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## Rural Banking: Designing an Effective Legal Framework for Microfinance

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# RURAL BANKING: DESIGNING AN EFFECTIVE LEGAL FRAMEWORK FOR MICROFINANCE

IAN DAVIS<sup>1</sup>

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Approximately 1.2 billion people live in extreme poverty, surviving on less than \$1 per day.<sup>2</sup> In emerging markets, commercial banks generally serve only ten to twenty percent of the population, excluding eighty to ninety percent of the population from the formal financial sector.<sup>3</sup> Many in this “un-banked” population could benefit from access to financial services.

In most developing countries, rural financial markets are based partially on a foundation of law and partially on a non-legal foundation of extra-legal (and sometimes illegal) activities.<sup>4</sup> These legal and non-legal foundations directly

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<sup>2</sup> ROBERT PECK CHRISTEN & DOUGLAS PEARCE, CONSULTATIVE GROUP TO ASSIST THE POOR (CGAP), MANAGING RISKS AND DESIGNING PRODUCTS FOR AGRICULTURAL MICROFINANCE: FEATURES OF AN EMERGING MODEL 1 (2005), [http://www.cgap.org/gm/document-1.9.2705/OccasionalPaper\\_11.pdf](http://www.cgap.org/gm/document-1.9.2705/OccasionalPaper_11.pdf).

<sup>3</sup> See MARGUERITE S. ROBINSON, THE MICROFINANCE REVOLUTION: SUSTAINABLE FINANCE FOR THE POOR 6 (World Bank Publication 2001).

<sup>4</sup> HEYWOOD W. FLEISIG & NURIA DE LA PEÑA, LEGAL AND REGULATORY REQUIREMENTS FOR EFFECTIVE RURAL FINANCIAL MARKETS 1 (Ctr. for the Econ. Analysis of Law 2003). This principle is illustrated in detailed fashion in HERNANDO DE SOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE (Basic Books 2000). De Soto explains that most businesses in developing economies function in the extra-legal sphere, meaning they do not enjoy

influence the operation of rural financial institutions.<sup>5</sup> This comment will discuss the intersection between rural finance and legal systems. The focus of the paper will be on an emerging legal issue in developing countries: integration of microfinance institutions with the formal legal framework. The comment argues that the benefits of microfinance regulation outweigh the costs and is divided into four sections: The first section is an introduction to microfinance; the second section provides an overview of the issue of microfinance regulation;<sup>6</sup> the third section offers suggestions for specific aspects of a favorable legal framework for microfinance;<sup>7</sup> the final section analyzes an example of an effective microfinance regulation law.<sup>8</sup>

## I. INTRODUCTION TO MICROFINANCE

Microfinance organizations aim to help individuals rise out of poverty.<sup>9</sup> Providing access to credit for low income groups that have traditionally been excluded from financial markets allows the poor to “expand and diversify their

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legal protection and benefits since they are not registered as legal entities. De Soto describes the predicament: “[e]xtralegal businesses are taxed by the lack of good property law and continually having to hide their operations from the authorities. Because they are not incorporated, extralegal entrepreneurs cannot lure investors by selling shares; they cannot secure low-interest formal credit because they do not even have legal addresses.” *Id.* at 155.

<sup>5</sup> FLEISIG & DE LA PEÑA, *supra* note 4, at 1. The legal structure of rural financial institutions influences the institutions’ legitimacy and ability to operate efficiently. Additionally, if institutions operate in the extra-legal sphere, they live in fear of government detection. *See* DE SOTO, *supra* note 4, at 155. De Soto states that such fear makes it difficult for institutions to reach their potential, as “underground entrepreneurs cannot openly advertise to build up their clientele or make less costly bulk deliveries to customers.” *Id.*

<sup>6</sup> *See infra* note 34.

<sup>7</sup> *See infra* note 104.

<sup>8</sup> *See infra* note 199.

<sup>9</sup> The website of Unitus, a leader in the microfinance industry, provides an overview of the history of microfinance:

Microfinance emerged in the 1970s as social innovators began to offer financial services to the working poor — those who were previously considered “un-bankable” because of their lack of collateral. Once given the opportunity, not only did clients of [microfinance institutions] expand their businesses and increase their incomes, but their high repayment rates demonstrated that the poor are capable of transforming their own lives given the chance. This model of lending disproved all conventional thinking. Microfinance was born. Since then, microfinance has become one of the most sustainable and effective tools in the fight against global poverty.

Unitus, The Microfinance Solution, <http://www.unitus.com/unitus-in-action/background-poverty-and-microfinance/the-microfinance-solution> (last visited Mar. 1, 2009).

Further, the Unitus website briefly explains the fundamentals of microfinance:

The most common microfinance product is a microcredit loan — usually less than \$100. These tiny loans are enough for hardworking micro-entrepreneurs to start or expand small businesses such as weaving baskets, raising chickens, or buying wholesale products to sell in a market. Income from these businesses provides better food, housing, health care and education for entire families, and most important, additional income provides hope for a better future.

*Id.* Unless otherwise indicated, this paper refers only to microfinance in developing countries. Microfinance in wealthy countries presents drastically different issues.

economic activity, increase their incomes, and improve their self-confidence.”<sup>10</sup> The Consultative Group to Assist the Poor, a World Bank sponsored consortium of globally respected donors, explains:

Empirical evidence shows that, among the poor, those participating in microfinance programs who had access to financial services were able to improve their well-being both at the individual and household level much more than those who did not have access to financial services.<sup>11</sup>

Access to microfinance services can broaden the economic opportunities available to many individuals of the developing world. The only alternative sources of financial services to many who are excluded by the formal sector are informal money lenders and loan sharks.<sup>12</sup> Such lenders take advantage of the plight of the poor and charge exorbitant interest rates that are typically five to twenty times higher than most microfinance organizations.<sup>13</sup>

Many empirical studies demonstrate the positive effects of microfinance programs.<sup>14</sup> Microfinance programs have proven effective at increasing incomes and reducing vulnerability.<sup>15</sup> Research indicates that such financial benefits also lead to a positive social impact.<sup>16</sup> Microfinance programs typically target women, and studies have demonstrated that such access to financial services has improved the status of women:

There is strong evidence that access to financial services and the resultant transfer of financial resources to poor women, over time, lead to women becoming more confident and assertive. Access to finance enables poor women to become economic agents of change by increasing their income and productivity, access to markets and information, and decision-making power.<sup>17</sup>

The strong body of evidence demonstrating its positive impact has led microfinance to garner much support. Muhammad Yunus, pioneer of the microfinance movement and founder of the Grameen Bank in Bangladesh, was

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<sup>10</sup> ROBINSON, *supra* note 3, at 37.

<sup>11</sup> CGAP, <http://www.cgap.org/p/site/c/template.rc/1.26.1306/> (last visited Apr. 3, 2009).

<sup>12</sup> Informal money lenders and loan sharks are individual lenders who conduct transactions directly with their clients. See A.C. KULSHRESHTHA, TREATMENT OF INFORMAL SECTOR FINANCIAL ACTIVITIES INCLUDING OWN MONEY LENDERS IN THE SNA 1 (2004), <http://unstats.un.org/unsd/nationalaccount/AEG/papers/m4MoneyLendersKulsh.pdf>. Their clients are typically the poor and illiterate members of society who have no hope of qualifying for a loan from commercial sources. *Id.*

<sup>13</sup> ROBINSON, *supra* note 3, at 16-17.

<sup>14</sup> See Jonathan Morduch, *Analysis of the Effects of Microfinance on Poverty Reduction* (NYU Wagner Working Paper Series, Paper No. 1014, 2002) (Providing a helpful overview of such studies).

<sup>15</sup> See ROBINSON, *supra* note 3, at 9.

<sup>16</sup> See responsAbility Social Investment Services AG, *The Social Impact of Microfinance and How to Measure It*, <http://www.thinkmicrofinance.org/wp-content/uploads/2006/12/discuspaper2.pdf> (last visited Mar. 11, 2009).

<sup>17</sup> CGAP, <http://www.cgap.org/p/site/c/template.rc/1.26.1306/> (last visited Apr. 3, 2009).

awarded the Nobel Peace Prize in 2006.<sup>18</sup> The United Nations legitimized the effectiveness of microfinance by anointing 2005 as the “International Year of Microcredit.”<sup>19</sup> Each year, influential world leaders such as the Queen of Spain, the Queen of Jordan, and the First Lady of South Africa attend conferences organized by the Microcredit Summit Campaign.<sup>20</sup> Globally, there are approximately 3,000 microfinance organizations serving over 130 million poor clients.<sup>21</sup>

While microfinance has expanded significantly, the movement remains far from reaching its potential. After thirty years of industry effort, there is still a large gap between the supply and demand for microfinance services.<sup>22</sup> At current growth rates, in 2010 there will still be 395 million un-served individuals who desire access to microfinance.<sup>23</sup> This slow growth is due to the fact that most microfinance institutions (MFIs) rely on a limited pool of donor funds to finance their operations.<sup>24</sup> As MFIs move towards securing growth capital from financial markets, they will be able to grow more rapidly.<sup>25</sup> Favorable banking laws for microfinance can play a key role in enabling MFIs to reach this objective.<sup>26</sup>

For decades, credit cooperatives and development finance institutions have

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<sup>18</sup> Dr. Yunus received the Nobel Peace Prize jointly with the Grameen Bank. See Nobelprize.org, Peace 2006, [http://nobelprize.org/nobel\\_prizes/peace/laureates/2006/](http://nobelprize.org/nobel_prizes/peace/laureates/2006/) (last visited Mar. 1, 2009). In his book, *Banker to the Poor*, Dr. Yunus recalls that in 1974 he was teaching economics at Chittagong University in southern Bangladesh, when the country experienced terrible famine in which thousands starved to death. MUHAMMAD YUNUS, *BANKER TO THE POOR* vii (1999). He noted that the thrill he had once experienced from studying economics and teaching his students elegant theories that could supposedly cure societal problems left him entirely unsatisfied. *Id.* at viii. Yunus visited the nearby village of Jobra, where he learned the real-life economics of the poor. *Id.* at viii – ix. He wanted to help, and he designed several plans. *Id.* at ix. One plan was more successful than the others: offering poor individuals tiny loans for self-employment. *Id.* Grameen Bank was born and an economic revolution had begun.

<sup>19</sup> In furtherance of its efforts to reach the Millennium Development Goals, the UN launched a year-long campaign to promote microfinance. The official UN website for the International Year of Microcredit states, “[t]he Year of microcredit 2005 calls for inclusive financial sectors and strengthening the powerful, but often untapped, entrepreneurial spirit existing in communities around the world.” International Year of Microcredit 2005, <http://www.yearofmicrocredit.org/> (last visited Mar. 1, 2009).

<sup>20</sup> The Microcredit Summit Campaign is a publicity campaign that works to “ensure that 175 million of the world's poorest families, especially the women of those families, are receiving credit for self-employment and other financial and business services by the end of 2015.” Microcredit Summit Campaign, <http://www.microcreditsummit.org> (last visited Mar. 1, 2009). In its efforts to achieve this stated goal, the Microcredit Summit Campaign collects data from MFIs around the world and organizes annual best-practice conferences. *Id.*

<sup>21</sup> The statistics are based on published estimates from the Microcredit Summit Campaign. See SAM DALEY-HARRIS, *STATE OF THE MICROCREDIT CAMPAIGN REPORT 2007* (2007), <http://www.microcreditsummit.org/pubs/reports/socr/EngSOCR2007.pdf> (last visited Mar. 11, 2009).

