

**Why Do Low-Income Households Continue to Rely on Informal Credit
Despite Access to Formal Banking?
*A Quantitative Comparative Study Across Urban and Rural Telangana***

Agastya Reddy

Hyderabad, Telangana

DOI: 10.46609/IJSSER.2026.v11i05.034 URL: <https://doi.org/10.46609/IJSSER.2026.v11i05.034>

Received: 12 May 2025 / Accepted: 26 May 2026 / Published: 30 May 2026

ABSTRACT

Background

This research paper presents a comprehensive analysis of how contemporary formal banking systems have created an environment in which low-income households continue to rely on informal lending – 77% of respondents rely on informal credit vs. only 22.9% on formal banking, despite widespread awareness of and access to formal banking services. The investigation examines the factors that strongly influence the decisions of low-income households in Telangana to choose informal credit over formal financial institutions.

Methodology

To understand these factors, the study draws on primary field survey data from 75 individuals across both urban and rural Telangana, combining two contrasting perspectives to highlight the disparities in banking access and experience across these demographics. The investigation also considers an institutional perspective, analysing the provisions and structures surrounding loan approval in order to develop a broader understanding of the processes that determine the formal lending system.

The findings prove a greater reliance on informal lending due to operational barriers within formal systems, including requirements for collateral, the frequent non-approval of personal loans (which are often essential for low-income households), and a lack of flexibility in repayment structures. Another significant factor evident across responses is the high level of trust placed in informal lenders.

Conclusions

Overall, the study concludes that the persistence of informal credit is not due to a lack of access to formal banking or financial illiteracy, but rather the inability of formal systems to effectively meet the practical, social, and financial needs of low-income households across rural and urban Telangana.

Keywords: Informal Credit, Financial Inclusion, Institutional Trust, Credit Access Barriers, Low-Income Households Telangana

1. Introduction

1.1 Background and Context

This investigation is situated within the broader context of financial inclusion and exclusion in India, where significant progress in expanding banking access has been accompanied by persistent gaps in usage. According to national estimates, over 75–80% of adults possess bank accounts, largely driven by financial inclusion initiatives; however, a substantial proportion of low-income households, particularly in rural areas, remain underbanked, with limited active engagement in formal financial systems.

Between the two prominent credit access mechanisms, formal and informal, that are present across rural and urban areas, formal lending refers to regulated financial institutions such as banks and microfinance organisations offering systematic credit under a qualification-driven approval system (Loan Origination System [LOS]) (Reserve Bank of India). Informal lending encompasses unregulated, flexible systems that include local moneylenders, peer-to-peer networks, and community-based borrowing. In both rural and urban Telangana, there has been a prominent trend of increased reliance on institutional informal lending. The landscape has developed to create a space where private financing entities such as Shriram Finance, Siddharth Money Lenders, and OxyLoans thrive, along with smaller local support and self-help groups (SHGs) such as the Mahila Group (Government of India, Ministry of Rural Development) and DWCRA (Development of Women and Children in Rural Areas) (Government of India, Ministry of Rural Development) groups, further stimulating informal credit flow through accessible and adaptive lending practices.

Simultaneously, the formal banking landscape has expanded through initiatives such as Pradhan Mantri Jan Dhan Yojana and the growth of microfinance institutions. Despite this, a paradox persists: low-income households continue to rely on informal credit, even when faced with higher interest rates and reduced security. Despite their fragile financial situation, they would

rather risk paying more for a loan than face the alternative of not obtaining one at all, reflecting a structural disconnect between access to banking and its practical usability.

1.2 Rationale and Significance

This paper holds significant relevance within the socio-economic landscape of India, with its rapidly evolving financial systems, where financial inequality continues to present a major structural imbalance. Despite the substantial progress that has been made in expanding formal banking access with over 500 million bank accounts opened (Government of India, Ministry of Finance) under financial inclusion initiatives such as Jan Dhan Yojana (Government of India, Ministry of Finance) the persistence of informal credit reliance among low-income populations reflects deeper systemic inefficiencies that extend beyond accessibility and policy provision. Furthermore, nearly 190 million adults remain unbanked (World Bank). This research contributes to a more detailed understanding of financial inclusion by examining not only economic, structural, and systemic barriers, but also the social and behavioural factors that influence financial decision-making, specifically among low-income individuals.

While existing literature has largely focused on macro-level indicators of financial inclusion (Financial Inclusion Index, FI-Index, used by the RBI (Reserve Bank of India), such as account ownership and credit availability, it often overlooks the realities and decision-making frameworks of low-income households. In addition, only around 22–27% of low-income individuals actively access formal credit, further illustrating the gap between access and utilisation. This investigation addresses that gap by analysing the intersection between institutional constraints, such as rigid loan approval systems, and behavioural factors, including trust and perceived reliability, in a specific regional context. By focusing on Telangana and incorporating both rural and urban perspectives, the study provides a more grounded and contextually relevant analysis of credit choice. In doing so, the research highlights the limitations of current financial systems in addressing inequality, positioning informal credit not merely as an alternative but as an adaptive response to systemic exclusion.

2. Research Question and Hypotheses

2.1 Research Question

What are the factors that strongly influence the choice of low-income households in Telangana to choose informal credit over formal banking?

2.2 Hypotheses

H1: Institutional Trust and Borrowing Choice

Lower levels of institutional trust in formal banking institutions significantly increase the likelihood of low-income households in Telangana relying on informal credit sources for borrowing.

Perceived lender reluctance, frequent loan rejections, and asymmetric power dynamics between banks and low-income borrowers reinforce beliefs that formal institutions are inaccessible or biased, thereby pushing households toward informal lenders who operate on personal trust rather than formal credit assessments. Furthermore, many of these low-income individuals have come from rural parts of India, where informal lending is considered the norm, leading to its continuation in urban areas as well.

H2: Regulatory and Documentation Barriers

Strict documentation requirements, regulatory compliance burdens, the need for collateral, and complex repayment rules imposed by formal financial institutions increase the dependence of low-income households on informal credit markets.

The inability to meet requirements related to identity proof, income stability, credit history, and repayment documentation disproportionately excludes households engaged in informal or daily-wage employment from accessing formal credit.

H3: Perceived Credit Risk and Lender Reluctance

Higher perceived credit risk and reluctance from formal lenders — arising from volatile incomes, informal employment, and lack of credit history — push low-income households toward informal lenders who are more willing to absorb risk.

The absence of collateral, guarantees, and rigid group-liability mechanisms in informal lending arrangements increases their appeal relative to formal credit sources. Formal institutions' risk-averse lending practices — driven by volatile income patterns among low-income households — limit loan approval rates, while informal lenders absorb higher risk by relying on borrower reputation and social familiarity.

H4: Repayment Flexibility versus Cost of Credit

For low-income households, repayment flexibility and personalised lending terms offered by informal lenders have a stronger influence on borrowing decisions than the interest rate charged by formal financial institutions.

Repayment flexibility and convenience exert a stronger influence on borrowing decisions than nominal interest rates among low-income households. Informal lenders' willingness to adjust repayment schedules, accept delayed or partial payments, and renegotiate terms during income shocks outweighs the cost disadvantage of higher interest rates when compared to the rigid repayment structures enforced by formal financial institutions.

3. Literature Review

This study utilises three primary theoretical lenses to explain credit preferences. Information Asymmetry Theory (Stiglitz & Weiss, 1981) suggests that formal banks face "adverse selection" because they cannot easily distinguish between high- and low-risk borrowers, leading to rigid credit rationing and strict credit access structures. Social Capital Theory (Coleman, 1988) posits that social networks and relationships substitute for physical collateral, creating the foundation upon which informal borrowing was built. This theory relies on the logic that trust-based relations — described as social capital — create human capital, enabling citizens to be more financially secure and stable. Finally, Institutional Trust Theory (Luhmann, 1990) explores how a deficit of trust toward formal systems tilts households toward familiar informal lenders. This effectively reflects the situation in India, where the constant perception of formal banks as a foreign entity within rural communities — communities that function heavily on trust and social belonging — reduces their approachability and positions community members as more reliable sources of credit.

