MICROFINANCE REGULATION AND SUPERVISION: A MULTI-FACED PRISM OF STRUCTURES, LEVELS AND ISSUES

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Microfinance is a new, varied and intriguing sector for academics, practitioners and regulators. The current debate about financial sector reforms after the global financial crisis, the recent phenomenon of commercialization of microfinance and related criticism including scandals about predatory lending in the sector have stimulated a wide debate on the topic of regulating microfinance at domestic and transnational levels. This paper deals with such challenging topics, analyzing the different and coexisting levels of regulation, the variety of interests touched upon and the inappropriateness of our traditional legal categories, and proposes a framework for the allocation of rulemaking power among such levels. The paper argues for a differentiated approach based on the characteristics, interests, forces and instruments involved at each level and for each issue (e.g., development perspective versus financial regulation, prudential versus non-prudential regulation, financial markets versus consumer protection). The focus of the discussion will be on prudential aspects of financial regulation, but in order to better clarify the reasoning and justify the arguments about the allocation of regulatory power among different levels, the work examines some aspects and examples from other sectors, such as consumer protection.

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I. INTRODUCTION

A. *Microcredit and Microfinance*

Microfinance is the provision of a wide range of financial services to financially excluded people. It became renowned worldwide in its basic form of microcredit—small loans to poor prospective entrepreneurs excluded from the formal financial sector because of their perceived risk and lack of traditional forms of guarantees.[1] It had roots in informal mechanisms of financing, such as tontines in Africa and Rotating Savings and Credit Associations ("ROSCAs") in India.[2] Like these, microfinance involves small groups of borrowers and tight links with local social structures and reality, but it is distinguishable by features such as group lending,[3] progressive lending,[4] focus on women,[5] short-term contracts,[6] high interest

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1. ASIF DOWLA & DIPAL BARUA, THE POOR ALWAYS PAY BACK: THE GRAMEEN II STORY 2-3 (2006).

2. BERND BALKENHOL & E.H. GUEYE, INT'L LABOUR OFFICE, TONTINES AND THE BANKING SYSTEM: IS THERE A CASE FOR BUILDING LINKAGES (1994), http://www.ilo.int/wcmsp5/groups/public/—ed_emp/documents/publication/wcms_118281.pdf.

3. In order to address information problems and monitoring costs, loans are made to each member of a group of people who consider the others reliable and trustworthy. The group as a whole is responsible in case of non-repayment by one of them; if they can't cover for the defaulted member, they are denied further loans. *See* Jameel Jaffer, *Microfinance and the Mechanics of Solidarity Lending: Improving Access to Credit through Innovations in Contract Structure* (Apr. 1999), Harvard Law School, Olin Center for Law, Economics and Business, Working Paper No. 254, *available at* http://ssrn.com/abstract=162548 or http://dx.doi.org/10.2139/ssrn.162548, at 5; Xavier Giné, Pamela Jakiela, Dean S. Karlan, & Jonathan Morduch, *Microfinance Games*, (June 2006), Yale University Economic Growth Center Discussion Paper No. 936, *available at* http://ssrn.com/abstract=912301, at 4; Dean S. Karlan, *Social connections and group banking*, 117 ECON. J. F52 (2007), F52.

4. This includes incentives to repay on the prospect of receiving a larger loan when the previous one is repaid. *See* Dominik Egli, *Progressive Lending as an Enforcement Mechanism in Microfinance Programs*, 8 REV. DEV. ECON. 505 (2004).

5. Although traditionally excluded from access to financial services in developing countries, women are considered more reliable, more dedicated to saving for the family, less prone to wasteful consumption, more subject to social pressure to repay, less mobile and, thus, more easily monitored. *See* MOHAMMED YUNUS, BANKER TO THE POOR: MICROLENDING AND THE BATTLE AGAINST WORLD POVERTY, (1998).

rates[7] and coaching services such as financial education and business training.[8]

Microfinance has spread around the world and has been adapted to different contexts by developing new forms and models such as individual lending, becoming more profit-oriented and evolving in some countries into a wide range of services for the poor such as micro-savings, micro-consumer credit, micro-insurance and money transfers. The size of the sector—over $44 billion in loans and 86 million borrowers in 2008[9]—and its recent growth rate are impressive, but development is not the same everywhere. Eastern Europe, Central Asia, Latin America and South Asia have the most mature and sophisticated microfinance markets, while the Middle East,

6. These loans have short maturities and frequent installments to facilitate monitoring and assistance and to reduce microfinance institutions' exposure. *See* YUNUS, BANKER TO THE POOR, *supra* note 5; Paul Mosley & David Hulme, *Micro-enterprise Finance: Is There a Conflict Between Growth and Poverty Alleviation?*, 26(5) WORLD DEVEL. 783 (1998).