<sup>22</sup> See *id.*

<sup>23</sup> This figure is based on CGAP data and population growth rates from the UN population division. Unitus, [www.unitus.com](http://www.unitus.com).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*; see *infra* note 90.

<sup>26</sup> A substantial portion of this comment is dedicated to this issue. See *infra* section II.

provided access to credit to customers that commercial banks have neglected.<sup>27</sup> Legal charters govern the financial operations of these organizations and allow them access to savings or other public sources of funding.<sup>28</sup> During the past two decades, many innovative methodologies for delivering microfinance services have emerged.<sup>29</sup> Development of such innovation has been led by non-governmental organizations (NGOs), “who typically do not have a legal charter authorizing them to engage in financial intermediation.”<sup>30</sup>

Currently, there is much discussion among governments, practitioners, and donors about new legal structures for microfinance.<sup>31</sup> Many countries have regulatory laws specifically tailored to the microfinance sector.<sup>32</sup> There are clear costs and benefits to microfinance regulation.<sup>33</sup> The following section provides an overview of microfinance regulatory issues.

## II. MICROFINANCE REGULATION AND SUPERVISION

To reach large numbers of people, microfinance must operate through institutions that are licensed and supervised by a country’s financial authorities.<sup>34</sup> A licensed institution can offer savings services to its clients and increase its own

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<sup>27</sup> ROBERT PECK CHRISTEN & RICHARD ROSENBERG, CGAP, THE RUSH TO REGULATE: LEGAL FRAMEWORKS FOR MICROFINANCE 1 (2000), [http://www.cgap.org/gm/document-1.9.2699/Occasional\\_Paper\\_04.pdf](http://www.cgap.org/gm/document-1.9.2699/Occasional_Paper_04.pdf).

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* Two leading microfinance models are the Grameen Bank model and the village banking model. The Grameen Bank model consists of group lending, and was pioneered by the Grameen Bank. See YUNUS, *supra* note 18; see also Grameen Bank, Credit Lending Markets, [http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=43&Itemid=93](http://www.grameen-info.org/index.php?option=com_content&task=view&id=43&Itemid=93) (last visited Mar. 11, 2009). Village banking is a lending methodology developed by FINCA International. See Glenn Westley, *Village Banking: Joining the Mainstream*, 7 MICROENTERPRISE DEV. REV. 1, 1 (2004). A village bank is an informal self-help support group of 20-30 members, predominantly female heads-of-household. *Id.* at 2. These women meet once a week in the home of one of their members to avail themselves of working capital loans, a safe place to save, skill training, mentoring, and motivation. See also FINCA, Microfinance and Village Banking, <http://www.villagebanking.org/site/c.erKPI2PCIoE/b.2394109/k.BEA3/Home.htm> (last visited Mar. 11, 2009).

<sup>30</sup> CHRISTEN & ROSENBERG, *supra* note 27, at 1.

<sup>31</sup> See generally STEFAN STASCHEN, REGULATORY REQUIREMENTS FOR MICROFINANCE: A COMPARISON OF LEGAL FRAMEWORKS IN 11 COUNTRIES WORLDWIDE (Eschborn 2003), <http://www.intercooperation.ch/finance/download/divers/staschen-comparision-between-countries.pdf>. See also RICHARD ROSENBERG ET AL., DONOR BRIEF NO. 12: REGULATION AND SUPERVISION OF MICROFINANCE (May 2003), <http://www.cgap.org/p/site/c/template.rc/1.9.2415/>.

<sup>32</sup> For example, Uganda passed the Microfinance Deposit-taking Institution Act in 2003, establishing a unit within the Bank of Uganda to regulate microfinance deposit-taking institutions (MDIs). DAVID KALYANGO, UGANDA’S EXPERIENCE WITH THE REGULATORY AND SUPERVISORY FRAMEWORK FOR MICROFINANCE INSTITUTIONS 9 (Bank of Uganda 2005). The act allows for wider access to public funds and places minimum capital requirements of 15% of risk weighted assets on all MDIs. *Id.* See generally STASCHEN, *supra* note 31 (where the author compares the regulatory frameworks and relevant laws in eleven countries).

<sup>33</sup> See *infra* note 56.

<sup>34</sup> ROSENBERG ET AL., *supra* note 31, at 1.

capital by capturing deposits.<sup>35</sup> Microfinance is substantially different from conventional banking; therefore, “[the banking and regulatory laws] in most countries will eventually need some adjustment to accommodate licensed microfinance.”<sup>36</sup>

Financial regulation includes prudential and non-prudential aspects.<sup>37</sup> The purpose of the prudential aspect is to control systemic risk in the financial system and to protect depositors.<sup>38</sup> Microfinance institutions that receive deposits from the general public need prudential regulation.<sup>39</sup> Prudential regulation mandates capital adequacy requirements and rules for provisioning loan losses; it also requires a supervisory process to ensure compliance.<sup>40</sup> Granting a license to a “regulated” institution portrays the government’s stamp of approval for the soundness of the institution.<sup>41</sup>

There is a growing consensus that not all MFIs need to be regulated.<sup>42</sup> Specifically, donor-funded, credit-only MFIs that do not receive deposits from the general public do not need to be formally regulated.<sup>43</sup> Regulatory resources should be primarily reserved for larger institutions, and caution should be exercised when

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> Prudential regulation refers to regulation that is designed specifically to protect the financial system as a whole while also protecting small deposits in individual institutions. See ROBERT PECK CHRISTEN ET AL., GUIDING PRINCIPLES ON REGULATION AND SUPERVISION OF MICROFINANCE (2003), <http://www.cgap.org/p/site/c/template.rc/1.9.2787/> [hereinafter *Microfinance Consensus Guidelines*]. When a deposit-receiving institution becomes insolvent, its failure could send a signal to the public, leading to a run on deposits. *Id.* Prudential regulation refers to the government’s oversight of the financial soundness of the regulated institutions. *Id.* The government aims to ensure that licensed institutions remain financially viable or stop receiving deposits if they become insolvent. *Id.*; see also CHRISTEN & ROSENBERG, *supra* note 27.

<sup>38</sup> See ROSENBERG ET AL., *supra* note 31. Systemic risk refers to the risk that affects the entire market or system, and not just specific participants. See also Aaron Jones, *Promotion of a Commercially-Viable Microfinance Sector in Emerging Markets*, 13 GEO. J. ON POVERTY L. & POL’Y 187, 200 (2006).

<sup>39</sup> See *Microfinance Consensus Guideline*, *supra* note 37.

<sup>40</sup> See ROSENBERG ET AL., *supra* note 31; see also Jones, *supra* note 38, at 201.

<sup>41</sup> See CHRISTEN & ROSENBERG, *supra* note 27. Some requirements are non-prudential, not because they are insignificant, but because they do not require the government’s financial authority to vouch for, or assume responsibility for, the soundness of the institution. *Id.* at 9. Such regulation includes consumer protection measures, external audits, and certain disclosure requirements. *Id.*

<sup>42</sup> *Id.*; see also *Microfinance Consensus Guidelines*, *supra* note 37; HENNIE VAN GREUNING ET AL., A FRAMEWORK FOR REGULATING MICROFINANCE INSTITUTIONS (Dec. 1998), [http://www.mfc.org.pl/doc/backgroundmaterials/A\\_Framework\\_for\\_Regulating.pdf](http://www.mfc.org.pl/doc/backgroundmaterials/A_Framework_for_Regulating.pdf).

<sup>43</sup> See CHRISTEN & ROSENBERG, *supra* note 27. These institutions are too small to cause systemic risks and they do not create risks to depositors. The task of supervising many smaller institutions would be burdensome on the regulatory authority, and could divert resources from the primary objective of maintaining the safety and soundness of the banking system. See ALEX COUNTS & SHARMI SOBHAN, RECOMMENDATIONS FOR THE CREATION OF A PRO-MICROCREDIT REGULATORY FRAMEWORK (2001), available at [http://www.microfinancegateway.org/files/35924\\_file\\_10.pdf](http://www.microfinancegateway.org/files/35924_file_10.pdf).

With the growth of the microfinance sector, many countries are home to thousands of small institutions offering microcredit. See Mix Home Page, <http://www.themix.org/>. Many of these institutions have less than 1,000 borrowers; it would be an inefficient allocation of financial and administrative resources for the regulatory body to supervise all of them.

regulating smaller deposit-taking MFIs.<sup>44</sup> “Regulation of [smaller] institutions may be impracticable because proportionately more regulatory resources and costs are required to regulate them, while their small size and community focus may make private peer supervision by members and depositors more effective.”<sup>45</sup>

Regarding the issue of which regulations to apply to MFIs, a growing body of research argues that regulations and supervisory tools should be adapted to the unique characteristics of the microfinance sector.<sup>46</sup> Some countries have developed legal “windows” that are dedicated to microfinance and under which MFIs are regulated and licensed.<sup>47</sup> Adapting the existing framework to the needs of microfinance may be more likely to attract existing financial institutions to microfinance.<sup>48</sup> However, local factors will determine the feasibility of such an option. Lawmakers may be hesitant to expand the existing banking laws to reach microfinance, as such a practice could lead to further, unrelated, reconsiderations of banking issues.<sup>49</sup>

In determining whether certain characteristics of microfinance banks justify special adaptation from existing regulatory laws, there are several factors to consider. While a bank is a bank—whether it is small or large, basic or complex—it may be beneficial to examine several distinguishing aspects of microfinance banks. The client base of MFIs differs from that of commercial banks as MFI borrowers are poor entrepreneurs typically working in the informal economy, rather than working for registered, formal businesses.<sup>50</sup> The lending methodologies differ, as lending decisions in MFIs are based on character and are rarely backed by conventional collateral, whereas conventional banking loans are based on sophisticated analysis of financial statements and are backed by tangible assets.<sup>51</sup> The structure and governance of MFIs are unique. Taking loans to a widely dispersed rural clientele typically results in a decentralized structure, rather than the centralized and bureaucratic structure of most commercial banks. Together with the lending methodology this accounts for high transactional costs

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<sup>44</sup> See *Microfinance Consensus Guidelines*, *supra* note 37.

<sup>45</sup> Jones, *supra* note 38; see also CHRISTEN & ROSENBERG, *supra* note 27, at 10-11.

<sup>46</sup> See *Microfinance Consensus Guidelines*, *supra* note 37; see also CHRISTEN & ROSENBERG, *supra* note 27; Jones, *supra* note 38.

<sup>47</sup> *Microfinance Consensus Guidelines*, *supra* note 37, at 9. Such windows can be helpful as the microfinance sector begins maturation, but may not be necessary at further stages of development of the sector. At an early stage, the desired regulatory impact can be accomplished by adapting general banking laws to the specific needs of microfinance. CHRISTEN & ROSENBERG, *supra* note 27. This practice will allow regulators and legislators time to acquire more expertise with the microfinance sector and to consider which regulations will balance the twin objectives of creating a welcoming legal framework that allows MFIs to flourish and adequately addressing safety and soundness concerns. *Id.*

<sup>48</sup> *Microfinance Consensus Guidelines*, *supra* note 37, at 9. Commercial financial institutions may be more likely to do business with MFIs that operate under the same banking laws. Additionally, it may make mergers between MFIs and commercial banks more logistically feasible. See *infra* note 227-28.

<sup>49</sup> *Microfinance Consensus Guidelines*, *supra* note 37.

<sup>50</sup> JAY K. ROSENGARD ET AL., MICROFINANCE DEVELOPMENT IN KENYA: K-REP'S TRANSITION FROM NGO TO DIVERSIFIED HOLDING COMPANY AND COMMERCIAL BANK 1 (June 2000).

