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Role of Microfinance in Development of MSMEs and Economic Empowerment in India

Paridhi Gupta*
paridhigupta0109@gmail.com

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Introduction:

Microfinance is a source of financial services for entrepreneurs and small businesses that do not have easy access to banking and related services. The main objective of microfinance is to assist the poor to overcome poverty and thus help in economic development. Microfinance plays an important role in promoting inclusive growth by providing credit to borrowers at the bottom of the economic pyramid.[1] Microfinance has become one of the most effective and Widely discussed tools for poverty alleviation and financial inclusion in developing countries, especially in India, where a significant proportion of its population is living below the poverty line. The growth of the microfinance sector in India has been fuelled by the country's large unbanked population, particularly in rural areas.[2]

The microfinance sector has been providing huge impetus to the unorganized sector, driving small businesses, creating jobs and transforming the lives of millions of beneficiaries. The Microfinance sector has its own set of challenges ranging from lack of formal credit history, absence of collateral, laborious customer acquisition process and low digital and financial literacy.[3] This paper explores the role and impact of microfinance in India and the discussion delves into the evolution of microfinance in India, its challenges, regulatory frameworks, and the overall impact on growth of small and medium scale industries and socio economic development.

Key words: Microfinance, medium and small businesses, women empowerment

Definition of Microfinance:

As per RBI, microfinance is defined as a provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve their living standards. Microfinance provides the access to financial services to the low-income individuals or to small and medium size enterprises. Microfinance is supply of loans, savings and other basic financial services to the poor.

A microfinance loan is defined as a collateral free loan given to a household having annual household income upto Rs 3,00,000.[4]

Microfinance- Institutions & Ecosystem:

Microfinance Institutions (MFIs) are those institutions which has microfinance as their main operation. The main aim of MFIs is to offer microfinance services. In India the microfinance ecosystem encompasses following components-

1. **Consumers and Borrowers:** These are the customers who require financial services and these include self-employed individuals, small business owners, farmers, traders and daily wagers who need micro loans or micro credits to generate income

a. A Joint Liability Group (JLG) is an informal group comprising preferably of 4 to 10 individuals coming together for the purposes of availing bank loan either singly or through the group mechanism against mutual guarantee. The JLG members would offer a joint undertaking to the bank that enables them to avail loans.
b. A Self-Help Group (SHG) is a registered or unregistered group of micro entrepreneurs having homogenous social and economic backgrounds; voluntarily coming together to save regular small sums of money, mutually agreeing to contribute to a common fund and to meet their emergency needs on the basis of mutual help. This system eliminates the need for collateral

2. **Microfinance Institutions:** These are the financial organizations who provide financial services. MFIs typically play as distributor and hence generate fee income from banks and insurance companies.
3. **Investors and Financiers:** These are typically scheduled commercial banks (SCBs), NBFCs and SFBs who deploy capital to MFIs as part of priority sector lending.
4. **Regulator:** Reserve Bank of India is the primary regulator of MFIs in India which lays out the necessary framework and policies to maintain confidence in the ecosystem.

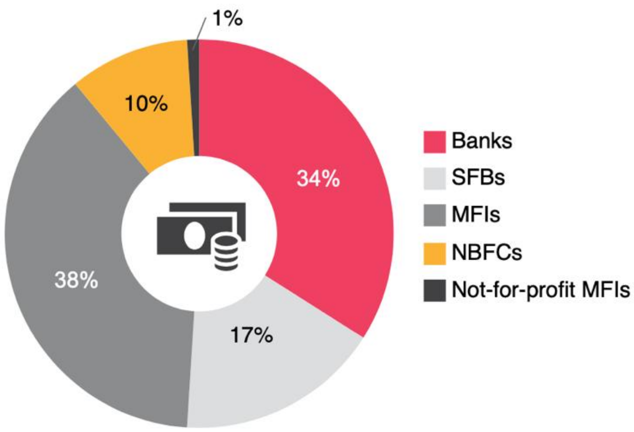

Figure 1: Market share of financial institutions in lending landscape in India
(Source: SIDBI & Equifax Microfinance Pulse report, June 2019)

Evolution of microfinance:

Indian Microfinance can be chronologically classified into four phases as below:
Phase 1: 1900s-1969- Co-operative movement
Phase 2: 1969-1991- State driven through banks and emergence of NGOs
Phase 3: SHGs-Bank linkage program and growth of NGO-MFIs
Phase 4- 2000 onwards- Commercialization of microfinance

The term Micro-loan or micro crediting didn’t exist till the ‘70s of last century, when Mohammad Yunus, and his Grameen Bank started providing loans to poor women living in rural areas for starting a small business aimed at improvement of their living conditions in their households. Amount of these loans were minimal, to purchase livestock and tools and no formal collateral forms were used other than verbal promises.

