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The Role of Private Sector Investment in International Microfinance and the Implications of Domestic Regulatory Environments

*William Langer**

I. INTRODUCTION

Microfinance is the practice of providing small, working capital loans and other financial services to individuals unable to obtain access to commercial sources of credit. Microfinance has transformed the lives of over 100 million micro-entrepreneurs throughout the world. Modern microfinance began in the mid-1970s with initiatives, first in Bangladesh and then in Bolivia, to distribute small loans to the working poor.¹ These ventures demonstrated both the sustainability of microfinance through loan repayment rates of nearly 100%² and the effectiveness of microfinance as a poverty-alleviation tool.³ Building on these initial successes, the microfinance industry has grown to an estimated 10,000 lending institutions,⁴ approximately \$22 billion in total assets, and a client base of over

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1. MICROCAPITAL INSTITUTE, MANAGING COMMERCIAL MICROFINANCE: THE PEOPLE AND INSTITUTIONS BEHIND THE ASSET CLASS 1 (2004) [hereinafter MANAGING COMMERCIAL MICROFINANCE], available at http://www.microfinancegateway.org/files/45828_file_19.pdf.

2. Sylvie Golay & Ursula Oser, *Microfinance as an Attractive Business Model*, CREDIT SUISSE: GLOBAL INVESTOR FOCUS, May 2005, at 17. While variation exists, mature lending institutions experience repayment rates of 98%. *Id.* In the solidarity model of microfinance, social collateral is leveraged by grouping borrowers; where a group member defaults on an installment, the remaining members are jointly liable for the loss. Klaus Tischhauser, Ecuador: The Market, Credit Systems and Clients, CREDIT SUISSE: GLOBAL INVESTOR FOCUS, May 2005, at 15.

3. Elizabeth Littlefield, et al., *Is Microfinance an Effective Strategy to Reach the Millennium Development Goals?*, 24 FOCUS NOTE 2 (2003).

4. MANAGING COMMERCIAL MICROFINANCE, *supra* note 1, at 7. MicroCapital Institute, Grameen Foundation USA, and ACCION International all estimate a population of 10,000 MFIs worldwide. *Id.*; JENNIFER MEEHAN, TAPPING THE FINANCIAL MARKETS FOR MICROFINANCE 1 (Grameen Foundation USA 2005), available at <http://www.grameenfoundation.org/pubdownload/dl.php?pubID=4>; *Small Loans and Big Ambitions*, ECONOMIST, Mar. 17, 2007, at 108.

100 million borrowers worldwide.⁵ While at least 90% of microfinance institutions (MFIs) have yet to reach profitability, by 2006 roughly 1,000 institutions had demonstrated profits through increased efficiency and scale.⁶ Profitability potential is shown by leading MFIs on various continents that outperform local commercial banks in terms of profitability.⁷ The number of profitable MFIs continues to increase due to the transformation of nonprofit MFIs into regulated, for-profit enterprises.⁸

Despite its rapid growth, the microfinance industry currently reaches only a fraction of the estimated demand for microfinance services.⁹ Practitioners agree that to dramatically reduce world poverty and close the gap between supply and demand, microfinance institutions need to access funding from the private sector.¹⁰ Indeed, funds from philanthropic donations and public and multilateral development agencies are far from sufficient.

The recent emergence of successful microfinance institutions, along with an increasing crop of wealthy and willing private investors, fosters optimism for the expansion of the microfinance industry. To date, relevant commentary has focused on the growth of the microfinance sector and its potential for continued expansion.¹¹ Given the increasing interest on the part of investors, such commentary also discusses whether there will be so few of these

5. Elizabeth Nelson, *What Are the Total Global Assets in Microfinance?*, MICROCAPITAL, Oct. 31, 2007, available at <http://www.microcapital.org/?p=1450>.

6. WORLD ECONOMIC FORUM, BLENDED VALUE INVESTING: CAPITAL OPPORTUNITIES FOR SOCIAL AND ENVIRONMENTAL IMPACT 62 (Mar. 2006) [hereinafter BLENDED VALUE INVESTING].

7. Tilman Ehrbeck, *Optimizing Capital Supply in Support of Microfinance Industry Growth* 5 (Omidyar Network & the SEEP Network, Working Paper, Oct. 2006).

8. ELISABETH RHYNE & BRIAN BUSCH, THE GROWTH OF COMMERCIAL MICROFINANCE: 2004–2006, at 10 (Sept. 2006).

9. The Shurush Initiative, Information on Microfinance, <http://www.shurush.org/economic/economic-background.html#2> (last visited Jan. 30, 2009). The fraction of unmet demand for microfinance is in flux due to growth and changes in the industry. Charted data gathered by the Microfinance Summit Campaign in 2005 showed roughly 80% of demand unmet and forecasted a reduction to 72% of demand unmet by 2010. *Id.*

10. See, e.g., MEEHAN, *supra* note 4, at 1; BLENDED VALUE INVESTING, *supra* note 6, at 7; Guatam Ivatury & Xavier Reille, *Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors*, 25 FOCUS NOTE 1 (Jan. 2004); MARC DE SOUSA-SHIELDS & CHERYL FRANKIEWICZ, FINANCING MICROFINANCE INSTITUTIONS: THE CONTEXT FOR TRANSITIONS TO PRIVATE CAPITAL, at vii (2004); Ehrbeck, *supra* note 7, at 8.

11. See, e.g., MEEHAN, *supra* note 4; Rekha Reddy, *Microfinance Cracking the Capital Markets II*, 22 ACCION INSIGHT 1 (May 2007); Ehrbeck, *supra* note 7, at 3; Guatam Ivatury & Julie Abrams, *The Market for Foreign Investment in Microfinance: Opportunities and Challenges*, 30 FOCUS NOTE 3 (Aug. 2005).

“investible” microfinance institutions that private capital will remain concentrated among a minority of exceptional institutions, leaving the microfinance sector as a whole unable to close the gap between supply and demand.¹²

This Article seeks to contribute to the current understanding of the microfinance industry’s potential to address currently unmet demand for its services. The purpose of this Article is twofold: first, to assess the current supply and demand for commercial investment in microfinance; and second, to analyze some of the legal and regulatory challenges affecting the capacity of participating investors in the microfinance industry to satisfy unmet worldwide demand. In recent years, the increasing number of large, innovative transactions indicates that private investors are poised to supply as much capital as microfinance institutions can successfully and profitably deploy.

This development could enable microfinance institutions to satisfy a vast portion of currently unmet worldwide demand for microfinance services. However, demand for private capital investment depends on more than potential client base. Such demand also largely depends on the ability of individual institutions to grow into profitable organizations that serve an expanded client base, making them attractive candidates to receive and deploy private capital investment. This Article concludes that domestic regulatory environments—often disjointed and ill suited to the relatively new microfinance industry—constitute one of the principal challenges that currently limit microfinance institutions’ ability to achieve the level of growth and profitability to make them “investible.” Thus, regulatory reform is crucial to the microfinance industry’s ability to attract investment, increase outreach, and ultimately close the gap between the supply and the demand for microfinance services.

Part II of this Article assesses the level of supply and demand for commercial investment capital in microfinance institutions and examines whether there will be enough large microfinance institutions to attract and effectively deploy the amount of private capital that investors are able to provide. It discusses the current private sector involvement developed over the last several years to increase the supply of private capital, the creation of international investment vehicles to absorb private sector capital, and efforts to deliver increased financial services to micro-entrepreneurs. Part II

12. See, e.g., Ivatury & Abrams, *supra* note 11, at 11; Reddy, *supra* note 11, at 14.

also describes the growing demand for private investment in microfinance institutions.

Part III addresses the regulatory challenges that the microfinance industry and participating private sector actors may face in meeting the demand for private capital. It then discusses the microfinance sectors within Brazil, China, and India, three countries representing over half of the unmet demand for microfinance.¹³ Each case study examines the country's regulatory environment and analyzes the impact of regulations on the extent of microfinance outreach and potential for growth in each country. These assessments of the microfinance industry's potential to operate successfully within specific regulatory regimes provide a deeper understanding of the industry's overall potential to meet worldwide demand and suggest ways to improve efforts to fulfill that potential.

II. THE SUPPLY AND DEMAND FOR PRIVATE INVESTMENT IN MICROFINANCE

While microfinance traditionally receives funding through government grants and non-profit subsidized loans, private investors have become increasingly interested in microfinance investment given the favorable financial and social returns. Indeed, building on initial investments in the 1990s, private commercial investment in microfinance began to grow at annual rates approximating 50% in the year 2000,¹⁴ reaching an estimated total of \$2 billion invested by the end of 2006.¹⁵ Private investment is expected to gradually overtake funding from non-commercial and public sources.¹⁶

Microfinance practitioners have welcomed the initial successes of private investment in microfinance, in part because the industry has been able to meet only a fraction of worldwide demand for microfinance services through traditional public funding sources.¹⁷ Industry professionals agree that the funding necessary to close the gap between supply and demand must come from commercial

13. Ehrbeck, *supra* note 7, at 2.

14. MANAGING COMMERCIAL MICROFINANCE, *supra* note 1, at 2.

15. Xavier Reille & Ousa Sananikone, *Microfinance Investment Vehicles*, Consultative Group to Assist the Poor (CGAP), Brief, Apr. 2007, at 1.

16. Elisabeth Rhyne & María Otero, *Microfinance Through the Next Decade: Visioning the Who, What, Where, When and How*, ACCION INTERNATIONAL, 2006, at 45.

17. BLENDED VALUE INVESTING, *supra* note 6, at 8; *see also supra* note 9 and accompanying text.

sources within the private capital markets.* Thus, private investment may be essential to fulfilling the original mission of microfinance—namely, the provision of permanent access to financial services that enables large numbers of working poor to lift themselves out of poverty. This Part examines the growing role played by private capital investment in the microfinance industry.

A. Current Private Sector Involvement: The Supply of Private Capital

This Section first assesses the volume of investment from private sources. It then examines private investment as a portion of total worldwide microfinance investment, the rate at which private investment has expanded in recent years, the types of investors involved, and the various investment instruments developed to channel funds into microfinance.

1. Microfinance investment vehicles and the supply of private capital

Individual investors do make direct investments in MFIs; however, private investment in microfinance comes primarily from microfinance investment vehicles (MIVs)—microfinance funds that pool investor capital for investment in a number of MFIs. While some commercial investment in MFIs comes from the local markets, most initial investment comes from Western investors hoping to pave the way for local investors.¹⁹ MIV investment grew from \$2 billion in 2006²⁰ to an estimated \$3.2 billion by the end of 2007.²¹ Approximately 75% of this investment is debt, 22–25% is equity,²² and 2% consists of guarantees for local investors.²³ In terms of equity investment, 75% goes to Greenfield, for-profit institutions, and other young MFIs, demonstrating investor interest in funding start-up institutions that seek to eventually become large-scale profitable MFIs.²⁴

18. See, e.g., MEEHAN, *supra* note 4; BLENDED VALUE INVESTING, *supra* note 6, at 7; Ivatury & Reille, *supra* note 10, at 1; DE SOUSA-SHIELDS & FRANKIEWICZ, *supra* note 10, at vii; Ehrbeck, *supra* note 7, at 1.

19. Paul DiLeo & David FitzHerbert, *The Investment Opportunity in Microfinance*, GRASSROOTS CAP. MGMT., June 2007, at 17; MEEHAN, *supra* note 4, at 6.

20. Reille & Sananikone, *supra* note 15.

21. DEVELOPING WORLD MARKETS, MICROFINANCE INDUSTRY POTENTIAL (2007) (unpublished report on file with author).

22. Reddy, *supra* note 11, at 3.

23. Ivatury & Abrams, *supra* note 11, at 5; Ehrbeck, *supra* note 7, at 4.

24. Reddy, *supra* note 11, at 3.

As of mid-2007 there were about eighty-five MIVs focused on investing in microfinance.²⁵ These funds include a variety of debt- and equity-focused investments ranging from highly concessionary to purely commercial in their profit orientation.²⁶ While new MIVs have recently entered the market, the supply is still heavily concentrated because the leading MIVs remain the most active.²⁷ A 2005 study of seventy-four MIVs found that the top ten MIVs are responsible for 65% of all MIV investment.²⁸ ProCredit Holding AG, the largest of these funds, held \$390.4 million in total capitalization, while sixty-one of the seventy-four MIVs held less than \$1 million.²⁹ The subsections below discuss how MIVs fit into the larger picture of present and future microfinance funding.

2. Private investment as a portion of total investment in microfinance

Private foreign investment continues to represent a relatively small but fast-growing portion of the total investment in microfinance. A 2004 study found that domestic investment accounts for 76% of the total \$17 billion invested in MFIs, with 60% of that domestic investment coming from deposits made by the borrowers or clients of the MFIs.³⁰ The ability of MFIs to mobilize domestic deposits through savings is essential to the vitality of the microfinance industry, offering MFIs the lowest cost and most stable funding available,³¹ while also providing savings to clients.³² Despite the desirability of deposits as a source of funding, deposit-taking can be difficult to administer and is sometimes prohibited for certain MFIs under local legal regimes.³³ Larger MFIs successfully engaged in deposit-taking require significant funds for liquidity and interest rate risk management,³⁴ thus furthering the need for investment from private investors.

25. DiLeo & FitzHerbert, *supra* note 19, at 18.

26. *Id.*

27. Reddy, *supra* note 11, at 3.

28. *Id.*

29. *Id.*

30. Ehrbeck, *supra* note 7, at 3.

31. Marc de Sousa-Shields & Brad King, *MFI Financing Strategies and the Transition to Private Capital*, USAID: MicroReport #32, June 2005, at 1.

32. SAVINGS ARE AS IMPORTANT AS CREDIT: DEPOSIT SERVICES FOR THE POOR I (CGAP Donor Brief No. 4, 2002), *available at* http://www.cgap.org/gm/document-1.9.2435/DonorBrief_04.pdf.

33. *See, e.g.*, de Sousa-Shields & King, *supra* note 31, at 13.

34. *Id.* at 2.

Excluding deposits, foreign investment comprises roughly 43% of total microfinance investment worldwide, or approximately \$4 billion.³⁵ Within foreign investment, private investment from MIVs accounts for nearly half of the \$4 billion currently invested.³⁶ The majority of foreign investment currently comes from private MIV funds and essentially public International Financial Institutions (IFIs), having invested \$2 billion and \$2.3 billion respectively by the end of 2006.³⁷ This breakdown is somewhat misleading, however, because 36% of investment in MIVs currently comes from IFIs, which blurs the distinction between private and public funding.³⁸

3. The growth of private investment

Private investment continues to show great potential for meeting microfinance capital demands. Indeed, private investment is poised to overtake public investment as the major source of microfinance funding, as evidenced by the recent growth of investment activity by MIVs. This would be a significant development given that public investment, largely from IFIs, was the only source of foreign funding until the 1990s. Evidence of this trend emerged in recent years as MIV investment has increased faster than IFI investment. While microfinance investment among IFIs more than doubled from \$1 billion in 2004 to \$2.3 billion in 2006, MIV investment more than tripled over the same period, from \$600 million to \$2 billion.³⁹ Roughly forty new MIVs began operations from 2005 to 2007, nearly doubling their number.⁴⁰

While establishment of new MIVs increases, existing MIVs have expanded their investment activities. A 2006 study of fifty-four MIVs found that total assets increased from just under \$1 billion in 2004 to \$1.45 billion in 2006, an increase of 47%.⁴¹ Investments increased

35. Ehrbeck, *supra* note 7, at 3.

36. *See id.* The 43% is the percentage of foreign investment as a fraction of total “external” investment, where “external investment” is total investment (foreign and domestic, public and private), minus deposits (clients’ savings) is an internal source.

37. Reille & Sananikone, *supra* note 15, at 1.

38. Ivatury & Abrams, *supra* note 11, at 4.

39. Reille & Sananikone, *supra* note 15, at 1.

40. *Id.* at 1; Julie Abrams & Damian von Stauffenberg, *Role Reversal: Are Public Development Institutions Crowding Out Private Investment in Microfinance?*, MICRORATE: MFINSIGHTS, Feb. 2007, at 4.

41. *Microfinance Investment Vehicles: An Emerging Asset Class*, MICRORATE: MFINSIGHTS, Nov. 2006, at 2.

91%, from \$513 million in 2004 to \$981 million in 2006.⁴² Thirty-five of the fifty-four MIVs in the study were founded after 2000, suggesting that only twenty MIVs existed in 2000, compared to the eighty-five operating in 2007.⁴³ Taken together, these figures indicate that an overwhelming majority of the \$2 billion invested by the eighty-five MIVs has emerged over the last ten years. This growth suggests a rapidly increasing supply of capital at the disposal of MFIs. Indeed, Deutsche Bank has predicted that by the year 2015, investment will increase tenfold, from the 2006 estimate of \$2 billion to \$20 billion.⁴⁴

4. Investors in microfinance investment vehicles

Investors in microfinance funds constitute a diverse group with varied profit orientation. MIVs invest not only in mature and profitable MFIs but also in start-ups and those undergoing transformation from unregulated nonprofit organizations to regulated profit-seeking banks; thus, there is a wide range in risk and profitability of potential investments. The nature of investment has four categories: (1) fully commercial, (2) blended value, (3) preservation of capital, and (4) grants.⁴⁵ Commercial banks and institutional investors—including pension funds, private equity firms, and venture capital firms—typically engage in fully commercial investment, which seeks market-based, risk-adjusted returns. Funds of institutional investors earmarked for “socially responsible investment,” high net-worth individuals, and corporate social responsibility initiatives of commercial banks generally undertake blended value investment, which seeks commercial or near-commercial gains and a substantial social return on investment. Foundations and IFIs engage in preservation of capital investment, which does not necessarily seek financial returns, and devote funding in the form of grants where no financial return is expected.⁴⁶

While initial MIV investment came from socially responsible investors and IFIs, private capital has shown an increased interest. Although engagement from the traditional capital markets is promising, purely commercial investment from mainstream

42. *Id.*

43. *Id.* at 4.

44. DEVELOPING WORLD MARKETS, *supra* note 21.

45. Ehrbeck, *supra* note 7, at 3; BLENDED VALUE INVESTING, *supra* note 6, at YY, 5.

46. *See* Ehrbeck, *supra* note 7, at 3; BLENDED VALUE INVESTING, *supra* note 6, at 5.

institutional investors still comprises only 17% of investment in MIVs.⁴⁷ Of the remaining 83%, 47% comes from socially responsible investors, high net-worth individuals and foundations, and 36% comes from IFIs (down from an estimated 70% in 2004).⁴⁸ Thus, MIVs have shown an increase in ability to attract non-public investment.

5. Where private microfinance funds are invested

The emergence of private investment has been driven by the investment potential of the leading MFIs in those regions of the world where the microfinance industry is most developed. As a result, investment has been concentrated both in the top MFIs and in those regions exhibiting the most vibrant microfinance sectors. In total, 450 to 500 MFIs receive investment from MIVs.⁴⁹ However, just ten MFIs located in Latin America, Eastern Europe, and Central Asia currently absorb 26% of all MIV investment.⁵⁰

In general, MIV and IFI investment is heavily concentrated within the top fifty MFIs.⁵¹ These MFIs are licensed and regulated by local banking authorities, represent larger and more profitable institutions, and exhibit relatively less investment risk. This creates competition among private investors interested in investing in those “top tier” MFIs that exceed most MFIs in scale and profitability. At the same time, investment interest in “tier 2” and “tier 3” MFIs has been growing as investors become more familiar with microfinance and are able to pursue profitable investments in a broader class of institutions.⁵²

Some analysts argue that IFIs and government development banks crowd out private investment by continuing to invest in the most successful MFIs, and that these public investors should instead focus on funding the “next generation” of smaller but up-and-coming MFIs in order to help them develop and eventually join the “tier 1”⁵³ institutions.⁵⁴ Public investment concentration among top

47. CGAP, GROWING INVESTMENT IN MICROFINANCE 14 (2007), available at http://www.cgap.org/gm/document-1.9.3910/Portfolio_Jun2007.pdf.

