

**THE ROLE OF PRIVATE SECTOR INVESTMENT IN INTERNATIONAL MICROFINANCE AND
THE IMPLICATIONS OF DOMESTIC REGULATORY ENVIRONMENTS**

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TABLE OF CONTENTS

I. INTRODUCTION.....	3
II. THE SUPPLY AND DEMAND FOR PRIVATE INVESTMENT IN MICROFINANCE	6
A. INTRODUCTION: PRIVATE INVESTMENT IN MICROFINANCE.....	6
B. CURRENT PRIVATE SECTOR INVOLVEMENT: THE SUPPLY OF PRIVATE CAPITAL	8
1. Microfinance Investment Vehicles (MIVs) – The Supply of Private Capital	9
2. Private Investment as a Portion of Total Investment in Microfinance	11
3. The Growth of Private Investment	12
4. Investors in Microfinance Investment Vehicles (MIVs)	14
5. Where Private Microfinance Funds are Invested	15
6. Investment Instruments of Microfinance Investment Vehicles	17
C. THE MICROFINANCE INDUSTRY: THE DEMAND FOR PRIVATE CAPITAL	23
1. Total, Worldwide Demand for Microfinance	24
2. The Current Landscape of Microfinance Institutions.....	25
3. Types of Microfinance Institutions	26
4. The Funding of Microfinance Institutions.....	29
5. Growth of Microfinance Institutions	30
6. Trends Driving Industry Growth.....	32
7. MFI Demand for Private Investment.....	33
8. Projections for Growth	35
D. CONCLUSION: ASSESSMENT OF PRIVATE INVESTMENT SUPPLY AND DEMAND.....	36

III. REGULATORY CHALLENGES TO PRIVATE SECTOR INVESTMENT IN MICROFINANCE.....	38
A. INTRODUCTION: THE IMPORTANCE OF REGULATION AND THE IDEAL REGULATORY ENVIRONMENT.....	38
1. Important Regulatory Issues.....	40
2. Prudent Regulation: Striking a Balance between Protection and Access.....	49
B. BRAZIL	50
1. The Brazilian Microfinance Industry	51
2. Microfinance Regulation in Brazil	54
C. CHINA.....	67
1. The Chinese Microfinance Industry	67
2. Microfinance Regulation in China	73
D. INDIA.....	87
1. The Indian Microfinance Industry.....	88
2. Microfinance Regulation in India.....	93
IV. CONCLUSION	114

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I. INTRODUCTION

Microfinance – the practice of providing small, working capital loans and other financial services to poor individuals unable to obtain access to commercial sources of credit – has been able to transform the lives of over 100 million microentrepreneurs and their families in various regions throughout the world. Despite the growth that the international microfinance industry has experienced since its inception about 30 years ago, microfinance currently reaches only 10% of the estimated demand for microfinance services, comprised of approximately 1 to 1.5 billion microentrepreneurs worldwide. Practitioners agree that in order to significantly close the supply/demand gap – and to reduce dramatically world poverty in the process – microfinance institutions will need to access funding from the private sector, as funds from philanthropic donations and public and multilateral development agencies will be far from sufficient.

Fortunately, in response to the ability of increasing number of microfinance institutions to demonstrate both social and financial gains, a growing number of private and mainstream commercial investors are exhibiting an interest in investing in microfinance. The recent emergence of a group of highly successful – both in terms of

*J.D., Harvard Law School; B.A., Columbia University. I would like to thank Jim Kaddaras and Developing World Markets for giving me the guidance and the opportunity to work on this issue, and without whose help in research and editing, this article would not have been possible.

client outreach as well as profitability – microfinance institutions around the world, combined with an increasing crop of private investors looking to deploy large amounts of capital in search of the “double bottom line” of financial and social gains, has cause many to be optimistic about the potential growth and expansion of the microfinance industry.

In order to obtain a deeper understanding of this potential, and to determine more precisely how much of the latent demand the microfinance sector will be able to reach, recent commentary has focused upon the issue of whether there will be a large enough supply of microfinance institutions that will be able to both attract private capital and then successfully deploy it towards dramatically increasing client outreach, or whether there will be so few of these “investible” microfinance institutions such that private capital will be concentrated on a small amount of exceptional institutions as the microfinance sector as a whole is unable to significantly close the supply/demand gap.

This paper attempts to contribute to the current understanding of the potential of microfinance – and the emergence of private investment in the microfinance industry – to reach the currently un-served portion of the demand. In light of this objective, the purpose of this paper is two fold: (1) to assess the current supply and demand for commercial investment in microfinance, and (2) to analyze legal and regulatory challenges that affect commercial investors’ capacity to reach the unmet portions of worldwide demand.

Legal and regulatory regimes have a profound effect on how easy or difficult it is for individual microfinance institutions to attain sustainability and profitability, and thereby play a role in determining an institution’s ability to extend outreach to a large

number of clients and to attract capital from private investors (thus building the capacity to further increase outreach). While a more favorable legal and regulatory environment is conducive to the flourishing of a large number of profitable and “investible” microfinance institutions reaching a large number of clients, an inhospitable legal regime can be so constrictive that no such large institutions capable of reaching a large client base and attracting private investment are able to emerge. An examination of the various legal and regulatory issues will thus provide a more comprehensive understanding of how much of the latent demand the microfinance sector will be able to reach. Specifically, this paper will look at the legal and regulatory environments for microfinance in Brazil, China and India – three countries where over half of the unreached demand for microfinance is estimated to be located.¹ An assessment of how many of these individuals can be reached by microfinance and its private investors will thus provide a deeper understanding of microfinance’s overall potential to close the worldwide supply/demand gap.

This paper attempts to provide a comprehensive picture of the potential of microfinance to close the supply/demand gap, and to discuss the role of regulatory issues within the big picture. With these dual goals in mind, this paper proceeds in two additional parts. Part II discusses the current private sector involvement that has developed over the last several years – the supply of private capital, as well as the current expansion of the international microfinance movement and its increasing ability to absorb private sector capital in order to fund efforts to deliver increased financial services to microentrepreneurs – the demand for private capital. This portion of the paper will

¹ *Optimizing Capital Supply in Support of Microfinance Industry Growth*, Small Enterprise Education and Promotion (SEEP) Network, October 2006 [hereinafter *Optimizing Capital Supply*], pg. 2

address the more common question of whether there will be enough demand for private capital, i.e., enough large microfinance institutions able to attract and effectively deploy the amount of private capital that the supply of investors are able to provide. Following the discussion of the supply and demand for private investment, Part III of this paper then discusses the regulatory challenges that the private sector may face in meeting this demand.

II. THE SUPPLY AND DEMAND FOR PRIVATE INVESTMENT IN MICROFINANCE

A. INTRODUCTION: PRIVATE INVESTMENT IN MICROFINANCE

Modern microfinance began in the mid-1970s with simultaneous initiatives in Brazil, Bangladesh and Bolivia to distribute small loans to the working poor.² These ventures demonstrated the sustainability of microfinance through loan repayment rates of close to 100%,³ as well as the impact of microfinance as a means to help people lift themselves out of poverty.⁴ Building on these initial successes, the microfinance industry has grown to a point where it now encompasses an estimated 10,000 lending

² *Managing Commercial Microfinance: The People Behind the Asset Class*, MicroCapital Institute, 2004, pg. 1

³ While variation exists, mature lending institutions experience repayment rates of 98%. This can be compared to the repayment rate of 95% among US credit card holders. Microfinance institutions are able to realize high repayment rates because credit risk is spread across thousands of borrowers, all of whom have high incentives to repay their loan as their business is typically their only means of financial survival. Sylvie Golay and Ursula Oser, *Microfinance as an Attractive Business Model*, Credit Suisse: Global Investor Focus, May 2006, pg. 15. In addition, risk is further mitigated by the fact that microenterprise is insulated from macroeconomic shocks because they often operate in the informal sector, and because of concentration on basic products and services. Adrian Gonzalez, *Resilience of Microfinance to national Macroeconomic Events: A Look at MFI Asset Quality*, MicroBanking Bulletin, Issue 14, Spring 2007, pg. 36

⁴ For a description of the efficacy of microfinance in alleviating poverty and improving the lives of borrowers, see Elizabeth Littlefield, Jonathan Morduch, and Syed Hashemi, *Is Microfinance an Effective Strategy to Reach the Millennium Development Goals?*, Consultative Group to Assist the Poor (CGAP), Focus Note No. 24, January 2005

institutions,⁵ with around \$33 billion in total assets and a gross loan portfolio of about \$24 billion,⁶ and with a client base of over one hundred million borrowers worldwide.⁷ While at least 90% of microfinance institutions (MFIs) have yet to reach profitability, up to 10%, roughly 1,000 institutions, have been able to demonstrate profits through increased efficiency and scale.⁸ Profitability potential is exemplified by leading MFIs on various continents that outperform local commercial banks in terms of profitability.⁹ The amount of profitable MFIs continues to increase due to the transformation of nonprofit MFIs into regulated, for-profit enterprises, as well as initiatives to launch new “Greenfield” MFIs, start-up commercial MFIs that are profit-focused from their inception.¹⁰

While microfinance has traditionally been funded through grants and subsidized loans, primarily from government agencies and international financial institutions (IFIs), private investors have become increasingly interested in microfinance investment given the financial as well as social returns that have been demonstrated thus far. Building on initial investments beginning in the 1990s, commercial investment in microfinance began to grow at annual rates of around 50% since 2000,¹¹ reaching an estimated total \$2 billion

⁵ MicroCapital Institute, Grameen Foundation USA, and ACCION International all estimate a population of 10,000 MFIs worldwide. *Managing Commercial Microfinance*, supra note 2 at 7; Jennifer Meehan, *Tapping the Financial Markets for Microfinance*, Grameen Foundation USA, October 2004, 5; *Small Loans and Big Ambitions*, The Economist, March 15, 2007, http://www.economist.com/finance/displaystory.cfm?story_id=8861522

⁶ *Microfinance Industry Potential*, Developing World Markets, 2007

⁷ Elizabeth Nelson, *What Are the Total Global Assets in Microfinance?*, MicroCapital, October 2007, <http://www.microcapital.org/?p=1450>

⁸ *Blended Value Investing: Capital Opportunities for Social and Environmental Impact*, World Economic Forum, March 2006, pg. 62

⁹ *Optimizing Capital Supply*, supra note 1 at 5

¹⁰ Elisabeth Rhyne and Brian Busch, *The Growth of Commercial Microfinance: 2004-2006*, Council of Microfinance Equity Funds, September 2006, pg. 11

¹¹ *Managing Commercial Microfinance*, supra note 2 at 2

invested by the end of 2006,¹² and is expected to gradually overtake and eventually replace funding from non-commercial and public sources.¹³

The entry and initial successes of private investment in microfinance has been welcomed by practitioners in the microfinance industry given that traditional, public funding sources have only been able to reach an estimated 10% of the total (and growing) worldwide demand for microfinance.¹⁴ Indeed, many professionals within the industry agree that the funding necessary for microfinance to close the supply/demand gap can only come from commercial sources in the private capital markets.¹⁵ Private investment can thus be essential to fulfilling the original mission of microfinance, that of providing permanent access to financial services that enables working poor people to lift themselves and their families out of poverty, as well as doing so on a large enough scale so as to significantly reduce world poverty.

B. CURRENT PRIVATE SECTOR INVOLVEMENT: THE SUPPLY OF PRIVATE CAPITAL

This section assesses the supply and nature of private capital investment in microfinance. After assessing the volume of investment from private sources, this section examines private investment as a portion of total worldwide investment in microfinance as well as the rate at which private investment has taken up an increasing share of that portion in recent years. This section also discusses the types of investors

¹² Xavier Reille & Ousa Sananikone, *Microfinance Investment Vehicles*, Consultative Group to Assist the Poor (CGAP), Brief, April 2007, pg. 1

¹³ Elisabeth Rhyne & María Otero, *Microfinance Through the Next Decade: Visioning the Who, What, Where, When and How*, ACCION International, 2006, pg. 45

¹⁴ *Blended Value Investing*, *supra* note 8 at 8

¹⁵ See e.g., Meehan, *supra* note 5 at 5; *Blended Value Investing*, *supra* note 8 at 7; Guatam Ivatury and Xavier Reille, *Foreign Investment in Microfinance: Debt and Equity From Quasi-Commercial Investors*, Consultative Group to Assist the Poor, Focus Note No. 25, January 2004, pg. 1; Marc de Sousa-Shields and Cheryl Frankiewicz, *Financing Microfinance Institutions: The Context for Transitions to Private Capital*, US Agency for International Development, MicroReport #8, December 2004, pg. vii; *Optimizing Capital Supply*, *supra* note 1 at 1

making investments in microfinance investment funds, as well as in what types of MFIs and in what geographic regions these funds are deploying their investments. Finally, this section looks at the various investment instruments that investors have pioneered in recent years in order to channel funds into microfinance.

1. Microfinance Investment Vehicles (MIVs) – The Supply of Private Capital

While individual investors have made direct investments in MFIs, private investment from commercial sources is generally made through investment in microfinance funds known as microfinance investment vehicles (MIVs). Countries vary in terms of how much private investment in the microfinance sector comes from domestic as opposed to foreign investors. In general, while some commercial investment in MFIs comes from the local markets, the greater capacity of Western investors to invest larger sums and to take on greater risk has led to most commercial investment coming in the form of foreign commercial investment, with foreign investors expected to pave the way for local investors as capacity increases.¹⁶ Investment from MIVs totaled \$2 billion in 2006,¹⁷ and was estimated to have grown to \$3.2 billion by the end of 2007.¹⁸ Around 75% of this investment is in the form of debt, with around 25% in the form of equity,¹⁹ while around 2% is in the form of guarantees for local investors.²⁰ While debt investment has traditionally been made exclusively in hard currency, typically in dollars or euros, MIVs over the last few years have increasingly been able to lend to MFIs in

¹⁶ Paul DiLeo & David FitzHerbert, *The Investment Opportunity in Microfinance*, Grassroots Capital Management, June 2007, pg. 17; Meehan, *supra* note 5 at 6

¹⁷ Reille & Sananikone, *supra* note 12 at 1

¹⁸ *Microfinance Industry Potential*, *supra* note 6

¹⁹ Rekha Reddy, *Microfinance Cracking the Capital Markets II*, ACCION International, Insight Number 22, May 2007, pg. 3

²⁰ Guatam Ivatury & Julie Abrams, *The Market for Foreign Investment in Microfinance: Opportunities and Challenges*, Consultative Group to Assist the Poor (CGAP), Focus Note No. 30, August 2005, pg. 5

their local currency, which minimizes foreign exchange risk for the MFIs. To date, about 30% of debt investment is being made in local currency, while the remaining 70% is in hard currency. In terms of equity investment, 75% of equity investment goes to Greenfield institutions and other young MFIs, demonstrating investor appetite to fund start-up institutions that seek to eventually become large-scale, profitable MFIs.²¹

As of mid-2007 there were about 85 MIVs wholly or largely focused on investing in microfinance. These funds include a variety of debt as well as equity focused investments, and range from highly concessionary to purely commercial in their profit orientation. 17 of these funds were identified as commercial funds focused solely on equity investment, with a total of \$615 million invested, while the study found a dozen debt funds that devote a total of \$100 million to equity investment.²² While new MIVs have been increasingly entering the market in recent years, the supply is still heavily concentrated, as the leading MIVs are much more active than their peers.²³ A 2005 study of 74 MIVs found that the top 10 MIVs are responsible for 65% of all MIV investment. While the largest of these funds, ProCredit Holding AG, held \$390.4 million in total capitalization, 61 out of the 74 MIVs held less than \$1 million.²⁴ As will be discussed below, private investment is growing rapidly. Indeed, it is predicted by Deutsche Bank that institutional investment will increase tenfold over the next 10 years, growing from the 2006 figure of \$2 billion invested to \$20 billion by the year 2015.²⁵

²¹ Reddy, *supra* note 19 at 3

²² DiLeo & FitzHerbert, *supra* note 16 at 18

²³ Reddy, *supra* note 19 at 3

²⁴ *Id.* at 3

²⁵ *Microfinance Industry Potential*, *supra* note 6

2. Private Investment as a Portion of Total Investment in Microfinance

Private foreign investment still represents a relatively small, albeit fast-growing, portion of the total investment in microfinance. A 2004 study found domestic investment to be the overwhelming primary source of funding for MFIs, accounting for 76% of the total \$17 billion invested in microfinance, with 60% of domestic investment coming from deposits made by the borrowers or clients of the MFIs.²⁶ The frequency of deposit-taking varies greatly from country to country, with MFIs in some countries more active in savings than in lending, while in other countries deposit-taking is associated exclusively with the largest and most successful MFIs. The ability of MFIs to mobilize domestic deposits through savings is seen as essential to the vitality of the microfinance industry, both in terms of the potential of providing MFIs with the lowest cost and most stable funding possible,²⁷ as well as providing the service of savings to clients, a service thought to be equally if not more beneficial than credit.²⁸ Despite the desirability of deposits as a source of funding, administrative difficulties have caused uneven success rates in MFIs' efforts in deposit-taking. This is further complicated by legal regimes that prohibit certain MFIs from taking deposits. Finally, larger MFIs engaged successfully in deposit-taking will continue to require significant funds for liquidity and interest rate risk management.²⁹ Outside financing in the form of debt and equity investment will thus continue to prove a vital source of funds for MFIs.

²⁶ *Optimizing Capital Supply*, *supra* note 1 at 3

²⁷ Marc de Sousa-Shields & Brad King, *MFI Financing Strategies and the Transition to Private Capital*, US Agency for International Development, MicroReport #32, pg. 1

²⁸ *Savings are as Important as Credit: Deposit Services for the Poor*, Consultative Group to Assist the Poor (CGAP), Donor Brief No. 4, June 2002, pg. 1

²⁹ de Sousa-Shields and King, *supra* note 27 at 2

Excluding deposits, foreign investment comprises roughly 43% of total investment in microfinance worldwide.³⁰ In terms of the overall amount of foreign investment in microfinance, private investment from MIVs accounts for nearly half of the \$4 billion dollars currently invested. The majority of foreign investment currently comes from the MIV funds as well as the IFIs, having invested \$2 billion and \$2.3 billion by the end of 2006, respectively.³¹ This breakdown is somewhat misleading, however, due to the fact that about 36% of investment in MIVs currently comes from IFIs, thus blurring the distinction between private and public funding.³²

3. The Growth of Private Investment

Private investment in microfinance began during the early 1990s and has been growing by annual rates of about 50% since 2000 to reach its current volume of \$2 billion.³³ In the period between January and October of 2007 alone, private investment completed 355 transactions in debt investment, totaling an investment of \$462 million, as well as 40 transactions in equity totaling an investment of \$96 million.³⁴ The growth of investment activity on the part of MIVs illustrates that private investment is poised to overtake public investment as the major foreign source of funding of microfinance. This would be a significant development as public investment, largely from IFIs, was the only source of foreign funding up until the 1990s.

Signaling a change in the nature of the industry, the investment capacity of international private capital has begun to demonstrate its potential as MIV investment

³⁰ *Optimizing Capital Supply*, *supra* note 1 at 3

³¹ Reille & Sananikone, *supra* note 12 at 1

³² Ivatury & Abrams, *supra* note 20 at 4

³³ *Managing Commercial Microfinance*, *supra* note X at 2;

³⁴ *Microfinance Capital Markets Update*, Consultative Group to Assist the Poor (CGAP), No. 21, October 2007, pg. 2

has, in recent years, increased faster than investment from IFIs. While microfinance investment among the IFIs more than doubled from \$1 billion in 2004 to \$2.3 billion in 2006, MIV investment more than tripled during the same period, from \$600 million in 2004 to \$2 billion in 2006.³⁵ About 40 new MIVs were set up over the last three years, bringing the number of MIVs from around 45 in 2005 to 85 in 2007.³⁶

While new MIVs are increasingly being established, existing MIVs have also been growing their investment activities. A 2006 study of 54 MIVs found that total assets increased from just under \$1 billion in 2004 to \$1.45 billion in 2006, an increase of 47%. Investments increased 91%, from \$514 million in 2004 to \$981 million in 2006. 35 of the 54 MIVs in the study were founded after 2000, suggesting that only around 20 MIVs were in existence in 2000, compared to the 85 operating in 2007.³⁷ The above figures indicate that, of the \$2 billion dollars that the 85 MIVs have invested in microfinance, an overwhelming majority of this investment has emerged over the last 10 years, while nearly half of existing MIVs and about 70% of current MIV investment have been added over the last three years alone. This growth suggests a rapidly increasing supply of capital that will be at the disposal of MFIs as long as there is sufficient demand to absorb the funds. Indeed, Deutsche Bank has predicted that by the year 2015, investment will increase tenfold, from the 2006 estimate of \$2 billion to \$20 billion.³⁸

³⁵ Reille & Sananikone, *supra* note 12 at 1

³⁶ *Id.* at 1; Julie Abrams & Damian von Stauffenberg, *Role Reversal: Are Public Development Institutions Crowding Out Private Investment in Microfinance?*, MicroRate, MFInsights February 2007, pg. 4

³⁷ *Microfinance Investment Vehicles: An Emerging Asset Class*, MicroRate, MFInsights, November 2006, pg. 4

³⁸ *Microfinance Industry Potential*, *supra* note 6

4. Investors in Microfinance Investment Vehicles (MIVs)

Investors in microfinance funds constitute a diverse group with varied profit orientations. As MIVs attempt to invest not only in mature and profitable MFIs but also start-ups and those undergoing transformation from unregulated nonprofit organizations to regulated profit-seeking banks, there is also a wide range in risk and profitability of potential investments. The nature of investment is generally split into the categories of (1) fully commercial, (2) blended value, (3) preservation of capital, and (4) grants.³⁹ Fully commercial investment in microfinance, which seeks market based, risk-adjusted returns, is typically engaged in by commercial banks, institutional investors including pension funds, private equity firms, and venture capital firms. Blended value investment, which seeks commercial or near-commercial gains, while simultaneously seeking a substantial social return on investment, is undertaken by funds of institutional investors earmarked for “socially responsible investment,” high net-worth individuals, and corporate social responsibility initiatives of commercial banks. Preservation of capital investment does not necessarily seek financial returns, and is typically engaged in by foundations and IFIs, which also devote funding in the form of grants where no financial return is expected.

