to banks. This overlapped with a strong presence of the MFI network. The result was rapid growth in lending accompanied by high competition, credit saturation, multiple borrowings and rising default rates. The ordinance of the Andhra Pradesh government in October 2010 proved to be the straw that finally broke the camel's back. More than 90 per cent of MFI loans in Andhra Pradesh overnight turned into Non-Performing Assets(NPA). Government scrutiny of the sector and news of defaults in Andhra Pradesh led the banking sector to heavily curtail the flow of funds in the form of term loans further choking the sector. It was time for a complete overhaul of the sector.

## 4. RESPONSE TO THE CRISIS: REGULATOR HERALDS A NEW REGIME- MICROFINANCE VERSION 2

Following the AP crisis, RBI constituted the Malegam Committee in 2011 to study the microfinance sector. Among other things, the committee was entrusted to perform the following tasks :

- Review the definition of microfinance and MFIs for regulating NBFCs undertaking microfinance
- Examine the prevalent practices of MFIs concerning interest rates, lending and recovery practices from a 'customer protection' perspective
- Delineate the objectives & scope of regulation of NBFCs undertaking microfinance and the regulatory framework needed by the Reserve Bank to achieve those objectives.

The new RBI regulations were introduced based on the recommendations of the Malegam Committee. The regulations notified the formation of a new category of regulated entities (REs) called NBFC-MFI (NBFC- Microfinance Institution) and were targeted at encouraging the growth of the microfinance sector alongside customer protection, improved regulatory oversight and avoidance of build-up of systemic risks. The regulations clearly outlined micro rules like:

- Criteria for eligibility of a customer based on income;
- Level of indebtedness of the borrower;
- Interest rates that could be charged by the NBFC-MFIs;
- Loan tenure is linked to loan size.

Given the class of customers catered to by microfinance, the Fair Practices Code was made stricter and greater focus was placed on corporate governance. Additional measures were proposed to strengthen the ecosystem and aid its development.

- Every NBFC-MFI had to be a member of at least one Credit Information Company (CIC), provide timely and accurate data to the CICs and use the data available with them to ensure compliance with the conditions regarding membership of JLG (joint liability group), level of indebtedness and sources of borrowing.
- All NBFC-MFIs were encouraged to become a member of at least one Self-Regulatory Organization (SRO) which is recognised by the Reserve Bank and will also have to comply with the Code of Conduct prescribed by the SRO.

Monitoring of compliance with the regulations had a 3-tiered structure:

- NBFC-MFI themselves supported by SRO;
- Banks' lending to NBFC-MFIs;
- Reserve Bank of India.

While the responsibility for compliance with all regulations prescribed for MFIs lays primarily with the NBFC-MFIs themselves, they were to be supported by the SRO. In addition, banks' lending to NBFC-MFIs was required to ensure that systems practices and lending policies in NBFC-MFIs are aligned with the regulatory framework.

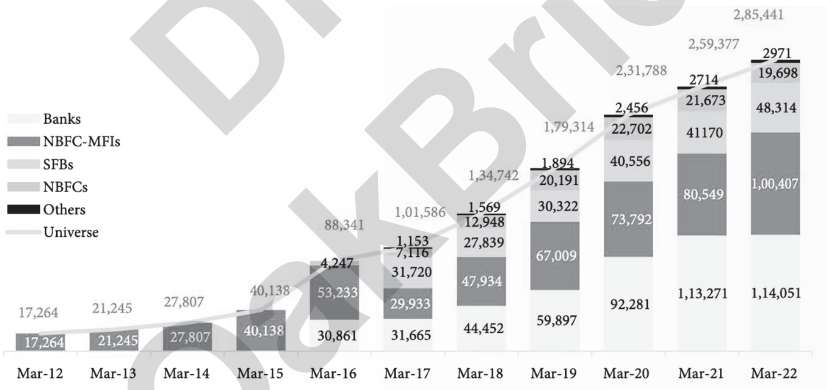
# 5. A DECADE OF FAR-REACHING CHANGES

## 5.1 Growth of Microfinance over the last decade

Under the new regulatory regime applicable for NBFC-MFIs, the JLG portfolio registered manifold growth over the last decade (Figure 2). The Gross Loan Portfolio (GLP) of the JLG lending has grown more than 15 times from ₹ 17,264 Crore in March 2012 to ₹ 2,85,441 Crore in March 2022. The number of unique borrowers has increased to more than 6 Crore in March 2022. Other than the increase in loan volumes and outreach, two key aspects changed the landscape.