<sup>51</sup> *Id.*



for most microfinance institutions.<sup>52</sup> MFI portfolios are comprised of a high volume of small, short-term loans rather than more efficient larger, long-term loans that are typical of retail banking portfolios.<sup>53</sup> Deposits in MFIs are primarily from low-income community-based savers, rather than highly mobile short-term investors.<sup>54</sup> These characteristics distinguish MFIs from commercial banks and support the notion that MFIs should be regulated differently.<sup>55</sup>

#### *A. Challenges for microfinance regulation*

While there is a general understanding that regulation of microfinance has positive results for the sector,<sup>56</sup> it is not without challenges. As microfinance institutions are unique in structure, regulatory supervision poses issues that do not arise in the commercial banking sector.<sup>57</sup>

Banking supervisors in many developing countries supervise a commercial banking system with extreme structural problems, often including many struggling large banks.<sup>58</sup> The collapse of one of these banks (many countries face the potential of numerous collapsing banks) could threaten the country's financial system with implosion.<sup>59</sup> While managing bank risk, the supervisor may have to handle political ramifications, as "the owners of banks are seldom underrepresented in the political process."<sup>60</sup> If a bank supervisor shows resistance to adding MFIs—mostly small institutions offering uncollateralized loans and posting small profitability numbers—to his or her list of responsibilities, it is important to acknowledge that his or her rationale may be better than outright disregard for the poor.<sup>61</sup>

When a supervising body determines to oversee MFIs, it will face many challenges. The most basic challenge arises from ownership structure.<sup>62</sup> For

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<sup>52</sup> *Id.*; see *infra* note 179.

<sup>53</sup> ROSENGARD ET AL., *supra* note 50, at 1.

<sup>54</sup> *Id.*

<sup>55</sup> See *supra* notes 46 & 47.

<sup>56</sup> See HENNIE VAN GREUNING ET AL., *supra* note 42; see also, ROBIN YOUNG & LAUREN MITTEN, LEGAL FRAMEWORKS AND PERFORMANCE STANDARDS FOR MICROFINANCE: A DESK STUDY (Feb. 2000) *Microfinance Consensus Guidelines*, *supra* note 37.

<sup>57</sup> GREUNING ET AL., *supra* note 42

<sup>58</sup> CHRISTEN & ROSENBERG, *supra* note 27, at 3. This portion of the paper refers frequently to a "banking supervisor." *Id.* This term refers to the individual supervisor or the supervisory body that is charged with regulating the country's financial system. *Id.* Typically, this is the role of a country's central bank. *Id.*

<sup>59</sup> *Id.* Implosion refers to a sudden inward collapse of the institution, the effects of which would be felt by the entire financial system. This is a similar concept as systemic risk. See *supra* note 38.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* Supervisors in developing countries typically have their hands full with problems among the commercial banks. See, e.g., *Microfinance Consensus Guidelines*, *supra* note 37. Because of the existing difficulties even without inclusion of risky MFIs, supervisors can appear reluctant to add MFIs to their supervisory responsibilities. *Id.*

<sup>62</sup> ROBERT PECK CHRISTEN & RICHARD ROSENBERG, THE RUSH TO REGULATE: LEGAL

commercial banks, ownership generally includes wealthy individuals with their own money at risk in the bank.<sup>63</sup> Such owners desire a financial return from the bank and have a personal interest in the bank's success. They have an incentive to monitor the bank's manager to ensure that management is consistent with the long-term financial health of the bank.<sup>64</sup> These owners play a role in the line of defense for the safety of the bank;<sup>65</sup> as such, they help the supervising body with its job of maintaining stability in the financial system.

Most MFIs are under different ownership structures than commercial banks. Nearly all MFIs have a governing board that provides independent management of oversight.<sup>66</sup> Where board members serve for altruistic reasons and do not have large amounts of personal wealth at risk in the MFI, they tend not to monitor management's actions as scrupulously as business investors do.<sup>67</sup> This ownership situation is not a surface level dilemma that can be solved by a banking license and regulation by the supervising body. It is a deeply rooted issue that can only be solved when the ownership moves more into the hands of people who have personal financial interests in the success of the institution.<sup>68</sup>

The difference between bank owners with personal money at risk and owners without it becomes most apparent when the institution incurs financial difficulties.<sup>69</sup> A capital call is one of the supervising body's most effective regulating tools.<sup>70</sup> Bank owners are likely to comply with such calls in order to preserve the capital they have already committed to the bank.<sup>71</sup> While capital calls can be effective with commercial banks, they lose much of their influence when

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FRAMEWORKS FOR MICROFINANCE 6 (Dec. 1999), <http://www.gdrc.org/icm/govern/regulation.pdf>.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* These owners play a role in ensuring the safety of the bank as they are self-interested in the bank's financial success. *Id.* Naturally, they will motivate the managers to perform well. If the managers do not meet expectations, the owners can make the decision to replace them. *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* Of course there are exceptions, but boards of NGOs are in large measure more relaxed about their financial institution's financial viability than their commercial banking counterparts. *Id.* This should not be taken as any derogatory shot at such boards; it is not a question of quality of board members, but is simply a reflection of the structure of their incentives. While such is currently accurate, the trend is moving more towards hiring proven business minds to the boards of non-for-profits. See Elizabeth Littlefield & Richard Rosenberg, *Microfinance and the Poor: Breaking Down the Walls Between Microfinance and the Formal Financial System*, 41-2 FIN. & DEV. 38 (June 2004), available at <http://www.imf.org/external/pubs/ft/fandd/2004/06/pdf/littlefi.pdf>.

<sup>68</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 6; see also *supra* note 61.

<sup>69</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 8.

<sup>70</sup> A regulating tool is a way in which a supervisor ensures the solvency of the institutions she oversees. *Id.* A capital call is when the supervisor instructs bank owners to put more capital into the bank or the institution will be shut down. *Id.* Such calls are issued to ensure the long-term viability of the institution and to minimize systemic risk. See *id.*

<sup>71</sup> *Id.* As indicated, commercial bank owners are typically wealthy individuals who can come up with additional money on short notice. In fact, many countries make such readily accessible capital an important condition to obtaining a license. CHRISTEN & ROSENBERG, *supra* note 62, at 8.

applied to MFIs.<sup>72</sup>

Another supervisor's tool is to order a halt to new lending until a problem is taken care of. While effective for commercial banks, this tool is not as applicable to MFIs.<sup>73</sup> A commercial bank can stop new loans without jeopardizing the ability to collect on its existing loans; MFIs do not enjoy such liberty.<sup>74</sup> MFI clients are motivated to repay loans by their expectation of reliable and responsive future services.<sup>75</sup> If the MFI "denies prompt follow-up loans to clients who have punctually repaid prior loans, the MFI is breaching an implicit contract with its customers, many of whom will stop repaying their *existing* loans the minute the word gets out."<sup>76</sup> Thus, an order for an MFI to stop its lending can wipe out the institution's loan portfolio if kept in place for very long.<sup>77</sup>

The cost of supervision is another challenge to regulating the microfinance sector. Supervisory agency costs are relatively low in the case of commercial banks, and can usually be passed on to the banks and their customers.<sup>78</sup> Costs for supervising MFIs are "likely to be much more expensive, given the MFIs' generally smaller asset base, their much larger number of accounts, their high degree of decentralization, and finally the more labor-intensive nature of inspecting their portfolio."<sup>79</sup> In addition to the costs to the supervisor, the

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<sup>72</sup> *Id.* This point is illustrated by the experience of Finansol, an MFI in Colombia. Finansol had suffered deep loan losses, reducing its cushion of owners' capital. See Carlos Vasconcellos & Solange Monteiro, *How Not to Manage a Microfinance Institution: The Microfinance Industry's Most Common Errors Affect the Entire Chain of Small and Microenterprises* MICROENTERPRISE AMERICAS, 2003, available at <http://www.iadb.org/sds/mic/micamericas/eng/3/pages30.33.pdf>. The Colombian bank supervisor issued a capital call. *Id.* The principal owner of Finansol was the NGO Corposol, which had no additional funds to contribute to the rescue. *Id.* Finansol's closure and the consequential loss of the NGO's investment would not affect the personal pocket books of the NGO's board members. *Id.* Naturally, the board members decided not to dig into those pocket books to infuse more money into the failing finance company. See CHRISTEN & ROSENBERG, *supra* note 62, at 8.

<sup>73</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 5; see also *Microfinance Consensus Guidelines*, *supra* note 37, at 26.

<sup>74</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 5.

<sup>75</sup> Microfinance borrowers are reliant on continual access to loans. Access to future loans is contingent upon borrowers' timeliness of repayments, so the borrowers are motivated to make consistent payments. If borrowers learn that an MFI is ordered to temporarily halt lending, the borrowers may lose motivation to make timely repayments on current loans. See *id.*

<sup>76</sup> *Id.* at 8.

<sup>77</sup> *Id.* This principle is illustrated by the example of Finansol, a licensed MFI in Colombia. See Vasconcellos & Monteiro, *supra* note 72. The Colombian bank supervisor issued a lending halt to Finansol because of escalating repayment problems. *Id.* Three months after issuing the lending halt, the supervisor declared Finansol to be insolvent, as loan losses had wiped out over half of its equity during the year. *Id.* The lending freeze had worsened Finansol's repayment problem; when clients learned that they would not get new loans, many stopped paying their old loans. *Id.*

<sup>78</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 11.

<sup>79</sup> *Id.* For example, a decentralized MFI with 10,000 clients could expect to incur supervision costs of one to five percent of assets, which would likely be passed on to the MFI and its clients. *Id.* This raises an important issue in determining whether it is beneficial to supervise MFIs, as it becomes a fragile balance of costs and benefits of doing such. This does not imply that MFIs are unable to absorb such costs; rather, the high spreads and loan interest rates allow a sufficient cushion for many MFIs. *Id.* Additionally, some governments with a favorable outlook for microfinance may be willing to subsidize these costs by allowing MFIs to pay the same percentage of assets as commercial banks. *Id.*

supervised institution incurs substantial costs.<sup>80</sup> Such costs can typically equal about five percent of the portfolio in the MFI's first year of operations.<sup>81</sup> The Consultative Group to Assist the Poor estimates that the cost of supervision can be up to five percent of total costs during the first year of regulation and declines to about one percent for the ensuing years.<sup>82</sup> However, many of the initial costs associated with regulation involve internal improvements required to meet supervisory benchmarks.<sup>83</sup> Most of these improvements benefit the institution in the long-term, as they are necessary for operating a viable microfinance institution.<sup>84</sup>

In addition to the financial burdens, there are non-monetary costs to regulation. Regulation can hinder competition and can stifle innovation.<sup>85</sup> The act of writing a set of rules for microfinance entails the supervising body making decisions as to which types of institutions are the best to do microfinance.<sup>86</sup> This may limit some institutions; boundaries are drawn and experimentation outside those boundaries can be squelched.<sup>87</sup>

### *B. Benefits to microfinance regulation*

ACCION International, a leading microfinance organization whose network of partners has lent over \$23 billion to over seven million people,<sup>88</sup> conducted a study on the costs and benefits of microfinance regulation.<sup>89</sup> With the exception of

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<sup>80</sup> *Microfinance Consensus Guidelines*, *supra* note 37, at 28.