While investment in MIVs initially came primarily from socially responsible investors and IFIs, private capital has shown an increased interest. A recent example of the growing commercial investment is the \$43 million equity investment by TIAA-CREF, a major US pension fund, in ProCredit Holding AG, the world’s largest MIV.⁴⁰

³⁹ *Optimizing Capital Supply*, supra note 8 at 3; *Blended Value Investing*, supra note 8 at YY; *Blended Value Investing*, supra note 8 at 5

⁴⁰ Reille & Sananikone, supra note 12 at 1

While this example of engagement from the traditional capital markets is promising, purely commercial investment from mainstream, institutional investors such as pension funds still comprises only 17% of investment in MIVs, with 47% of funding coming from socially responsible investors, high net-worth individuals and foundations, and 36% coming from the IFIs. The current figure of IFI investment accounting for 36% of investment in MIVs demonstrates MIVs' increasing ability to attract non-public investment, as IFIs were estimated to have contributed about 70% of investment in MIVs in 2004.⁴¹

5. Where Private Microfinance Funds are Invested

As private investment in microfinance has emerged, it has been driven by the investment potential of the leading MFIs in those regions of the world where the microfinance industry is most developed. This has meant concentration among investment both in the top MFIs and in those regions exhibiting the most vibrant microfinance sectors. In total, about 450 to 500 MFIs receive investment from the MIVs. However, just ten MFIs located in Latin America and Eastern Europe and Central Asia currently absorb 26% of all MIV investment. In general, MIVs, as well as IFIs, have heavily concentrated their investment on the top 50 MFIs.⁴² These MFIs are licensed and regulated by local banking authorities and 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 have gone above and beyond the majority of MFIs in terms of scale and profitability, however investment interest in “tier 2” and “tier 3” MFIs has been growing as investors become more familiar

⁴¹ Ivatury & Abrams, *supra* note 20 at 3

⁴² Reddy, *supra* note 19 at 3

with microfinance and are able to pursue profitable investments in a broader class of institutions.

There has also been discussion among practitioners that IFIs and government development banks are crowding out private investment by continuing to invest in the most successful MFIs, and should instead focus on funding the “next generation” of smaller but up-and-coming MFIs in order to help them join the “tier 1”⁴³ institutions.⁴⁴ This is not altogether surprising since most of the “tier 1” MFIs invested in by IFIs were relatively young and small institutions when IFI investment began, and indeed it was this investment that helped them grow into “tier 1” MFIs. Thus it may be unrealistic to expect that IFIs immediately exit their investments in these newly-flourishing MFIs and start anew with investments in the “next generation.” Nonetheless, as awareness of this issue deepens within the industry, IFIs and development agencies can be expected eventually to deploy their relatively more risk-tolerant capital in those smaller and growing MFIs most in need of risk capital, thus opening opportunity for private investment, in a transition that should be influential in increasing the amount of mature and efficient MFIs able to serve a large client-base and to do so profitably. The amount of investible MFIs that can effectively absorb and produce a return on private funding – still a small, albeit growing percentage among the total 10,000 in operation – is decisive in determining the amount of capital that investors are able to commit toward microfinance, and is further discussed in Part I, Section 2 of this paper.

⁴³ “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 Part I, Section 2 of this paper.

⁴⁴ Abrams & von Stauffenberg, *supra* note 36 at 1

Finally, in addition to – and as a result of – concentration among the top MFIs, private investment in microfinance is also concentrated in those regions where the microfinance sector is most developed. To date, 42% of MIV investment occurs in Latin America and the Caribbean, while 39% is allocated to Eastern Europe and Central Asia. This leaves only 20% of investment occurring in East and South Asia as well as Africa, where microfinance development, especially in terms of the proliferation of large MFIs, lags behind that of Latin America and Eastern Europe.⁴⁵ The fact that only 20% of investment currently occurs in East and South Asia and Africa, which contain a vast percentage of the world’s poor especially in countries such as China and India, is indicative of the vast potential for growth in microfinance investment.

6. Investment Instruments of Microfinance Investment Vehicles

In the last several years, innovative investment strategies have emerged in order 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 are offering local currency products, in order to mitigate foreign exchange risk, as well as currency-linked products. This section outlines the various innovations in investment instruments that MIVs have begun to pursue over the last several years.

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 make it possible for local investors or banks to lend to MFIs where they

⁴⁵ Rhyne & Busch, supra note X at 12

might otherwise be unwilling to invest due to the perceived risk. This is accomplished, first, through the issuing, by an international bank, of a stand-by 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 transaction is made complete by the role of the foreign investor, which pledges its own assets to the international bank, should the international bank have to pay in the event that the MFI defaults. Guarantees are most helpful where they cause the investor community to reassess its perception of the risk of MFIs. It has been demonstrated that an MFI's timely repayment on its loans can pave the way for additional transactions wherein it is no longer necessary to provide guarantees, enabling MFIs to broaden their investor base as more investors realize that microfinance investment is not as risky as they initially believed.⁴⁶ A 2006 study found the use of guarantees to be increasing, although interest in these transactions was noted to come more from IFIs and other development agencies.⁴⁷ Indeed, a 2005 study found that IFI investment makes up 90% of the funding directed towards guarantees, with MIVs accounting for the remaining 10%.⁴⁸ Guarantees are useful not only as a way to stimulate domestic markets for investment in microfinance, but also as a way to channel external funds into microfinance where regulations may place a cap on foreign funding.

Private Equity Investment. Private equity investment can be especially useful for start-up MFIs, which, according to their business plans, typically operate at a loss for their first few years and thus are unable to be candidates for debt investment. In addition,

⁴⁶ Didier Thys, *The Scope on Funding Mechanisms*, The MicroBanking Bulletin, Special Issue on Financing, May 2005, pg. 11

⁴⁷ Alexia Latortue, Elizabeth Littlefield, Hannah Siedek, and Katherine McKee, *Managing the Floodgates? Making the Most of the International Flows of Microfinance Funding*, Consultative Group to Assist the Poor (CGAP), 2006, pg. 14

⁴⁸ Ivatury & Abrams, *supra* note 20 at 5

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, was founded in 1995 and, according to its original business plan, exited its investment and distributed profits to its investors in 2005.⁴⁹ The success of ProFund, the only fund of its kind in the mid-1990s, served to stimulate private equity interest in microfinance, as by 2006 there had emerged at least 17 commercially-oriented, equity focused MIVs.⁵⁰ The first half of 2007 saw two major private equity investments that are expected to further this trend. The first of these transactions was conducted by Sequoia Capital – a venture capital company known for its early investments in Google and YouTube – which invested \$11.5 million in the MFI SKS. Two months later, Legatum, a private company which 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 to date.⁵¹

Bond Issues. 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.⁵² MFI bond offerings are not linked directly to any of the MFIs individual loans but are rather structured as obligations of the MFIs themselves, which are then supported by the MFIs' individual loans to their borrowers and the borrower's repayment of interest and principal on the underlying microloans. Through this arrangement, the holder of the bonds takes on the balance sheet risk of the MFI. In the aggregate, MFIs in Latin America had placed over \$100 million in bonds in their local

⁴⁹ *Blended Value Investing*, *supra* note 8 at 45

⁵⁰ DiLeo & FitzHerbert, *supra* note 16 at 18

⁵¹ Gil Crawford & Lauren Clark, *Capital Markets: A Long-Term Solution to Financial Freedom*, Inter-American Development Bank, Microenterprise Development Review, Vol. 10 No. 1, July 2007, pg. 9

⁵² Abrams & von Stauffenberg, *supra* note 36 at 5

capital markets by 2005, and more MFIs in other regions are expected to continue this trend.⁵³ Indeed, microfinance bond offerings have grown from Finamerica's pioneering transaction of \$2 million in 2001, to representative transactions ranging from \$7 million to \$52 million – issued by Colombian MFI Women's World Bank – in 2005.⁵⁴ The success of these transactions have also served to stimulate investment interest from a growing variety of mainstream investors. This trend is exemplified by three bond issues by Peruvian MFI MiBanco, from 2003 to 2004. The first issuing, in September 2002, was facilitated by a 50% guarantee from the development institution USAID. The second issuing, in September 2003 was again guaranteed at 50%, however this time from a regional bank and at a lower rate of interest than the 2002 transaction. In October 2003, MiBanco was able to complete the third offering without a guarantee, as the previous offerings had proven the MFI to be an attractive investment. Furthermore, while investment in the first issuing came predominantly from pension funds, investment in the second and third issues was more evenly distributed among mutual funds, public entities, pension funds, banks and insurance companies.⁵⁵

Securitizations. Securitizations in microfinance have come primarily in the form of international collateralized debt obligations. This is structured through the setting up 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 the several MFIs are then pledged as collateral to investors. The pooling of the underlying loans of a group of MFIs serves to diversify investment and spread risk, and also to increase the

⁵³ María Otero, *A Commercial Future for Microfinance: Opportunities and Challenges*, United Nations Capital Development Fund, Microfinance Matters, Issue 17, October 2005, pg. 26

⁵⁴ Abrams & von Stauffenberg, *supra* note 36 at 5

⁵⁵ Thys, *supra* note 46 at 11

scale of the investment, making these transactions more appealing to many investors as opposed to investing 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 US investment company Developing World Markets and Swiss investment company BlueOrchard. Although microfinance securitization is still in its nascent stage, some groundbreaking transactions have suggested that this trend will increase. Two of the largest transactions to date were completed jointly by international investment bank Morgan Stanley and MIV BlueOrchard Finance, with issues of \$106 million in March of 2006, and \$108 million in May 2007.⁵⁶ The 2007 transaction was rated by Standard & Poor's, and was able to channel funds to 21 MFIs in 13 countries. The countries were Azerbaijan, Bosnia, Cambodia, Colombia, Georgia, Ghana, Kenya, Mongolia, Montenegro, Nicaragua, Peru, Russia and Serbia.⁵⁷ This demonstrates that while the Latin America and Eastern Europe/Central Asia regions continue to be the most developed for microfinance, investors have also found individual developed and investible MFIs in Africa and Southeast Asia. Although large transactions such as these are still not applicable to the majority of MFIs, it is expected that these transactions will become more prevalent as more large-scale MFIs continue to emerge, and as investors continue to pursue innovative transactions that broaden the range of MFI investment options. Indeed, recent securitizations have already demonstrated an ability to move down market from the "tier 1" MFIs and fund smaller MFIs still in their maturing stage.⁵⁸

⁵⁶ Steven Craig, *Morgan Stanley Forms Microfinance Group to Provide Investment Banking Services to Microfinance Institutions*, MicroCapital, September 2007, <http://www.microcapital.org/?p=1342>

⁵⁷ *Morgan Stanley, BlueOrchard in Microfinance ABS*, Reuters, May 4, 2007, <http://africa.reuters.com/business/news/usnBAN423600.html>

⁵⁸ *Blended Value Investing*, *supra note 8* at 20

Initial Public Offerings. IPOs, the first sale of stock by a company to the public, were first seen in the microfinance industry in 2003 when the MFI Bank Rakyat Indonesia listed on the Jakarta, Singapore and other stock exchanges. In 2006, Equity Bank of Kenya listed on the Nairobi Stock Exchange. Finally, in April 2007, Banco Compartamos of Mexico listed on the Mexican Stock Exchange. Proceeds from the Compartamos IPO totaled \$486 million, with purchases coming from 5,920 institutional and retail investors from Mexico, the United States, Europe and South America. Another point of interest in the Compartamos IPO is the fact that it was a secondary offering, meaning that all of the shares were sold by existing investors, many of which wished to exit their investment in the extremely successful MFI and refocus their investments in start-up initiatives.⁵⁹ The ability of these investors to sell their shares demonstrates the increasing liquidity of microfinance assets, as microfinance investment is able to draw interest from an increasingly broad class of private investors. Thus, although Compartamos did not raise any money from this offering, the liquidity of microfinance assets demonstrated by the transaction should increase investor confidence and general interest in investing in microfinance.

While these three MFIs represent industry leaders, practitioners believe that an increasing number of MFIs are exhibiting the scale, growth and profitability sufficient to pursue an IPO.⁶⁰

Syndication. In December 2006, three independent US-based MIVs – MicroVest, The Calvert Social Investment Foundation, and The Dignity Fund – completed a

⁵⁹ Elisabeth Rhyne & Andres Guimon, *The Banco Compartamos Initial Public Offering*, ACCION International, Insight Number 23, June 2007 pg. 1, 5

⁶⁰ Id. at 14

syndicated loan to D-MIRO, an MFI in Ecuador.⁶¹ While syndicated loans are common in mainstream commercial banking, this loan was the first of its kind in the microfinance industry, which until now has been characterized exclusively by bilateral loan transactions. These joint transactions help to save time and expenses for both the MFIs and the MIVs, especially by pooling due diligence and other administrative resources among MIVs, resulting in a lower cost of capital and increased profitability for MFIs.

Mezzanine Funds. In 2005, a group of institutional investors and IFIs founded the Global Commercial Microfinance Consortium. The capital structure of this fund consists of senior debt, sub-debt, equity and grant capital. This structure allows different types of private and public investors to pool their funding and to 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 occupied less risky positions. The fund is managed by Deutsche Bank, and Merrill Lynch is also among the partners. To date, the fund has approved \$80.6 million for investment in MFIs across 21 countries.

C. THE MICROFINANCE INDUSTRY: THE DEMAND FOR PRIVATE CAPITAL

This section examines the diverse array of MFIs that make up the microfinance industry, focusing on the growth of the industry in recent years and the MFIs' increasing demand for private capital to fund their operations. This section begins by looking at the overall worldwide demand for microfinance, and the extent to which the microfinance industry is meeting the potential demand. Next, this section discusses the nature of the

⁶¹ Crawford & Clark, *supra* note 51 at 8

current landscape of MFIs that make up the industry, as well as the growth that the industry has been experiencing over the last several years. Given the nature and growth of the industry, this section will then examine the demand for private investment exhibited thus far by MFIs, as well as how this demand has grown in recent years, and finally how this demand can be expected to increase into the future.

1. Total, 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 500 million families, live on less than \$2 per day purchasing power parity, and that, among those, 1.2 billion people live on less than \$1 per day. Fewer than 18% of these 2.8 billion are estimated to have access to financial services.⁶² In developing countries, microenterprise represents the main source of jobs for poor people. Indeed, microenterprise consists of 80% of total enterprises, 50% of urban enterprises, and 20% of GNP for developing countries worldwide.⁶³

Current estimates of the total working poor in demand of microfinance services typically range from about 1 billion to 1.5 billion people.⁶⁴ Despite the undeniable successes of the microfinance industry, able to extend access to financial services to over 100 million working poor over the last thirty years, the industry still has a long way to go in terms of closing the supply/demand gap. Worldwide penetration rates estimate that, at

⁶² Meehan, *supra* note 5 at 5

⁶³ *Microfinance: The Key to Independence*, ResponsAbility Global Microfinance Fund, ResponsAbility Social Investment Services AG, 2005, pg. 2

⁶⁴ See e.g., DiLeo & FitzHerbert, *supra* note 16 at 12; *Optimizing Capital Supply*, *supra* note 1 at 2

present, microfinance is only reaching around 10% of its potential client base.⁶⁵ The majority of those still not reached by microfinance are located in China, India and Sub-Saharan Africa.⁶⁶ A 2007 study concluded that current penetration rates are no higher than 9% of the poor population for any given region of the world.⁶⁷ These figures demonstrate the tremendous potential for growth in the microfinance industry and with it the potential demand for increased funding from various sources. Practitioners estimate that the total amount of debt/deposit and equity funding necessary to meet the latent demand is \$250 to \$300 billion.⁶⁸ This indicates an enormous unmet financial demand, as today's total existing debt/deposit and equity funding of MFIs is estimated at \$17 billion, only around 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 will continue to grow.⁶⁹

2. The Current Landscape of Microfinance Institutions

The demand for funding among the microfinance industry will depend on the ability of the various MFIs to demonstrate an ability to achieve broad client outreach as well as profitability. It is important to note that the total amount and individual characteristics of MFIs worldwide is difficult to gauge, as results have varied among

⁶⁵ See e.g., *Blended Value Investing*, supra note 5 at 8; DiLeo and FitzHerbert, supra note 16 at 12; *Optimizing Capital Supply*, supra note 1 at 2

⁶⁶ *Optimizing Capital Supply*, supra note 1 at 2

⁶⁷ *Microfinance Industry Potential*, supra note 6

⁶⁸ See e.g., *Players Report 2005: Insights from the Microfinance Private Capital Symposium*, MicroCapital Institute, 2005, pg. 2; *Optimizing Capital Supply*, supra note 8 at 3; *Blended Value Investing*, supra note 5 at 8; Meehan, supra note 5 at 5

⁶⁹ Rhyne & Otero, supra note 13 at 11

studies, owing to the number of MFIs that practitioners are able to survey in-depth in any given study, as well as the fact that the numbers change quickly as the industry continues its rapid growth. That being said, it is estimated that the current landscape of MFIs comprises of about 10,000 institutions,⁷⁰ exhibiting widely varied levels of outreach and profitability. One of the largest studies to date, conducted in 2006 by the Microcredit Summit Campaign, collected data from 3,316 MFIs serving over 133 million clients.⁷¹ The regional distribution of the MFIs in the study consisted of 1,677 MFIs in Asia and the Pacific (51%), 970 in Sub-Saharan Africa (30%), 579 in Latin America & the Caribbean (18%), and 30 in the Middle East and North Africa (1%).⁷² In terms of the scope of MFIs' financial operations, a 2006 study collected data on 704 MFIs, finding these institutions to have a gross loan portfolio of \$24 billion, with combined total assets of \$33 billion. In the course of funding their activities, the 704 MFIs reported that 65%⁷³ of portfolio funding came from commercial sources, up from 40% in 2003.⁷⁴ This indicates a strong demand for private capital, which can be expected to increase as the 20 largest MFIs surveyed have increased their aggregate gross loan portfolios by about 33% per year from 2003 to 2006.⁷⁵

3. Types of Microfinance Institutions

MFIs vary widely in terms of type of institution. The largest MFIs are for-profit institutions, most of which are subject to banking regulations, while the majority of MFIs

⁷⁰ Supra note 5

⁷¹ Sam Daley-Harris, *State of the Microcredit Summit Campaign Report 2007*, Microcredit Summit Campaign, 2007, pg. 2

⁷² Id. at 26

⁷³ *Microfinance Industry Potential*, supra note 6

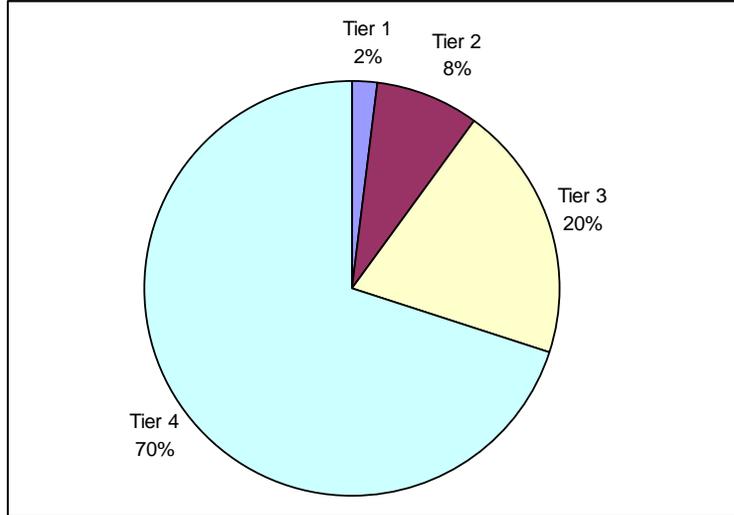
⁷⁴ Blaine Stephens, *Commercialization Continues Apace*, *MicroBanking Buletin*, Issue 14, Spring 2007, pg. 33

⁷⁵ *Microfinance Industry Potential*, supra note 6

are non-profits and NGOs. Many MFIs start as NGOs and, once they have grown sufficiently in terms of scale and operating efficiency, decide to undergo a “transformation” into for-profit corporations, in order to maximize the amount of funding they are able to attract both from domestic savings and outside investment, ultimately in pursuit of reaching the largest number of borrowers possible. There has also been an increase in so-called “Greenfield MFIs,” start-up MFIs founded as for-profit entities from their inception, which attempt to emulate other successful for-profit MFIs by adopting the best practices of that portion of the industry.

One challenge for the success of the microfinance industry and its ability to attract and absorb private investment is the current fragmentation of the industry into various “tiers” of MFIs. A 2004 paper published by Grameen Foundation USA outlined the breakdown of the various tiers and how the distribution can be expected to change in the future, seen below. The industry is clearly led by a small percentage of pioneer institutions that have been able to achieve success above and beyond that of their peers, an important implication for the total investment demand of MFIs, which, as discussed in Part I of this paper, has traditionally been concentrated in “tier 1” and “tier 2” institutions. While the increasing interest and ability of MIVs to move down-market, as discussed above, as well as the consistent growth of the MFI sector and the continued increase in the numbers of MFIs of all tiers, as discussed below, demonstrates the growing investment potential in MFIs, an understanding of the current industry landscape guards against an unrealistic overestimation of that potential.

Breakdown of “Tiers” of MFIs: Grameen Foundation USA, 2004



Source: Grameen Foundation USA, 2004⁷⁶

Tier 1: Mature and best known MFIs with strong financial and operational track record. Most are regulated. 2% of MFIs.

Tier 2: Successful but smaller, younger, MFIs. At/near profitability. Mostly NGOs; considering conversion. Majority will progress up. 8% of MFIs.

Tier 3: Approaching profitability. Understandable shortcomings due to young organization, lack of capital, etc. Nearly all NGOs. Some will progress up. 20% of MFIs.

Tier 4: Mix of unprofitable MFIs: start-ups, post-conflict settings, weak institutions or microfinance is not focus. Some will progress up. 70% of MFIs.

