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UNITED STATES MICROFINANCE: REGULATING TO PROMOTE GROWTH

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Abstract: *This study draws on 20 in-depth interviews with microfinance institutions, practitioners, analysts/ policy makers, and academics along with a review of literature to understand and assess the state of the microfinance industry in the United States in terms of its salient features, critical issues and regulatory landscape using the microfinance chain of funders, providers and customers as an organizing framework. Global microfinance is used as a baseline comparison where relevant. The study finds that the microfinance industry in the United States is very much in a nascent microcredit stage, populated with microfinance institutions (MFIs) that are largely, non-profit, non-depository, credit only institutions, with some of the larger MFIs forming symbiotic partnerships with commercial banks in order to overcome the banking challenge. Their target market, funding sources and governance issues that stem from the MFIs existence at the nexus of banking and development are discussed. The current state of microfinance regulation in the United States is assessed in light of the costs and benefits of regulation as well as its unintended consequences. We suggest a tiered/ gradual regulatory growth promoting approach that would allow an MFI to transform gradually to offer more comprehensive services, while making allowances for the industry's developmental state.*

JEL Classifications*: G21, O17, Q14*

Keywords*: microfinance, risk, poverty, NGOs, outreach*

1. INTRODUCTION

Microfinance has been lauded as an innovation in the important new frontier market for risk capital to the under-banked, or those who have been previously excluded from the financial system. This attempt at democratization of capital access to the bottom of the pyramid consumer has been called an active frontier of "creative capitalism," "bottom billion capitalism" or "poverty capital" (Roy, 2011) suggesting its roots in the some of the poorest countries in the developing

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world, like Bangladesh where it flourished primarily due to financial service product innovations suited to the local context. Typically in developing countries, microfinance institutions (MFI) seek to provide credit to very low income households, or to 'necessity' entrepreneurs to start survival scale businesses, to smooth consumption, to insure risk and to offer a safe haven for micro-savings. A typical MFI in the global context is a non-profit organization, funded by host governments and other multilateral agencies, while some are member owned cooperatives. Funding for this type of MFI comes from patient[1] or undemanding capital seeking social returns versus commercial or demanding capital, which seeks a return commensurate with risk.

MFI business models globally have evolved over the past three decades from grant-dependent, credit only models to more comprehensive deposit mobilizing institutions (IMF, 2005) facilitated by regulatory changes, and in an increasing number of cases to profit seeking institutions funded by commercial capital. In terms of MFIs in the United States, there is a clear distinction between the financial systems approach and the mission centered approaches that take starkly different perspectives on outreach and sustainability[2]. Hence, MFIs have been broadly classified into Type 1 and Type 2 organizations, where Type 1 organizations are mission driven, they emphasize outreach over profits and self-sustainability, versus Type 2 organizations that are driven by the profit motive in response to market forces with less emphasis on social consequences (Von Pischke, 2002). Mohammed Yunus, one of the leading pioneers of microfinance discussed the merits of the social business which harnesses market forces in the pursuit of social ends, since in his view microfinance mainly revolves around financial support for the entrepreneurial efforts of the poor to allow them to survive the seasonality of unemployment in places with no social safety nets along with unexpected shocks that punctuate their precarious livelihoods. A social business is a non-loss, non-dividend paying business that ploughs its profits back into the business in a never ending cycle of renewal rather than dividend it out to shareholders (Yunus, 2007).

The United States arguably has one of the most well developed financial systems in the world, yet excludes 12-15 million households are either under banked or unbanked (FDIC, 2009). In the past decade or so, there has been increasing interest in adapting the microfinance innovation to the United States context to enable financial inclusion for low-income households. The more formal nature of the United States economy makes it harder to start smaller, survival scale businesses that face limited market demand or "puddles of demand". A more complex, highly formal economy also requires an adequate level of financial training and education. Consequently the microfinance sector in the United States is atomized with a number of smaller, dispersed MFIs providing microcredit, or credit plus training to clients. (Schreiner and Morduch, 2002; Talen, Weiss and Sarkar, 2002) Economic activity in the United States is not just more formal, but also more regulated particularly when it comes to finance; all forms of finance are to some extent regulated by consumer protection laws on the demand side and by prudential or non-prudential banking regulations, State level usury laws limiting interest rates and capital adequacy ratios designed for commercial banking on the supply side, depending on whether or not the MFI engages in financial intermediation by way of deposit mobilization.

Microfinance in the United States has not evolved into a comprehensive range of financial services covering the gamut from microcredit to savings and insurance as it has in some parts of the developing world, where the service spectrum is much broader and mobile technology is

used quite effectively to enhance outreach to clients in remote rural locations as well as SMEs. Hence, we argue in this study that the United States is in microfinance 1.0[3] or still nascent, very much in the growth stage of its evolutionary life cycle or in Jonathan Lewis's words, it is still a movement trying to find its way, not a sector[4]. As microfinance in the United States evolves and matures adapting to unique contextual features as it has elsewhere in the developing world, the regulatory and governance dimensions of microfinance are expected to move to the forefront, since regulation is a powerful tool that can either help the productive growth of this emerging sector or curb its development if applied in a misguided manner.

This paper is organized as follows. Following the introduction, Section 2, outlines the method used for this study, which draws upon expert opinions as well as extant literature. Section 3, provides a review of the critical issues confronting the microfinance industry in a global setting. Section 4 discusses salient features and similarities and differences between the relatively more mature global microfinance experiences in developing countries and the evolving microfinance sector in the United States, which like its global counterpart is far from monolithic consisting of a variety of bank and non-bank institutions, but is marked by some important differences related to its earlier life cycle stage, such as its relatively brief service spectrum focused primarily on microcredit and training components. Section 5 of the paper discusses the current state of regulations impacting microfinance in the United States, and the need for context sensitive regulations tailored to the unique nature of microfinance, along with motivations for commercial bank-MFI partnerships, the role of self-regulation and unique governance issues faced by MFIs and their implications. Section 6 concludes the discussion with recommendations for promoting scale and growth of MFIs in the United States.

2. METHODS

The intent of this study was to gain an understanding of the nature of microfinance in the United States in terms of its institutional structure, target market, products and services, nature of innovations, and governance issues in order to assess current regulations of microfinance and to suggest regulatory best practices based on global experience in the sector. Given the scant literature in the field compared to the literature on global microfinance as well as the early evolving nature of the field, the expert interview method was chosen for this study as a means for primary data collection. The in-depth, semi-structured interview method was selected, since this modality provides for focused and systematic information collection, while allowing the interviewee to provide rich and relevant contextual information appropriate to each case (Eisenhardt, 1989; Yin, 1994).

Interviewee selection was first based on a review of extant literature, related to global and United States microfinance, as well as perusal of web sites, academic papers and press releases related to the core topics of the study. After the first set of interviews was conducted, the snowball method (Rubin and Rubin, 1994) was used along with the first approach of contacting authors of academic papers or people named in published sources for locating relevant expertise. An interview instrument was designed for MFI practitioners, which was later modified to suit the interviewee's institutional background as the interview base expanded from MFI practitioners to various institutions related to microfinance such as the Consultative Group to Assist the Poor (CGAP), World Bank, Association for Enterprise Opportunity (AEO), Center for Financial

Inclusion, Microfinance Opportunity International, Citibank Microfinance Unit, Grameen Foundation USA, to academics with published output in the field and other research and policy think tanks involved in work related to microfinance. In addition, academics and practitioners in Sao Paulo, Brazil and Bangalore, India were interviewed to provide local insights into global developments in microfinance. Interview questions were grouped around broad categories related to the microfinance chain: funders, providers and customers, followed by those related to regulation of the sector in the United States. The interview protocol also underwent changes as new information gleaned from interviews expanded the researcher's understanding of the key themes. The use of multiple informants from various institutional backgrounds spanning the academic to the practical helped develop a rich and prismatic view of the landscape of United States microfinance and its salient features to provide the backdrop for an assessment of the nature of regulation. Interviews with academics with the relevant publications in the field were used to gain theoretical insights that countered and complemented the practitioner perspective. Extensive use of archival and extant literature on the topics of microfinance and regulation in the United States and developing country contexts were used to add theoretical grounding for the study.