Prior to this, 1950s-70s, the provision of financial services by donors and governments was mainly in the form of subsidized rural credit programmes. These often resulted in high loan defaults, high loses and inability to reach poor households.[5] Between 1950-1970, the emphasis was on promotion of co-operatives.

The nationalization of banks in 1969 along with strong political emphasis towards poverty eradication led to a new rural finance policy that was directed at reducing the lending imbalances in particular sectors. The microfinance initiative in the private sector in India can be traced back to initiative taken by SEWA (Self Employed Women Association) Sahkari bank in 1974 to provide the banking services to the poor women employed in the unorganized sector in Ahmedabad, Gujrat.[6]

MYRADA (Mysore Rehabilitation and Development Agency) of Karnataka was another NGO to start in 1968 to foster the process of change in favour of poor. Government initiated the integrated Rural Development Programme (IRDP) in 1980-81 with the objective of providing subsidized loans to poor self-employed people through banking sector. Under IRDP, loans of less than Rs 15000 were given to poor. The problem with IRDP was that its design incorporated a substantial element of subsidy and this resulted in extensive malpractice and misutilization of funds. The two decades of IRDP in 1980s and 1990s affected the credibility of micro borrowers in the view of bankers and hindered the access of less literate people to banking system.[7]

The microfinance got a boost in India in 1992 when the SHG-Bank linkage program was initiated by NABARD and in 1993, Rashtriya Mahila Kosh (RMK) was established to accelerate the flow of credit to self-employed women in the unorganized sector. On 1st April 1999, a new program called Sawaranjayanti Gram Swarojgar Yojana (SGSY) was launched by amalgamating the programmes like IRDP and other allied programs like TRYSEM (Training of Rural Youth for Self Employement), DWCRA (Development of Women and Children in Rural Areas), SITRA (Supply of Improved Toolkits to Rural Artisans), GKY (Ganga Kalyan Yojana) and MWS (Million Wells Scheme). This was a holistic program covering all aspects of self-employment such as formation of Self-Help Groups (SHGs), training, credit, technology, infrastructure and marketing. SGSY is a credit-cum-subsidy program which lays emphasis on activity clusters. Several other state governments also launched similar programmes like Mahalir Thittam in TamilNadu in 1997-98, Kudumbashree in Kerala in 1998 and Indira Kranthi Pratham in Andhra Pradesh in 2000-2001.[8]

With the NABARD program on SHGs in 1992, the emphasis shifted to loans without collateral, 100 percent repayment norms and lending to a group of people who would also invest their savings and regulate their group loans. The operating strategy under the new microfinance involves several features such as simple procedures for reviewing and approving loan applications, delivery of credit at commercial rate of interest, quick disbursement of small and short term loans, clear recovery strategies, maintaining high recovery rates and organizational culture, structure and capacity that can support and sustain the delivery to a significant and growing number of poor clients.[9]

The early nineties also witnessed the rise of several microfinance institution (MFI)- initiatives. The success of MFIs encouraged banks to lend money to MFIs and with this MFIs started to grow fast and this sector of MFI started assuming the shape of a formal financial system. This sector got major recognition when the United Nations declared year 2005 as the year of Micro-credit and Prof M Yunas and Grameen bank jointly got Nobel Peace Prize in 2006.

In 2000, development of microfinance was marked by further changes in policies of the financial services space. This period also witnessed many NGO-MFI transform into regulated legal formats such as Non-Banking Finance Companies (NBFC). This period emphasized on Inclusive growth and Financial Inclusion. In 2005 government of India allowed MFIs and banks to do business transactions and thereby increasing the capacity of MFIs. In 2008, based upon recommendations of D.C Rangrajan committe report, NABARD Act was amended to enable it to provide microfinance services to urban poor.[10]

Micro Enterprise Development Programme (MEDP) launched in 2006-07 and Livelihood and Enterprise Development Programme (LEDP) launched in 2015-16, are initiative NABARD for SHGs for skill upgradation, refresher training, handholding and providing end-to-end solutions.[11]

The Micro Finance Institution (Development & Regulation) Bill 2012 was introduced in parliament which aimed to provide for development and regulation of MFIs in India This bill viewed MFIs as extended arm of banks and financial services and had been a beginning of end of microfinance institutions' crisis in India but unfortunately this bill got lapsed in 15th Lok Sabha.[12]

The Government of India launched Pradhan Mantri Jan-Dhan Yojana (PMJDY) in 2014 which is mission on financial inclusion, aimed at opening bank accounts, financial literacy, overdraft facility up to Rs 5000, Rupay debit cards etc. Subsequently the Prime Minister of India launched the Micro Units Development and Refinance Agency (MUDRA) bank for refinancing and regulating the microfinance sector.[13]

In 2014-15, RBI granted in-principal approval for set up of Small Finance Banks which could undertake basic banking activities, accepting deposits and lending to underserved sections, particularly small and marginal farmers, micro- and small industries and unorganized sector entities and also issued notification to issue license payment banks in country to further financial inclusion.