First was the move of large NBFC-MFIs and banks into each other's domains which were hitherto marked clearly with little overlap. Bandhan Financial Services Pvt. Ltd, an NBFC-MFI, was granted a universal bank license in 2014 which was followed by the graduation of eight more large NBFC-MFIs as Small Finance Banks in 2016. At the same time, many commercial banks and mainstream NBFCs started entering the microfinance space. As a result, the JLG microfinance market now has a diverse financial architecture. As of March 2022, the JLG microfinance portfolio was split between Banks (38 per cent), SFBs (17 per cent), NBFC-MFIs (37 per cent) and NBFCs (8 per cent).

**Figure 2:** *Growth in Gross Loan Portfolio- Entity-wise*




Secondly, following the regulatory changes, the microfinance sector also took major steps to ensure responsible finance.

- **Credit Bureau:** A separate microfinance credit bureau was established in 2011. Extensive efforts were taken across the sector to streamline the collection and reporting of data regularly to the bureaus. The MFI credit bureau expanded to cover the credit history of more than 6 crore microfinance borrowers with nearly 60 Crore records. Application Programming Interface (API) integration between the MFIs and the credit bureau made the credit report of borrowers available in real-time and played an important part in underwriting decisions. At the same time, widespread awareness of the credit report amongst borrowers had a positive impact on repayment behaviour.

- **Self-Regulatory Organization (SRO):** The regulations placed a high emphasis on ensuring customer protection. Consequently, Microfinance Institutions Network (MFIN) was recognised as the first Self-Regulatory Organization (SRO) for NBFC-MFIs by the Reserve Bank of India in 2014. MFIN works closely with microfinance providers, regulators, government, and other key stakeholders to promote responsible lending, client protection, and good governance practices across the sector. The SRO played an important role in identifying issues concerning customer satisfaction and in evolving industry-wide norms.
- **Code of Conduct (CoC):** After widespread consultations by the SRO, an industry Code of Conduct was evolved as a document to guide the sector. The CoC stressed fair interaction, suitability of products and services, financial literacy and grievance redressal and employee engagement practices as the foundational elements of microfinance. The CoC found industry-wide acceptance and it has been regularly updated to keep abreast with the latest developments.[4]
- **Customer Grievance Redressal Mechanism (CGRM):** Given the geographical spread of the microfinance business and the profile of a typical borrower, a responsive customer grievance redressal mechanism is an important part of customer protection. MFIN supported the development of grievance redressal practices amongst its NBFC-MFI members. MFIN also provides a grievance redressal system for the customers of its members - the MFIN CGRM attends to more than 1 Lakh customers per year and handles complaints related to disbursement, repayment, insurance, errors in credit bureau records etc.
- **Employee Bureau:** The microfinance model requires a high-touch approach keeping in mind the borrower profile and the highest standards of customer service. This is provided by a frontline force of more than 2 lakh employed with different entities in the microfinance sector. To support the adoption of best practices regarding employee engagement, MFIN helped in establish an employment bureau for the microfinance sector. The member institutions share relevant employee information through the bureau.