<sup>81</sup> *Id.* For example, BancoSol's chief financial officer estimated costs of regulation to his institution at five percent for the first year, with the percentage declining in later years. See CLAUDIO GONZALEZ-VEGA ET AL., BANCOSOL: THE CHALLENGE OF GROWTH FOR MICROFINANCE ORGANIZATIONS (Aug. 1996), [http://www.microfinance.com/English/Papers/Bolivia\\_BancoSol\\_Growth.pdf](http://www.microfinance.com/English/Papers/Bolivia_BancoSol_Growth.pdf). Once the institution reaches scale, the costs of supervision are insignificant. *Id.* BancoSol's financial manager estimates that reporting to the supervisory body costs one percent of its lending portfolio. See, CHRISTEN & ROSENBERG, *supra* note 62, at 6.

<sup>82</sup> See *Microfinance Consensus Guidelines*, *supra* note 37, at 28; see also Elisabeth Rhyne, Senior Vice President, Research, Dev. and Pol'y, ACCION Int'l, Presentation of *The Experience of Microfinance Institutions With Regulation and Supervision* at the 5<sup>th</sup> International Forum on Microenterprise 2 (Sept. 10, 2002) (transcript available at [http://www.microfinancegateway.org/files/14184\\_Rhyne.doc](http://www.microfinancegateway.org/files/14184_Rhyne.doc)).

<sup>83</sup> See Rhyne, *supra* note 82.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* By placing too many restrictions on the institutions it regulates, a supervisory body can limit the institution's ability to experiment and innovate. See COUNTS & SOBHAN, *supra* note 43.

<sup>86</sup> See CHRISTEN & ROSENBERG, *supra* note 62, at 10; see also *Microfinance Consensus Guidelines*, *supra* note 37.

<sup>87</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 12. This is not merely a theoretical concern. For many years, Latin American microfinance NGOs experimented with microcredit products and methodologies that were inconsistent with the legal provisions of the regulated financial system. See *id.* Without such experimentation, it is questionable that microfinance in the region would have blossomed as it has. *Id.*

<sup>88</sup> See ACCION, <http://www.accion.org/NETCOMMUNITY/Page.aspx?pid=492&srcid=254> (last visited Apr. 3, 2009).

<sup>89</sup> The study consisted of detailed interviews with microfinance institutions from six countries in

one, all of the institutions in the study had experienced transformation from NGO status to a formally regulated institution, and thus were able to compare the experiences of doing business in an unregulated versus a regulated environment.<sup>90</sup> The results indicate that the institutions were overwhelmingly pleased to be regulated, as all reported that the benefits of regulation outweighed the costs.<sup>91</sup> The institutions indicated that the process of becoming regulated had led to many benefits, namely: 1) “greater access to sources of funds for both equity and debt financing, especially commercial sources”;<sup>92</sup> 2) greater ability to expand services to serve more clients;<sup>93</sup> 3) improved operations by meeting stricter control and reporting standards;<sup>94</sup> 4) more flexibility in offering products beyond microcredit, especially savings and transfers;<sup>95</sup> and 5) legitimacy in the commercial sector and enhanced credibility with clients.<sup>96</sup>

The licensing process can be lengthy and several institutions noted that this was the most difficult aspect of being regulated.<sup>97</sup> Nonetheless, they indicated that “most of the internal improvements they were required to make during this process were beneficial, in areas such as internal control, reporting capabilities, branch physical security, and the like.”<sup>98</sup> Typically, the minimum capital requirements are higher for formalized institutions than for NGOs.<sup>99</sup> It is important to note that meeting the higher capital requirements was not a major issue for the institutions in the survey.<sup>100</sup> Most of the institutions reported that “the minimum capital needed was the same or less than the amount of capital needed to achieve and maintain profitable operations, and therefore, it did not pose a binding constraint.”<sup>101</sup>

While the challenges to microfinance regulation may be substantial, the institutions in ACCION’s study indicate that such impediments are outweighed by the resulting benefits.<sup>102</sup> Regulation of the microfinance sector allows MFIs to reach more clients sustainably, as they are enabled to tap into commercial sources

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Latin America. Leslie Theodore & Jacques Trigo Loubiere, *The Experience of Microfinance Institutions with Regulation and Supervision: Perspectives from Practitioners and a Supervisor* (Microenterprise Best Practices, Working Draft, Oct. 2001), available at [http://www.microlinks.org/ev02.php?ID=7499\\_201&ID2=DO\\_TOPIC](http://www.microlinks.org/ev02.php?ID=7499_201&ID2=DO_TOPIC) (follow “File the experience of microfinance institutions.pdf” hyperlink).

<sup>90</sup> Rhyne, *supra* note 82, at 1; *see infra* Section III (providing a detailed discussion of transitioning from an NGO to a formalized bank).

<sup>91</sup> Rhyne, *supra* note 82, at 2; *see also* CHRISTEN & ROSENBERG, *supra* note 62.

<sup>92</sup> Rhyne, *supra* note 82, at 2; *see also* Littlefield & Rosenberg, *supra* note 67.

<sup>93</sup> Rhyne, *supra* note 82, at 2.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*; *see also* ROSENGARD ET AL., *supra* note 50, at 1.

<sup>96</sup> Rhyne, *supra* note 82, at 3.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *See* STASCHEN, *supra* note 31.

<sup>100</sup> Rhyne, *supra* note 82, at 3.

<sup>101</sup> *Id.*

<sup>102</sup> *See* CHRISTEN & ROSENBERG, *supra* note 62, at 6.

of funding.<sup>103</sup> Additionally, regulated MFIs enjoy more flexibility in the range of products (particularly savings) they can offer their clients. As such, MFIs gain credibility among clients and the formal financial sector. For these reasons, this comment supports the notion that the benefits to microfinance regulation outweigh the challenges.

### III. ASPECTS OF A SOUND LEGAL FRAMEWORK FOR MICROFINANCE

It is understood that each country should adapt its legal framework to the specific needs of the country. Nevertheless, there are several principles that transcend borders; this section outlines four such principles. This comment submits that legal and regulatory frameworks for microfinance should possess the following four characteristics: microfinance services integrated with formal financial sector; regulation based on a tiered approach; ease of transitioning from an NGO to a formalized bank; and no cap on interest rates.

#### *A. Microfinance services should be integrated with the formal financial sector*

Microfinance services in developing countries were initiated primarily by socially-conscious NGOs and multi-lateral donors.<sup>104</sup> The sector currently remains dominated by such organizations.<sup>105</sup> However, in recent years, the microfinance sector has been moving towards more commercial models.<sup>106</sup> Such commercialization includes traditional MFIs or credit unions that have commercialized and become licensed financial institutions to broaden their reach, commercial banks expanding their services to the poor, and new MFIs established with the objective of operating financially sustainably.<sup>107</sup> Littlefield and Rosenberg describe this recent trend:

[F]inancial systems that serve poor clients [are] beginning to engage all kinds of financial institutions providing a wide range of financial service. Financial regulators, mainstream rating agencies, commercial and state banks, insurance companies, and credit bureaus are all starting to play a part in developing sound, inclusive financial systems that serve the majority of poor countries' citizens. The

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<sup>103</sup> As MFIs move towards financial markets, they can tap into additional funding. This funding will allow MFIs to expand their outreach to more clients. *See* Rhyne, *supra* note 82.

<sup>104</sup> PATRICK MEAGHER, MICROFINANCE REGULATION IN DEVELOPING COUNTRIES: A COMPARATIVE REVIEW OF CURRENT PRACTICE (IRIS 2002), [http://microfinancegateway.org/files/14077\\_14077.pdf](http://microfinancegateway.org/files/14077_14077.pdf).

<sup>105</sup> *See* CHRISTEN & ROSENBERG, *supra* note 62.

<sup>106</sup> ROBERT PECK CHRISTEN, COMMERCIALIZATION AND MISSION DRIFT: THE TRANSFORMATION OF MICROFINANCE IN LATIN AMERICA (Jan. 2001), [http://www.cgap.org/gm/document-1.9.2700/OccasionalPaper\\_05.pdf](http://www.cgap.org/gm/document-1.9.2700/OccasionalPaper_05.pdf); *see* Littlefield & Rosenberg, *supra* note 67, at 38-40. Commercial models refer generally to the provision of financial services to the poor by institutions that rely in part or whole on private sources of financing, managed so as to be financially sustainable by lending on economically viable terms. *See* THE COMMERCIALIZATION OF MICROFINANCE: BALANCING BUSINESS AND DEVELOPMENT 3 (Deborah Drake & Elisabeth Rhyne eds., 2002).

<sup>107</sup> *See* CHRISTEN, *supra* note 106, at 4.

boundaries between microfinance and the formal financial sector are breaking down.<sup>108</sup>

Advocates for the commercialization of microfinance point to the limitations of operating on donor funds.<sup>109</sup> In order to narrow the gulf between microfinance demand and supply, proponents argue that MFIs will need to become economically viable and tap into commercial sources of funding, particularly deposits.<sup>110</sup> If outreach is a primary objective for microfinance, proponents see commercialization as the only viable way for rapid expansion.<sup>111</sup> While NGOs and other smaller, unlicensed MFIs may continue to have an impact on the sector, it is generally accepted that the only way to expand services to a scale that is sufficient to meet the unmet demand is through commercialization.<sup>112</sup> There is an emerging consensus that the growth of sustainable institutions and mobilization of local savings are the most likely ways to meet this unmet demand.<sup>113</sup>

Critics raise the issue that market principles should not be introduced into microfinance practices, as it could lead to “mission drift,” whereby practitioners focus more on profits than the social benefits that microfinance originally set out to obtain.<sup>114</sup> Such critics point out that financially sustainable MFIs typically have larger loan sizes than smaller NGOs, suggesting they do not serve the smaller clients.<sup>115</sup> The argument is, therefore, that it is not possible to attain financial sustainability while maintaining fidelity to the poorer clients.<sup>116</sup>

As to the critics’ argument, the available literature suggests that the dual objectives of financial sustainability and impact on poverty are not incompatible.<sup>117</sup> Studies have shown that financially sustainable MFIs have a greater impact on clients’ incomes than those that are not sustainable, though the

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<sup>108</sup> Littlefield & Rosenberg, *supra* note 67, at 38-40.

<sup>109</sup> *Id.*; see *supra* note 22; see also CGAP, MAXIMIZING THE OUTREACH OF MICROENTERPRISE FINANCE: THE EMERGING LESSONS OF SUCCESSFUL PROGRAMS (Oct. 1995), [http://www.cgap.org/gm/document-1.9.2548/FocusNote\\_02.pdf](http://www.cgap.org/gm/document-1.9.2548/FocusNote_02.pdf); Jones, *supra* note 38.

<sup>110</sup> See CHRISTEN & ROSENBERG, *supra* note 62; see also Robert C. Vogel et al., Microfinance Regulation and Supervision Concept Paper 1 (USAID 2000).

<sup>111</sup> See Littlefield & Rosenberg, *supra* note 67, at 38-40; see DALEY-HARRIS, *supra* note 21; see also CHRISTEN, *supra* note 106, at 4; Jones, *supra* note 38.

<sup>112</sup> See Littlefield & Rosenberg, *supra* note 67; see DALEY-HARRIS, *supra* note 21; see also CGAP, MAXIMIZING THE OUTREACH OF MICROENTERPRISE FINANCE: THE EMERGING LESSONS OF SUCCESSFUL PROGRAMS (Oct. 1995), [http://www.cgap.org/gm/document-1.9.2548/FocusNote\\_02.pdf](http://www.cgap.org/gm/document-1.9.2548/FocusNote_02.pdf); Jones, *supra* note 38.

<sup>113</sup> There is a large body of literature arguing this point. See Robinson, *supra* note 3; see also Littlefield & Rosenberg, *supra* note 67; *Microfinance Consensus Guidelines*, *supra* note 37; CHRISTEN, *supra* note 106, at 4.