A total of 20 in person and telephone interviews were conducted by the first author between November 2010 and November 2011. Relevant content from presentations and panel discussions from the Microfinance USA 2011 Conference, New York City, May 23-24, 2011 were also incorporated into the current study. Interviews ranged from 20-45 minutes and were digitally recorded with the interviewee's consent and transcribed for review and analysis. Data analysis started with a reduced set of initial interviews in order to avoid data suffocation (Pettigrew, 1990). An initial set of interviews was selected using the criteria of content relevance / richness and potential for variance for deeper analysis (Strauss and Corbin, 1998). Subsequently, information from all the interviews were clustered and related to theoretical concepts and core ideas from the microfinance literature to start a dialog between theory and primary data collected from interviews (Ragin, 1994). This interactive process helped add dimensionality, meaning and relevance to the interview data, while suggesting new avenues of thought and information not obvious or present in the extant literature.

3. EMERGING CONCERNS IN MICROFINANCE INSTITUTIONS: GLOBAL SCENARIO

This section provides a discussion on the ongoing poverty lending versus financial systems approach debates in the microfinance industry based on global experience, followed by the renewed importance on savings, graduation programs to strengthen the agency of clients and technological advances in the sector. The section also discusses the recent crisis in the microfinance sector of Andhra Pradesh which has implications for the regulatory and governance fabric of microfinance globally.

In microfinance, both the financial systems and the poverty lending approach, share the goal of making financial services available to the poor. The poverty lending approach focuses on reducing poverty through credit and other services funded through subsidies and concessional funds whereas, the financial systems approach focuses on commercial financial intermediation and institutional self-sufficiency. There is a view that the poverty lending vis-à-vis financial

system approaches is more than an either/or argument, rather it is the extent to which an institution pursues either of these goals and its potential consequences (Rhyne, 1998). Although in most parts of the world, the microfinance sector appears to be trending toward a financial systems approach, individual institutional strategies differ significantly as is evident in the case of Grameen and BRAC in Bangladesh, Vietnam Bank for Agriculture and Rural Development (VBRAD), the Vietnam Bank for the Poor (VBP) and the People's Credit Funds (PCFs) in Vietnam, Rural Credit Cooperatives in China and Bank Rakyat in Indonesia.

Globally, there is an increasing shift towards the commercialization of the sector, leading to what is popularly known as "mission drift", which refers to "the de-emphasis of social mission in pursuit of higher financial returns" (Woller, 2002). This phenomenon of shifting the focus towards relatively better off poor borrowers in the pursuit of profits is feared by Muhammad Yunus and those that subscribe to the mission-centered view that microfinance seeks to replace the money lender, not become one. There is a view that subsidies could help push MFIs towards their double bottom line of social and financial results (Copestake, 2007) as a way to avoid mission drift. An associated argument is that the continuous use of subsidies crowds out other potential sources of funding such as savings mobilization (Morduch, 2000), and possibly restrict institutional ability to seek efficiency gains. However, recent empirical evidence shows mixed results, with one recent study indicating that outreach is negatively related to efficiency of MFIs (Hermes *et al.*, 2011). Mersland and Strom (2010) find that an increase in MFI average profit and average cost tends to serve financially sound clients who can absorb large loans. The verdict of empirical findings, indicate that the results are inconclusive on the issue of commercialization and its impacts on MFIs in terms of efficiency and outreach.

The Grameen II experience indicates the need for savings in a successful microfinance program, in the context of commercialization debates in the sector. Under the classical Grameen I model, group loans were offered to create self-employment or for other income-generating activities rather than for supporting consumption. The compulsory weekly savings and loan deductions were the inbuilt mechanisms to promote a savings culture among the members and to support activities to improve members' welfare. Over the 1980s and early 1990s the clients took bigger consumption loans as well as new types of loans such as housing (Hulme, 2009), and attached less importance to savings. This was encouraged by the Bank to some extent, leading clients to take on levels of debt which they could not service from their income. The situation was further worsened due to the flood situation in 1998, and the Grameen experiment started to crumble.

The concept of the group fund has been changed in Grameen II and the borrowers were offered individual accounts, along with a number of savings products including a pension savings scheme. Going into debt often worries low-income households, so many prefer to turn regular microsavings into 'lumps' of money that can be spent on major purchases or events (Rutherford, 2000). Overall, the Grameen II experiences provide the first sound proofs of the saving capability of the poor and indicate the rich and complicated saving strategies used by the poor (Dowla and Barua, 2006) leading to the conclusion that the poor may need savings / deposit services as much as they do credit. In a recent field experiment study in rural Kenya, the results suggest that households would save more if they had access to a broader array of saving devices, from simple safe boxes to commitment contracts (Dupas and Robinson, 2011). In sum, the mobilization

of the savings, an important fundamental to the microfinance institutions, requires an understanding of the nature of such savings, which may be small and short-lived surpluses that accrue to the household with high frequency and seasonality. However, the saving aspect of the microfinance institutions put further challenges on the regulatory legislations in the sector (see Section 5).

Whether microfinance is an appropriate instrument to target the extreme poor is another concern in the sector. There are alternate models of serving this segment, such as cash transfers which are targeted at the ultra-poor, as well as those that provide access to diverse types of non-cash resources. According to Hashemi and Montesquiou (2011), successful efforts to reach the extreme poor often have combined access to financial services with a variety of nonfinancial services, such as livelihood training, as evident in the "Challenging the Frontiers of Poverty Reduction/ Targeting the Ultra Poor (CFPR/TUP)" program by BRAC in Bangladesh, which had reached around 300,000 poorest households who are managing sustainable economic activities. To meet the primary needs of the borrowers in the ultra-poor category, an *integrated microfinance* that includes financial services along with a host of other services is being encouraged by institutions such as BRAC. In Vietnam, the government has integrated microcredit into the National Poverty Reduction and Growth Strategy by utilising the state-owned banks to provide credit to the rural credit market, such as providing credit access to the rural poor at a preferable interest rate[5]. Different forms of credit are available to the rural credit market such as individual lending, group lending, and village banking. In particular, many microcredit programmes have been developed to provide greater credit accessibility to rural households. These include the provision of formal microcredit through the Vietnam Bank for Agricultural and Rural Development (VBARD), Vietnam Bank for Social Policy (VBSP), and others. These integrated services generate opportunities for the ultra-poor to gradually integrate them into mainstream microfinance programs, through a broad-based and multidimensional approach which involves enterprise development training, asset transfer, social development, and essential health care. This experience reconfirms that microfinance institutions could play a greater role in helping the extreme poor, if target client needs are better understood and appropriate delivery mechanisms are developed in response. These types of *graduation programs* in microfinance provide substantial support to develop the capabilities of the poor, in terms of confidence, skills, assets and access to micro financial services to help them operate more effectively in a market situation.

New technologies, such as cellular telephone, ATMs and debit cards have enabled the MFIs in developing countries to provide a wider range of services to existing clients at a reduced cost, such as mobile banking, managing a network of retail agents and providing electronic transaction facilities to customers and to financial institutions. Technology has also enabled outreach to new clients based in remote areas of the country as witnessed by experiences of correspondent or branchless banking in Brazil, Kenya and South Africa, where branchless banking services appear to reach the most vulnerable populations across a range of services (Bankable Frontier Associates LLC, 2010), while reducing service costs and increasing service quality (Kapoor *et al.,* 2007). However, technological advances have brought in new supervisory challenges related to the payment system. For instance, a recent study on the experience of M-PESA in Western Kenya indicated that the need for intense daily liquidity management support

is restricted by factors such as employee misconduct and physical security (Eijkman, Kendall & Mas, 2010). Many countries in Sub Saharan Africa (SSA) are gearing up to embrace these technological changes and have implemented specific laws and regulations to tackle the potential security threats posed by these new channels by setting guidelines on the use of agents and M-banking in South Africa and Ghana (Arun and Murinde, 2010). Thus technological advances have enabled or increased access, while infusing the regulatory spectrum of microfinance with many specific variants of regulatory legislations.

