

## Microcredit is not the enemy

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In the name of protecting India's poor, the state government of **Andhra Pradesh has caused deep turmoil** in microfinance. A new law clearly signals that borrowers need not repay their small-scale loans. Not surprisingly this has led to large-scale default, throwing the industry in India into a crisis it may not survive. This is having repercussions for microfinance worldwide.

As a result, **the sense is growing that microfinance itself is a flawed idea**. Some have even drawn parallels between this crisis and the sub-prime disaster. But this is badly misguided. Microfinance institutions are highly focused on avoiding default. The historic default rates in India have been close to zero, reflecting trust built over many years. If borrowers are encouraged to default en masse the system will fall apart, and a valuable financial product will disappear. This, in short, is a crisis born of government intervention, not flaws in microfinance itself.

If this sector collapses Indian banks will suffer losses, while commercially viable efforts to lend to the poor at reasonable rates will be thwarted for years to come. Clients will have found out that it is possible not to repay. Banks will learn that doing business with the poor is riskier than it need be. India's poor will, once again, have to rely either on failed public-sector efforts for financial inclusion, or on money lenders. It is even possible that this crisis could scare capital away in other countries too, threatening a sector that currently serves more than 200m poor borrowers across the world.

Microfinance fills a vital need in developing countries: the provision of financial services to those on low-incomes who lack access to formal banking. It is not a silver bullet that ends poverty, as is sometimes claimed. But studies have shown sound evidence that it allows many of the world's poorest people to develop businesses, insure against bad weather and illness, maintain employment, and smooth consumption. Its main innovation is not lending to the poor – but doing so at lower cost, and with lower interest rates, than informal moneylenders. Microcredit can be profitable, but its profits, at least in South Asia, come mainly from large volumes rather than large mark-ups.

To be sure, India's microfinance industry is not without its problems. Microfinance institutions charge rates ranging from 18 to 35 per cent. This looks higher than regular banks, creating the impression that microfinance is inequitable. But this impression needs to be tempered by the fact that credit card rates are quite similar. The costs of lending small amounts to vast numbers of poor people who lack collateral or credit records are high anyway, which is why they are often excluded altogether from formal credit channels. Microfinance manages to provide some credit access at rates substantially below the informal market, which ranges from 30 to 120 per cent.

Other problems in microfinance relate to its rapid growth. Loan officers are given financial incentives to recruit more clients, and may not screen them adequately. Anecdotal evidence suggests **over-indebtedness of clients is a problem**, while there are also rumours of debt-related suicide. Yet tragic though these problems are, we must remember that rural indebtedness is mostly a problem caused by loans from non-microfinance sources, and, in particular, from old fashioned money lending.

The priority now should be to stop the current crisis. Andhra Pradesh should withdraw its ordinance. Microfinance also does need better regulation, but the primary focus should not limit interest rates or profits. Instead, it should reform rules to help microfinance institutions better screen borrowers, thereby lowering costs. Other initiatives can help too, such as new ways to investigate client grievances and better enforcement of the code of conduct for credit officers.

When it works well microfinance really can be a win-win. Institutions need to be more diligent in their lending – but politicians also need to be wary. In taking aim at the occasional overstep, they may inadvertently destroy microfinance itself. That would be a disservice to the world's poor, and their hopes of climbing out of poverty.

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