<sup>114</sup> See DRAKE & RHYNE, COMMERCIALIZATION OF MICROFINANCE, 2 (2002).

<sup>115</sup> See CHRISTEN, *supra* note 106, at 4; see also DRAKE & RHYNE, *supra* note 105, at 4.

<sup>116</sup> See CHRISTEN, *supra* note 106, at 4.

<sup>117</sup> See Littlefield & Rosenberg, *supra* note 67; see also CGAP, *supra* note 109; Jones, *supra* note 38.

sustainable MFIs may target clients who are not as poor.<sup>118</sup> Additionally, when poorer clients with small loans are shown to be an economically viable sector, sustainable banks typically seek to enter the sector.<sup>119</sup> This evidence seems to suggest that the goals of financial sustainability and poverty reduction are compatible. Therefore, introducing market principles in the microfinance sector does not necessarily lead to mission drift.

As financially sustainable MFIs exemplify the feasibility of profitably offering financial services to the poor, integration between microfinance and the formal financial sector is expanding. Most of the leading microfinance organizations implement similar techniques and disciplines of commercial finance.<sup>120</sup> Such organizations “are investing in more sophisticated management and information systems, applying International Accounting Standards, contracting annual audits from mainstream auditing firms, and seeking ratings from commercial rating agencies.”<sup>121</sup> Recognizing the successful trend towards commercialization, “more and more MFIs are getting licensed as banks or specialized finance companies, allowing them to fund themselves from capital markets, and from deposits that are not only a source of capital but also an important service to their clients.”<sup>122</sup>

A successful legal framework will encourage microfinance involvement with mainstream financial markets. Such involvement may come in the form of the government creating new types of financial licenses that allow for lower minimum capital.<sup>123</sup> Another possibility is creating partnerships between microfinance institutions and commercial banks; such partnerships enable MFIs to reduce expenses while extending outreach and allow banks to diversify assets while increasing revenue and tapping new markets.<sup>124</sup> Such initiatives allow microfinance to thrive, because “[t]o achieve its full potential, microfinance must become a fully integrated part of a developing country’s mainstream financial system.”<sup>125</sup>

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<sup>118</sup> See CGAP, FINANCIAL SUSTAINABILITY, TARGETING THE POOREST, AND INCOME IMPACT: ARE THERE TRADEOFFS FOR MICROFINANCE INSTITUTIONS? (Dec. 1996), [http://www.cgap.org/gm/document-1.9.2551/FocusNote\\_05.pdf](http://www.cgap.org/gm/document-1.9.2551/FocusNote_05.pdf).

<sup>119</sup> ROBINSON, *supra* note 3, at 14-17.

<sup>120</sup> Littlefield & Rosenberg, *supra* note 67, at 5.

<sup>121</sup> *Id.* In 2004, rating agencies such as Standard & Poor’s, Moody’s, and Duffs and Phelps carried out credit ratings of over 100 MFIs. *Id.* These credit rating agencies are companies that assign credit ratings to organizations that issue different types of debt obligations. These rating agencies measure such things as credit worthiness and loan repayment records. *Id.*

<sup>122</sup> *Id.* The fact that MFIs are entering capital markets is evidenced by several Latin American MFIs’ bond issuances. For example, Compartamos, an MFI in Mexico, raised \$15 million from issuing a straight bond in 2002. *Id.*

<sup>123</sup> *Id.* at 6.

<sup>124</sup> *Id.*

<sup>125</sup> Littlefield & Rosenberg, *supra* note 67, at 6.



*B. Regulation should be based on a tiered approach*

The legal and regulatory framework should be flexible enough to deal with different institutions differently. One way to ensure this flexibility is to incorporate a process of tiered regulation and supervision, within which the type and degree of supervision and regulation depends upon the degree of risk associated with the institution's activities.<sup>126</sup> In a tiered banking structure, "a range of financial intermediaries is licensed by the regulatory banking authority to provide banking and financial services to the public."<sup>127</sup> The licenses granted indicate limits to the services that may be offered, as well as the necessary prudential guidelines.<sup>128</sup> Small, community-focused banks can function alongside large universal banks in a "tiered banking" structure which remains under the jurisdiction of the regulatory bank authority.<sup>129</sup> The MFI's source of funds is the primary factor in determining in which "tier" the institution should be categorized.<sup>130</sup> MFIs can be classified into three categories: (1) MFIs which depend on donors or money from others, (2) MFIs that depend on money from their members, and (3) MFIs that leverage money from the public.<sup>131</sup> The table below illustrates the tiers.<sup>132</sup> The table identifies thresholds of financial intermediation activities which indicate a requirement for an MFI to meet external or mandatory regulatory guidelines.

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<sup>126</sup> GREUNING ET. AL., *supra* note 42, at i.

<sup>127</sup> *Id.* at 14.

<sup>128</sup> *Id.* For example, a license will indicate whether an MFI can collect deposits from the general public or if it will be limited to taking deposits only from its members. See MEAGHER, *supra* note 104, at 5; *supra* note 37 (discussing prudential regulation).

<sup>129</sup> GREUNING ET. AL., *supra* note 42, at 14.; see also MEAGHER, *supra* note 104, at 5.

<sup>130</sup> The source of funds refers to the source from which the MFI receives its funds, i.e. deposits, commercial debt or equity. See JOANNA LEDGERWOOD, MICROFINANCE HANDBOOK: AN INSTITUTIONAL AND FINANCIAL PERSPECTIVE 149 (World Bank 1999). Ledgerwood provides a broad introduction to the financial aspects of microfinance. She provides a wealth of information on the similarities and differences among microfinance and commercial banking. *Id.*

<sup>131</sup> See GREUNING ET AL., *supra* note 42, at i. MFIs leverage money from the public by offering savings accounts. The MFI uses the money collected in the savings accounts as lending capital to other clients. This practice is advantageous to the MFIs as they can charge a higher interest rate to the borrower than they pay out to the depositor.

<sup>132</sup> *Id.* at ii.

**Regulatory action based on type of MFI<sup>133</sup>**

<b>MFI Type</b>	<b>Activity that Determines Regulatory Status</b>	<b>Proposed Form of External Regulation, if Required</b>	<b>Regulatory Agency</b>
<b>Category A MFIs</b>			
Type 1: Non-profit NGO	Making microfinance loans not in excess of grants donated	None—voluntary registration, with self-regulatory organization	None, or self-regulatory organization
Type 2: Non-profit NGO with limited deposit-taking	Taking minor deposits—forced savings or mandatory deposit schemes, from microfinance clients	None—exemption or exclusion provision of banking law; mandatory registration with self-regulatory organization	Self-regulatory organization
Type 3: NGO transformed into incorporated MFI	Issuing instruments to generate funds through wholesale deposit substitutes (commercial paper, large-value certificates of deposit, investment placement notes)	Registration as corporate legal entity; authorization from Bank Supervisory Authority or Securities & Exchange Agency, with limitations on size, term and tradability of commercial paper instruments	Companies' Registry Agency; Bank Supervisory Authority or Securities & Exchange Agency
<b>Category B MFIs</b>			
Type 4 Credit Union, Savings & Credit Cooperative Society	Operating as closed or open common bond credit union; deposit-taking from member-clients	Notification to and registration with Cooperatives Authority or Bank Supervisory Authority; or certification and	Cooperatives Authority, or Bank Supervisory or Credit Rating Entity

<sup>133</sup> ROBIN YOUNG & LAUREN MITTEN, LEGAL FRAMEWORKS AND PERFORMANCE STANDARDS FOR MICROFINANCE: A DESK STUDY (2000), [http://pdf.usaid.gov/pdf\\_docs/pnacj223.pdf](http://pdf.usaid.gov/pdf_docs/pnacj223.pdf).

		rating by a private independent credit rating agency	
<b>Category C MFIs</b>			
Type 5 Specialized bank, deposit-taking institution, or finance company	Taking limited deposits (savings and fixed deposits) from general public beyond minor deposits exemption in banking law. Microfinance activities more extensive than NGOs, but operations not on scale of licensed banks	Registration and licensing by Bank Supervisory Authority, with a limitation provision (e.g., savings and fixed deposits, smaller deposits-to-capital multiple, higher liquidity reserves, limits on asset activities and uses)	Bank Supervisory Authority
Type 6 Licensed mutual ownership bank Type 7 Licensed equity bank	Non-restricted deposit-taking activities, including generating funds through commercial paper and large-value deposit substitutes, from the general public	Registration and full licensing by Bank Supervisory Authority as a mutual ownership or equity bank; compliance with capitalization/capital adequacy requirements, loan loss provisioning and full prudential regulations	Bank Supervisory Authority

As the table indicates, there are three categories of microfinance institutions, distinguished by how the institution receives its primary source of funding. Category A MFIs use other people's money (i.e., donors); category B MFIs use members' money; and category C MFIs use the general public's money.<sup>134</sup> The categories (except for category B) consist of a variety of institutional types that engage in very different activities. For example, category A includes three types of NGOs: 1) type one is a basic non-profit NGO that engages uniquely offering credit; 2) type two is a non-profit NGO that makes loans and receives minor deposits from clients in the community through forced savings or mandatory

<sup>134</sup> See *supra* note 131.

deposit schemes; 3) type three, unlike the previous two, is an NGO that has evolved into an incorporated MFI, and subsequently mobilizes funds through the issuance of commercial paper and/or deposits. This type poses the highest probability of causing systemic risk, and therefore requires the most stringent regulation within category A.

The activities, and the risks associated with these activities (including the risks associated with how the institution obtains its funds), determine the regulatory status of an institution.<sup>135</sup> No external regulation is necessary for types 1 and 2 MFIs. Donors, government agencies and commercial banks fund these MFIs, and are presumed to have the capability for institutional due diligence.<sup>136</sup> The institutions that receive savings from the general public pose the highest level of risk (to themselves and the financial system) and are therefore subject to the most stringent forms of regulation.<sup>137</sup>

There is much variety among microfinance institutions.<sup>138</sup> An effective legal framework for microfinance will not treat each institution the same, but will adapt its regulation to the varying levels of sophistication of the institution.<sup>139</sup>

*C. The framework should facilitate an easy transition from NGO to formalized bank*

The percentage of NGO MFIs likely to scale to wide outreach and financial viability is small.<sup>140</sup> In order to achieve such objectives, MFIs need to collect deposits.<sup>141</sup> Deposits can only be raised from the general public when MFIs undergo institutional transformation into licensed formal banking institutions subject to prudential regulation.<sup>142</sup> While the microfinance industry has experienced operational growth, “the range of institutional channels is segmented by the current legal and regulatory environment in most countries.”<sup>143</sup> A sound legal framework would benefit microfinance by transforming the fragmented spectrum into a cohesive continuum, which would enable MFIs to pursue a process

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<sup>135</sup> YOUNG, *supra* note 133, at 10.

<sup>136</sup> GREUNING ET AL., *supra* note 42, at 12.

<sup>137</sup> *Id.*

<sup>138</sup> *See, e.g.*, YOUNG, *supra* note 133. Some institutions receive funding from donors; others collect deposits from the public. Some MFIs only offer credit, while others offer a wide range of products to clients. *See* LEDGERWOOD, *supra* note 130.

<sup>139</sup> For example, small non-profit NGOs that do not receive deposits do not require supervision from a regulatory body. *See, e.g.* YOUNG, *supra* note 133; *see also supra* note 37 (discussing non-prudential regulation and systemic risk). Larger, specialized banks with unlimited deposit-taking activities would require regulation from the bank supervisory authority. *See*, YOUNG, *supra* note 133.

<sup>140</sup> GREUNING ET AL., *supra* note 42, at 9.