The Indian State of Andhra Pradesh once hailed as a successful region for microfinance institutions received international media coverage in 2010 in relation to unethical loan recovery practices followed in the sector and subsequent government clampdown of the sector with rather draconian regulations. The media coverage of SKS, Microfinance in India, a non-banking finance company regulated by the Reserve Bank of India is a for profit MFI, whose stratospheric Initial Public Offering (IPO) in the Indian State of Andhra Pradesh was not in the favor of the interests/image of the social mission of microfinance, and added fuel to the public perceptions of predatory microfinance that exploited rather than served the poor (CGAP, 2010). The situation was complicated by the fact that the newly recruited staff of MFIs in Southern India, sought to achieve financial targets using aggressive and unethical practices, which have influenced the State government to introduce regulatory legislation named as Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010, aimed at regulating the lending and recovery practices of the microfinance institutions in the state. The Act initiates a penalty on the use of coercive loan collection practices by the MFIs and prohibits lending to the Self Help Groups (SHGs) that are covered by the formal banking sector without prior approval of the banks. The Act also insists on the public display of the rates of interest charged by MFIs in a noticeable place visible to all members. Porteus (2006) finds that mandatory requirements on MFIs to publish interest rates in a uniform and transparent manner could in the long run lead to reductions in interest rates. Hence, these newly devised non-prudential regulations for the microfinance sector in Southern India may in fact have a salutary effect on the sector's growth.

Hulme and Arun (2011) find a better managed crisis situation in Bangladesh, where the MFIs hold 'compulsory savings' from clients, which provide a buffer (for the MFI and client) in case of client difficulties with repayment and to manage a potential default. By comparison, in India, the regulatory restriction of not allowing MFIs to hold savings raises the risk of client defaults and MFI collapse. In light of findings that MFI clients need access to safe savings services as much as they do credit and the role of savings in MFI sustainability, the issue of savings mobilization has opened up further discussion on necessary changes in the regulatory legislation of the sector.

The Andhra Pradesh crisis had highlighted two issues – the need for appropriate regulations and the need for training among the borrowers. The tendency among poor households to borrow in excess of their repayment capacity may require exposure to programs of financial education which enable them to better assess their credit needs in light of repayment capacity as well as terms and conditions of the available financial products. This in turn has already resulted in the imposition of financial regulations that require transparency and truth in lending similar to developed countries. Financial education and training could also serve to inculcate a certain degree of financial responsibility among individuals in the wise use of credit and understanding

of consumer rights. Although, training such as this could allow households to take informed decisions, the question remains as to who will provide appropriate training and bear the additional cost of training. The justification for regulating microfinance has been stimulated by a desire to correct unethical practices in an industry that had grown too soon and too fast for its own good. For example, SKS microfinance in India is a leading example of the profit oriented MFI that has been criticized by Yunus and many others. It has also led the government of India to impose rather draconinan regulations to curb unethical profit seeking behavior in MFIs.

4. SALIENT FEATURES AND KEY ISSUES IN MICROFINANCE IN THE UNITED STATES

This section provides an overview of the nature of United States microfinance, its origins, and evolution with an emphasis on key issues animating the field: the nascent nature of United States microfinance marked by an emphasis on microcredit versus the more holistic microfinance seen in developing countries, the goal of financial inclusion of microfinance into mainstream finance and the problems associated with the transfer of this technology to the United States, sources of funds, target market, structure of MFIs, need of scale and barriers to growth of the microfinance sector, and the challenge of continuing subsidy dependence.

Like any transplant, the microfinance innovation has changed and adapted to its new environment in the United States, hence comparisons are drawn to the global scenario, where relevant. Globally, microfinance has a much longer history marked by notable innovations in lending methodologies, flexible collateral, and savings mobilization (Armendariz de Aghion and Morduch 2004). Other innovations in the global arena include advances in mobile banking, such as MPesa in Kenya and the innovative use of branchless banking in Brazil supported both by mobile banking technology and regulatory innovations respectively (Rhyne 2009). By comparison, microfinance innovations in the United States capitalize on technology based solutions to client outreach and service delivery, such as the Microloan Management System (MMS), an automated loan underwriting systems for online loan approval developed by ACCION[6] Interviewees mentioned microfinance business model innovations that had led to new sources of revenue and funds[7]. However, interviewees did concede that client outreach via innovative technologies is still evolving in the United States.

The global model of microfinance popularized by the Grameen Bank I is predicated on small dollar loans, a peer or group lending model that serves as a substitute for collateral, subscription to the 16 Grameen principles which span lifestyle choices, forced savings, and graduated loan sizes to assess repayment behavior and capacity. Given the cultural, social and geographic differences in the United States, this model was not open to easy transfer to the United States, where average loan sizes tended to be larger (around $5000 or more), and the peer lending model was not as easily deployable due to dispersion of target consumers, as well as cultural differences. Hence the web of incentives for repayment in the form of peer pressure, threat of repossession of chattel goods or loss of future access to loans (Armendariz de Aghion and Morduch, 2004) in the developing world that may have contributed to the much publicized 98% repayment rates was absent in the United States. Moreover, the poor in the United States have, in principle access to banks for savings and other services, with the caveat that costs may be prohibitive or access may be sub-prime compared to prime customers

who benefit from no cost checking and savings and other benefits and services by virtue of higher bank balances.

In addition, global microfinance has moved beyond microcredit to offer a raft of innovative services that encompass education, health and insurance as discussed in the previous section. By contrast, United States microfinance focuses to a large extent on microcredit and training. A few practitioner definitions of microfinance in the United States are illustrative of the driving forces in this field in the United States context. Gina Harman, CEO, ACCION USA defines microfinance as assisting people who do not have access to capital, that is part of a much larger picture of aiding communities to develop economically, to serve as change agents that pave the way for financial inclusion and eliminate obstacles to economic growth. Leslie Kane of Grameen America states that microfinance is about community building, creating the infrastructure or social network for people to interact and learn, while providing catalyzing capital for entrepreneurial activity. Eric Weaver of Opportunity Fund notes that microfinance is more about helping the economically disadvantaged build wealth, since focusing purely on financial inclusion may be no different than sub-prime or pay day lenders[8]. All of these definitions emphasize financial inclusion and wealth creation for the low income individual and for the community, while seeking to differentiate microfinance or microcredit from for profit lending.

Microcredit refers to very small loans given with little or no collateral, provided by legally registered microfinance institutions. Microfinance, by comparison refers to a far more comprehensive range of financial services including credit, savings, insurance, money transfers, and other financial products provided by different service providers, targeted at poor and low-income people. (http://www.microfinancegateway.org). The microfinance chain includes Investors (Capital Providers), microfinance service providers or microfinance institutions and Users of Services (Base of Pyramid customers). In the United States, microcredit is typically offered along with a training or education component while the other forms of microfinance, such as insurance are not as common, though housing loans for low to moderate income households are gaining popularity with the recent economic crisis[9]. In addition, in the United States, there seems to be a clearer distinction between consumer and business loans for low-to-moderate income (LMI) households as compared to developing country microfinance, where the dividing line is nebulous at best due to the fungible nature of very low income household consumption patterns in developing countries along with a less formal economic structure.[10]

Financial inclusion, which refers to ease of access to mainstream financial services by all members of the economy, is an important policy concern in the United States, due to the significant presence of low to moderate income households in the United States, who lack access to mainstream financial services (FDIC, 2009). According to a United Nations report, the overarching goal of financial inclusion includes the availability of a variety of financial institutions offering a range of appropriate products and services at reasonable costs to all sections of the society backed by an enabling and supportive legal and regulatory infrastructure (UNCDF, 2006). The FDIC (2009) survey further states that approximately 7.7 percent of households in the United States are unbanked (annual earnings less than $30,000) and almost half of them had never obtained bank accounts, while the other half previously had one but were excluded at present. In addition, roughly 17.9 percent of United States households were under banked (annual earnings less than $50,000); they do have a checking or savings account,

but rely on Alternative Financial Services (AFS) to cover lost income or meet the needs of basic living expenses. The United States has 40 million households with limited access to mainstream financial institutions and of that number 28 million are completely excluded (*www.accionusa.org*). In aggregate, 25.6 percent of households, or 60 million adults, are unbanked or under banked in the United States. This presents a strong argument for substantial financial services expansion in the microfinance sector. Moreover, most of the unbanked households in US do not have enough money to need an account at banks, and hence remained unbanked (FDIC, 2009). Hence, the focus of United States microfinance has been on financial inclusion by providing microcredit to the unbanked in order to later channel them into mainstream finance. Microfinance currently exists at the periphery of mainstream finance making this a challenging uphill road to financial inclusion.