48. *Id.*

49. Reddy, *supra* note 11, at 3.

50. *Id.*

51. *Id.*

52. See, e.g., Ehrbeck, *supra* note 7, at 8.

53. “Tier 1” institutions represent the top 2% among the most successful MFIs. The fragmentation of the MFI landscape into “tiers” of MFIs is discussed further in *infra* Part II.B.

MFI is not altogether surprising. Most of the “tier 1” MFIs were relatively young and small institutions when IFI investment began, and it was this investment that helped them grow into “tier 1” MFIs. Thus, it may take time before IFIs exit their investments in these newly flourishing MFIs and start anew with investments directed toward the “next generation.”

Nonetheless, as awareness of this issue spreads within the industry, IFIs and development agencies can be expected to deploy their more risk-tolerant capital to those small and growing MFIs that need it. This will open opportunity for private investment and generate a transition that should be influential in increasing the amount of MFIs able to profitably serve a large client-base. The amount of investible MFIs that can effectively absorb and produce a return on private funding—a small, albeit growing percentage—is decisive in determining the amount of capital that investors are able to commit to microfinance. This is further discussed in Part II, Section B of this Article.

Finally, due to concentration of the top MFIs, private investment in microfinance is funneled into regions where the microfinance sector is most developed. To date, 42% of MIV investment occurs in Latin America and the Caribbean while 39% occurs in Eastern Europe and Central Asia.⁵⁵ This leaves only 20% of investment going to East and South Asia and Africa, which contain a great portion of the world’s poor and where microfinance development lags behind that of Latin America and Eastern Europe.⁵⁶ As the microfinance sector continues to develop in these regions and MFIs become more established, increased private capital investment should follow.

6. Investment instruments used by microfinance investment vehicles

In the last several years, innovative investment strategies have emerged to channel private capital into microfinance. Relatively new investment structures include holding companies, equity funds, country level funds, and funds of funds. In addition, some funders offer local currency products to mitigate foreign exchange risk and currency-linked products. This subsection outlines the various innovations in investment instruments that MIVs have recently begun to pursue.

54. Abrams & von Stauffenberg, *supra* note 40, at 1.

55. Reddy, *supra* note 11, at 3.

56. RHYNE & BUSCH, *supra* note 8, at 12.

a. Credit guarantees and enhancements. Loan guarantees, also known as credit enhancements, have been prevalent in international development for decades and have been a part of the microfinance industry since the mid-1980s. Guarantees in microfinance encourage local investors and banks to lend to MFIs where they might have otherwise been deterred by the perceived risk. This is accomplished through an international bank issuing a standby letter of credit or credit enhancement to the local bank, whereby the international bank promises to pay the local bank if the MFI defaults on its debt. The international bank's commitment is typically guaranteed by a foreign investor who pledges its own assets to the international bank in the event that the MFI defaults.

Such guarantees are most helpful where they cause the investor community to reassess its perception of the risk of MFIs. An MFI's timely repayment of its loans can pave the way for additional transactions that do not require guarantees. This would enable MFIs to broaden their investor base as microfinance investment is shown to be less risky than initially believed.⁵⁷ Although a 2006 study found an increase in the use of guarantees, this increase primarily came from IFIs and other development agencies.⁵⁸ Indeed, a 2005 study found that IFI investment makes up 90% of the funding directed towards guarantees with MIVs accounting for the remaining 10%.⁵⁹ Guarantees effectively stimulate domestic markets for investment in microfinance and channel external funds into microfinance where regulations cap foreign funding.

b. Private equity investment. Private equity investment can be especially useful for start-up MFIs that, according to their business plans, typically operate at a loss for their first few years and thus are unlikely candidates for debt investment. In addition, MIVs with industry experience can help disseminate best practices, technological innovation, and organizational capacity building among their investments. The first commercial microfinance equity fund, ProFund, founded in 1995, exited its investment and distributed profits to its investors in 2005.⁶⁰ The success of ProFund, the only

57. Ann Miles, *Financial Intermediation and Integration of Regulated MFIs*, in 11 MICROBANKING BULL. 9, 11 (Didier Thys, ed., Aug. 2005).

58. Alexia Latortue et al., *Managing the Floodgates? Making the Most of the International Flows of Microfinance Funding*, CONSULTATIVE GROUP TO ASSIST THE POOR (2006), at 14.

59. Ivatury & Abrams, *supra* note 11, at 5.

60. BLENDED VALUE INVESTING, *supra* note 6, at 45.

fund of its kind in the mid-1990s, stimulated private equity interest in microfinance.⁶¹ By 2006 at least seventeen commercially-oriented, equity-focused MIVs had emerged.⁶²

The first half of 2007 saw two major private equity investments—both in Indian MFIs—that are expected to further this trend. The first of these transactions was conducted by Sequoia Capital, a venture capital company known for early investments in Google and YouTube, which invested \$11.5 million in the MFI SKS. Two months later, Legatum, a private company that focuses on a blend of financial and social returns, invested \$25 million in Share Microfin Limited, completing the largest private equity investment in a single MFI as of July 2007.⁶³

c. Bond issues in microfinance institutions. Bond issues began in 2001 with a \$2 million issue by Colombian MFI Financiera América (Finamerica). By 2005, MFIs in Africa and Eastern Europe had also issued bonds.⁶⁴ Bond offerings are not linked directly to any individual MFI loans, but are rather structured as obligations of MFIs themselves. The borrowers' repayment of interest and principal on the microloans back the bond offerings. Through this arrangement, the holder of the bonds absorbs the balance sheet risk of the MFI. Aggregately, MFIs in Latin America had placed over \$100 million in bonds in their local capital markets by 2005, and more MFIs in other regions are expected to continue this trend.⁶⁵ Indeed, microfinance bond offerings have grown from Finamerica's pioneer transaction of \$2 million in 2001 to transactions ranging from \$7 million to \$52 million in 2005.⁶⁶

The success of these transactions has also stimulated investment interest from a growing variety of mainstream investors. Three bond issues made between 2002 and 2004 by Peruvian MFI MiBanco exemplify this trend. The first, in September 2002, was facilitated by a 50% guarantee from the United States Agency for International Development (USAID). The second, in September 2003, was again

61. DiLeo & FitzHerbert, *supra* note 19, at 18.

62. *Id.*

63. Gil Crawford & Lauren Clark, *Capital Markets: A Long-Term Solution to Financial Freedom*, MICROENTERPRISE DEV. REV., July 2007, at 9.

64. Abrams & von Stauffenberg, *supra* note 40, at 5.

65. María Otero, *A Commercial Future for Microfinance: Opportunities and Challenges*, MICROFINANCE MATTERS, Oct. 2005, at 26.

66. Abrams & von Stauffenberg, *supra* note 40, at 5.

guaranteed at 50%; however this time from a regional bank and at a lower rate of interest than the 2002 transaction. The third was completed in October 2003 without a guarantee because the previous two had established MiBanco as an attractive investment. Furthermore, while investment in the first issuing came predominantly from pension funds, investments in the second and third issues were more evenly distributed between mutual funds, public entities, pension funds, banks, and insurance companies.⁶⁷

d. Securitizations. Securitizations in microfinance come primarily in the form of international collateralized debt obligations. This is structured through the establishment of a special purpose vehicle, which issues securities to investors and then uses the proceeds to make loans to a group of MFIs. The underlying microloans of several MFIs are then pledged as collateral to investors. The pooling of the underlying loans of a group of MFIs diversifies investment and spreads risk and increases the scale of the investment, making these transactions more appealing than investment in a single MFI. The first microfinance securitizations occurred in 2004 and 2005, with transactions of \$40 million and \$47 million, respectively, completed jointly by Developing World Markets (an American investment company) and BlueOrchard (a Swiss investment company).⁶⁸

Although microfinance securitization is still in its nascent stage, some groundbreaking transactions suggest a promising future. Two of the largest transactions to date were completed jointly by the international investment bank Morgan Stanley and the MIV BlueOrchard with issues of \$106 million in March 2006 and \$108 million in May 2007.⁶⁹ The 2007 transaction, rated by Standard & Poor's, was able to channel funds to twenty-one MFIs in thirteen countries.⁷⁰ This demonstrates that while Latin America, Eastern Europe, and Central Asia remain the most developed regions for

67. Miles, *supra* note 57, at 11.

68. Press Release, Developing World Markets Microfinance, The First Securitization of Cross-Border Loans to Microfinance Institutions, *available at* <http://www.dwmarkets.com/PDF/PR1.pdf>.

69. Steven Craig, *Morgan Stanley Forms Microfinance Group to Provide Investment Banking Services to Microfinance Institutions*, MICROCAPITAL, Sept. 2007, *available at* <http://www.microcapital.org/?p=1342>.

70. The countries are Azerbaijan, Bosnia, Cambodia, Colombia, Georgia, Ghana, Kenya, Mongolia, Montenegro, Nicaragua, Peru, Russia, and Serbia. *Morgan Stanley, BlueOrchard in Microfinance ABS*, REUTERS AFR., May 4, 2007, *available at* <http://africa.reuters.com/business/news/usnBAN423600.html>.

microfinance, investors have begun to find investible MFIs in Africa and Southeast Asia. Although such large transactions are still not applicable to most MFIs, they will likely become more prevalent as more large-scale MFIs emerge and as investors continue to pursue innovative transactions that increase investment options. Indeed, recent securitizations have already demonstrated an ability to move from the “tier 1” MFIs to small MFIs still in their maturing stage.⁷¹

However, the economic and financial events of 2008 highlighted risks inherent in securitizations of risky or overvalued assets. It is essential to recognize the susceptibility of MFIs to speculation and the need for accurate risk assessments if securitization is to benefit rather than harm MFIs. As noted above, securitization helps MFIs because individual MFIs cannot take on loans large enough to attract commercial investors with large amounts of capital to invest. Securitization can thus allow for a series of loans to a group of MFIs, aggregating a series of transactions, all of which would be too small individually to be attractive to investors holding large amounts of capital. While smaller investors could theoretically provide the individual loans, this would diminish individual MFIs’ prospects for attracting investment. In addition, most of these smaller investors are increasingly placing their capital in the hands of large investors, namely institutional investors such as banks, insurance companies, pension funds, and mutual funds.

e. Initial public offerings. Use of the initial public offering (IPO), or first sale of stock by a company to the public, emerged in the microfinance industry in 2003 when the MFI Bank Rakyat Indonesia was listed on the Jakarta, Singapore, and other stock exchanges.⁷² In 2006, Equity Bank of Kenya listed on the Nairobi Stock Exchange.⁷³ In April 2007, Banco Compartamos of Mexico listed on the Mexican Stock Exchange.⁷⁴ Proceeds from the Compartamos IPO totaled \$486 million, with purchases emanating from 5,920 institutional and retail investors from Mexico, the United States, Europe, and South America.⁷⁵ While these three MFIs represent industry leaders,

71. BLENDED VALUE INVESTING, *supra* note 6, at 20.

72. ACCION INTERNATIONAL, *The Banco Compartamos Initial Public Offering*, INSIGHT Num. 23, June 2007, at 11 [hereinafter *Banco Compartamos*], available at http://www.microcreditsummit.org/enews/2007-07_Accion%20Compartamos%20Article.pdf.

73. *Id.*

74. *Id.* at 1.

75. *Id.*

practitioners believe that an increasing number of MFIs are exhibiting the scale, growth, and profitability sufficient to pursue an IPO.⁷⁶

Furthermore, the Compartamos IPO was a secondary offering in which all of the shares were sold by existing investors.⁷⁷ Many of these investors wished to exit their investment in the extremely successful MFI and reinvest in start-up initiatives.⁷⁸ Their ability to sell their shares demonstrates the increasing liquidity of microfinance assets as microfinance investment draws interest from an increasingly broad class of private investors. Thus, although Compartamos did not yield profits from this offering, the liquidity of microfinance assets demonstrated by the transaction should increase investor confidence and general interest in microfinance investment.

f. Syndication. While syndicated loans are common in mainstream commercial banking, bilateral loan transactions exclusively characterized the microfinance industry. However, in December 2006, three independent American MIVs (MicroVest, the Calvert Social Investment Foundation, and the Dignity Fund) completed a syndicated loan to D-MIRO, an MFI in Ecuador.⁷⁹ These joint transactions saved time and expenses for both the MFIs and the MIVs largely by combining the due diligence and other administrative efforts between MIVs, thus increasing profitability for MFIs.

g. Mezzanine funds. In 2005, a group of institutional investors and IFIs established the Global Commercial Microfinance Consortium.⁸⁰ The capital structure of this mezzanine fund consists of senior debt, sub-debt, equity, and grant capital. Deutsche Bank and Merrill Lynch are among those who manage the fund.⁸¹ It allows different types of private and public investors to pool their funding

76. BLENDED VALUE INVESTING, *supra* note 6, at 14.

77. *Banco Compartamos*, *supra* note 72, at 1.

78. Elisabeth Rhyne & Andres Guimon, *The Banco Compartamos Initial Public Offering*, ACCION INTERNATIONAL INSIGHT, June 2007, at 1, 5.

79. Crawford & Clark, *supra* note 63, at 8.

80. Lisa Kalajian, *Deutsche Bank's Global Commercial Microfinance Consortium (CGMC) lends over USD 2 mn to 4 Microfinance Institutions in Eastern Europe: Zena za Zena, Prizma, MicroInvest and NorMicro*, MICROCAPITAL, Apr. 11, 2007, available at <http://microcapitalmonitor.com/cblog/index.php?/archives/752-Deutsche-Banks-Global-Commercial-Microfinance-Consortium-CGMC-lends-over-USD-2-mn-to-4-Microfinance-Institutions-in-Eastern-Europe-Zena-za-Zena,-Prizma,-MicroInvest-and-NorMicro.html>.

81. *Id.*

and take more or less risky positions depending on their profit orientations. The IFI partners, such as USAID, occupy the riskiest positions while institutional investors, such as pension funds and individual investors, occupy less risky positions.⁸² To date, the fund has approved \$80.6 million for investment in MFIs across twenty-one countries.⁸³

These innovative investment strategies have increased the channels available to private investors. Along with the development of MFIs in currently under-serviced parts of the world, these new investment instruments should further increase the supply of private investment in microfinance. Overall, private investment in microfinance is on the rise and will soon outstrip public funding as the major source of capital in the industry.

B. The Microfinance Industry: The Demand for Private Capital

The increased supply of private investment in microfinance is accompanied by increases in MFI demand for capital investment and entrepreneurial demand for microfinance services. This Section examines the diverse array of MFIs that compose the microfinance industry, focusing on the growth of the industry in recent years and MFIs' increasing demand for private capital to fund their operations. It begins by looking at the overall worldwide demand for microfinance and the extent to which the microfinance industry meets the aggregate demand. This Section next discusses the nature of the current landscape of MFIs and the growth that the industry has recently experienced. Finally, this Section examines the recent and potential growth of MFI demand for private investment.

1. Worldwide demand for microfinance

Attempts to assess the total demand for microfinance typically begin with estimates of global poverty levels. The World Bank estimates that 2.8 billion people, or 560 million families, live on less than \$2 per day purchasing power parity; among those, 1.2 billion people live on less than \$1 per day.⁸⁴ Fewer than 18% of these 2.8

82. Jennifer Lee, *Microfinance Cracking the Capital Markets II*, MICROCAPITAL, Feb. 15, 2008, available at <http://www.microcapital.org/paper-wrap-up-microfinance-cracking-the-capital-markets-ii/>.

83. *Id.*

84. MEEHAN, *supra* note 4, at 2.

billion people are estimated to have access to financial services.⁸⁵ In developing countries, microenterprise represents the main source of jobs for the poor. Indeed, microenterprise consists of 80% of total enterprises, 50% of urban enterprises, and 20% of GNP for developing countries worldwide.⁸⁶

Investment estimates also indicate an enormous unmet financial demand. Practitioners estimate that the total amount of debt/deposit and equity funding necessary to meet the latent demand is \$250 to \$300 billion,⁸⁷ while current total debt/deposit and equity funding of MFIs is roughly \$17 billion,⁸⁸ or 6% of the estimated demand. Furthermore, various demographic and economic conditions in developing countries, such as population growth, large proportions of youth, limited education and skills training, increased rural to urban migration, and an insufficient ability of the formal sector to absorb new workers suggest that the amount of potential microfinance clients worldwide will only continue to grow.⁸⁹

Despite the 133 million people reached thus far among the working poor,⁹⁰ the microfinance industry still has a long way to go to close the gap between supply and demand. Current estimates of the total working poor who demand microfinance services range from about 1 to 1.5 billion people.⁹¹ Worldwide penetration rates imply that microfinance currently reaches 10% of its potential client base.⁹² Individuals located in China, India, and sub-Saharan Africa form the majority of those not reached by microfinance.⁹³ A 2007 study concluded that current penetration rates are no higher than 9% of the poor population for any given region of the world.⁹⁴ These figures demonstrate the tremendous potential for growth in the

85. *Id.* at 1.

86. RESPONSABILITY GLOBAL MICROFINANCE FUND, MICROFINANCE: THE KEY TO INDEPENDENCE 2 (2005).

87. *See, e.g.*, MICROCAPITAL, PLAYERS REPORT 2005: INSIGHTS FROM THE MICROFINANCE PRIVATE CAPITAL SYMPOSIUM 2 (2005), *available at* <http://www.microcapital.org/downloads/whitepapers/Geneva.pdf> ; Ehrbeck, *supra* note 7, at 3; BLENDED VALUE INVESTING, *supra* note 6, at 8; MEEHAN, *supra* note 4.

88. Ehrbeck, *supra* note 7, at 3.

89. Rhyne & Otero, *supra* note 16, at 11.

90. SAM DALEY-HARRIS, MICROCREDIT SUMMIT CAMPAIGN, STATE OF THE MICROCREDIT SUMMIT CAMPAIGN REPORT 2007, at 4 (2007).

91. *See, e.g.*, DiLeo & FitzHerbert, *supra* note 19, at 12; Ehrbeck, *supra* note 7, at 2.

92. *See, e.g.*, DiLeo & FitzHerbert, *supra* note 19, at 12; Ehrbeck, *supra* note 7, at 2.

93. *See, e.g.*, BLENDED VALUE INVESTING, *supra* note 6, at 8; DiLeo & FitzHerbert, *supra* note 19, at 12; Ehrbeck, *supra* note 7, at 2.

94. DEVELOPING WORLD MARKETS, *supra* note 21.

microfinance industry and, with it, the potential demand for increased funding from various sources.

2. *The current landscape of microfinance institutions*

The demand for funding within the microfinance industry depends on the ability of MFIs to achieve broad client outreach and profitability. Individual characteristics and the total number of MFIs worldwide are difficult to gauge because results have varied between studies. The different results are due to the varying number of MFIs that practitioners survey in any given study and the fact that data changes quickly as the industry rapidly grows. That said, estimates show that the current landscape of MFIs comprises of roughly 10,000 institutions;⁹⁵ these institutions exhibit a wide variety of levels of outreach and profitability.