From 2017-2022, microfinance sector in India has acted as financial support system for low-income households and the microfinance landscape underwent multiple transformation in terms of inclusivity and expansion. 2017 onwards, microfinance sector embraced the digital transformations and innovations including mobile banking, e-wallets and bank transfers at large scale. The Aadhar enabled identification and Aadhar based payments became preferred mode for MFIs to reduce operational costs, enhancing customer on boarding and reducing frauds.[14]

Role of Microfinance in SMEs growth and Socio-Economic development:

Micro, small, and medium-sized enterprises (MSMEs) have gained increased attention in India in recent times, considering their strategic importance to the economy and the country. MSMEs play an important role in generating employment and contributing to the GDP of the country. In spite of their contribution, MSMEs in India face several challenges. They often need to keep pace with rapidly changing technologies, face high costs of credit and are usually unable to identify their key competitive strengths to maintain product standards and quality, deal with the issue of protection of their intellectual property and with the scarcity of skilled workers. studies on MSMEs have identified the importance of the availability of sources of finance and the accessibility to these sources as the most crucial factors to promote growth of MSMEs in developing Economies. Major challenges in accessing finance by enterprises included the difficulty in providing collateral or a guarantee, high lending rates, long processing time for loan applications, lack of knowledge about available schemes, and procedural complications.[15] MFIs play a crucial role in mitigating the basic challenges faced by MSMEs and provide boost to their growth and income generation, in various ways:

1. **Access to capital-** Microfinance institutions (MFIs) offer loans with more flexible terms, lower collateral requirements, and tailored financial products. This access to capital enables MSMEs to start, sustain, and expand their operations.
2. **Promoting financial inclusion-** MSMEs are usually excluded from formal financial system but microfinance bridges this gap and this enhances the financial stability and growth prospects of MSMEs
3. **Enhancing entrepreneurial skills-** Many MFIs provide training and capacity-building programs alongside financial services. These programs cover essential areas such as financial literacy, business planning, marketing, and operational efficiency, empowering entrepreneurs to manage their businesses more effectively.
4. **Facilitating market access-** Microfinance programs sometimes include support for market linkages, helping MSMEs connect with larger markets, suppliers, and distributors.
5. **Encouraging innovation and adaptation-** Microfinance enables MSMEs to invest in new technologies, diversify their product offerings, and improve their competitive edge by providing the necessary financial resources. This can lead to increased productivity and resilience against market fluctuations.
6. **Supporting women entrepreneurs-**Women often face additional barriers in accessing finance, such as gender discrimination and lower asset ownership. Microfinance has a significant impact on empowering women entrepreneurs by providing them with the necessary financial support and fostering gender equality in business. This not only helps in personal development but also contributes to broader social and economic benefits.
7. **Fostering Community development-** By supporting SMEs, microfinance contributes to the diversification of local economies. Successful SMEs can create jobs, stimulate local supply chains, and contribute to the economic development of their communities.

Current Status of Microfinance in India and its Impact on Socio-economic development and poverty alleviation:

MFIs in India have been playing a major role in purveyance of small credit to weaker sections without collaterals. These are contributing immensely to the cause of financial inclusion in the country. Over the years, MFIs have grown from a few to several hundred in numbers. The dynamics of the microfinance sector has changed over the last few years. Banks and NBFCs started taking a major share of the microfinance pie and MFIs lagged behind. Technology has become a key driver for business processes and functions. Increased penetration of mobile technology brings multiple benefits and helps to track transactions on a real-time basis, digitise physical records, and improve transparency and process efficiencies. The adoption of technology by microfinance players has made a huge difference in the operations of the microfinance sector and was a redeeming factor in the face of the pandemic.

Microfinance operations are spread across 641 district of 36 states and Union Territories. Banks are leading with presence in 636 districts followed by SFBs and NBFC-MFIs. The microfinance penetration level is below 10% mostly in areas of J&K, coastal Maharashtra, Western UP, Uttarakhand etc., while it is higher in Southern States such as Tamil Nadu, Karnataka, Kerala and Eastern States such as West Bengal, Odisha, Bihar, etc.[11]

The Self-Help Group Bank Linkage Program (SHG-BLP), is the largest microfinance programme in the world, in terms of the client base and outreach. It touches 16.2 crore households through more than 134 lakh SHGs with deposits of over Rs 58,893 crores and annual loan offtake of

