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Review on Micro Finance Models: Role of Indian Banks in Providing Microfinance in India

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Abstract

The study examines the pivotal role of the banking sector in providing microfinance in India, emphasizing its contribution to financial inclusion and economic empowerment. It reviews various microfinance models adopted by Indian banks, such as the Self-Help Group (SHG) Bank Linkage Program, Joint Liability Groups (JLG), Pradhan Mantri Mudra Yojana (PMMY), and Business Correspondent (BC) models, all of which have expanded access to financial services for underserved populations. The research explores the motivations behind banks' involvement in microfinance, including fulfilling Priority Sector Lending (PSL) obligations and engaging in Corporate Social Responsibility (CSR) initiatives. These factors encourage banks to provide credit to economically weakened sectors, aligning their financial goals with broader social objectives. However, the study also highlights several challenges faced by Indian banks in microfinance operations. High operational costs, such as extensive documentation and personalized customer service, pose a significant hurdle to profitability. Additionally, borrowers often lack collateral or have unstable income streams, increasing the risk of default. Regional disparities, including poor infrastructure and low literacy rates in rural areas, further complicate microfinance delivery. Technological barriers, such as limited digital infrastructure, hinder the scalability of microfinance initiatives. By evaluating these models, motivations, and challenges, the study provides insights into the banking sector's role in promoting inclusive economic growth. It underscores the importance of innovative strategies, regulatory support, and targeted interventions to overcome barriers and ensure the sustainable growth of microfinance in India.

Keywords: *Micro Finance, Indian Banks, Self Help Group Bank Linkages Program (SHG-BLP), Pradhan Mantri Mudra Yojana (PMMY).*

1. <u>Introduction</u>

1.1 Background of Microfinance

Microfinance represents a specialized stratum within the financial services sector, meticulously designed to address the exigencies of economically marginalized individuals and nascent micro-enterprises, predominantly within the socioeconomic frameworks of developing nations. The primary goal is to enable these groups, reduce persistent poverty, and drive economic growth by providing access to financial services that are often overlooked or inaccessible through conventional banking systems. Microfinance institutions (MFIs) operationalize this mandate through the provision of a diverse array of services, including microcredit (characterized by small-scale loan disbursements), micro savings mechanisms, micro insurance products, and remittance facilities. These services are intricately tailored to accommodate the unique financial constraints of low-income clientele, who typically lack collateralizable assets and possess limited access to formal financial infrastructures. A prevalent operational strategy employed by MFIs is the group lending model, wherein borrowers form cohesive units that collectively guarantee loan obligations, thereby mitigating institutional risk and enhancing repayment efficacy. Empirical studies have demonstrated a positive correlation between microfinance interventions and outcomes such as poverty reduction, the enhancement of women's socioeconomic agency, and the stimulation of localized economic activity. The microfinance industry, however, faces its own set of challenges and criticisms, such as issues related to high interest rates, the risk of trapping borrowers in cycles of debt, and cases where its effectiveness has been limited in certain situations.

Within the Indian financial landscape, the role of banks in the microfinance sector has undergone a profound transformation, evolving from a peripheral engagement to a position of strategic centrality. Historically, traditional financial institutions exhibited a pronounced reluctance to engage with microfinance, perceiving it as a high-risk, low-return domain due to the small-scale nature of loan disbursements, the absence of conventional collateral, and the perceived credit unworthiness of the target demographic—primarily economically disadvantaged populations in rural and semi-urban areas. This systemic exclusion created a vacuum that was exploited by informal moneylenders and predatory lending practices, often characterized by usurious interest rates and exploitative terms. This policy shift catalyzed the gradual integration of microfinance into the operational frameworks of banks. Initially, banks operated primarily in a wholesale capacity, channeling funds to microfinance institutions (MFIs), which subsequently disbursed these resources to end borrowers. However, the RBI's evolving regulatory framework has progressively enabled banks to engage more directly with the microfinance sector. This has given rise to innovative models such as the Business Correspondent (BC) model, which leverages local agents to deliver microfinance services at the grassroots level, and the Self-Help Group (SHG) Bank Linkage Programme, which establishes formalized connections between informal women's collectives and banking institutions. Through these multifaceted approaches, banks in India have significantly expanded the reach of microfinance, providing access to credit and other essential financial services to previously excluded populations, thereby playing a critical role in advancing financial inclusion and fostering sustainable economic development.

