



Microfinance in India: Relevance of Current Delivery Mechanism and a Road Map to Propel Prosperity

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ABSTRACT

Microfinance Institutions (MFIs) have long been a primary bridge to finance the ‘unbanked’ since their inception in the early 1990s. As of September 30, 2025, the total portfolio outstanding reached ₹2.90 lakh crore, supporting over 9 crore active loans and 5.5 crore unique borrowers (RBI 2025). Microfinance has always run in cycles of downturn and recovery, but history shows that the sector adapts and rebounds. The microfinance industry, a vital support for the rural population, is undergoing a structural transition and currently facing challenges owing to rising bad loans and overleveraging. India’s microfinance faced the sharpest decline with YoY de-growth of 10.8% driven by rising NPAs & delinquency rates (CRIF). Several structural issues are driving the current de-growth. The microfinance landscape in India is dominated by two primary delivery models, underpinned by collective guarantees: the Self-Help Group (SHG) model and the Joint Liability Group (JLG) model. This model has historically been successful, delivering high repayment rates and profitable loan portfolios. However, the relevance of these models is in question, marked by regulatory guardrails, deliberate portfolio reforms, changing borrower demographics, rising digital adoption, and a shift away from traditional group-based lending to individual lending.

This research paper is an endeavour to explain the relevance of the current delivery mechanism of microfinance and highlight the current scenario. The paper concludes the strategic actions that are required for the microfinance sector at the crossroads to achieve a more robust, data-driven ecosystem that continues to empower marginalised borrowers,

especially women, for whom MFIs remain the most accessible path to formal credit.

Keywords: Microfinance, SHGs, Financial Inclusion, Digital Transformation.

1. INTRODUCTION

India's vision of a \$5 trillion economy mark is not achievable without inclusive growth. The microfinance industry supports unbanked borrowers through small credit, savings and insurance, aligning with India's priority sector lending goals under RBI guidelines. Besides financial inclusion, the sector aims for socio-economic development of the country.

A Micro Finance Institution (MFI) is one type of NBFC that caters to the financial needs of the poorer section of the country, mainly the rural population. The Reserve Bank of India is the sole regulator for this institution. The main purpose of promoting and enhancing such institutions is to uplift the poorer section of society and further financial inclusion in the system. Financial institutions involved in microfinance enable livelihood promotion and women's empowerment via SHG-bank linkages. In order to build resilience in rural economy schemes, such as Mudra Yojana, PM SVANidhi, and the Lakhpati Didi scheme, have also converged with microcredit to promote livelihood initiation and entrepreneurship.

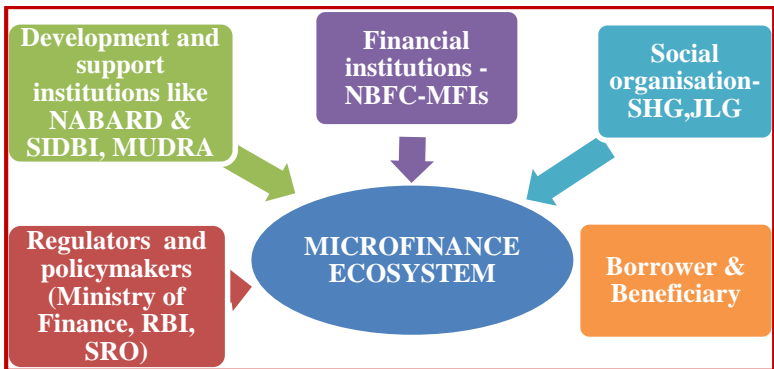


Figure 1.1 Key participants in the microfinance ecosystem
Source: Author Compiled

Since this sector mainly deals with the poorer section of society, over-indebtedness by such borrowers is a common and serious challenge

faced by this sector. Borrowers are in constant need of money, and thus, they resort to borrowing from all possible sources.

The total outstanding loan of the microfinance sector reached ₹2.90 lakh crore, supporting over 9 crore active loans and 5.5 crore unique borrowers. Every few years, the microfinance sector gets into crises, every time with the same reason: high interest rates, multiple lending and coercive recovery practices. Microfinance, since its inception, has been serving millions of people. Several plans are implemented, focusing on development in the rural economy. Policy-driven growth in the rural sector over the last decade has made a shift towards diversified income and consumption. In the current perspective, certain issues have caused stress in the microfinance sector and decelerated its growth. Over the past year, since Covid pandemic, the Microfinance industry has made a significant shift as an outcome of macroeconomic changes post Covid-19 and regulatory norms by the RBI. In FY2025, this sector has marked a significant slowdown (Sa-Dhan chart)

Digital lending has emerged as a transformative force in strengthening the sustainability of microfinance. By streamlining processes and expanding outreach, it enhances efficiency and financial inclusion. At the same time, it introduces new risks, particularly the potential for over-indebtedness that require vigilant management. In India, digital lending is increasingly seen as a complement to traditional microfinance models, especially in light of regulatory changes taking effect in 2026. Positive Impacts are Operational Efficiency, Expanded Outreach, Financial Sustainability Risks and Considerations. While digital lending offers clear benefits, it also raises concerns about borrower over-indebtedness due to easier access to credit. Effective monitoring, borrower education, and regulatory oversight are essential to balance innovation with responsible lending practices.

