



The Perfect Storm: When Expansion Meets Regulation

The microfinance sector in India stands at a critical juncture. As non-banking financial companies (NBFCs) and fintech platforms race to capture the lucrative bottom-of-the-pyramid market, regulators are tightening their grip with unprecedented intensity. What began as a growth opportunity is increasingly looking like a regulatory minefield, where aggressive expansion meets systemic risk concerns, and financial inclusion collides with consumer protection imperatives.

The numbers tell a sobering story. Between 2024 and October 2025, India's microfinance landscape has undergone a seismic shift. Banks, traditionally a cornerstone of microfinance lending, have dramatically retreated from the sector. This withdrawal has created a vacuum that NBFCs and fintech platforms eagerly filled—but not without consequences. The 22% decline in Microfinance Institution (MFI) portfolios since 2024, combined with approximately 4 lakh borrowers exiting formal finance channels, signals a market correction that goes far deeper than mere cyclical adjustment.

For regulators like the Reserve Bank of India (RBI) and the Microfinance Industry Network (MFIN), the implications are alarming. In their view, the rapid consolidation of microfinance among non-traditional lenders has created concentrations of risk, overleveraged borrowers, and a vulnerable underclass of borrowers slipping into the shadows of informal lending networks.

The Banking Retreat: Understanding the Great Pullback

To comprehend the regulatory urgency of October 2025, one must first understand why banks abandoned microfinance. The answer lies in a toxic combination of asset quality deterioration and regulatory tightening that commenced in earnest during 2024.

The microfinance sector's growth had become intoxicating. Between 2022 and 2023, deregulation of lending rates opened the floodgates for aggressive expansion. Lenders could now charge higher interest rates, making microfinance extraordinarily profitable. But profitability came at a cost: discipline. MFIs, armed with technology and access to cheap capital, began lending indiscriminately. Borrowers, particularly in rural areas, found themselves holding loans from multiple lenders simultaneously—a phenomenon known as overleveraging.

By mid-2024, the consequences became undeniable. Delinquency rates on microfinance loans surged to 4.3% by September 2024, up from just 2% a year earlier—a more than doubling of default rates. Even more alarming, borrowers holding three or more active loan associations—a segment particularly vulnerable to defaults—saw their proportion increase significantly across states. Regions like Bihar, Tamil Nadu, Uttar Pradesh, and Odisha became default hotspots, accounting for 62% of incremental delinquencies.

Ankit Baid, Research Analyst

Affluence Advisory Pvt. Ltd. | [Website - www.affluence.net.in](http://www.affluence.net.in) | [Email - connect@affluence.net.in](mailto:connect@affluence.net.in)



Banks responded predictably: they retreated. Funding to NBFC-MFIs dropped dramatically, with debt funding falling by 35.7% in FY25 alone. Small Finance Banks (SFBs), which had been aggressive microfinance lenders, saw Portfolio at Risk (PAR) 31-180 days spike from 5.4% in September 2024 to 7.2% by December 2024—the highest stress ratio among all lender categories.

By early 2025, the withdrawal was complete. Overall stress in the NBFC-MFI sector had surged to 15.3% by March 2025, compared to just 5.9% a year earlier—a measure that captures the deterioration across all asset quality metrics. The sector's loan portfolio, which had grown 29% in FY24, contracted by 12% in FY25. For the first time in a decade, microfinance began to shrink rather than expand.

Enter the Non-Regulated: NBFCs and Fintechs Filling the Vacuum

Into this regulatory vacuum stepped NBFCs and fintech platforms. Unlike banks, which are subject to stringent deposit insurance norms and retail lending restrictions, NBFCs and fintechs operate with greater flexibility. They are less encumbered by the regulatory apparatus that constrained banks during the sector's crisis. This asymmetry created an unusual dynamic: as regulated entities retreated, less regulated entities advanced.

The numbers reveal the scale of this shift. As of June 2025, NBFC Fintechs grew by 34.9% year-on-year, significantly outpacing overall NBFC growth. These platforms now account for nearly 90% of all personal loan originations in the sub-1 lakh ticket size—the exact segment that overlaps with microfinance. Their appeal is clear: digital-first approaches, automated underwriting, minimal physical infrastructure, and access to borrowers through smartphone apps rather than field officers.