Microenterprises, defined as 5 or fewer employees constitute approximately 18% of employment in the United States. Out of the 20 million microenterprises in the US, less than 1% are currently receiving credit or business assistance (www.grameenamerica.org). In 2009, the Aspen Institute's Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD) Program conducted a US Microenterprise Census to identified 696 micro enterprise programs providing loans, training, assistance and other services to 274,128 micro entrepreneurs in the US. Yet, only 2% of potential microfinance customers are being served in the US, compared to 17% in the developing world (U.S. Microenterprise Census Highlights, 2008).

The first attempt at microfinance in the United States started in 1986 with Bill Clinton's, then governor of Arkansas, invitation to Muhammad Yunus to visit the United States to discuss microfinance and its possibilities, which resulted in the creation of a Grameen style fund to provide uncollateralized, trust or good-faith based, micro loans to low income entrepreneurs in rural Arkansas to bootstrap their way out of poverty and financial exclusion (Yunus, 2007). However, the Good Faith Fund was never able to achieve scale or self-sufficiency to significantly alleviate poverty; it is argued that socio-cultural differences that led to the failure of the group lending model in the United States could have been the primary reason for the failure of the transplant to yield the same results as in the developing countries (Taub, 1998). Other reasons for the failure of the group lending model could be due to failure of the borrowers to form a socially cohesive group in a context where population densities are far less compared to Bangladesh, which is a country the size of Florida with a population of 160 million. Moreover, the groups formed in the United States were not voluntary; the main benefit of voluntary grouping is 'assortative matching' which tends to ameliorate the problem of adverse selection by allowing safe and risky borrowers to form separate groups, but were based on groups of relative strangers picked from training programs offered by the Fund (Sengupta and Aubuchon, 2008; Armendariz de Aghion and Morduch, 2004).

In January 2008, Grameen America opened its first branch in New York and has loaned over $25 million to 7,300 borrowers at interest rates of 15% (www.grameenamerica.org). Grameen America is experimenting with transplanting the storied Grameen I group lending methodology to the United States[11]. In the intervening years, several types of microfinance institutions have proliferated in the United States. Newer types of non-profit and for-profit financial institutions who have entered the microfinance market in the past few years are

categorized into two broad categories: lenders targeting Low to Moderate Income (LMI) Microenterprises (Progresso Financiero, Finaciera Confianza and OUR Microlending) and Lenders targeting broader client bases with capital needs less than $35,000 (P2P lenders such as Prosper and Lending Club as well as larger retailers like Sam's Club and alternative commercial lenders such as On Deck Capital) (Gomez & Edgecomb, 2011). In the United States, non-bank financial services offered by big box retailers like Wal Mart, such as money orders ($75billion a year) and check cashers ($60 billion a year) and pay day lending ($338 billion in 2010) are gaining popularity (The Economist, Sept. 24, 2011*)* . In spite of this trend, a large majority of MFIs in the United States are still non-profit, non-depository MFIs that rely on subsidies from plural sources for on lending to their target clientele. Some of the larger MFIs have well-developed commercial bank partnerships that serve to fulfill the deposit function.

In the United States, the microfinance market is targeted at marginalized, self-employed individuals and families struggling to meet basic needs through small entrepreneurial initiatives, or the necessity entrepreneur. On average, they have incomes at or below 80% of the median income and more than 51% fall into the LMI category, those that are shut out of conventional credit channels due to lack of or limited financial records, insufficient collateral, blemished credit histories and so on. They tend to rely on alternative financial service providers such as payday loans, check cashing services and pawnshops to fund personal and business endeavors. In terms of outreach, ACCION Texas emphasizes breath versus depth of outreach, so targeting the poorest of the poor is not the primary objective[12]. In the global situation, there is some concern that with the increase of for profit lenders, a focus on sustainability may strengthen the trend of emphasizing breadth of outreach over depth of outreach leading microlenders to move into larger loans that target the not so poor over the poorest of the poor (Morduch, 1999) In addition, if the United States follows the global trend toward commercial microfinance it may open up the risk of mission drift, because of the relative ease with which circumstances may divert organizations to prioritize the financial sustainability or banking logic over the development or poverty alleviation logic (Battilana and Dorado, 2010).

Government grants and loans, corporate grants and loans, bank grants and loans, individual contributions and loans and private foundation grants are the main sources of funds for MFIs in the United States. By far, corporations and banks are the largest funders in general, with earned revenue coming in next for some of the larger MFIs followed by government sources and the other sources. In the United States, MFIs can be government/ non-governmental owned, member-owned, owned by socially-minded investors or by profit maximizing investors (www.cgap.org). In terms of a key source of government funding, the CDFI Fund, a government agency which was created in 1994 provides funding to individual CDFIs through a competitive application process. In addition, the Community Reinvestment Act (CRA) was revised in 1995 to explicitly recognize loans and investments in CDFIs as a qualified CRA activity for which Banks get credit in regulatory reviews. Today, there are 947 registered Community Development Financial Institution MFIs in the United States (*www.cdfi.org*). A majority of qualified United States MFIs seek and get this designation, which enables them to get CDFI funding. A rating system called the CDFI Assessment and Rating System (CARS) is used to assess and accredit qualified MFIs. Microlending is also receiving support from the American Reinvestment and Recovery Act of 2009, which set aside $50 million for the US Small Business Administration to lend to

microenterprises, defined as businesses with 5 or fewer employees (American Offshoots, 2011). Subsidies, grants, concessionary loans and loan guarantees from multiple sources make it difficult for the sector to wean itself away from these sources and move to a more self-sustaining commercial operation.

United States microfinance consists of providers who target different parts of the financing chain for the unbanked and under-banked. For instance, Grameen USA and Opportunity Fund provide loans for the unbanked with little or no collateral or credit history, whereas ACCION USA requires rudimentary credit history and some form of collateral. The common denominator linking these loans is that mostly microcredit in the United States is provided in the form of risk capital for microenterprise creation, as opposed to the more fungible business/ consumption loans in developing countries. Commercial banks are moving downstream to serve the under banked as technology-driven deceases in transaction costs facilitate outreach. Large banks, like Citibank in the United States seem to prefer to reach out to the unbanked primarily through partnerships with MFIs[13] to overcome the high transaction costs of reaching and servicing low income clients. Hence, partnerships with commercial banks, such as Citibank or Bank of America appear to be a defining feature of the more well-established MFIs in the United States.

Unlike some of their global counterparts, United States microfinance institutions typically do not choose to transform into full service financial institutions either by choice, or due to regulatory constraints: they tend to partner with banks to offer low cost savings accounts to clients and report back on payment patterns that could lead to the development of a credit history for the borrower. Compared to commercial banks, MFIs typically have more flexible loan underwriting guidelines and underwrite the loan for clients, in addition to reporting on repayments to build credit history which may be the gateway for transitioning clients to full bank customers down the road[14]. Banks invest low cost, concessionary loan funds in MFIs partly to meet Community Reinvestment Act (CRA) requirements, which in turn benefit MFIs and their clients who gain access to savings services from banks as part of their services from MFIs[15]. Bhatt, Tang and Painter (2002) point out that 23% of MFI funding in the United States comes from banks. As part of this symbiotic relationship between banks and MFIs in the United States, banks such as Capital One's Second Look Program tend to direct clients who do not meet their requirements for loans to MFIs for loans to start or grow their businesses, with the ultimate goal of integrating these customers into mainstream banking.