## 5.2 Adoption of digitalisation

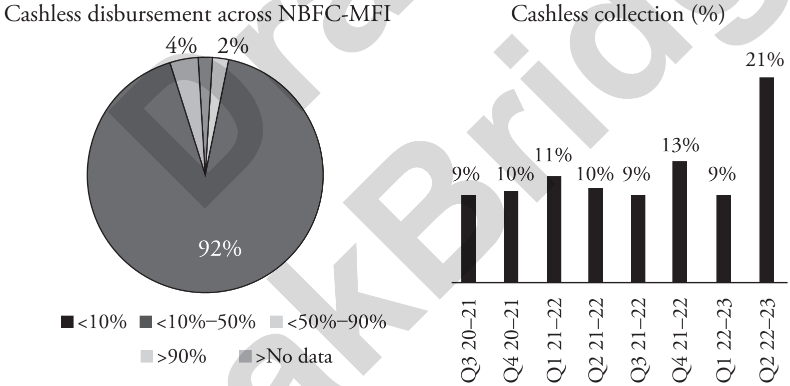
The rapid growth of the microfinance sector was supported by rapid and deep-reaching changes in the other sectors of the Indian economy. Increasing penetration of mobile phones, faster communication due to apps and dissemination of information using social media platforms had a positive impact

4. The latest edition of the Code of Conduct can be accessed at https://mfinindia.org/assets/upload_image/publications/IndustryStandards/Industry Code of Conduct (CoC) - 4th Edition.pdf

on the awareness and knowledge levels of consumers. The number of mobile phone subscribers hit 100 Crore in 2016 and by 2018, the internet had more than 50 Crore. subscribers. The Pradhan Mantri Jan-Dhan Yojana for providing a no-frills savings account to every citizen led to the opening of more than 40 Crore accounts. These accounts provided basic banking transactions leveraging the Aadhaar Enable Payment Systems (AEPS) and the widespread business correspondent[5] network. Similarly, the launch of the Unified Payments Interface (UPI) changed the paradigm of digital payments which saw rapid growth.

Keeping in step with the changes, the microfinance sector initiated digitalisation efforts aligned to the levels of financial literacy of their borrowers. The microfinance model today deploys an optimum mix of technology and human touch. Tab-based solutions are employed in the field to achieve a faster turnaround of loan applications and customer complaints. The MFIs use API integration credit bureaus to pull the credit information report of loan applicants in real-time. A field force of nearly 2 Lakh across the sector provides an assisted digital interface to the borrowers.

**Figure 3:** *Cashless disbursements and collections*




Today, nearly 100 per cent of microfinance loans are being digitally disbursed directly to the borrower's bank account. The percentage of digital repayments is also improving due to constant efforts at customer awareness and training (Figure 3).

The widespread availability of a bank account and increased adoption of digital transactions have helped create transaction histories of microfinance borrowers. Such data is supporting the development of new lending products for the customers.

5. Business correspondents are retail agents engaged by banks for providing banking services at locations other than a bank branch/ATM. For example: a local kirana shop or the postman..

## 6. FROM ENTITY-BASED TO ACTIVITY-BASED REGULATIONS: MICROFINANCE VERSION 3

As discussed previously, the microfinance landscape in terms of entities completely changed from 2014-2022. While it heralded the business case of microfinance alongside inclusion objectives, it also led to regulatory issues. The RBI regulations of 2011 were framed when NBFC-MFIs were the only providers of microfinance; the situation changed with different REs having a substantial share of the microfinance market. All institutions had similar products, client profiles and operational methodology but the applicability of regulations to only about one-third of the market serviced by NBFC-MFIs was causing field issues.

- The new market structure faced a peculiar situation of regulatory arbitrage. While NBFC-MFIs had the same microfinance consumer profile as other REs and catered to about one-third of the market, they had to comply with different regulations.
- While other REs did not have to conform to regulations about interest rate caps, the number of lenders was limited to one client, linking loan size to a pre-fixed tenure etc., NBFC-MFIs had to follow all these norms.
- Since NBFC-MFIs are non-deposit taking entities, they borrowed funds from banks while competing with them on the final interest rate offered to the borrower. This put them at a competitive disadvantage.