However, their rapid rise has created a new problem. Many of these fintech platforms operate through a complex web of partnerships with regulated entities—banks and NBFCs—that lend their regulatory license for a fee. The fintech provides the customer interface and credit decisioning algorithms; the bank or NBFC provides regulatory legitimacy. This structure, while legally compliant, creates moral hazard. The regulated entity bears the credit risk but has minimal control over underwriting standards. The fintech, which controls customer acquisition and credit decisioning, has minimal exposure to the consequences of defaults.

This misalignment of incentives has spawned predatory lending practices. High interest rates, hidden charges, aggressive collection tactics, and unauthorized access to borrower data have become commonplace. Between January 2020 and February 2021 alone, the RBI identified 600 illegal lending apps in India. Many of these operated with impunity, exploiting borrowers in rural



and low-income communities who had neither the awareness nor the recourse to challenge exploitative terms.

The Perfect Trap: Bottom-of-the-Pyramid Borrowers and Overleveraging

The tragedy of the microfinance sector's current state is most acute at its intended beneficiary level: the bottom-of-the-pyramid borrower. These are individuals with annual incomes up to ₹3 lakh, typically engaged in self-employment or informal employment, with minimal access to traditional credit.

When banks and regulated MFIs were lending responsibly, these borrowers benefited. A woman entrepreneur in rural Bihar could secure a ₹50,000 loan to expand her vegetable trading business or a tailor could access working capital for fabric purchases. The loans were small, collateral-free, and designed to support livelihood activities.

But as competition intensified and growth targets demanded expansion, underwriting standards eroded. Borrowers, incentivized by easy credit and unaware of their total indebtedness across multiple lenders, took loans they could not service. A ₹50,000 loan from one MFI, a ₹30,000 loan from a fintech, a ₹25,000 loan from another NBFC—suddenly, a borrower with ₹50,000 in annual income carried ₹1 lakh in outstanding microloans.

This overleveraging dynamic created a catastrophic vulnerability. When income shocks occurred—poor agricultural yields, illness in the family, local economic disruptions—borrowers could not service even their first loan, let alone juggle three or four. Default cascaded across multiple lenders simultaneously.

The RBI and MFIN recognized this risk and tightened lending norms in August 2024. New guidelines mandated stricter underwriting standards, capped the number of active lenders per borrower at two, and imposed income assessment requirements. The impact was immediate: originations in Q3 FY25 contracted 41.7% in volume year-on-year.

But here's the critical juncture: as formal lenders tightened, approximately 4 lakh borrowers exited formal finance channels entirely. Where did they go? The answer is unsettling: many migrated to informal lending networks—loan sharks, unregulated fintech apps, and exploitative local lenders who operate outside any regulatory framework. These informal lenders charge 24-36% annual interest rates, engage in coercive collection tactics, and often demand social collateral (seizure of personal assets, social ostracization) when borrowers default.

From a financial inclusion perspective, this represents a regression. The microfinance sector's entire raison d'être is to bring low-income borrowers into the formal financial system. When



tightened regulations push these borrowers back into informal lending, the sector has failed its core mission—even if it has succeeded in reducing systemic risk.

Regulatory Surveillance: The October 2025 Turning Point

This is the context in which the RBI and MFIN increased surveillance of NBFCs and fintechs in October 2025. The regulatory concerns are multifaceted and justified by deteriorating sector metrics.

First, there is the issue of concentration. As banks retreated, microfinance became increasingly concentrated among NBFCs and fintechs. NBFC-MFIs, which controlled 38.3% of the microfinance portfolio by March 2024, became the dominant player—a position that created systemic risk. If NBFC-MFIs encountered a sudden shock, there was no backup capacity among banks to absorb the impact. The sector would face a liquidity crisis.

Second, there is the issue of risk migration. As regulated MFIs tightened underwriting standards, some NBFCs and fintechs responded by easing their standards further, capturing borrowers deemed too risky by mainstream lenders. This race-to-the-bottom dynamic created a concentration of high-risk borrowers among the least regulated lenders. If these borrowers defaulted en masse, the impact would fall disproportionately on entities with minimal capital buffers.

Third, there is the issue of consumer protection. The RBI's Digital Lending Directions, notified in May 2025, consolidated previous guidelines on digital lending. But compliance remains spotty. Many fintechs continue to charge hidden fees, access sensitive mobile data without consent, and employ coercive recovery tactics. The regulatory framework exists on paper; enforcement remains weak.