2. LITERATURE REVIEW

Only small segment of world population has access to mainstream financing. Microfinance is the way to make financial services available to those unbanked poor people who require small credit support to fund their activities for livelihood (Marzys 2006). It is not cost-effective for formal financing institutions to lend to marginalised business activities. Also, lending to the poor involves high transactional costs, associated assessment risk and moral hazard. (Stiglitz and Weiss, 1981). Research studies from various countries provide important insights into the impact

of microfinance. People widely regard microfinance, which originated in Bangladesh, as a successful model, especially for empowering women (Karim, 2011). The SHG-Bank Linkage Programme and Joint Liability Group changed the delivery dynamic by enabling collateral-free loans through collective guarantees. By 2020, more than 10 million SHGs had been linked to banks, making this the largest microfinance programme in the world (Reserve Bank of India, 2020). Tanwar (2018) in their study analysed the growth of microfinance in India and also examined the role of development financial institutions in strengthening the SHGs. This paper concludes the crucial role of microfinance in financial inclusion and highlights its shortcomings. Biswas (2022) analyses the overall impact of microfinance in the inclusive development of the country under some parameters and states a robust growth of the rural client base post 2020 pandemic. A study during the same period describes the underscored vulnerabilities within the microfinance sector, exposing risks such as loan defaults and declining client engagement (Posel et al., 2021).

The technology adoption in the microfinance industry is accelerating with eKYC, AI-based credit assessment and tracking, improving collection and customer service. Santos (2023) studied the growth of digital payments in the Philippines and emphasised the change in the financial landscape and client accessibility through the internet. In a similar study, Cui et al. (2021) examined the importance of mobile technology in enhancing client service and product penetration. However, the adoption of technology exposes the sector to risks and challenges like transparency gaps, fraud risks, and limited equitable distribution of financial services (Sarpong-Danquah et al., 2023).

Previous studies show a direct link between the financial stress of MFIs and the overleveraging of borrowers. The evolving credit behaviour leads to an overburdened borrower who borrows beyond their repayment capabilities. Regulatory frameworks play a pivotal role in shaping the success of MFIs. Morshed et al. (2020) and Villanueva (2021) underscored the necessity of unified guidelines and reshaping the operational model to promote transparency, consumer protection, and standardized practices with changing market dynamics.

3. RESEARCH METHODOLOGY

To conduct a comprehensive study on the topic of the microfinance models operating in India and its ecosystem, a descriptive research method was used. Extensive research was conducted to explore the current scenario of the small finance delivery mechanism in India.

Various sources, such as scholarly publications, articles, online databases, and company platforms, were utilized to compile relevant information on the subject.

Objective of the study

- To study the relevance of the present microfinance model in India and to describe the significance of SHGs and JLG.
- To highlight the reasons for the slowdown in the microfinance sector and to study the challenges for the growth of the sector.
- To understand the changing landscape of microfinance in India.

4. ANALYSIS AND DISCUSSION

4.1 Current Landscape of the Microfinance Sector

As of year-end FY2025, the total microfinance loan accounts stood at ₹1,399 lakhs (YoY decline of 13%), with a total outstanding value of ₹3,81,225 crore (YoY decrease of 14%) (Sa-Dhan report). The sector witnessed the recent phase of consolidation.