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more than Rs 1,45,200 crores. SHG formation under SHG-BLP grew at CAGR of 42% from 1993 to 2022. Total disbursement of all lenders amounted to Rs. 3,19,380 crore during FY 22-23, a 26% growth compared to Rs. 2,48,006 crore during FY 21-22. The average loan disbursed per SHG during FY 2022-23 (Rs. 3.38 lakh) is 15% higher than average loan disbursed during FY 2021-22 (Rs. 2.93 lakh). Among the lenders, NBFC-MFIs have disbursed a maximum of Rs. 1,25,248 crore, closely followed by Banks at Rs. 1,15,619 crore. Also, for Y-o-Y growth, NBFCs have registered highest growth in disbursement (59%), followed by NBFC-MFIs (48%), SFBs (18%), NFPs (18%) and Banks (7%) respectively. A decline in NPA has been observed at the national level from 3.80% in FY 2021-22 to 2.79% in FY 2022-23.[11]

Kumar Vipin et. al. study concluded that the SHG's and MFI's are playing a vital role in delivery of microfinance services which leads development of poor and low income people in India.[16] Mahanta et. al. Study revealed that lending to the poor through microcredit is not the end of the problem but beginning of a new era. If effectively handled, it can create miracle in the field of poverty alleviation. it is very important to provide skills development training program like handicraft, weaving, carpentry, poultry, goat rearing, masonry, bees farming, vegetable farming and many other agricultural and non-agricultural training.[17]

The impact of microfinance on rural women entrepreneurs is evident in the positive outcomes reported across various regions of India. For instance, a study by the Microcredit Summit Campaign (2015) found that 75% of women borrowers reported an increase in income after accessing microfinance, and 60% reported an improvement in their overall economic status.[18] The access to financial resources has enabled women to invest in various income-generating activities, such as agriculture, livestock, small-scale retail, and handicrafts. The impact of microfinance extends beyond economic empowerment to include significant improvements in social empowerment. Access to microfinance has been linked to enhanced social status for women in their communities and households. Women who contribute to household income through entrepreneurship often experience increased respect and decision-making power within their families.[19]

Challenges and Road Ahead:[20]

1. Over-Indebtness- While microfinance provides crucial access to credit, it can also lead to a cycle of debt if not managed properly. Studies have shown that some women, in their eagerness to start or expand businesses, take on multiple loans from different microfinance institutions (MFIs). This can lead to an unsustainable debt burden, especially if their businesses do not generate sufficient income to cover repayments.
2. Lack of Financial services awareness: The financial risks are further exacerbated by the lack of comprehensive financial literacy among many rural women. Without adequate understanding of interest rates, loan terms, and repayment schedules, women may inadvertently make financial decisions that jeopardize their economic stability.
3. High interest rates and limited loan size- High interest rates can erode the profits of micro-enterprises, limiting their ability to reinvest in business growth or improve household welfare. Furthermore, the loan sizes offered by MFIs are often too small to meet the capital needs of expanding businesses. While initial microloans may be sufficient to start small ventures, women entrepreneurs who wish to scale their operations often find themselves constrained by the limited credit available.

4. Lack of comprehensive support services- Regulatory challenges and fluctuating government policies can create an uncertain environment for MFIs. Moreover, there is often a lack of tailored support for the specific needs of uneducated poor sections of the society.
5. Institutional challenges and sustainability concerns- High operational costs, coupled with the need to keep interest rates affordable, can strain the financial viability of MFIs, leading to service limitations or even institutional failures
6. Regulatory challenges and fluctuating government policies can create an uncertain environment for MFIs.

   There are few steps which need to be implemented for enhancing the impact of microfinance[21]

1. Interest rate transparency
2. Strengthening financial literacy programs
3. Expanding access to larger loans and diverse financial products
4. Integrating non-financial support services
5. Promoting gender sensitive policies and inclusive financial ecosystems
6. Addressing social and cultural barriers
7. Enhancing the sustainability and accountability of MFIs

Conclusions:

Microfinance plays a pivotal role in the development and growth of Medium small and micro enterprise (MSME) businesses, particularly in developing economies. By providing access to tailored financial services, microfinance addresses the barriers that often hinder MSMEs from accessing traditional banking channels. The impact of microfinance on MSMEs extends far beyond financial support, as it fosters financial inclusion, empowers entrepreneurs, and contributes to economic and social development. As MSMEs are significant contributors to job creation and poverty alleviation, the support provided by microfinance institutions stimulates local economies and improves livelihoods. To harness the full potential of microfinance in supporting MSMEs, policymakers, financial institutions, and development agencies must continue to collaborate and innovate. Efforts to enhance financial literacy, enforce robust regulations, and offer targeted financial products will ensure that microfinance remains a powerful force in propelling MSME businesses towards prosperity.

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