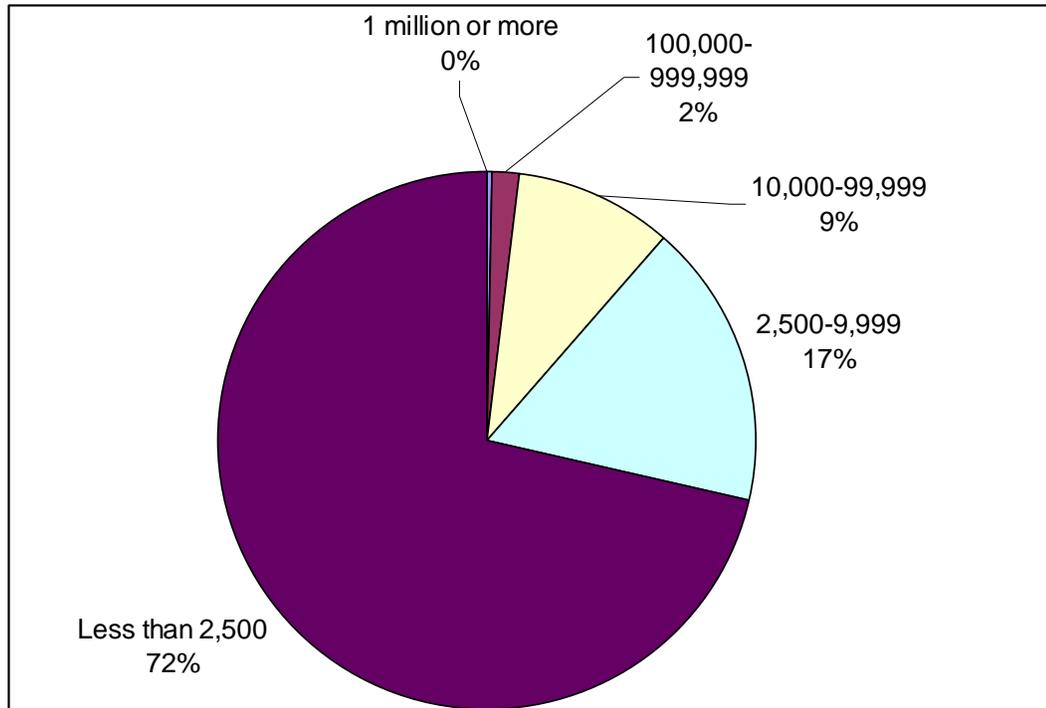
While the Grameen study did not specify the size or amount of borrowers that correspond to each tier, the 2006 Microcredit Summit Campaign study provides a picture of the relative distribution in terms of MFI size.

The study of 3,316 MFIs found 7 MFIs with 1 million or more borrowers, 54 MFIs with 100,000-999,999 borrowers, 313 MFIs with 10,000-99,999 borrowers, 572 MFIs with 2,500-9,999 borrowers, and 2,364 MFIs with less than 2,500 borrowers.⁷⁷

⁷⁶ Meehan, supra note 5 at 7

⁷⁷ Daley-Harris, supra note 71 at 24

Breakdown of 3,316 MFIs by Amount of Borrowers
Microcredit Summit Campaign, 2007



Source: Microcredit Summit Campaign, 2007⁷⁸

4. The Funding of Microfinance Institutions

For MFIs of all types and tiers, a major challenge in progressing up the ladder is funding. To date, total debt/deposit and equity funding of MFIs is estimated at \$17 billion, with \$13 billion coming from domestic sources (about \$8 billion of which comes from deposits), and \$4 billion coming from foreign investment, which is split roughly evenly between public investment from IFIs and private investment from MIVs.⁷⁹ As mentioned above, around 450 to 500 MFIs receive private funding from MIVs, indicating that only “tier 1” and “tier 2” MFIs have demonstrated the ability to attract and absorb

⁷⁸ Id.

⁷⁹ *Optimizing Capital Supply*, *supra* note 1 at 3

private funding.⁸⁰ Among these MFIs, private capital accounts for about 65% of portfolio funding,⁸¹ demonstrating the extent to which the demand for private capital will increase as a growing number of MFIs progress to “tier 1” and “tier 2” status.

5. Growth of Microfinance Institutions

Over the last several years microfinance has made great strides in closing the immense supply/demand gap. Indeed, microfinance institutions continue to grow, both in terms of the scale of individual institutions as well as the number of institutions of all sizes, in all regions of the developing world.⁸² According to the Microcredit Summit Campaign, MFIs served only 13.5 million clients worldwide as of 1997,⁸³ compared to 133 million clients by the end of 2006,⁸⁴ growing in client outreach at 25 to 30% annually. A 2006 study of 200 MFIs, representing 21 million borrowers in 75 countries, reported median growth rates, in amount of borrowers, of 25% annually, while the fastest growing MFIs added new borrowers at 40% annually. Among MFIs undergoing transformation from NGOs to for-profit institutions, MFIs in all countries aside from Uganda were able to add borrowers at a rapid pace as a result of transformation. Excluding Ugandan MFIs, client outreach in transforming MFIs increased by an average annual rate of 70%. Finally, the median Greenfield MFI added 50% more clients.⁸⁵

⁸⁰ Reddy, *supra* note 19 at 3

⁸¹ *Microfinance Industry Potential*, *supra* note 6

⁸² Rhyne & Bush, *supra* note 10 at 13

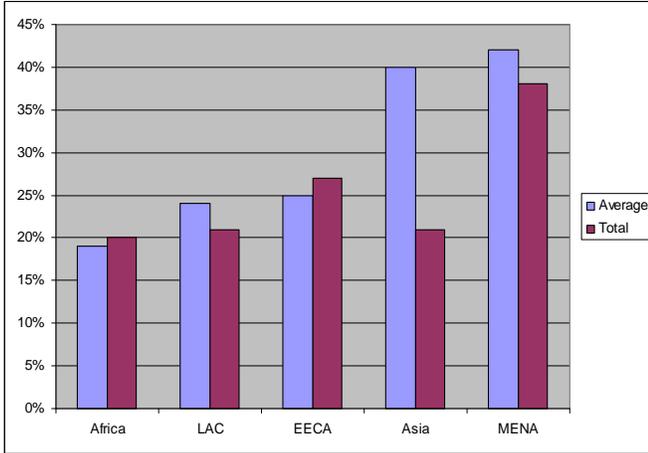
⁸³ DiLeo & FitzHerbert, *supra* note 16 at 11

⁸⁴ Daley-Harris, *supra* note 71 at 20

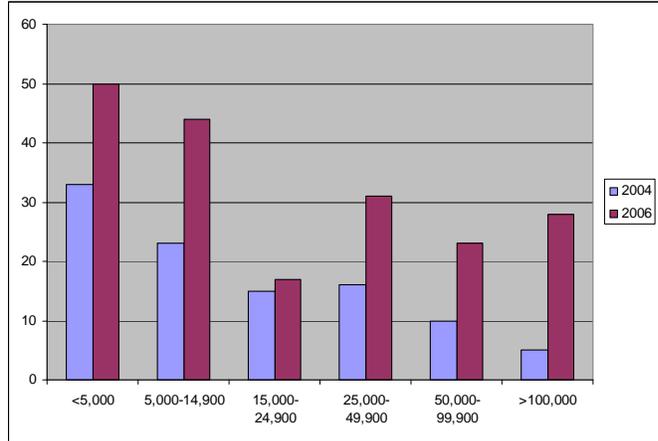
⁸⁵ Stephens, *supra* note 74 at 32

Indicators of Recent Growth of Microfinance

Growth in Clients Served 2004-2005



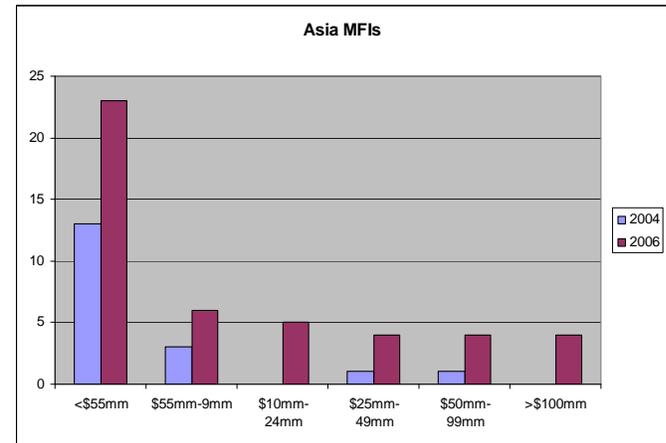
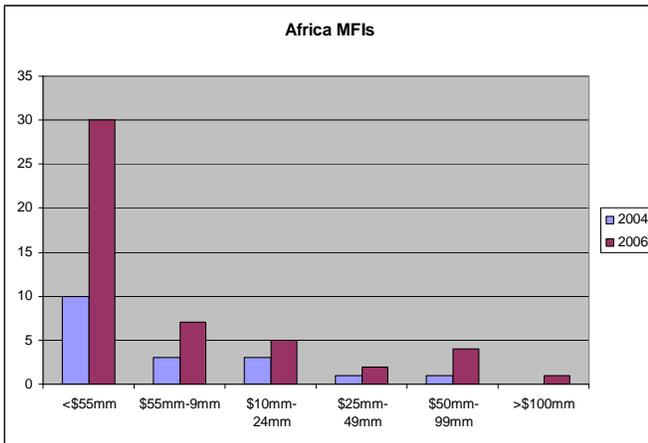
MFI Growth by Clients Served



Source: *MicroBanking Bulletin*, 2006⁸⁶
2006⁸⁷

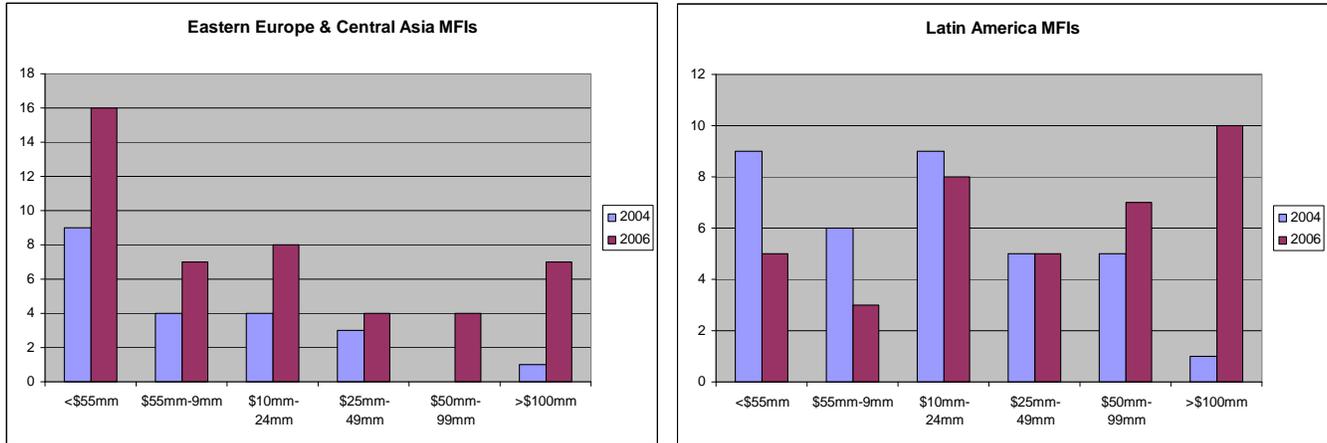
Source: *Council of Microfinance Equity Funds*,

Growth in Number of MFIs by Portfolio Size: 4 Regions



⁸⁶ Id.

⁸⁷ Rhyne & Bush, *supra* note 10 at 11.



Source: Council of Microfinance Equity Funds⁸⁸

6. Trends Driving Industry Growth

As the amount of MFIs as well as the total outreach increase, the industry continues to show improvements in various respects. These improvements serve to accelerate industry growth.

Efficiency. 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. 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 2007.⁸⁹

Break-Even Rates. Building on best practices pioneered by successful MFIs, the “new generation” of MFIs established in the last several years has been able to achieve profitability at increasingly faster rates. A 2005 study of 60 MFIs found that those MFIs founded in the late 1990s took an average of 4 years to reach profitability, compared to 9

⁸⁸ Id. at 13

⁸⁹ DiLeo & FitzHerbert, *supra* note 16 at 5

years among MFIs founded in the early 1990s, and 13 years for MFIs founded in the 1980s.⁹⁰

Leverage Ratios. Mature MFIs operating in relatively well-functioning domestic markets have been able to attract funding from various sources, increasing their financial leverage by substituting subsidized funding with savings and commercial debt. Median debt/equity ratios of MFIs were estimated to have increased from 1.1 in 1999 to 1.9 in 2004.⁹¹

These improvements in operations enabled leading MFIs in countries such as Bolivia, Cambodia, Peru, Kenya and Uganda to become more profitable than mainstream commercial banks in their respective countries.⁹² In countries where microfinance is most developed, various “enablers” of the industry – such as credit bureaus and rating agencies, venture capital firms, research and training organizations, and technology providers all focused on microfinance – are emerging, creating what has been called an “ecosystem” around microfinance.⁹³

7. MFI Demand for Private Investment

Of the approximately 10,000 MFIs in operation worldwide, it is estimated that around 1,000 of these are profitable.⁹⁴ Of these institutions, only around 450 to 500 receive private investment from MIVs.⁹⁵ A 2006 study found there to be 222 regulated, commercial and shareholder-owned MFIs worldwide, as compared to 124 such

⁹⁰ *Optimizing Capital Supply, supra note 1* at 6

⁹¹ *Id.* at 5

⁹² *Id.*

⁹³ *Id.* at 7

⁹⁴ *Blended Value Investing, supra note 8* at 62

⁹⁵ Reddy, *supra note 19* at 3

institutions in 2004. While the amount of commercial MFIs have increased in all regions, the largest increases occurred in Asia, Eastern Europe and Africa.⁹⁶ 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. The study found that the number of MFIs with over 100,000 borrowers increased from 5 in 2004 to 20 in 2006, while the number of MFIs with loan portfolios of more than \$100 million increased from four in 2004 to 20 in 2006, with 6 MFIs appearing on both lists. Large institutions were identified in all regions of the developing world, although no MFI in Eastern Europe has reached over 100,000 borrowers. Among the 20 MFIs reaching over 100,000 clients, 10 were located in Asia, while 6 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.⁹⁷

Study of 199 Commercial MFIs in 2006 Compared to 92 MFIs in 2004				
	2004	2006	Increase	% Change
# Commercial MFIs	92	199	107	116%
Clients	2.9mm	11.5mm	8.6mm	296%
Loan Portfolio	\$1.6bb	\$8.7bb	\$7.1bb	463%
Assets	\$2.5bb	\$13.8bb	\$11.3bb	454%
Equity	\$363mm	\$1.6bb	\$1.2bb	326%

Source: Council of Microfinance Equity Funds⁹⁸

⁹⁶ DiLeo & FitzHerbert, supra note 16 at 14

⁹⁷ Rhyne & Bush, supra note 10 at 11

⁹⁸ Id. at 10

In addition to having grown in numbers, for-profit MFIs themselves have become increasingly profitable over the last several years, with median returns on equity rising from 14.3 in 2000 to 23.1 in 2005.⁹⁹ A study of 71 commercial MFIs found that in the two years from 2004 and 2006, total assets tripled, borrowers increased by 73%, and a total of \$435 million was added to total equity.¹⁰⁰ Lending portfolios have also increased among mature MFIs, by around 35% annually since 2001.¹⁰¹

8. Projections for Growth

The growing amount of profitable MFIs have in turn exhibited a growing appetite for private capital. In 2006, mature MFIs sourced 65% of their loan portfolios from commercial funds,¹⁰² up from 40% in 2003.¹⁰³ As new MFIs are created and progress up the ladder to become profitable and investible institutions, and as the industry continues to undergo improvements in efficiency, leverage, and enabling environments, the increase in the ability to attract and absorb private capital can be expected to continue.

Within the next five years, it has been estimated that commercial MFIs will reach \$36 billion in outstanding loans to 23 million clients worldwide, which would require total assets of over \$45 billion and nearly \$5 billion in total equity.¹⁰⁴

Over the next ten years, it has been estimated that the microfinance industry will grow at around ten-fold, serving more than 500 million clients and with total assets of \$200 to \$300 billion, requiring equity finances of \$25 to \$30 billion.¹⁰⁵

⁹⁹ Id. at 28

¹⁰⁰ Rhyne & Bush, *supra* note 10 at 6

¹⁰¹ Abrams & von Stauffenberg, *supra* note 36 at 4; *Microfinance Industry Potential*, *supra* note 17

¹⁰² *Microfinance Industry Potential*, *supra* note 6

¹⁰³ Stephens, *supra* note 74 at 33

¹⁰⁴ Rhyne & Bush, *supra* note 10 at 14

Finally, it has been estimated by the Small Enterprise Education and Promotion (SEEP) Network that, during the next several years, the absorptive capacity of the microfinance sector will exceed the available supply of commercial funding (predicted to occur in the early 2010s), eventually increasing in ability to attract and deploy funds to the point where capacity will be sufficient to meet the overall global demand for microfinance services (1 to 1.5 billion people) by 2030.¹⁰⁶ While SEEP's prediction is based on the above-mentioned successes of the microfinance industry to grow and innovate, others point to the still-low percentage of "tier 1" institutions as compared to the industry as a whole, and conclude that this will limit the demand for private investment, keeping it below the supply from investors.

D. CONCLUSION: ASSESSMENT OF PRIVATE INVESTMENT SUPPLY AND DEMAND

A summary of the numbers behind the supply and demand for microfinance investment, as discussed above, indicates that both the supply and demand have been growing at tremendous rates in recent years. As MFIs continue to emerge and improve their operations, private investors of different types have become increasingly interested in the opportunities that these MFIs offer. While it is difficult to estimate whether the supply of capital that private investors are ready to put towards microfinance, or the demand from MFIs that can attract and absorb this capital, it is of note that practitioners have estimated ten-fold growth both in terms of the supply of private capital, and in terms of the microfinance industry, over the next 10 years.

¹⁰⁵ DiLeo & FitzHerbert, *supra* note 16 at 14

¹⁰⁶ *Optimizing Capital Supply*, *supra* note 1 at 4

Growth: Supply of Private Capital				
Growth of Investment	Aggregate Investment		Amount of MIVs	
50% growth since 2000	<u>2004</u>	<u>2006</u>	<u>2000</u>	<u>2007</u>
	\$600mm	\$2bb	20	85
Projection: Ten-fold growth over next 10 years				

Growth: Demand for Private Capital					
% Growth in Clients	Total Clients		Amount of Commercial MFIs		
27% growth since 1997	<u>1997</u>	<u>2006</u>	<u>2004</u>	<u>2006</u>	
	13.5mm	133mm	124	222	
Commercial Funding as % of Loan Portfolio	MFIs with 100,000+ borrowers		MFIs with \$100m+ Loan Portfolio		
<u>2003</u>	<u>2006</u>	<u>2004</u>	<u>2006</u>	<u>2004</u>	<u>2006</u>
40%	65%	5	20	4	20
Projection: Ten-fold growth over next 10 years					

III. REGULATORY CHALLENGES TO PRIVATE SECTOR INVESTMENT IN MICROFINANCE

A. INTRODUCTION: THE IMPORTANCE OF REGULATION AND THE IDEAL REGULATORY ENVIRONMENT

This section discusses how different legal and regulatory regimes can affect the microfinance industry, and thus impact the level of private investment in microfinance that is feasible for any given country. The previous sections of this paper have demonstrated the growing interest among increasing types of mainstream investors to invest in those MFIs that have been able to reach profitability through efficient management and scale. It was also observed that, while private investors are increasingly pursuing innovative transactions that channel funds to smaller, younger and lower tiered MFIs, it has been the large and mature MFIs that, apart from providing valuable financial services to tens of thousands of microentrepreneurs, have offered the most promising and desirable investments. According to a study published by the Grameen Bank, the most important constraint to growth among MFIs, after the ability to obtain financing, is the regulatory environment in which MFIs operate, as each country's legal regime has a direct impact on the ability of domestic MFIs to pursue growth and sustainability strategies, and to obtain access to capital from various sources.¹⁰⁷ Another study, issued by the Consultative Group to Assist the Poor (CGAP) and the World Bank agreed that the

¹⁰⁷ Meehan, *supra* note 5 at 11

microfinance industry in a given country cannot reach its full potential until MFIs are regulated and supervised in a coherent and prudent manner.¹⁰⁸

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, thus making it harder or easier for large-scale, mature and “investible” MFIs to emerge, or increasing the likelihood that lower tier MFIs, given capital infusions from various sources of funding such as private investment, will be able to successfully grow into “tier 1” institutions. Legal regimes also affect the attractiveness of investment in MFIs where limits can be placed on the extent to which investors, and in certain cases foreign investors, can make investments in MFIs.

Below, this section discusses the regulatory environments in Brazil, China and India, all of which are large-population countries in which the microfinance sector still exhibits a relatively low penetration rate among each country’s large population of working poor.

Significant demand for microfinance services exists within each country. Demand as a percentage of national population is estimated at 8% in Brazil, 30% in China, and 25% in India, while the percentage of demand that remains unmet in each country is estimated at 93% in Brazil, 77% in China, and 70% in India. These and other figures are discussed in further detail in each respective country study below.

¹⁰⁸ Robert Peck Christen, Timothy R. Lyman & Richard Rosenberg, *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance*, CGAP / The World Bank Group, July 2003, pg. 26

The large supply-demand gap in these countries, in terms of microentrepreneurs reached by the microfinance sector in comparison to the total potential demand for microfinance services, suggests a tremendous potential for growth of the microfinance industry in these countries, which would also grow the potential for private investment as an increasing amount of strong MFIs emerge. 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 will pose a challenge to the industry in achieving growth and sustainability.

1. Important Regulatory Issues

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 (1) minimizing risk and (2) facilitating the transaction of business. These two goals can be but are not always in conflict. At one end of the spectrum, when there is very little regulation, risk is high due to insufficient barriers to entry into the market and inadequate supervision of market participants. This regulatory environment will stifle any significant growth and development of the financial sector because experienced investors and entrepreneurs will refrain from transacting business as it will be seen as too risky. In this situation, the goal of risk minimization and facilitating transactions are in concord, and thus additional regulation will further both goals. On the other end of the spectrum, when there is very heavy regulation, although risk is low, investors and entrepreneurs will find it extremely difficult to cover the cost of compliance with the regulation (especially if these costs include foregone earnings from prohibited business activities) and may not be able to sustain business.

Microfinance regulators thus face the challenge of finding an appropriate balance that minimizes the risk both to providers and consumers of microfinance services while at the same time tempering regulatory intervention such that providers have the ability and incentive to sustain and grow their business operations. Only when an adequate balance is achieved can a proper enabling environment for microfinance be established, thereby making it possible for a vibrant and robust microfinance sector – and with it a proliferation of large and investible MFIs – to develop.

With the above goals in mind, the following country studies will assess the extent to which each country’s regulatory regime facilitates or impairs the growth and development of the microfinance sector. The discussion will focus on some of the most important and challenging aspects of microfinance regulation, including the issues of legal status, state subsidies, source of funds, restrictions on the provision of financial services, prudential requirements, and interest rate controls. Before turning to the country studies, a summary of some of the concerns and trade-offs inherent in these regulatory issues are summarized immediately below. Reference will be made to international best practices in microfinance as outlined by a paper issued jointly by the Consultative Group to Assist the Poor (CGAP) and the World Bank, which distills a “general agreement among most of the specialists with wide knowledge of past experience and current developments in microfinance regulation.”¹⁰⁹ As indicated above, the ideal regulatory regime for microfinance to flourish is neither one of unfettered, laissez-faire deregulation, nor is it one marked by heavy government regulation and involvement. Rather, attaining the ideal legal environment requires regulators to pursue a

¹⁰⁹ Christen, supra note 108 at 5

prudent balance, tailored to domestic conditions, that reduces risk to an acceptable level while providing the incentives for healthy amounts of investment and innovation.