In South Asia and Sub-Saharan Africa, informal credit remains a cornerstone of household finance, reflecting a global trend. Morduch (1995) highlights that informal credit acts as a vital tool for "income smoothing" during periods of financial instability, as it is readily accessible. This parallels the situation of farmers and villagers within rural India, who are subject to prolonged income instability and wealth variance due to their heavy reliance on agricultural income, creating an environment conducive to heavy reliance on informal credit. Similarly, Banerjee and Duflo (2007) observe that low-income households often manage complex financial situations where moneylenders and rotating savings groups (chit funds) provide the necessary liquidity that formal banks do not. While moneylenders offer speed, community-based borrowing relies on mutual trust and social pressure, while raising interest rates for credit.

Research suggests that a lack of institutional trust is a significant driver of informal credit use. When formal banks are perceived as biased or inaccessible, social networks fill the void. The gap in the existing literature stems from its macro-level focus, with research concentrating on national indicators such as the RBI's FI-Index rather than the localised decision-making frameworks of low-income households.

While formal access has expanded, systemic inefficiencies and social factors sustain informal lending. This paper fills a critical gap by providing a comparative analysis of rural and urban Telangana, moving beyond macro-indicators to offer a new, contextually specific lens — grounded in evidence — on how operational barriers and social trust dictate credit choices in this regional context.

4. Methodology

4.1 Research Design

This study adopts a quantitative research design to systematically investigate the specific factors driving informal credit reliance among low-income households in both rural and urban locations. A quantitative approach was selected because it facilitates the use of structured survey data to enable a comparative statistical analysis between rural and urban borrower groups, as well as the factors that impact borrowing decisions. This design is essential for addressing the research question, as it allows for the measurement of specific behavioural patterns and the direct testing of hypotheses regarding institutional trust and procedural barriers across different demographics, effectively gauging the weight each factor holds in the choice between formal and informal credit.

4.2 Sampling Strategy

The study employs a convenience sampling method to compile primary data from the target population. The total sample size was $n=75$ respondents, bifurcated into 51 rural respondents and 24 urban respondents. The rationale for this split derives from the historically high prevalence of informal credit reliance in many villages across rural India, which necessitates a larger sub-sample to ensure an accurate and contextually relevant analysis of borrowing trends and challenges.

4.3 Data Collection Tool

Data was collected using a structured survey (Google Forms) consisting of closed-ended (multiple choice) questions centred on the relevance of various factors that influenced credit source choices. The instrument utilised multiple-choice and Likert-scale formats to quantify subjective responses and financial decisions. By providing predefined options, multiple-choice questions allowed for specific psychological recognition responses that reduced cognitive load, permitting respondents to provide more accurate and consistent reflections on the various factors impacting their choices. Key variables measured include:

- Primary credit source and frequency.

- Degree of trust in formal and informal institutions.
- Perceived loan approval time and disbursement speed.
- Paperwork and documentation difficulty encountered during the process.
- Interest rate sensitivity and primary lender choice drivers.

4.4 Data Collection Process

The survey was administered in person, with all responses recorded via Google Forms. This ensured that responses were accurately and automatically recorded into a central database. The investigation prioritised ethical considerations, with participation being entirely voluntary and anonymous, and informed consent obtained from all respondents before data submission.

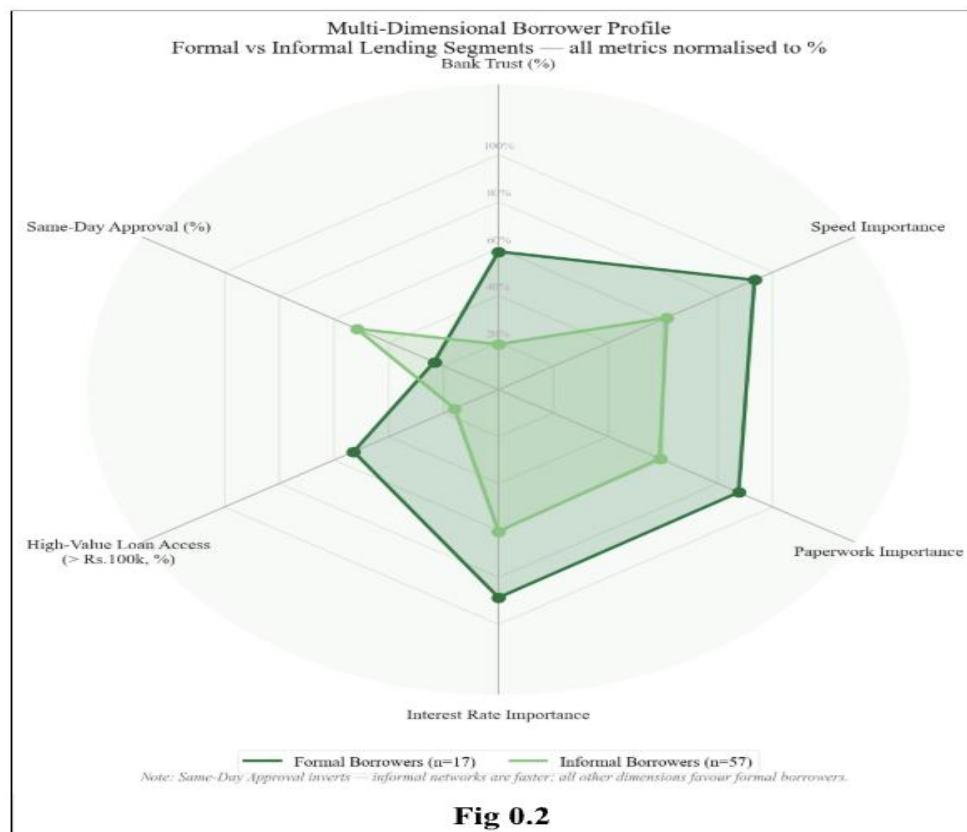
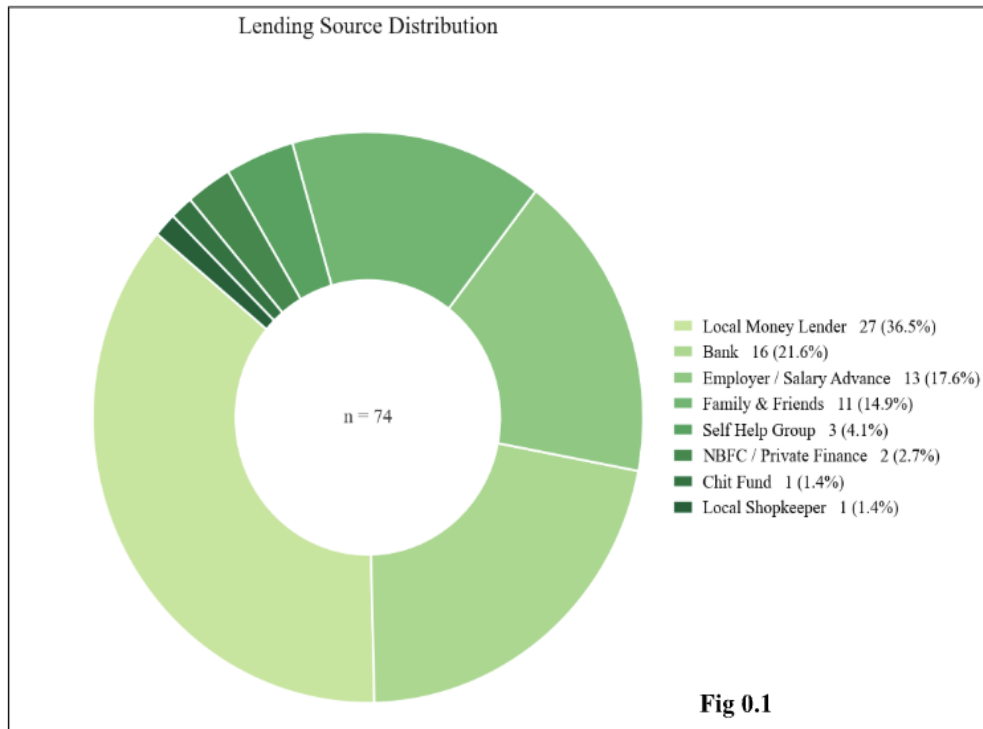
The raw data was processed and analysed using Google Sheets and script code. The analysis leveraged descriptive statistics, frequency distributions, and cross-tabulation methods that allowed effective comparison of rural and urban respondents across key variables to either support or refute the established hypotheses.