Microcredit Summit Campaign's 2006 study collected data from 3,316 MFIs, which serve over 133 million clients.⁹⁶ It is one of the largest surveys of its kind, providing perhaps the most accurate picture of the current geographic distribution of MFIs. Of the participating MFIs, 1,677 were located in Asia and the Pacific (51%), 970 in Sub-Saharan Africa (30%), 579 in Latin America and the Caribbean (18%), and 30 in the Middle East and North Africa (1%).⁹⁷ Another 2006 study, which collected data from 704 MFIs, found that their gross loan portfolio was \$24 billion and that they had a combined total of \$33 billion assets.⁹⁸ In the course of funding their activities, the 704 MFIs reported that 65%⁹⁹ of portfolio funding came from commercial sources, up from 40% in 2003.¹⁰⁰ The 20 largest MFIs of the 704 surveyed increased their aggregate gross loan portfolios by about 33% per year from 2003 to 2006.¹⁰¹ This growth indicates a strong demand for private capital, which will likely increase.

95. Nelson, *supra* note 5.

96. DALEY-HARRIS, *supra* note 90, at 2.

97. *Id.* at 26.

98. DEVELOPING WORLD MARKETS, *supra* note 21.

99. *Id.*

100. Blaine Stephens, *Commercialization Continues Apace*, 14 MICROBANKING BULL. 33 (Spring 2007).

101. DEVELOPING WORLD MARKETS, *supra* note 21.

3. Types of microfinance institutions

MFIs range from non-profits to for-profit institutions. The majority of MFIs are non-profits and NGOs. However, the largest are for-profit institutions, which are often subject to banking regulations. Many MFIs start as NGOs and transform into for-profit corporations once they have grown sufficiently in terms of scale and operating efficiency.¹⁰² “Greenfield MFIs,” which have recently increased in number,¹⁰³ are start-up MFIs founded as for-profit entities and from their inception attempt to emulate the best practices of successful for-profit MFIs.¹⁰⁴

The industry is currently divided into four “tiers.” Tier 1, comprising 2% of MFIs, consists of mature, established, and regulated MFIs with strong financial and operational track records.¹⁰⁵ Tier 2, comprising 8% of MFIs, consists of successful, but smaller and younger MFIs that are at or near profitability.¹⁰⁶ Although these are mostly NGOs, many may convert to for-profit organizations, thus progressing up to tier 1. A small percentage of pioneer institutions lead the industry, and the total investment demand of MFIs has traditionally been concentrated in these first two tiers.¹⁰⁷ Tier 3, comprising 20% of MFIs, consists of young organizations that are approaching profitability, but have shortcomings due to lack of capital.¹⁰⁸ These are nearly all NGOs, some of which will progress to higher tiers. Tier 4, comprising 70% of MFIs, consists of a mix of unprofitable MFIs that are start-ups often in post-conflict settings, and weak financial institutions in regions where microfinance is not a priority.¹⁰⁹ Some of these will progress to higher tiers.¹¹⁰ This division between tiers is reflected in the graph below.

MFIs are frequently categorized by the number of borrowers. For example, the 2006 Microcredit Summit Campaign study of 3,316 MFIs found 7 MFIs with 1 million or more borrowers, 54

102. KATE LAUER, TRANSFORMING NGO MFIS: CRITICAL OWNERSHIP ISSUES TO CONSIDER 1 (CGAP Occasional Paper No. 13, 2008), available at http://www.cgap.org/gm/document-1.9.4213/OccasionalPaper_13.pdf.

103. Reddy, *supra* note 11, at 4.

104. *Id.*

105. MEEHAN, *supra* note 4, at 3.

106. *Id.*

107. *See, e.g., id.*; Reddy, *supra* note 11, at 3.

108. MEEHAN, *supra* note 4, at 3.

109. *Id.*

110. *Id.*

MFIs with 100,000 to 999,999 borrowers, 313 MFIs with 10,000 to 99,999 borrowers, 572 MFIs with 2,500 to 9,999 borrowers, and 2,364 MFIs with fewer than 2,500 borrowers.¹¹¹ These findings demonstrate the diversity of size among MFIs worldwide.

An understanding of the current microfinance industry landscape guards against an unrealistic overestimation of the growth potential of MFIs. While the increasing interest and ability of MFIs to move down-market, consistent sector growth, and continued increase in the numbers of MFIs in all tiers demonstrate growing investment potential, complexities of the industry lead some to develop a skewed perspective.

4. The funding of microfinance institutions

Obtaining funding constitutes a principal challenge to MFI growth. Approximately \$13 billion of the total debt/deposit and equity funding of MFIs comes from domestic sources, with \$4 billion from foreign investment.¹¹² Although these funds are split equally between public investment from IFIs and private investment from MIVs,¹¹³ only “tier 1” and “tier 2” MFIs have demonstrated the ability to attract and absorb private funding.¹¹⁴ Indeed, private capital constitutes roughly 65% of portfolio funding for tier 1 and tier 2 MFIs,¹¹⁵ demonstrating the extent to which the demand for private capital will increase as MFIs progress to higher tiers.

5. Growth of microfinance institutions and trends driving industry growth

Microfinance institutions continue to grow in terms of scale and number throughout the developing world.¹¹⁶ MFIs served only 13.5 million clients worldwide in 1997¹¹⁷ compared to 133 million clients by the end of 2006.¹¹⁸ This is a growth rate in client outreach of 25–30% annually.¹¹⁹ Excluding Ugandan MFIs, client outreach in

111. DALEY-HARRIS, *supra* note 90, at 24.

112. Ehrbeck, *supra* note 7, at 3.

113. *Id.*

114. Reddy, *supra* note 11, at 3.

115. DEVELOPING WORLD MARKETS, *supra* note 21.

116. RHYNE & BUSCH, *supra* note 8, at 13.

117. DiLeo & FitzHerbert, *supra* note 19, at 11.

118. DALEY-HARRIS, *supra* note 90, at 20.

119. Stephens, *supra* note 100, at 32.

transforming MFIs increased by an average annual rate of 70%, while the median Greenfield MFI added 50% more clients.¹²⁰ As the numbers of MFIs and total outreach increase, the industry continues to mature and improve in performance. These trends accelerate growth. Efficiency, break-even rates, and leverage rates measure improvement and growth in the microfinance industry.¹²¹

a. Efficiency. Efficiency is typically measured by operating expense. The Microfinance Information Exchange found that operating expense, as a proportion of average loan portfolio, decreased from 36.7% in 1999 to 21.5% in 2007.¹²² It is expected that MFIs will continue to realize improvements in efficiency.¹²³

b. Break-even rates. The “new generation” of MFIs, established in the last several years, has achieved profitability at increasingly faster rates. Time to reach profitability has decreased, on average, from 13 years for MFIs founded in the 1980s, to 9 years for those founded in the early 1990s, and to 4 years for those founded in the late 1990s.¹²⁴

c. Leverage ratios. Mature MFIs operating in relatively well-functioning domestic markets have attracted funding from various sources, which has increased their financial leverage by replacing subsidized funding with savings and commercial debt. Median debt/equity ratios of MFIs are estimated to have increased from 1.1 in 1999 to 1.9 in 2004.¹²⁵

These improvements in operational efficiency enable leading MFIs in countries such as Bolivia, Cambodia, Peru, Kenya and Uganda to become more profitable than their counterpart mainstream commercial banks.¹²⁶ In countries where microfinance is most developed, various industry “enablers”—microfinance-driven entities such as credit bureaus and rating agencies, venture capital firms, research and training organizations, and technology

120. *Id.*

121. It is expected that MFIs will continue to realize improvements in efficiency, catching up to industry leaders such as ASA in Bangladesh, which had an operating expense ratio of 6.5% of portfolio in 2007. DiLeo & FitzHerbert, *supra* note 19, at 5.

122. *Id.*

123. *Id.*

124. Ehrbeck, *supra* note 7, at 6.

125. *Id.* at 5.

126. *Id.*

providers—are emerging and creating a more stable microfinance environment.¹²⁷

6. Demand for private investment and projections for growth in microfinance institutions

MFI demand for private investment capital—not to be confused with micro-entrepreneurial demand for microfinance services—depends not only upon the above-mentioned demand for microfinance services, but also upon individual MFIs' ability to grow into profitable organizations serving a large client base. This growth makes them attractive candidates to receive and deploy private capital investment.

For-profit MFIs have become increasingly profitable over the last several years, with median returns on equity rising from 14.3 in 2000 to 23.1 in 2005.¹²⁸ A study of seventy-one commercial MFIs found that between 2004 and 2006 total assets tripled, borrowers increased by 73%, and \$435 million was added to total equity.¹²⁹ Lending portfolios have also increased among mature MFIs by about 35% annually since 2001.¹³⁰ Despite these advances, however, there is still room for improvement. Of the approximately 10,000 MFIs operating worldwide, only about 1,000 are profitable,¹³¹ and of those only 450 to 500 receive private investment from MIVs.¹³²

Profitable MFIs exhibit a growing demand for private capital. In 2006, mature MFIs sourced 65% of their loan portfolios from

127. *Id.* at 7.

128. *Id.* at 28.

129. RHYNE & BUSCH, *supra* note 8, at 6.

130. ABRAMS & VON STAUFFENBERG, *supra* note 40, at 4; DEVELOPING WORLD MARKETS, *supra* note 21.

131. BLENDED VALUE INVESTING, *supra* note 6, at 62.

132. Reddy, *supra* note 11, at 3. A 2006 study found 222 regulated, commercial and shareholder-owned MFIs worldwide, as compared to 124 such institutions in 2004. RHYNE & BUSCH, *supra* note 8, at 11. While the amount of commercial MFIs has increased in all regions, the largest increases occurred in Asia, Eastern Europe and Africa. *Id.* Another study looked at data on the largest MFIs—those with either 100,000 borrowers or loan portfolios of over \$100 million—from 2004 to 2006. *Id.* The study found that the number of MFIs with over 100,000 borrowers increased from five in 2004 to twenty in 2006, while the number of MFIs with loan portfolios of more than \$100 million increased from four in 2004 to twenty in 2006, with six MFIs appearing on both lists. *Id.* Large institutions were identified in all regions of the developing world, although no MFI in Eastern Europe has reached over 100,000 borrowers. *Id.* Among the twenty MFIs reaching over 100,000 clients, ten were located in Asia, while six were located in Africa, demonstrating the potential of microfinance to achieve scale in Africa despite the sector's relatively less developed status compared to regions such as Latin America and Asia. *Id.*

commercial funds,¹³³ up from 40% in 2003.¹³⁴ Continued increases in the ability to attract and absorb private capital can be expected. Within the next 5 years, commercial MFIs are estimated to reach \$36 billion in outstanding loans to 23 million clients worldwide.¹³⁵ Additionally, over the next ten years, the microfinance industry is expected to grow ten-fold, serving more than 500 million clients with total assets of \$200 to \$300 billion, and requiring equity finances of \$25–\$30 billion.¹³⁶

The Small Enterprise Education and Promotion (SEEP) Network estimates that during the next few years, the absorptive capacity of the microfinance sector will exceed the available supply of commercial funding.¹³⁷ Eventually, the ability of the industry to attract and deploy funds may increase to the point where capacity is sufficient to meet the overall global demand for microfinance services of 1 to 1.5 billion people by 2030.¹³⁸ However, other analysts point to the comparatively still low percentage of tier 1 institutions and conclude that this limits MFI demand for private investment, keeping it below the supply offered by investors and preventing available capital from reaching unmet demand for microfinance services.¹³⁹

In short, both supply and demand for private investment in microfinance have grown tremendously in recent years. Indeed, practitioners anticipate ten-fold growth in the microfinance industry over the next ten years.¹⁴⁰ Such an expansion would be a significant step towards reaching the 90% of demand for microfinance services that remains unmet. Ultimately, however, sustained investor interest will depend on the ability of the microfinance industry to continue expansion. Part III examines one of the principal challenges to such expansion, namely domestic regulatory environments.

133. DEVELOPING WORLD MARKETS, *supra* note 21.

134. Stephens, *supra* note 100, at 33.

135. RHYNE & BUSCH, *supra* note 8, at 14.

136. DiLeo & FitzHerbert, *supra* note 19, at 14.

137. Ehrbeck, *supra* note 7, at 4.

138. *Id.*

139. *See, e.g.*, Reddy, *supra* note 11, at 2; Ivatury & Abrams, *supra* note 11, at 7.

140. *See* DiLeo & FitzHerbert, *supra* note 19, at 14.

III. REGULATORY CHALLENGES TO PRIVATE SECTOR INVESTMENT IN MICROFINANCE

Whether private investment is able to bridge the gap between supply and demand in microfinance outreach depends in large part on the regulatory environment in which MFIs operate. A country's regulatory environment can profoundly influence the ability of domestic MFIs to achieve growth and sustainability, and to obtain access to capital.¹⁴¹ A study issued by the Consultative Group to Assist the Poor (CGAP) and the World Bank concluded that a country's microfinance industry cannot reach its full potential until MFIs are regulated and supervised in a coherent and prudent manner.¹⁴²

Regulatory regimes affect the level of opportunity for private investment in microfinance by facilitating or constraining the ability of MFIs and the microfinance sector to grow and develop. This influences the ability of large-scale mature and "investible" MFIs to emerge and increases the likelihood that lower tier MFIs will be able to become tier I institutions. Legal regimes also affect the attractiveness of investment in MFIs, potentially limiting the extent to which investors and foreign investors can invest in MFIs.

This Part first discusses the most significant regulatory challenges to the growth and development of private investment in the microfinance industry, emphasizing the need for balance between protection and growth, and the importance of quality regulation that maximizes the two. It then examines how these challenges have shaped the microfinance industry in three countries: Brazil, China, and India.

A. Important Regulatory Issues and the Need for a Prudent Balance

As is the case for financial regulation in general, government officials regulating their country's microfinance sector face the challenge of balancing the goals of minimizing risk and facilitating the transaction of business. These two goals can but do not always conflict. At one end of the spectrum, where there is very little regulation, risk is high due to insufficient barriers to entry into the market and inadequate supervision of market participants. This

141. MEEHAN, *supra* note 4, at 7.

142. Robert Peck Christen et al., *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance*, CGAP / THE WORLD BANK GROUP, July 2003, at 25.

regulatory environment limits growth and development because experienced investors and entrepreneurs refrain from transacting business as risk is high. Additional regulation furthers the goals of risk minimization and transaction facilitation. On the other end of the spectrum, heavy regulation decreases risk but increases the cost of compliance to investors and entrepreneurs, upon whom MFIs depend. This is especially true if these costs include foregone earnings from prohibited business activities.

Microfinance regulators thus face the challenge of finding an appropriate balance between minimizing the risk to providers and consumers of microfinance services and tailoring regulatory intervention so that providers have the ability and incentive to sustain and grow operations. A proper enabling environment for microfinance can be established only where an adequate balance is achieved, thereby making it possible for a robust microfinance sector to develop with a proliferation of large and investible MFIs. Finally, and perhaps most importantly, the issue is not simply a matter of *how much* regulation, but rather *what kind* of regulation is imposed. Regulations currently imposed on mainstream commercial banks will not suffice. Rather, an ideal regulatory environment will seek to tailor regulation to the unique nature of MFIs and the microfinance industry.

The economic and financial events of 2008 further underscore the importance of regulatory reform carefully tailored to the specific institutions and entities regulated. However, while recent events have demonstrated the grave risks of assuming excessive debt, it does not follow that debt and financial services should *per se* be limited to certain types of consumers. Rather, governments must carefully regulate against predation by comparing quantities and terms with ability to pay based on future earnings. Regulation, although necessary to prevent predation, must not deny the working poor access to the same kinds of financial services that have been essential to the economic security and well-being of those on higher economic rungs.

This Section outlines the following six most crucial regulatory challenges and their impact on private investment: legal status, state subsidies, source of funds, restrictions on provision of financial services, prudential requirements, and interest rate controls.

1. *Regulatory challenges*

a. Legal status. A legal and regulatory environment granting legal status to MFIs—including organizational registration and authority to conduct operations—is essential to any MFI. Legal status provides certainty for MFI entrepreneurs and confidence for their investors, while also introducing oversight and supervision that minimizes risk.¹⁴³ Additionally, an MFI must comply with the standards of relevant supervisory institutions. While certain types of supervisory standards are essential to MFI stability, others, if excessively restrictive, can also be detrimental.

b. State subsidies. The microfinance sector has traditionally been funded by public sources, including state subsidies. In the long-term, however, a persistence of public funds can provide disincentives for the innovation and improvements in operations that lead to growth, sustainability, and profitability.

c. Source of funds. High transaction costs are inherent to microfinance given the small loan sizes, the amount of work done in rural areas, and the more “hands-on” approach with clients. MFIs must have access to a diverse source of funds to sustain and grow their operations. Because microfinance is not yet a particularly attractive investment to domestic investors, international debt and equity investment provides a much-needed avenue for vital capital infusions.

Many countries, however, restrict the amount of debt and equity investment that MFIs may receive from international sources. These regulations aim to ensure that shareholders have the financial capacity and strategic commitment necessary to supply additional funds, building checks and balances into governance, and preventing bank “capture” by individual or group owners.¹⁴⁴ One suggested solution for balancing between protection for MFIs and creating access to funding is to permit regulatory agencies to consider the particular characteristics of individual MFIs and their proposed investors and to approve external investment on a case-by-case basis.¹⁴⁵ In general, any initiative to regulate sources of funding for

143. See Kate Druschel, *U.S. Agency Int'l Dev., The Ultimate Balancing Act: Investor Confidence and Regulatory Considerations for Microfinance*, 28 MICROREPORT 13 (2005).

144. Christen et al., *supra* note 142, at 23.

145. *Id.*

MFIs must keep in mind the importance of these funds for the viability of individual MFIs and of the sector as a whole.

d. Restrictions on the provision of financial services. Restrictions on the types of financial services and products an MFI is allowed to offer can profoundly affect the business model and profitability of MFIs. Most successful MFIs have expanded their services from solely providing microcredit to offering traditional financial products like savings and insurance. Moreover, MFI loans have evolved from the original working capital loans for microenterprise to larger sums for housing and even education. Apart from widening clients' access to this diverse range of financial services, these services can be essential to the business model and to the growth and development of the MFIs.

Perhaps the most important and challenging aspect of this issue is the ability of MFIs to take deposits from or provide savings vehicles for their clients. When done successfully, deposit-taking provides poor micro-entrepreneurs with an essential service thought to be at least as important and beneficial as lending. According to CGAP and the World Bank, international best practices recommend that not all MFIs be permitted to take deposits, but rather that the ability to take deposits be allowed only for those that can demonstrate the capacity to do so.¹⁴⁶ This means that an MFI must meet requirements that indicate an ability to manage its lending profitably enough to cover costs, including the additional overhead and administrative costs of taking deposits. In addition, regulators must ensure that an MFI's account and loan tracking systems are reliable.

e. Prudential requirements. Prudential requirements such as capital adequacy requirements serve the dual purposes of protecting the financial system as a whole and protecting the safety of the savings that individual customers deposit with the financial institution. Practitioners believe that while the first goal is crucial for large commercial banks in the traditional banking sector, it is not as relevant for the microfinance industry, which deals with smaller sums of money both individually and on aggregate levels.¹⁴⁷ Even where microfinance reaches hundreds of thousands of clients, the sector seldom accounts for a large enough portion of financial assets for it

146. *Id.* at 13.