<sup>141</sup> Collecting deposits will provide a consistent source of funds for MFIs, which will allow them to expand their outreach more rapidly. *See supra* note 24-25.

<sup>142</sup> GREUNING ET AL., *supra* note 42, at 9.

<sup>143</sup> *Id.*

of progressive institutional transformation.<sup>144</sup>

The framework for banking laws “should be structured to provide MFIs with a clear view of the thresholds to attain on the path to institutional development and transformation.”<sup>145</sup> There are several examples of NGOs that have successfully made the transformation into formalized banks.<sup>146</sup> The following examples of K-Rep Bank in Kenya and BancoSol in Bolivia are two such examples.

### *1. Example of K-Rep Bank*

The Kenya Rural Enterprise Programme (K-Rep) was established in 1984 by World Education Inc., a private voluntary group based in the United States.<sup>147</sup> It is now one of the most successful microfinance organizations in Africa, with over 110,000 active borrowers and a gross loan portfolio of over \$50 million.<sup>148</sup> After K-Rep had established itself as a sound provider of microloans, management decided to transform its microenterprise credit program into a commercial bank.<sup>149</sup> K-Rep cites several objectives for this decision:

1) Achieve institutional and financial sustainability through improved governance and increased profitability; 2) Balance management time between profitable microfinance activities and complementary services that usually require some degree of subsidization; 3) Gain access to additional sources of capital, particularly from client savings, thereby reducing K-Rep’s dependence on donor funds, expanding K-Rep’s market outreach, and recycling client savings to microenterprises rather than channeling them through traditional banks to finance wealthier sectors of the economy; and 4) Offer additional financial services to microentrepreneurs and other low-income populations.<sup>150</sup>

In March 1999, the Central Bank of Kenya granted K-Rep a commercial banking license, marking a key point in financial sector development in Kenya, as it was the first banking license ever issued to a microfinance institution.<sup>151</sup>

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<sup>144</sup> *Id.* This approach is outlined in the concept of tiered regulation, *supra* note 131.

<sup>145</sup> JOSELITO GALLARDO, FRAMEWORK FOR REGULATING MICROFINANCE INSTITUTIONS 13 (2002).

<sup>146</sup> *See* LEDGERWOOD, *supra* note 130.

<sup>147</sup> ROSENGARD ET. AL., *supra* note 50, at 1.

<sup>148</sup> See a financial overview of K-Rep on the website for the Mix Market, a clearing house of microfinance information. Mix Market, Profile of K-Rep, <http://www.mixmarket.org/en/demand/demand.show.profile.asp?token=&ett=956> (last visited Mar. 11, 2009).

<sup>149</sup> ROSENGARD ET AL., *supra* note 50, at 1.

<sup>150</sup> *Id.*

<sup>151</sup> *Id.* at 22. Granting the banking license signified the Kenyan government’s efforts to promote the microfinance sector. In the 2000 budget speech, the Kenyan Minister of Finance expressed public sector support for microfinance as he announced plans for the Central Bank of Kenya to establish a division within its banking department to assist the microfinance sector. *Id.* He further encouraged integration between microfinance institutions and the commercial banking sector. *Id.*

## 2. Example of BancoSol

BancoSol is one of the leading microfinance organizations in Latin America, with over 100,000 active borrowers and a total loan portfolio of over \$160 million.<sup>152</sup> BancoSol is a commercial bank that is dedicated to serving the poor entrepreneurs of Bolivia, and is respected as the first private commercial bank to specialize in microfinance.<sup>153</sup> Just as any bank in Bolivia, BancoSol operates under the regulatory framework of the Central Bank and is subject to prudential regulation.<sup>154</sup> BancoSol distinguishes itself from the other Bolivian banks as it has developed its strong portfolio on well-performing microloans.<sup>155</sup> Although licensed as a formal bank, BancoSol has altruistic roots. Its majority shareholders are NGOs and donor organizations, and the remaining shareholders are influential Bolivian businessmen.<sup>156</sup>

Founded as an NGO by the name of PRODEM, the institution transitioned to a formalized commercial bank in 1992.<sup>157</sup> While the NGO was successful in reaching poor clients, the management recognized that their NGO status placed limitations on expansion by preventing access to commercial funds.<sup>158</sup> Funds from the market would enable the organization to respond to clear demands for credit from the rural poor and to manage its cash flows better amidst seasonal variations of such demand.<sup>159</sup> Additionally, the NGO was limited in the financial services it could provide its clients. Specifically, it could not offer savings services and therefore could not generate capital through leveraging savings.<sup>160</sup> Thus, BancoSol was created in order to better serve the rural poor through channeling sources from the commercial markets.

Formalization as a licensed bank resulted in several advantages for BancoSol. Chief among the advantages of upgrading to a commercial bank included: 1) the ability to mobilize funds from the market with increased

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<sup>152</sup> See Mix Market, Profile for Bancosol, <http://www.mixmarket.org/en/demand/demand.show.profile.asp?token=&ett=280> (last visited Mar. 11, 2009).

<sup>153</sup> A. Glosser, *The Creation of BancoSol in Bolivia*, in *THE NEW WORLD OF MICROENTERPRISE FINANCE 307* (Mario Otero & Elisabeth Rhyne, eds. 1994).

<sup>154</sup> CLAUDIO GONZALEZ-VEGA ET AL., *BANCOSOL: THE CHALLENGE OF GROWTH FOR MICROFINANCE ORGANIZATIONS*, 6 (1996), [www.microfinance.com/English/Papers/Bolivia\\_BancoSol\\_Growth.pdf](http://www.microfinance.com/English/Papers/Bolivia_BancoSol_Growth.pdf); see *supra* note 37 (providing a discussion of prudential regulation).

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* International shareholders include public organizations and several NGOs: Societe d'Investissement de Development International, Inter-American Investment Corporation, the Rockefeller Foundation, the Calmeadow Foundation, and ACCION International. *Id.*

<sup>157</sup> See Miriam J. Koreen, *Banco Solidario: A New Model For Microfinance* (Apr. 1999), available at [http://www.microfinancegateway.org/files/2137\\_bancosol\\_pub.doc](http://www.microfinancegateway.org/files/2137_bancosol_pub.doc).

<sup>158</sup> *Id.* at 2. PRODEM could not meet the growing demand for microcredit in Bolivia because the NGO's source of funds was limited to donations, subsidized loans, and the interest it received from its lending portfolio. Because of its NGO status, it could not access commercial sources of financing. *Id.*; see also GONZALEZ-VEGA ET AL., *supra* note 154.

<sup>159</sup> GONZALEZ-VEGA ET AL., *supra* note 154, at 4; see also Glosser, *supra* note 153.

<sup>160</sup> GONZALEZ-VEGA ET AL., *supra* note 154, at 4.

flexibility, through deposits from the public, bonds placed on domestic and international capital markets, inter-bank loans, or access to Central Bank rediscounts and other lines of credit;<sup>161</sup> 2) the benefits from expanded outreach, realizing economies of scale;<sup>162</sup> 3) the protection offered from more intense, rigorous and professional monitoring of its financial performance by the regulatory supervisor (Superintendency of Banks), new lenders (other banks and bond holders), and shareholders;<sup>163</sup> and 4) the value of a bank charter in a financial market with strict limitations on entry.<sup>164</sup>

As BancoSol switched from donor funding to market-based liabilities, the average cost of funds increased from four percent at the time of conversion to a commercial bank in 1992 to twelve percent in 1996.<sup>165</sup> While BancoSol experienced an increase in the cost of funds, transformation into a formal financial entity resulted in increased funding from the market.<sup>166</sup> Due to its bank charter license, BancoSol increased the ratio of its liabilities to equity from 1.0 at the end of 1992 to 6.2 at the end of 1994.<sup>167</sup> With a healthy rate of return on assets, “the rate of return on equity increased sharply, from 4.1 in 1992 to 13.8 in 1994, reflecting this higher leverage.”<sup>168</sup>

There are certain policies to which a regulatory authority for microfinance should adhere while facilitating an easy transition from NGO to formalized bank. The amount of absolute capital to be held at all times is viewed as a very important regulatory measure.<sup>169</sup> Microfinance banks should be subject to the same minimum capital adequacy requirements as formalized banks.<sup>170</sup> As for

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<sup>161</sup> *Id.* at 5; *see also supra* notes 90 & 92.

<sup>162</sup> GONZALEZ-VEGA ET AL., *supra* note 154, at 2. Economies of scale is an economics term that refers to a production process in which the increase in outreach of an organization results in a decrease in the average cost of each unit. Here, BancoSol is becoming more efficient as it reaches economies of scale.

<sup>163</sup> *Id.* at 4.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.* at 13. This drastic increase in cost of funds is due to changing from reliance on donors and soft loans. At the end of 1991, about 15% of PRODEM’s liabilities were deposits; 19% were loans from private organizations, and the remaining 68% were soft loans from public entities. *Id.* These numbers changed dramatically after the transition to BancoSol: by the end of 1994, loans from public entities represented just 2% of total liabilities and deposits represented the majority. *Id.*

<sup>166</sup> *Id.* As a commercial entity, BancoSol was able to raise funds through commercial markets, whereas it was limited primarily to donor funds while it operated under NGO status. While its costs of funds increased, its total number of available funds also increased, easing the strain of the increased costs. *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> STASCHEN, *supra* note 31, at 10. In this detailed study, the author found that each country with microfinance regulation set an absolute amount of capital as one of the criteria for entry. *Id.* While such a requirement allows for a general standard, the author notes a potential downside: the real value of capital depletes over time, especially in the wake of inflation. *Id.*

<sup>170</sup> *Id.* at 5. There is no dearth of commentary that argues that microfinance banks should be able to maintain lower capital amounts, allowing them to transition from their NGO status more easily. *See, e.g.* COUNTS & SOBHAN, *supra* note 43. While this argument has legitimacy, it does not account for the relatively larger and faster impact that losses have on a microfinance bank’s capital base, as

management quality, the regulatory body should not require unnecessarily complex organizational structures or top-heavy staffing regimes for microfinance banks.<sup>171</sup> The regulatory authority should not impose unduly high liquidity requirements on microfinance banks.<sup>172</sup> High reserve requirements would increase the cost of doing business for a microfinance bank by lowering the number of available lending capital from the institution's deposit base.<sup>173</sup> Several countries with a thriving microfinance industry place limitations on MFI product characterizations. The most common limitations are restrictions on the type of deposit facilities to be offered.<sup>174</sup> Countries also place restrictions on lending amounts, mandating maximum loan sizes expressed as a percentage of capital or as a set amount.<sup>175</sup> Such limitations are encouraged, so long as they are reasonable and do not hinder innovation. The limitations protect the financial longevity of the institution and maintain stability in the broader financial system.

*D. There should be no interest rate cap*

The administrative costs of managing a portfolio of many small loans are much higher than managing a portfolio of several large loans.<sup>176</sup> For this reason, MFIs typically cannot operate sustainably unless they charge interest rates that are

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compared to commercial banks. See STASCHEN, *supra* note 31, at 5. This argument also seems to neglect the fact that many microfinance banks lack geographic or loan size diversification, and are thus more vulnerable to institution-wide shocks. *Id.* In fact, for these reasons, some commentators suggest that the capital adequacy ratio should be a little higher for microfinance banks than for commercial banks. See generally ROSENGARD, *supra* note 50. Certain countries, such as Pakistan and Indonesia, have different capitalization requirements for different regions of the country. See STASCHEN, *supra* note 31, at 11. This rationale implies that certain regions may have higher average loan sizes or may be more vulnerable to systemic economic shocks.