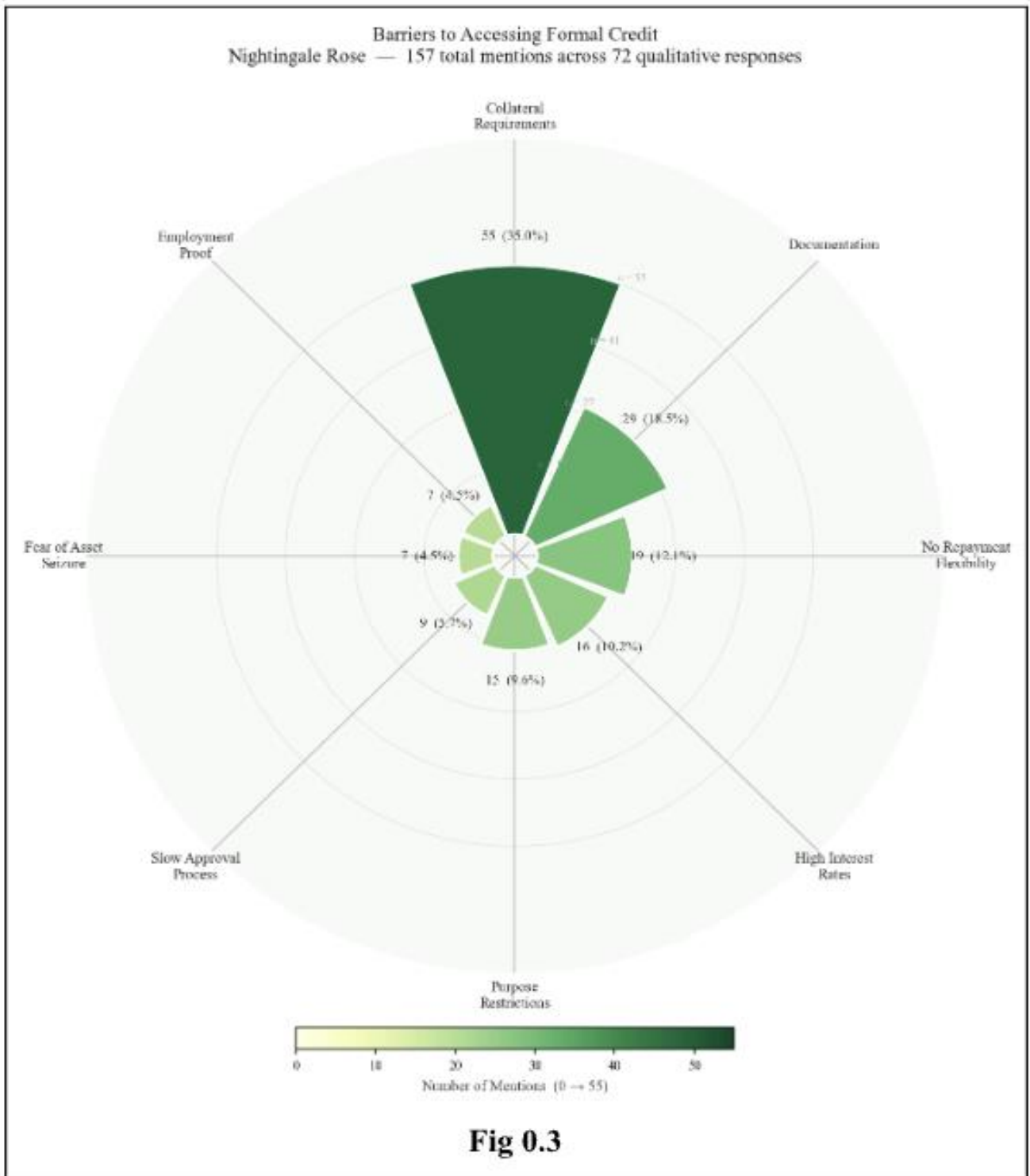
4.5 Limitations of Methodology

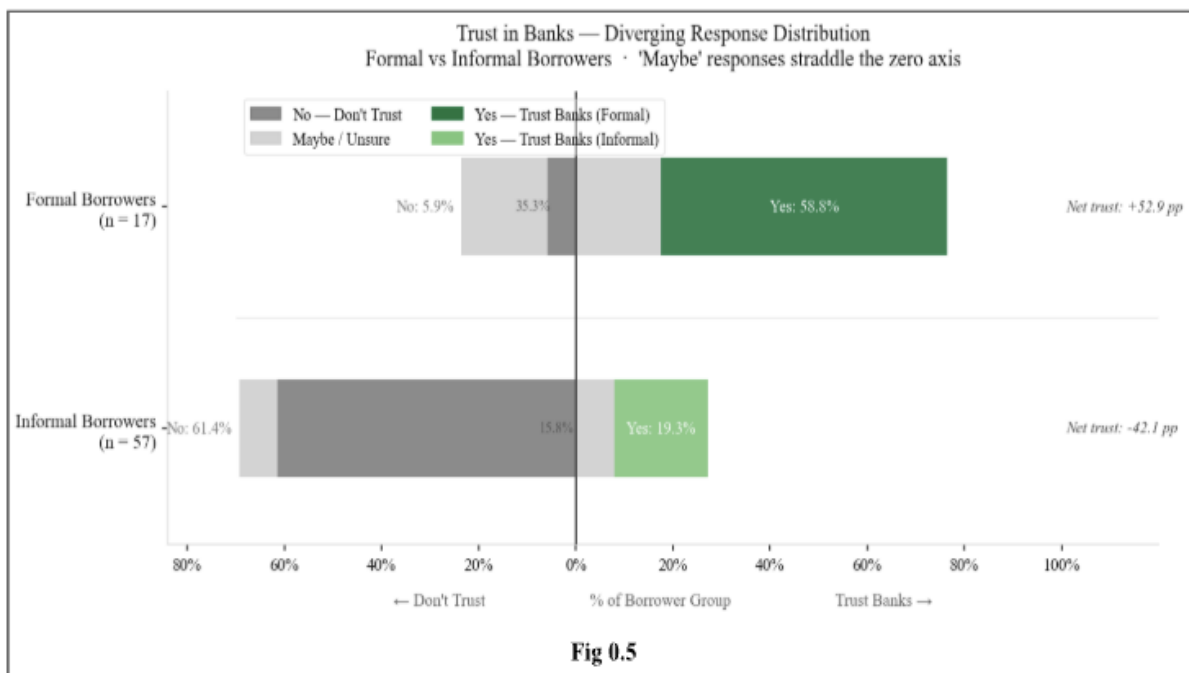
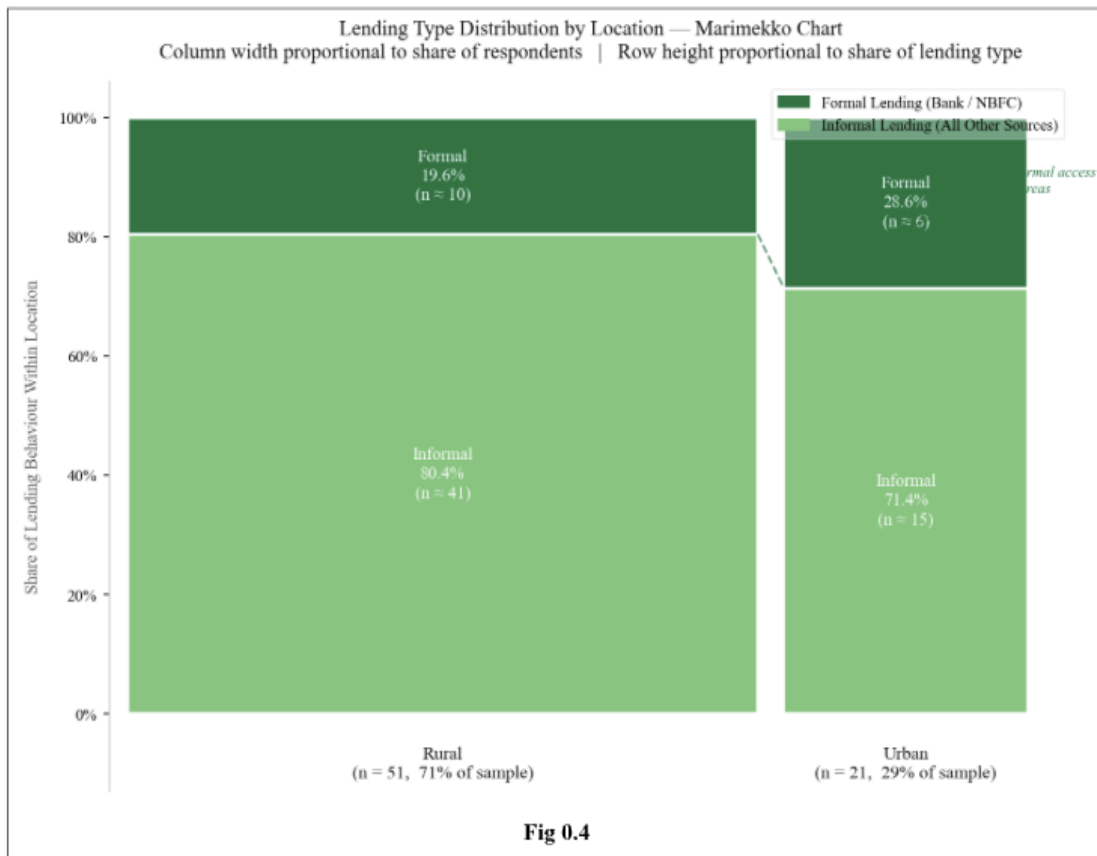
The limitations of this investigation are as follows:

- The relatively small sample size (n=75) and use of convenience sampling may introduce selection bias.
- Heavy dependence on self-reported data can lead to social desirability or recall bias.
- Some degree of reluctance may exist among low-income households when discussing financial situations, given prevailing attitudes in rural Indian communities regarding the disclosure of wealth, potentially leading to inaccurate or biased results.
- The limited geographic diversity within Telangana restricts the applicability of findings to this single region.

5. Key numerical results







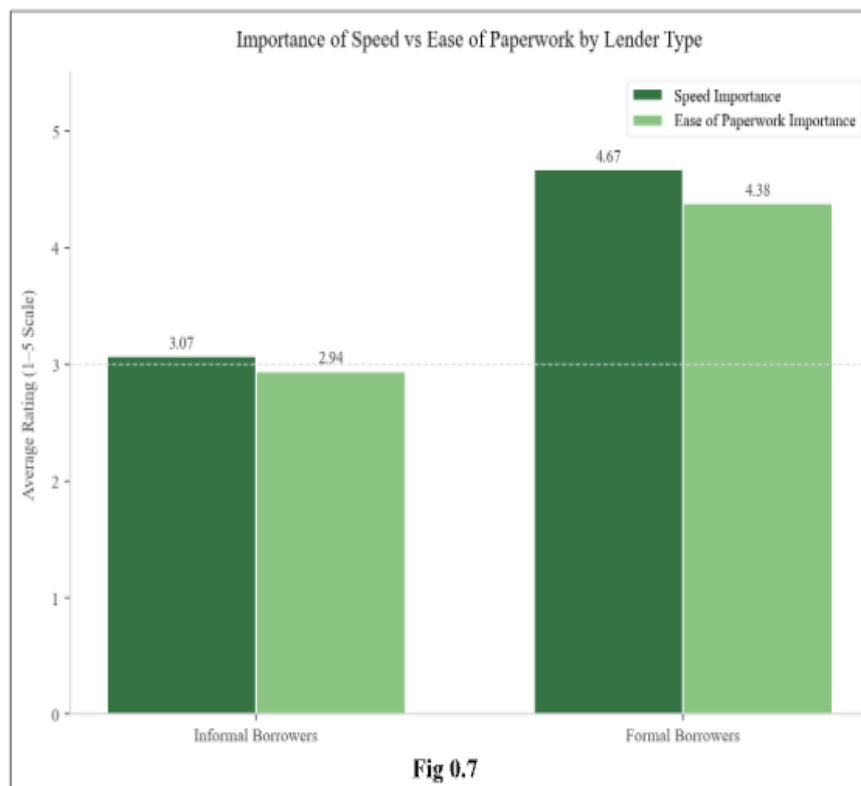
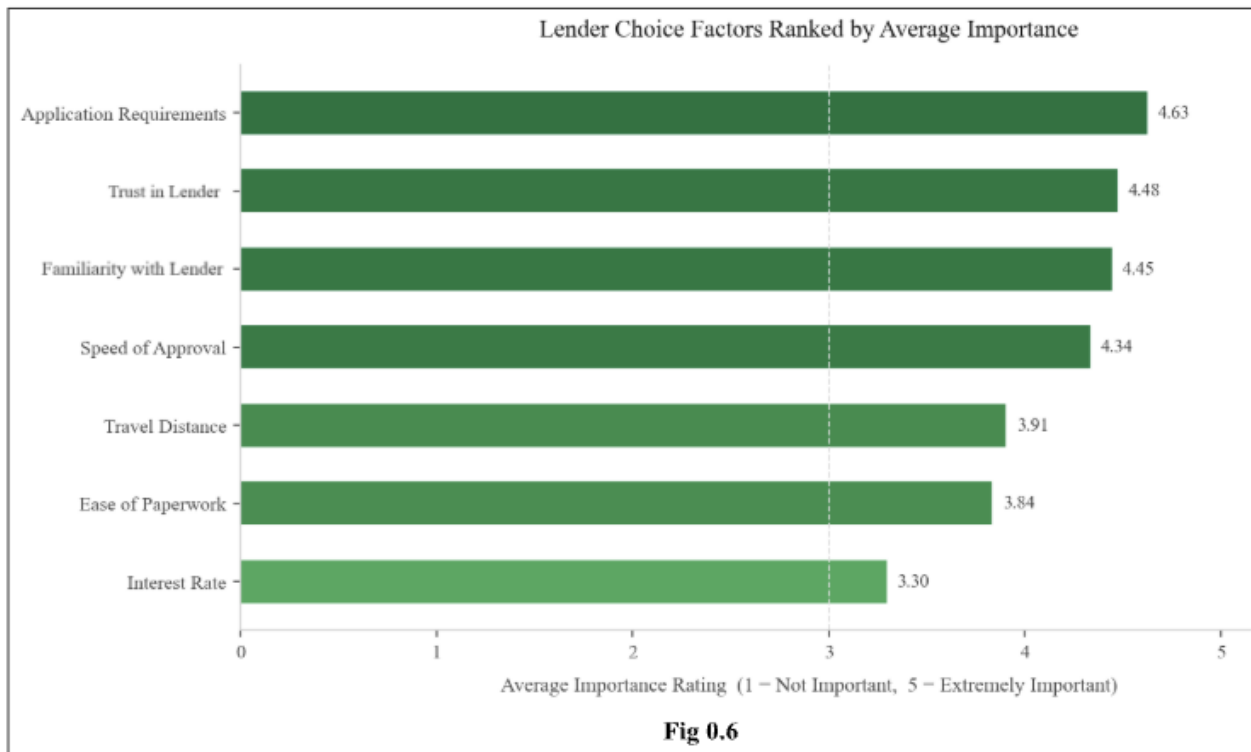