Legal Status

Legal status for MFIs, and with it, a clear path for organizational registration and legal authority to conduct operations, is perhaps the cornerstone of a clear and enabling legal and regulatory environment. The fact an MFI operates under legal status also gives private investors more confidence in an MFI and its stability given that it completed a registration process and thus operates under the sanction and protection of the legal system. Legal status thus provides certainty for microfinance entrepreneurs and confidence for their investors, while also introducing oversight and supervision which minimizes risk. The requirement that MFIs report to a supervisory authority will serve to make investors more comfortable as they will know that individual MFIs must meet minimum, ongoing standards that are applied to the sector as a whole. These requirements can often be beneficial for MFIs, while if they are excessive they can be detrimental.

State Subsidies

The emergence and the initial development of the microfinance sector has traditionally been funded by public sources. In the long-term, however, a persistence of public funds can provide counterincentives for the innovation and improvements in operations that lead to growth, sustainability and profitability. Thus, while government has an essential role to play as an enabler of the microfinance sector, heavy government

involvement as a provider in the market for microfinance services has been generally warned against within circles of international advocates of best practices in microfinance.

Source of Funds

Given the small loan sizes, the amount of work done in rural areas, and the more “hands-on” approach with clients, high transaction costs are inherent to microfinance. For this reason it is vital that MFIs be able to access a diverse source of funds in order to sustain and grow their operations. Because microfinance has not yet become a particularly attractive investment to domestic investors in many countries, international debt and equity investment – mostly from MIVs and other socially-motivated investors – provides a much-needed outlet for vital capital infusions. Despite this, many countries place restrictions as to the amount of debt and equity investment that MFIs may take on from international sources. These rules serve legitimate objectives, such as ensuring that shareholders will have the financial capacity and the direct interest to supply additional funds when necessary, as well as building checks and balances into governance and preventing bank “capture” by single owners or groups.¹¹⁰ Practitioners recognize the challenge in achieving a balance between protecting MFIs and facilitating access to funding, and there seems to be no easy or universal prescription on how to strike this balance. Indeed, one suggested solution has been to permit regulatory agencies the discretion to consider the particular characteristics of individual MFIs and their proposed investors, and to waive the external commercial borrowing requirements on a case by case basis.¹¹¹ This solution may be very difficult to administer however, and thus any

¹¹⁰ Id. at 24

¹¹¹ Id.

initiative to regulate MFIs' sources of funds must keep in mind the importance of these funds for the viability of individual MFIs and of the sector as a whole.

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 the prospects of attaining profitability for MFIs. While the microfinance industry initially began with the provision of microcredit, or loans, the largest and most successful MFIs have expanded their services to include such useful financial products as savings and insurance, while loans have evolved from the original working capital loans for microenterprise, to larger sums for housing and even education loans. Apart from widening clients' access to this diverse range of financial services commonly taken for granted by those that do enjoy access, these services can be essential to the business model and to the growth and development of the MFIs themselves.

Perhaps the most important and challenging aspect of this issue is the ability of MFIs to take deposits from (or provide savings to) their clients. When done successfully, deposit-taking provides poor microentrepreneurs with an essential service thought to be equally important and beneficial, if not more so, than lending. However, when done unsuccessfully, deposit-taking subjects the money – and thus the livelihood – of an already disadvantaged and vulnerable population to an unacceptable level of risk. Given this, international best practices recommend that not all MFIs should be permitted to take deposits, rather the ability to take deposits should only be allowed for those that can

demonstrate the capacity to do so.¹¹² This means that an MFI must meet some requirements that indicate an ability to manage its lending profitably enough so that it can cover its costs, including the additional financial and administrative costs of taking deposits. In addition, regulators must ensure that an MFI's account and loan tracking systems are reliable.

Prudential Requirements

Prudential requirements such as capital adequacy requirements serve the dual purposes of (1) protecting the financial system as a whole as well as (2) protecting the safety of the savings that individual customers deposit with the financial institution. Practitioners believe that while the first goal – the prevention of runs on deposits resulting from the insolvency of one large institution and the resulting erosion of public confidence in the financial system – 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 in terms of individual and aggregate levels.¹¹³ Even where microfinance reaches hundreds of thousands of clients, the sector will seldom account for a large enough portion of financial assets for it pose any serious risk to a country's overall banking and payments system. Thus, while it is certainly possible that the failure of an MFI with a large number of customers could be contagious for other customers, it is assumed that the main rationale of prudential regulation for MFIs is to protect client savings.¹¹⁴

¹¹² Id. at 31

¹¹³ Id. at 7

¹¹⁴ Id.

As mentioned above, ensuring the safety of deposits is especially important for microfinance, as clients represent vulnerable and disadvantaged populations and are certainly not well-positioned to assess an MFI's soundness before deciding to take part in their services. Given the above, international best practices call for prudential regulation on those MFIs that take deposits. Conversely, international best practices maintain that, these regulations are not necessary and thus unduly burdensome for those MFIs that do not engage in deposit-taking.¹¹⁵ Because they do not place clients' savings at risk, MFIs that do not take deposits should generally not be required to adhere to capital adequacy requirements, rather these institutions should be allowed greater flexibility to put their capital to productive uses in pursuit of sustainability and growth.

Given the importance of capital adequacy requirements for deposit-taking MFIs, a further issue is the extent of these requirements. International best practices recommend that capital adequacy requirements for deposit-taking MFIs should be stricter than those applied to traditional commercial banks.¹¹⁶ This is because MFI's exhibit greater portfolio volatility and can be harder to manage in comparison to large commercial banks. Relatively more pronounced portfolio volatility tends to exist among MFIs because loans are often unsecured or secured by assets that are insufficient to cover the loan plus the costs of collection. In addition, comparatively higher interest rates among MFIs means that a given level of loan delinquency will deplete an MFI's capital more quickly than it would for a commercial bank. Finally, loan delinquency among MFI clients can diminish other clients' perceptions of the MFI's ability to make further loans, introducing increased potential for outbreaks of delinquency. MFIs can also be harder to

¹¹⁵ Id. at 8, 30

¹¹⁶ Id. at 21

manage than commercial banks since microfinance is a newer industry and most MFIs are young organizations. Management and staff thus tend to be relatively inexperienced, and this factor in combination with the fast growth that many MFIs experience can offer substantial challenges for managers. For the above reasons, best practices favor higher capital adequacy requirements for MFIs in comparison to commercial banks, at least until a few years of historical performance can demonstrate that MFIs can adequately manage the risks and challenges confronted by the industry.

While this level of regulation has the effect of reducing the return on equity and conferring a competitive advantage upon commercial banks, it is assumed that much of the loss in potential profits can be recovered by charging higher interest rates, as demand in the microfinance sector – compared to the traditional banking sector – is less sensitive to interest rates.

A further issue regarding capital requirements is the minimum capital requirement for MFIs. Practitioners have noted that minimum capital requirements are decreasingly seen as a safety measure and are principally thought of as a way to ration the number of financial institutions that are able to enter the market and that the regulatory authorities must supervise.¹¹⁷ As regulatory agencies have limited resources, barriers to entry such as this serve the legitimate goal of preventing regulators from becoming overwhelmed by the presence of more new institutions that they are able to supervise effectively. On the other hand, regulators should exercise caution in not setting minimum capital requirements so high that they will deter too large a number of the type of socially-motivated investors that are willing and able to finance MFIs.

¹¹⁷ Id. at 19

Interest Rate Controls

Interest rate levels charged by microfinance institutions is a complicated issue in that it presents a confrontation between the dual nonprofit and for-profit aspects that make up microfinance. While higher interest rates raise the cost of capital for the clients – the very members of the working poor that microfinance was created in order to enable and empower – it is also recognized that MFIs take on high costs of operation relative to small loan sizes, and charging interest is crucial in order to cover costs and achieve sustainability and profitability, thereby enabling MFIs to broaden the number of clients that they are able to serve.¹¹⁸ Because administrative costs for microfinance are much higher than those of traditional commercial banks MFIs, cannot afford to provide microloans unless they are able to charge comparatively high interest rates.

Despite these concerns, microfinance interest rates can easily become a target among politicians eager to be viewed as championing the cause of the poor, thus subjecting interest rates – and with them, local MFIs’ abilities to pursue flexible strategies in achieving sustainability – to the whims of the political system. Indeed, neither state legislatures nor the general public tend to understand the above dynamic, and thus some have expressed disapproval with MFI interest rates even in instances where rates reflect neither inefficiency nor excessive profits. This being the case, if the government undertakes to set limits on MFI interest rates, political forces will make it extremely difficult to set rate caps at levels high enough to permit MFIs to cover costs and pursue growth. Practitioners therefore generally agree that interest rate caps almost

¹¹⁸ Kate Druschel, *The Ultimate Balancing Act: Investor Confidence and Regulatory Considerations for Microfinance*, MicroReport #28 [hereinafter “*Investor Confidence and Regulatory Considerations*”, US Agency for International Development, July 2005, pg. 24

always hurt the poor, through limiting access to financial services, far more than they help the poor by lowering rates.¹¹⁹ Finally, some legislatures have introduced interest rate controls in response to abusive lending and loan collection practices on the part of individual or groups of MFIs. An important overlapping concern is the over-indebtedness of microfinance clients that can result from lenders that make loans without sufficiently investigating borrowers' repayment capacity, which can lead to or exacerbate abusive collection practices. While microfinance clients must certainly be protected from such practices, interest rate controls, especially given their importance to the viability of the sector, seem to be an unwise and counterproductive means of carrying out such protection.

2. Prudent Regulation: Striking a Balance between Protection and Access

In summary, the regulations outlined above and to be examined as they apply to the countries discussed below all serve legitimate goals in protecting both MFIs and their clients. Thus the purpose of this study is not to offer a general call for deregulation, but rather to examine the intricate effects of individual regulatory environments on the microfinance sector as a whole, and to underscore the importance of seeking a prudent balance between risk minimization and the facilitation of business operations, a balance which when struck properly provides an enabling environment that will make possible a vibrant and robust microfinance sector, thereby maximizing access to formal and sustainable financial services for all citizens.

In pursuing this goal of maximizing access, it is important to be mindful of the demands of the working poor for financial services, evidenced by their participation in

¹¹⁹ Christen, *supra* note 108 at 13

various forms of *informal* financial services. In terms of borrowing, poor microentrepreneurs often turn to local moneylenders where they pay dramatically higher interest rates than those typically charged by unregulated MFIs. In the realm of savings, poor people without access to formal savings pursue informal methods such as currency under the mattress, investment in livestock and building materials, or local savings and credit clubs. These activities are often more risky than pursuing formal savings even in an unregulated financial institution.¹²⁰

The fact that restricting access to microfinance services indirectly increases the risk faced by small borrowers and savers underscores the need to strike a balance and to ensure that regulations that pursue safety and risk minimization are limited so that they do not unnecessarily diminish the ability of the microfinance sector to provide access to formal financial services to a large number of microentrepreneurs. With these considerations in mind, the following sections discuss the regulatory environments for microfinance in Brazil, China and India.

B. BRAZIL

With over 190 million inhabitants, Brazil is the fifth most populous country in the world.¹²¹ The total GDP of Brazil is \$1.84 trillion, making it the largest economy in Latin America and the 9th largest in the world.¹²² Income inequality in Brazil is among the most severe in the world, with 10% of the population receiving about half of total

¹²⁰ Id. at 19

¹²¹ CIA World Factbook, Rank Order – Population, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2119rank.html>

¹²² CIA World Factbook, Rank Order – GDP (purchasing power parity), <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html>

income.¹²³ With 31% of the population below the poverty line,¹²⁴ Brazil has the largest poor population in Latin America,¹²⁵ suggesting a large demand for microfinance.

1. The Brazilian Microfinance Industry

Microfinance in Brazil dates back to 1972, when the first microfinance program in Latin America was started in the city of Recife in northeastern Brazil.¹²⁶ The microfinance landscape in Brazil was changed substantially beginning in the late 1990s and early 2000s, as a result of a political movement that placed microcredit at the center of civil society development.¹²⁷ Regulatory reforms stemming from this movement have attempted, and succeeded to a degree, to make it easier for the microfinance industry to grow, and among other things, to open MFIs up to private capital.¹²⁸ Recent efforts have not significantly increased outreach however, as the microfinance industry currently serves only around 3% of the estimated 15 million microentrepreneurs in demand for microfinance services.

Types of Institutions Offering Microfinance Services

Legislation in 1999 created two distinct categories of MFIs – SCMs (*Sociedades de Crédito ao Microempreendedor*), or Microentrepreneur 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

¹²³ Simeon Nichter, Lara Goldmark & Anita Fiori, *Understanding Microfinance in the Brazilian Context*, Programa de Desenvolvimento Institucional (PDI) / Banco Nacional de Desenvolvimento Econômico e Social (BNDES), July 2002, pg. 9

¹²⁴ CIA World Factbook, Brazil, <https://www.cia.gov/library/publications/the-world-factbook/geos/br.html>

¹²⁵ Nichter, *supra* note 123 at 9

¹²⁶ Patrick Meagher, *Microfinance and Regulation in Seven Countries: A Comparative Study*, The Iris Center, University of Maryland, May 2006, pg. 15

¹²⁷ *Id.* at 16

¹²⁸ *Id.* at 40

Bank of Brazil, while OSCIPs are unregulated nonprofit organizations. There are currently around 180 SCMs and OSCIPs serving a total of 350,000 clients.¹²⁹ While SCMs and OSCIPs are private organizations, the single largest provider of microfinance is the state-owned development bank Banco do Nordeste, which created the MFI Crediamigo in 1997. Crediamigo currently serves around 150,000 clients.¹³⁰ Municipal banks have also engaged in microfinance services since a 2001 law that allowed the municipalities to create “people’s banks” and local funds to operate microfinance on a nonprofit basis. Commercial banks have also become increasingly involved in microfinance, owing largely to legislation in the early 2000s making it easier for them to offer savings and loans in smaller amounts, as well as requiring commercial banks to dedicate 2% of sight deposits to microcredit, either through SCMs and OSCIPs, or through direct loans to microentrepreneurs.¹³¹

The State of the Microfinance Industry – Supply and Demand

As mentioned above, the total clients served by the Brazilian microfinance industry is 500,000, with Crediamigo responsible for 150,000 of these, and the 180 private MFIs serving the remaining 350,000. The outreach attained by the 180 MFIs is considered to be disappointing, since this means that these MFIs have an average number of under 2,000 clients, making them some of the smallest MFIs by world standards. A look at the concentration in the industry reveals that the six largest MFIs have several thousand clients and each of the remaining 170+ institutions have about one thousand

¹²⁹ Id. at 17

¹³⁰ Id. at 16

¹³¹ Id. at 42

clients each, demonstrating the difficulties that MFIs have encountered in achieving the large client base that makes sustainability and profitability possible.¹³²

On the demand side, there are an estimated 15 million microentrepreneurs in the economy,¹³³ meaning that the penetration of the microfinance industry has only reached about 3%.¹³⁴

Growth of the Microfinance Industry

Growth among MFIs is considered to have been slow over the last several years. In terms of client outreach, leading MFIs have grown at a rate of 14% per year from 2000 to 2005,¹³⁵ in comparison to the total, worldwide microfinance industry, which has grown at 25 to 30%.¹³⁶ Finally, over the last several years, none of the nonprofit OSCIPs have transformed into regulated, for-profit SCMs, an outcome that contrasts with the increasing trend of transformation in other countries.¹³⁷

Much of the growth that has occurred in the provision of microfinance services has been achieved by commercial banks in the traditional consumer finance sector, resulting in large part from legislation in the late 1990s and early 2000s. One legislative initiative allowed banks to establish banking correspondents that offered microcredit and savings in underserved locations. 57 private banks participated in this initiative, which led to the opening of 3 million savings accounts, and to the number of municipalities

¹³² Id. at 17

¹³³ Id. at 119

¹³⁴ Id. at 15

¹³⁵ Id. at 18

¹³⁶ Stephens, *supra* note 74 at 32

¹³⁷ Meagher, *supra* note 126 at 119

without any access to banking services to drop from 1,444 to zero.¹³⁸ The second initiative was the creation of simplified deposit accounts, which made it easier to conduct business with low-income clients. The first two years of this program saw 6 million of these special accounts opened up, with over \$100 million lent.¹³⁹ Despite these promising results, some doubt has been cast on the efficacy of these programs in reaching the working poor, and it has been estimated that most of this lending has gone to salaried employees, retirees, and others in the formal sector.¹⁴⁰ One reason for this is that employers typically pay their employees through the banks, and banks are able to deduct directly from their salary the sum that the employees owe the banks. This element of certainty and extremely low transaction cost provides extra incentive for commercial banks to target salaried employees. The reluctance of commercial banks to put forth any substantial effort to serve microentrepreneurs is especially problematic given the fact that, as will be demonstrated below, commercial banks are the only financial institutions that are well-placed to provide comprehensive and sustainable microfinance services.

2. 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 considered overly restrictive and burdensome on the microfinance sector. Indeed, 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,¹⁴¹ and that individual regulations are substantial and are “notorious for changing with

¹³⁸ Id. at 97

¹³⁹ Id.

¹⁴⁰ Id.

¹⁴¹ Nichter, *supra* note 123 at 38

dizzying frequency.”¹⁴² The discussion below focuses on some of the most important regulatory issues affecting the microfinance industry.

Legal Status

The above-mentioned 1999 legislation, which created SCMs and OSCIPs, allowed MFIs to operate formally and with greater certainty and security over their ability to conduct their activities. This has the effect of increasing investor confidence given that Brazilian MFIs were required to complete a registration process in order to be established, and currently operate under the sanction and protection of the legal system.

SCMs are regulated by the Central Bank of Brazil and must comply with reporting requirements on a regular basis. SCMs are also subject to prudential requirements which the Central Bank is authorized to modify. OSCIPs are not subject to prudential regulation, however they must meet reporting requirements under the supervision of the Ministry of Justice. This supervision and the ongoing standards applied to MFIs and to the sector as a whole further serves to bolster investor confidence.

There is some concern that reporting requirements for SCMs may be excessive, especially because document requirements for microloans exceed those required for other types of institutions such as OSCIPs and commercial banks.¹⁴³ In addition, a paper by BNDES lists the cost of compliance with regulation as one of the top four regulatory challenges faced by MFIs that have contributed to the slow growth of the sector.¹⁴⁴

State Subsidies

¹⁴² Id. at 36

¹⁴³ Meagher, *supra* note 126 at 119

¹⁴⁴ Tor Jansson, *Ensaio e Experiências*, Banco Nacional de Desenvolvimento Econômico e Social (BNDES), 2000, Part IV

Over the last decade, the Brazilian government has been heavily involved in the microfinance industry. Apart from operating by far the largest and most successful MFI in Crediamigo, the government also provides much of the financial support for private SCMs and OSCIPs, which receive most of their funding from BNDES. The constant stream of funds available from BNDES is believed to have diminished incentives to seek alternate sources of funding, such as from commercial banks or other private investors. However, there have also been some problems with BNDES funding that has reduced the ability of MFIs to operate efficiently. In addition to exhibiting slow approval cycles, it has been observed that BNDES is often late in disbursing committed funds, leading directly to delays in MFI loan disbursement, and promoting poor repayment incentives. In many cases expected funds are late or do not arrive, leading to liquidity problems for MFIs and creating further repayment problems as clients realize that MFIs are not a reliable source of funds.¹⁴⁵ These inefficiencies are characteristic of the criticisms often made toward large state-subsidized credit initiatives, and also serve to undermine incentives to seek funding from the private sector.

Source of Funds

As mentioned above, the Brazilian government is the major source of funds for the microfinance industry through its constant channeling of funds into individual MFIs from the BNDES development bank. Apart from public sector funds, MFIs can also receive funds from commercial banks, donors, and private investors. SCMs can also access lines of credit from foreign or domestic financial institutions, while OSCIPs may

¹⁴⁵ Meagher, supra note 126 at 120

not.¹⁴⁶ Additional restrictions placed on MFIs' sources of funding include an inability to issue securities or participate in the Interbank deposit market, and a prohibition among OSCIPs from accessing funds from financial institutions.¹⁴⁷

While committed to making public funds available, Brazilian regulators are also interested in developing private sector investment in MFIs. To this end, certain loans from BNDES require that SCMs raise matching funds from private investors that equal one-third of the loan amount. BNDES has also assisted in linking MIVs with Brazilian MFIs, as in one instance where BNDES linked the Panama MIV ProFund and Paraguay MIV Financiera Visión with an MFI in São Paulo.¹⁴⁸

Foreign investment in MFIs must be registered in advance with the Central Bank of Brazil, and is subject to various and often-changing restrictions such as currency and interest rate restrictions, as part of the Bank's anti-inflationary measures.¹⁴⁹ 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 investment possible, especially given the relatively smaller size of MFIs in Brazil.¹⁵⁰ One report issued by BNDES notes the low level of foreign investment in Brazilian MFIs, which it attributes to limited opportunities within the microfinance sector (i.e., a lack of investible MFIs), a lack of familiarity with

¹⁴⁶ Id. at 161

¹⁴⁷ Meagher, *supra* note 126 at 41

¹⁴⁸ Lucy Conger, *Return of the State*, MicroEnterprise Americas, Inter-American Development Bank, 2002, pg. 40

¹⁴⁹ Paul Haus Martins, Andrei Winograd & Renata de Carvalho Salles, *Regulamentação das Microfinanças*, Programa de Desenvolvimento Institucional (PDI) / Banco Nacional de Desenvolvimento Econômico e Social (BNDES), July 2002, pp. 46, 86, 109; Nichter, *supra* note 123 at 36

¹⁵⁰ Haus Martins, *supra* note 149 at 109

microfinance among investors, and a lack of a secondary market for shares.¹⁵¹ While this paper did not mention legal restrictions on investment among this list of factors, it did note the high cost of complying with regulations pertaining to the registration of transactions with the Central Bank. An additional study issued by BNDES commented that the prolonged registration process, as well as currency restrictions may discourage foreign investors from investing in Brazilian MFIs.¹⁵²

While the lack of strong and investible MFIs appears to be the principal factor limiting foreign investment interest in the Brazilian microfinance sector, restrictions on sources of funding clearly contribute to the ability of MFIs to grow, thus directly affecting the number of investible MFIs in the industry. While steady contribution from BNDES means that MFIs are seldom starved for funds, a reliance on public sector funds, in addition to the conditioning of the funds upon certain restrictions, diminishes incentives and capacity to innovate and grow into the type of institution that would attract commercial investment.