1.2. Definition and Importance of Micro Finance

Microfinance involves providing a range of financial services, such as small loans, savings accounts, insurance options, and remittance solutions, to low-income individuals and small-scale entrepreneurs who typically lack access to traditional banking services. This exclusion often stems from their constrained income levels, absence of collateral, and the perceived high-risk nature of their financial profiles. The significance of microfinance is underscored by its capacity to empower marginalized groups, particularly women, by equipping them with the resources necessary to initiate or scale small-scale enterprises, enhance their quality of life, and break free from the cycle of poverty. Through the provision of accessible credit, microfinance facilitates investments in income-generating ventures, asset acquisition, and the development of financial resilience among underserved populations. Additionally, it promotes financial inclusion by integrating previously unbanked individuals into the formal financial ecosystem. Beyond individual empowerment, microfinance stimulates local economic growth by fostering entrepreneurial activities, generating employment opportunities, and amplifying economic engagement at the grassroots level. While microfinance is not a universal solution to poverty, it serves as a vital instrument in creating pathways for socioeconomically disadvantaged individuals to elevate their living standards and contribute meaningfully to their communities.

1.3. Research Objectives

- To understand the concept of Microfinance in India.
- It will explain the various models of micro finance provided by Indian banks.
- It also explain the factors that motivate the Indian banks to micro finance.
- It also explain the challenges that Microfinance faces and suggests some recommendations.

2. Literature Review

2.1. Overview of Previous Study on Micro Finance

Microfinance has been widely recognized for its role in empowering women, particularly through self-help groups (SHGs). Kabeer and Subrahmanian (2005) highlight that microfinance enables women to gain economic independence, enhance their decision-making autonomy, and challenge traditional gender norms. In Kerala, the Kudumbashree program has demonstrated significant success in empowering women through microfinance, leading to improved household incomes and social status (Prakash and Shanmugam, 2015). However, Garikipati (2012) cautions that microfinance alone cannot address deep-rooted gender inequalities and may sometimes reinforce existing power dynamics within households.

Microfinance has been instrumental in reducing poverty by providing access to credit for income-generating activities. Puhazhendi and Satyasai (2001) found that SHG-based microfinance programs in Tamil Nadu significantly improved household incomes and asset accumulation. Similarly, Banerjee (2015) used randomized controlled trials (RCTs) to demonstrate that microfinance positively impacts poverty alleviation, particularly when combined with financial literacy programs. However, Bateman (2010) argues that microfinance can sometimes perpetuate poverty cycles due to high interest rates and over-indebtedness.

Microfinance has played a critical role in rural development, particularly in agriculture and livelihood generation. Deshpande and Sharma (2016) found that SHGs in Maharashtra significantly improved farm productivity and rural incomes. Sriram and Upadhyayula (2004) highlighted the success of the SHG-Bank Linkage Programme in Andhra Pradesh, which enabled rural households to access credit and invest in income-generating activities. However, regional disparities in microfinance penetration remain a challenge, with states like Bihar and Uttar Pradesh lagging behind Kerala and Tamil Nadu (IIBF, 2022).

One of the major criticisms of microfinance is the risk of over-indebtedness among borrowers. Guerin et al. (2012) found that multiple borrowing and high interest rates can lead to unsustainable debt cycles, particularly among low-income households. Bateman (2010) argues that the commercialization of microfinance has exacerbated this issue, with some MFIs prioritizing profits over social impact. These findings underscore the need for responsible lending practices and stronger regulatory oversight.

Microfinance has been a key driver of financial inclusion in India, particularly through the SHG-Bank Linkage Programme and the Business Correspondent (BC) model. The World Bank (2023) highlights that these initiatives have enabled millions of unbanked individuals, especially in rural areas, to access savings accounts, credit, and insurance products. However, Kumar and Mishra (2019) emphasize that financial literacy is critical for the success of microfinance programs, as it enables borrowers to make informed financial decisions.

The integration of technology has revolutionized microfinance delivery in India. Ghosh and Vinod (2020) highlight that digital platforms and mobile banking have reduced transaction costs and improved access to financial services, particularly during the COVID-19 pandemic. The use of fintech innovations, such as blockchain and digital lending platforms, has further enhanced the efficiency and scalability of microfinance programs (CGAP, 2023).

2.2. Identification of Research Gap

The role of Indian banks in microfinance is a critical yet underexplored area of research. While the existing literature provides valuable insights into microfinance as a whole, there is a significant gap in understanding how banks have shaped the microfinance landscape in India. Addressing these gaps through targeted research will provide a more comprehensive understanding of the challenges, opportunities, and impact of bank-led microfinance initiatives This will also inform policymakers, regulators, and practitioners in designing more effective strategies for financial inclusion and poverty alleviation.