Fig 8: Loan Approval Timeframes — Formal vs Informal Borrowers

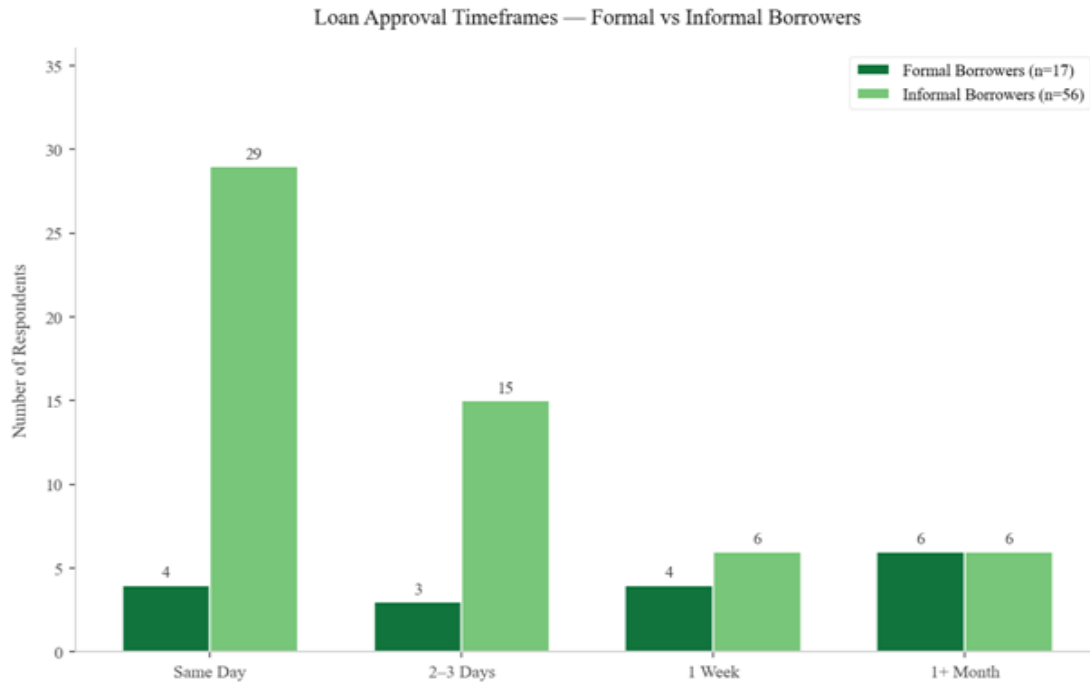


Fig 9: Formal vs Informal Lending Distribution by Location

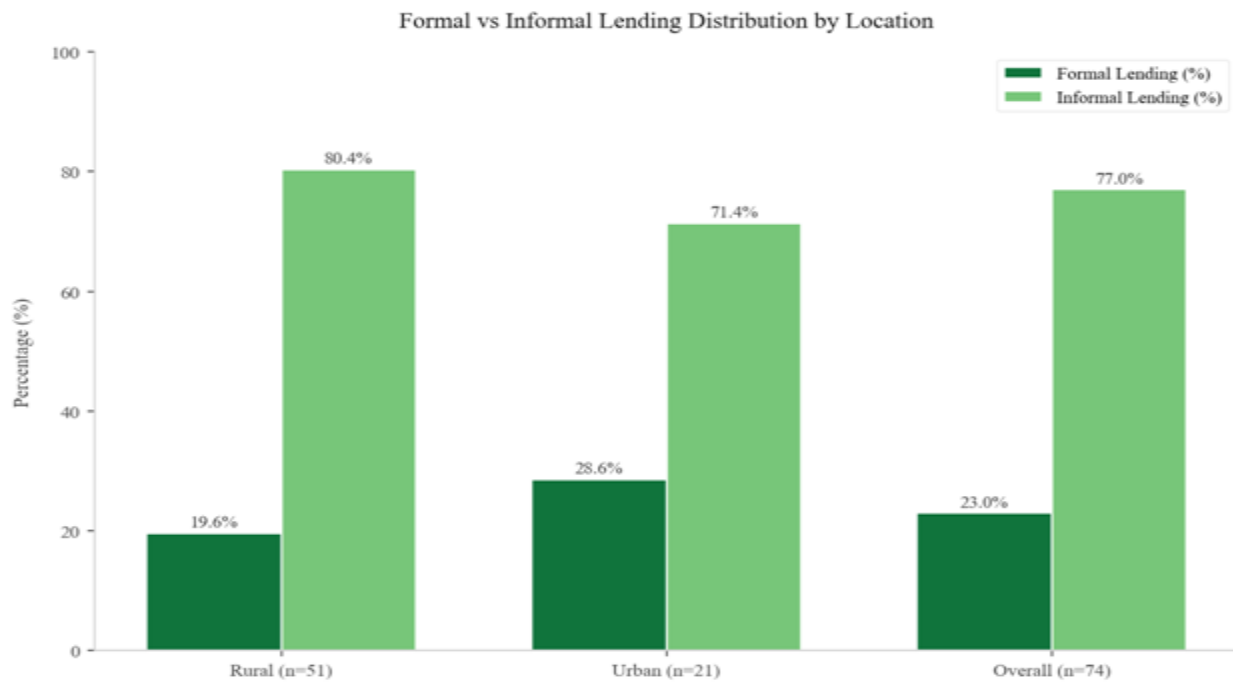


Fig 10: Perceived Difficulty of Paperwork — Formal vs Informal Borrowers

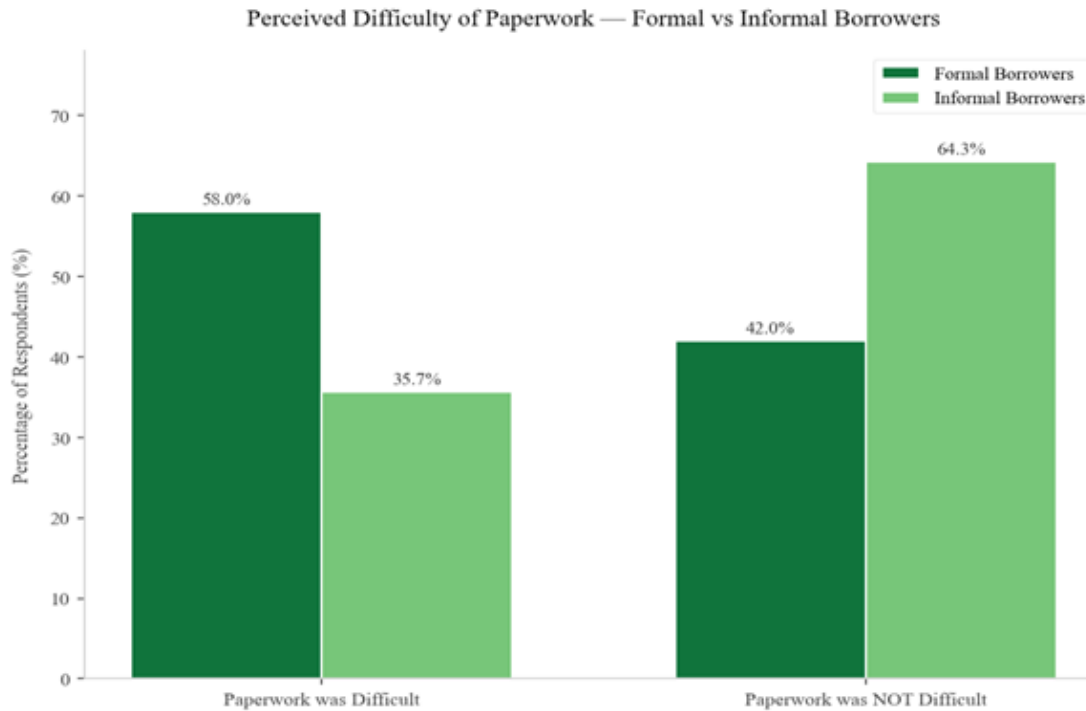