7. High rates cover at least a part of the considerable operational expenses including the high cost of capital from traditional operators, intensive staff work for frequent direct meetings with the borrowers, servicing remote areas and dealing with many loans and accounts of small amounts. *See* Richard Rosenberg, Adrian Gonzalez & Sushma Narain, *The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates?*, (Febr. 2009), CGAP, *available at* http://www.cgap.org/gm/document-1.9.9534/op15.pdf.

8. For a description and presentation of the typical coaching services and their link with financial inclusion, see SUSAN HENRY, GOOD PRACTICE IN BUSINESS DEVELOPMENT SERVICES: HOW DO WE ENHANCE ENTREPRENEURIAL SKILLS IN MFI CLIENTS?, (July 2006), *available at* http://www.microcreditsummit.org/papers/Workshops/30_Henry.pdf; MONIQUE COHEN & CANDACE NELSON, FINANCIAL LITERACY: A STEP FOR CLIENTS TOWARDS FINANCIAL INCLUSION, (2011), *available at* http://microfinanceopportunities.org/docs/Micro credit%20Summit%20Paper%20Final.pdf; Dean Karlan and Martin Valdivia, *Teaching Entrepreneurship: Impact of Business Training on Microfinance Clients and Institutions*, (July 2006), Yale University Economic Growth Center Discussion Paper No. 941, *available at* http://www.econ.yale.edu/growth_pdf/cdp 941.pdf or http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920487; Merten Sievers & Paul Vandenberg, *Synergies through linkages: Who benefits from linking micro-finance and business development services?*, 35(8) WORLD DEV. 1341 (2007).

9. Adrian Gonzalez, *Microfinance at a Glance - 2008*, MIX MARKET (Dec. 31, 2009), *available at* http://www.themix.org/sites/default/files/Microfinance% 20at%20a%20Glance%202009-12-31.pdf.

North Africa, and Sub-Saharan Africa are the regions with the lowest level of microfinance assets.[10]

It is currently difficult to draw the borders of microfinance. Broadly speaking, microfinance is any activity expanding financial access to low-income people, but many countries have chosen narrower definitions for regulatory purposes with references to, for example, a specific scope of activity or target clients.[11]

These activities have been carried on through different types of entities, from not-for-profit entities to commercial banks and regulated financial institutions, with varied objectives, techniques and geographic interests. MicroFinance Institutions ("MFIs") are entities of various legal forms (e.g., banks, companies, cooperatives, NGOs, etc.) that specialize in the

10. In Eastern Europe and Central Asia, for example, MFIs, which are primarily credit unions and non-bank financial institutions, provide loans, consumer credit and deposit accounts, with a savings penetration rate of 14.5%: RALITSA SAPUNDZHIEVA & OLGA TOMILOVA, CONSULTATIVE GROUP TO ASSIST THE POOR & MICROFINANCE INFORMATION EXCHANGE, EASTERN EUROPE AND CENTRAL ASIA 2009: MICROFINANCE ANALYSIS AND BENCHMARKING REPORT 5 (Feb. 2010), http://www.themix.org/sites/default/files/2009%20ECA%20Microfinance%20Analysis%20and%20Benchmarking%20Report.pdf. About the geographical distribution of microfinance assets, see MicroRate, *State of Microfinance Investment 2011*, at 7, *available at* http://www.microrate.com/media/downloads/2012/04/The-State-of-Microfinance-Investment-2011-MicroRate.pdf; Raimar Dieckmann, *Microfinance: An Emerging Investment Opportunity*, (19 Dec. 2007), at 4 et seq., *available at* https://www.dbresearch.com/PROD/DBR_INTERNET_DE-PROD/PROD0000000000219174/Microfinance%3A+An+emerging+investment+opportunity.pdf.