Restrictions on the Provision of Financial Services

Restrictions on the types of financial services and products an MFI is allowed to offer has direct effects on the business model and the prospects of attaining profitability for MFIs. The types of financial products that SCMs are permitted to offer are limited to microloans and guarantees to individuals and organizations.

¹⁵¹ Bruett Tillman, Reuben Summerlin & Sharon D’Onofrio, *Técnicas de Gestão Microfinanceira*, Programa de Desenvolvimento Institucional (PDI) / Banco Nacional de Desenvolvimento Econômico e Social (BNDES), July 2002, pg. 156

¹⁵² Nichter, supra note 123at 36

In addition to being unable to take deposits, SCMs are prohibited offering consumer loans, mortgage loans, pawn services, insurance services, and *troca de cheque*, a service offering immediate cashing of post-dates checks, which are commonly used in Brazil. OSCIPs are allowed to offer microloans and consumer loans, as well as *troca de cheque*, while they are prohibited from offering savings, housing loans, insurance services, pawn services and credit card services.¹⁵³

Permitted Products for Various Banking Institutions			
	Banks	SCMs	OSCIPs
Microcredit	Yes	Yes	Yes
Consumer loans	Yes	No	Yes
<i>Troca de cheque</i>	Yes	No	Yes
Savings Accounts	Yes	No	No
Insurance	Yes	No	No
Pawn Services	Yes	No	No
Housing Loan	Yes	No	No
Credit Cards	No	No	No

Prohibition of certain financial services in comparison to services provided by commercial banks.

*Source: Nichter, Understanding Microfinance in the Brazilian Context*¹⁵⁴

¹⁵³ Nichter, supra note 123at 37; Meagher, supra note 126 at 163

¹⁵⁴ Nichter, supra note 123at 37

As demonstrated by the above chart, MFIs ability to integrate a variety of useful services into their business model is severely limited by these restrictions. Apart from putting MFIs at a competitive disadvantage with regard to commercial banks, these regulations make MFIs less useful and less attractive options for microentrepreneurs that are in demand of but are unable to access the variety of financial services that commercial banks are able to provide but MFIs are not. These restrictions are thus cited by BNDES as one of the four principal regulatory challenges that contribute to the slow growth rates of the microfinance sector.¹⁵⁵

Prudential Requirements

The regulation of capital requirements is marked by the trade-off between ensuring safety and soundness of the bank and putting capital to productive uses that raise profits and attract private investors. The Brazilian Central Bank places prudential regulations on SCMs only, while OSCIPs have no prudential requirements.

The minimum capital required for SCMs is legislated at 100,000 reals (about \$60,000), with authority granted to the Bank to adjust that rate.¹⁵⁶ SCMs are also restricted on their capital adequacy, with maximum debt-to-liquid assets ratios at five times.¹⁵⁷

¹⁵⁵ *Ensaios e Experiências, supra note 144* at Part IV

¹⁵⁶ Meagher, *supra* note 126 at 41

¹⁵⁷ *Id.* at 162

Regulations on Financial Institutions - Latin America		
<u>Country</u>	<u>Deposits Permitted</u>	<u>Capital Adequacy Requirement</u>
Bolivia	Savings, Time	Same as banks
Brazil	None	51% more than banks
El Salvador	Savings, Time	Same as banks
Honduras	Savings, Time	66% more than banks
Mexico	Savings, Time	0-38% more than banks
Panama	Demand, Savings, Time	Same as banks
Peru	Savings, Time	0-51% more than banks
Venezuela	Demand, Savings, Time	Same as banks

Among 8 Latin American countries, Brazilian SCMs are the only MFIs prohibited from taking deposits but nonetheless subject to capital adequacy regulation.

*Source: Jansson, Principles and Practices for Regulating and Supervising Microfinance*¹⁵⁸

As the chart above demonstrates, Brazil is unique in Latin America for both prohibiting deposit-taking while nonetheless placing capital adequacy requirements on MFIs. In addition, the capital adequacy requirements are among the most substantial in the region. This runs counter to international best practices as advocated by CGAP and the World Bank. As mentioned above, best practices maintain that capital adequacy requirements are not necessary for MFIs that do not take deposits. These requirements place

¹⁵⁸ Tor Jansson, Ramon Rosales, & Glenn D. Westley, *Principles and Practices for Regulating and Supervising Microfinance*, Inter-American Development Bank, 2004, pg. 19

substantial limitations on the ability of SCMs to invest their capital in profitable activities, and thus constitute a severe constraint on their ability to pursue sustainability and growth. Due to this outcome, the minimum capital requirements are also listed by BNDES among the four principal regulatory obstacles contributing to the slow growth of the microfinance industry.¹⁵⁹

Restrictions on Loan Size

While microfinance actively targets poor microentrepreneurs in need of small sums of seed capital, flexibility over loan sizes has been recognized as beneficial to MFIs for various reasons.¹⁶⁰ One reason is that it allows MFIs to grow with their clients, giving them increasingly larger loans as their microenterprises become more profitable. The provision of some relatively larger loans among a portfolio of smaller loans also allows MFIs to cross-subsidize the smaller loans with the larger, and thus more profitable loans. Furthermore, it enables MFIs to diversify into other financial services such as housing loans, which require larger sums than working capital loans. Finally, loan size flexibility can be helpful in allowing MFIs to respond to changes in the economy such as inflation.

While OSCIPs are without prudential requirements, SCMs are limited in loan size to 10,000 reals (about \$6,000) per client.¹⁶¹ This limitation has been criticized by one study, which points out that other MFIs across Latin America have been able to realize major gains in financial efficiency through increasing average loan size, as investing a portion of their portfolio in their wealthiest clients brings total costs down and enables

¹⁵⁹ *Ensaio e Experiências*, supra note 144 at Part IV

¹⁶⁰ *Investor Confidence and Regulatory Considerations*, supra note 118 at 22

¹⁶¹ Meagher, supra note 126 at 41

MFI's to grow their numbers of especially poor clients.¹⁶² In this way, a cap on loan size can cause MFI's to avoid lending to a large number of the poorest potential clients in order to keep costs down through larger loans.

Interest Rate Controls

While SCMs and OSCIPs are exempt from Brazilian usury law, interest rate controls are placed on the MFI's as a condition of taking funds from BNDES, which, as mentioned above, is the MFI's primary source of funding. Interest rates on these funds are capped at 4% monthly for loans above 1,000 Brazilian reals (about \$600) and below 10,000 (about \$6,000), while loans below 1,000 reals are limited to a 2% monthly interest rate.¹⁶³

In contrast to the current 2-4% limits, it is estimated that, given Brazilian MFI's traditional levels of operation, monthly interest rates of between 4 and 8% would be necessary simply in order to break even.¹⁶⁴ These restrictions are thus believed to make it difficult for MFI's to reach profitability, thus reinforcing MFI dependency on public funding. Interest rate restrictions are also among the four principal regulatory obstacles that BNDES believes are contributing to the slow growth of the microfinance sector.¹⁶⁵

Credit Collection

SCMs and OSCIPs are subject to regulations under the consumer protection code, which defines soliciting payment before the loan is five days past due as harassment.¹⁶⁶

¹⁶² Id. at 120

¹⁶³ Meagher, *supra* note 126 at 42

¹⁶⁴ Id. at 119

¹⁶⁵ *Ensaio e Experiências*, *supra* note 144 at Part IV

¹⁶⁶ Nichter, *supra* note 137 at 8

This can be ill-suited to microfinance operations, which are typically more “hands-on” with the clients than traditional banking. This regulation could thus lower willingness to loan, or lead to higher scrutiny of potential borrowers.

Taxes

All of the above issues add to the cost of regulatory compliance, which must be considered before an MFI decides how to register itself and to conduct its operations. As SCMs are subject to income tax and CPMF (a levy on financial transactions in Brazil) while OSCIPs are not, the above regulations, as well as tax treatment – and the ensuing challenges in maintaining sustainable business operations – could provide a partial explanation of why OSCIPs in Brazil do not transform into SCMs.¹⁶⁷ In general, income taxes on SCMs are considered by the MFIs to be excessive.¹⁶⁸ While tax rates are comparable to those charged by banks, the cap on interest rates makes it more difficult for SCMs to meet this tax burden, and adds to the already skewed playing field that favors commercial banks over MFIs in the market for the provision of microfinance services.

Assessment of Regulation

Having observed the regulatory environment for microfinance in Brazil, it is apparent that regulatory limitations on MFIs, especially in contrast to the greater flexibility allowed to commercial banks that compete with MFIs in the provision of microfinance services, have contributed to some degree to the slow growth of the microfinance sector and the lack of large, profitable and investible MFIs.

¹⁶⁷ Id. at 41

¹⁶⁸ Id. at 120

Competition with local banks aside, it is also presumable that microentrepreneurs unable to gain access to commercial banking services are nonetheless interested in many of the diverse array of services that commercial banks provide but MFIs are prohibited from offering. This not only restricts access to financial services where it could otherwise be provided, but also limits the MFIs' ability to pursue growth through comprehensive and dynamic business models.

One study by BNDES lists 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 banks and oriented towards low-income clients, and (4) an unfriendly legal and regulatory regime.¹⁶⁹ This study mentions an inability to take deposits, restrictions on financial services and products offered, and consumer protection laws such as interest rate controls and credit collection rules as the principal legal obstacles,¹⁷⁰ while another BNDES report lists the four principal regulatory challenges to MFIs as (1) prudential requirements, (2) restrictions on financial services and products offered, interest rate controls, and total cost of regulation.¹⁷¹ Both of these papers cite the inability to offer commercial loans, consumer credit, and housing loans as the principal limitations on products offered.

Finally, an independent study conducted by a research institute at the University of Maryland concluded that the regulatory regime is "far too restrictive."¹⁷² The study emphasizes (1) the regulations on source of funds, (2) interest rate controls, (3) loan size

¹⁶⁹ Nichter, *supra* note 137 at 6

¹⁷⁰ *Id.* at 8

¹⁷¹ *Ensaios e Experiências, supra* note 144 at Part IV

¹⁷² Meagher, *supra* note 126 at 120

limits, and (4) costly reporting requirements as having “created a disincentive for growth in an already underperforming sector.”¹⁷³ The study also emphasizes the role of government subsidies in undermining incentives towards sustainability,¹⁷⁴ as well as the overall skewed playing field that advantages commercial banks over MFIs.¹⁷⁵ Similar to BNDES’ assessment, the study acknowledges that the regulatory environment as one aspect that has contributed to the underdevelopment of the microfinance sector. The study however places the major blame for this underdevelopment on the microfinance sector itself – concluding that the sector’s inability to come up with innovative and creative solutions to achieving scale have been more decisive than challenging external conditions faced by the industry.¹⁷⁶

In summary, while the regulatory environment is not necessarily the most important obstacle to the growth of the sector, it does seem that regulators have yet to strike a proper balance between protection and access, as outlined in the above discussion on international best practices. One of the primary examples of this is the prohibition on SCMs from taking deposits, along with the imposition of capital adequacy requirements, a race combination advised against by international best practices, which, as demonstrated by regulations in other Latin American countries, advocates capital adequacy and other prudential regulations for deposit-taking institutions, but not necessarily for lending-only organizations.

¹⁷³ Id. at 93

¹⁷⁴ Id. at 140

¹⁷⁵ Id. at 120

¹⁷⁶ Id.

C. CHINA

With 1.3 billion inhabitants, China is the world's most populous country.¹⁷⁷ China's GDP of \$7.04 trillion makes it the second largest economy in the world behind the United States.¹⁷⁸ 10% of China's population – over 100 million people – live on less than \$1 per day.¹⁷⁹ Much of China's poor live in rural areas, especially in remote mountainous areas in China's northwest and southwest regions.¹⁸⁰ In rural areas, it is estimated that 75% of the population has no access to financial services.¹⁸¹ These figures suggest a large demand for microfinance in China.

1. The Chinese Microfinance Industry

One study has estimated the total demand for microfinance services in China to encompass 350 million people.¹⁸² Of the total demand, it is estimated that 23% (80.5 million people) has been reached, while 77% (269.5 million people) of the demand remains unmet.¹⁸³ At present, about 95% of all microfinance services in China are provided by state banks and state-owned postal banks, as well as Rural Credit Cooperatives (RCCs), with MFIs providing the other 5%.¹⁸⁴ Attempts are currently underway to reverse the disparity and increase the role of Chinese MFIs, as these organizations have proven the most capable among the various providers in achieving

¹⁷⁷ CIA World Factbook, Rank Order – Population, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2119rank.html>

¹⁷⁸ CIA World Factbook, Rank Order – GDP (purchasing power parity), <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html>

¹⁷⁹ CIA World Factbook, China, <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html>; Du Xiaoshan, *Development and Policies of Microfinance in China*, Rural Development Institute, Chinese Academy of Social Science, March 2006, pg. 3

¹⁸⁰ Enjiang Cheng, *The Demand for Micro-credit As a Determinant for Microfinance Outreach – Evidence from China*, United Nations Food and Agriculture Organization, March 2007, pg.

¹⁸¹ Hans Byström, *Structured Microfinance in China*, Department of Economics, Lund University, pg. 3

¹⁸² *Optimizing Capital Supply*, *supra note 1* at 2

¹⁸³ Id.

¹⁸⁴ DiLeo & FitzHerbert, *supra note 16* at 13

efficient and sustainable operations while also targeting poor farmers and microentrepreneurs, as well as a large proportion of women.¹⁸⁵ The main reason that MFIs play such a minimal role in the provision of microfinance services is that they lack any legal status to conduct their operations, and thus operate as informal institutions, pursuant to special – and often temporary – government licenses. This limits the number of MFIs that are established and also creates great difficulty for those MFIs in operation. In the absence of a thriving MFI sector, the provision of microfinance services is predominantly undertaken by formal financial institutions, which have not demonstrated a willingness or ability to target microentrepreneurs and work to close the supply-demand gap. In light of this dilemma, the government has recently pursued new initiatives designed to revitalize the microfinance sector, the current composition of which is described in further detail below.

Formal Financial Institutions

Agricultural Bank of China (ABC). During the decades following certain economic reforms in the late 1970s, the state-operated Agricultural Bank of China (ABC) was the main provider of financial services to the rural economy.¹⁸⁶ The ABC has offices in provinces, cities, counties and large townships. Up until 1996,¹⁸⁷ the ABC was also in charge of the RCCs, which have branches in almost every township in rural

¹⁸⁵ Nick Young, *Capitalist Fillip for China's New Socialist Countryside*, China Development Brief, Volume XII, Number 2, February/March 2007, pg. 9

¹⁸⁶ Shen Minggao & Cheng Enjiang, *Restructuring China's Rural Financial System: Existing Approaches, Challenges and The Future of Microfinance*, German Agency for Technical Cooperation (GTZ), December 2004, pg. 8

¹⁸⁷ *Id.* at 9

China.¹⁸⁸ Since the RCCs were privatized, however, the ABC has steadily withdrawn from rural lending operations, devoting an increasing proportion of loans to larger investments in urban areas.¹⁸⁹ Currently, only around 10% of the ABC's lending is in the form of agricultural loans, with much of these funds going to larger farming units such as seed companies and marketing cooperatives,¹⁹⁰ as well as a large proportion of loans going towards wealthier households in rural areas with connections to important local officials.¹⁹¹

Rural Credit Cooperatives (RCCs). Given the decline of the ABC's rural loan provision activities, the RCCs are the dominant provider of credit for rural areas in China and thus the main provider of microfinance services.¹⁹² After being privatized in 1996, RCCs were required by the People's Bank of China (PBC) to implement microfinance operations and provide loans to poor farmers and microentrepreneurs.¹⁹³ While RCCs are private financial institutions, they continue to receive heavily subsidized funding from the (PBC), as well as constant refinancing by the PBC.¹⁹⁴ There are approximately 35,000 RCCs operating in China, collectively providing 86% of China's agricultural loans¹⁹⁵ and reaching over 130 million clients.¹⁹⁶ Despite exhibiting the largest outreach among rural loan providers, much of the activity of the RCCs is not reaching the poor farmers and the microentrepreneurs that microfinance is intended to serve. Rural lending

¹⁸⁸ Kathleen Druschel, *Microfinance in China: Building Sustainable Institutions and a Strong Industry*, School of International Service of American University, Fall 2002, pg. 36

¹⁸⁹ Minggao & Enjiang, supra note 186 at 15

¹⁹⁰ Druschel, supra note 188 at 36

¹⁹¹ *Banking on Reform*, China Development Brief, 2004, <http://www.chinadevelopmentbrief.com/node/123>

¹⁹² Minggao & Enjiang, supra note 186 at 15

¹⁹³ Xiaoshan, supra note 179 at 4

¹⁹⁴ Young, supra note 185 at 5

¹⁹⁵ Xiaoshan, supra note 179 at 4

¹⁹⁶ International Year of Microcredit 2005, *Country: China*, 2005, pg. 3, www.yearofmicrocredit.org/docs/countryprofiles/China.doc

operations are generally concentrated towards rural middle income clients, often focusing on men,¹⁹⁷ while a large proportion of lending goes to parent institutions or real estate investment projects.¹⁹⁸ A further problem with the RCCs is that they have been unable to demonstrate sustainability. In 2007, one third of RCCs were seriously indebted and another third were close to insolvency, while those that reported profits are understood not to be lending to small borrowers.¹⁹⁹ Thus, as a result of the business incentive structures faced by RCCs – which have only made microfinance a part of their operations as a result of a government mandate – these institutions do not offer a promising solution to the problem of delivering financial services poor farmers and microentrepreneurs. Given that the RCCs provide the only substantial offering of financial services to rural and poor regions, the government is essentially forced to provide bail-outs to prevent them from going bankrupt, at least until some alternative institutions can replace them.

Assessed generally, the formal financial institutions have largely failed to provide significant outreach of financial services to poor microentrepreneurs, and have been unable to reach sustainability and instead have remained dependant on government subsidies.²⁰⁰ One particularly problematic aspect of the current situation is that deposit-taking from ABC and RCC banks have increased in recent years, while the ratio of total rural institutional loans to deposits has been declining. Rural institutional lending as a proportion of total rural deposits has more than halved in the last decade and has been falling even more rapidly since 1996 when ABC began withdrawing from rural

¹⁹⁷ Druschel, *supra* note 188 at 43

¹⁹⁸ Young, *supra* note 185 at 6

¹⁹⁹ *Id.*

²⁰⁰ Druschel, *supra* note 188 at 40

activities.²⁰¹ This not only highlights a large demand for rural credit, apparent from the increase in rural savings, but also demonstrates how funds are being taken from the rural economy, in the form of deposits, and channeled out of poor rural areas and into the more developed urban areas, where investments are perceived as more profitable, thus depriving rural areas the opportunity to invest their own money in the growth of their economies.

Microfinance Institutions

China's MFIs are known as being the most successful providers of rural credit both in terms of sustainability as well as targeting poor clients and thus effectively going after the unmet demand for microfinance services.²⁰² As mentioned above, MFIs have no legal standing to conduct their business but rather must be granted special licenses from the government, and are thus not part of the formal market for the provision of financial services. Unlike the RCCs and branches of the ABC, MFIs are unable to take deposits from their clients. Funds come almost entirely from donors, international NGOs, and IFIs. The first MFI was established in 1993, organized by a group of researchers from the Rural Development Institute of the Chinese Academy of Social Sciences. As of 2004 there were approximately 200 county-level MFIs in various regions of China, predominantly located in very poor and remote Western areas.²⁰³ Given the barrier to entry of acquiring a license from the government, as well as the challenges faced once an MFI has been licensed and established (namely a lack of legal status and uncertainty regarding how long the government will allow the MFI to operate under the originally

²⁰¹ Minggao & Enjiang, *supra* note 186 at 15

²⁰² *Banking on Reform*, *supra* note 191

²⁰³ Minggao & Enjiang, *supra* note 186 at 23

delineated terms), MFIs as a whole have thus far been able to provide a level of outreach that is largely insignificant when compared to the overall demand for microfinance services. One study estimates that MFIs in China currently meet 1% of this demand.²⁰⁴

New Institutions

As a response to the failures of previous initiatives to deliver financial services to a significant amount of the rural poor, the Chinese government created two new kinds of financial institutions in the last few years. The two new entities – Credit Only Companies and Village Banks – are for-profit companies funded entirely from the private sector. It is hoped that these initiatives will reverse the monopoly of RCCs over rural financial services and lead to a competitive market that will foster efficiency and effective outreach and attract private investment.

Credit Only Companies. Credit Only Companies were created by the PBC in November of 2005.²⁰⁵ They are for-profit institutions created to provide only credit (no deposit-taking) to microentrepreneurs and farmers in poor areas, and can be established upon the granting of a license from the regional government. The pilot program has been implemented in five provinces – Sha’anxi, Shanxi, Sichuan, Guizhou and Inner Mongolia Autonomous Region, with 7 institutions established as of 2007.²⁰⁶ One such institution, Microcred Nanchong, opened in Sichuan Province in 2006.²⁰⁷ Investors include microfinance-focused international investment company MicroCred SA of France, the

²⁰⁴ DiLeo & FitzHerbert, *supra* note 16 at 13

²⁰⁵ Young, *supra* note 185 at 6

²⁰⁶ Thorsten Giehler, Sun Yinhong, Ren Changqing & Guo Pei, *Microcredit Companies and Village Banks – Competition or Pluralism*, German Agency for Technical Cooperation (GTZ) / International Fund for Agricultural Development (IFAD), 2007, pg. 3

²⁰⁷ Yu Min, *First Wholly Foreign-Invested Microfinancing Company Launched in Rural China*, China Association of Microfinance, 2007, <http://www.chinamfi.net/en/Article/ArticleShow.asp?id=1716>

IFC under the World Bank, German development bank KfW Bankengruppe, and the private insurance company American International Group (AIG). The institution will provide credit loans, secured loans and mortgage loans, and is hoping to receive a special license to take deposits.²⁰⁸

Village Banks. Village banks were created in December 2006 by the China Banking Regulatory Commission (CBRC), a separate body from the PBC in charge of banking regulation.²⁰⁹ They are organized as formal, private financial institutions (and are thus able to take deposits) with limited geographic scope to operate in designated rural areas, either at county or township levels. Unlike Credit Only Companies, Village Banks receive full banking licenses. However, as with Credit Only Companies, entry into the market is still constrained as investors and entrepreneurs seeking to establish Village Banks must first receive approval from the CBRC. This pilot program has been implemented in six provinces – Jinli, Inner Mongolia, Sichuan, Hubei, Gansu and Quinghai. A total of 36 institutions have been established thus far. By the end of April 2007 it was reported that the CBRC had received 21 applications to establish village banks, with fifteen approved thus far.²¹⁰

2. Microfinance Regulation in China

While the recent creation of Microcredit Company and Village Bank pilot programs is certainly a step in the right direction, the microfinance sector still faces a challenging and inhospitable regulatory environment. Legal constraints on microfinance in China are perhaps the principal factor for the underdevelopment of the microfinance

²⁰⁸ Id.