Fig 11: Trust in Banks by Borrower Type

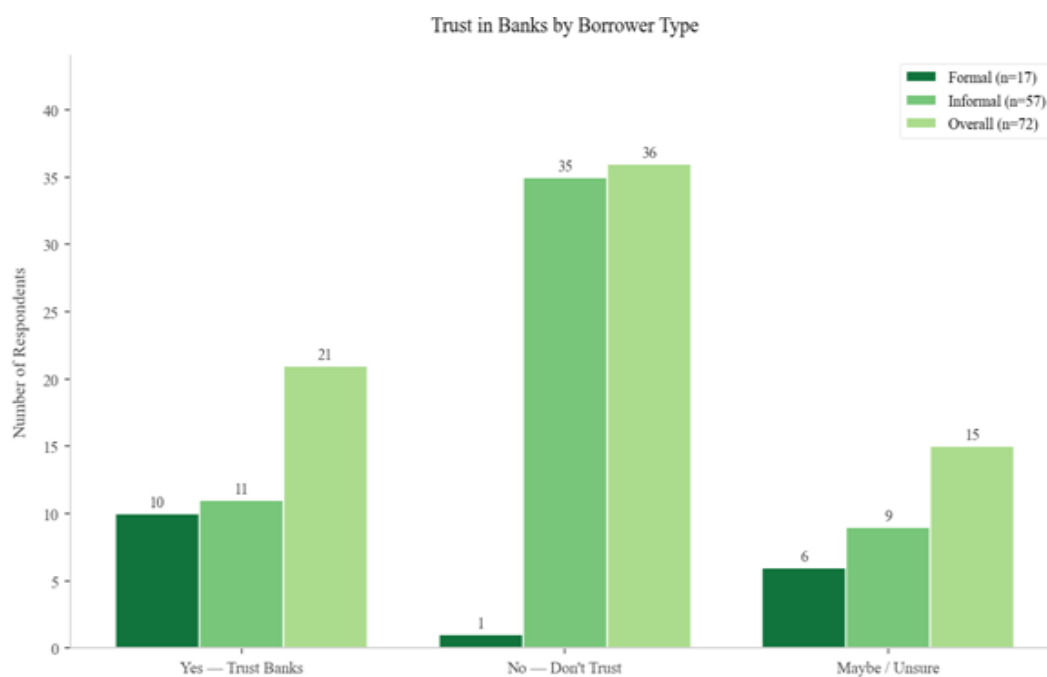


Fig 12: Importance of Interest Rates by Borrower Type

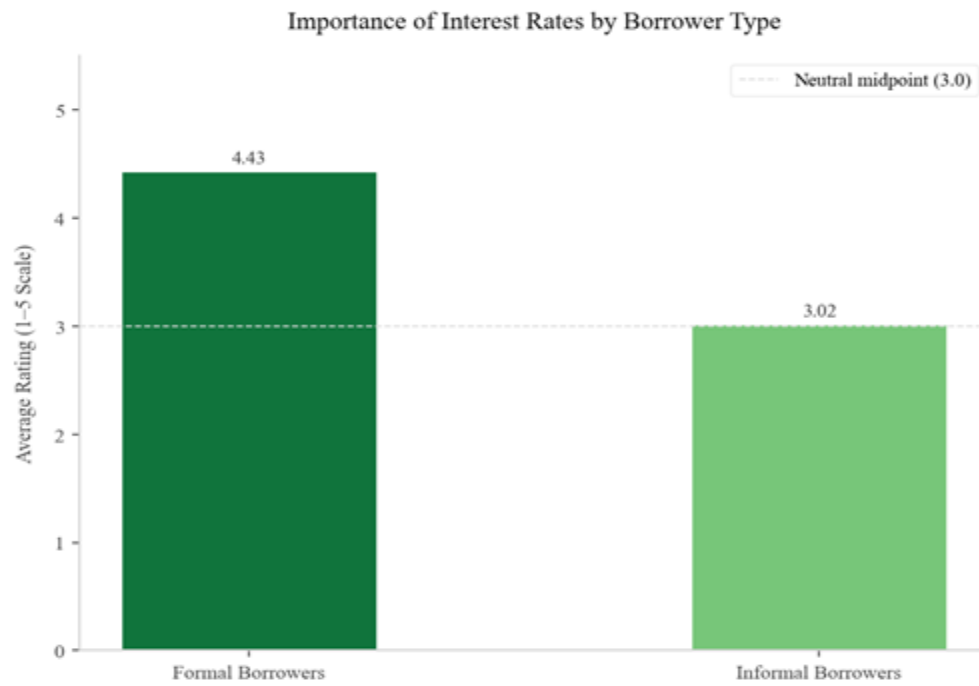


Fig 13: Loan Amount Ranges by Lending Type

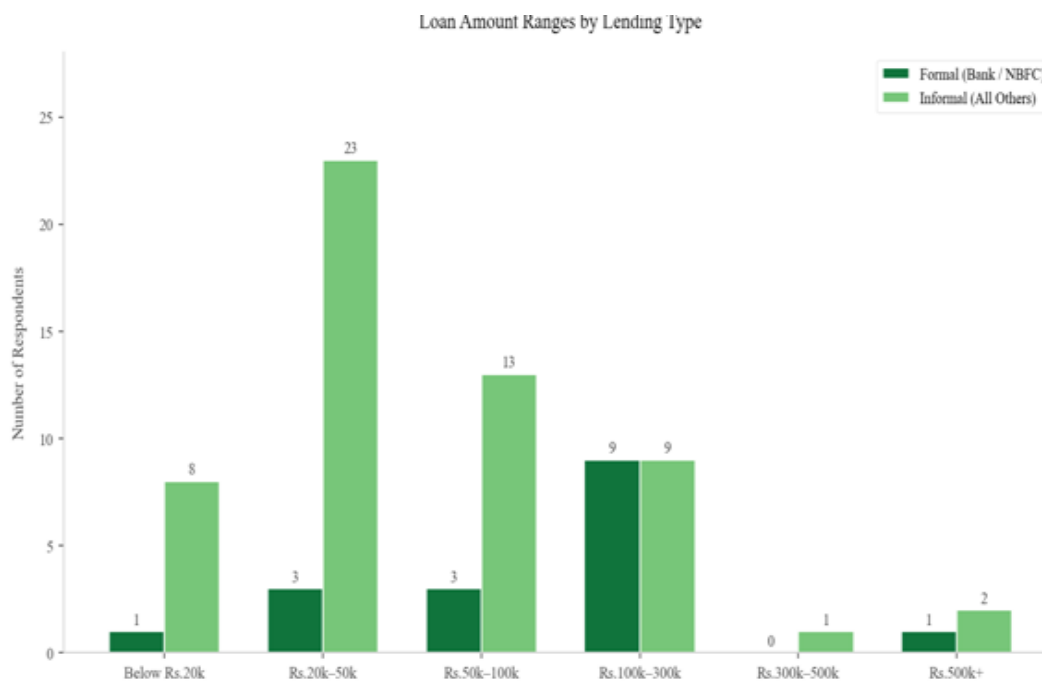
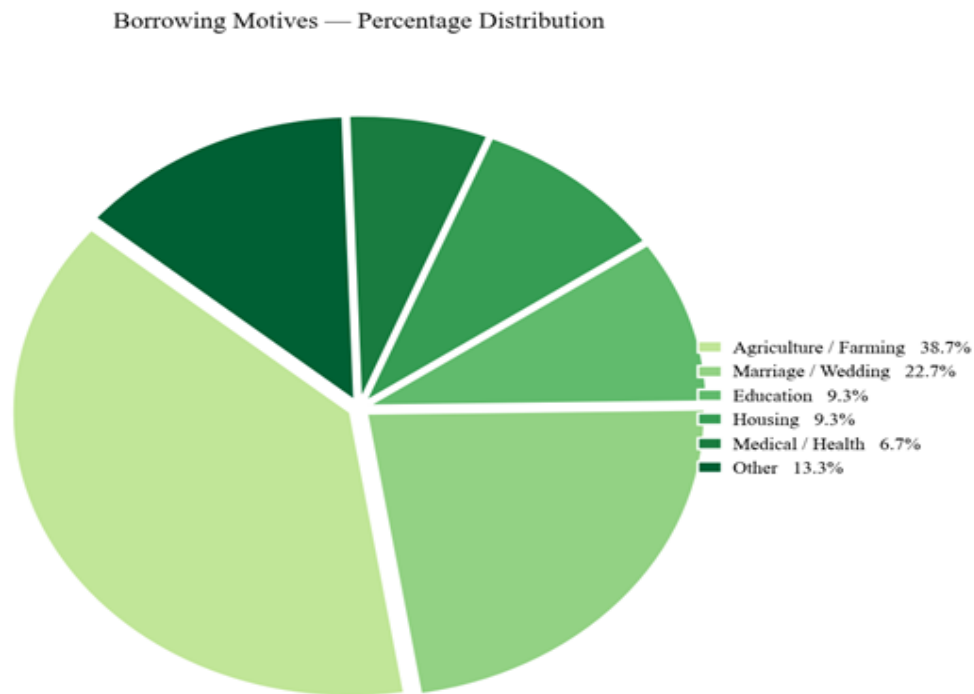