It was important to address this issue as any adverse field situation could lead to collateral damage to the industry and nullify the gains made. MFIN along with other industry bodies took the lead in plugging this gap through the "Code of Responsible Lending (CRL)" in 2019. CRL focussed on key issues of client protection and all microfinance lenders signing CRL voluntarily agreed to follow the norms. However, a few major lenders chose to not become a part of it. Regular discussions were held with the regulator by MFIN and other sector participants to rectify this anomaly. After the Reserve Bank of India (RBI) Governor's announcement that the RBI will be coming out with a discussion paper on regulation for the microfinance sector, the Consultative Document was released on 14 June 2022, and the final set of regulations was published in March 2022.

The new regulations are a paradigm shift in regulation on two main counts. First, the regulatory arbitrage based on the legal form of RE is no longer applicable, and all REs doing microfinance lending have to abide by the same set of rules. The sector has now moved to "asset class" based regulation, over "legal form of the entity" based regulation. Further, the regulatory paradigm has now changed to "principles-based" over micro-business rules with greater accountability placed on the boards of REs. The regulations are designed to benefit and protect customers from indebtedness and unethical practices.

The key regulations governing the microfinance space now are summarised in Box 1. The *HouseHold* (HH) income limit has been revised to ₹ 3 Lakh from the earlier ₹2 Lakh in urban/semi-urban locations and ₹1.25 Lakh in rural locations. This has increased the size of the microfinance market and the different regulated entities will now be able to serve the "middle" segment which gets lost between the microfinance market and the typical banking customer.

**Box 1**

- Definition of Microfinance Loans:
  - Collateral free;
  - Annual Household Income: Up to ₹ 3 lakh [revised from the earlier ₹ 2 lakh (urban/semi-urban) and ₹ 1,25 lakh (rural locations)];
  - Household: Husband, Wife & Unmarried Children;
  - No restrictions on end use;
  - Irrespective of the mode of processing/disbursal: Physical or Digital.
- Borrower Indebtedness: Defined as 'the ratio of total loan repayment obligations to income ratio for the HH' and a maximum of 50 per cent is allowed. Earlier only NBFC-MFIs had to conform to the cap on the number of lenders and on loan outstanding.
- Cap on the pricing of loans applicable only to NBFC-MFIs removed.
- Board-approved policies to govern:
  - Method of household income assessment;
  - Limit on the ratio of 'monthly loan obligations of the household and monthly household income' (maximum 50 per cent);
  - Pricing of microfinance loans;
  - Policies regarding conduct of employees and system for their recruitment, training and monitoring.
- Credit Bureau: The following were made mandatory for REs
  - Submission of HH income data
  - Submission of 'Loan Obligations To Income Ratio'
  - Use of credit bureau report to calculate HH indebtedness.



Further, the distinction between rural and urban has been removed which is the right step as with migration and interlinkages the boundaries between rural/urban often get blurred. As such households in rural areas would not be disadvantaged with lower credit limits despite having a higher capacity to pay. The total loan repayment obligations to income ratio of a maximum of 50 per cent of a household's income is a better approach to the indebtedness issue, unlike the earlier method of a limited number of lenders and fixing a cap on loans outstanding & that too only for NBFC-MFIs. The inclusion of board-approved policy on HH income assessment and HH level credit bureau checks to estimate the loan repayment obligations to income ratio adds robustness to the process and would ensure that clients are protected from overlending and in a way lead to timely repayments of loans and good portfolio quality.

Finally, deregulation of the lending rates for microfinance loans will have a far-reaching impact on RE's sustainability and encourage healthy competition among them which in the medium to long term should bring down the lending rates. The new policy stipulates that all REs should have a board-approved policy on pricing, which will be subject to regulatory scrutiny and clients have to be given a fact sheet disclosing an all-encompassing APR (Annual Percentage Rate). This flexibility in pricing is expected to spur innovation, incentivise REs to reach excluded areas as they can price for risk and at the same time ensure transparency in pricing disclosures to the customers.