²⁰⁹ Giebler, *supra* note 206 at 4

²¹⁰ Id.

sector and its inability to reach out to anything beyond a minor portion of microentrepreneurs.²¹¹ The discussion below examines the specific legal issues that have constrained the ability of microfinance in China to achieve sustainability and scale.

Legal Status

Microfinance Institutions. There are currently no formal procedures or regulations pertaining to MFIs in China.²¹² Thus, in contrast to RCCs, which have clear legal status as banking institutions part of the formal financial sector, MFIs in China are wholly without any legal status. This is problematic because the presence of an enabling legal and regulatory environment necessarily begins with the clearly defined legal status of institutions that provide microfinance, providing the certainty that both allows MFIs to pursue bold business strategies, and also assures investors that the MFI operates under the protection of the law.

As it is “virtually impossible” for new financial institutions such as RCCs to enter the market,²¹³ most MFIs in China are registered as NGOs. However, China’s financial laws make it illegal for non-financial institutions such as NGOs to supply any type of financial services.²¹⁴ Thus, with no standard procedures in place, in order to conduct their operations MFIs must negotiate for legal standing with local government officials on an ad hoc basis. MFIs can then gain informal sanction and license to conduct business

²¹¹ See e.g., Lynn Chia & Alex Counts, *Microfinance Regulation and the Chinese Context: An Opportunity for Making a Major Impact on Reducing Poverty*, Grameen Foundation USA, 2004, pg. 1; Giehler, supra note 206 at 7; Druschel, supra note 188 at 89

²¹² Xiaoshan, supra note 179 at 4

²¹³ Minggao & Enjiang, supra note 186 at 10

²¹⁴ Xiaoshan, supra note 179 at 4

under a memorandum of understanding with the local government.²¹⁵ MFIs thus have some assurance that they are not operating completely illegally, however these arrangements are at the mercy of changing political conditions, changing interpretations of the memorandum of understanding, and various forms of state intervention in general.²¹⁶

According to Du Xiaoshan, deputy director of the Rural Development Institute at the Chinese Academy of Social sciences, and the founder of the first MFI in China, the lack of legal status is the main obstacle that has led to the slow and low quality of development of the microfinance sector, whereas the potential for MFIs to succeed in China would be promising under a more enabling policy environment.²¹⁷ The lack of legal status means that MFIs could have their operations shut down or significantly compromised by state intervention, adding great uncertainty to their ability to run their operations and attract various sources of capital. Specifically, Xiaoshan highlights three consequences of the uncertainty resulting from the MFIs' lack of legal status. First, it undermines client confidence and clients' expectations of the MFI as a reliable source of credit, which can lead to lower repayment rates. Second, it makes it difficult to attract and retain quality staff, especially where the alternative is employment in secure government positions. Finally, it makes it much more difficult to attract funds since a lack of legal status means a lack of credibility and thus a risky investment from the perspective of investors.²¹⁸

²¹⁵ Chia & Counts, *supra* note 211 at 2

²¹⁶ Chia & Counts, *supra* note 211 at 2; Minggao & Enjiang, *supra* note 186 at 26

²¹⁷ Xiaoshan, *supra* note 179 at 6

²¹⁸ *Id.* at 11

Credit Only Companies. In order to establish a Credit Only Company, private investors must bid for a license, which can then be granted by the PBC.²¹⁹ These institutions, however, are not formally recognized by the CBRC and thus their legal status is also ambiguous, and their regulatory framework is generally determined on an ad hoc basis during the licensing process and subsequently by local government oversight.²²⁰

As with MFIs, the unclear legal status of Credit Only Companies will make it harder for them to develop any long-term strategy for conducting business or attracting different sources of capital, and MFIs will as a result be risk-averse in their lending and outreach initiatives.

Village Banks. Village banks possess full banking licenses from the CBRC and are considered, and regulated as, formal financial institutions.²²¹ In contrast to Credit Only Companies, Village Banks enjoy the security and stability of full legal status from the outset, enabling them to develop long-term strategies and attract a wider range of capital.

State Subsidies

China is seen as an example of why heavy government involvement in the provision of microfinance services has been generally warned against within circles of international advocates of best practices in microfinance.²²² The heavily subsidized funding allocated to the RCCs – the PBC lends to the RCCs at interest rates of 2% per

²¹⁹ Young, *supra* note 185 at 7

²²⁰ Gehler, *supra* note 206 at 9

²²¹ *Id.* at 10

²²² Druschel, *supra* note 188 at 40

year – contributed greatly to the monopoly position held by RCCs over the provision of rural credit, which in turn created the situation whereby the PBC was forced to continually inject cash into the RCCs to keep them alive, which had the consequence of diminishing the incentives of RCC management and staff to seek sustainability and profitability.²²³ Because neither MFIs nor Credit Only Companies or Village Banks receive public funding, the subsidized funding granted to RCCs and the bail-outs from PBCs put MFIs at a severe competitive disadvantage, especially since RCCs – comparatively unconstrained financially – are able to charge lower rates of interest and crowd out competition from the MFIs.

While this arrangement clearly distorts the market for rural finance and crowds out private microfinance initiatives, it may be difficult to reform. As can be the case with government subsidies, entrenched interests have found ways to benefit from the subsidized funding granted by the PBC. RCC directors and staff are known to provide subsidized loans to their favorite enterprises and household clients, as well as to the local government.²²⁴ These groups could thus resist efforts to end this subsidy.

Source of Funds

In terms of accessing capital, RCCs appear to be in the best position as they enjoy access both to deposits taken from clients, as well as funding from the PBC. MFIs in contrast must rely on donor funding, international NGOs, and private investors. In terms of accessing foreign investment, the state government practices control over short-term external debt balances and thus borrowing from abroad requires approval from the

²²³ Minggao & Enjiang, *supra* note 186 at 32

²²⁴ *Id.* at 33

regulatory authorities, which then plays a role in setting the financing terms of the transaction.²²⁵

Rural Credit Cooperatives. RCCs receive funding from deposits, the PBC, and international grants. RCCs however face intense competition over deposit-taking from the ABC and the state-owned postal and savings banks, both of which operate large-scale deposit-taking operations in rural areas. Due to this competition deposits are insufficient for RCCs to finance loans, a trend which reinforces dependence on PBC funding and compromises incentives and abilities to serve significant numbers of working poor.²²⁶

Microfinance Institutions. Traditional MFIs neither take deposits from clients nor receive PBC financing or commercial bank financing, and are thus funded mainly via international donors and NGOs, and foreign investors.²²⁷ Options for funding are thus severely limited, making it extremely difficult to replenish loan capital and achieve financial sustainability. This also leads to deviation from the mission of serving the poorest clients, as MFIs are incentivized to target the middle income – rather than the poorest – households in poor rural areas in order to remain financially viable. The result has been that the clients of most MFIs are of lower income than the clients of RCCs, but are of higher income than the clients of informal lenders such as loan sharks, further demonstrating the extent of unmet demand and its harmful consequences.²²⁸

²²⁵ Dr. Guo Shunqing, Deputy Governor, People's Bank of China, Director-General, State Administration of Foreign Exchange, *Management of Capital Flows in Corporate Sector: Current Situation and Outlook in China*, The People's Bank of China, 2002, <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=9>

²²⁶ Xiaoshan, *supra* note 179 at 7

²²⁷ Xiaoshan, *supra* note 179 at 7; Druschel, *supra* note 188 at 89

²²⁸ Cheng, *supra* note 180 at 12

Credit Only Companies. Credit Only Companies are not allowed to take deposits and do not receive public funding, and are thus funded by private investors and donations.²²⁹ This has led to some problems as most Credit Only Companies have presently lent out nearly all of their start-up capital and are encountering difficulties raising additional loan funds. This is further complicated by their unclear legal status and lack of formal recognition from the CBRC, which obstructs efforts to borrow from commercial banks.²³⁰ Credit Only Companies do however have a clear and flexible ownership structure, the only significant limitation being a maximum of five shareholders, which makes these institutions relatively attractive to both Chinese and foreign investors.²³¹

Village Banks. Village banks are private, formal financial institutions licensed and regulated by the CBRC, and thus they enjoy the ability to take deposits and to borrow from a larger variety of sources such as commercial banks. Village Banks are however considered less attractive – in comparison to Credit Only Companies – to private foreign and domestic investors because of their ownership rules.²³² These rules require that new Village Banks be initiated by existing, commercial financial institutions, and that these commercial banks hold a minimum of 20% of total shares.²³³ Individual, non-bank shareholders, on the other hand, are restricted to a maximum of 10% of total shares.²³⁴ This arrangement enables Village Banks to become dominated by commercial banking institutions with business interests that are often inconsistent with the objectives of

²²⁹ Young, *supra* note 185 at 6

²³⁰ *Id.*

²³¹ Giebler, *supra* note 206 at 10

²³² *Id.*

²³³ *Id.* at 4

²³⁴ *Id.* at 10

microfinance. Indeed, this requirement will crowd out those investors that are most interested in serving poor microentrepreneurs, and require the participation of primarily profit-focused investors that will not necessarily undertake the same efforts in terms of reaching out to the poorest clients.

Restrictions on the Provision of Financial Services

Rural Credit Cooperatives. 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.²³⁵ Despite this flexibility, due to the counterproductive incentive structure in place as a result of the subsidy regime, as well as the reality that RCCs engage in microfinance not as part of their original business model but as a result of a government mandate, RCCs have proven unable to meet a significant portion of the demand for microfinance services among the working poor.

Microfinance Institutions. One of the significant limitations on microfinance institutions is that, while individual licenses are negotiated on an ad hoc basis and are thus varied, MFIs generally can offer microloans only and are unable to take deposits.

Credit Only Companies. As with MFIs above, Credit Only Companies are only authorized to offer loans and may not take deposits. Their operations are confined to the jurisdiction assigned in the granting of the license, and thus their client base is limited to

²³⁵ *Comparative Database: China*, Microfinance Gateway, Regulation Home Page, Consultative Group to Assist the Poor (CGAP), http://www.microfinancegateway.org/resource_centers/reg_sup/micro_reg/country/9/

those living within the administrative jurisdiction where the institution is located.²³⁶

These restrictions make it more difficult to achieve scale and bring down costs. Credit Only Companies are also subject to a maximum loan size of 100,000 RMB (nearly \$14,000), and lending quotas earmarking 75-80% of loans for agricultural sector.²³⁷

These restrictions impair the flexibility of management to structure their portfolios in a way that best achieves sustainability, and both of these limitations make it more difficult for Credit Only Companies to cross-subsidize smaller loans with larger loans.

Village Banks. Village Banks are allowed to take deposits from clients, which widens their options in seeking sustainable sources of funding. They are however limited by the fact that they can only operate in one county, which places a cap on potential client base, and makes it much more difficult to lower cost and pursue sustainability and profitability through scale.

Prudential Requirements

Along with the relaxation of interest rate caps pertaining to Credit Only Companies, reductions in minimum capital requirements for new MFIs is also a positive sign. These reforms will be beneficial as they ease the burden of entry into the microfinance sector.

There are no prudential requirements for traditional MFIs as they lack any legal and regulatory recognition, however the minimum capital requirements for Credit Only Companies and Village Banks are lower than previous limits placed on various types of RCCs and should thus make it easier for more investors to enter the microfinance market.

²³⁶ Id. at 3

²³⁷ Id. at 10

The minimum capital requirement for Credit Only Companies is around 100 million RMB, much less than that of commercial banks or cooperative financial institutions (typically 1 billion RMB, and 150-200 million RMB respectively).²³⁸

The minimum capital requirement for Village Banks is set at 3 million RMB for county banks and 1 million RMB for village and township banks,²³⁹ while Village Banks operating credit cooperatives have minimum capital requirements of 300,000 RMB at the township level and 100,000 RMB at the village level.²⁴⁰ One criticism of this policy has been that, despite the lowered capital adequacy requirements, new investors will still be deterred from entering the market as a result of the above-mentioned requirement of 20% commercial bank ownership, as commercial banks will not be incentivized by the low capital adequacy requirement.²⁴¹

Interest Rate Controls

Interest rates are controlled in China by the PBC setting a base interest rate, and then permitting the various institutions with different intervals across which they are allowed to vary their particular rates. As of 2007 the base rate was reported to be around 6% annually.²⁴² Interest rate controls can present especially difficult challenges for microfinance, since interest rates are usually the means by which MFIs compensate for the higher costs of efficiently delivering small loans to poor borrowers. Caps on interest rates not only make it harder for MFIs to survive but also present a disincentive to lend to

²³⁸ Young, supra note 185 at 6

²³⁹ Giehler, supra note 206 at 10

²⁴⁰ Young, supra note 185 at 8

²⁴¹ Giehler, supra note 206 at 7

²⁴² Young, supra note 185 at 5

the poorest potential clients and provide a counterincentive for new MFIs to enter the market.²⁴³

Rural Credit Cooperatives (RCCs). RCCs currently can lend at up to 1.3 times the base rate, a ceiling which 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% interest per year, a rate which is not profitable.²⁴⁴

Microfinance Institutions. Given a lack of regulatory status, management of MFI interest rates is applied inconsistently depending on individual licenses. Annual interest rates for MFIs have traditionally ended up being around 6% and 10%, which, again, is considered unsustainable. Indeed, one study reports that international standards for sustainable microfinance interest rates fall between 18% and 35% annually.²⁴⁵

During licensing negotiations, special – and temporary – permission is sometimes granted to charge higher interest rates, an arrangement which various internationally funded pilot projects have been able to secure.²⁴⁶ In terms of these initiatives, effective interest rates for sustainable MFIs in China have been between 14-17% annually.²⁴⁷

Credit Only Companies. Credit only companies are permitted to charge 4 times the statutory benchmark interest rate, which is considered a favorable policy that will not constrain these institutions in seeking sustainability and profitability, and is thus one

²⁴³ Chia & Counts, *supra* note 211 at 5

²⁴⁴ Young, *supra* note 185 at 6

²⁴⁵ Druschel, *supra* note 188 at 64

²⁴⁶ *Banking on Reform, supra note 191*

²⁴⁷ Cheng, *supra* note 180 at 9

positive aspect signifying progress by the Chinese government in fostering a more hospitable regulatory environment for microfinance.²⁴⁸

Village Banks. In contrast to the favorable rate cap placed on Credit Only Companies, Village Banks are only able to charge 2.3 times the base rate, which is considered to be insufficient to cover costs.²⁴⁹ The inconsistency in terms of interest rate restrictions between the two newly-created MFI entities probably results from the fact that they were created by different regulatory bodies (Credit Only Companies under the PBC and Village Banks under the CBRC), and points to a need for these two government offices to coordinate their efforts.

Taxes

Finally, practitioners have cited high taxes as a further barrier to achieving sustainability in the microfinance industry.²⁵⁰ RCCs are subject to operating taxes, income taxes, transaction taxes, business taxes and consumption taxes, and local governments have been known to introduce high taxes and fees on RCCs because they know that the central government will not allow them to go bankrupt.²⁵¹ While the government has no taxation policy on MFIs, local governments have also levied taxes on MFI operations, creating further complications in their ability to conduct business.²⁵²

Assessment of Regulation

²⁴⁸ Giehler, *supra* note 206 at 10

²⁴⁹ *Id.*

²⁵⁰ Xiaoshan, *supra* note 179 at 4

²⁵¹ *Banking on Reform, supra note 191*

²⁵² Xiaoshan, *supra* note 179 at 6

Various practitioners have commented on the “repressive” regulatory environment for microfinance and its role as the main obstacle in the development of microfinance in China.²⁵³ Further reforms that create a more friendly and enabling framework for MFIs will be necessary in order for microfinance in China to serve a significant portion of the unmet demand. Practitioners also agree that, should successful reforms and liberalization of the microfinance sector continue, there is tremendous potential for microfinance institutions to achieve scale and attract commercial investment.²⁵⁴

The potential in China is especially strong among developing countries given the large pool of domestic investors, and the strength and importance of the Chinese currency, which will cause more international investors to be willing to lend in local currency. For this to occur, reforms are needed in terms of the liberalization of interest rates, the elimination of government subsidies that crowd out private investment and also cause RCCs to crowd out private MFIs, as well as the relaxation of restrictions on financial services that have prohibited services such as deposit-taking.

The new MFI entities – Credit Only Companies and Village banks – that have been created in recent years represent a step in the right direction, as the regulatory structure for these institutions shows that regulators are becoming more realistic and attuned to the concerns of MFIs with regard to interest rates and a need to attract funding from a variety of sources including client savings and private sector investment. One complication with the new entities is that so few of them have been established thus far.

²⁵³ See e.g., Druschel, *supra* note 188 at 89; Chia & Counts, *supra* note 211 at 2; Giehler, *supra* note 206 at 7

²⁵⁴ See e.g., Min, *supra* note 207; Young, *supra* note 185 at 9; Byström, *supra* note 181 at 15

Some have criticized the fact that only a select few new MFIs have been allowed to enter the various provinces where the pilot programs are being undertaken, arguing that this simply means that new monopolies have been created.²⁵⁵ This lack of competition will diminish incentives to grow in terms of clients served and products offered, and overall quality of service. The reforms would thus stand a better chance of achieving their objective of fostering a competitive marketplace if entry into the market was available to a wider field of investors and entrepreneurs than the small amount to which the government has thus far granted licenses.

A further issue regarding the two new entities is the fact that each of them has its own regulatory advantages and disadvantages over the other in terms of its capability to be sustainable and profitable. For example, Credit Only Companies have much more flexible ownership restrictions than Village Banks, making Credit Only Companies more attractive to foreign and domestic investors. Credit Only Companies also have much more favorable interest rate restrictions while those placed on Village Banks are expected to be a serious obstacle in achieving sustainability. Village Banks on the other hand enjoy the advantage of a formal banking license and a clear legal status, and the ability to take deposits, advantages not conferred on Credit Only Companies. One study concluded that because of the more flexible interest rate caps and ownership regulations, Credit Only Companies are better positioned than Village Banks to maintain viable operations.²⁵⁶ However this study also suggested that new legislation be enacted that would make possible the creation of new types of MFI entities that combine the advantages of both Credit Only Companies and Village Banks. The reason for the

²⁵⁵ Young, *supra* note 185 at 7

²⁵⁶ Giehler, *supra* note 206 at 10

disparities in the regulatory treatment of the Credit Only Companies and Village Banks is presumably due to the fact that they were created by different regulatory bodies, namely the PBC and the CBRC, respectively. Thus, in order to achieve regulatory reform that will be conducive to the growth and development microfinance sector, it will be essential that the PBC and the CBRC work together in shaping a coherent regulatory framework.

Despite their limitations, recent reforms have nonetheless indicated that both regulatory bodies are interested in revitalizing the microfinance sector. Although regulation is still inconsistent with regard to different types of institutions, many of the new regulations, such as interest rate liberalization and the ability to provide additional financial services such as deposit taking, demonstrate that the legal regime is moving from an overly-restrictive environment towards the sort of balance between protection and access as advocated in the above discussion on international best practices.

While there is still a large gap between the current regulatory framework and one that would be friendly to microfinance, if reform efforts continue it is possible that the Chinese microfinance sector could be transformed over the next several years. In the meantime, however, the industry remains heavily constrained in its ability to close the supply-demand gap.

D. INDIA

With 1.2 billion inhabitants, India is world's second most populous country.²⁵⁷

With a GDP of \$2.9 trillion, it is home to world's fourth-largest economy.²⁵⁸

²⁵⁷ CIA World Factbook, Rank Order – Population, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2119rank.html>

Approximately 25% of the population (300 million people) lives below the poverty line.²⁵⁹ The World Bank estimates that more than 87% of India's poor do not have access to formal sources of credit, and that informal sources such as moneylenders charge interest rates ranging from 48% to 120% per year, and sometimes much higher²⁶⁰ (formalized MFIs, by contrast, charge interest rates ranging from 15% to 30% per annum).²⁶¹ A 2008 report published by the National Bank for Agriculture and Rural Development (NABARD) noted that only 27% of all farm households accessed formal sources of credit, and that one third of these households also borrowed from the informal sector.²⁶² This report also noted that exclusion from formal financial services was most pronounced in the North East, East and Central regions of India.²⁶³

1. The Indian Microfinance Industry

One study has estimated the total demand for microfinance services in India to encompass 300 million people.²⁶⁴ It is estimated that around 30% of this demand has been reached, while about 70% of this remains unmet.²⁶⁵ With the exception of ICICI bank, which collaborates with Indian MFIs, the traditional commercial banking sector has shown minimal interest in the provision of microfinance and thus nearly all microfinance

²⁵⁸ CIA World Factbook – Rank Order – GDP (purchasing power parity)

²⁵⁹ CIA World Factbook – India, <https://www.cia.gov/library/publications/the-world-factbook/geos/in.html>

²⁶⁰ Raven Smith, *The Changing Face of Microfinance in India*, The Fletcher School, Tufts University, 2006, pg. 10

²⁶¹ Developing World Markets

²⁶² *Report of the Committee on Financial Inclusion*, National Bank for Agricultural and Rural Development (NABARD), January 2008, [hereinafter *Committee on Financial Inclusion*] pg. 2

²⁶³ Id.

²⁶⁴ *Optimizing Capital Supply*, *supra note 1* at 2

²⁶⁵ *A Study of the Regulatory Environment and its Implications for Choice of Legal Form by Microfinance Institutions in India*, Micro-Credit Ratings International Limited (M-CRIL), September 2005 [hereinafter *Microfinance Institutions in India*], pg. 3; *Optimizing Capital Supply*, *supra note 1* at 2; DiLeo & FitzHerbert, *supra note 16* at 13

is being delivered by the various types of MFIs that make up the microfinance sector.²⁶⁶

The sector is concentrated in the southern states of Andhra Pradesh, Tamil Nadu, Karnataka and Kerala, with Andhra Pradesh alone encompassing 50 to 70% of microfinance activity.²⁶⁷ In order to assess the broad landscape of MFI types and their institutional characteristics, it may be useful to separate the discussion into nonprofit MFIs, also known as NGO-MFIs, and for-profit MFIs. Two fundamental differences in the characteristics of these two categories pertain to formal regulation and the ability to take deposits. For-profit MFIs are, to different degrees, regulated by the Reserve Bank of India (RBI), and can obtain licenses to take deposits, while nonprofits MFIs are not formally regulated and are prohibited from deposit-taking.²⁶⁸

Non-Profit MFIs

Societies and Trusts. The vast majority of MFIs in India are organized as charitable societies or trusts, and these organizations number over 1,000.²⁶⁹ 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 microentrepreneurs.²⁷⁰ SHGs take out loans from the MFIs which they then disburse throughout the group, and also pool their income, which they deposit with MFIs (deposits are typically placed with a bank by the MFIs) into a common fund from which they can

²⁶⁶ Slavea Chankova, Nathanael Goldberg, Genevieve Melford, Hind Tazi & Shane Tomlinson, *India Microfinance Investment Environment Profile*, Princeton University, 2004, pg. 7; *Microfinance Institutions in India*, *supra* note 265 at 3

²⁶⁷ *Microfinance Institutions in India*, *supra* note 265 at 7

²⁶⁸ *Id.* at 47

²⁶⁹ *Committee on Financial Inclusion*, *supra* note 262 at 87; Chankova, *supra* note 266 at 11

²⁷⁰ Chankova, *supra* note 266 at 7

borrow.²⁷¹ A majority of the funding for this comes from the public sector as well as donations.