Fig 14: Borrowing Motives — Percentage Distribution



6. Results & Analysis

6.1 Analysis of H1: Institutional Trust and Borrowing Choice - Accepted

H1: Lower levels of institutional trust in formal banking institutions significantly increase the likelihood of low-income households in Telangana relying on informal credit sources for borrowing.

This hypothesis can be considered valid to a significant extent, as the data indicates that trust plays a heavily influential role in nudging households towards informal credit options. In Figure 0.1, four of the top five lending sources are informal, showing a greater distribution of borrowers reliant on sources such as local money lenders (36.5%), employers providing salary advances (17.6%), self-help groups (14.9%), and other informal sources (4.1%), while formal lending remains relatively low at 21.6%. A trend of distrust in formal lending was identified as a prevalent feature among rural populations (Fig. 0.5: Trust in Banks), with 61.4% of individuals not trusting banks and 15.8% unsure, while only 19.3% trust them. This contrasts sharply with the 58.5% of formal borrowers who do trust banks. Trust is also demonstrated as a factor that directly influences the choice of lending source, being rated the second most important factor at an average importance score of 4.48 out of 5 (Fig. 0.6: Lender Choice Factors). This effectively

demonstrates the prevalence of trust as a psychological factor that governs lending source choice, especially within low-income communities.

6.2 Analysis of H2: Procedural Barriers and Informal Credit Preference - Accepted

H2: Strict documentation requirements, regulatory compliance burdens, the need for collateral, and complex repayment rules imposed by formal financial institutions increase the dependence of low-income households on informal credit markets.

This hypothesis can be considered valid to a significant extent, as the data clearly demonstrates that documentation burdens, compliance complexity, and rigid repayment structures systematically discourage low-income households from engaging with formal credit systems. In Figure 0.6 (Lender Choice Factors), application requirements, primarily the requirement to submit personal assets as collateral, proved to be the highest-ranked factor influencing lender selection, with a score of 4.63 out of 5. Additionally, ease of paperwork was rated notably at 3.84, reinforcing the idea that procedural friction has played a central role in borrowing decisions. This is further supported by Figure 0.3 (Barriers to Accessing Formal Credit), where responses across 157 total mentions identified the requirement for collateral as the most frequent barrier at 35%, followed by documentation at 18.5%, no repayment flexibility at 12.1%, and employment proof at an additional 4.5%, together accounting for over two-thirds of all reported barriers. Supporting this further, Figure 0.7 (Perceived Difficulty of Paperwork) shows that 58.0% of formal borrowers found paperwork difficult, compared to 35.7% of informal borrowers, reflecting a 22.3 percentage-point difference. The dominance of collateral requirements as a formal lending barrier suggests that asset-based exclusion may act as a primary driver of informality.

6.3 Analysis of H3: Perceived Credit Risk and Lender Reluctance - Accepted(to a low degree)

H3: Higher perceived credit risk and reluctance from formal lenders — arising from volatile incomes, informal employment, and lack of credit history — push low-income households toward informal lenders who are more willing to absorb risk.

H3 can be considered valid to a substantial degree, as the data reflects clear structural trends consistent with formal lender risk aversion, particularly toward low-income borrowers. In Figure 0.3 (Barriers to Accessing Formal Credit), collateral requirements constituted the single largest barrier at 35.0% across all categories, indicating a systemic perception of risk, while employment proof accounted for another 4.5%, together representing how formal institutions procedurally exclude informally employed individuals with unstable incomes. This is supported by Figure 0.9 (Loan Amount Ranges by Lending Type), where informal lending was heavily concentrated in

smaller amounts, with 23 informal borrowers receiving ₹20,000–50,000 versus only 3 formal borrowers, reflecting how formal lenders avoid high-risk, low-value lending. Accordingly, Figure 0.6 (Formal vs. Informal Lending Distribution by Location) shows informal borrowing constituting 77.0% overall and 80.4% in rural areas. A counterpoint to this argument emerges from Figure 0.2 (Trust in Banks by Borrower Type), where 61.4% of informal borrowers distrust banks, indicating that the low rate of formal lending is not solely attributable to institutional and procedural barriers but also to demand-side preferences. This suggests that neither factor alone is an independent driver of informality.

6.4 Analysis of H4: Repayment Flexibility versus Cost of Credit - Accepted

H4: For low-income households, repayment flexibility and personalised lending terms offered by informal lenders have a stronger influence on borrowing decisions than the interest rate charged by formal financial institutions.

This hypothesis can be considered valid to a substantial extent, as the data consistently demonstrates that flexibility and accessibility outweigh cost concerns in borrowing decisions among low-income households. Contrary to common perception, in Figure 0.8 (Lender Choice Factors Ranked by Average Importance), interest rate was ranked the lowest of all seven indicators at 3.30 out of 5, considerably below application requirements (4.63), familiarity with lender (4.48), and speed of approval (4.34), revealing that relational and structural characteristics of informal lending are far more influential than cost of borrowing. This is corroborated by Figure 0.3 (Barriers to Accessing Formal Credit), where no repayment flexibility was cited more frequently — at 12.1% of mentions — than high interest rates at 10.2%, confirming that the rigidity of repayment terms is a more acute deterrent than price. A partial counterargument arises from Figure 0.5 (Importance of Interest Rates by Borrower Type), where formal borrowers rated interest rates at 4.43 versus 3.02 for informal borrowers, suggesting that cost sensitivity exists, albeit among those already engaging with formal institutions. Overall, this hypothesis is substantially validated, with repayment flexibility emerging as the dominant driver of informal credit preference over interest rate considerations.

7. Discussion

Based on the data above, the prominence of informal lending is evident in both rural and urban settings and across a multitude of sources. Seventy-seven percent of total respondents indicated reliance on informal lending, with only 22.9% reliant on bank-based lending, and the rural/urban split remaining consistent at 70–80% using informal credit.

The biggest barriers faced by these low-income groups can be categorised into two specific groups: psychological and systemic. Under the psychological category, the results identify that

“trust in the lender” functioned as a major factor influencing lending source decisions. This psychological aspect stems from the perception that banks are a “foreign” entity that only benefits higher-income individuals, alienating the government institution due to its lack of alignment with the borrowing needs of low-income individuals. This is closely tied to Institutional Trust Theory. Local lenders, by contrast, were members of the community and carried a degree of familiarity that was non-existent with banks, lending them greater reliability in the eyes of borrowers — precisely what is described in Social Capital Theory, where societal trust outweighs institutional lending and logic is governed more by trust than by financial security, creating a paradigm in which ease of access and trust become more important than factors such as interest rates.