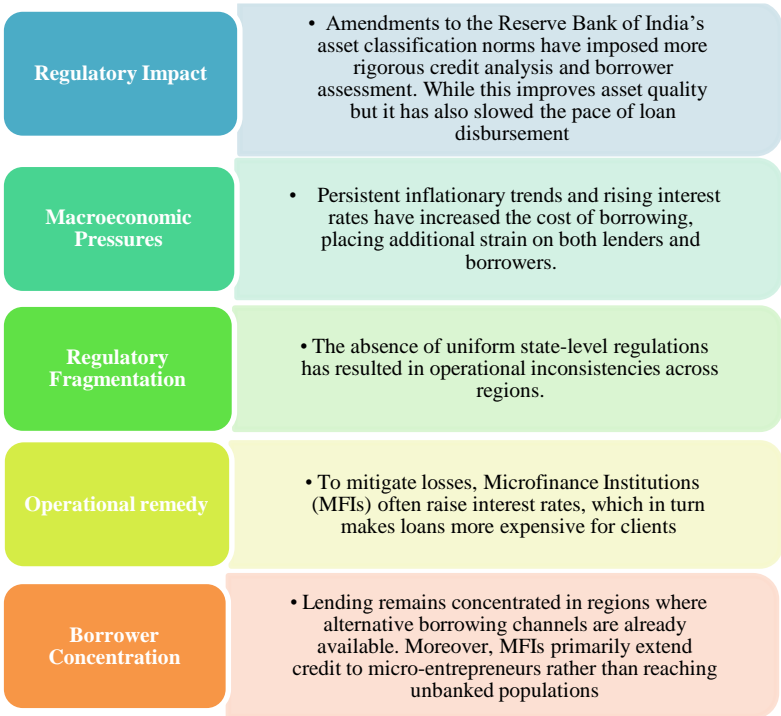


Figure 1.2 Reasons for this slowdown
Source: Author Compiled

Nearly 50% of the loan disbursement in the microfinance sector is contributed by NBFC-MFIs, largely because of their specialized priority for micro lending and penetrated reach, utilising SHGs delivery channels. RBI report 2024 highlighted that the average loan of existing borrowers has risen significantly, evident from the data that although the total loan disbursement has grown at a CAGR of 22.1% in FY 2024, the number of new borrowers has increased only by 6.9%. At the same time, business Challenges, digital adoption, and market dynamics are evolving to drive a new trend of growth and sustainability in the sector.

4.2 Primary delivery mechanisms of microfinance

Since its inception, the delivery mechanism of microfinance in India has been primarily dominated by two socially driven models: the Self-Help Group (SHG) model and the Joint Liability Group (JLG) model. SHGs is saving led social model consisting of 10-20 members with an objective of collective loan and skill building. SHG has been instrumental in

generating sustained annual income for rural women & long-term poverty alleviation. Primary lenders for SHGs are NABARD and DAY-NRLM. The effectiveness of SHG is the financial inclusion and socio-economic upliftment of the unbanked marginalised population. DAY-NRLM has mobilised 10.05 crore women into more than 90.9 lakh SHGs across India (SA-DHAN 2025).

JLG is a credit-led model providing an individual loan backed by a mutual group guarantee. Typically, the size of members is 4-10 and is primarily driven by NBFC-MFIs. The core objective of the model is operational efficiency, allowing for faster loan disbursement. The effectiveness of the JGL is in the commercial scaling of income-generating activities relevant for micro entrepreneurs and landless farmers, with the total Rs 3.81 trillion amount of loans disbursed in 2025.

The Relevance of these traditional group lending models has become challenging on account of deteriorating asset quality and delayed repayments. Group size is diminishing, and collection cost is rising owing to the changing approach from group lending to individual lending.

4.3 Challenges and Issues

- A high Rate of Interest Charged by the Company (MFI): MFIs charge a very high rate of interest to the borrowers as compared to commercial banks, which are more mature and have a diversified portfolio of collateral-based lending. Borrowers of micro credit generally have no options to access the fund. Such high interest may lead to default in payment by borrowers.
- Dependence on the Banking System for the Funding for Business: The majority of the MFIs are dependent on financial institutions such as commercial banks for their funding requirements. Around 80% of their fund requirements have been met through banks, leading to a high burden and shrinking profit margin. Such over-dependence on banks makes MFIs incompetent and less reactive towards the recovery of dues.
- The Absence of knowledge of the concept of MFIs: Lack of proper knowledge and awareness of operations and financial services given by the MFIs is also a challenge for both prospect borrower and MFIs. This factor is the main hindrance for the rural population to work with MFIs to meet their funding needs.

- **Multiple Borrowings and heavy Indebtedness:** A borrower gets small credit from several lenders, and heavy indebtedness is a major cause of concern for MFI's smooth functioning. The inefficient risk management by borrowers makes MFIs open to credit risk and further increases the cost of monitoring the portfolios. As MFI lends to borrowers without collateral which often results in bad debts and financial loss to MFI.
- **Regulatory Framework Issues Faced by MFIs:** Imposing stringent regulatory norms has improved the asset quality and helped the industry greatly, but has slowed the performance and development of new financial products and services by which the rural population can be benefited.
- **Challenge in Identifying an Appropriate Lending Model:** Microfinance Institutions (MFIs) in India predominantly rely on either the Self-Help Group (SHG) model or the Joint Liability Group (JLG) model. However, the choice between these models is often subjective rather than guided by scientific or situational analysis. Once a model is adopted, it is rarely revisited or adjusted, which creates structural rigidity.