147. *Id.* at 3.

to pose any serious risk to a country's overall banking and payments system. While it is certainly possible that the failure of a large MFI could be contagious for other institutions, it is assumed that the main rationale of prudential regulation for MFIs is to protect client savings.¹⁴⁸

Given the importance of capital adequacy requirements for deposit-taking MFIs, a further issue is the extent of these requirements. CGAP and the World Bank's study of international best practices recommends that capital adequacy requirements for deposit-taking MFIs be stricter than those applied to traditional commercial banks.¹⁴⁹ This is because MFIs exhibit greater portfolio volatility and can be harder to manage in comparison to large commercial banks. MFIs are more volatile because loans are often unsecured or undersecured.¹⁵⁰ In addition, comparatively higher interest rates among MFIs means that a given level of loan delinquency will deplete capital more quickly than for a commercial bank. Loan delinquency of MFI borrowers can also diminish client perception of the MFI's ability to make further loans, introducing increased potential for outbreaks of delinquency.

MFIs can also be more difficult to manage than commercial banks. Management and staff tend to be relatively inexperienced because microfinance is a relatively new industry and most MFIs are young organizations.¹⁵¹ Ultimately, best practices favor higher capital adequacy requirements for MFIs in comparison to commercial banks, at least until performance demonstrates that MFIs can adequately manage the risks and challenges of the industry.

Minimum capital requirements for MFIs present another issue. These requirements are decreasingly seen as a safety measure and are principally thought of as a way to limit the number of financial institutions that enter the market and are supervised by regulatory authorities.¹⁵² These requirements effectively prevent agencies with limited resources from becoming overwhelmed by the number of new institutions. However, regulators should not set minimum capital requirements so high as to deter a large number of the socially motivated investors who are willing and able to finance MFIs.

148. *Id.* at 4.

149. *Id.* at 20.

150. *See id.* at 19.

151. *See id.*

152. *Id.* at 16.

While a high level of regulation in the area of capital adequacy reduces the return on equity and confers a competitive advantage upon commercial banks, MFIs can recover much of the loss of potential profits by charging higher interest rates. The demand in the microfinance sector creates a market less sensitive to interest rates compared to the traditional banking sector.

f. Interest rate controls. The interest rate charged by microfinance institutions is a complicated issue because of the conflict between nonprofit and for-profit aspects of microfinance. While higher interest rates raise the cost of capital for clients, the interest capital is crucial for MFIs to cover expenses, achieve sustainability, and increase client base.¹⁵³

Despite these concerns, microfinance interest rates are an easy target for politicians eager to be champions for the poor. Political whims may impact interest rates and the ability of MFIs to pursue flexible sustainability strategies. Neither state legislatures nor the general public tend to understand the dynamic of interest rates in the microfinance industry; some have even expressed disapproval of MFI interest rates in instances where rates reflect neither inefficiency nor excessive profits. Government-imposed rate caps on MFI interest rates pose an obstacle to MFI viability. Practitioners generally agree that interest rate caps almost always hurt the poor far more than they help, as lower rates limit the number of borrowers MFIs can serve, thereby limiting access to microfinance services.¹⁵⁴

Some legislatures have introduced interest rate controls in response to abusive lending and loan collection practices from certain MFIs.¹⁵⁵ A relevant concern is the over-indebtedness of microfinance clients resulting from lenders who issue loans without sufficiently investigating the capacity of borrowers to repay. This can lead to or exacerbate abusive collection practices. While microfinance clients must be protected from abusive practices, interest rate controls seem a counterproductive means of achieving such protection.

153. See Druschel, *supra* note 143, at 24.

154. Christen et al., *supra* note 142, at 11.

155. See, e.g., Brigit Helms & Xavier Reille, *Interest Rate Ceilings and Microfinance: The Story So Far*, Occasional Paper, No. 9, CGAP, Sept. 2004.

2. *Striking the proper balance*

In an attempt to balance risk with business opportunity, regulations that err excessively on the side of overregulation or simply apply generic commercial banking regulations to MFIs, place unnecessary limitations on microfinance outreach. An inquiry into regulatory reform must consider not only the presence of over- or under-regulation but also the quality of specific regulatory policies. In many instances, regulatory reform can best be achieved by adapting existing laws to the microfinance industry rather than by deregulation. A regulatory approach focusing on quality, protection, and growth would foster a robust microfinance sector, thereby maximizing access to safe, formal, and sustainable financial services.

Poor micro-entrepreneurs demand access to capital and other financial services. They pay local moneylenders dramatically higher interest rates than those typically charged by unregulated MFIs. Additionally, they pursue informal savings methods such as hiding currency under their mattresses, investing in livestock and building materials, or participating in local savings and credit clubs—activities far more risky than pursuing formal savings even in an unregulated financial institution.¹⁵⁶

Restricting access to microfinance services thus indirectly increases the risks to borrowers and depositors by limiting their options to existing, often riskier sources. This dynamic underscores the need to strike a balance and ensure that regulations intended to achieve safety and risk minimization do not unnecessarily restrict access to the safest financial services available.

B. Microfinance Industry and Regulation in Brazil, China, and India

With these considerations in mind, the following subsections discuss the regulatory environments for microfinance in Brazil, China, and India—highly populated countries with relatively low microfinance penetration rates among their working poor. Significant demand for microfinance services exists within each country. Demand for microfinance services, as a percentage of national population, is estimated at 8% in Brazil, 30% in China, and 25% in India.¹⁵⁷ This demand remains grossly unmet.¹⁵⁸ The chart

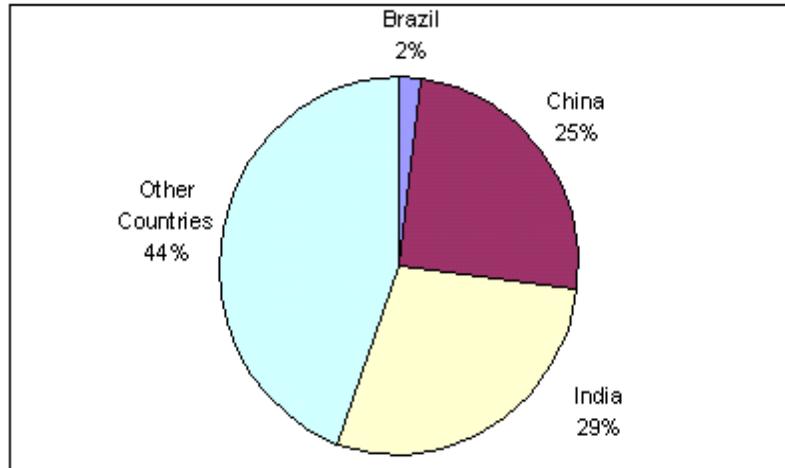
156. *Id.* at 19.

157. Ehrbeck, *supra* note 7, at 2.

158. The rate of unmet demand is estimated at 93% in Brazil, 77% in China, and 70% in India.

below, depicting the geographical breakdown of unmet worldwide demand, illustrates the importance of these three countries to the analysis of the unmet demand among potential microfinance clients.

THE UNTAPPED DEMAND FOR FINANCIAL SERVICES¹⁵⁹



The large gap between supply and demand in these three countries suggests a tremendous potential for growth of the microfinance industry. For each country, this Section analyzes the regulatory environment within which the microfinance industry operates and discusses the extent to which different aspects of microfinance regulation may challenge the industry in achieving growth and sustainability.

1. Brazil's experience in microfinance

Statistical information about Brazil's population and economy reveal a fertile ground for microfinance. Brazil is the world's fifth most populous country,¹⁶⁰ with the largest economy in Latin America and the ninth largest in the world.¹⁶¹ However, income inequality in Brazil is among the most severe, with 10% of the

159. Ehrbeck, *supra* note 7, at 2.

160. CIA WORLD FACTBOOK, RANK ORDER – POPULATION (2008), <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2119rank.html> [hereinafter RANK ORDER – POPULATION].

161. CIA WORLD FACTBOOK, RANK ORDER (2008), <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html> [hereinafter RANK ORDER].

population receiving roughly half of the total income.¹⁶² Thirty-one percent of the population lives below the poverty line¹⁶³ giving Brazil the largest poor population in Latin America,¹⁶⁴ and thus making it fertile ground for microfinance. This case study examines the relationship between an underdeveloped Brazilian microfinance sector, and some of the regulatory issues that complicate further development.

a. The Brazilian microfinance industry. Since its inception, the Brazilian microfinance industry has struggled to reach its potential, currently serving roughly 3% of the estimated 15 million individuals in need of microfinance. After introducing Latin America's first microfinance program in 1972,¹⁶⁵ Brazil's microfinance industry changed substantially in the late 1990s when a political movement placed microcredit at the center of civil society development.¹⁶⁶ While still leaving the demand vastly unmet, the regulatory reforms stemming from this movement made inroads in facilitating industry growth and access to private capital.¹⁶⁷ However, recent efforts have not significantly increased outreach: the microfinance industry currently only serves 3% of the estimated 15 million micro-entrepreneurs.¹⁶⁸

(1) Types of institutions offering microfinance services. Both public and private institutions serve the demand for microfinance in Brazil. Legislation passed in 1999 created two distinct categories of private MFIs: SCMs (Sociedades de Crédito ao Microempreendedor), or Micro-entrepreneur Credit Companies, and OSCIPs (Organizações da Sociedade Civil de Interesse Público), or Public Interest Non-Profit Organizations. SCMs are for-profit financial entities regulated by the Central Bank of Brazil, while OSCIPs are unregulated nonprofit organizations. Currently,

162. SIMEON NICTER ET AL., UNDERSTANDING MICROFINANCE IN THE BRAZILIAN CONTEXT 9 (Programa de Desenvolvimento Institucional (PDI) / Banco Nacional de Desenvolvimento Econômico e Social (BNDES) 2002).

163. CIA WORLD FACTBOOK, BRAZIL (2008), <https://www.cia.gov/library/publications/the-worldfactbook/geos/br.html>.

164. NICTER ET AL., *supra* note 162.

165. PATRICK MEAGHER ET AL., IRIS CTR., UNIV. OF MARYLAND, MICROFINANCE AND REGULATION IN SEVEN COUNTRIES: A COMPARATIVE STUDY 15 (2006).

166. *Id.* at 16.

167. *Id.* at 40.

168. *Id.* at 15.

approximately 180 SCMs and OSCIPs serve 350,000 clients.¹⁶⁹ Municipal banks have also provided nonprofit microfinance services since 2001. Likewise, commercial banks have become increasingly involved in microfinance since the early 2000s, as they must designate 2% of their deposits to microcredit, either through SCMs and OSCIPs or through direct loans to micro-entrepreneurs.¹⁷⁰ The largest provider of microfinance is the state-owned development Banco do Nordeste, which created the MFI Crediamigo in 1997.¹⁷¹ Crediamigo is responsible for 150,000 of the 500,000 total clients served by the Brazilian microfinance industry.¹⁷²

(2) Growth of the microfinance industry. Despite the change in the regulatory landscape, growth among MFIs has been slow over the last several years. In terms of client outreach, leading MFIs grew at a rate of 14% per year from 2000 to 2005,¹⁷³ while the total worldwide microfinance industry has grown 25–30% per year.¹⁷⁴ Additionally, in contrast to trends in other countries, none of the Brazilian nonprofit OSCIPs has recently transformed into regulated for-profit SCMs.¹⁷⁵ Such transformation is a key component in the maturation of a country's microfinance industry.

Commercial banks are responsible for much of the growth of microfinance services in the traditional consumer finance sector, resulting largely from two legislative initiatives in the late 1990s and early 2000s. The first initiative allowed banks to establish banking correspondents that offered microcredit and savings in underserved locations.¹⁷⁶ Fifty-seven private banks participated in this initiative, leading to the opening of 3 million savings accounts, while the number of municipalities without access to banking services dropped from 1,444 to 0.¹⁷⁷ The second initiative created simplified deposit accounts, making it easier to conduct business with low-income clients. The first two years of this program saw the opening of 6 million of these special accounts with over \$100 million in loans

169. *Id.* at 17.

170. *Id.* at 42.

171. *Id.* at 16.

172. *Id.*

173. *Id.* at 18.

174. Stephens, *supra* note 100, at 32.

175. MEAGHER ET AL., *supra* note 165, at 119.

176. *Id.* at 98.

177. *Id.* at 97.

granted.¹⁷⁸

Despite these promising results, the efficacy of these bank programs in reaching the working poor is questionable, as most of the loans are estimated to have been lent to salaried employees, retirees, and others in the formal sector.¹⁷⁹ Banks are apt to give loans to salaried employees whose employers typically pay them through the banks. Therefore, the banks are able to deduct loan repayments directly from the employee's salary. These elements of certainty and extremely low transaction costs provide extra incentives for commercial banks to target salaried employees. The reluctance of commercial banks to put forth substantial effort to serve micro-entrepreneurs is especially problematic for the microfinance industry because commercial banks are the only financial institutions in a position to provide comprehensive and sustainable microfinance services.

b. Microfinance regulation in Brazil. While the regulatory reforms of the late 1990s and early 2000s made it easier for MFIs to operate and grow their operations, the current regulatory regime is still overly restrictive and burdensome on the microfinance sector. For example, a 2002 report from the Brazilian National Bank for Social and Economic Development (BNDES) asserts that the legal environment presents a formidable obstacle to MFIs,¹⁸⁰ and that individual regulations are substantial and "notorious for changing with dizzying frequency."¹⁸¹ The discussion below focuses on some of the most important regulatory issues affecting the microfinance industry.

(1) Legal status. The 1999 legislation that created SCMs and OSCIPs allowed MFIs to formally operate and conduct activities with greater certainty and security. This improvement increased MFI investor confidence because Brazilian MFIs were required to complete a registration process to be established and to operate within the protection of the legal system.¹⁸²

The Central Bank of Brazil regulates SCMs and imposes

178. *Id.*

179. *Id.*

180. NICTER ET AL., *supra* note 162, at 38.

181. *Id.* at 36.

182. MEAGHER ET AL., *supra* note 165, at 41, 161.

reporting requirements on a regular basis.¹⁸³ SCMs are also subject to prudential requirements that the Central Bank can modify.¹⁸⁴ OSCIPs, however, are not subject to prudential regulation,¹⁸⁵ but must meet reporting requirements under the supervision of the Ministry of Justice.¹⁸⁶ This supervision further strengthens investor confidence in the MFI industry. However, there is concern that reporting requirements for SCMs may be excessive, at least in part, because document requirements for microloans exceed the requirements of other types of institutions such as OSCIPs and commercial banks.¹⁸⁷ Additionally, the cost of regulation compliance is one of the four major regulatory challenges faced by MFIs that contribute to the slow growth of the sector.¹⁸⁸

(2) State subsidies. The Brazilian government has been heavily involved in the microfinance industry over the last decade. Apart from operating the largest and most successful MFI in Crediamigo, the government also provides much of the financial support for private SCMs and OSCIPs via BNDES.¹⁸⁹

One downside of offering government financial support is that the constant stream of funds available from BNDES diminishes the incentive among MFIs to seek alternative sources of funding from commercial banks or private investors. Problems with BNDES funding have also reduced the ability of MFIs to operate efficiently. In addition to exhibiting slow approval cycles, BNDES is often late in disbursing committed funds,¹⁹⁰ thereby causing liquidity problems and delays in MFI loan disbursement. Where expected funds are late or do not arrive at all, repayment problems arise as clients realize that MFIs are not a reliable source of funds.¹⁹¹

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.* at 119.

188. Tor Jansson, Inter-American Development Bank, Presentation on Microfinance Regulation at the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) Microfinance Seminar (May 2, 2000), in BNDES SEMINÁRIO MICROFINANÇAS: ENSAIOS E EXPERIÊNCIAS (2000).

189. See MEAGHER ET AL., *supra* note 165, at 16–17, 140.

190. *Id.* at 140.

191. *Id.* at 120. These inefficiencies are characteristic of the criticisms often made toward large state-subsidized credit initiatives and also undermine incentives to seek funding from the private sector.

(3) Source of funds. The Brazilian microfinance industry is over-reliant on public funding, though MFIs can also receive funds from commercial banks, donors, and private investors.¹⁹² SCMs may also access lines of credit from foreign or domestic financial institutions, while OSCIPs may not.¹⁹³ Additionally, MFIs are not allowed to issue securities or to participate in the interbank deposit market, and OSCIPs are prohibited from accessing financial institution funds.¹⁹⁴

To reduce inflation, foreign investment in MFIs must be registered in advance with the Central Bank of Brazil and is subject to various and oft-changing restrictions, such as currency and interest rate restrictions.¹⁹⁵ As a prudential regulatory measure, SCMs are also limited to a maximum debt to liquid assets ratio of five times, which reduces the size of possible investment, especially given the relatively small size of MFIs in Brazil.¹⁹⁶

Brazilian regulators are interested in developing private sector investment in MFIs. To this end, certain loans from BNDES require that SCMs match funds from private investors equaling one-third of the loan amount¹⁹⁷ and have linked MIVs with Brazilian MFIs.¹⁹⁸ However, there is generally a low level of foreign investment in Brazilian MFIs. One BNDES report attributes this low level to limited opportunities within the microfinance sector (i.e., a lack of investible MFIs, a lack of familiarity with microfinance among investors, and a lack of a secondary market for shares).¹⁹⁹ This report also notes the high cost of compliance associated with registering transactions with the Central Bank. An additional study issued by BNDES identifies that the prolonged registration process and currency restrictions may further discourage foreign investment in Brazilian MFIs.²⁰⁰

While the lack of strong and investible MFIs appears to be the

192. *Id.* at 121.

193. *Id.* at 161.

194. MEAGHER ET AL., *supra* note 165, at 41.

195. PAUL HAUS MARTINS ET AL., REGULAMENTAÇÃO DAS MICROFINANÇAS 46, 86, 109 (PDI/BNDES 2002); NICTER ET AL., *supra* note 162, at 36.

196. MARTINS ET AL., *supra* note 195, at 109

197. Lucy Conger, *Return of the State*, MICROENTERPRISE AMERICAS, 2002, at 36, 40.

198. *Id.* BNDES linked the Panama MIV ProFund and Paraguay MIV Financiera Visión with an MFI in São Paulo. *Id.*

199. BRUETT TILLMAN ET AL., TÉCNICAS DE GESTÃO MICROFINANCEIRA 156 (PDI/BNDES 2002).

200. NICTER ET AL., *supra* note 162, at 36.

principal factor limiting foreign investment interest in the Brazilian microfinance sector, restrictions on sources of funding clearly contribute to the inability of MFIs to grow. Although MFIs are seldom starved for funds, due to steady contributions from BNDES, a reliance on conditional public sector funds diminishes incentive to innovate and become institutions attractive to commercial investment.

(4) Restrictions on the provision of financial services. Restriction on the financial services and products an MFI may offer decreases the profitability of MFIs. For example, the only financial products SCMs may offer are microloans and guarantees.²⁰¹ Thus, in addition to being unable to take deposits, SCMs are prohibited from offering many common services in Brazil, such as consumer loans, mortgage loans, pawn services, insurance services, and *trocas de cheques*.²⁰² OSCIPs, on the other hand, may offer not only microloans and consumer loans, but *trocas de cheques* as well. However, OSCIPs are prohibited from offering savings, housing loans, insurance services, pawn services, and credit card services.²⁰³

These restrictions severely limit MFIs' ability to integrate a variety of useful services into their business model. Apart from competitively disadvantaging MFIs, as compared to commercial banks, these regulations decrease the attractiveness of MFIs as a viable option for micro-entrepreneurs.

