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Microfinance needs reform more than credit backstops

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India's newly unveiled CGSMFI 2.0, a ₹20,000 crore credit guarantee scheme for microfinance, aims to revive credit flows to the stressed sector. Yet, in its current form, it only partially addresses the symptoms and largely ignores the causes.

India's microfinance sector is in downturn. Its total loan book shrank from ₹4.4 trillion to ₹3.2 trillion between March 2024 and December 2025, with nearly 13 million borrowers exiting the system in just a year. Four consecutive quarters of negative growth underline the depth of this slowdown. Unfortunately, this is not unprecedented. Roughly every five years, the sector enters a phase of stress, as seen in Andhra Pradesh in 2010, nationwide in 2016, eastern India in 2019-20, and now the current episode.

The prevailing discourse treats each crisis as idiosyncratic, driven by local or temporary shocks. Our recent paper, 'India's Most Recent Microfinance Crisis: Theory, Empirics & Learnings,' argues otherwise. By examining lender and borrower behaviour, we

show that such crises are not aberrations but recurring features of the microfinance model in place. Under it, over-lending by providers and over-leveraging by borrowers are endogenous to the credit cycle, which routinely creates a crisis. Cyclical excesses can be significantly reduced with appropriate regulatory action, but the proposed intervention addresses only post-crisis liquidity. Thus, the guarantee risks being a misplaced solution for an inherent problem.

Even if we set aside these concerns and focus on the scheme's stated objective—to "facilitate increased credit flow to the MFI sector"—it raises this question: What constitutes the microfinance institution sector?

As per SIDBI's *MFI Pulse Report*, at the peak of the recent cycle (March 2024), microfinance lending was distributed across five institutional categories: universal banks (31.4%), small finance banks (16.2%), NBFC-MFIs (41.1%), NBFCs (11.1%) and non-profit MFIs (0.1%). By December 2025, the shares had shifted to 24.3%, 14.7%, 43.5%, 15.9% and 1.5%, respectively. This suggests it is not a monolithic sector but a diverse ensemble of lenders. Yet, the scheme only targets NBFC-MFIs and non-profit MFIs. The exclusion of banks and small finance banks may be defensible, given their deposit-taking capacity, but

the omission of NBFCs is hard to justify.

Non-banking finance companies (NBFCs) account for nearly 16% of the market and serve over 8.8 million borrowers. They depend heavily on wholesale funding, the very constraint the guarantee seeks to address. Their exclusion is therefore not just puzzling, but distortionary. The consequences are non-trivial. *First*, included entities may expand aggressively and cherry-pick lower-risk borrowers, leaving NBFCs with a riskier residual pool. *Second*, more capital may flow towards guaranteed entities, tightening liquidity further for the excluded. *Third*, to stay competitive, NBFCs may compress margins, leading to higher risk-taking or, paradoxically, rate hikes down the line. In each scenario, market distortions deepen.

It also sits uneasily with the Reserve Bank of India's 2022 regulatory framework which moved towards risk-based pricing and entity-neutral regulation to improve efficiency and borrower outcomes. This scheme, by

contrast, undermines the principle and re-introduces lender segmentation.

Finally, lending caps with a narrow permissible spread, while intended to protect borrowers, overlook a basic tenet of credit markets: pricing must reflect risk. Microfinance portfolios are heterogeneous, with variation in borrower profiles, operational costs and funding structures. Price constraints incentivize lenders to gravitate towards entities with less concentration risk.

None of this is to suggest that intervention is unwarranted. Microfinance is critical for financial inclusion and this sector must be kept stable. But in its current form, the scheme risks acting as a narrow liquidity backstop rather than a recovery catalyst. Its coverage and pricing approach are design flaws that must be fixed.

Liquidity support alone cannot substitute for structural reform. Given the cyclical nature of this sector, policy must aim to smoothen booms and busts. This requires a four-point structural reform package.

Liquidity support offers symptomatic relief but this sector requires deep structural changes

Adaptive regulation: Let's move away from large discontinuous changes towards incremental and measurable adjustments based on a feedback loop between regulatory interventions and market responses.

Stronger supervision and market monitoring: Focus on early detection of stress by tracking indicators such as borrower over-leveraging, loan size inflation and portfolio concentration, and act before a crisis strikes.

Revamped delegation: We must ensure underwriting discipline is not diluted at any stage. Greater accountability, combined with tighter oversight of field-level decision-making, can align institutional incentives with regulatory intent.

Deeper funding markets for MFIs: These would reduce vulnerability to bank funds. A diversified funding base would smoothen credit supply across cycles and reduce the procyclicality of single-source reliance.

Wouldn't the money earmarked for the ill-designed guarantee scheme be better allocated for such structural interventions?

Without these shifts, policy interventions like the guarantee scheme risk treating symptoms while leaving the underlying potential for cyclical excesses intact. That would only yield a false sense of mission accomplished—until the next crisis.