11. BANK FOR INT'L SETTLEMENTS (BIS), BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES AND THE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 32 (Aug. 2010), [hereinafter MICROFINANCE ACTIVITIES], *available at* http://www.bis.org/publ/bcbs175.pdf (explaining the different concepts of microfinance adopted worldwide); TOR JANSSON, RAMÓN ROSALES & GLEN D. WESTLEY, INTER-AMERICAN DEVELOPMENT BANK, PRINCIPLES AND PRACTICES FOR REGULATING AND SUPERVISING MICROFINANCE 29-31 (2004), *available at* http://www.microfinancegateway.org/gm/document-1.9.25002/21298_30.pdf.

As an example, in Peru the *Resolución* No. 11356/2008, *available at* http://intranet1.sbs.gob.pe/idxall/financiero/doc/resolucion/pdf/11356-2008.r.pdf, limits the concept of microcredit to loans intended to finance (even through credit cards) the production of goods or services as well as their commercialization and offered to individuals or corporations with a total level of indebtedness in the financial system (but without counting loans intended for buying, building, renovating and expanding a home) below S/ 20,000 (*Nuevos Soles*, approximately $7,700).

provision of microfinance services, specifically microcredit.[12] They are generally characterized by their small size (but with important exceptions), the geographic or social (focusing on the poor) concentration of their activities, their decentralized decisions (because of the need for close relationships between bank agents and clients and direct knowledge and analysis of the client's profile) and, thus, the consequent operational and human resource risks (including staff selection, compensation techniques and internal controls).[13] A principal lesson learned from the microcredit experience is that financial services to the poor can be offered in a commercially viable way, expanding financial access and improving the poor clients' way of life, though some have debated these conclusions.[14]

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12. This almost tautological definition is needed to leave it open to the different experiences among countries and address the difficulty in defining microfinance for regulatory purposes.

13. *See* BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11, at 4, 10-11, 23-26, 46; ROBERT PECK CHRISTEN, TIMOTHY R. LYMAN & RICHARD ROSENBERG, MICROFINANCE CONSENSUS GUIDELINES. A GUIDE TO REGULATION AND SUPERVISION OF MICROFINANCE, 25, 34 (2012), (hereinafter MICROFINANCE CONSENSUS GUIDELINES 2012) *available at* http://www.cgap.org/sites/default/files/Consensus-Guideline-A-Guide-to-Regulation-and-Supervision-of-Microfinance-Oct-2012_0.pdf; JANSSON, ROSALES & WESTLEY, *supra* note 11, at 23, 61-62, 92.

14. About the debate on microfinance's role and effectiveness, see Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why the West has Misperceived the Grameen Bank's Vision of Microcredit*, 41 STAN. J. INT'L 217 (2005); Michael Barr, *Microfinance and Financial Development*, 26 MICH. J. INT'L L. 271 (2004); *Banking the Poor*, 21 YALE J. ON REGULATION 121 (2004); *Credit Where it Counts*, 80 N.Y.U. L. REV. 101 (2005); Patrick Honohan, *Financial Sector Policy and the Poor: Selected Findings and Issues*, (2004), World Bank Working Papers No. 43, at 25 et seq.; Isobel Coleman, *Defending Microfinance*, 29 FLETCHER F. WORLD AFF. 181 (2005), at 183 et seq.; Kenneth Anderson, *Microcredit: Fulfilling or Belying the Universalist Morality of Globalizing Markets?*, 5 YALE HUM. RTS. & DEV. L. J. 86 (2002), at 109 et seq. Specifically on microfinance's impact on clients' lives: Signe-Mary McKernan, *The Impact of Micro-Credit Programs on Self-Employment Profits: Do Non-Credit Program Aspects Matter?*, 84(1) REVIEW OF ECONOMICS AND STATISTICS, 93 (2002); Christian Ahlin & Neville Jiang, *Can micro-credit bring development?*, 86 J. OF DEV. ECON. 1 (2008); Dean S. Karlan & Jonathan Zinman, *Expanding Credit Access: Using Randomized Credit Supply Decisions to Estimate the Impacts*, (2007), Yale University Economic Growth Center Discussion Paper No. 956, *available at* http://ssrn.com/abstract=982921; Robert Cull, Asli Demirgüç-Kunt & Jonathan Morduch, *Microfinance Meets the Market*, 23(1) J. OF ECON. PERSPECTIVES 167 (2009), at 189; Katherine Odell, *Measuring the Impact of Microfinance. Taking Another Look*, (2010), Grameen Foundation, *available at* http://www.grameenfoundation.org/sites/default/