(5) Prudential requirements. Regulations on capital requirements must balance the competing interests of ensuring a bank's safety and using its capital to yield profits and attract private investors. Brazil's policy of requiring relatively high capital adequacy for MFIs, while simultaneously prohibiting them from taking deposits, appears to err on the side of safety, potentially inhibiting MFI growth. The Brazilian Central Bank places prudential regulations only on SCMs, while OSCIPs have no prudential requirements.²⁰⁴ The minimum capital required for SCMs is legislated at 100,000 reais (about \$60,000), with authority granted to the bank to adjust the rate.²⁰⁵

201. MEAGHER ET AL., *supra* note 165, at 41, 161.

202. *Trocas de cheques* are services offering immediate cashing of post-dated checks.

203. NICTER ET AL., *supra* note 162, at 37; MEAGHER ET AL., *supra* note 165, at 163.

204. MEAGHER ET AL., *supra* note 165, at 41, 161.

205. *Id.* at 41.

Brazil is unique in Latin America as it prohibits deposit-taking but places capital adequacy requirements on MFIs. In addition, the capital adequacy requirements in Brazil are among the most stringent in the region. This practice contradicts the international best practices advocated by CGAP and the World Bank, which maintain that capital adequacy requirements are not necessary for MFIs that do not take deposits.²⁰⁶ Brazilian requirements thus place substantial limitations on the ability of SCMs to invest their capital in profitable activities, severely constraining their ability to pursue sustainability and growth.²⁰⁷

Lastly, while OSCIPs lack prudential requirements, SCMs are limited in loan size to 10,000 reais (about \$6,000) per client.²⁰⁸ One study criticizes this limitation, asserting that MFIs across Latin America have realized major efficiency gains through investing a portion of their portfolio in relatively wealthy clients and using the proceeds and transaction costs savings (from making fewer, larger loans) to cross-subsidize a larger amount of loans to especially poor clients.²⁰⁹ Conversely, a cap on loan size can cause MFIs to keep costs down by focusing on the relatively wealthy and avoiding the poorest potential clients.

(6) Interest rate controls. Interest rate controls on public funding inhibit the growth of MFIs. While SCMs and OSCIPs are exempt from Brazilian usury law, interest rate controls are placed on the MFIs as a condition of taking funds from BNDES, which is the MFIs' primary source of funding.²¹⁰ Interest rates on these funds are capped at 4% monthly for loans above 1,000 reais (about \$600) and below 10,000 reais (about \$6,000), while loans below 1,000 reais are limited to a 2% monthly interest rate.²¹¹ In contrast, it is estimated that monthly interest rates between 4 and 8% would be

206. Christen et al., *supra* note 142, at 4–7 (“Where the legal power to lend is either ambiguous or is prohibited to institutions that are not prudentially licensed, a strong justification exists for introducing non-prudential regulation that explicitly authorizes non-depository MFIs to lend.”).

207. Jansson, *supra* note 188, at Part IV.

208. MEAGHER ET AL., *supra* note 165, at 41.

209. *Id.* at 120.

210. *Id.* at 140.

211. *Id.* at 42.

necessary to simply break even.²¹² These restrictions make it difficult for MFIs to reach profitability.²¹³

(7) Credit collection. Credit collection practices in Brazil also inhibit the growth of MFIs. SCMs and OSCIPs are subject to regulations under the Brazilian consumer protection code, in which soliciting payment before the loan is five days past is deemed harassment.²¹⁴ This regulation is ill-suited to microfinance, as providers prefer to have a closer working relationship with borrowers than do traditional bankers. Additionally, this regulation may also lower willingness to loan or lead to higher scrutiny of potential borrowers.²¹⁵

(8) Taxes. SCMs are subject to income tax and a levy on financial transactions, while OSCIPs are not.²¹⁶ This preferential tax treatment may explain why OSCIPs in Brazil do not transform into SCMs.²¹⁷

(9) Assessment of regulation. The regulatory limitations on MFIs have contributed to the slow growth of the microfinance sector and the lack of large, profitable, and investible MFIs. In contrast, commercial banks are more loosely regulated and therefore can provide more expansive financial services. Micro-entrepreneurs desire the services that commercial banks provide, but regulations prohibit MFIs from offering such expansive services. Thus, borrowers are restricted from access to services and MFIs are limited in their ability to grow through comprehensive and dynamic business models.

One study by BNDES lists the following four reasons for the underdevelopment of the Brazilian microfinance industry: (1) macroeconomic conditions, such as inflation; (2) an excess of government subsidized loans of credit; (3) competition from a highly developed market for consumer credit, operated by commercial

212. *Id.* at 119.

213. *Id.* at 119, 140.

214. NICTER ET AL., *supra* note 162, at 8.

215. *See, e.g.*, Interview by Manuel Bueno with Mark Pickens, Microfinance Analyst, CGAP. (Apr. 7, 2008), *available at* <http://www.nextbillion.net/blogs/2008/04/07/interview-with-cgaps-mark-pickens-branchless-banking-sector-exploding-part-2>.

216. MEAGHER ET AL., *supra* note 165, at 41.

217. *Id.*

banks and oriented towards low-income clients; and (4) an unfriendly legal and regulatory regime.²¹⁸ This study identifies the principle legal obstacles as inability to take deposits, restrictions on financial services and products, and consumer protection laws (e.g., interest rate controls and credit collection rules).²¹⁹ Another BNDES report similarly lists the four principal regulatory challenges to MFIs as prudential requirements, restrictions on financial services and products offered, interest rate controls, and total cost of regulation.²²⁰ Both studies cite the inability to offer commercial loans, consumer credit, and housing loans as the principal limitations on products offered by MFIs.

Brazil's microfinance industry faces many challenges in continuing growth. The regulatory environment, although not the only obstacle, presents a significant challenge as regulators have yet to achieve an ideal quantity and quality of regulation to maximize safety and growth. Additionally, private, for-profit MFIs face more government regulations than private, non-profit MFIs, which places for-profit MFIs at a competitive disadvantage, inhibits their growth, and inhibits the development of the microfinance industry generally in Brazil.

2. China's experience in microfinance

With 1.3 billion inhabitants, China is the most populous country in the world.²²¹ Its GDP of \$7.04 trillion makes it the second largest economy in the world.²²² Nevertheless, 10% of China's population lives on less than \$1 per day,²²³ and much of its poor live in rural areas.²²⁴ Roughly 75% of the population in these areas has no access to financial services.²²⁵ These figures suggest a large demand for microfinance in China.

218. NICHTER ET AL., *supra* note 162, at 6.

219. *Id.* at 8.

220. Jansson, *supra* note 188, at Part IV.

221. RANK ORDER – POPULATION, *supra* note 160.

222. RANK ORDER, *supra* note 161.

223. CIA – THE WORLD FACTBOOK – CHINA, <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html>; Du Xiaoshan, *The Regulatory Environment for Microfinance in China* (CGAP, Essays on Regulation and Supervision No. 11, 2005), available at http://www.microfinancegateway.org/files/25978_file_China.pdf.

224. Enjiang Cheng, *The Demand for Micro-credit As a Determinant for Microfinance Outreach—Evidence from China*, UN Food and Agric. Org., Mar. 2007.

225. Hans Byström, *Structured Microfinance in China*, Dep't of Econ., Lund Univ., at 3.

a. *The Chinese microfinance industry.* One study estimates the Chinese demand for microfinance services at 350 million people.²²⁶ Only 23% of this demand (or 80.5 million people) has been met.²²⁷ State banks, state-owned postal banks, and rural credit cooperatives (RCCs) currently provide 95% of all microfinance services in China, with MFIs providing the rest.²²⁸ However, regulators are attempting to increase the role of MFIs, especially because MFIs have been the institutions most successful in achieving efficient and sustainable operations while also targeting poor farmers and micro-entrepreneurs.²²⁹

MFIs' lack of legal status prohibits them from operating on a larger scale. They instead operate as informal institutions pursuant to special, often temporary, government licenses.²³⁰ Informality limits the number of established MFIs and creates difficulty for operating. Without a thriving MFI sector, formal financial institutions are the primary providers of microfinance services. However, these formal institutions have not demonstrated a willingness or an ability to target micro-entrepreneurs, nor have they shown sustainability. In light of this dilemma, the government has recently pursued initiatives designed to revitalize the microfinance sector, the current composition of which is described in further detail below.²³¹

(1) Formal financial institutions. During the decades following the economic reforms of the late 1970s, the state-operated Agricultural Bank of China (ABC) was the main provider of financial services to the rural economy.²³² Until 1996, ABC also operated the rural credit cooperatives,²³³ which have branches in almost every township in rural China.²³⁴ Since RCCs were privatized, however,

226. Ehrbeck, *supra* note 7, at 2.

227. *Id.*

228. DiLeo & FitzHerbert, *supra* note 19, at 13.

229. See Nick Young, *Capitalist Fillip for China's New Socialist Countryside*, 7 CHINA DEV. BRIEF, Feb.–Mar. 2007, at 9.

230. See, e.g., Du, *supra* note 223, at 6; Shen Minggao & Cheng Enjiang, *Restructuring China's Rural Financial System: Existing Approaches, Challenges and The Future of Microfinance*, GERMAN AGENCY FOR TECHNICAL COOPERATION, Dec. 2004, at 24–26, 31.

231. See, e.g., Young, *supra* note 229; Thorsten Giehler et al., *Microcredit Companies and Village Banks – Competition or Pluralism*, GERMAN AGENCY FOR TECHNICAL COOPERATION / INT'L FUND FOR AGRIC. DEV., 2007.

232. Shen & Cheng, *supra* note 230, at 8.

233. *Id.* at 9.

234. Kathleen Druschel, *Microfinance in China: Building Sustainable Institutions and a Strong Industry* (Fall 2002) (unpublished M.A. Thesis, Am. Univ.) at 36 [hereinafter Building

ABC has steadily withdrawn from rural lending operations, devoting an increasing proportion of loans to larger investments in urban areas.²³⁵ Only 10% of ABC's lending currently originates from agricultural loans; much of these funds are allocated to larger farming units such as seed companies and marketing cooperatives.²³⁶ Additionally, a large portion of ABC's loans are allocated to wealthy, rural households with connections to important local officials.²³⁷

Given the decline of ABC's rural lending, RCCs are now the dominant provider of credit and microfinance services in rural China.²³⁸ After privatization in 1996, the People's Bank of China (PBC) required RCCs to implement microfinance operations and provide loans to poor farmers and micro-entrepreneurs.²³⁹ While RCCs are private financial institutions, they are heavily subsidized by the PBC.²⁴⁰ There are approximately 35,000 RCCs operating in China, collectively providing 86% of China's agricultural loans²⁴¹ and reaching over 130 million clients.²⁴² Although RCCs exhibit the largest outreach among rural loan providers, much of their activity does not reach poor farmers and micro-entrepreneurs. Middle-income men are the most common clients,²⁴³ with parent institutions or real estate investment projects receiving a large proportion of lending.²⁴⁴

In addition to their limited willingness and ability to assist poor farmers and micro-entrepreneurs, RCCs have been unable to demonstrate sustainability. In 2007, one third of RCCs were seriously indebted and another third neared insolvency, while those reporting profits were not lending to small borrowers.²⁴⁵ Thus, RCCs do not offer a solution to the problem of delivering financial services to poor farmers and micro-entrepreneurs.

Sustainable Institutions].

235. Shen & Cheng, *supra* note 230, at 15.

236. Building Sustainable Institutions, *supra* note 234, at 36.

237. *Banking on Reform*, China Dev. Brief, 2004, <http://www.chinadevelopmentbrief.com/node/123>.

238. Shen & Cheng, *supra* note 230, at 15.

239. Du, *supra* note 223, at 4.

240. Young, *supra* note 229, at 5.

241. Du, *supra* note 223, at 4.

242. International Year of Microcredit 2005, *Country: China*, 2005, at 3, <http://www.yearofmicrocredit.org/docs/countryprofiles/China.doc>.

243. Building Sustainable Institutions, *supra* note 234, at 43.

244. Young, *supra* note 229, at 6.

245. *Id.*

Another problem has emerged as deposit-taking from ABC and RCCs have increased, while the ratio of total rural institutional loans to deposits has declined over the last decade.²⁴⁶ Rural institutional lending as a proportion of total rural deposits has fallen rapidly since 1996, when ABC began withdrawing from rural activities.²⁴⁷ This disproportion not only highlights a large demand for rural credit (apparent from the increase in rural savings), but also demonstrates the method of taking deposit funds from the rural economy and channeling from the poor rural areas to the more developed urban areas. Thus, where capital is most needed, it is most scarce. This trend deprives rural areas of opportunities to invest their own money back into the growth of their economies.

(2) Microfinance institutions. MFIs are the most successful providers of rural credit in China because they are sustainable and target poor clients.²⁴⁸ As mentioned above, MFIs have no legal standing to conduct business and require special licenses from the government. Unlike RCCs and branches of ABC, MFIs are unable to take deposits from their clients. Instead, funds come almost entirely from donors, international NGOs, and IFIs.²⁴⁹ A group of researchers from the Rural Development Institute of the Chinese Academy of Social Sciences established the first MFI in 1993.²⁵⁰ By 2004, there were approximately 200 county-level MFIs in various regions of China, predominantly located in very poor and remote Western areas.²⁵¹ Given the difficulty of acquiring a license from the government and the challenges faced once an MFI has been licensed and established, MFIs have thus far been able to provide a level of outreach that is largely insignificant when compared to the overall demand for microfinance services. Indeed, one study estimates that MFIs in China currently meet only 1% of this demand.²⁵²

(3) New institutions. Responding to the failures of previous initiatives to deliver financial services to a significant number of the rural poor, the Chinese government recently created two new kinds

246. Shen & Cheng, *supra* note 230, at 15.

247. *Id.*

248. *Banking on Reform*, *supra* note 237.

249. Shen & Cheng, *supra* note 230, at 28.

250. CHINA FOUND. FOR POVERTY ALLEVIATION, WHY MICROFINANCE?, <http://mf.cfpa.org.cn/en/detail.cfm?classid=57>.

251. Shen & Cheng, *supra* note 230, at 23.

252. DiLeo & FitzHerbert, *supra* note 19, at 13.

of financial institutions. The two new entities, Credit Only Companies (COCs) and Village Banks, are for-profit companies, funded entirely from the private sector.²⁵³ The hope is that these initiatives will reverse the monopoly of RCCs over rural financial services and lead to a competitive market that will attract private investment and foster efficiency and effective outreach.

The PBC Credit created COCs in November 2005.²⁵⁴ These institutions provide only credit (i.e., no deposit-taking) to micro-entrepreneurs and farmers in poor areas and are established when granted a license by the regional government.²⁵⁵ They first appeared in a pilot program, implemented in five provinces, with seven institutions established by 2007.²⁵⁶ One such institution, Microcred Nanchong, opened in Sichuan Province in 2006.²⁵⁷ Investors include microfinance-focused international investment company MicroCred SA of France, the IFC under the World Bank, German development bank KfW Bankengruppe, and the private insurance company American International Group (AIG).²⁵⁸ The institution plans to provide credit loans, secured loans, and mortgage loans and hopes to receive a special license to take deposits.²⁵⁹

Similarly, the China Banking Regulatory Commission (CBRC) created Village Banks in December 2006.²⁶⁰ Village Banks, however, are formal, private, deposit-taking financial institutions with limited geographic scope to operate in designated rural areas.²⁶¹ Unlike COCs, Village Banks receive full banking licenses.²⁶² As with COCs, though, market entry is still constrained as investors and entrepreneurs must first receive approval from the CBRC to establish Village Banks.²⁶³ The pilot program began in six provinces.²⁶⁴ By

253. *See, e.g.*, Young, *supra* note 229; Giehler et al., *supra* note 231, at 2.

254. Young, *supra* note 229, at 7.

255. *See, e.g.*, Shen & Cheng, *supra* note 230, at 24–26, 31.

256. The five provinces are Sha'anxi, Shanxi, Sichuan, Guizhou and Inner Mongolia Autonomous Region. Giehler et al., *supra* note 231, at 3.

257. Yu Min, *First Wholly Foreign-Invested Microfinancing Company Launched in Rural China*, China Ass'n of Microfinance, 2007, <http://www.chinamfi.net/en/Article/ArticleShow.asp?id=1716>.

258. *Id.*

259. *Id.*

260. CBRC is a separate body from the PBC in charge of banking regulation. Giehler et al., *supra* note 231, at 4.

261. *Id.* at 7–11.

262. *Id.*

263. *Id.*

264. The six provinces are Jinli, Inner Mongolia, Sichuan, Hubei, Gansu, and Quinghai.

April 2007, the CBRC had received twenty-one applications to establish village banks and approved fifteen.²⁶⁵ With the current problems of unwillingness to assist micro-entrepreneurs, low sustainability, and channeling of deposits from poor rural areas to more developed urban areas, these new initiatives are promising attempts to meet the demand in China.

b. Microfinance regulation in China. While the recent creation of the COC and Village Bank pilot programs is certainly a step in the right direction, the Chinese microfinance sector still faces a challenging and inhospitable regulatory environment. Legal constraints on microfinance in China create the principal factor for the underdevelopment of the microfinance sector and its inability to access a greater portion of micro-entrepreneurs.²⁶⁶ The discussion below examines the specific legal issues that have constrained the ability of microfinance in China to achieve sustainability and scale.

(1) Legal status. Unlike RCCs, which have clear legal status as banking institutions in the formal financial sector, Chinese MFIs have no legal status. No formal procedures or regulations pertaining to MFIs in China currently exist.²⁶⁷ This is problematic because the presence of an enabling legal and regulatory environment necessarily begins with a clearly defined legal status. This status provides certainty, allowing MFIs to pursue bold business strategies and assure investors that the MFI operates under the protection of the law.

Regulatory restraints force most MFIs in China to register as NGOs.²⁶⁸ However, China's financial laws make it illegal for non-financial institutions to supply any type of financial service.²⁶⁹ Thus, with no official standing, MFIs must negotiate ad hoc with local officials for legal standing to conduct business.²⁷⁰ While this provides MFIs with a modicum of legality, these arrangements can fluctuate

Id.

265. *Id.* at 4.

266. See, e.g., Lynn Chia & Alex Counts, *Microfinance Regulation and the Chinese Context: An Opportunity for Making a Major Impact on Reducing Poverty*, Grameen Found. USA, 2004, at 1; Gehler et al., *supra* note 231, at 7; Building Sustainable Institutions, *supra* note 234, at 89.

267. Du, *supra* note 223, at 4.

268. *Id.* at 6.

269. *Id.* at 4.

270. Chia & Counts, *supra* note 266, at 2.

with changing political conditions, interpretations of relevant memoranda, and state intervention.²⁷¹

According to Du Xiaoshan, founder of the first Chinese MFI, the lack of legal status leads to the slow development and low quality of the microfinance sector.²⁷² Without legal status, the government can shut down or significantly compromise MFI operations. Du highlights three results of this uncertainty: (1) it undermines client confidence in MFIs as a reliable source of credit, which can lead to lower repayment rates; (2) it makes attracting and retaining quality staff more difficult, especially where employment in secure government positions is the alternative; and (3) it makes attracting funds much more difficult because a lack of legal status means a lack of credibility as a safe investment.²⁷³ Thus, securing the legal status of MFIs is of utmost importance to the future success of China's microfinance industry.

To establish a COC, private investors must bid for a license from PBC.²⁷⁴ However, the CBRC does not formally recognize these institutions, leaving their legal status ambiguous and their regulatory framework generally determined on an ad hoc basis and by local government oversight.²⁷⁵ As in the case of MFIs, these uncertainties make it harder to develop any long-term strategy for conducting business or attracting different sources of capital. The result is that MFIs inevitably become more risk-averse to lending and outreach initiatives.