Much of the public funding is orchestrated through a Linkage program run by NABARD, where NABARD refinances commercial banks' loans to MFIs.²⁷² The Linkage program, started in 1992, currently connects dozens of commercial banks and hundreds of regional and cooperative banks with MFIs and serves over 10 million families.²⁷³ Societies and trusts also receive direct loans from NABARD, as well as the Small Industries Development Bank of India (SIDBI), another state-run institution established to promote broader financial sector outreach.²⁷⁴

While private commercial banks have not generally become involved in the microfinance sector, one notable exception is that of ICICI bank, the second-largest bank in India. Attracted to the sector both for the financial and social returns that MFIs have demonstrated, ICICI has developed a “partnership model” whereby it provides funds to various MFIs for their lending operations, with the MFIs functioning as agents for the bank.²⁷⁵ Under this model, ICICI is currently partnered with several hundred MFIs, with total lending operations reaching over 1 million clients.²⁷⁶

²⁷¹ Rajarshi Ghosh, *Microfinance in India: A Critique*, Social Science Research Network (SSRN), May 2005, pg. 2

²⁷² *Microfinance Institutions in India*, *supra note 265* at 3

²⁷³ Chankova, *supra note 266* at 8

²⁷⁴ *Id.*

²⁷⁵ *Microfinance Institutions in India*, *supra note 265* at 47

²⁷⁶ *ICICI Bank Expands Retail Microfinance Business in India*, MicroCapital, April 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, September 2006, <http://microcapitalmonitor.com/cblog/index.php?archives/383-Indian-Bank-ICICI-Reaches-Arrangement-with-Provincial-Government-on-Micro-Loan-Interest-Rates.html>

Section 25 Companies. A small percentage of Indian MFIs are registered as nonprofit companies under Section 25 of the Companies Act.²⁷⁷ This provides MFIs with the formal ownership and governance structure of a limited liability company while exempting the MFI from many of the regulations placed on for-profit companies.²⁷⁸ These MFIs have been able to achieve larger scale than societies and trusts.²⁷⁹ In the last several years around 10 society and trust MFIs have transformed into Section 25 Companies.²⁸⁰ These organizations have also participated in partnerships with ICICI whereby the large commercial bank provides funds to the MFIs for their lending operations.²⁸¹

For-Profit MFIs

Cooperative Banks. There are over 150,000 cooperative banks in India,²⁸² around 30,000 of which are dedicated to microfinance.²⁸³ 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 all of the regulations placed on larger banks.²⁸⁴ After trusts and societies, cooperative banks are the second-most common form of MFI in terms of number of institutions.²⁸⁵ Cooperative banks focusing in microfinance are typically organized either as Urban Cooperative Banks (UCBs) or as Mutually Aided Cooperative Societies (MACs). Partly

²⁷⁷ *Microfinance Institutions in India*, *supra* note 265 at 18

²⁷⁸ *Id.* at 20

²⁷⁹ Kapil Bajaj, *Microfinance Muddle*, Business Today, India Today Group, October 2007, http://businesstoday.digitaltoday.in/index.php?issueid=18&id=2131&option=com_content&task=view

²⁸⁰ Sanjay Sinha, *Microfinance Regulation for Financial Inclusion: The 'Street Child' Needs Nurturing*, Micro-Credit Ratings International Limited (M-CRIL), 2007, pg. 6

²⁸¹ *Microfinance Institutions in India*, *supra* note 265 at 47

²⁸² *Id.* at 1

²⁸³ *Committee on Financial Inclusion*, *supra* note 262 at 87

²⁸⁴ *Id.* at 35

²⁸⁵ Sinha, *supra* note 280 at 3

due to the low barriers to entry and an ineffective regulatory regime, several cooperative banks have experienced failures in recent years and it is currently extremely difficult to obtain licenses from the RBI to establish new cooperative banks.²⁸⁶

Non-Bank Financial Companies (NBFCs). NBFCs have traditionally played an important role in the Indian financial sector in terms of filling the supply/demand gap among smaller clients and rural or poor regions that large banks do not reach.²⁸⁷ NBFCs are characterized by lower barriers to entry and higher returns than mainstream commercial banks, and have thus attracted many entrepreneurs.²⁸⁸ Currently there are over 13,000 NBFCs operating in India, while around 20 of them are MFIs focused on microfinance activity.²⁸⁹ Despite being among the least prevalent institutional forms, NBFCs, along with Section 25 Companies, account for about 80% of microfinance outreach in India, both in terms of clients served²⁹⁰ as well as loan portfolios.²⁹¹

Until recently, NBFCs were without any registration or regulation requirements.²⁹² This situation combined low barriers to entry with a lack of oversight culminating in the failure of a number of NBFCs. While registration and regulatory requirements are now in place, the RBI – given recent failures of NBFCs as well as cooperative banks – is reluctant to grant further licenses for NBFCs and is also wary of the challenge of having to regulate the microfinance sector in addition. Despite recent

²⁸⁶ *Microfinance Institutions in India*, *supra* note 265 at 38

²⁸⁷ *Id.* at 21

²⁸⁸ *Id.* at 22

²⁸⁹ *Committee on Financial Inclusion*, *supra* note 262 at 87

²⁹⁰ Bajaj, *supra* note 279

²⁹¹ *Committee on Financial Inclusion*, *supra* note 262 at 87

²⁹² *Id.* at 5

NBFC failures, NBFCs remain uniquely positioned to reach out to India's rural poor.²⁹³

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.²⁹⁴

2. Microfinance Regulation in India

The regulatory environment for microfinance is 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, while much fewer NBFCs, capable of serving large client bases, have emerged.²⁹⁵ Regulatory changes in the last several years, such as certain 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.²⁹⁶ Despite these positive developments, the sector still faces many regulatory hurdles, such as restrictions on investment and disjointed regulation of the sector. Finally, a new microfinance bill is currently being considered by the Indian Parliament that has received mixed reviews from commentators.²⁹⁷

Legal Status

²⁹³ *Committee on Financial Inclusion*, supra note 262 at 5

²⁹⁴ Chankova, supra note 266 at 14

²⁹⁵ Rajat Wanchoo, *Microfinance in India, The Changing Fact of Micro-Credit Schemes*, Munic Personal RePEc Archive (MPRA), June 2007; *Microfinance in India Has a Long Way to Go: Vikram Akula*, India eNews, 2006 [hereinafter *Long Way to Go*], <http://www.indiaenews.com/business/20061128/30324.htm>; *Microfinance Institutions in India*, supra note 265 at 46; Smith, supra note 260 at 91; Chankova, supra note 266 at 17; Bajaj, supra note 279

²⁹⁶ Sinha, supra note 280, pg. 6

²⁹⁷ Kaushiki Sanyal, PRS Legislative Research, Legislative Brief, The Micro Financial Sector (Development and Regulation) Bill, 2007, PRS Legislative Research, Centre for Policy Research, June 2007, pg. 4, Mukul G. Asher & Savita Shankar, *Microfinance Bill: Need for Major Re-think*, http://www.karmayog.org/billsinparliament/upload/8457/CFO_Article-final.doc; Sinha, supra note 280 at 12,

From the Indian perspective, the options for legal status of MFIs is particularly influential in determining the MFIs' ownership and governance structure as well as their business model, two concerns closely related to the MFIs' prospects for accessing a range of funding and pursuing growth.

Societies and Trusts. Societies and trusts are legally registered organizations whereby the members serve as trustees of the property of the organization. Rationalized partly due to their charitable nature, societies and trusts are not regulated in their microfinance operations, nor are they regulated in terms of management and governance. Furthermore, they are not under any prudential regulations, partly due to the fact that they are not authorized to take deposits.²⁹⁸

While this structure provides low barriers to entry and organizational autonomy in pursuing charitable initiatives, this legal structure has made it very difficult for MFIs to grow operations and attract outside sources of funding.²⁹⁹ The informal management and governance standards can be conducive to inefficient management which would slow the growth of an MFI. Furthermore, the management structure undermines confidence among investors, thus making it harder to mobilize funds required for expansion.³⁰⁰ These factors make transformation into larger institutions such as Section 25 Companies or NBFCs more difficult to achieve, although there have been instances in which some nonprofit MFIs have transformed into large and profitable NBFCs.³⁰¹

²⁹⁸ *Microfinance Institutions in India*, *supra* note 265 at 9, 15, 48

²⁹⁹ *Id.* at 47

³⁰⁰ *Id.* at 48

³⁰¹ Two examples of MFIs that began as nonprofits and transformed into NBFCs re SHARE and SKS. Smith, *supra* note 260 at

Section 25 Companies. Section 25 of the Companies Act allows for the establishment of nonprofit, limited liability companies, the activities of which are restricted to charity or other social purpose.³⁰² MFIs organized as Section 25 Companies are formally recognized and regulated by the RBI, although, because of their smaller and nonprofit character and because they do not take deposits, they are exempt from many of the regulations placed on NBFCs and large commercial banks.³⁰³

Registration under the Companies Act and supervision under the RBI places a higher barrier to entry on Section 25 Companies and makes them more difficult to establish in comparison to societies and trusts. However, forming a Section 25 Company adds to the legitimacy of the institution given the more formal ownership and management structure under the Companies Act and the supervision of the RBI, which helps to foster better management and governance. Section 25 Companies are thus a much more attractive target for investment than MFIs organized as societies and trusts, although private equity investment is essential precluded due to the companies' non-profit status.

Cooperative Banks. Cooperative banks, including Urban Cooperative Banks (UCBs) and Mutually Aided Cooperative Societies (MACs) are for-profit entities governed by members of the board serving as beneficiaries.³⁰⁴ Because they are smaller entities and because they are only allowed to take deposits from their borrowers, MACs are under minimal regulatory and supervisory requirements and are relatively easy to

³⁰² *Microfinance Institutions in India, supra note 265* at 18

³⁰³ *Id.* at 48

³⁰⁴ *Id.* at 49

establish, while the opposite is true for UCBs.³⁰⁵ An important issue pertaining to UCBs is that they are subject to substantial regulation and supervision from both the central and state governments. While administrative aspects such as managerial supervision are conducted by the Registrar of Cooperative Societies within the state governments, banking operations are regulated and supervised by the central government through the RBI.³⁰⁶ As financial and administrative areas of regulation often intersect, this has resulted in overlapping jurisdiction which 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.³⁰⁷

In general, current organizational structure and regulatory regimes have unfavorable implications for growth and development of cooperative MFIs. First, the structure of governance by beneficiaries is problematic – often consisting of thousands of members each holding voting shares and annual general meetings where member approval is required for management decisions.³⁰⁸ This corporate governance problem will raise doubts from commercial investors, as will the lack of regulatory oversight placed on MACs. RBI and state regulations placed on UCBs will serve to increase investor confidence, however the recent problems in performance of UCBs, along with the high barriers to entry for new institutions will continue to create complications for MFIs pursuing this legal structure.

³⁰⁵ Id.

³⁰⁶ Id.

³⁰⁷ Id. at 36

³⁰⁸ Developing World Markets

Non-Bank Financial Companies. NBFCs are registered with the RBI, which regulates activities such as compulsory credit ratings of deposit taking and prudential norms.³⁰⁹ The regulation and supervision under the RBI and the formal and professional governance structure are conducive to investor confidence and make NBFCs the most viable MFIs for attracting various sources of funds and achieving growth and sustainability.

State Subsidies

Some relatively recent initiatives on the part of the Indian government have demonstrated an effort to assist in the development of the microfinance sector. In 1982, the National Bank for Agriculture and Rural Development (NABARD) was established with the purpose of providing and regulating credit in order to promote the development of agriculture and small rural enterprises.³¹⁰ In 1992, NABARD began its linkage program, which encourages commercial banks to work with MFIs by refinancing the banks' loans to the MFIs.³¹¹ In addition, NABARD also provides subsidized loans to MFIs.³¹² More recently, the central government created the Microfinance Development Fund, which allocated Rs 1 billion (about \$25.3 million) to NABARD in order to finance skill development, foster institutional support, and offer funding to MFIs for their

³⁰⁹ *Microfinance Institutions in India*, supra note 265 at at 22

³¹⁰ Chankova, supra note 266 at 8

³¹¹ Chankova, supra note 266 at 8, *Microfinance Institutions in India*, supra note 265 at 3

³¹² Chankova, supra note 266 at 8

loans.³¹³ Since the establishment of the fund, the government has continued to provide additional funding to NABARD for its promotion of microfinance.³¹⁴

In 1990, the Small Industries Development Bank of India (SIDBI) was established specifically to promote the growth and sustainability of the microfinance sector.³¹⁵

SIDBI provides subsidized loans and grants, as well as support with institutional capacity.³¹⁶

Subsidized funding is provided by the central government to nonprofit MFIs and not to NBFCs.³¹⁷ While this does have the effect of skewing incentives in favor of pursuing the institutional types of MFIs that have had comparatively minimal success in terms of outreach and sustainability, this is probably not a decisive factor in slowing the development of the microfinance sector.

Source of Funds

Alongside the lack of a comprehensive and uniform regulatory system for microfinance,³¹⁸ various MFIs' inability to access large sources of funding from diverse sources is consistently cited as one of the principal factors inhibiting the ability of Indian MFIs to achieve scale.³¹⁹ While bank loans, due in large part to NABARD's linkage

³¹³ Sinha, *supra* note 280 at 6

³¹⁴ *Microfinance in India*, Consultative Group to Assist the Poor (CGAP), http://microfinancegateway.com/resource_centers/indiapage/mf_india?print=1; *Govt to Set Up Two Funds on Microfinance*, Rediff India Abroad, October 2007, <http://www.rediff.com/money/2007/oct/09micro.htm>

³¹⁵ Chankova, *supra* note 266 at 9

³¹⁶ *Id.*

³¹⁷ Wanchoo, *supra* note 295 at 6

³¹⁸ Chankova, *supra* note 266 at 13; Bajaj, *supra* note 279; *Committee on Financial Inclusion*, *supra* note 262 on 89; Wanchoo, *supra* note 295 at 10

³¹⁹ *Microfinance Institutions in India*, *supra* note 265 at 46; Bajaj, *supra* note 279; Wanchoo, *supra* note 295 at 10

program, make up the majority of MFI funding,³²⁰ scaling up requires larger infusions of capital and thus the inability to mobilize deposits as well as problems in accessing commercial investment are some of the regulatory factors behind MFIs funding constraints.

Societies and Trusts. Societies and trusts are able to access grants, government subsidies and debt investment. However, because they lack a formal ownership structure, they cannot take on equity investment.³²¹ They are also prohibited from taking deposits from the public or collecting savings from their clients, although the RBI may allow this to go on in practice.³²²

Foreign grants are allowed and are tax-exempt, however they are subject to an application process involving registration and various procedural requirements.³²³ As of 2005, nonprofit MFIs can access external commercial borrowing as long as they meet certain conditions. Requirements include that the MFI must have a successful credit history for at least three years with a scheduled commercial bank, and it must have a certificate of due diligence indicating the “fit and proper” status of the board and managing committee. For nonprofit MFIs the loan amount is capped at \$5 million per MFI per year.³²⁴ For societies and trusts, this ability to take on debt investment will be

³²⁰ Chankova, *supra* note 266 at 11;

³²¹ *Microfinance Institutions in India*, *supra* note 265 at 51

³²² *Id.*

³²³ *Id.* at 11

³²⁴ *Id.* at 53

tempered by low investor confidence in these organizations.³²⁵ Finally, it is required that the foreign lender either be a financial institution, or provide banking references.³²⁶

Section 25 Companies. Section 25 companies may access grants under the same rules as pertain to societies and trusts above, however without the tax exemption. Like their nonprofit counterparts the society and trust MFIs, Section 25 companies are not allowed to take deposits. Section 25 companies are able to access debt funding, and will be a much more attractive option for investment in comparison to societies and trusts given their more formal ownership and governance structure.³²⁷ Section 25 companies are not conducive to equity investment, however, because their nonprofit status prohibits them from declaring dividends.³²⁸ Finally, rules exist limiting the price at which owners can sell shares.³²⁹

Cooperative Banks. Cooperative banks may access grants on the same terms as Section 25 companies – i.e., with requirements and no tax exemption.³³⁰ Unlike societies, trusts, and Section 25 companies, cooperative banks are able to take deposits – UCBs may do so from the public, while MACs may only collect deposits from their members.³³¹ Cooperative banks are able to access external debt on the same terms as above for nonprofit MFIs, however without the \$5 million per MFI per year limit.³³² UCBs will be much more attractive to investors than MACs however due to the fact that UCBs are heavily regulated and have a formal governing structure, where the opposite is

³²⁵ Id. at 48

³²⁶ Developing World Markets

³²⁷ *Microfinance Institutions in India, supra note 265* at 48

³²⁸ Id. at 21

³²⁹ Developing World Markets

³³⁰ *Microfinance Institutions in India, supra note 265* at 37

³³¹ Id. at 37, 40

³³² Id. at 40

true for MACs.³³³ Both UCBs and MACs may access equity investment, however investor confidence may be low given the difficulties that the cooperative banking industry has suffered recently.³³⁴

Non-Bank Financial Companies. NBFCs may access grants on the same terms as Cooperative Banks above. Like cooperative banks, NBFCs are allowed to take deposits, however they must meet certain requirements to do so. First, an NBFC must complete two years of operation and then obtain an investment grade rating. This is considered difficult for MFIs because conventional credit agencies are still wary of lending to the poor and to rural clients, and generally regard the practice as “inherently risky.”³³⁵ Second, NBFCs must also obtain a license to collect savings from the RBI, which is known to deny most request in order to limit the amount of NBFCs that it must oversee.³³⁶

NBFCs can access external debt investment on the same terms as pertain to cooperative banks above –i.e., that they have a successful credit history for at least 3 years with a scheduled commercial bank and have a certificate of due diligence on the “fit and proper” status of the management.³³⁷ However, below-market interest rate ceilings on external commercial borrowing effectively prohibit NBFCs from obtaining cross-border loans.³³⁸

³³³ Id. at 49

³³⁴ Id.

³³⁵ Id. at 32

³³⁶ Chankova, *supra* note 266 at 14

³³⁷ *Microfinance Institutions in India*, *supra* note 265 at 40

³³⁸ Developing World Markets

NBFCs may access equity investment under the restrictions imposed by foreign direct investment rules, which differ depending on the size of the investment. In order to acquire up to 51% of the equity of an MFI, the minimum investment is \$500,000 up front. To acquire more than 51% and up to 75%, the minimum investment is \$5 million up front. In order to acquire more than 75% and up to 100%, the minimum investment is \$50 million, of which \$7.5 million up front and the remainder within 24 months of the initial investment.³³⁹ This is understood to effectively prohibit foreign equity investment in NBFCs.³⁴⁰ A recent paper released by NABARD notes that the \$500,000 minimum investment requirement for 51% of equity should be lowered to \$100,000 so that it can equity can be more feasibly accessed by the MFIs, and so that a broader range of investors would be able to invest.³⁴¹ Regulatory barriers aside, in terms of investor confidence, the regulatory and ownership structures, as well as the relatively superior management quality of NBFCs make them the preferred options for both debt and equity investors in the microfinance sector.³⁴²

Prudential Requirements

Societies and Trusts. As charitable organizations not recognized by the banking sector, societies and trusts are without any significant regulatory or prudential requirements such as capital adequacy and minimum capitalization.³⁴³

Section 25 Companies. As with their nonprofit counterparts the society and trust MFIs, Section 25 companies are also unregistered with the RBI and are subject to very

³³⁹ *Microfinance Institutions in India*, supra note 265 at 88; Developing World Markets

³⁴⁰ Chankova, supra note 266 at 14

³⁴¹ *Committee on Financial Inclusion*, supra note 262 at 88

³⁴² *Microfinance Institutions in India*, supra note 265 at 33, 49

³⁴³ *Microfinance Institutions in India*, supra note 265 at 57

few regulatory requirements.³⁴⁴ While they do not have minimum capital or capital adequacy requirements,³⁴⁵ they are subject to loan size limits, in the amount of Rs 50,000 (about \$1,260) for working capital loans and Rs 125,000 (about \$3,160) for housing loans.³⁴⁶

Cooperative Banks. UCBs are subject to similar prudential requirements as NBFCs although to a lesser degree. Their minimum capital requirement is Net Owned Funds (NOF)³⁴⁷ of Rs 1 lakhs (equal to .01 crores, about \$2,526), which is 200 times less than the requirement of Rs 2 crores (about \$505,305) for NBFCs.³⁴⁸ Microfinance practitioners consider this to be a low limit on minimum capital.³⁴⁹ The capital adequacy requirement for cooperative banks is 10%.³⁵⁰ In contrast to UCBs, MACs are under virtually no regulation, and are without capital adequacy and minimum capital requirements.³⁵¹

Non-Bank Financial Companies. While the RBI prescribes prudential and compliance norms for all NBFCs, the prudential norms are only applicable to those NBFCs that engage in deposit-taking.³⁵² As mentioned above, minimum capital regulations require NOF of 2 crores. This was raised in 1999, when it was previously 25 lakhs (.25 crores), after concerns with NBFC bank failures.³⁵³ This minimum capital level is considered by practitioners to be high, as it is a substantial challenge to mobilize

³⁴⁴ Id. at 20

³⁴⁵ Id. at 57

³⁴⁶ Id. at 20

³⁴⁷ Net Owned Funds (NOF) is defined as shareholder equity plus internally generated reserves. Id at 22.