With the progressive building of digital infrastructure building in the form of credit bureaus, universal bank accounts, digital payments, conducive regulation and diversified regulated entities (REs) operating in the micro-credit space, the sector is all set to unleash its potential in contributing to building an Inclusive India.

## 7. THE IMPACT OF MICROFINANCE

Going beyond these impressive numbers (Fig 2), several microeconomic studies have investigated the positive impact of microfinance on the borrowing household's health, education, income generation and consumption, on women's empowerment, and other non-economic benefits, namely, conflict resolution and social and political reconciliation (Johnson 2005, Grown 2006, Sanyal 2009, Huis et al 2017). However, as there was an absence of any macroeconomic study quantifying the contribution of microfinance to the Indian economy, MFIN commissioned a research project by the National Council of Applied Economic Research (NCAER).

**Box 2**

Contribution to Gross Value Added:

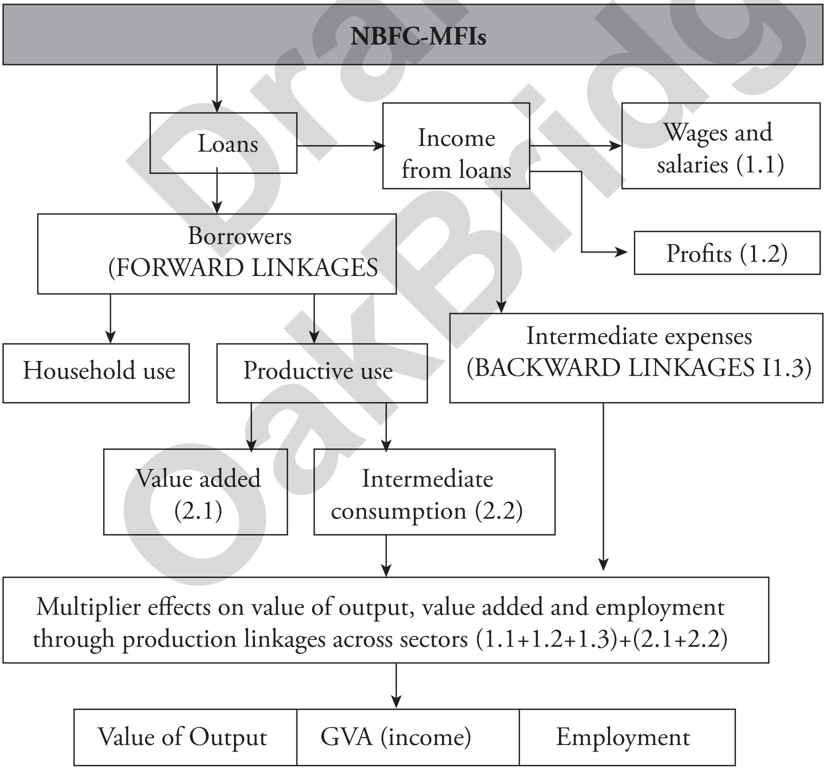
- Contribution of the direct, indirect backward and forward linkages of the NBFC-MFI sector: 0.61 per cent of national GVA.
- The contribution of microfinance sector as a whole including all entities: 2.03 per cent of GVA

Contribution to Employment:

- Impact through the direct, indirect backward and forward linkages of the NBFC-MFI sector: 38.54 lakh jobs.
- The contribution of microfinance sector as a whole, inclusive of direct, indirect backward and forward linkages and including all including all entities: 128.46 lakh jobs.

The study titled 'Present and Potential Contribution of Microfinance to India's Economy'[6] was a pioneering attempt to estimate the contribution of microfinance to the Gross Domestic Product (GDP) and employment in India. The study estimated contributions of the microfinance sector to the macroeconomy in 2018–19 to be 2.03 per cent of the Gross Value Added (GVA) while generating nearly 1.3 Crore jobs. These numbers are significant. The financial sector as a whole, including insurance, of which microfinance is a part, accounted for 5.5 per cent of GVA in 2018–19. While the microfinance delivery system is relatively small even within the formal financial sector of the economy, the important effects of microfinance include its forward linkages: the households and enterprises that use credit to add value through their production processes. When we consider the 'forward linkages' of the sector, which in turn, generate value addition and jobs, the significance of the microfinance sector in the economy is more appropriately captured. Figure 4 captures these linkages.