Village Banks fall under the same regulatory schemes as formal financial institutions and possess full banking licenses from the CBRC.²⁷⁶ Thus, unlike COCs, they enjoy the security and stability of full legal status, allowing for long-term strategies and a wider range of capital. Therefore, until China recognizes MFIs and COCs as legal entities, Village Banks will likely continue to occupy this space as the leading providers of microfinance.

(2) State subsidies. China illustrates why experts in microfinance caution against heavy government involvement in the

271. *Id.*; Shen & Cheng, *supra* note 230, at 26.

272. Du, *supra* note 223, at 6.

273. *Id.* at 11.

274. Young, *supra* note 229, at 7.

275. Giehler et al., *supra* note 231, at 9.

276. *Id.* at 10.

provision of microfinance services.²⁷⁷ The heavily subsidized funding allocated to RCCs, with rates as low as 2%, has contributed greatly to the monopolistic position held by RCCs over the provision of rural credit. This, in turn, has forced the PBC to continually inject cash into RCCs to sustain them. This, however, diminishes the incentive of RCC management and staff to seek sustainability and profitability.²⁷⁸ RCC directors and staff often provide subsidized loans to their favorite enterprises and household clients and to the local government.²⁷⁹ Because MFIs, COCs, and Village Banks do not receive public funding, the subsidized funding and bailouts granted to RCCs from the PBC competitively disadvantage MFIs. For example, RCCs' lower interest rates quash competition from MFIs.²⁸⁰ The difficulty of governmental reform clearly distorts the market for rural finance and crowds out private microfinance initiatives.

(3) Source of funds. RCCs are in the best position to access capital because they enjoy access both to deposits taken from clients and to PBC funding. In contrast, MFIs must rely on donor funding, international NGOs, and private investors. In terms of accessing foreign investment, the state government controls short-term external debt balances so that borrowing from abroad requires approval from the regulatory authorities, which then affects the financing terms of the transaction.²⁸¹

RCCs receive funding from deposits, the PBC, and international grants. However, they face intense competition for deposits from ABC and state-owned postal and savings banks, both of which operate large-scale deposit-taking operations in rural areas. Due to this competition, RCCs cannot finance loans with deposits alone, reinforcing their dependence on PBC funding and compromising incentives and abilities to serve significant numbers of working poor.²⁸²

Limited funding options for traditional MFIs make it difficult to

277. Building Sustainable Institutions, *supra* note 234, at 40.

278. Shen & Cheng, *supra* note 230, at 32.

279. *Id.* at 33.

280. *See, e.g., id.* at 31.

281. Dr. Guo Shunqing, Deputy Governor, People's Bank of China, Director-General, State Admin. of Foreign Exch., Speech: Management of Capital Flows in Corporate Sector: Current Situation and Outlook in China (Oct. 11, 2002), <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=9>.

282. Du, *supra* note 223, at 7.

replenish loan capital and achieve financial stability. MFIs neither take deposits from clients nor receive PBC or commercial bank financing. Instead, funding comes primarily from international donors, NGOs, and foreign investors.²⁸³ Furthermore, deviation from the mission of serving the poorest clients occurs because MFIs are incentivized to target middle-income households to remain financially viable. The clients of most MFIs have lower incomes than those of RCCs, but have higher incomes than the clients of informal lenders such as loan sharks, which further demonstrates the extent of unmet demand and its harmful consequences.²⁸⁴

Because COCs receive funding from private investors and donations, and cannot take deposits or public funding,²⁸⁵ most COCs lend out the bulk of their start-up capital and encounter difficulties raising additional loan funds. Additionally, their ambiguous legal status and lack of formal recognition from the CBRC prevents borrowing from commercial banks.²⁸⁶ COCs do, however, have a clear and flexible ownership structure, to which the only significant limitation is a maximum of five shareholders, making these institutions relatively attractive to investors.²⁸⁷

Although Village Banks are private, formal financial institutions licensed and regulated by the CBRC to take deposits and borrow from commercial banks, private foreign and domestic investors find Village Banks less attractive than MFIs because of their ownership rules.²⁸⁸ These rules require that existing commercial financial institutions, holding a 20% minimum of total shares, initiate new banks.²⁸⁹ Alternatively, individual non-bank shareholders are restricted to a maximum holding of 10%.²⁹⁰ This arrangement enables commercial banking institutions with business interests contrary to microfinance objectives to dominate Village Banks. Indeed, this requirement crowds out investors who are most interested in serving poor micro-entrepreneurs and requires the participation of primarily profit-focused investors.

283. *Id.*; Building Sustainable Institutions, *supra* note 234, at 89.

284. Cheng, *supra* note 224, at 12.

285. Young, *supra* note 229, at 7.

286. *Id.*

287. Giehler et al., *supra* note 231, at 10.

288. *Id.*

289. *Id.* at 4.

290. *Id.* at 10.

(4) Restrictions on the provision of financial services. RCCs undoubtedly exhibit the most flexibility in terms of business operations. These institutions may take deposits, offer loans, issue bonds, and provide guarantees, insurance, and domestic payment services.²⁹¹ However, RCCs have not been able to meet a significant portion of the demand for microfinance services among the working poor. This is due to the counterproductive incentive structure produced by the subsidy regime and the reality that RCCs engage in microfinance because of a government mandate rather than their own business model. In contrast, MFIs can generally offer only microloans and cannot take deposits.

COCs are similarly limited. As with MFIs, COCs may only offer loans and cannot take deposits. They are confined by jurisdiction and the jurisdiction's client base according to the granted license.²⁹² This makes it difficult to achieve scale and reduce costs.²⁹³ COCs are also subject to a maximum loan size of 100,000 yuan (nearly \$14,000) and quotas earmarking 75–80% of loans for the agricultural sector.²⁹⁴ These restrictions inhibit portfolios structured to best achieve sustainability. Both limitations obstruct the efforts of COCs to cross-subsidize smaller loans with larger loans.

Village Banks can take deposits from clients, thus widening their options in seeking sustainable sources of funding. However, Village Banks may only operate in one county, capping the potential client base and obstructing cost reduction and pursuit of sustainability and profitability through scale.

(5) Prudential requirements. There are no prudential requirements for traditional MFIs because they lack legal and regulatory recognition. However, COCs and Village Banks enjoy lower minimum capital requirements than previous limits placed on various types of RCCs, which should allow more investors to enter the microfinance market. The minimum capital requirement for COCs is around 100 million yuan, which is much less than that of commercial banks or cooperative financial institutions.²⁹⁵

291. Microfinance Gateway: Regulation Home Page: Comparative Database: China, http://www.microfinancegateway.org/resource_centers/reg_sup/micro_reg/country/9/ (last visited Jan. 30, 2009).

292. *Id.* at 3.

293. *Id.*

294. *Id.* at 10.

295. Young, *supra* note 229, at 7. The minimum capital requirement for commercial banks or cooperative financial institutions is typically 1 billion yuan, and 150–200 million

The minimum capital requirement for Village Banks is set at 3 million yuan for county levels and 1 million yuan for village and township levels.²⁹⁶ In contrast, Village Banks operating credit cooperatives have minimum capital requirements of 300,000 yuan at the township level and 100,000 yuan at the village level.²⁹⁷ Critics of the policy lacking prudential requirements argue that despite the lowered capital adequacy requirements, the 20% commercial bank ownership requirement will still deter new investors from entering the market. They argue that the low capital adequacy requirement will not incentivize commercial banks.²⁹⁸

(6) Interest rate controls. The PBC controls interest rates by establishing a base rate and providing the various institutions with different intervals across which they may vary their particular rates.²⁹⁹ As of 2007, the base rate was roughly 6%.³⁰⁰ Interest rate controls particularly hinder MFIs because MFIs use interest rates to compensate for the higher transaction costs incurred from large numbers of small transactions, often to borrowers in remote areas. Caps on interest rates not only pose a challenge to the survival of MFIs, but also discourage lending to the poorest potential clients and provide a counterincentive for new MFIs to enter the market.³⁰¹

RCCs currently can lend at up to 1.3 times the base rate, a ceiling that makes it difficult for RCCs to achieve sustainability. According to Tang Min, Deputy Representative of the Asia Development Bank in China, RCCs generally lend at 9–10% annually, an unprofitable rate.³⁰² Interest rate controls on RCCs thus frustrate their ability to become sustainable and profitable.

Ad hoc licenses and the lack of regulatory status result in inconsistently applied MFI interest rates. Annual interest rates for MFIs are typically between 6% and 10%. One study reports that international standards for sustainable microfinance interest rates lie between 18% and 35%.³⁰³ During licensing negotiations, special

yuan, respectively. *Id.*

296. Giehler et al., *supra* note 231, at 10.

297. Young, *supra* note 229, at 8.

298. Giehler et al., *supra* note 231, at 7.

299. Young, *supra* note 229, at 5.

300. *Id.*

301. Chia & Counts, *supra* note 266, at 5.

302. Young, *supra* note 229, at 7.

303. Building Sustainable Institutions, *supra* note 234, at 64.

temporary permission is sometimes granted to charge higher interest rates, which various internationally funded pilot projects have charged.³⁰⁴ These initiatives have produced effective interest rates for sustainable MFIs in China between 14% and 17% annually.³⁰⁵ It appears that only those MFIs that can successfully negotiate for at least a 14% interest rate will have the means to achieve sustainability.

COCs may charge interest at four times the statutory benchmark rate, a favorable policy that will assist COCs in achieving sustainability and profitability. This policy demonstrates the Chinese government's progress in fostering a more hospitable regulatory environment for microfinance.³⁰⁶

In contrast to the favorable rate cap placed on COCs, Village Banks can only charge interest at 2.3 times the base rate, which is insufficient to cover costs.³⁰⁷ The inconsistency in rate restrictions probably results from the participation of different regulatory bodies—COCs under the PBC and Village Banks under the CBRC. Interest rate controls on the various institutions can impede the sustainability and profitability of these institutions. Thus, coordinating standards established by the different regulatory bodies can provide consistency to all of the various institutions, which could strengthen the microfinance industry.

(7) Taxes. Practitioners cite high taxes as another barrier to achieving sustainability in the microfinance industry.³⁰⁸ Local governments have introduced high taxes and fees on RCCs because the central government will not allow them to go bankrupt. RCCs are subject to operating, income, transaction, business, and consumption taxes.³⁰⁹ Local governments, rather than the national government, also levy taxes on MFI operations, which further hinders business operations.³¹⁰ National and local governments need to balance the amount of required taxes in order to allow these institutions the ability to achieve sustainable levels.

304. *Banking on Reform*, *supra* note 237.

305. Cheng, *supra* note 224, at 9.

306. Giehler et al., *supra* note 231, at 10.

307. *Id.*

308. Du, *supra* note 223, at 4.

309. *Banking on Reform*, *supra* note 237.

310. Du, *supra* note 223, at 6.

(8) Assessment of regulation. Various practitioners cite the “repressive” regulatory environment for microfinance as the main obstacle in China’s microfinance development.³¹¹ Additional reform to create a more friendly and enabling framework for MFIs is necessary for microfinance in China to reach a significant portion of the unmet demand. Practitioners are optimistic that, should successful reforms and microfinance liberalization continue, there is tremendous potential for microfinance institutions to achieve scale and attract commercial investment in China.³¹² Among developing nations, China’s potential is especially strong given the large pool of domestic investors and the strength of the Chinese currency. However, for microfinance to succeed, the government must liberalize interest rates, eliminate subsidies that crowd out private investment and cause RCCs to crowd out private MFIs, and relax restrictions on financial services.

The newly created MFI entities (i.e., COCs and Village Banks) represent positive change for microfinance. The entities’ regulatory structures show that regulators are becoming more realistic and attuned to the concerns of MFIs regarding interest rates and the need to attract funding from a variety of sources. Some criticize the fact that only a few new MFIs have been allowed to enter the provinces where pilot programs operate, arguing that this simply creates new monopolies.³¹³ This lack of competition diminishes incentives to grow in terms of clients served, products offered, and overall quality of service. The reforms would thus better achieve their objective of fostering a competitive marketplace if entry into the market were available to a wider field of investors and entrepreneurs through government-granted licenses.

Furthermore, COCs and Village Banks each have their own regulatory advantages and disadvantages in their relative capabilities to be sustainable and profitable. For example, COCs have much more flexible ownership restrictions than Village Banks, making COCs more attractive to foreign and domestic investors. COCs also have much more favorable interest rate restrictions than Village Banks.

On the other hand, Village Banks enjoy the advantage of formal

311. See, e.g., Building Sustainable Institutions, *supra* note 234, at 89; Chia & Counts, *supra* note 266, at 2; Giehler et al., *supra* note 231, at 7.

312. See, e.g., Yu, *supra* note 257; Young, *supra* note 229, at 9; Byström, *supra* note 225, at 15.

313. Young, *supra* note 229, at 7.

banking licenses, clear legal status, and the ability to take deposits—advantages not conferred on COCs. One study concluded that the more flexible interest rate caps and ownership regulations better position COCs to maintain viable operations than Village Banks.³¹⁴ However, this study also suggested the necessity of enacting new types of MFI entities that combine the advantages of COCs and Village Banks. COCs and Village Banks were created by different regulatory bodies, namely, the PBC and the CBRC, respectively, resulting in disparities in regulatory treatment. To achieve regulatory reform conducive to the growth and development of the microfinance sector, the PBC and CBRC must cooperate to shape a coherent regulatory framework.

Despite their limitations, recent reforms indicate that both regulatory bodies are interested in revitalizing the microfinance sector.³¹⁵ Although regulation is still inconsistent among the different types of institutions, many of the new regulations, such as interest rate liberalization and the ability to provide additional financial services, demonstrate that the legal regime is moving towards appropriate quantity and quality of regulation that maximizes both safety and growth. While there is still a large gap between the current regulatory framework and one friendly to microfinance, continuing reforms may transform the Chinese microfinance sector over the next several years. In the meantime, the industry remains heavily constrained in the ability to close the gap between supply and demand.

3. India's experience in microfinance

With 1.15 billion inhabitants, India is the world's second most populous country.³¹⁶ With a GDP of \$2.9 trillion, it has the world's fourth largest economy.³¹⁷ Approximately 25% of the population (300 million people) lives below the poverty line.³¹⁸ The World Bank estimates that more than 87% of India's poor does not have access to formal sources of credit, while informal sources charge interest rates ranging from 48% to 120%, or higher, per year.³¹⁹ MFIs, by contrast,

314. Giehler et al., *supra* note 231, at 10.

315. See, e.g., Young, *supra* note 229; Giehler et al., *supra* note 231, at 2.

316. RANK ORDER – POPULATION, *supra* note 160.

317. RANK ORDER, *supra* note 161.

318. CIA WORLD FACTBOOK – INDIA, <https://www.cia.gov/library/publications/the-world-factbook/geos/in.html> (last visited Jan. 30, 2009).

319. Raven Smith, *The Changing Face of Microfinance in India*, (2006) (unpublished

charge interest rates ranging from 15% to 30% per year.³²⁰ A 2008 report published by the National Bank for Agriculture and Rural Development (NABARD) noted that only 27% of all farm-based households have access to formal sources of credit, and one-third of these households participate in the informal credit sector.³²¹ It also noted that the Northeast, East, and Central regions of India exhibit the most pronounced exclusion from formal financial services.³²²

a. The Indian microfinance industry. One study estimated the total demand for microfinance services in India to encompass 300 million people.³²³ However, microfinance has only reached 30% of this demand.³²⁴ With the exception of ICICI bank, which collaborates with Indian MFIs, the traditional commercial banking sector has shown minimal interest in providing microfinance services, and thus nearly all microfinance is delivered by MFIs.³²⁵ The microfinance sector is concentrated in the southern states of Andhra Pradesh, Tamil Nadu, Karnataka and Kerala; Andhra Pradesh alone encompasses 50–70% of all microfinance activity.³²⁶ Most Indian MFIs are classified as either nonprofit MFIs (or NGO-MFIs), or for-profit MFIs. Two fundamental differences in the characteristics of these two categories pertain to formal regulation and the ability to take deposits. The Reserve Bank of India (RBI) regulates for-profit MFIs, which can obtain licenses to take deposits.³²⁷ No formal regulation exists for nonprofit MFIs, which cannot take deposits.³²⁸

M.A. thesis, Tufts Univ.), at 10.

320. DEVELOPING WORLD MARKETS, *supra* note 21.

321. NAT'L BANK FOR AGRIC. AND RURAL DEV., REPORT OF THE COMMITTEE ON FINANCIAL INCLUSION 2 (Jan. 2008) [hereinafter COMMITTEE ON FINANCIAL INCLUSION].

322. *Id.*

323. Ehrbeck, *supra* note 7, at 2.

324. *A Study of the Regulatory Environment and Its Implications for Choice of Legal Form by Microfinance Institutions in India*, Micro-Credit Ratings Int'l Ltd., Sept. 2005, at 3 [hereinafter *A Study of the Regulatory Environment*] (“describing outreach as “at best less than 25% of the 60-70 million poor families in the country.”); Ehrbeck, *supra* note 7, at 2; DiLeo & FitzHerbert, *supra* note 19, at 13.

325. SLAVEA CHANKOVA ET AL., INDIA MICROFINANCE INVESTMENT ENVIRONMENT PROFILE 7 (2004); *A Study of the Regulatory Environment*, *supra* note 324, at 3.

326. *A Study of the Regulatory Environment*, *supra* note 324, at 7.

327. *Id.* at 47.

328. *Id.*

(1) Non-profit MFIs. There are over 150,000 cooperative banks in India,³²⁹ around 30,000 of which are dedicated to microfinance.³³⁰ While these MFIs make loans on an individual basis, about 70% of their activity consists of lending to “self-help groups” (SHGs) made up of several (typically 15–25) poor micro-entrepreneurs.³³¹ SHGs take out loans from the MFIs to then disburse throughout the group. Additionally, they pool their income, which they deposit with MFIs into a common fund from which they can borrow.³³² A majority of the funding for this pooling comes from the public sector and donations.

A Linkage program run by NABARD orchestrates much of the public funding, where NABARD refinances commercial banks’ loans to MFIs.³³³ The Linkage program began in 1992 and currently connects dozens of commercial banks and hundreds of regional and cooperative banks with MFIs, serving over 10 million families.³³⁴ Societies and trusts also receive direct loans from NABARD and the Small Industries Development Bank of India (SIDBI), another state-run institution established to promote broader financial sector outreach.³³⁵

While private commercial banks are generally not involved in the microfinance sector, one notable exception is ICICI bank.³³⁶ The second largest bank in India, ICICI became interested in microfinance because of the financial and social returns demonstrated by MFIs.³³⁷ ICICI utilizes a “partnership model” whereby it provides funds to various MFIs for their lending operations, with the MFIs functioning as agents for the bank.³³⁸ Under this model, several hundred MFIs partner with ICICI, while

329. *Id.* at 1.

330. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 87; CHANKOVA ET AL., *supra* note 325, at 11.

331. CHANKOVA ET AL., *supra* note 325, at 7.

332. RAJARSHI GHOSH, MICROFINANCE IN INDIA: A CRITIQUE 2 (2005).

333. *A Study of the Regulatory Environment*, *supra* note 325, at 3; CHANKOVA ET AL., *supra* note 325, at 7.

334. CHANKOVA ET AL., *supra* note 325, at 8.

335. *Id.*

336. *A Study of the Regulatory Environment*, *supra* note 324, at 47.

337. CHANKOVA ET AL., *supra* note 325, at 8, 17; Annie Duflo, *ICICI Banks the Poor in India*, 17 MICROFINANCE MATTERS, Oct. 2005; ICICI Bank, *ICICI Bank’s Microfinance Strategy: A Big Bank Thinks Small*, MICROFINANCE GATEWAY, <http://www.microfinancegateway.org/content/article/detail/13446?print=1>.