Servon (2006) points out that while the United States microenterprise field has witnessed remarkable growth, scale and sustainability still remain elusive, themes echoed by many interviewees. She identifies fragmentation, lack of accreditation and regulation, insufficient data, inconsistent funding sources, increasing competition and difficulty in reaching the target market as the key challenges facing the field. Several interviewees indicated that the United States microfinance field is marked by lack of scale and a number of smaller, fragmented institutions that work independently replicating tasks that could be more effectively done as an industry, particularly in the areas of fund raising. Inability to scale up were also attributed to target market dispersion, lack of homogeneity in customer profiles/ needs and associated challenges of understanding the needs of a diverse and dispersed customer base. Over reliance on subsidies and lack of commercial funding could be a contributing cause to the inability to scale. The issue of subsidy dependence is a much-debated one in United States microfinance,

since most MFIs are still dependent on a mix of subsidies, grants and concessionary loans from various sources. Those subscribing to the mission centered view of microfinance do not view subsidies as necessarily harmful to the field and its growth, whereas the financial systems approach decries subsidies and its tendency to crowd out private capital and silence market signals as a major cause of slow growth in the sector. The frontier question here is whether social and economic impacts are large enough to justify ongoing subsidies based on rigorous impact studies (Cull, *et al.*, 2008).[16]

This current study posits that in terms of legal form or structure, funding, target market and a variety of other indicators such as product/service innovations, United States microfinance is still in its early growth phase or Microfinance 1.0. United States MFIs are also quite dependent on subsidies from plural sources, mainly government and private socially minded investors, commercial, while for profit microfinance is just nudging its way into the United States. Due to these reasons the issue of "mission drift" does not loom as large as it does in some parts of the developing world with its multi-million dollar IPOs by MFIs such as Compartamos, and their usurious rates of interest along with record profitability that has elicited outrage and negative attention to the entire sector leading to calls by Yunus and others that mission driven microfinance needs to be distinguished more clearly from the brute money lending that it set out to replace. The broader goal of United States microfinance is financial inclusion, i.e., integration of the unbanked/ under banked into mainstream finance, as it grapples with the challenges of scaling up, entry of commercial actors, subsidy dependence and sustainability.

5. REGULATION OF MICROFINANCE – THE UNITED STATES AND GLOBAL EXPERIENCE

This section focuses on 6 key themes extrapolated iteratively from composite interview data and review of relevant literature. It starts with a macro level argument for the need for regulation of the sector and then proceeds to elaborate on the following themes related to MF regulation in greater detail:

a) At the macro-level, microfinance needs a context-sensitive, sector-specific set of regulations.

b) At the industry level, United States microfinance is still very much in a nascent stage of development hence needs life cycle stage appropriate regulations based on the type of loans, typically consumer versus business loans. Most United States microcredit is for business purposes.

c) The impact of regulations emanating from Federal/ State levels on MFIs and the limited role of prudential regulations

d) Motivations for partnerships with commercial banks and the regulations that impact these partnerships.

e) The role of self-regulation followed by MFIs in conjunction with trade associations.

f) The unique governance issues faced by MFIs and their relationship to regulation.

5.1. Need for Sector Specific Regulation of Microfinance

Regulations in the financial service sector are essential to protect clients, investors and the country's financial system from systemic risks that could impact the integrity of the financial system, the larger economy as well as consumers. Regulations in microfinance are rightly intended to protect the finances of the poor against bank failure and fraud, and prevent the charging of usurious rates of interest that take advantage of dire customer need. While the need for regulation is clear, there appears to be consensus around the view that the growth of microfinance has been hurt by regulatory failures and attendant market failure in the provision of risk capital for uncollateralized microenterprises. The Economist (2005) argues that it is not so much that the poor are not credit worthy or do not make suitable clients for the full spectrum of financial services, but that they are hurt by massive market and regulatory and governance failure. Lack of regulation, over or under regulation of micro financial services could hurt the sector's growth and development. With reference to microfinance, regulation has the potential to increase donor confidence by allowing for greater transparency in governance and accountability (Counts and Shoban, 2002: Counts, 2008)[17]. In addition, it encourages competitiveness and market efficiency by clearly defining the rules of the game while taking stakeholder needs and consumer protection into account.

Microfinance is different from commercial banking in that microfinance institutions have higher portfolio volatility, smaller, high frequency loans, and thus high operating and administrative costs, limited capacity to increase capitalization levels and higher risks that flow from greater dependence on variable, more diversified sources of funds and lastly greater dependence on charismatic leaders (Greuning et al, 1998). In addition, their market is low income, poor, sub-prime clients, who bring non-traditional collateral that requires more labor intensive, high cost operations (Counts and Shoban, 2002). Globally, there is a dominant view in the sector which does not support regulating the microfinance sector with the formal financial sector apparatus, as evidenced by the following quote from Muhammad Yunus (2007) that - "existing regulations are designed with commercial banking in mind, but microfinance requires a dedicated regulator and a relevant set of rules. Commercial banking is like a super tanker, whereas microfinance is like a dinghy boat with which you can reach small corners. If you design a dinghy boat with the architecture of a supertanker, it is sure to fail".

The developing world has seen much experimentation in regulating this sector, which initially evolved without much regulatory oversight. Governments around the world are increasingly recognizing the power of microfinance to transform the lives of the poor to aid economic development and are eager for advice on ways to grow microfinance within a framework of rules and regulations that stimulate the BOP customers access to finance (Swibel, 2007), while mitigating the associated transaction costs. Microfinance in the United States is in its early stages of its life cycle compared to much of the developing world.

The microfinance movement that has more recently spread to the United States, which has a vastly different financial / institutional context that is far more regulated compared to the developing world. As innovations diffuse from one country context to another (Rogers, 2003) they undergo changes and adapt to the new context. Operationally, microfinance programs in the United States are significantly different compared to other parts of the world due to differences

in financial and institutional contexts, yet the fundamental purpose of microfinance remains the same across varying economic, social and political contexts: to offer financial services, primarily credit and secondarily training and education to poor, low income individuals who have been underserved, or excluded from mainstream financial institutions that operate with a set of rules inappropriate for the customer at the base of the economic pyramid. For instance, the United States is a far more formal economy with a plethora of rules and regulations for starting a business as well as laws that impact both lender and receiver compared to developing countries, that have a significant and thriving 'informal' or underground economy. Despite the differences, the core values of microfinance are to foster micro-entrepreneurship, sustainable livelihoods via economic opportunities and ultimately economic growth in the community (Bernanke, 2007). However microfinance differs considerably in terms of loan size, collateral requirements and repayment terms that require far greater flexibility for the base of pyramid (BOP) customer compared to the customer typically served by mainstream banks. In the United States, most MFI providers are smaller, non-profit community development financial institutions (CDFIs), and NGOs, hence existing banking regulations may not be amenable to transfer in 'ready to wear' form. If context insensitive regulations are imposed with a one size fits all regulatory philosophy driven by convenience and speed, it could have the perverse effect of stifling growth, restraining innovation, and constraining competition (Counts and Shoban, 2002) while imposing heavy costs of supervision on the regulator and crippling compliance costs on the MFI that impact its sustainability. Given such stark differences, regulations designed for commercial/ mainstream finance cannot be blindly transferred to MFIs.

Dan Letender, CDFI Lending and Investing Executive for the Bank of America states that the global microcredit industry has been growing at unsustainable rates of over 40% from 2004-08, quadrupling over a 5 year period coupled with record profitability and growth coming from new entrants in particular. If the United States hits the same kind of growth pattern, that would call for restraint and even regulation to curb excesses and bad actors. In contrast to global growth patterns, growth of microfinance in the United States has been marked by lack of scale (Rhyne, 2009; Servon, 2006) and a variety of mostly small, fragmented, mission driven players vying for a market this is not clearly defined.

5.2. Regulations Based on MFI Structure and the Type of Loans

The evolutionary trajectory of United States microfinance indicates progression from early credit-led models to more comprehensive training and credit-led institutions that offered a spectrum of financial services including coaching/mentoring, financial literacy among other business services along with credit. However, compared to global microfinance models, microfinance in the United States, as noted earlier is still very much focused on providing credit and training rather than a comprehensive range of financial services that includes micro-insurance, microsavings, etc. Alternative financial service providers have filled some of the void by providing services such as, high interest consumer loans, check cashing and money transfer. The United States has several barriers to full service banks in low income communities and potential consumers in low income communities have little or no experience dealing with banks and may have an associated mistrust. In addition, non-profit organizations are required to operate in conjunction with prudentially regulated banks in order to offer savings services. This coupled

with the welfare means test may inhibit community banks from serving low income communities and consumers from benefiting from their services (Caskey, 1994).