Fourth, and most critical, there is the issue of informal lending. When formal lenders tighten standards, vulnerable borrowers don't disappear—they migrate to the informal sector. Unregulated lending apps, loan sharks, and exploitative local lenders fill the vacuum. This creates a bifurcated credit system: quality lending in the formal sector for creditworthy borrowers, and predatory lending in the informal sector for those rejected by formal lenders. This outcome is worse for financial inclusion than a well-regulated, inclusive formal lending sector would be.

The Paradox: Regulation vs. Inclusion

Here lies the fundamental paradox facing the RBI and MFIN in October 2025. Tighter regulations on microfinance are necessary to reduce systemic risk and protect borrowers from overleveraging. The data unambiguously supports this case. But tighter regulations also have



costs: they reduce credit availability, push borrowers toward informal lending, and risk undoing decades of financial inclusion progress.

The RBI has attempted to balance these competing objectives through nuanced regulation. Rather than blanket restrictions, it has introduced targeted measures:

Risk Weight Optimization: In March 2025, the RBI reduced the risk weight on microfinance loans classified as consumer credit from 125% back to 100%. This makes it cheaper for banks to hold microfinance loans, theoretically encouraging renewed bank participation in the sector. But this measure has had limited effect—banks remain cautious, with lending to NBFCs growing only 2.6% in the first four months of FY26, compared to 12.7% a year earlier. Trust, once lost, is difficult to rebuild.

Qualifying Asset Relief: In June 2025, the RBI reduced the minimum qualifying assets requirement for NBFC-MFIs from 75% to 60%. This allows MFIs greater flexibility in their balance sheet composition and theoretically increases credit availability. But this measure, too, has had limited real-world impact on disbursements, which continue to contract.

Multi-Lender Platform Regulation: The Digital Lending Directions of May 2025 introduced new rules for multi-lender platforms—lending marketplaces that match borrowers with multiple lenders. These rules mandate transparency, borrower consent, and contractual clarity. In theory, this makes multi-lender platforms safer. In practice, many platforms continue to operate through regulatory workarounds.

Credit Data Improvements: In May 2025, the RBI introduced new Credit Information Reporting Directions mandating bi-monthly updates instead of monthly updates. This reduces the lag in tracking repayments and helps lenders detect borrower overleveraging earlier. This is a genuine systemic improvement—but it requires coordination among all credit information companies and lenders, and implementation remains incomplete.

The RBI's regulatory approach in October 2025 reflects this balance-seeking. Rather than restricting NBFC and fintech lending outright, regulators are increasing surveillance and tightening compliance standards. MFIN's Self-Regulatory Organization function now requires regular reporting on member compliance. The RBI's consolidated Master Directions, issued in October 2025, subject NBFCs to more granular regulatory oversight. Digital Lending Apps are now tracked through the Centralised Information Management System (CIMS), providing regulators real-time visibility into emerging risks.

But surveillance is not a solution—it is a holding pattern. Regulators are buying time while the microfinance sector rebalances itself through a combination of lower originations, asset quality stabilization, and cautious bank re-entry.



The Road Ahead: Financial Inclusion Under Pressure

As of October 2025, the microfinance sector faces genuine uncertainty. The immediate regulatory focus—reducing overleveraging, strengthening capital buffers, and improving consumer protections—will likely succeed. NBFC-MFI stress is expected to peak by March 2026, with recovery beginning in FY27. Delinquency rates have stabilized, reflecting stricter underwriting standards and reduced borrower overleveraging.

This tension between financial stability and financial inclusion will define the sector's trajectory over the next 2-3 years. If the RBI and state governments succeed in eventually reintegrating informal borrowers into regulated formal lending through improved consumer protections, reasonable pricing, and technology-enabled efficiency, the current period of constraint will have been worthwhile. If, however, informal lending becomes entrenched and borrowers remain trapped outside the formal system, the regulatory surveillance and tightening will have succeeded in making the system safer without making it more inclusive.

The microfinance sector's regulatory reckoning is not yet complete. But October 2025 represents the moment when regulators decisively shifted from accommodation to scrutiny, when the priorities shifted from growth to stability, and when the sector's participants—whether NBFCs, fintechs, or MFIs—fully recognized that the rules of the game had fundamentally changed.

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