Microfinance was developed as a private response to the unsatisfactory results of development aid and government programs aimed at poverty reduction. While it is possible to cast doubts on its pure market-oriented and private nature, microfinance can be seen as an innovative commercial activity with positive effects on the low-income population and as a new form of developmental assistance encouraging entrepreneurship, strengthening the financial sector and expanding the tax base in developing countries ("DCs"). Consequently many international organizations and governments are active in this field. As a consequence, the commercial/business perspective here intersects with the development aid, charity, public social policy and financial sector perspectives. The use of business and commercial models and instruments in the development aid and social service fields is now becoming quite a common phenomenon; as an example, social entrepreneurship is now seen as an efficient development tool, with the actions of donors and international organizations evaluated through metrics such as client/beneficiary feedback, surveys and ratings.[15]

Microfinance has substantially grown in size, attracting the attention of investors and financial markets and paving the way for the creation of a new segment of the socially responsible investing sector. Funds, called Microfinance Investment Vehicles ("MIVs"),[16] respond to varied investment objectives

files/Updated2_Measuring%20the%20Impact%20of%20Microfinance%20-%20Taking%20Another%20Look.pdf; Bauchet et al., *Latest Findings from Randomized Evaluations of Microfinance*, Access to Finance Forum - Reports by CGAP and Its Partners No. 2, (Dec. 2011), *available at* http://www.cgap.org/sites/default/files/CGAP-Forum-Latest-Findings-from-Randomized-Evaluations-of-Microfinance-Dec-2011.pdf.

15. Kevin E. Davis & Sarah Dadush, *The Privatization of Development Assistance: Symposium Overview*, 42 N.Y.U. J. INT'L L. & POL. 1079, 1085-86 (2010); Devesh Kapur & Dennis Whittle, *Can the Privatization of Foreign Aid Enhance Accountability?*, 42 N.Y.U. J. INT'L L. & POL. 1143, 1164-69 (2010).

16. Microfinance reached 200 million clients in 2010 and MFIs assets worldwide totaled $70 billion in 2010 with a 13% growth rate (compared to the previous year). Between 1998 and 2006 the median MFI's assets grew at a 36% annual rate, lending at almost 40% and return on equity (RoE) was close to 10%; Eastern Europe and Middle East and Central Asia median MFI grew faster and had better asset quality ratios. The global financial crisis has slowed down such process: in 2007-2009 assets of the median MFI grew at an annual rate of 22%, lending at 24%, and the mean RoE was about 5 percentage points lower, with the worst results in Eastern Europe and Central America and the Caribbean: Gabriel Di Bella, *The Impact of the Global Finan-*

ranging from profit maximization to socially oriented goals.[17] At the same time, new forms of funding such as securitization and online peer-to-peer lending have evolved as hedging instruments.

B. *Microfinance and Multiple Regulators: Looking at the Different Dimensions of the Phenomenon and the Structure of the Analysis.*

The hybrid and highly varied nature of microfinance (considering both the for-profit and social orientation, the different legal structures adopted, the varied nature of funders, investors and donors, etc.) has created tensions and uncertainty not only within economically advanced countries ("EACs") and DCs, but also between the countries involved and at an international organization level, challenging our

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cial Crisis on Microfinance and Policy Implications, (2011), IMF Working Paper No. 175, *available at* http://www.imf.org/external/pubs/ft/wp/2011/wp11175.pdf: Jan P. Maes & Larry R. Reed, *State of the Microcredit Summit Campaign Report 2012,* (2012), at 33, *available at* http://www.microcreditsummit.org/pubs/reports/socr/2012/WEB_SOCR-2012_English.pdf. MIVs' assets reached $6.4 billion at the end of 2010 (18% growth rate in 2010; 86% in 2007). *See* Cédric Lützenkirchen, *Microfinance in evolution. An industry between crisis and advancement,* (13 Sept. 2012), DB Research, at 2 et seq., *available at* http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000294314/Microfinance+in+evolution%3A+An+industry+between+crisis+and+advancement.pdf; MicroRate, *State of Microfinance Investment 2011,* note 10, at 5.