**Figure 4:** *The contribution of microfinance to the economy*






6. The full report can be accessed at https://mfinindia.org/Resources/studyreport

## 8. AN AGENDA FOR THE FUTURE: CONTRIBUTING TO BUILDING A $5 TRILLION ECONOMY

Before delving into the future agenda and the promise of microfinance, it is important to appreciate the dimensions of the current gap. To do so, we analyse the potential market for microfinance in India as well as the current outreach.

An estimation of the current outreach of microfinance in terms of the number of borrowers is a challenging exercise. Borrowers take loans from multiple providers and there is no unique identifier for a certain borrower. For example, a customer who has availed of a loan from a Scheduled Commercial Bank (SCB), could be shown under SHG figures also and could also have taken a loan from an MFI. To further complicate the matter, the SCB outreach figure is available as the number of accounts and one client could have multiple accounts. With this background, we consider the following data points:

- Lending under the JLG model (source: MFIN quarterly reports)
- Coverage under SHG-Bank Linkage Programme (source: NABARD reports)
- Small borrower account of Scheduled Commercial Banks (source: Statistics released by RBI)

The outreach figures as of Mar '22 are shown below

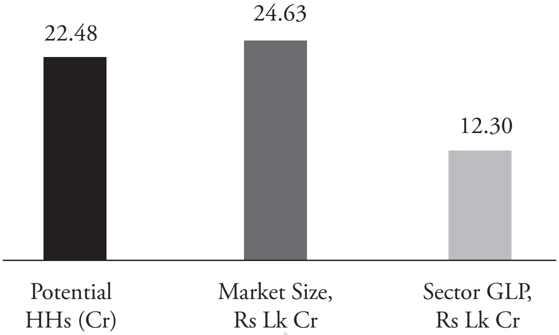
**Figure 5:** *Number of borrowers/accounts for different channels (Mar '22)*

| Channel/Lending Model | Number of Borrowers / Accounts (in lakh) | The amount outstanding (in crore) |
|---|---|---|
| SHG model | 578 | 1,51,000 |
| JLG model | 580 | 2,85,441 |
| SCB accounts (credit limit of ₹ 25,000 or less) | 555 | 41,382 |
| Total | 1713 | 4,77,823 |

Based on our field experience, the overlap between these three channels is in the range of 40-60 per cent. Taking an assumption of overlap of around 50 per cent, we estimate the outreach to be around 850 lakh borrowers.

Estimation of the total addressable microfinance market and demand is a factor of two variables: the number of HHs which qualify for a microfinance loan based on the annual income criteria and average credit demand of such a household keeping in mind the cap on 'total loan repayment to income ratio'. Using the census data from 2001 & 2011 and the Compound Annual Growth Rate (CAGR) observed over this period, we estimate the total potential microfinance HHs in India to be 20.32 Crore (as of March 2022). Additionally, we assess the credit demand based on the CAGR observed in the average loan outstanding per borrower during the period 2018 – 2022. We estimate the total current microfinance market size to be ₹ 10 lakh crore (21-22) which is expected to grow to ₹ 24.63 lakh crore by 2025-26.

