

In-Pro: Quarterly Dispatch on Financial Inclusion & Social Protection



IN FOCUS: NAVIGATING DEBT DISTRESS IN MICROFINANCE: DRIVERS, DYNAMICS, AND DIRECTIONS

5 mins read

Debt distress on the rise

While borrower distress is not new to the microfinance sector, the scale of the problem has escalated to one that can be characterised as a crisis. This marks a critical moment of reckoning for the sector, driven by factors across both supply and demand sides. The distress among borrowers lays importance on inquiry into structural issues, market practices, and regulatory frictions, as it threatens to undermine the promise of microfinance in India.

Drivers of Distress

In addition to the dynamics on both supply and demand sides, the current state is also an inherent aspect of cyclical credit markets resulting in times of boom and bust. It is, however, the practices on both the sides of the market that determine the nature and quantum of peaks in the cycle.

On the supply side, the sector is characterised by a continued focus on loan disbursements, rising competition among formal and quasi-formal lenders, and weak implementation of borrower suitability norms. The 2022 RBI regulations tried to bring greater flexibility and uniformity, but field studies show uneven adherence. While institutions are aware and accepting of the new norms, compliance is found lacking sometimes. For instance, the Fixed Obligation to Income Ratio (FOIR) rule is often implemented by many as a flat EMI cap, thus diluting its original intent. Loan product suitability in terms of size, pricing, and tenure is often considered a secondary issue (or not considered, at all) and the focus tends to be on disbursements and repayments mostly.

On the demand side, borrowers are increasingly depending on credit to meet various kinds of needs, including conspicuous consumption. Essentially, microcredit is often seen and used as a substitute for many other financial products, like insurance and savings, in addition to satiating needs and wants. Further, pressures to repay existing loans often manifests into fresh borrowings. Over time, a culture of over-lending and loan-churning emerged on the supply and demand side, respectively. This has led to unsustainable credit behaviours that eventually must correct, often in the form of a crisis.

Notes from a Field Study

Dvara Research conducted an in-depth field study in the summer of 2024, surveying over 1,100 customers of a major NBFC in Tamil Nadu and Odisha. The study explored not only the financial profiles of participants, including income, assets, and outstanding loans, but also delved into their subjective experiences of debt, the shocks they faced, and their sense of financial wellbeing.

A key focus was on the repayment and coping strategies that borrowers used to manage loan repayments. Respondents could identify with eight strategies, ranging from depleting savings, working extra hours, postponing expenses, and skipping festivals (representing the 'repayment strategies'), to pulling children out of school, foregoing medical care, selling or pawning assets, and borrowing to repay (the 'coping strategies').

The findings revealed that 72% of participants relied solely on repayment strategies, 18% used a mix of repayment and coping strategies, and 10% resorted exclusively to coping strategies. Notably, those who adopted coping measures often did so repeatedly, highlighting the persistent and acute nature of financial distress among a significant minority of borrowers.

What Needs to Be Done

A comprehensive response to the crisis must include immediate and medium-term actions that address both sides of the market. The first action ought to be to understand the true extent of distress, since distress sets in much before default in most cases. Thus, the RBI must assess and measure distress through borrower-centric indicators. Thereafter, revisiting implementation gaps in the current regulatory framework, and focusing on grievance redress, and increasing borrower understanding and awareness are key levers.

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In the long term, monitoring borrower distress must continue alongside a review of the key regulatory directives—especially those relevant to properly assessing household-level financial situation.

Conclusion

What was once envisioned as a transitory tool for poverty alleviation and a bridge to formal finance, has now become a permanent and significant fixture in the financial lives of many borrowers, especially those from low-income backgrounds. The risk of repeated crises will continue until debt distress is understood and addressed as both a structural and a cultural issue. The objective now must be to reimagine the role of microfinance and identify approaches such that the promise doesn't end up being a curse.

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“A multi-pronged approach to distress measurement is essential because over indebtedness is a complex, multifaceted experience for borrowers. By capturing self-reported indebtedness, consumption patterns, along with repayment and coping strategies, we gain a more nuanced and comprehensive understanding of debt distress. This method also highlights the importance of accounting for the shocks borrowers face, which can reveal whether repayment difficulties are truly beyond their control. Such depth is necessary to ensure that targeted interventions are both effective and empathetic.



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