What institutional forms can a microlender take in the United States and how does it impact regulation of the MFI? A microlender in the US can be broadly categorized as: a) Depository institution (DI), such as a national bank, state member or non-member bank, thrift or credit union or b) Non-depository institution (non-DI), such as the MFIs, NGOs[18]. CGAP, an MFI donor consortium affiliated with the World Bank captures the institutional complexity of MFIs in these terms: "An MFI can be broadly defined as any organization—credit union, down-scaled commercial bank, financial NGO, or credit cooperative—that provides financial services for the poor." (www.cgap.com). The MFI landscape in the United States consists of various types of depository and non-depository institutions ranging from formal to semi-formal, such as commercial banks, rural banks, credit unions, non-bank financial institutions (NBIF) and NGOs. Regulation is based on the MFIs activity and varies based on form and function.

Financial institutions face two broad types of regulations dependent on their legal form and activities: a) prudential and, b) non-prudential regulations. Prudential regulations aim to protect the financial health or bank solvency to avoid systemic contagion that could spread disastrously through a country's financial system leading to large scale domino effect failure of banks that could ultimately impact the entire economy. Examples of prudential regulation include capital adequacy rules, loan loss reserves and restrictions on uncollateralized lending. Non-prudential regulations, such as truth in lending laws, laws restricting abusive debt collection, anti-money laundering, etc are all other rules related to business conduct. Non-prudential rules do not require a specialized banking authority for enforcement, are less stringent and do not require direct, costly supervision as do prudential regulations. *(*Christen, Lyman and Rosenberg, 2003). Prudential regulations are typically applied only to deposit mobilizing institutions given their cost to both the supervisory body and compliance cost to the MFI. Using prudential regulations for non-depository MFIs would be akin to using a gun to kill a fly. A middle path could require prudential licensing for any MFI that intermediates clients' compulsory savings but not for the institutions that keep the savings in an account with a licensed bank or invested in low-risk securities.

5.3. Motivations for Partnerships with Commercial Banks and Regulatory Impacts

Most MFIs interviewed for this study did not mobilize deposits and were hence un-regulated entities that had developed symbiotic, necessity engendered partnerships with banks to complement their service gaps, especially in the area of FDIC insured financial intermediation of savings. Overall, MFI-bank partnerships were a defining feature of United States MFIs that did not transform into full service banks, as they have done in Bangladesh or other countries, where tiered regulations have enabled such transformations. Sensing opportunity and profits in microfinance, big banks such as Citibank, Capital One, Bank of America, Deutsche Bank, ABM Amro, ING and HSBC have entered microfinance through partnerships with MFI institutions, in many cases In terms of structuring MFI-commercial bank partnerships with the goal of financial inclusion, O'Rourke (2006) has suggested three structural alternatives, such as the a)incorporation of micro finance into the formal banking system, b) evolution of MFIs into formal banks, or c) the creation of commercial partnerships between banks and larger MFIs. In

the United States context, the incorporation of micro financial services into commercial banks is not a viable alternative given the high transaction associated with reaching a fragmented customer base, along with the entirely different nature of loan underwriting processes in microfinance. The second alternative is the evolution of MFI into full service banks has its drawbacks in terms of high bar set for transformation into a bank in the United States, with high capital adequacy and loan loss reserve rules and the inherent differences in risks, and transaction costs in microfinance portfolios. The third alternative of forging commercial partnerships between banks and MFIs seems to be the approach of choice by several of larger MFIs in the United States. The partnership model has gained further impetus and incentive from the Community Reinvestment Act (CRA) passed by Congress in 1977 mandating that Banks be rated by regulators based on their responses to credit needs of their communities. The CRA has been lauded as a comprehensive approach to microfinance promotion in the United States (Jones, 2006). Banks have the option to meet CRA requirements by channeling funds directly or indirectly through intermediaries to low income markets. This law has incentivized banks, such as Bank of America, Citibank and many others to work with MFIs like ACCION, which receive funding as well as customers who do not meet bank lending criteria. Since one of the main goals of MF in the United States is financial inclusion of LMI customers as well as integration of the MFI into mainstream financial systems (Littlefield and Rosenberg, 2011) the bank-MFI partnership serves multiple stakeholder interests and may be the most viable form of providing microcredit in the United States at this stage of the industry's evolution.

5.4. Impact of Consumer Protection Laws on Microfinance in the United States

In the United States, most MFIs sustain themselves through a mix of funding from banks, the CDFI Fund, private foundations, and various types of donors, with some interviewees indicating that financial sustainability via donor and other funding sources were feasible. There is increasing growth of for profit models of microcredit in the United States; however the commercialization trend lacks the depth and momentum of developing markets due to greater availability of subsidies or 'patient' capital by socially minded investors, government funds, i.e. US Treasury's CDFI Fund, commercial banks and private foundations/ individuals.

Unlike banks and other financial service institutions, non-profit MFI micro lenders are not regulated directly, except for compliance with Internal Revenue Service (IRS) as a 501 (3)(c) as a non-profit entity at the Federal level and compliance with consumer and business lending laws (Burrus, 2004), such as usury laws at the State level. MFIs in the United States do not fall under the purview of prudential or non-prudential regulations since they typically do not mobilize consumer deposits hence are not categorized as formal financial institutions. Essentially, MFIs in the United States operate in a twilight zone of little or no formal or direct regulation, except for consumer protection regulations that have a tangential impact on the sector based on MFI activities. All forms of finance in the United States are in some shape or form regulated by consumer protection regulations. In addition, the microcredit field in the United States has been informally regulated by due diligence of investors or funders. Alternative financial service providers such as fringe banks and loan sharks operate in an even more opaque and unregulated environment where they are able to charge between 300 to 4000% interest rates, though this may change with the new consumer protection laws introduced by the new Consumer Financial

Protection Bureau (CFPB) created in July 2010, by the Dodd-Frank Act as an independent agency with broad authority to protect consumers of financial services from unfair, abusive and deceptive practices by making credit products easier to understand from a consumer perspective and by playing an integrated gatekeeper role. David Berenbaum of the National Community Reinvestment Coalition points out that the priorities of the new consumer protection era are to conduct financial education programs for members and citizens of the community; to respond to consumer complaints; to monitor markets for financial products and services; to examine and enforce regulations for banks, credit unions with assets over $10 billion, pay day lenders and other debt collectors, consumer reporting agencies and to issue rules, orders and governances guiding all financial institutions[19].

What does the new consumer protection agency mean for MFIs in the United States? Legal form along with whether the loan is for a business or consumption purpose is an important distinction since it determines the nature of regulation. If it is considered a consumer loan many of the consumer protection laws especially the ones that emanate from the Dodd Frank Act's federal consumer laws and the Consumer Financial Protection Bureau (CFPB) will apply. MFIs in the United States can rely on the business purpose exemption to circumvent some of the stricter consumer lending laws, but the catch is that the distinction between a business and consumption loan is not always clear even in the United States. The added complexity comes from the fact that each United States State is different in terms of these laws. For example, in New York an MFI can lend to corporations without getting licensed; however if the MFI lends to individuals either for personal or business purposes they have to be registered in the State of New York. Similarly, usury laws, also considered to be consumer protection laws vary from State to State in the United States and the doctrine of 'legal exportation' allows a lender from another State with a very high usury cap to lend into New York. . Hence, consumers are not fully protected by usury laws due to State level variations and the exportability of laws into other States. However, Dodd Frank has strengthened laws protecting consumers at both the State and Federal levels against unfair and deceptive lending practices by adding an abusiveness standard. The new CFPB will be authorized to regulate the offering of consumer financial products or services under Federal consumer financial laws.[20]

5.5. Role of Self-Regulation in Microfinance

ACCION USA, one of the largest MFIs in the United States has been instrumental in developing self-regulation in the form of the SMART Campaign that echoes many of the same principles of the new consumer protection agency. There is a trend toward self-regulation by way of ACCION's SMART Campaign as well as the Association for Enterprise Opportunity (AEO), an industry trade group that has proposed minimal standards of performance and financial health for MFIs in the United States. Some in the field have called for external regulation indicating that self-regulation is no longer enough to help credibility and growth. Gina Harman of ACCION USA points out that regulation, whether it is self-regulation or external regulation it needs to be focused on building institutions that serve the customer first by structuring right products and by delivering them in a transparent way. She adds that the SMART Campaign in the United States started in mid-2008 amidst the furor over appropriate interest rates, appropriate pricing and profitability of microcredit over the Compartamos IPO. This, along with the recent memories

of the unregulated or lightly regulated sub-prime industry crisis in the United States were the main drivers of the Campaign, even though many interviewees pointed out that the microfinance industry did not bear similarities to the sub-prime market in the United States. Regulation can take the form of self-regulation or external/ third party regulation with pros and cons for each type. Self-regulation may not be the best method for removing bad actors who may be able to hide behind less stringent forms of self-regulation; however external regulation may have the unintended consequence of imposing a heavy regulatory compliance cost on MFIs already stretched thin by higher operational and loan service/ recovery costs.