**Figure 6:** *Estimated microfinance market size by 2025-26*




We triangulate the estimated outreach data with the findings of surveys done on rural indebtedness. NABARD Financial Inclusion Survey (NAFIS: 2016-17) reported that 22.7 per cent of rural households had at least one member associated with a microfinance institution. Nearly one-third of the HHs had a relationship with an MFI for more than 5 years The All India Debt & Investment Survey (AIDIA: January-December, 2019) found that the incidence of indebtedness was about 35 per cent in rural India. About 17.8 per cent of households were found to be indebted to institutional credit agencies only. These figures indicate that there is a substantial potential for the expansion of microfinance services to cater to the existing market. Using the survey findings and the number of HHs estimated above, we estimate the microfinance outreach to be in the range of 5.08 crore to 7.11 crore. HHs. Comparing the outreach data of borrowers and HHs, we get a ratio of borrowers per HH covered by microfinance in the range of 1.2-1.67.[7]

Based on the trends riding on features like fast adoption to client needs, doorstep delivery, adherence to a detailed set of regulatory guidelines on client protection and ably supported by the SRO, microfinance will be the key channel in meeting this unmet demand. This merits an examination of aspects that make microfinance suitable to bridge the gap. The following section examines both opportunities and issues.



## 8.1 Technological innovations and their adoption

Multiple development in the larger financial ecosystem will support the continued growth of the microfinance sector. The widespread use of digital payments is driving the change in consumer behaviour towards increased comfort with

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7. Microfinance Potential Estimated HHs (2022) : 20.32 cr. Indebtedness at 25per cent/35per cent translates to 5.08 cr /7.11 cr HHs. Taking the estimated 850 lac borrowers, the ratio of borrowers/HH is 1.67/1.2 which seems feasible.

digital financial transactions. UPI (Unified Payments Interface) has been the pivot around which a vibrant payment ecosystem has developed in India. More innovations allowing for cross-border remittances on the UPI platform are being developed. As an increasing number of transactions move to digital channels, it will create transaction histories which will support the development of newer ways of credit underwriting. Cash-flow-based lending is one such use case. Instead of the traditional way of looking at income and expense, it analyses the cash flows of a business which forms the basis of underwriting. As small and micro businesses become a part of the formal economy, such lending models hold a lot of promise. The initiative to issue an Udyam Registration number for all micro and small enterprises will further promote the formalisation efforts. Udyam is a permanent registration and basic identification number which requires only an Aadhaar number for its generation. The Udyam number will help such enterprises benefit from government schemes. Loans given to enterprises linked to an Udyam number will qualify for priority sector lending for banks. The Account Aggregator[8] framework promises to make the process of accessing and sharing one's financial data secure and fast.

MFIs (Microfinance Institutions) have been increasingly adopting technology to enhance operational efficiency, improve underwriting models and, reduce expenses while continuing the focus on customer centricity. Keeping in mind the low-income, low-literacy levels of microfinance borrowers, digitalisation initiatives have been aligned to the rapid diffusion of smartphones and the growing comfort of borrowers with digital modes of transactions. Improvements in internal processes of MFIs aided by digitisation have improved the timeliness and quality of data being submitted to the Credit Bureaus. This has a direct impact on the improvement in the quality of underwriting as well as the turnaround time for processing loan applications. Borrowers now have multiple channels available to them for registering their grievances. Field teams have online access to data like the status of an application or a grievance and can offer better customer service. Faster access to relevant data also equips the Self-Regulating Organization (SRO) to conduct better surveillance and be able to identify issues related to customer protection. Increased adoption of digital payments would also lead to better capital efficiency for the MFIs as well as reduce operational costs.

The adoption of any innovation follows a typical S-curve. There are a small number of people who start using a new product or process. Over time, as the word of mouth spreads, more people try the innovation. Once the critical mass of users is reached, the speed of adoption increases rapidly. Many of the initiatives



8. Account aggregators (AA) are RBI approve entities which helps an individual securely and digitally access information from one financial institution where they have an account to any other financial institution in the AA network.

mentioned above will become widely adopted over the next few decades. This will give an impetus to further deepening of microfinance. The microfinance sector is well-poised to leverage the evolving technologies optimally for providing better products and efficient customer service.