4.4. Evolving Trends in the Microfinance Industry

While SHG & JLG models are effective, both face challenges from current market dynamics, primarily due to the shift to Individual Lending. Traditional group accountability is weakening, and borrowers increasingly prefer direct lender relationships supported by digital footprints like UPI and mobile applications. Microfinance is shifting from collective credit solidarity to an individual assessment approach. Group sizes have reduced, and the centre has become a sourcing and collection channel rather than a client engagement mechanism. The traditional model, where sourcing is achieved through collective gatherings, is gradually losing influence as digital onboarding and exposure checks produce a more accurate view of an individual's cash flows and repayment capacity. MFIs are now more flexible in terms of repayment terms and sourcing, leveraging digital channels and personal customer connections. Other evolving practices in the sector are-

- **Digital Transformation:** The most significant aspect in India is the availability of a smartphone to rural households, allowing MFIs to move toward paperless onboarding and digital transactions to reduce high operational costs.
- **Regulatory Constraints:** Stricter regulatory measures have been introduced to mitigate the risk of over-indebtedness. These include capping a borrower's total outstanding exposure at ₹2

lakh and limiting access to credit from no more than three lending institutions.

- Demographic shift: initially grassroot MF organisations prioritised women borrowers but now the focus has shifted towards holistic family financial inclusion.

Shift from the core principles of social objectives to economic/ profit objectives-

4.5. Future outlook of the sector

Risk Management as a Priority: Small Finance Banks (SFBs) with significant exposure to microfinance, such as Ujjivan, Suryoday, and ESAF, are increasingly adopting a “risk-first” approach. This involves a strategic shift toward collateral-backed lending, including gold, housing, and vehicle loans, to safeguard asset quality and minimise further deterioration.

Regulatory Developments: The Reserve Bank of India (RBI) has recently introduced new regulatory measures, effective April 1, 2026, covering lending to related parties and co-lending arrangements. These amendments aim to strengthen transparency, enforce risk-sharing (requiring both lenders to retain at least 10% of the risk), and establish a single point of contact for borrowers, thereby fostering a more accountable and transparent lending ecosystem.

Digital Transformation and AI Integration: Technology continues to be a critical driver of growth. Financial institutions are leveraging artificial intelligence to enhance credit modeling, automate customer service, and improve collection efficiency. These innovations not only reduce operational costs but also support compliance and strengthen risk management practices.

Market Dynamics and Growth Outlook: The sector is projected to experience moderate expansion in the near term, with assets under management (AUM) for NBFC-MFIs expected to grow by 8–12% in FY2026. Larger institutions are well-positioned to secure funding, while smaller and mid-sized players face capital constraints, potentially accelerating consolidation within the industry.

Long-Term Prospects: Despite short-term challenges, the long-term outlook remains robust. The sector’s deep penetration into underserved

rural markets, combined with a strong regulatory framework, provides a solid foundation for sustainable growth and financial inclusion.

5. CONCLUSION

The Sustainability in MF industries lies in building a resilient, data-driven analytical model that integrates operational efficiency with the core objective of serving the marginalised segment and society. As of January 2026, India's microfinance industry is undergoing a critical phase of transition. The sector is balancing the benefits of regulatory reforms and rapid digital adoption against persistent challenges in asset quality and funding constraints for smaller institutions. While several lenders report rising business volumes and improved repayment performance, the overall outlook remains cautiously optimistic, with the industry working to strengthen its foundations for long-term resilience. Microfinance continues to play a vital role in advancing financial inclusion, particularly among rural and low-income households during the ongoing economic recovery. However, issues such as borrower over-indebtedness and regulatory pressures have placed stress on operations, underscoring the need for targeted corrective measures. A growing emphasis on digital profitability risks diverting focus away from poverty alleviation, thereby weakening the sector's social impact.

6. RECOMMENDATION

- **Strengthening Regulation:** Enhance RBI's NBFC-MFI framework by enforcing stricter caps on borrower indebtedness and mandating approved lists of digital lending platforms.
- **Financial Literacy & Inclusion:** Expand literacy initiatives and borrower re-entry programs to improve client sourcing, retention, and repayment discipline.
- **Technology for Efficiency:** Promote digital tools to streamline processes and reduce costs, while ensuring robust client protection mechanisms.
- **Funding Diversification:** Encourage impact investment and facilitate market consolidation to support smaller MFIs facing capital constraints.
- **Community-Based Solutions:** Scale up Self-Help Group (SHG) federations to provide micro-insurance and capacity-building programs, thereby enhancing sustainability and resilience.

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