<sup>171</sup> ROSENGARD, *supra* note 50, at 5. A key to the success of a microfinance institution is its simplicity in organization and operations in order to ensure the financial stability of the bank. While the management requirements should not be too complex, it would be prudent to insist on an organizational structure that separates key functions for internal controls such as bookkeeping and cashing. It is similar rationale for reporting requirements. "Standard statistical reports are usually designed for banks with a wide variety of extremely diverse and sophisticated services, while most microfinance banks offer a limited range of simple products." *Id.* at 26. Therefore, many commercial banking reporting requirements are inapplicable to microfinance banks, and should be adapted to the specific needs of microfinance. Specifically, documentation requirements should be simplified, in order to accommodate the high volume of small loans. *Id.* at 5.

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*; see also COUNTS & SOBHAN, *supra* note 43 (arguing that the minimum liquidity requirement for microfinance institutions should not exceed 25% of the total available funds).

<sup>174</sup> STASCHEN, *supra* note 31, at 18. For example, in Ghana, non-bank financial institutions, other than credit unions and savings institutions, can only take term deposits. *Id.* It is common for countries to limit deposit-taking by cooperatives from members of the cooperative. *Id.* In Nepal, cooperatives are subject to a restricted duration for savings and time deposits of three years; cooperatives in Uganda are not restricted to any duration limits on such deposits. *Id.*

<sup>175</sup> *Id.* For example, in Ethiopia, MFIs are only permitted to lend up to a fixed amount of \$600 to a single borrower. *Id.* In Indonesia, regulatory authorities are leery of one borrower causing systemic problems as MFIs are limited to lending 20% of their total capital to a single borrower. *Id.*

<sup>176</sup> *Microfinance Consensus Guidelines*, *supra* note 37, at 11.



substantially higher than the rates banks charge their traditional borrowers.<sup>177</sup> It is simply a matter of costs. Relative to the amount of money lent, small loans cost more to manage than big ones.<sup>178</sup> Even for the most efficiently managed MFIs, it is difficult to reduce administrative costs below about ten to twenty-five percent (depending on loan size, methodology, and local market forces) of their portfolio.<sup>179</sup> By contrast, comparable costs in an efficient developing country commercial bank are typically below five percent.<sup>180</sup> A financially sustainable MFI, therefore, must “charge an interest rate that could sound obscene in the normal commercial-bank market or in the arena of political discussion.”<sup>181</sup> The poor borrowers of microcredit loans have shown for many years that they are happy for access to loans, even at higher rates.<sup>182</sup>

Microcredit loan cycles are usually shorter than traditional commercial loans.<sup>183</sup> A typical loan term is six months to a year with payments plus interest due weekly.<sup>184</sup> Shorter loan cycles and weekly payments help the borrowers stay current and avoid overwhelmingly large payments. The transaction-intense nature of weekly payment collections, often in rural areas, is more expensive than running a bank that provides large loans to financially stable borrowers in a metropolitan area.<sup>185</sup> Consequently, MFIs must charge interest rates that might sound high—the average global rate is about thirty-five percent annually—to cover their costs.<sup>186</sup>

For a financial institution to scale and remain sustainable, at a bare minimum it has to cover its costs. In the example below, a large bank can charge anything over fourteen percent to recoup its costs, whereas the MFI has to charge a rate of at least thirty-one percent to cover its costs.<sup>187</sup>

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<sup>177</sup> *Id.*

<sup>178</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 7; *see also Microfinance Consensus Guidelines, supra* note 37, at 13.

[A]dministrative costs do not vary in proportion to the amount lent. One may be able to make a \$20,000 loan while spending only \$600 (3 percent) in administrative costs; but this does not mean that administrative costs for a \$200 loan will be only \$6. In comparison with the amount lent, administrative costs are inevitably much higher for microcredit than for conventional bank loans.

*Microfinance Consensus Guidelines, supra* note 37, at 10.

<sup>179</sup> CHRISTEN & ROSENBERG, *supra* note 62, at 7.

<sup>180</sup> *Id.* This is a conservative number; many commercial banks have administrative costs that are well below 5 percent. *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> *Microfinance Consensus Guidelines, supra* note 37, at 11; *see also* CHRISTEN & ROSENBERG, *supra* note 62.

<sup>183</sup> *See* LEDGERWOOD, *supra* note 130.

<sup>184</sup> *See* Unitus, *supra* note 9.

<sup>185</sup> *See* LEDGERWOOD, *supra* note 130.

<sup>186</sup> *Id.*

<sup>187</sup> This table demonstrates the differences in costs of administering a loan for a large bank and a microfinance institution. The numbers are based on a loan amount of \$1,000,000, and the number of loans is based off of estimates of an average loan size per client. Unitus, *supra* note 9.

**Cost of Administering a Loan**<sup>188</sup>

	Large Banks	Microfinance Institutions
Cost of Capital	10%	10%
Loan loss provision	1%	1%
<b>Total Cost of Capital</b>	<b>11%</b>	<b>11%</b>
Total amount of loan disbursed	\$1,000,000	\$1,000,000
Loan size	\$1,000,000	\$100
Number of loans	1	10,000
Yearly transactions	4-12	120,000-520,000
Cost of administering loan	3%	20%
<b>Total cost to institution</b>	<b>14%</b>	<b>31%</b>

Public officials and the general public seldom grasp this dynamic and they are therefore suspicious of microcredit interest rates, even in cases where the rates do not reflect excessive profits or inefficiency.<sup>189</sup> Policy makers in several developing countries have limited interest rates.<sup>190</sup> For example, in Bolivia, the limit on the interest rate charged on loans is three percent per month.<sup>191</sup> The objective is to protect the poor from aggressive lenders, but such intentions often backfire. When MFIs are required to charge a pre-determined interest rate, which is usually much below the cost that the MFI incurs, MFIs are often forced to go out of business.<sup>192</sup> As a result, those whom the MFI would have served are left without access to any financial services at all. This type of regulation often is a disservice to the very people it is meant to protect.<sup>193</sup> If government officials control microcredit interest rates, “practical politics will usually make it difficult to set an interest rate cap high enough to permit the development of sustainable microcredit.”<sup>194</sup> Interest rate caps usually hurt the poor—by limiting services—more than they help the poor by the lower rates.<sup>195</sup>

While usury limits are counter-productive, policy makers may resort to alternative means of protecting poor borrowers.<sup>196</sup> In regions where deception is

<sup>188</sup> *Id.* There are many aspects that determine an institution’s interest rate. See RICHARD ROSENBERG, MICROCREDIT INTEREST RATES (Nov. 2002), <http://www.microfinancegateway.org/content/article/detail/1827> (providing additional discussion of interest rate calculations). The numbers in this table are simply examples to show the difference in costs to an MFI and to a commercial bank.

<sup>189</sup> Sometimes high interest rates are reflective of high administrative costs and inefficient management. See *Microfinance Consensus Guidelines*, *supra* note 37, at 13.

<sup>190</sup> FLEISIG & DE LA PEÑA, *supra* note 4, at 27.

<sup>191</sup> *Id.*

<sup>192</sup> See LEDGERWOOD, *supra* note 130.

<sup>193</sup> See COUNTS & SOBHAN, *supra* note 43; see also Unitus, *supra* note 9.,

<sup>194</sup> *Microfinance Consensus Guidelines*, *supra* note 37, at 13.

<sup>195</sup> *Id.*

<sup>196</sup> FLEISIG & DE LA PEÑA, *supra* note 4, at 27.

common, regulations may be imposed that require lenders to provide clear statements of true annual interest rates to their clients.<sup>197</sup> Suggestions include providing numerical examples of what the interest rates mean, and protecting illiterate clients by requiring a videotape presentation in the client's native language of the implications of such interest rates.<sup>198</sup>

In sum, there should be no cap on interest rates. Because of the necessarily high administrative costs, microcredit programs may—at least initially—need to charge interest rates that are higher than the rates in commercial banking transactions. Such interest rate caps could stifle microfinance expansion, and would therefore prevent poor households from access to credit.

#### IV. THE MICROCREDIT REGULATORY ACT OF 2006

The first three sections of this comment have provided a guideline for the regulation of microfinance. The final section provides an example of an effective microfinance law.<sup>199</sup> While several countries have designed laws specifically for microfinance regulation,<sup>200</sup> Bangladesh stands apart as one of the first to establish an independent regulatory institution with the sole purpose of supervising the microfinance sector.<sup>201</sup> The Microcredit Regulatory Act of 2006 is an effective legislative model that other countries should emulate.

Microfinance is a familiar concept in Bangladesh. Since Dr. Yunus began lending money in 1976, the movement has gained tremendous momentum.<sup>202</sup> The twenty largest MFIs in Bangladesh reach twenty-one million clients affecting 105 million family members in a country of 140 million.<sup>203</sup> Nearly ninety percent of the microloan clients are female and the average loan amount is \$60.<sup>204</sup> The

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<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> The government of Bangladesh passed the law in 2006. See *infra* note 210. Bangladesh is commonly referred to as the “birthplace of microfinance.” See Nick Louth, *How to Help the Third World With eBay*, UK MSN MONEY, Nov. 15, 2007, available at <http://money.uk.msn.com/investing/articles/nicklouth/article.aspx?cp-documentid=6699608>. As such, it appears fitting to analyze the country's progress towards a legal framework for microfinance.

<sup>200</sup> See *supra* note 32.

<sup>201</sup> In this regard, Bangladesh is a rather pioneering example. Some commentators argue that the establishment of an independent regulatory body is essential to an effective legal framework for microfinance. See, e.g., COUNTS AND SORBAM, *supra* note 43; see also Microfinance Consensus Guidelines, *supra* note 37. As discussed, microfinance regulation is a daunting task. See *supra* note 60. When an institution is established for the sole purpose of microfinance regulation, it is able to focus its efforts.

<sup>202</sup> While not a panacea, microfinance has positively impacted the rural poor of Bangladesh. In a study for the World Bank, Shahidur Khandker's research of three Bangladeshi MFIs found that microcredit accounted for 40% of the entire reduction of moderate poverty in rural Bangladesh. See Sam Daley-Harris et al., *Debate on Microcredit*, FPIF, June 21, 2007, <http://www.fpif.org/fpifxt/4324>. Additionally, Khandker's study found that microcredit's spillover effects among non-participants reduced poverty among this group by some 1% annually for moderate poverty and 1.3% annually for extreme poverty. *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> See Microfinance Institutions (MFIs), <http://www.bangladesh-bank.org/fnansys/mfi.html>. It is a

payback rate in the microfinance industry in Bangladesh is astounding, averaging over ninety percent.<sup>205</sup>

As MFIs typically provide financial services to the poor outside the formal banking system, the issue of a regulatory framework has come to the forefront of political discussions.<sup>206</sup> The unique features of MFIs in the field of social and financial services with the core objectives of poverty alleviation differentiate the industry from the formal financial sector. However, that does not in any way downplay the importance of having some strategic monitoring measures that are compatible and appropriate to MFIs' objectives, institutional operation and development culture.<sup>207</sup>

The phenomenal growth of the microfinance sector in terms of outreach and product development encouraged the government to form a consortium of scholars and practitioners to formulate guidelines for a microfinance regulatory framework.<sup>208</sup> The Microfinance Research and Reference Unit (the Unit) was established in 2000, under the supervision of a National Steering Committee headed by the Governor of the Bangladesh Bank.<sup>209</sup> After much consultation with experts in the sector, the Committee submitted a draft of a regulatory framework to the government. The government passed a law, the Microcredit Regulatory Act of 2006 (the Act), in July 2006.<sup>210</sup> Under this law the government established a separate Microcredit Regulatory Authority (MRA) and constituted its board of directors, with the governor of the Bangladesh Bank as the chairperson.<sup>211</sup>

The law grants broad powers to the Microcredit Regulatory Authority and requires all active MFIs to apply for a license from the MRA.<sup>212</sup> To be considered for a license, MFIs must complete an application and submit it to the MRA office

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consensus among practitioners that lending to women is more beneficial to the family than lending to men. See Muhammad Yunus, *Social Enterprise: Doing Well by Doing Good*, 1 PEPP. J. BUS., ENTREPRENEURSHIP & L. 99 (2007) (providing an explanation of this phenomenon); see also *supra* note 17.