There is a need for a dedicated study on how Indian banks have transitioned from being peripheral players to central actors in microfinance. This includes their operational models, challenges, and strategies for scaling microfinance services.

3. Research Methodology

3.1. Description of Research Design

This study is based on the qualitative analysis to create a better understanding of the above given objectives. Qualitative analysis is specially type of to understand the grounded theoretical framework.

3.2. Sources of Data

The data that is collected is based on the digital data available in various websites, blogs and other digital data based, to satisfy the above said objectives. If require quantative and qualitative data is to be collected from any government, non-government organization to increase the understanding of the topic.

3.3. Analysis Method

Study is based on grounded to method to find the relationships between various models and also various statistical tools is used to provide proper insights of the topic. Conclusion is drawn from the analysis of the data using analytical tools such as table, graphs etc.

4. Findings

Microfinance serves as a critical mechanism for extending minimal credit facilities to impoverished individuals and small-scale enterprises that are typically excluded from conventional banking and associated financial services. Given the limited outreach of the organized banking sector to marginalized communities and small entrepreneurs, the microfinance sector has emerged as one of the most rapidly expanding domains globally.

The operational frameworks of microfinancing and Informal lending in India are characterized by diverse models, each shaped by the source of funding and its allocation. These models, though distinct, exhibit a degree of interrelatedness, with most microfinance institutions (MFIs) adopting a hybrid approach that integrates multiple models. Below, we delineate these models in greater detail:

4.1. Self-Help Group-Bank Linkage Program (SHG-BLP)

The SHG-BLP model includes the formation of 10 to 20 members from a target community, organized along lines of gender, religion, political affiliation, or cultural orientation. Members contribute fixed amounts to a communal fund on a regular basis. After demonstrating consistent functionality over several months, the group establishes a linkage with a financial institution, which subsequently extends credit to the collective. The group assumes responsibility for loan repayment, leveraging social cohesion, peer monitoring, and peer pressure to ensure adherence to repayment schedules.

4.2. Joint Liability Group (JLG)

The JLG model facilitates access to credit for small-scale farmers and entrepreneurs through the formation of informal groups consisting of 4 to 10 individuals engaged in similar economic activities. These groups provide mutual guarantees for bank loans, enabling members to avail themselves of collateral-free credit. This model is particularly beneficial for marginal farmers, lessees, who often lack requisite security or margin to secure traditional loans.

The primary objective of JLGs Is to enhance credit flow to agricultural and farm-related activities, particularly for marginalized farmers and individuals who are typically excluded from formal credit systems. By eliminating the need for collateral, the JLG mechanism democratizes access to financial resources, fostering economic empowerment at the grassroots level.

4.3. Pradhan Mantri Mudra Yojana (PMMY)

The Pradhan Mantri Mudra Yojana (PMMY) represents a milestone of India's microfinance framework, aimed at addressing the credit needs of the "unfunded" by providing affordable financing to micro and small enterprises (MSMEs). The scheme offers collateral-free loans of up to ₹10 lakh, categorized into Shishu, Kishore, and Tarun tiers, tailored to varying business requirements.

PMMY aligns closely with the objectives of microfinance by prioritizing accessibility, particularly for women and marginalized communities. While loans under PMMY are disbursed through a range of financial institutions, MFIs play a critical role in extending credit to micro-entrepreneurs, especially in underserved regions. Since its inception, PMMY has facilitated the disbursement of trillions of rupees in credit, with a substantial proportion allocated to women entrepreneurs, thereby advancing financial inclusion. However, the scheme faces challenges, including non-performing assets (NPAs) and the need for more rigorous impact assessments. Despite these issues, PMMY has significantly bolstered the microfinance sector by providing essential credit access to micro-entrepreneurs, thereby catalyzing economic growth.

4.4. Business Correspondent (BC) Model

It started nearly two decades ago, the BC model is bridge the gap between formal banking services and unbanked populations. The BC model addresses these challenges by providing "doorstep banking services," thereby providing financial services to rural population.

Through partnerships with local agents, banks have extended their operational reach urban population and, offers services like cash deposits, withdrawals, and money transfers to remote populations. This method has proved to promoting financial inclusion, enabling millions of Indians to access banking services.

4.5. Partnerships with Microfinance Institutions (MFIs)

Collaborations between banks and MFIs constitute a strategic approach to expanding financial inclusion in India. These partnerships harness the complementary strengths of both entities, facilitating broader outreach, efficient service delivery, and enhanced impact on marginalized communities. Banks collaborate with MFIs to extend their reach, reduce operational costs, access specialized microfinance expertise, and fulfill priority sector lending obligations. Conversely, MFIs benefit from access to funding, enhanced credibility, technical assistance, and the ability to diversify their service offerings.

