

Regulating Microfinance: Providing Opportunity and Protection for the Poor

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Dear Friends,

The Andhra Pradesh (AP) State government October 15, 2010 Ordinance against microfinance institutions (MFIs) could seriously undermine the microfinance industry and do significant damage to the cause of financial inclusion for the poor. Financial inclusion is being damaged as the strong credit culture that has lifted millions out of poverty is being eroded. Since the sector lends to 30 million poor households with a current loan portfolio of Rs. 30,000 Crores (\$6.7 billion), damage to MFIs has systemic implications.

The Ordinance's proximate stated cause was the suicide of 57 of AP's 6.5 million microfinance borrowers or their husbands. Suicide is a tragic, terrible loss for families and a societal shame but it is extremely unlikely that MFIs that foster ethical lending practices are the cause of these tragedies. There appears little basis for jumping to the conclusion that MFIs are the cause of broad-based societal problems in rural India.

Ethical lending mandates that loans are used for investment rather than immediate consumption and that loan officers are not incentivized based on loan size — so that the officers are not predisposed to over-lend. In fact, an independent study commissioned by the Small Industries Development Bank of India showed that microfinance members increase income by 45% annually, *after* paying off the interest.

Professionally run MFIs welcome constructive regulation. As a responsible MFI, SKS is registered as a Non-Bank Finance Company (NBFC), regulated by the Reserve Bank of India (RBI) and a member, in good standing, of the Microfinance Institution Network (MFIN), our industry association. We agree wholeheartedly that there should be no tolerance for unethical lending practices and that the AP State government has not only the right, but also the duty, to hold rogue financiers accountable. But an Ordinance that punishes an entire industry instead of addressing unethical lending practices is both inappropriate and harmful to the very people most in need of protection — the poor.

While well-intentioned, the potential negative effects of the Ordinance are enormous. Recognizing this, the AP High Court passed an interim order on October 22, 2010 that MFIs "shall be free to carry on their business." Yet microfinance operations are still being disrupted and the microfinance system remains at risk. The microfinance model has been developed, put into practice and refined over a period of several decades; producing outstanding results. With few credible alternate means of building financial inclusion for the poor of AP, changes to the microfinance model should be made with extreme caution.

MFIs are ready and willing to engage with the AP State government to adopt some of the measures set out in the Ordinance. However, it should not be overlooked that parts of the Ordinance will create significant difficulties for borrowers. For example, the requirement that MFIs collect monthly rather than weekly installments presents borrowers with the problem of saving for monthly payments with no secure place to store their money. Also, weekly repayments have the practical benefit of being small enough that it is possible for borrowing groups to smooth any disruptions in cash flow amongst themselves, strengthening the credit culture that has lifted so many out of poverty. The Ordinance imposes this change with retrospective effect literally rewriting millions of private contracts.

We hope that we can engage in a dialogue with the AP State government to share our first-hand experience of working in the field and amend some of the counterproductive provisions of the Ordinance. In this way, we can ensure the health of the microfinance sector while simultaneously ending unethical lending practices. If we don't do this very soon, there is a danger that the confidence in the credit system that links the poor via MFIs to India's financial system will evaporate. Microfinance's contribution toward financial inclusion of the poor will be irreparably damaged.

We look forward to receiving your assistance and guidance in this endeavor.

Best Regards,

Vikram Akula, Ph.D.