17. Dieckmann, *Microfinance: An Emerging Investment Opportunity, supra* note 10, at 12 et seq.; Patrick Goodman, *Microfinance Investment funds: Objectives, players, potential,* in INGRID MATTHÄUS-MAIER & J. D. VON PISCHKE (EDS.), MICROFINANCE INVESTMENT FUNDS: LEVERAGING PRIVATE CAPITAL FOR ECONOMIC GROWTH AND POVERTY REDUCTION, (2005), Heidelberg/New York, at 26 et seq.; Xavier Reille & Sarah Forster, *Foreign Capital Investment in Microfinance:Balancing Social and Financial Returns,* (2008), CGAP Focus NOTE No. 44, *available at* http://www.microfinancegateway.org/p/site/m/template.rc/1.9.29212/; William Langer, *The Role of Private Sector Investment in International Microfinance and Implications of Domestic Regulatory Environments,* 5 BYU INT'L & MGMT. REV. 1 (2008), at 8; CGAP, *2010 MIV Survey Report. Market Data & Peer Group Analysis,* (Aug. 2010), *available at* http://www.amt-forum.org/fileadmin/media_amt/publications/External_publications/CGAP_2010_MIV_Survey_Report.pdf; CGAP, *Microfinance Investment Vehicles Disclosure Guidelines,* (2010), *available at* http://www.cgap.org/sites/default/files/CGAP-Consensus-Guidelines-Microfinance-Investment-Vehicle-Disclosure-Guidelines-Sep-2010.pdf.

traditional legal categories.[18] For example, frictions can arise in the case of a non-profit and unregulated entity providing credit or collecting money from unsophisticated investors and consumers and investing in risky and unrated businesses such as MFIs. Consequently, a number of different regulations interact and compete with each other without a clear scheme.

The role of governments and regulators can be fundamental in this context; the use of existing laws or issuing new regulations can, depending on the case, either spur or hamper the development of the sector. In addition, looking at microfinance as either a mere economic activity or a development tool can influence the role assigned to governments and international organizations.

Many studies have tried to design principles for the best regulatory framework at the domestic level or irrespective of the vertical dimension,[19] but this task is complicated by the differences among countries in terms of institutions, experience and perspectives.

However, I believe that an additional issue deserving attention is the potential division of competencies among regu-

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18. About the most common problems in regulating microfinance, see Robert Peck Christen & Richard Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance*, CGAP Occasional Paper No. 4 (Apr. 2000), *available at* http://www.cgap.org/gm/document-1.9.2699/OP4.pdf. See also references in the next note.

19. *See* Rodrigo A. Chaves & Claudio Gonzalez-Vega, *Principles of Regulation and Prudential Supervision and Their Relevance for Microenterprise Finance Organizations*, in MARIA OTERO & ELISABETH RHYNE (EDS.), THE NEW WORLD OF MICROENTERPRISE FINANCE: BUILDING HEALTHY FINANCIAL INSTITUTIONS FOR THE POOR, (1994); Robert Peck Christen & Richard Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance*, *supra* note 18; ROBERT PECK CHRISTEN, TIMOTHY R. LYMAN & RICHARD ROSENBERG, MICROFINANCE CONSENSUS GUIDELINES: GUIDING PRINCIPLES ON REGULATION AND SUPERVISION OF MICROFINANCE, (2003), [hereinafter MICROFINANCE CONSENSUS GUIDELINES 2003], *available at* http://www.cgap.org/sites/default/files/CGAP-Consensus-Guidelines-Guiding-Principles-on-Regulation-and-Supervision-of-Microfinance-Jun-2003.pdf; MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13; World Savings Bank Institute, *WSBI Position Paper on the Regulation of Microfinance Services*, (June 2008), *available at* http://www.wsbi.org/uploaded Files/Position_papers/0608.pdf; PAUL B. MCGUIRE & JOHN D. CONROY, THE ROLE OF CENTRAL BANKS IN MICROFINANCE IN ASIA AND THE PACIFIC, Asia Development Bank (2000); Microcapital, *Microfinance 101. Regulation and Supervision: What Works*, *available at* http://www.microcapital.org/downloads/whitepapers/Regulation.pdf.