These partnerships manifest in various forms, including direct lending to MFIs, co-lending arrangements, utilization of MFIs as Business Correspondents, participation in credit guarantee schemes, and technology-driven collaborations. While precise data on the scale of these partnerships is challenging to aggregate, it is estimated that hundreds of MFIs in India are engaged in such collaborations, with bank lending to MFIs witnessing significant growth.

Banks are increasingly prioritizing due diligence and risk management in these partnerships, emphasizing responsible lending and client protection. Additionally, there is a growing focus on integrating technology to streamline operations and enhance service delivery. However, challenges such as risk management, information sharing, capacity building, and regulatory compliance persist
In summary, these models collectively underscore the dynamic and multifaceted nature of microfinance in India, highlighting its transformative potential in fostering economic inclusion and empowerment.

Factors That Motivate Indian Banks to Provide Micro Finance in India

This section of the study will explain the various factors that influence the micro finance as provided by Indian Banking system. The study examined the basically four factors that affect the micro finance in India. Each of these four factors is elaborated below.

- **Priority Sector Lending (PSL)**

The priority Sector lending is a kind of government intiative to care special sector of Indian economy. On 1st February 2014, the RBI started a regulation to mandates banks to proves financial loans to priority sectors at concessional interest rates. The PSL framework includes eight sectors: (i) Agriculture, (ii) Micro, Small, and Medium Enterprises (MSMEs), (iii) Social Infrastructure, (iv) Education, (v) Housing, (vi) Export Credit, (vii) Renewable Energy, and (viii) Other sectors.

Kline and Sadhu (2013), in their study titled "RBI Norms for Priority Sector Lending," explained that PSL is a government's initiative requiring Indian banks to grants approximately 40% of their total lending to these priority sectors. Microfinance is important tool for fulfilling this mandates by, compelling banks to extend credit to companies engaged in microfinance services.

- **RBI Roadmap for Village Coverage**

The Reserve Bank of India (RBI) has been at the forefront of efforts to promote financial inclusion, particularly in rural and underserved areas. One of its key initiatives is the RBI's roadmap for village coverage, which aims to ensure that banking services reach every village in India. This initiative plays a significant role in supporting microfinance activities and empowering economically weaker sections of society. Under the RBI's village coverage plan, the central bank has set specific targets to expand banking services to unbanked and underbanked regions. For instance, in 2010, the RBI mandated that banks cover all villages with a population of over 2,000 by March 2012. Data from the RBI's annual reports indicates that by 2012, over 74,000 villages with populations exceeding 2,000 had been provided with banking access. For smaller for smaller villages, the RBI encouraged the use of technology-driven solutions and the Business Correspondent (BC) model to ensure last-mile connectivity. As of 2021, more than 1.2 lakh BCs were operational across the country, serving as intermediaries to provide basic banking services in remote areas.

- **Divestment and Expansion Strategies**

The microfinance sector has increasingly become a focal point for banks as part of their divestment and expansion strategies. The microfinance sector has become an integral part of the divestment and expansion strategies of Indian banks. Initiatives like YES Bank's YES SAMPANN, SBI's SHG-Bank Linkage Program, HDFC Bank's SLI, ICICI Bank's rural banking efforts, Axis Bank's financial inclusion programs, and Bandhan Bank's microfinance focus demonstrate how banks are leveraging technology, partnerships, and innovative products to expand their reach and promote financial inclusion. These efforts not only diversify bank portfolios but also contribute to the socio-economic development of underserved communities. By continuing to invest in microfinance, banks can play a pivotal role in bridging the financial inclusion gap in India.

- **Corporate Social Responsibility (CSR)**

Many financial institution and banks provide the microfinance sector as part of their Corporate Social Responsibility (CSR). For example, Avanti Finance, a microfinance institution (MFI), was established by corporate entities as a CSR initiative. Similarly, NABFINS (NABARD Financial Services Limited), a subsidiary of NABARD, fulfill CSR obligations under the Companies Act, 2013. These programs focus on two broad areas: agriculture and microfinance, aligning with the regulatory requirements for CSR spending.

By channeling resources into microfinance, these institutions not only comply with CSR mandates but also contribute to socioeconomic development by providing financial services to marginalized communities. This dual focus on regulatory compliance and social impact underscores the growing intersection between CSR and microfinance.