<sup>205</sup> See Bank of Bangladesh's Microfinance Institutions Page, *supra* note 204.

<sup>206</sup> See W.A. Wijewardena, *Microfinance Policy and Regulatory Framework: Experience and Perspective of South Asian Region – Sri Lanka, Bangladesh, Nepal and India* (Islamabad, Pakistan: MicroFinance in Pakistan: Innovating & Mainstreaming Conf., 2004), available at [http://www.microfinancegateway.com/files/22945\\_Microfinance\\_Policy\\_and\\_Regulatory\\_Framework\\_by\\_Wije\\_Wardena.pdf](http://www.microfinancegateway.com/files/22945_Microfinance_Policy_and_Regulatory_Framework_by_Wije_Wardena.pdf).

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> *Id.* Initially this Committee prepared a set of guidelines which were implemented by the Unit. See Bangladesh Bank Financial System Overview, <http://www.bangladesh-bank.org/fnansys/mfi.html> (last visited Mar. 11, 2009). Those guidelines helped the sector prepare for a future regulatory environment and establish a friendly communication between the sector and the policy makers. *Id.*

<sup>210</sup> *Id.* A full text version of the bill is available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf).

<sup>211</sup> See Bank of Bangladesh Financial System Overview, *supra* note 208. The Microcredit Regulatory Authority is an independent organization that is charged with the responsibility of supervising and regulating the microfinance sector in Bangladesh.

<sup>212</sup> See Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf).

at the Bangladesh Bank.<sup>213</sup> The MRA then examines the application to evaluate the MFI's source of funds, ownership, and internal governance.<sup>214</sup> The law states that all institutions engaging in microcredit operations should separate their financial operations from other development works and keep their accounts separate.<sup>215</sup> The law authorizes the MRA to monitor and supervise all licensed MFIs.<sup>216</sup> The MRA also has the power to prepare detailed rules related to microcredit operations, including: conditions for spending any income, geographical areas of operations, guidelines on internal and external account audits, collection of deposits, and use of earned profit.<sup>217</sup> The MRA has the mandate to take punitive measures if any institution does not comply with any of the provisions of law and rules.<sup>218</sup>

The Microcredit Regulatory Act was passed in order to create a beneficial environment for microfinance institutions in Bangladesh.<sup>219</sup> For the following reasons, the law will prove successful.

The Microcredit Regulatory Act fares well with the four suggestions for a sound legal framework for microfinance discussed in section two of this comment. The first suggestion encourages microfinance integration with the formal financial sector.<sup>220</sup> The law permits deposit mobilization, which allows institutions to raise more capital in order to reach more clients.<sup>221</sup> Additionally, the law encourages future integration with the formal financial sector by requiring institutions to abide by internationally approved accounting standards.<sup>222</sup> The second suggestion

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<sup>213</sup> Email from Lila Rachid, Managing Director of the Microcredit Regulatory Authority (Jan. 26, 2008, 22:49 PST) (on file with author).

<sup>214</sup> See Steven Craig, *Bangladesh Micro Credit Regulatory Authority Begins Issuance of Licenses to Microfinance Institutions*, MICROCAPITAL, Aug. 15 2007, available at <http://microcapitalmonitor.com/cblog/index.php/?/archives/1079-MICROCAPITAL-STORY-Bangladesh-Micro-credit-Regulatory-Authority-Begins-Issuance-of-Licenses-to-Microfinance-Institutions.html#extended>. The MRA determines the type of regulation based on the institution's source of funds. See LEDGERWOOD, *supra* note 130. The MRA examines the background of executive team members and refuses to license individuals with fraudulent or bankrupt histories. See *infra* note 233.

<sup>215</sup> See Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf).

<sup>216</sup> *Id.*

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

<sup>220</sup> See *supra* note 103.

<sup>221</sup> See *supra* note 110 (providing a discussion of deposit mobilization). Additionally, the law facilitates mergers between smaller MFIs and larger banks, allowing MFIs to tap into commercial markets through mergers. See *infra* note 227.

<sup>222</sup> Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf). Such requirements prepare institutions for future integration with formal financial markets because they will learn to apply the same information systems as their counterparts in the formal sector. This will enable commercial institutions to have confidence in the MFIs' bookkeeping, thereby increasing their likelihood to conduct business with the MFIs. Additionally, if MFIs and commercial institutions implement comparable accounting systems, it will facilitate the process of MFIs merging with commercial banks. See *infra* note 227.

promotes a tiered approach to regulation.<sup>223</sup> Under Bangladesh's microfinance law, MFIs are regulated differently, depending on the institution's size.<sup>224</sup> Minimum capital requirements are based on the institution's geographic outreach.<sup>225</sup> The third suggestion encourages a legal framework that facilitates an easy transition from NGO to formalized bank.<sup>226</sup> While the law does not specifically provide an easy transition from NGO to formalized bank status, it does facilitate the process of MFIs merging with larger banks.<sup>227</sup> Such mergers enable MFIs to reduce costs while expanding outreach and allow banks to diversify assets while entering new markets and increasing revenue.<sup>228</sup> The final suggestion discourages interest rate limits.<sup>229</sup> The Microcredit Regulatory Act is silent on interest rates, thereby allowing institutions and the market to determine optimal rates.<sup>230</sup>

In addition to satisfying the four suggestions, the Microcredit Regulatory Act contains other positive aspects for the microfinance regulatory environment in Bangladesh. Proponents of microfinance regulation encourage policy-makers to establish an independent body dedicated to supervising the sector.<sup>231</sup> As noted,<sup>232</sup>

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<sup>223</sup> See *supra* note 125.

<sup>224</sup> Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf).

<sup>225</sup> See *id.* For example, if an institution operates in all of Bangladesh's districts, the institution will have a higher minimum capital requirement than one operating in just one district.

<sup>226</sup> See *supra* note 139. The original bill proposal from the Microfinance Research and Reference Unit to the government contained a provision outlining such a transition. Email from Lila Rachid, *supra* note 212. The government did not approve the provision, reasoning that establishment of the Microcredit Regulatory Authority was a bold move, and that legislation for microfinance regulation should move one step at a time. *Id.* The members of parliament explained that they want to move cautiously on microfinance regulation. After evaluating the effectiveness of the Microcredit Regulatory Authority, parliament members will re-visit the provision for an easy transition from NGO to formal bank status. Interview with Lila Rachid, Managing Director of the Microcredit Regulatory Authority, in Dhaka, Bangladesh (Jun. 10, 2007). Dr. Yunus, whose Grameen Bank is the only formalized bank conducting microfinance operations in Bangladesh, was a strong proponent of this provision. *Id.* Understandably, Dr. Yunus carries tremendous political influence in the country; as such, practitioners are optimistic that the parliament will soon adopt a provision to the law that will facilitate easy transition from NGO to formalized bank status.

<sup>227</sup> Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf).

<sup>228</sup> See *supra* note 105; see also *supra* note 190.

<sup>229</sup> See *supra* note 176.

<sup>230</sup> Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf). It has long been the policy of the Bangladesh Bank to allow financial service providers to compete freely regarding interest rates. See Bank of Bangladesh, <http://www.bangladesh-bank.org/fnansys/fnansys.html>.

<sup>231</sup> See, e.g., COUNTS & SOBHAN, *supra* note 43 (proposing central banks establish an independent supervisory body to regulate the microfinance sector). The rationale for this argument is rooted in the complexity of microfinance regulation. It is difficult for a banking supervisory body to regulate the commercial banking sector as well as microfinance. See *id.* Microfinance regulation is a daunting task, and involves detailed analysis of thousands of institutions. As of January 2008, the MRA had received applications from 4,000 institutions. Email from Lila Rachid, *supra* note 212. The MRA follows a thorough process before granting a license. For instance, the MRA considers whether the institution has followed the detailed registration requirements of the Microcredit Regulatory Act; whether the

the Microcredit Regulatory Act established the Microcredit Regulatory Authority, an independent microfinance supervisor. The law also promotes institutional transparency and stability of the microfinance sector. Under the law, no executive of an institution can have an unlawful or even a financially unstable background.<sup>233</sup> Each institution must abide by internationally recognized accounting standards and submit annual financial statements to the MRA.<sup>234</sup> While there is no requirement of minimum capital adequacy, the MRA notes the importance of establishing minimum liquid reserve requirements.<sup>235</sup> Finally, each institution is required to establish a reserve fund, so as to ensure long-term solvency.<sup>236</sup> The principles of the Act enable the institutions to thrive financially, protect the MFIs' borrowers and promote stability in the microfinance sector. As such the Microcredit Regulatory Act provides a model for other countries to follow.

## V. CONCLUSION

Will the eighty to ninety percent of the population who are excluded from the formal banking sector in developing countries be able to receive financial services? The answer depends in large part on whether sound legal frameworks for microfinance are established. There are many costs and benefits to microfinance regulation. Balancing the two, the benefits outweigh the costs, so long as sound practices are followed.<sup>237</sup> As countries undertake efforts to establish a framework for microfinance, the Microcredit Regulatory Act of 2006 is an example of an effective law that will provide a favorable legal framework for microfinance.

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institution has bona fide operations at the field level; whether it has adopted approved accounting and management information systems; and whether it has a properly functioning executive body. *Id.*

<sup>232</sup> *See supra* note 200.

<sup>233</sup> Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf). In addition, the MRA can pass a written order for an executive to step down if he or she is involved in prejudicial practices, or if he or she causes any public harm. *Id.* Each executive must submit, on behalf of the institution, a constitution to the MRA and the MRA must approve any changes to the document. *Id.*

<sup>234</sup> *Id.* The MRA has the authority to see any documents and visit any projects it deems necessary. *Id.* The MRA also has liberal permission to impose fines and it can even seize documents if there is any suspicious activity. *Id.*

<sup>235</sup> Email from Lila Rachid, *supra* note 212; *see also* Microcredit Regulatory Act of 2006, available at [http://www.microfinancegateway.org/files/37487\\_file\\_Bangladesh\\_Micro\\_Credit\\_Regulatory\\_Authority\\_Act\\_2006.pdf](http://www.microfinancegateway.org/files/37487_file_Bangladesh_Micro_Credit_Regulatory_Authority_Act_2006.pdf). A minimum liquid reserve requirement serves the purpose of ensuring the overall solvency of the institution, by requiring the institution to maintain a certain percentage of its total capital in liquid form. Commentators suggest that minimum standard liquidity requirements for microfinance should not exceed 25%. *See, e.g.,* COUNTS & SOBHAN, *supra* note 43.

<sup>236</sup> *Id.* A reserve fund is a safety net for the institution, and requirements typically require financial institutions to maintain a certain percentage of its total assets in the fund. *See* LEDGERWOOD, *supra* note 130.

<sup>237</sup> For example, practices such as those outlined in section II of this comment: Microfinance services should be integrated with the formal financial sector; regulation should be based on a tiered approach; the framework should facilitate an easy transition from NGO to formalized bank status; and there should be no interest rate cap. It should be noted that this list of four suggestions is not exhaustive.