At what point is self-regulation not enough? When commercial players in microfinance reach critical mass that would mark an inflection point, indicating a break from socially motivated capital to profit maximizing capital, signaling the need for third party or external regulation. At this point, bad capital can chase out good capital and most egregious practices ranging from high interest rate lending to less care for borrowers and ensuing higher profits will attract more private sector capital. Internationally, with high levels of market saturation of microfinance, there is evidence of very high interest rates charged by profit maximizing MFIs without caring much about borrower levels of indebtedness as seen in the recent Andhra Pradesh crisis, which has called for third party regulation. Steel (2010) points out that care should be taken not to place excessive reliance on self-regulation by associations / apex organizations, since these are primarily advocacy organizations not well placed to administer top-down regulations. Nonetheless, they do offer minimum standards as a baseline for regulation. In addition, they can be useful for collecting relevant performance data. Hence, self-regulation should be considered as a way of keeping tabs on MFIs that are too small to merit direct supervision, and not an actual tool of supervision.[21]

5.6. Governance of United States MFIs

The Microfinance Banana Skins Report (2011) has highlighted issues of weak corporate governance and inappropriate regulation as the two areas which seek immediate attention in the sector. Governance of the MFI and regulation are closely linked since these are double or triple bottom line organizations with different measures of success and attendant strategic foci. Donors or funders typically interested in the social mission operate with a different set of performance metrics compared to a for profit entity. The typical non-profit structure of the MFI also mutes market signals that serve to discipline a for profit entity in a market economy. In general, effective governance of an organization provides a clear framework of checks and balances to ensure attainment of corporate objectives and to prevent resource misuse. Microfinance institutions have multiple sponsors, and multiple objectives with context / country dependent differences in internal governance and operational strategies. In the case of MFIs, most originate as NGOs where ownership and organizational structure may be unclear and hence not geared for board supervision of management (Greuning et al., 1998). Many of these MFIs are funded by philanthropic investors and governments, who tend not to be activist shareholders creating an agency problem. Since stringent regulation of microcredit in the Unites States is not driven by investors, it may need a different set of external forces.

In addition, board members are faced with the challenge of balancing equally important twin goals of outreach and sustainability (Von Pischke, 2002). In mission-driven MFIs funded

by patient social investor capital, the key goal is not profitability, but outreach, which calls for different measures of success such as: 1) scope of outreach (number reached), 2) impact (on lives, economic /community development), and 3) depth of outreach (poor versus poorest) (CGAP, 2003). These criteria are not always amenable to hard measures applicable to profits, but may require softer, less quantifiable and relevant measures further exacerbating the governance challenge. Sometimes, these measures may be contradictory, for example scaling the sector requires growth and increased competition, decreased subsidy dependence, an inflow of commercial funds as well as savings/ deposit mobilization (Morduch 1999) and a well-regulated sector (Gallardo, 2002), whereas outreach to the poorest of the poor may call for patient capital or subsidies and lesser emphasis on sustainability. Thus, the more complex, 'black box' nature of MFI governance necessitates an important role for external governance structures, such as third party regulation (Arun and Annim, 2010) and market competition on microfinance institutions.

The trend toward commercialization / sustainability is not as strong in the United States due to the nascent nature of microfinance marked by far fewer profit seeking MFIs and the easier availability of subsidies along with consensus around the idea that subsidies are justified by the social benefits (Morduch, 1999; 2000), hence the majority of them are still subsidy or donor dependent (Rhyne, 2002). In a market based environment, the unforgiving invisible hand imposes hard budget constraints on firms. In the case of microfinance, such constraints are largely absent in a non-market based lending environment, risk is not appropriately priced and market forces are largely muted by government and investor grants or concessionary funds that may in some instances make it uncompetitive for private entrants. Government is by necessity a large player in the microfinance field here in the United States as well as in many other countries. Government involvement can additionally hinder market forces, by decreasing competition, crowding out private funds, promoting moral hazard behaviour and decreasing profitability of for profit entrants such as commercial banks (Hubka and Zaidi, 2005). In the absence of rigorous internal board governance, measurable performance metrics, and lack of market discipline, compatible external regulations designed to accommodate these challenges may be necessary.

6. CONCLUSIONS AND RECOMMENDATIONS

Microfinance in the United States is currently not regulated directly due to its relatively small scale and size of individual MFIs that do not meet the 'too big to fail' criteria for systemic damage. Since a majority of providers are non-profit, non-depository institutions, there has not been a direct need for the application of banking regulations in the form of prudential regulations. However, non-prudential regulations do impact MFIs by way of consumer protection and other State laws, if the loan is a consumer loan. Some of the larger MFIs have overcome the banking challenge through partnerships with commercial banks that offer benefits for the banks, MFIs and customers. Commercial entry into this field is evident, but on a limited scale resulting in the fact that MFIs are still largely subsidy or concessionary loan dependent. As the field evolves and grows and attracts competition from commercial entrants, the need for well-considered regulation may become more urgent and important.

The microfinance sector is typically characterized by non-collateralized loans and higher administrative costs, which supports the argument for a tailored set of regulations for

microfinance. The Basel Committee on Banking Supervision (2010) illustrated the general applicability of the Core Principles to the supervision of microfinance activities. The report suggested an efficient allocation of supervisory resources depending on the nature of institutions and developing a specialized knowledge within the supervisory team. Furthermore, the report recognized the distinct nature of control and managerial practices in the sector and the need for clarity in the regulations, while retaining flexibility to deal with individual cases underscoring the need for regulatory solutions to strike a careful balance between enabling access to credit and protecting consumers, which is a priority in the United States context. Globally, Yunus calls for a dedicated regulator and a relevant set of regulations tailored to the structure and needs of microfinance (Yunus, 2007). MFIs have very different risk profiles due to their portfolio characteristics, hence transferring banking regulations in a 'ready to wear' form is not a viable alternative.

Regulation of microfinance in the United States needs to be designed with the broad objective of supporting growth of the sector to enable viable and sustainable MFIs capable of delivering appropriate inclusive financial services that focus both on breadth and depth of outreach to the 12-15 million low-income poor in the United States. Regulatory reform should facilitate: 1) growth, and 2) integration of microfinance into mainstream banking (Hubka and Zaidi, 2005). A well-regulated microfinance sector will allow for growth in scale and range of services (Gallardo, 2002). Commercialization proponents argue that the field will remain insignificant in size until there is full blown entry of commercial players who can bring competition and efficiency.

Regulation of an emerging sub-sector confers greater legitimacy, enabling ease of access to funds from donors or government, allowing sustainable delivery of financial services to the poor, protecting both depositor and lender from moral hazard and adverse selection. Yet, two World Bank and Financial Access Initiative studies (Christen and Rosenberg, 2000; Cull et al., 2008) indicate that the cost of compliance may be onerous for emerging MFIs, where regulation may have a negative impact on financial service innovation of smaller organizations, which have grown organically in a grass roots response to environmental needs under the regulatory radar, in countries like Bangladesh. Regulation may have the unintended effect of creating boundaries that box in the growing sector constraining growth as well as service innovation. In addition, MFIs are dynamic, moving from semi-formal to formal as they grow and evolve. Regulation also needs to have requisite variety to match different MFI types, such as credit only MFIs that rely primarily on outside funding and serve as conduits of credit, to those MFIs that take consumer deposits as well as provide credit. In general, MFI regulation globally has moved from subscription to voluntary codes of conduct to self-supervision, to light, regulation by registration under special acts to more formal prudential regulation (Christen and Rosenberg, 2000).