## 8.2 Supportive Regulations and Role of SRO

The new regulations for microfinance released by RBI in March 2022 have moved away from entity-based regulations to an activity-based regime and in doing so provided a useful case study of how a regulatory regime may adapt naturally in response to changing market dynamics, industry self-regulation, consumer evolution, technology diffusion, and the emergence of sector-specific institutions. These regulations put all the different microfinance providers on the same footing and positioned the industry for the next phase of growth very well. The announcement has been welcomed by all stakeholders, but it also requires the sector to display nimbleness, notably in monitoring compliance with the new standards not just at the business level but also at the credit bureau and SRO levels. As we know, for long-term sustainability, efforts at expanding market reach must be accompanied by an intense focus on customer education, transparency and protection.

The Code of Conduct (CoC) for the microfinance industry released in October 2022 provides a robust framework for customer protection. The CoC incorporates elements of Universal Standards of Social Performance Management (USSPM), Client Protection Principles (CPP) and sector best practices. Its implementation will position the sector well for future growth. Digital processes are being widely adopted by microfinance lenders to improve process efficiency and customer experience. At the same time, the speed of adoption and the level of comfort with digital interactions might differ across borrowers. The lenders should keep this aspect of customer adoption in mind and ensure that adequate measures are taken in terms of training and grievance redressal when introducing such initiatives. COVID-19 had an impact on the discipline of weekly meetings and consequently negatively impacted customer engagement. The thrust towards the digital collection of repayments also seems to have reduced the need to attend weekly meetings. Frequent meetings with the customer are one of the pillars of MF lending process. Lenders would need to continue to focus on institutionalising this practice and prevent its dilution. However, it should be mentioned that the revival of collections has been greatly aided by digital repayments. Although 98 per cent of payments is made cashless, collection by digital methods climbed from 5 per cent in the pre-pandemic era to 13 per cent in Q4 FY 21-22, enabling speedier recovery and more consumer comfort.

## 8.3 Educating clients about "app-based lending"

Although digital modes increase process efficiency, they also give rise to the possibility of borrowers falling victim to fraudsters. The rapid growth of digital lending apps has increased these risks. The recently released RBI regulations regarding such activities are a positive step.

As the industry is going through these wide-ranging changes and adjusting to a new normal, customer grievance redressal is going to be of pivotal importance. The modularisation of product delivery and customer service has been seen to impact customer experience. The lenders would have to be mindful of the aspects of customer interaction and protection which they continue to manage in-house. At the same time, rapid advancements in Artificial Intelligence (AI) applications in this area promise an enhanced experience for customers. Lenders would have to plan the adoption of such tools to improve their customer centricity.

## 8.4 Avoiding geographical concentration

The sector also needs to be cognisant of the possible risks arising out of portfolio concentration and the opportunity provided by the underpenetrated districts. When the top 10 states are examined at the state level, they account for 82.4 per cent of total GLP as of 31 March 2022. Analysis at the district level reveals that activities are concentrated in the top 300 districts, which account for over 88.1 per cent of total GLP. From a geographical risk management standpoint, the data reveals that there are around 333 districts where the depth of outreach is less than the national average and much less than the top 300 districts, and where FIs can consider increasing operations.

Economic and geographical factors and the comfort derived from 'being where others are present' are the reasons for the skewed growth of the sector. The earlier cap on interest rates also could be a factor in restraining risk-taking involved in venturing into newer geographies. With the new regulations allowing flexibility to the lenders to design policies to respond to such situations, it is expected that the microfinance lenders would expand to newer areas and also be innovative in their product offerings. This would increase the depth and breadth of the availability of microfinance.

In summary, a supportive regulatory regime, encouraging changes in consumer behaviour, improvement in efficiency due to the digitalisation of processes, and the promise of continued economic growth present a picture of an exciting future. The microfinance model is well-positioned to benefit from these trends over the coming decades by continuing its focus on customer centricity. If the above aspects are kept in mind, and the responsible growth of microfinance covers 10 Crore more clients by 2030, it will be a humongous contribution to building a US$5 trillion economy. Pertinently, it will be a broad-based economic growth, wherein the rising tide will lift all boats.

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