338. *A Study of the Regulatory Environment*, *supra* note 324, at 47.

total lending operations reaches over 1 million clients.³³⁹

A small percentage of Indian MFIs are registered as nonprofit companies under Section 25 of the Companies Act.³⁴⁰ The Act provides MFIs with the formal ownership and governance structure of a limited liability company while exempting them from many of the regulations placed on for-profit companies.³⁴¹ These MFIs are more active on a larger scale than societies and trusts.³⁴² In the last several years, ten society and trust MFIs have transformed into Section 25 Companies.³⁴³ These organizations have also participated in partnerships with ICICI.³⁴⁴

(2) For-profit microfinance institutions. There are over 150,000 cooperative banks in India,³⁴⁵ around 30,000 of which are dedicated to microfinance.³⁴⁶ Cooperative banks facilitate the smaller-scale operations characteristic of microfinance institutions by allowing MFIs to enjoy the advantages within the mainstream financial sector without being subject to the regulations placed on larger banks.³⁴⁷ After trusts and societies, cooperative banks are the second most common form of MFI in terms of number of institutions.³⁴⁸ These banks are typically organized either as Urban Cooperative Banks (UCBs) or Mutually Aided Cooperative Societies (MACs). Partly due to the low barriers to entry and an ineffective regulatory regime,³⁴⁹ several cooperative banks have experienced

339. *ICICI Bank Expands Retail Microfinance Business in India*, MICROCAPITAL, Apr. 14, 2006, <http://www.microcapitalmonitor.com/cblog/index.php?/archives/200-ICICI-Bank-Expands-Retail-Microfinance-Business-In-India.html>; *Indian Bank – ICICI Reaches Arrangement with Provincial Government on Micro-Loan Interest Rates*, MICROCAPITAL, Sept. 29, 2006, <http://microcapitalmonitor.com/cblog/index.php?/archives/383-Indian-Bank-ICICI-Reaches-Arrangement-with-Provincial-Government-on-Micro-Loan-Interest-Rates.html>.

340. *A Study of the Regulatory Environment*, *supra* note 324, at 18.

341. *Id.* at 20.

342. Kapil Bajaj, *Microfinance Muddle*, BUS. TODAY (INDIA TODAY GROUP), Oct. 2007, http://businesstoday.digitaltoday.in/index.php?issueid=18&cid=2131&option=com_content&task=view.

343. Sanjay Sinha, *Microfinance Regulation for Financial Inclusion: The “Street Child” Needs Nurturing* 6 (CGAP, Essays on Regulation and Supervision No. 22, 2007), available at http://microfinancegateway.com/files/39046_file_India_Sinha_final_formatted_PDF_.pdf.

344. *A Study of the Regulatory Environment*, *supra* note 324, at 47.

345. *Id.* at 1.

346. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 87.

347. *Id.* at 35.

348. Sinha, *supra* note 343, at 3.

349. *A Study of the Regulatory Environment*, *supra* note 324, at 22.

failures in recent years, and it is currently extremely difficult to obtain licenses from the RBI to establish new cooperative banks.³⁵⁰

Non-Bank Financial Companies (NBFCs) have traditionally played an important role in the Indian financial sector by filling the gap between supply and demand among poorer clients and rural regions that large banks do not reach.³⁵¹ NBFCs have lower barriers to entry and higher returns than mainstream commercial banks. They have therefore attracted many entrepreneurs.³⁵² Currently over 13,000 NBFCs operate in India, 20 of which are MFIs focused on microfinance activity.³⁵³ Despite being among the rarest institutional forms, NBFCs and Section 25 Companies account for 80% of microfinance outreach in India, both in terms of clients served³⁵⁴ and loan portfolios.³⁵⁵

Until recently, NBFCs lacked registration or regulation requirements.³⁵⁶ This lack—including low barriers to entry and a lack of oversight—culminated in the failure of a number of NBFCs.³⁵⁷ While registration and regulatory requirements are now in place, the RBI—given recent failures of NBFCs and cooperative banks—is reluctant to grant further licenses for NBFCs and is wary of the challenge of having to regulate the microfinance sector. Despite recent NBFC failures, NBFCs remain uniquely positioned to reach out to India's rural poor.³⁵⁸

b. Microfinance regulation in India. The regulatory environment remains one of the principal reasons why the Indian microfinance sector is predominately comprised of a large number of small NGO MFIs, each serving a relatively small clientele.³⁵⁹ Meanwhile, fewer

350. *Id.* at 38.

351. *Id.* at 21.

352. *Id.* at 22.

353. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 87.

354. Bajaj, *supra* note 342.

355. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 87.

356. *Id.* at 5.

357. *A Study of the Regulatory Environment*, *supra* note 324, at 22.

358. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 5. Given that none of the NBFCs that failed were MFIs, it is believed that with the proper amount of supervision NBFC MFIs can effectively protect their clients' deposits. CHANKOVA ET AL., *supra* note 325, at 14.

359. RAJAT WANCHOO, MICRO-FINANCE IN THE INDIA: THE CHANGING FACE OF MICRO-CREDIT SCHEMES (Munic Personal RePEc Archive (MPRA) 2007); Nayanima Basu, *Microfinance in India Has a Long Way to Go: Vikram Akula*, INDIA ENEWS, 2008, <http://www.indiaenews.com/business/20061128/30324.htm> [hereinafter *Long Way to Go*];

NBFCs, which are capable of serving large client bases, have emerged.³⁶⁰ Regulatory changes in the last several years, such as reforms regarding barriers to entry and sources of funding, have made the legal environment more favorable for MFIs and have encouraged both the growth of small MFIs and the founding of large MFIs.³⁶¹ Despite these positive developments, the sector still faces many regulatory hurdles, such as restrictions on investment and disjointed regulation of the sector. Finally, the Indian Parliament is considering a new microfinance bill, which has received mixed reviews from commentators.³⁶²

(1) Legal status. From the Indian perspective, the options for legal status of MFIs influence the determination of the MFIs' ownership, governance structure, and their business model.³⁶³ Societies and trusts are legally registered organizations in which members are trustees of the organization's property.³⁶⁴ As charitable organizations, societies and trusts are not regulated in microfinance operations, management, or governance.³⁶⁵ Nor are they under any prudential regulations, partly because they cannot take deposits.³⁶⁶

While this structure provides low barriers to entry and organizational autonomy in pursuing charitable initiatives, increasing operations and attracting outside funding is difficult for MFIs.³⁶⁷ These informal management and governance standards can result in inefficient management slowing MFI growth. Furthermore, the management structure undermines confidence among investors, which poses a challenge to mobilizing funds required for

A Study of the Regulatory Environment, *supra* note 324, at 46; Smith, *supra* note 319, at 91; CHANKOVA ET AL., *supra* note 325, at 17; Bajaj, *supra* note 342.

360. WANCHOO, *supra* note 359; *Long Way to Go*, *supra* note 359; *A Study of the Regulatory Environment*, *supra* note 324, at 46; Smith, *supra* note 319, at 91; CHANKOVA ET AL., *supra* note 325, at 17; Bajaj, *supra* note 342.

361. Sinha, *supra* note 343, at 6.

362. See, e.g., KAUSHIKI SANYAL, PRS LEGISLATIVE RESEARCH, LEGISLATIVE BRIEF, THE MICRO FINANCIAL SECTOR (DEVELOPMENT AND REGULATION) BILL, 2007, at 4 (2007); Mukul G. Asher & Savita Shankar, *Microfinance Bill: Need for Major Re-Think*, http://www.karmayog.org/billsinparliament/upload/8457/CFO_Article-final.doc (last visited Jan. 30, 2009); Sinha, *supra* note 343, at 12.

363. These are two concerns closely related to the MFIs' prospects for accessing a range of funding and pursuing growth.

364. *A Study of the Regulatory Environment*, *supra* note 324, at 9, 15, 48.

365. *Id.*

366. *Id.*

367. *Id.* at 12, 13, 47.

expansion.³⁶⁸ Thus, transformation into larger institutions such as Section 25 companies or NBFCs is difficult to achieve.³⁶⁹

Section 25 of the Companies Act allows for the establishment of nonprofit, limited liability companies, whose activities are restricted to charity or other social purposes.³⁷⁰ The RBI formally recognizes and regulates MFIs organized as Section 25 companies.³⁷¹ However, these MFIs are exempt from many of the regulations placed on NBFCs and large commercial banks because of their small, nonprofit character and because they do not take deposits.³⁷²

Registration under the Companies Act and supervision under the RBI places a higher barrier to entry on Section 25 companies. However, forming a Section 25 company adds legitimacy to the institution, given the more formal ownership and management structure under the Companies Act and the supervision of the RBI.³⁷³ Section 25 Companies are more attractive targets for investment than MFIs organized as societies and trusts.³⁷⁴

Cooperative banks, including UCBs and MACs, are for-profit entities governed by members of the board, serving as beneficiaries.³⁷⁵ Because they are smaller entities and only allowed to take deposits from their borrowers,³⁷⁶ MACs are under minimal regulatory and supervisory requirements and are relatively easy to establish.³⁷⁷ The opposite is true for UCBs, which are subject to substantial regulation and supervision from both central and state governments.³⁷⁸ While the Registrar of Cooperative Societies conducts administrative aspects, such as managerial supervision within the state governments, the central government regulates and supervises banking operations through the RBI.³⁷⁹ The frequent

368. *Id.* at 13, 47.

369. While this is true, there are instances in which some nonprofit MFIs have transformed into large and profitable NBFCs. Two examples are SHARE and SKS. Smith, *supra* note 319, at 5.

370. *A Study of the Regulatory Environment*, *supra* note 324, at 18.

371. *Id.* at 18–21.

372. *Id.* at 18–21, 48.

373. *Id.*

374. While this is true, private equity investment is essentially precluded due to the companies' non-profit status.

375. *A Study of the Regulatory Environment*, *supra* note 324, at 49; CHANKOVA ET AL., *supra* note 325, at 9.

376. *Id.* at 39–42, 49.

377. *Id.*

378. *Id.*

379. *Id.* at 36, 50.

intersection of financial and administrative regulation has resulted in overlapping jurisdiction that has undermined effective regulation and supervision. Indeed, several studies have emphasized the dual control over cooperative banks as one of the primary reasons for the recent problems of the cooperative banking sector.³⁸⁰

In general, current organizational structure and regulatory regimes have unfavorable implications for growth and development of cooperative MFIs. The structure of governance by beneficiaries is problematic, often consisting of thousands of voting members and annual general meetings that require member approval for management decisions.³⁸¹ Such corporate governance problems combined with the lack of regulatory oversight placed on MACs will likely raise concerns from commercial investors. While RBI and state regulations placed on UCBs increase investor confidence, the recent problems in performance of UCBs and high barriers to entry for new institutions continue to pose problems.

NBFCs must register with the RBI, which regulates activities such as compulsory credit ratings of deposit taking and prudential norms.³⁸² RBI's supervision, along with the formal and professional governance structure, create investor confidence and make NBFCs the most viable MFIs for attracting funds, achieving growth, and reaching sustainability.

(2) State subsidies. The Indian government has demonstrated an effort to assist in microfinance development through a number of relatively recent initiatives. For example, in 1982, the government established the National Bank for Agriculture and Rural Development (NABARD) to provide and regulate credit and promote the development of agriculture and small rural enterprises.³⁸³ In 1992, NABARD began its Linkage program, encouraging commercial banks to work with MFIs by refinancing bank loans to MFIs.³⁸⁴ Additionally, NABARD provides subsidized loans to MFIs.³⁸⁵ More recently, the central government created the Microfinance Development Fund, which allocated one billion rupees (about \$25.3 million) to NABARD to finance skill development,

380. *Id.* at 36.

381. DEVELOPING WORLD MARKETS, *supra* note 21.

382. *A Study of the Regulatory Environment*, *supra* note 324, at 22.

383. CHANKOVA ET AL., *supra* note 325, at 8.

384. *Id.*; *A Study of the Regulatory Environment*, *supra* note 324, at 3.

385. CHANKOVA ET AL., *supra* note 325, at 8

foster institutional support, and offer funding to MFIs for their loans.³⁸⁶ Since the establishment of the fund, the government has continued to provide additional funding to NABARD to promote microfinance.³⁸⁷ Similarly, the government established the Small Industries Development Bank of India (SIDBI) in 1990, specifically to promote the growth and sustainability of the microfinance sector.³⁸⁸ SIDBI provides subsidized loans and grants.³⁸⁹ While the central government provides subsidized funding to nonprofit MFIs, it does not offer the same support to NBFCs.³⁹⁰

(3) Source of funding. Indian MFIs' inability to access large, diverse sources of funding largely inhibits large-scale growth of the industry.³⁹¹ While bank loans comprise the majority of MFI funding,³⁹² scaling up requires larger infusions of capital. The inability to mobilize deposits and challenges with accessing commercial investments are some of the regulatory factors behind the funding constraints of MFIs. While societies and trusts may access grants, government subsidies, and debt investment, they lack a formal ownership structure and therefore cannot take on equity investment,³⁹³ take deposits from the public, or collect savings from their clients.³⁹⁴

While the government permits and awards tax-exempt status to foreign grants, they are subject to an application process involving registration and certain procedural requirements.³⁹⁵ As of 2005, nonprofit MFIs could access external commercial borrowing provided the MFI met certain conditions.³⁹⁶ These conditions included having a three-year successful credit history with a scheduled commercial bank and having a certificate of due diligence

386. Sinha, *supra* note 343, at 6.

387. CGAP, *Microfinance in India*, http://microfinancegateway.com/resource_centers/indiapage/mf_india?print=1; *Govt to Set Up Two Funds on Microfinance*, Rediff India Abroad, Oct. 2007, <http://www.rediff.com/money/2007/oct/09micro.htm>.

388. CHANKOVA ET AL., *supra* note 325, at 9.

389. *Id.*

390. WANCHOO, *supra* note 359, at 6.

391. See Bajaj, *supra* note 342, at 1; WANCHOO, *supra* note 359, at 10. See also *A Study of the Regulatory Environment*, *supra* note 324, at 46–50 (explaining the restrictions on collecting deposits as well as the difficulty of attracting private investment).

392. CHANKOVA ET AL., *supra* note 325, at 1.

393. *A Study of the Regulatory Environment*, *supra* note 324, at 51.

394. *Id.*

395. *Id.* at 11.

396. *Id.* at 53.

indicating the “fit and proper” status of the board and managing committee.³⁹⁷ For nonprofit MFIs, the loan cap is \$5 million per MFI per year.³⁹⁸ Low confidence from investors tempers the ability to assume debt investment.³⁹⁹ The government also mandates that foreign lenders either be a financial institution or provide banking references.⁴⁰⁰

Section 25 companies may access grants under the same rules as societies and trusts, but they are not tax-exempt.⁴⁰¹ Like their nonprofit counterparts, Section 25 companies cannot take deposits;⁴⁰² however, they can access debt funding and are a more attractive option for investment than societies and trusts because of their formal ownership and governance structure.⁴⁰³ Section 25 companies are not conducive to equity investment, however, because their nonprofit status prohibits them from declaring dividends⁴⁰⁴ and regulations limit the price at which owners can sell shares.⁴⁰⁵

Cooperative banks may access grants on the same terms as Section 25 companies.⁴⁰⁶ Unlike the Section 25 companies, however, cooperative banks may take deposits—UCBs from the public and MACs from their members.⁴⁰⁷ Cooperative banks may also access external debt on the same terms as nonprofit MFIs, but without the \$5 million per MFI per year limit.⁴⁰⁸ The strict regulations and formal governing structure surrounding UCBs, which MACs lack, appeal and give confidence to investors.⁴⁰⁹ While UCBs and MACs may access equity investments, recent difficulties in the cooperative banking industry may have damaged investor confidence.⁴¹⁰

NBFCs may access grants on the same terms as Section 25 companies and Cooperative Banks.⁴¹¹ Like cooperative banks,

397. *Id.*

398. *Id.*

399. *Id.* at 48.

400. DEVELOPING WORLD MARKETS, *supra* note 21.

401. *See A Study of the Regulatory Environment, supra* note 324, at 53.

402. *Id.* at 48.

403. *Id.*

404. *Id.* at 21.

405. DEVELOPING WORLD MARKETS, *supra* note 21.

406. *A Study of the Regulatory Environment, supra* note 324, at 37.

407. *Id.* at 37, 40.

408. *Id.* at 40.

409. *Id.* at 49.

410. *Id.* at 49, 73.

411. *See id.* at 11, 21, 31, 37.

NBFCs may take deposits but are subject to certain requirements.⁴¹² First, an NBFC must be in operation for two years and obtain an investment grade rating.⁴¹³ This is challenging for MFIs because conventional credit agencies generally regard lending to poor and rural clients as inherently risky.⁴¹⁴ Second, NBFCs must obtain a license to collect savings from the RBI, which traditionally denies requests in order to limit the amount of NBFCs that it must oversee.⁴¹⁵ NBFCs can access external debt investment on the same terms as cooperative banks.⁴¹⁶ However, below-market interest rate ceilings on external commercial borrowing effectively prohibit NBFCs from obtaining cross-border loans.⁴¹⁷

NBFCs may access equity investment under the restrictions imposed by foreign direct investment rules, which vary according to investment size. To acquire up to 51% of the equity of an MFI, the minimum up-front investment is \$500,000.⁴¹⁸ To acquire more than 51% and up to 75%, the minimum investment is \$5 million up-front.⁴¹⁹ To acquire more than 75% and up to 100%, the minimum investment is \$50 million, of which \$7.5 million up must be up-front and the remainder must be provided within 24 months of the initial investment.⁴²⁰ This effectively prohibits foreign equity investment in NBFCs.⁴²¹ NABARD recommends lowering the \$500,000 minimum investment requirement for 51% of equity to \$100,000 so that MFIs can feasibly access equity and a broader range of investors can participate.⁴²²

Regulatory barriers aside, NBFCs' strict regulatory and ownership structures, along with their relatively superior management quality, make them the preferred option for both debt and equity investors in the microfinance sector.⁴²³

412. *Id.* at 32.

413. *Id.*

414. *Id.*

415. CHANKOVA ET AL., *supra* note 325, at 14.

416. *See A Study of the Regulatory Environment*, *supra* note 324, at 30, 40, 53, 57.

417. DEVELOPING WORLD MARKETS, *supra* note 21.

418. *See A Study of the Regulatory Environment*, *supra* note 324, at 53–54.

419. *Id.* at 33–34.

420. *Id.* at 53–54, 88; DEVELOPING WORLD MARKETS, *supra* note 21.

421. CHANKOVA ET AL., *supra* note 325, at 14.

422. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 88.

423. *A Study of the Regulatory Environment*, *supra* note 324, at 33, 49.