Shankar and Asher (2010) capture four key reasons for regulation of microfinance in India, some of which are applicable to the United States situation. Regulation, in their view would enable MFIs to offer savings services, provide for monitored entry of commercial participants, allow MFIs to scale their service spectrum to insurance, pension schemes, and so on to provide a clear regulatory framework for diverse legal forms of MFIs, thereby preventing regulatory arbitrage. Christen *et al.* (2011) favor a clear distinction between depository (DI) and non-

depository (non-DI) MFIs in terms of regulation. Currently, United States MFIs appear to choose partnerships with commercial banks over the option of transforming into deposit mobilizing institutions perhaps due to the high bar for transformation that is better suited for banking rather than a development institution.

Rosenberg (2008) indicates two broad approaches to regulation of the microfinance sector. The 'regulation as promotion' view states that if the government wants to expand and deepen the sector in a situation where the predominant number of MFIs are smaller, non DIs opening a new licensing window for MFIs to take in deposits, while meeting prudential regulations that are not as high as those set for regular banks could be one option. The dual advantage of this approach is that MFIs would get access to funding that can be recycled as credit and consumers get access to savings. In the United States and elsewhere, savings is a buffer that cushions the poor from the vagaries of emergencies, as well as a net that allows MFIs to manage risk in case of default (Roy 2011). In the second view of 'regulation that follows', Rosenberg (2008) posits that in actual practice in most countries regulation came after the sector had developed critical mass. This approach would require just in time adjustments to a country's banking regulations to create the necessary regulatory space for the sector's growth. Given the emergent nature of the field in the United States, it may be all the more critical to tread the fine line between too much and too little regulation, by devising a regulatory regime that leads as well as follows. Over regulation can impose a heavy compliance cost on the MFI undermining its sustainability; additionally on the supervisory side, costs of regulation need to be weighed against expected benefits. The impact of regulation on the end customer as well as funders, public or private is also an important consideration.

Interviewees indicated that the typical MFI is not directly regulated due to its non-profit, non-depository institutional status. Some of the largest MFIs, such as ACCION USA along with industry associations have initiated self-regulation via the SMART Campaign principles, which deal with consumer protection in various ways. However, experts in the field tend to point out that self-regulation is no longer enough particularly with the entry of profit seeking MFIs, although this might generate technical expertise within the industry[22]). In addition, most United States MFIs are designated CDFIs, which are rated by the CDFI Assessment and Rating System (CARS), a rating system developed by the CDFI Fund to qualify and maintain CDFI designation for MFIs, which could be considered a soft regulatory equivalent. In the global context, joint liability serves as an effective internal check and balance, since it protects against the twin problems unique to microfinance of adverse selection (identifying risky credit consumers in the face of weak information) and moral hazard (group monitoring to curb potential cheaters) in the context of a loan methodology that employs collateral substitutes (Hubka and Zaidi, 2005). The group methodology is being tested by Grameen America in New York[23], but has met with little success in the United States environment in previous experiments due to various social and logistical differences. So, the question is how to prevent self-regulation from becoming toothless, lip service that could be hijacked by brute moneylending MFIs that place profit over social mission, or even MFIs suffering "mission creep" under the pressure of sustainability and decreasing donor funding?

Many of the larger United States MFIs have developed partnerships with commercial banks to overcome the banking challenge. While these commercial bank partnerships offer symbiotic

benefits for both parties, it may not be the best option in the long run, since many of the smaller MFIs may not have this option. Opening up a special regulatory window for microfinance and specialized knowledge as suggested by the Basel Committee (2010) may be a better long run option to scale the sector and to support less dependence on subsidies and sustainable sources of funding. The provision of adequate regulation may allow MFIs to attract deposits from public, which may lead them to grow in a sustainable way and eventually achieving linkages with the banking sector, with an improved operating network and higher standards of control and reporting.

The problem with regulation is that there are always unintended consequences, as in the case of usury rates. If the rate is set too low, then it will chase out microcredit lenders leaving the door open for predatory lenders. Gina Harman of ACCION USA is one of the few CDFIs that operate in multiple States in the United States with the burden of understanding and interpreting multiple State laws related to licensing and consumer protection. Based on a market survey of microcredit need versus laws such as usury rates, ACCION has chosen to stay out of certain States with highly restrictive usury caps, which essentially hurts the consumer of microcredit in those States, with the ironic effect of hurting the same consumer the laws were intended to protect[24]. The high transaction costs of smaller loans make interest rate caps counterproductive since they hurt both the provider's sustainability and the consumer's interest by causing providers to withdraw from these markets leading to loss of access to microcredit for potential consumers in these States (Rosenberg, 2008, Christen et al., 2003). There is concurrence with this view that interest rate caps could lead to the exclusion of high-risk, yet needy consumers when MFIs stay out of difficult geographies (Shankar and Asher, 2011).

Given the complexities of regulating this emerging sector, creating a tiered regulatory approach that treads the line between forward looking promotion of the sector along with following the state of development in the field may be appropriate. MFIs may be able to scale gradually to full service banking, if they were provided a regulatory window with tailored banking regulations to suit the nature of microfinance. This, along with MFI commercial bank partnerships may create a richer and more robust set of MFIs that are able to exist between the colliding logics of banking and development.

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Notes

1. We use this term here to indicate that 'patient' capital is invested for the longer term relative to Wall Street money that is hot footed and will fly out fast during a rough patch.
2. US MFI in general lean toward the financial systems approach over the mission centered approaches due to the belief that financial sustainability is important.
3. This is similar to Web 1.0 or 2.0, first generation or second generation.
4. Jonathan Lewis, Microfinance USA 2011 Conference, May 23, 2011.
5. Decision No 67/1999/QĐ on March 30th, 1999 of the Prime Minister.

6. Interview Catherine Pena, ACCION Texas, October 14, 2011.
7. Interview Tammy Halevy, Association for Enterprise Opportunity, May 18, 2011.
8. Microfinance USA 2011 Conference Key Note speeches, May 23-24, New York City.
9. Interview Galen Gondolfi, Justine Petersen, July 2011.
10. One of the interviewees made this point very starkly when she indicated that in one case a family in Africa had purchased a refrigerator with a business loan from an MFI leading the lender to wonder if this was in fact a business loan until the discovery that the intended use for the refrigerator was to rent out cooling space to neighbors (Leslie Barcus, Microfinance Opportunity International, Washington, D.C. May 2011).
11. Interview with Katherine Rosenberg, Grameen America VP, New York, November 11, 2011.
12. Personal communication with Janie Barrera, CEO ACCION-Texas Louisiana, October 12, 2011.
13. Interview Bob Annibale, Global Director, Citi Microfinance Unit, London, May 2011.
14. Interview Catherine Pena, ACCION Texas- Louisiana, October 13, 2011.
15. Interview Bob Annibale, Citibank Microfinance Unit, Citibank, London, May 13, 2011.
16. Interview Robert Cull, World Bank, May 13, 2011.
17. Interview Alex Counts, Grameen Foundation, Washington, D.C., May 2011.
18. Michael Campbell, Legal Counsel Banking Regulation and Supervision, Federal Reserve Bank of New York, May 23, 2011.
19. David Berenbaum, Presentation at the Microfinance USA 2011 Conference, New York, May 23-24, 2011.
20. The section on consumer protection laws impacting microfinance in the United States is based on a personal interview with and conference presentation by Michael Campbell, Legal Counsel, Federal Reserve Bank of New York, New York in November and May 2011.
21. Interview and email communication William Steel, World Bank, 2010.
22. William Steel, Email communication April 2011.
23. Interview Katherine Rosenberg, Grameen America, November 2011.
24. Interview Gina Harman, CEO ACCION USA, New York, November 2011.

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