

# Making Indian microfinance work

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The crisis [threatening the Indian microfinance industry](#) – triggered by a crackdown on microlenders by authorities in the state of Andhra Pradesh – is a wake-up call for regulators.

[The crackdown](#) was ill-judged. Local politicians blamed a spate of suicides in Andhra Pradesh on harassment by microfinance debt collectors. But rather than dealing directly with the problem, they passed an emergency order to suspend collections. Bank credit to microlenders quickly froze, bringing the industry to the verge of collapse. The contagion could spread to other states if debtors begin to believe that their payments will also be suspended.

The episode raises questions about the lack of regulation of microfinance companies. They have come a long way from the non-profit organisations championed by Muhammad Yunus, the father of modern microfinance. The Hyderabad-based SKS Microfinance raised \$350m in an initial public offering earlier this year. With 30m borrowers and a loan portfolio of \$6.5bn, the industry has become too big to ignore.

Rapid growth has made it a target for politicians, particularly in a country where much of the financial system remains in the grip of the state. Political attacks are ironic: much of the microfinance industry's growth derives from its designation by authorities as one of the 'priority sectors' to which commercial banks must devote 40 per cent of their lending.

Microfinance companies should be regulated – albeit intelligently. In spite of their high interest rates, such companies have small margins: making tiny, short-term loans involves substantial transaction costs.

Many officials overlook this fact. In September the finance ministry urged state-owned commercial banks to [impose an interest rate cap](#) on the microlenders they fund. As well as interfering with the price mechanism, such burdensome rules could make these lenders unprofitable.

Regulators should take measures to boost competition in the microfinance sector. Lenders should be obliged to disclose their interest rates. This would strengthen the price mechanism and bring rates down. Though leading companies have signed up to a voluntary code of conduct demanding transparency, few have complied.

The microfinance industry has brought crucial services to India's poor. Regulators can ensure that it does an even better job of helping people lift themselves out of poverty.