(4) Prudential requirements. While the Indian government imposes several prudential requirements on MFIs, these requirements vastly differ among organizations. For example, as charitable organizations not recognized by the banking sector, societies and trusts lack any significant regulatory or prudential requirements, such as capital adequacy and minimum capitalization.⁴²⁴ Their nonprofit counterparts, Section 25 companies, are unregistered with the RBI and subject to few regulatory requirements.⁴²⁵ However, they are subject to loan size limits of 50,000 rupees (about \$1,064) for working capital loans and 125,000 rupees (about \$2,659) for housing loans.⁴²⁶

Although to a lesser degree, UCBs are subject to similar prudential requirements as NBFCs. UCBs' minimum capital requirement is Net Owned Funds (NOF)⁴²⁷ of about \$2,127, which is about 200 times less than the requirement of roughly \$425,531 for NBFCs.⁴²⁸ This requirement is a low limit for minimum capital.⁴²⁹ The capital adequacy requirement for cooperative banks is 10%.⁴³⁰ In contrast to UCBs, MACs are loosely regulated and lack capital adequacy and minimum capital requirements.⁴³¹

The RBI prescribes prudential and compliance norms for all NBFCs, but the prudential norms only apply to NBFCs that engage in deposit-taking.⁴³² Because it is difficult to mobilize large amounts of funds,⁴³³ minimum capital regulations are high—NOF of 2 crores.⁴³⁴ The requirement was previously 25 lakhs (.25 crores) and rose in 1999 following NBFC bank failures.⁴³⁵ This new limit

424. *Id.* at 57.

425. *Id.* at 20.

426. *Id.*

427. NOF is defined as shareholder equity plus internally generated reserves. *Id.* at 22.

428. *Id.* at 57.

429. *Id.* at 50.

430. *Id.* at 57.

431. *Id.* at 42, 57.

432. *Id.* at 22.

433. *Id.* at 32.

434. *Id.*

435. *Id.* ("Many such companies have been unable to service their debt obligations due to ineffective asset-liability matching and spectacular collapses like CRB Caps in Ahmedabad and Century Consultants in Lucknow have resulted in considerable loss of public confidence in NBFCs' services. Recognizing the importance of NBFCs in the Indian financial sector and with the objective of integrating these with the financial mainstream, RBI started to regulate them from 1996. These measures include mandatory registration of companies offering financial services with the RBI, compulsory credit rating of deposit taking NBFCs and

impedes the establishment of new NBFCs and the transformation of MFIs into NBFCs. In addition, the capital adequacy requirement for NBFCs is 12%, compared to 10% for commercial banks.⁴³⁶ NBFCs also have loan size limits as a percentage of their NOF, with caps of 15% of NOF for loans to a single borrower and 25% of NOF for loans to a single group of borrowers.⁴³⁷ Furthermore, NBFCs are subject to extensive investment restrictions and substantial reporting and accounting requirements.⁴³⁸ These steep management and governance-related requirements likely contribute to NBFCs' status as the most attractive MFIs to investors.

(5) Interest rate controls. Private MFIs including NBFCs, Section 25 Companies, and Cooperative Banks are not subject to interest rate controls under RBI regulation.⁴³⁹ While state and local governments enact their own usury laws, the central bank regulates private MFIs.⁴⁴⁰ However, NGO MFIs, such as societies and trusts, may be subject to usury laws and other state legislation that allow state governments to introduce interest rate caps,⁴⁴¹ thereby limiting the potential for abuse. For instance, one study in India found effective interest rates on MFI loans were 15–24% per year, while effective rates on loans from moneylenders, landlords, and traders were 48–150% per year.⁴⁴²

(6) Assessment of regulation. The lack of an enabling regulatory environment is a principal reason why more MFIs have not achieved larger scale and why the microfinance sector in India has only been able to reach 30% of the estimated demand.⁴⁴³ The disjointed nature of the regulatory environment, coupled with an inability to access various sources of funding, inhibit the growth and sustainability of Indian MFIs.⁴⁴⁴ Vikram Akula, founder and chairman of the Indian MFI SKS, believes that “the regulatory

imposition of prudential norms.”).

436. *Id.* at 57.

437. *Id.* at 27.

438. *Id.*

439. Sinha, *supra* note 343, at 9.

440. *Id.*

441. *A Study of the Regulatory Environment*, *supra* note 324, at 13; Smith, *supra* note 319, at 18.

442. CHANKOVA ET AL., *supra* note 325, at 10.

443. See WANCHOO, *supra* note 359, at 8–10.

444. *Id.* at 10; Smith, *supra* note 319, at 91.

environment created by the RBI is unfavorable for the growth and proliferation of microfinance in India.”⁴⁴⁵

The inability of MFIs to access various sources of funding is closely related to the regulatory regime within which MFIs operate. Depending on their structural limitations, different types of MFIs face varying degrees of difficulty in scaling up. While some MFIs are well suited to progress, others lack sufficient access to funds. Specifically, societies and trusts may be inherently inhibited in their efforts to scale up⁴⁴⁶ because they cannot take deposits, they have an informal institutional structure, and they are unattractive to investors because of instances of ineffective management.⁴⁴⁷ Section 25 companies and cooperative banks are better positioned to increase scale and outreach than society and trust MFIs.⁴⁴⁸ However, they too face substantial challenges in their efforts to raise the funding necessary to achieve growth. For example, Section 25 companies cannot raise funds by taking deposits and declaring dividends, making them less attractive to equity investors.⁴⁴⁹ Meanwhile, though cooperative banks may take deposits, investor confidence in UCBs might be unstable given the current state of the cooperative banking sector.⁴⁵⁰ MACs are less attractive targets for investments given their more informal governance and lack of regulatory requirements.⁴⁵¹ These factors reduce the attractiveness of cooperative banks for equity investors, which may ultimately lead to leverage problems.⁴⁵²

Therefore, NBFCs are the MFIs best positioned to achieve growth and scale. However, to attain NBFC status, new NBFCs must overcome steep establishment barriers and existing MFIs must overcome steep transformation barriers.⁴⁵³ Additionally, regulatory obstacles to foreign equity and debt investment⁴⁵⁴ nearly eliminate

445. See WANCHOO, *supra* note 359.

446. *A Study of the Regulatory Environment*, *supra* note 324, at 13, 17, 47–48.

447. *Id.* at 50.

448. *Id.* 47–50.

449. *Id.* at 50.

450. *Id.* at 47, 50.

451. *Id.*

452. *Id.* at 50.

453. *Id.* at 47–49. Barriers are in terms of legal requirements (both administrative (ex: registration) and substantive (ex: regulatory requirements)), as well as access to funding. The information under “Governance” and “Scaling up of operations” in the chart on pages 48 to 49 of the study are also relevant.

454. CHANKOVA ET AL., *supra* note 325, at 14, 18.

foreign investment in NBFCs.⁴⁵⁵ The only viable option for NBFC's to find funding is to solicit foreign investors to guarantee domestic bank loans to local MFIs.⁴⁵⁶ However, transaction costs for loan guarantees are much higher than they are for direct lending and investment.⁴⁵⁷ Higher transaction costs dampen investment interest in loan guarantees, leaving the public sector and IFIs as the primary investors in loan guarantees. Thus, although interest in microfinance investment among the private sector is comparatively smaller than that of international investors and MIVs, NBFCs are often forced to resort to domestic sources to access funds. Furthermore, private lenders are crowded out of the market by commercial banks that are required to provide loans to low-income recipients including MFIs.⁴⁵⁸ This creates downward pressure on interest rates to MFIs and further limits participation of commercial lenders.⁴⁵⁹

Another concern for growth and sustainability is that the lack of a comprehensive, clear, and uniform regulatory system.⁴⁶⁰ NABARD has recommended that the RBI centralize microfinance regulation under a single mechanism that regulates all MFIs in a coherent manner.⁴⁶¹ A single regulatory body could remedy many of the inconsistencies in regulation. This would also enable the standardization of financial disclosures based on international best practices, across MFIs of all types, which would substantially reduce transaction costs and thus attract more investors and donors.⁴⁶²

(7) Proposed microfinance legislation. The Indian Parliament introduced the Micro Financial Sector (Development Regulation) Bill (the Bill) in March 2007 to promote the development of microfinance through new regulations and supervisory requirements for society and trust MFIs administered by NABARD.⁴⁶³ Under the Bill, societies and trusts would be required to register with NABARD and comply with regular reporting requirements, including

455. *Id.* at 18.

456. *Id.*

457. Latortue et al., *supra* note 58, at 14.

458. CHANKOVA ET AL., *supra* note 325, at 17.

459. DEVELOPING WORLD MARKETS, *supra* note 21.

460. Bajaj, *supra* note 342.

461. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 89.

462. CHANKOVA ET AL., *supra* note 325, at 13, 18.

463. SANYAL, *supra* note 362, at 14. The Bill remained under consideration at the time of this writing.

submitting audited financial statements.⁴⁶⁴ The Bill also introduces procedures for dispute settlement between MFIs and their clients and details procedures for inspections of MFIs whose practices may constitute harassment.⁴⁶⁵

Most controversially, the Bill would allow societies and trusts to take deposits from their members upon meeting certain requirements.⁴⁶⁶ To be eligible to take deposits, a society or trust would have to exist for three years and have a minimum capitalization of NOF 1 lakh (about \$2,127).⁴⁶⁷ The Bill would also require deposit-taking societies and trusts to create a reserve fund by transferring a minimum of 15% per year of their net profits from savings and microfinance services.⁴⁶⁸

Some perceive the Bill as providing a means for MFIs to access a wider range of funding for their operations, enabling them to broaden their outreach and offer their local expertise to a wider range of clients.⁴⁶⁹ From this perspective, MFIs would have a greater opportunity for increased client outreach, which provides a needed alternative for those currently dependent on riskier lending at higher rates from informal sources.

However, allowing small and relatively informal and inexperienced MFIs to take deposits may put poor clients' money at risk. The lower level of protection for clients' savings in comparison to NBRCs has been criticized,⁴⁷⁰ although the proposed minimum capital requirement for MFIs is the same as that currently in place for cooperative banks.⁴⁷¹ From this perspective, the current regime in which NBFCs and the formal banking sector offer experienced management and adequate protection, while NGOs serve as facilitators, is preferable to the arrangement in the proposed

464. *Id.* at 1.

465. *Id.* at 3.

466. *Id.* at 1, 2.

467. *Id.* at 4. As discussed above, NOF 1 lakh is the same minimum capital requirement placed on cooperative banks, which is considered a moderate amount, while NBFCs, in comparison, are under a minimum capital requirement of 2 crores, or 200 lakhs (about \$500,000).

468. *Id.* at 1.

469. ASHER & SANKAR, *supra* note 362.

470. Smita Premchander & M. Chidambaranatham, *One Step Forward or Two Steps Back? Proposed Amendments to NABARD Act*, ECON. AND POL. WKLY, Mar. 24, 2007, at 1006.

471. See SANYAL, *supra* note 362, at 4; *A Study of the Regulatory Environment*, *supra* note 324, at 50, 57.

legislation, which would dilute the safety of client deposits.⁴⁷²

Prudential norms have been criticized as inadequate for deposit-taking MFIs.⁴⁷³ One report argues that the mandatory reserve fund, as the single prudential regulation, will be ineffective for MFIs not realizing profits, and that it is necessary to limit the volume of deposits an MFI can take.⁴⁷⁴ Practitioners stress the necessity of prudential norms for deposit-taking MFIs, citing the importance of stricter capital adequacy requirements at the inception of an MFI's deposit-taking operations.⁴⁷⁵ New legislation enabling MFIs to take deposits should impose prudential supervision through capital adequacy requirements in order to provide protection of client savings in conformity with international best practices.

Practitioners recommend that MFIs demonstrate their ability to manage their lending profitably before they are given permission to take deposits.⁴⁷⁶ Regulators are thus encouraged to set criteria and requirements, the satisfaction of which would ensure that a bank covers its costs such as the additional financial and administrative costs of taking deposits. From this perspective, the requirement of three years of experience as an MFI appears promising.

Commentators have highlighted the registration, reporting, and audit requirements of the Bill as measures that will improve management and increase professionalism across the sector.⁴⁷⁷ The provisions for inspection and dispute settlement are noted as important positive aspects of the proposed regulation.⁴⁷⁸ However, the Bill is criticized for neither addressing nor remedying the disjointed nature of microfinance regulation.⁴⁷⁹ The bifurcated regulatory structure inherent in the legislation requires the NABARD to regulate societies and trusts, whereas the RBI would continue to regulate NBFCs, cooperative banks, and Section 25 companies. This runs counter to calls by NABARD and others to consolidate regulation of all MFIs under a single authority.⁴⁸⁰ One solution advocated by Sanjay Sinha, managing director of the India-

472. Premchander & Chidambaranatham, *supra* note 470.

473. SANYAL, *supra* note 362, at 1; Asher & Shankar, *supra* note 362.

474. Asher & Shankar, *supra* note 362.

475. See Christen et al., *supra* note 142, at 13.

476. See *id.*

477. Asher & Shankar, *supra* note 362.

478. *Id.*

479. SANYAL, *supra* note 362, at 1; Sinha, *supra* note 343, at 11.

480. Sinha, *supra* note 343, at 12.

based international microfinance rating agency M-CRIL, is that all MFIs be regulated by the RBI and thus “treated as an integral part of the financial system.”⁴⁸¹

There is also concern that giving NABARD oversight of societies and trusts may present a conflict of interest because NABARD is a key participant in the microfinance sector and provides equity capital and debt funding to society and trust MFIs. Criticism of the Bill has emphasized that combining the role of service provider and regulator is poor governance.⁴⁸² Some have also taken issue with NABARD’s expertise and general capacity to regulate effectively.⁴⁸³

The Bill also provides for loan size limits for societies and trusts equal to those placed on Section 25 companies: 50,000 rupees for working capital loans and 150,000 rupees for housing loans.⁴⁸⁴ However, the Bill does not include an exemption for MFIs from state and local interest rate laws. This discrepancy could create an uneven playing field for MFIs relative to Section 25 companies, cooperative banks, and NBFCs, which charge cost-covering interest rates.⁴⁸⁵ Concern has also been raised as to whether societies and trusts are appropriate vehicles for providing microfinance services.⁴⁸⁶ This concern stems from society and trust MFIs’ relative lack of banking expertise and the transaction costs involved in the subsidized funding that MFIs receive from NABARD.

Perhaps the pivotal component will be NABARD’s ability to prescribe additional norms that it deems necessary. The manner in which NABARD uses its regulatory power could determine the success of the regulatory program. On one hand, the implementation of capital adequacy requirements conforming to international best practices could provide much needed investor protection. On the other hand, if NABARD implements excessive prudential norms and regulation to appease its critics, the result could be an overly burdensome regulatory scheme. This, in turn, would reduce incentives for individuals and investors to start and grow MFIs and ultimately restrict access to financial services among micro-entrepreneurs.

Overall, the Bill has received mixed reviews. NABARD

481. *Id.*

482. SANYAL, *supra* note 362, at 1; ASHER & SANKAR, *supra* note 362.

483. *Id.*

484. *Id.* at 2.

485. SANYAL, *supra* note 362, at 1; ASHER & SANKAR, *supra* note 362.

486. Premchander & Chidambaranatham, *supra* note 470; SANYAL, *supra* note 362.

commented that the Bill would help promote the growth of the Indian microfinance sector,⁴⁸⁷ while others assert that its positive features are “more than outweighed” by its deficiencies.⁴⁸⁸

IV. CONCLUSION

Despite recent expansion, the vast majority of worldwide demand for microfinance services remains unmet. New MFIs are emerging in all regions of the developing world, and existing MFIs are expanding client outreach to reach the vast unmet demand for financial services among the working poor. A small but growing number of MFIs worldwide have scaled up operations such that their profitability surpasses even that of local commercial banking institutions. These large MFIs transform lives by providing access to invaluable financial services—including credit, insurance, and savings—to those without access to traditional commercial providers.

While the investment capital needed to create and expand MFIs has traditionally come from public and multilateral institutions, this funding has enabled MFIs to access only 10% of the estimated demand for microfinance services thus far. Fortunately, an increasing number of private investors, likely attracted by the opportunity to realize both financial and social returns, appear poised and ready to meet the demand for additional funding. Recent years have shown a growing number of investors pursue significant, innovative investment transactions and channel large amounts of much needed funding to promising MFIs. This trend further demonstrates the enormous potential for the private sector to work together with MFIs to reach a significant portion of the still unmet demand. Indeed, recent developments indicate that investors in the private sector will provide the necessary investment capital as long as MFIs continue to increase outreach into areas with unmet demand.

To accomplish this outreach and obtain more private sector funding, MFIs need to achieve a sufficient level of sustainability and growth. While previous scholarship has provided an assessment of the percentage of MFIs that have thus far been able to do this, this Article analyzes some of the external factors that influence an MFI’s capability to become “investable.” An examination of the relationship between domestic regulatory environments and microfinance industry development, with specific case studies from

487. COMMITTEE ON FINANCIAL INCLUSION, *supra* note 321, at 89.

488. Asher & Shankar, *supra* note 362.

Brazil, China, and India demonstrates that domestic regulatory regimes profoundly influence the business model of MFIs and their capacity for growth and sustainability.

The interplay between regulation and growth is particularly evident in these three countries, where the inability of microfinance to meet a significant portion of the demand is partially attributed to a cumbersome and disjointed regulatory environment. Because investors are unlikely to invest in MFIs that cannot show the potential to reach a large client base and achieve profitability, the stagnant growth of domestic microfinance limits MFI access to funding. The result is that, while private investors are interested in helping MFIs bridge the gap between current supply and total demand for microfinance services, they are restricted by the regulatory environment. This Article argues that regulatory environments constitute one of the biggest challenges to the development and sustainability of MFIs, and that a significant portion of demand for microfinance services will remain unreachable without regulatory reform.

An essential goal for the microfinance movement is thus to work towards domestic regulatory reform reflecting quantity and quality of regulation that maximizing both safety and growth. In particular, NGOs, IFIs, and other microfinance-focused organizations must emphasize international regulatory best practices and encourage individual countries to foster coherent regulatory regimes tailored to the uniqueness of their economic and microfinance industry circumstances.

One promising solution is for national governments to establish agencies within their banking authorities that focus specifically on the microfinance industry.⁴⁸⁹ Such an agency could cultivate an understanding of the unique attributes of the microfinance sector and work to integrate MFIs into the overall banking system through coherent and appropriate regulation. These agencies could also coordinate and exchange information with their foreign counterparts and microfinance experts at NGOs and international organizations such as the World Bank and CGAP. Such information sharing would disseminate expertise in microfinance regulation to government officials, helping them towards a domestic regulatory environment

489. See Christen et al., *supra* note 142, at 37. This, in effect, already exists in Bolivia—the first country to have a regulated MFI (BancoSol). See Association of Financial Entities Specialized in Microfinance, <http://www.asofinbolivia.com/en/default.asp> (last visited Jan. 30, 2009).

that maximizes both safety and growth in the microfinance sector. Indeed, now that private sector investment is increasingly available for MFIs, the necessity of facilitative domestic legal environments may be the greatest and most important challenge for the microfinance movement to address as it seeks to close the demand gap and thereby dramatically reduce world poverty.

APPENDIX: LIST OF ACRONYMS

ABC: Agricultural Bank of China
AIG: American International Group
BNDES: Bank for Social and Economic Development
CBRC: China Banking Regulatory Commission
CGAP: Consultative Group to Assist the Poor
COC: Credit Only Company
IFI: international financial institution
MAC: Mutually Aided Cooperative Society
MFI: microfinance institutions
MIV: microfinance investment vehicle
NABARD: National Bank for Agriculture and Rural Development
NBFC: Non-Bank Financial Company
NOF: Net Owned Funds
PBC: People's Bank of China
OSCIP: Organização da Sociedade Civil de Interesse Público (Public Interest Non-Profit Company)
RBI: Reserve Bank of India
RCC: rural credit cooperative
SCM: Sociedade de Crédito ao Microempreendedor (Microentrepreneur Credit)
SEEP Network: Small Enterprise Education and Promotion Network
SHG: self-help group
SIDBI: Small Industries Development Bank of India
UCB: Urban Cooperative Bank
USAID: United States Agency for International Development Organizations