Challenges Confronting Indian Financial Institutions in the Disbursement of Microfinance

- **Exorbitant Operational Expenditures**

The administration of microfinance loans with nominal amounts necessitates an intricate array of documentation, constant oversight, and bespoke customer service, rendering microfinance operations financially untenable for banking institutions.

- **Absence of Tangible Collateral**

Borrowers from economically marginalized sections often lack traditional forms of collateral, thereby exacerbating default risks and compelling banks to resort to unconventional risk-mitigating strategies such as collective lending frameworks.

- **Prevalence of Excessive Indebtedness and Fragmented Borrowing**

Individuals frequently accumulate debt from a diverse range of sources, including informal lenders and microfinance entities, thereby escalating repayment complications and amplifying the probability of default.

- **Regulatory Encumbrances**

Financial institutions are obligated to adhere to a rigid array of regulations, including mandates such as Priority Sector Lending (PSL) quotas and interest rate caps, which curtail their operational flexibility and diminish profitability within the microfinance sphere.

- **Geographical Disparities**

Regions with socio-economic challenges, such as Bihar and Uttar Pradesh, grapple with infrastructural inadequacies, limited educational attainment, and a general lack of financial awareness, hindering the penetration of microfinance services.

- **Technological Constraints**

Inadequate digital infrastructure in rural locales impedes the widespread adoption of digital platforms and financial technology solutions, constraining the scalability and efficiency of microfinance initiatives.

- **Elevated Credit Risk and Default Incidence**

Microfinance borrowers often possess erratic income sources and insufficient credit histories, resulting in heightened default rates and escalating financial risks for lending institutions.

- **Intense Competition from Microfinance Institutions (MFIs) and Informal Credit Providers**

Commercial banks face formidable competition from microfinance institutions and informal lenders, who frequently proffer more lenient and accessible lending options, thereby undermining the banks' market share.

- **Deficient Financial Literacy**

A substantial proportion of borrowers exhibit a marked lack of understanding regarding financial products and services, which often leads to improper utilization of loaned funds and difficulties in meeting repayment obligations.

- **Impact of Economic Disturbances**

Catastrophic events such as the COVID-19 pandemic have exacerbated existing financial vulnerabilities, resulting in widespread job losses and economic dislocation, which in turn, amplify defaults and diminish borrowers' repayment capacity.

- **Challenges in Achieving Sustainability and Profitability**

Maintaining a delicate equilibrium between social impact and financial viability remains an ongoing struggle for banks, as they endeavour to render their microfinance operations financially sustainable over the long term.

- **Inadequate Reach in Remote Regions**

The geographic isolation and poor infrastructural connectivity of rural and remote areas pose significant barriers to the establishment of a tangible banking presence, thereby impeding the effective delivery of microfinance services.

Mitigating these impediments requires a multifaceted approach, encompassing innovative strategic initiatives, regulatory reinforcement, advancements in technological infrastructure, and focused intervention programs aimed at fostering the sustainable expansion of microfinance in India.

5. Conclusion and Recommendations

The study emphasizes the profound and transformative impact of microfinance in promoting financial inclusion, empowering rural, untapped underserved communities, and fostering economic growth across India. Microfinance has emerged as an essential tool in bridging the financial gap by providing access to credit, savings, and other essential financial services to populations that have traditionally been excluded from mainstream banking systems. Indian banks, by embracing a variety of operational models such as the Self-Help Group-Bank Linkage Program (SHG-BLP), Joint Liability Groups (JLG), Pradhan Mantri Mudra Yojana (PMMY), and the Business Correspondent (BC) model, have considerably broadened their reach, enabling them to extend financial services to even the most remote and impoverished regions of the country.

Despite these significant strides, the study also identifies several persistent challenges that continue to hinder the full potential of microfinance in India. High operational costs, due to the need for extensive documentation, frequent monitoring, and the provision of personalized services, remain a major hurdle for banks. Additionally, regional disparities, especially in economically backward states with poor infrastructure and low literacy rates, create barriers to effective microfinance penetration. Technological limitations, particularly in rural and remote areas, further restrict the adoption of digital financial platforms, which could otherwise enhance the scalability and efficiency of microfinance services.

To overcome these challenges, the study calls for a concerted effort that involves the development of innovative strategies, the introduction of supportive regulatory measures, and the implementation of targeted interventions that address the specific needs of underserved regions and communities. By overcoming these challenges, microfinance can play an even more vital role in driving economic empowerment, improving livelihoods, and reducing poverty, ultimately fostering a more inclusive and prosperous society.

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