³⁴⁸ Id. at 57

³⁴⁹ Id. at 50

³⁵⁰ Id. at 57

³⁵¹ Id. at 42

³⁵² Id. at 22

³⁵³ Id.

such a large amount of funds.³⁵⁴ This limit will thus make it more difficult for entrepreneurs to establish new NBFCs but also for MFIs such as societies, trusts and Section 25 companies to transform into NBFCs. The capital adequacy requirement for NBFCs is 12% compared to 10% for commercial banks.³⁵⁵ NBFCs are also subject to 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.³⁵⁶

NBFCs are also subject to extensive restrictions on the investments that they can make with their funds, as well as substantial reporting and accounting requirements, including requirements to form audit committees.³⁵⁷ These management and governance-related requirements probably contribute to NBFCs' status as the most attractive MFIs from the perspective of investors.

Interest Rate Controls

Private MFIs including NBFCs, Section 25 Companies and cooperative banks are not subject to interest rate controls under any RBI regulations, as the RBI has supported MFIs' ability to charge cost-covering interest rates while at the same time criticizing overzealous collection practices on the part of some MFIs. While state and local governments enact their own usury law, private MFIs are regulated by the central bank and thus are not subject to state law on interest rates.³⁵⁸ However, NGO MFIs such as

³⁵⁴ Id. at 32

³⁵⁵ Id. at 57

³⁵⁶ Id. at 27

³⁵⁷ Id.

³⁵⁸ Sinha, *supra* note 280 at 9

societies and trusts, may be subject to usury law and other state legislation allowing state governments to introduce interest rate caps.³⁵⁹

One recent example of the introduction of state-level interest rate caps occurred in 2006 in Andhra Pradesh, a state that is home to a large proportion of the microfinance sector.³⁶⁰ In that instance, the government imposed interest rate controls and temporarily closed several branches after reports of extortionate lending practices and unethical collection methods among MFIs that had led to multiple suicides among clients.³⁶¹

One study of multiple MFIs in India found effective interest rates from MFI loans to clients were 15-24% per year, in comparison to the effective rates from moneylenders, landlords and traders, which were found to be 48-150% per year.

Assessment of Regulation

The lack of an enabling regulatory environment has been cited in several reports as one of the principal reasons why a greater number of MFIs have not achieved larger scale, and why the microfinance sector in India has only been able to reach around 30% of the estimated demand.³⁶² One high-profile practitioner who has commented on the regulatory challenges and their effects on the sector is Vikram Akula, founder and chairman of the Indian MFI SKS. SKS represents an MFI success story, as it transformed from a nonprofit to an NBFC in 2005, and currently serves nearly 1.5 million

³⁵⁹ *Microfinance Institutions in India*, *supra* note 265 at 13; Smith, *supra* note 260 at 18

³⁶⁰ For a broader discussion on the controversial issue of interest rates and harassment on the part of MFIs, *see* Sinha, *supra* note 280 at 7

³⁶¹ *Indian Bank ICICI Reaches Arrangement with Provincial Government on Micro-Loan Interest Rates*, MicroCapital, September 2006,

http://businesstoday.digitaltoday.in/index.php?issueid=18&id=2131&option=com_content&task=view

³⁶² *Supra* note 39

clients.³⁶³ Akula believes that it is difficult for other MFIs to achieve similar results, stating that “the regulatory environment created by the RBI is unfavorable for the growth and proliferation of microfinance in India.”³⁶⁴

Perhaps the two most important issues affecting Indian MFIs’ abilities to achieve growth and sustainability are the ability to access various sources of funding for their operations, as well as the disjointed nature of the regulatory environment itself.³⁶⁵ The first concern, access to funding to pursue growth and sustainability, is closely related to the regulatory regime within which MFIs conduct operations. Societies and trusts are thought by some to be inherently inappropriate for scaling up, mostly due to funding constraints such as the inability to take deposits and their informal institutional structure which makes the MFIs unattractive to investors, while also contributing actual instances of ineffective management.³⁶⁶

Section 25 companies and cooperative banks are better positioned to increase scale and outreach than society and trust MFIs. Despite their more professional governance and the higher investor confidence this will engender, substantial challenges also confront Section 25 companies and cooperative banks in their efforts to raise the necessary funding to achieve growth. For Section 25 companies, challenges to scaling up operations manifest themselves in the form of an inability to raise funds from taking deposits, and an inability to declare dividends, which makes Section 25 MFIs less

³⁶³ As of December 31, 2007, SKS reported 1,459,482 clients. SKS Microfinance, <http://www.sksindia.com>

³⁶⁴ Wanchoo, *supra note 295*

³⁶⁵ Wanchoo, *supra note 295* at 10; Smith, *supra note 260* at 91

³⁶⁶ *Microfinance Institutions in India*, *supra note 265* at 50

attractive to equity investors, which in turn effects their leveraging capacity.³⁶⁷ While cooperative banks are allowed to take deposits, investor confidence in UCBs may be shaky given the state of the cooperative banking sector. MACs will be a far less attractive target for investment given their more informal governance and lack of regulatory requirements. These factors together will lessen the attractiveness of cooperative banks for equity investors which, as above with Section 25 companies, can lead to leverage problems.³⁶⁸

Finally, NBFCs are the MFIs best positioned to achieve growth and scale. The problem however is the attainment of NBFC status given the barriers to establishing new NBFCs and the barriers facing smaller MFIs with long-term strategies involving upscaling and transformation. NBFCs also face some regulatory hurdles on their operations, such as the regulatory obstacles to foreign equity and debt investment. One study concluded that these regulations are all but prohibitive of foreign investment.³⁶⁹ The result in practice is often that loan guarantees – the practice of foreign investors backing domestic bank loans to local MFIs – remains as the only option. While guarantees can be a more feasible way to channel funding to MFIs while also encouraging domestic commercial banks to become more involved with the microfinance sector, transaction costs are much higher than for direct lending and investment. The higher transaction costs dampens investment interest in loan guarantees, which explains why they are more commonly pursued by the public sector and the IFIs as opposed to

³⁶⁷ Id. at 50

³⁶⁸ Id. at 50

³⁶⁹ Chankova, *supra* note 266 at 18

commercial investors and MIVs.³⁷⁰ Access to funds for NBFCs can thus be substantially restricted to domestic sources, where interest in microfinance investment among the private sector is considerably small compared to that of international investors and MIVs. Finally, private lenders are further crowded out of the market by commercial banks that, pursuant to “priority sector” governmental regulations, are required to provide loans to low-income recipients including MFIs. This serves to create downward pressure on interest rates to MFIs, and further limits the participation of commercial lenders.³⁷¹

Second, apart from the constraints on accessing funding, the regulatory environment for microfinance as a whole remains generally unclear and disjointed. Indeed, some believe that the lack of a comprehensive, clear and uniform regulatory system is the single most important issue hampering the growth of the microfinance industry.³⁷² In its 2008 report on access to financial services in India, NABARD recommended that microfinance regulation should be centralized by the RBI under a single mechanism that regulates all MFIs in a coherent manner.³⁷³ A single regulatory body could remedy many of the inconsistencies in regulation such as the virtual lack of regulation for societies, trusts and MACs compared to the extensive regulations placed on UCBs and NBFCs. This would also enable the standardization of financial disclosures based on international best practices, across MFIs of all types, which would serve to substantially reduce transaction costs and thus attract more investors and donors.³⁷⁴

Proposed Microfinance Legislation

³⁷⁰ Supra note 47

³⁷¹ Developing World Markets

³⁷² Bajaj, supra note 279

³⁷³ *Committee on Financial Inclusion*, supra note 8 at 89

³⁷⁴ Chankova, supra note 266 at 13, 18

The Micro Financial Sector (Development Regulation) Bill, 2007 was introduced in Parliament in March of 2007, and remains under consideration at the time of writing.³⁷⁵ The bill was drafted with the intent to improve regulation and also to promote the development of the microfinance sector.³⁷⁶ The bill would introduce new regulations and supervisory requirements on society and trust MFIs, to be administered by NABARD. Societies and trusts would be required to register with NABARD, and to comply with regular reporting requirements including submission of audited financial statements.³⁷⁷ The Bill also introduces procedures for dispute settlement between MFIs and their clients, and also details procedures for inspections of MFIs if the regulatory authorities have reason to believe that an MFI's practices constitute harassment towards their clients.³⁷⁸

Most controversially, the proposed microfinance bill would allow societies and trusts to take deposits from their members after meeting certain requirements.³⁷⁹ In order to be eligible to take deposits, a society or a trust would have to have been in existence for three years, and to have a minimum capitalization of at least NOF 1 lakh (about \$2,500).³⁸⁰ 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). The Bill would also require societies and trusts taking deposits to create a reserve fund by transferring a minimum of 15% per year of their net profits from savings

³⁷⁵ Sanyal, *supra* note 297

³⁷⁶ *Id.* at 14

³⁷⁷ *Id.* at 1

³⁷⁸ *Id.* at 3

³⁷⁹ *Id.* at 1, 2

³⁸⁰ *Id.* at 4

and microfinance services.³⁸¹ The Bill also allows NABARD to prescribe additional norms that it deems necessary.³⁸² The Bill also provides for loan size limits for societies and trusts, of Rs 50,000 for working capital loans and Rs 150,000 for housing loans.³⁸³ As noted above, these are the same loan size limits as those currently placed on Section 25 companies.

Commentators have highlighted the registration, reporting and audit requirements as measures that will improve management and increase professionalism across the sector.³⁸⁴ The provisions for inspection and dispute settlement have also been noted as important positive aspects of the proposed regulation.³⁸⁵ However the proposed legislation has also been criticized, perhaps most widely for not addressing or remedying the disjointed nature of microfinance regulation.³⁸⁶ The bifurcated regulatory structure inherent in the legislation, with societies and trusts being regulated by NABARD, whereas NBFCs, cooperative banks and Section 25 companies would continue to be regulated by the RBI, runs counter to calls by NABARD and others to consolidate regulation of all MFIs under one single authority. According to Sanjay Sinha, managing director of M-CRIL, an international microfinance rating agency headquartered in India, societies and trusts, and indeed all MFIs, should be regulated by the RBI and thus “treated as an integral part of the financial system rather than as an insignificant pocket to

³⁸¹ Id. at 1

³⁸² Id. at 4

³⁸³ Id. at 2

³⁸⁴ Mukul G. Asher & Savita Shankar, *Microfinance Bill: Need for Major Re-think*, http://www.karmayog.org/billsinparliament/upload/8457/CFO_Article-final.doc

³⁸⁵ Id.

³⁸⁶ Sanyal, supra note 297 at 1; Sinha, supra note 280 at 11;

be placed in a separate segment unworthy of attention by the main national institutions.”³⁸⁷

There is also concern that placing NABARD in charge of regulating societies and trusts will lead to a conflict of interest since 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 the fact that combining the role of service provider and regulator is not considered good governance practice, while some have also taken issue with NABARD’s expertise and general capacity to regulate effectively.³⁸⁸

The prudential norms proposed for the MFIs have been criticized as inadequate for MFIs taking deposits.³⁸⁹ One report criticized the fact that the mandatory reserve fund is the single prudential regulation, arguing that it will be ineffective for MFIs not realizing profits, and that it was also necessary to place limits – linked to an MFIs reserve fund or its NOF – on the volume of deposits that an MFI can take.³⁹⁰ As indicated in the above discussion on international best practices, practitioners stress the necessity of prudential norms for MFIs taking deposits, emphasizing the importance of capital adequacy requirements, which should be stricter than those imposed on banks at least at the inception of an MFI’s deposit-taking operations. Thus, apart from the debate on minimum capital, new legislation enabling MFIs to take deposits should impose prudential supervision through capital adequacy requirements in order to provide adequate protection of client savings in conformity with international best practices.

³⁸⁷ Sinha, *supra* note 280 at 12

³⁸⁸ Sanyal, *supra* note 297 at 1; Asher & Sankar, *supra* note 384

³⁸⁹ Sanyal, *supra* note 297 at 1; Asher & Sankar, *supra* note 384

³⁹⁰ Asher & Shankar, *supra* note 384

The Bill does not include an exemption of MFIs from state and local interest rate laws, which could serve to create an uneven playing field in comparison with Section 25 companies, cooperative banks and NBFCs which will continue to be able to charge cost-covering interest rates.³⁹¹ Concerns have also been raised as to whether societies and trusts are appropriate vehicles for to provide microfinance services including savings.³⁹² 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 in order to finance their lending operation.

Finally, allowing society and trust MFIs to take deposits from their members is the most controversial portion of the proposed legislation. Some see this as one of the advantages of the Bill, providing a means for MFIs to obtain access to a wider range of funding for their operations and enabling them to broaden their outreach and offer their local expertise to a wider range of clients.³⁹³ From this perspective, offering the financial service of savings and providing MFIs with increased opportunity for increased client outreach provides a needed alternative to increased numbers of working poor that are currently dependent on riskier lending at higher rates from informal sources such as local moneylenders.

The alternative perspective is that allowing these small and relatively informal and inexperienced MFIs to take deposits would put poor clients' money at risk. The lower level of protection for clients' savings (minimum capital requirement of NOF 1

³⁹¹ Sanyal, *supra* note 297 at 1; Asher & Sankar, *supra* note 384

³⁹² Smita Premchander & M. Chidambaranatham, *One Step Forward or Two Steps Back? Proposed Amendments to NABARD Act*, *Economic and Political Weekly*, March 24, 2007, pg. 1006; Sanyal, *supra* note 297

³⁹³ Asher & Sankar, *supra* note 384

lakhs in comparison to 200 lakhs for NBFCs) in comparison to other banks has been criticized, although the proposed minimum capital requirement is the same as that currently in place for cooperative banks. From this perspective, the current division of labor where NBFCs and the formal banking sector offer savings in combination with experienced management and adequate protection, while NGOs serve as facilitators, is preferable to the arrangement in the proposed legislation, which would dilute the safety of client deposits.³⁹⁴

As noted in the above discussion on best practices, practitioners recommend that not all MFIs should be permitted to take deposits, but rather the ability to take deposits should be contingent on an MFI's ability to make some demonstration of the capacity to do so. Regulators are thus encouraged to set some criteria and requirements, the satisfaction of which would indicate a bank's ability to manage its lending profitably enough so that it can cover its costs, including the additional financial and administrative costs of taking deposits. From this perspective, the requirements of three years of experience as an MFI is a good sign, while it is unclear whether the extent of the proposed minimum capital requirement and reserve fund will serve to provide adequate prudential regulation that balances protection and access – evidenced by the above-described debates both praising and criticizing the proposed regulation. Perhaps the pivotal component will be NABARD's ability to prescribe additional norms that it deems necessary. How NABARD uses this regulatory power could serve to make or break the success of the regulatory program. On one hand, the implementation of capital adequacy requirements in conformity with international best practices could complete the

³⁹⁴ Premchander & Chidambaranatham, supra note 392 at 1006

regulatory scheme, adding the final touches that provide the necessary investor protection. On the other hand, if NABARD goes too far in this direction, implementing excessive prudential norms and regulation to appease some of its critics, the regulatory scheme could end up being overly burdensome, reducing incentives for individuals and investors to start and grow MFIs, ultimately restricting access to financial services among microentrepreneurs.

In conclusion, the proposed Bill has been met with mixed reviews. NABARD has commented that the Bill would help in promoting the growth of the Indian microfinance sector,³⁹⁵ while others assert that the Bill's positive features are "more than outweighed" by its deficiencies.³⁹⁶

IV. CONCLUSION

The worldwide microfinance movement is expanding rapidly. To reach the vast unmet demand for financial services among the working poor, new MFIs are being established in all regions of the developing world, while existing MFIs are continuing to expand client outreach. A small, albeit growing proportion of MFIs worldwide has been able to scale up operations such that their profitability surpasses even that of local commercial banking institutions. In addition to achieving sustainability and profitability, these large MFIs are able to transform the lives of numerous individuals by providing access to invaluable financial services such as credit, insurance and savings to those who are unable to obtain access to traditional commercial providers.

³⁹⁵ *Committee on Financial Inclusion, supra note 262 at 89*

³⁹⁶ Asher & Sankar, *supra note 384*

While the investment capital needed to establish and expand MFIs has traditionally come from public and multilateral institutions such as governments and IFIs, this funding, while instrumental in getting the industry off the ground, is seen as greatly insufficient if microfinance is to significantly close the supply/demand gap (MFIs currently reach around 10% of the estimated demand for microfinance services) and thereby dramatically reduce world poverty. Attracted by the opportunity to realize both financial and social returns, an increasing amount of private investors seem poised to meet this demand for additional funding. The last several years have seen a growing number investors pursuing large and innovative investment transactions and channeling large amounts of much-needed funding to promising MFIs. This trend has demonstrated the enormous potential for the private sector to work together with MFIs in order to reach a significant portion of the still-unmet demand. Indeed, recent developments indicate that as long as MFIs continue to demonstrate a capacity to increase outreach into still-unreached portions of the demand and to do so profitably, investors in the private sector will be willing and able to provide the necessary investment capital.

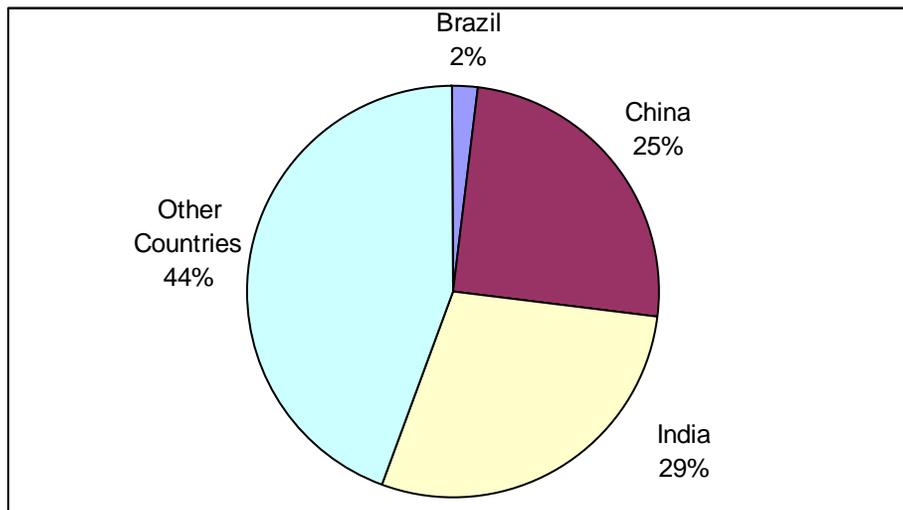
The ability of microfinance to increase outreach among portions of the still-unreached demand will thus depend on the ability of MFIs around the world – and especially in those regions where a large portion of the demand remains unreached – to demonstrate an ability to achieve the level of sustainability and growth necessary to attract private sector investment. While previous scholarship has provided an assessment of the percentage of MFIs that have thus far been able to do this, this paper has attempted to contribute to that discussion by analyzing some of the external factors that influence an MFI's capability of becoming “investable.” This was done by assessing the legal and

regulatory environments for microfinance in Brazil, China and India – three countries where over half of the unreached demand for microfinance services is estimate to be located – and examining how regulations affect the ability of individual MFIs to pursue the sustainability and growth that would make them desirable targets for commercial investment. The analysis demonstrated that a given regulatory regime, and specifically the nature and extent of the various requirements and restrictions placed on MFIs, can profoundly influence an MFI’s business model and its capacity to achieve sustainability and growth. This is believed to be the case with regard to the three countries discussed above, where the microfinance sectors are currently estimated to be reaching 3% of demand in Brazil, 23% in China, and 30% in India. Practitioners agree that the ability of MFIs in these countries to reach large numbers of clients is substantially constrained, among other factors, by each country’s respective regulatory regime. Regulatory constraints on MFIs’ ability to cover costs and increase outreach also make MFIs in these countries less attractive to investors, while other barriers to market entry and foreign investment further decrease the likelihood of private investment capital reaching these MFIs. Together, these factors may go as far as to rule out private investment for a majority of MFIs in these countries under the existing legal and regulatory framework, which completes a vicious cycle that limits the potential for growth in the microfinance sector.

Thus, while the 90% figure for still-unreached demand for microfinance is indicative of a tremendous potential for growth, any optimism must be tempered by an understanding of the constraints inherent in reaching the unmet demand. Despite the fact that the private sector is increasingly willing to provide the investment necessary to close

the supply/demand gap, legal and regulatory barriers can still serve as a formidable obstacle to extending MFI outreach. While MFIs in Brazil, China and India are certainly not “off-limits” for private investment, current regulatory environments place substantial limitations on private capital’s ability to find investible MFIs capable of extending microfinance outreach within those countries. As discussed above, microfinance penetration rates are currently estimated at reaching 3% of demand in Brazil, 23% in China, and 30% in India. Practitioners agree that the ability in these countries to reach large numbers of clients is substantially constrained, among other factors, due to each country’s respective legal and regulatory environment. Thus, under current regulatory conditions, an increased availability of private sector capital, above all foreign private capital, may not be able to play a significant role in increasing microfinance outreach for these countries. This is important for the international microfinance movement as a whole, because, as the chart below demonstrates, these three countries are estimated to make up over one half of the still-unreached demand for microfinance services.

Estimated Percentage of Still-Unmet Demand for Microfinance Services Worldwide



*Source: Small Enterprise Education and Promotion (SEEP) Network*³⁹⁷

An understanding of the role of domestic legal regimes and the extent to which they can limit the potential for growth of a given country's microfinance industry indicates that domestic regulatory environments must be an essential area of focus within the field of microfinance. Given this importance, NGOs, IFIs and other microfinance-focused organizations have an important role to play in terms of deepening worldwide understanding of international best practices for microfinance regulation, so that countries can strike a better balance that not only protects the safety of the financial system and of institutions and clients alike, but at the same time allows for the flexibility of business operations that will enable a vibrant microfinance sector to emerge. Some have also called for national governments to establish specific agencies or departments within the banking authorities that are specifically focused on the microfinance industry.³⁹⁸ Such a department could cultivate an understanding of the unique attributes of the microfinance sector and work to integrate MFIs into the overall banking sector in a way that achieves coherent and appropriate regulation. These departments could also coordinate and exchange information with their counterparts in other countries, as well as with microfinance experts at nongovernmental and international organizations such as the World Bank and CGAP. This information sharing could serve to disseminate expertise in microfinance regulation to government officials in charge of shaping and implementing regulation, helping them to work towards a domestic regulatory environment that limits risk to an acceptable level and also facilitates the growth and development of the microfinance sector. Indeed, now that private sector investment is becoming increasingly

³⁹⁷ *Optimizing Capital Supply, supra note 1 at 2*

³⁹⁸ This, in effect, already exists in Bolivia – the first country to have a regulated MFI (BancoSol).

available for promising 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 supply/demand gap and thereby dramatically reduce world poverty.