Systemic barriers encompass three main reasons: the need for collateral, inflexibility in repayment, and unjustified or unverifiable borrower intent. As highlighted by Morduch, informal lending proves to be a valuable instrument for those facing fluctuating incomes, functioning as an income-smoothing device. Income fluctuation also prevents low-income individuals from making regular, timely payments — caused by, for example, crop failures, absence of daily wage income, or high-cost expenditures — which the rigid bank repayment system penalises. Informal lenders, by contrast, offer more flexible repayment plans that are more convenient for low-income borrowers.

Another main barrier is the need for collateral. Given the income volatility of low-income borrowers, banks use collateral as a security measure. This requirement is met with significant resistance, as many low-income individuals are extremely protective of their high-value assets — such as vehicles, homes, and jewellery — which are the very items commonly taken as collateral. Furthermore, they are aware of their potential inability to make recurring payments and therefore do not wish to risk losing their collateral, especially not to an unfamiliar institution. This is one of the most prominent factors preventing many low-income households from even approaching or applying for a loan, as they recognise that without collateral, their application will be rejected. Due to the pre-established trust between a local lender and borrower, the need for collateral ceases to be a problem, illustrating how societal trust between the two parties holds a higher regard than physical security (as also reflected in Social Capital Theory). This barrier also demonstrates the interconnectedness of repayment inflexibility and collateral requirements, with the former contributing to the latter.

The final factor is unjustified or unverifiable borrower intent. A key issue is the inability of banks to approve loans for personal purposes such as marriage, despite this being one of the most common motivations for borrowing. This is closely linked to the findings of Banerjee and Duflo, who suggest that informal lenders understand this need, particularly for high-expenditure personal uses such as weddings, while banks do not share this perspective — often rejecting such

applications. This reflects a lack of systemic understanding of the borrowing motivations of low-income households. Together, these factors act as prominent barriers that not only prevent banks from issuing loans but also prevent low-income individuals from applying for them in the first place. This leads to a heavy reliance on informal lenders who, based on the social standards of many low-income communities, are more trustworthy and approachable and offer a relatively higher degree of certainty of loan approval. However, this is financially damaging to low-income individuals, as informal lenders often charge much higher interest rates and sometimes resort to coercive tactics when borrowers are unable to repay.

8. Evaluation and Measures of Error

The research demonstrates a certain degree of methodological strength, particularly through its direct engagement with the target population and its use of primary data, which grounds the findings in lived experience rather than secondary abstraction. The latter often fails to capture non-systemic barriers such as interpersonal trust. By capturing responses from individuals actively participating in informal and formal credit systems, the study achieves a strong degree of contextual validity, allowing insights to emerge organically from real-world financial behaviour. Furthermore, the incorporation of both quantitative data (through structured survey responses and statistical representation) and qualitative inputs (through perceived barriers and preferences) enabled a degree of methodological triangulation, strengthening the reliability of the findings. This multi-layered approach allows patterns to be identified numerically and explained contextually, enhancing the depth, validity, and interpretive reliability of the analysis.

Despite these strengths, the research has notable limitations, particularly in relation to sample design and representativeness. The reliance on a relatively small sample size, combined with a non-probability-based sampling method, introduces potential selection bias, as respondents may not fully represent the broader low-income population across Telangana. This limitation is compounded by possible survey design limitations, including response bias and social desirability bias, where participants may have provided answers they perceived as favourable or socially acceptable rather than fully accurate depictions of their financial behaviour and choices.

Most critically, the findings of this study are contextually bound to a specific region and income group, limiting their external validity and broader applicability. While the data offers valuable insights into specific communities within Telangana, it cannot be generalised to represent all low-income populations across India, given the significant regional, cultural, and institutional diversity that characterises the country's financial landscape. The structural and psychological barriers influencing informal credit usage in one region may differ substantially in another, particularly when considering variations in banking infrastructure, financial literacy levels, and

socio-economic conditions. As such, the conclusions drawn must be interpreted within the scope of the sample and region studied, rather than as indicative of nationwide trends.

To enhance the applicability of future research, several improvements can be made. Expanding the sample size within the same region would improve reliability, while extending the study across multiple regions — including more remote and underbanked rural areas, diverse villages, and varied demographic groups — would provide a more comprehensive understanding of informal credit dynamics. Increasing representation from urban populations would also allow for stronger comparative analysis. Additionally, incorporating longitudinal studies could track how credit behaviour evolves over time, offering deeper insights into causation rather than correlation. Finally, engaging directly with formal financial institutions — such as bank managers — as well as institutionalised informal lenders would introduce a critical institutional perspective, enabling a more comprehensive understanding of both demand-side and supply-side constraints within the credit ecosystem. This would incorporate the operational, regulatory, and risk-based considerations that shape formal lending decisions. By understanding how banks assess creditworthiness, manage default risk, and interpret borrower profiles, the research would gain greater explanatory depth regarding why certain barriers persist despite policy interventions.

9. Conclusion

This research set out to answer the question: what factors strongly influence the choice of low-income households in Telangana to opt for informal credit over formal banking? The investigation, through a structured analysis of primary data, has revealed that borrowing decisions are not driven by a single systemic constraint, but rather by a culmination of systemic and psychological factors embedded within formal financial systems. Key issues include rigid repayment structures, high collateral requirements, the perceived illegitimacy of formal institutions, and a persistent lack of trust in banks, which are often viewed as distant or “foreign” entities. The results indicate that these barriers collectively contribute to a misalignment between formal banking structures and the lived financial realities of low-income households, thereby pushing many borrowers towards informal, trust-based credit systems that are more accessible and reliable.

Addressing these challenges requires solutions that are not only targeted but also structurally aligned with current banking systems. The SHG/JLG (Self-Help Groups/Joint Liability Groups) lending ecosystem serves as the most comprehensive answer to the identified barriers, simultaneously tackling collateral constraints, lack of trust, rigid repayment structures, and limited borrower understanding. These groups utilise group guarantees in place of physical collateral and situate lending within local social networks, enabling banks such as SBI (State Bank of India) to reduce risk while enhancing accessibility. In addition, the community banking

and Bank Mitra model introduces a human-centric process that simplifies formal banking systems, building trust through local engagement and improving borrower comprehension through linguistically and culturally appropriate services. Another viable solution is the introduction of flexible micro-loan products, designed with smaller principal amounts, adaptive repayment structures, and minimal documentation, directly targeting income volatility and procedural friction. Importantly, all three solutions align with existing banking regulatory frameworks, including Priority Sector Lending norms, the SHG-Bank Linkage Programme, and KYC guidelines (Reserve Bank of India 23), making them both feasible and scalable within the current banking ecosystem.

Overall, this paper contributes to development economics by highlighting that financial exclusion is less a function of access and more a consequence of institutional design misalignment. Moving forward, embedding flexibility, trust, and contextual understanding into formal systems will be critical in transitioning low-income borrowers toward sustainable financial inclusion.

References

- Banerjee, A., & Duflo, E. (2007). The economic lives of the poor. *Journal of Economic Perspectives*, 21(1), 141–167. <https://doi.org/10.1257/jep.21.1.141>
- Coleman, J. S. (1988). Social capital in the creation of human capital. *American Journal of Sociology*, 94(S1), S95–S120.
- Government of India, Ministry of Finance. (n.d.). *Pradhan Mantri Jan Dhan Yojana: Progress report*.
- Government of India, Ministry of Rural Development. (n.d.). *Self-help group programmes*.
- Luhmann, N. (1990). *Trust and power*. Wiley.
- Morduch, J. (1995). Income smoothing and consumption smoothing. *Journal of Economic Perspectives*, 9(3), 103–114. <https://doi.org/10.1257/jep.9.3.103>
- Reserve Bank of India. (n.d.). *Annual report and financial inclusion index*.
- Stiglitz, J. E., & Weiss, A. (1981). Credit rationing in markets with imperfect information. *American Economic Review*, 71(3), 393–410.
- World Bank. (n.d.). *The Global Findex Database*. <https://www.worldbank.org/en/publication/globalfindex>