lators at the different levels. My analysis will explore three dimensions: the horizontal dimension of the problem, such as the allocation of rulemaking and supervisory powers among different sectors of the law and related authorities (e.g., development assistance, financial authority, charity authority, etc.); the vertical dimensions, such as the geographical level of organization (i.e., the local, regional, or international level); and issues related to the nature of the authority, such as having a private, public or hybrid regulator. This appears to be crucial considering the multitude of various potential regulators, both public and private, in the microfinance field under the perspectives of Global Administrative Law[20] and the benefits from clear principles of competence.[21]

This paper will focus on the microfinance sector in its microcredit and micro-savings functions and the question of whether an international or transnational regulation of microfinance should exist. In doing so, in the first part of this work, I will first briefly analyze the horizontal dimension of the problem with particular reference to the competing categories of development aid and financial regulation (section II, especially subsection B); second, I will address the allocation of rulemaking power at different vertical levels (section III); finally, I will consider the opportunities offered by the interaction between public and private regulators (section IV). In a second part of the paper I will develop a discussion about the

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20. On Global Administrative Law, see, Benedict Kingsbury & Lorenzo Casini, *Global Administrative Law Dimensions of International Organizations Law*, 6 INT'L ORG. L. REV. 319 (2010); Nico Krisch, *The Pluralism of Global Administrative Law*, 17 EUR. J. OF INT'L L. 247 (2006); Rolf H. Weber, *Multilayered Governance in International Financial Regulation and Supervision*, 13 J. INT'L ECON. L. 683 (2010).

21. *See* BIS, BASEL COMMITTEE ON BANKING SUPERVISION, BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (revised 2006), *available at* http://www.bis.org/publ/bcbs129.pdf (principle 1: "An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.").

optimal allocation of rulemaking power, mixing the different previously described perspectives (i.e., horizontal, vertical and nature of the regulator) (section VI), distinguishing among different fields of the law (e.g., consumer protection, transparency and prudential regulation) (section VI.A), focusing then on prudential regulation (section VI.B) and not discarding possible differences between developing countries and economically advanced countries relevant to the discussion (section VI.C). My analysis and conclusions (section VII) argue for a more public and domestic rulemaking power in the prudential field (as compared to a more transnational and market-based regulation in the consumer protection field), leaving nonetheless some room for a transnational authority or (a more principles-based) transnational regulation.

This work represents a first attempt at laying the foundations of a more coherent structure of the principles, standards and rules at different regulatory levels in the field.

At present, the topic appears of particular interest for many reasons. First, the current financial crisis has promoted wide debate on reforms of the regulation and supervision of the financial sector in general, with a trend toward more public regulation and international harmonization.[22] The crisis hit

22. *See* the intense publication work by the Joint Forum (REVIEW OF THE DIFFERENTIATED NATURE AND SCOPE OF FINANCIAL REGULATION - KEY ISSUES AND RECOMMENDATIONS; DEVELOPMENTS IN MODELING RISK AGGREGATION; REPORT ON ASSET SECURITISATION INCENTIVES; PRINCIPLES FOR THE SUPERVISION OF FINANCIAL CONGLOMERATES), the Financial Stability Board (FSF PRINCIPLES FOR CROSS-BORDER COOPERATION ON CRISIS MANAGEMENT; FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES; KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS; FSB REPORT ON INTENSITY AND EFFECTIVENESS OF SIFI SUPERVISION; FSB REPORT ON SECURITIES LENDING AND REPOS: MARKET OVERVIEW AND FINANCIAL STABILITY ISSUES; FSB REPORT WITH RECOMMENDATIONS TO STRENGTHEN OVERSIGHT AND REGULATION OF SHADOW BANKING), the Basel Committee on Banking Supervision (e.g., REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP; PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE; GOOD PRACTICE PRINCIPLES ON SUPERVISORY COLLEGES; THE BASEL COMMITTEE'S RESPONSE TO THE FINANCIAL CRISIS: REPORT TO THE G20; SOUND PRACTICES FOR THE MANAGEMENT AND SUPERVISION OF OPERATIONAL RISK; BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING; BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS; OPERATIONAL RISK - SUPERVISORY GUIDELINES FOR THE ADVANCED MEASUREMENT APPROACHES; REPORT ON ASSET SECURITISATION INCENTIVES; GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY

the microfinance sector in different ways, suggesting the need of governmental support as well as an improvement in structures and disclosures to reduce risks related to microfinance. On the other hand, a rush to publicly regulate microfinance might threaten its very existence, whereas private regulation or public/private cooperation might be more efficient.

In addition, institutions such as the European Union, the Basel Committee on Banking Supervision ("BCBS") and the G20 have manifested a recent interest in this area—both in microfinance in general as an instrument of financial inclusion and in its regulation[23]—so that the idea of microfinance

AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT - FINAL DOCUMENT; CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION; A FRAMEWORK FOR DEALING WITH DOMESTIC SYSTEMICALLY IMPORTANT BANKS). The European Union has been conceiving a reform to unify financial sector supervision: European Commission, *Communication for the Spring European Council. Driving European recovery,* COM(2009) 114 and *id., Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank. Regulating financial services for sustainable growth,* COM(2010)301; *id., Communication from the Commission to the European Parliament and the Council. A Roadmap towards a Banking Union,* COMM(2012)510; *Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No. 1093/2010 Establishing a European Supervisory Authority (European Banking Authority),* COM(2012)512; *Regulation (EU) No. 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union Macro-Prudential Oversight of the Financial System and Establishing a European Systemic Risk Board.* Among the authors attesting such trend, Guido Ferrarini, Niahm Moloney & Maria Cristina Ungureanu, *Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe,* 10(1) JOURNAL OF CORPORATE LAW STUDIES 73 (2010), at 75 et seq.; Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics and the International Principles for Sound Compensation Practices. An Analysis of Executive Pay at European Banks,* 64 VAN. L. REV., 431 (2011); *id., Lost in Implementation: The Rise and Value of the FSB Principles for Sound Compensation Practices at Financial Institutions,* 1-2 REVUE TRIMESTRIELLE DE DROIT FINANCIER 60 (2011); David Rouch, *Self-regulation is Dead: Long Live Self-regulation,* 4 (2) L. & FIN. MARKETS REV. 102 (2010); Roberta Romano, *Regulating in the Dark,* Yale Law & Economics Research Paper No. 442, (30 March 2012), *available at* http://ssrn.com/abstract=1974148 or http://dx.doi.org/10.2139/ssrn.1974148; Jeffrey Gordon & Colin Mayer, *The Micro, Macro and International Design of Financial Regulation,* (March 28, 2012), Columbia Law and Economics Working Paper No. 422, *available at* http://ssrn.com/abstract=2047436 or http://dx.doi.org/10.2139/ssrn.2047436.

23. BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11; Council Decision 283/2010, 2010 O.J. (L87)1 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:087:0001:0005:EN:PDF;G20, *Leaders Statement. The Pittsburgh Summit*

as a global phenomenon might prevail over localized regimes and lead to the adoption of global standards, principles and even rules.[24] At the same time, the microfinance sector is currently agitated by debate about the risks and opportunities linked to the growth and commercialization of the sector such as mission drift, fraud and consumer abuse, and the effectiveness of microfinance in alleviating poverty.[25]

(September 24–25 2009), *available at* http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

24. On the distinctions and similarities among the three, see John H. Walsh, *Institution-Based Financial Regulation: A Third Paradigm*, 49 HARV. INT'L L.J. 381 (2008); Frederick Schauer, *The Convergence of Rules and Standard*, 2003 N.Z. L. REV. 303 (2003); Dan Awrey, *Regulating Financial Innovation: A More Principles-Based Alternative?*, Oxford Legal Stud. Research Paper No. 79/2010, (2010), *available at* http://ssrn.com/abstract=1702457.

25. The expansion of the microfinance sector has been accompanied by a commercialization process (e.g., transformations of NGO-MFIs in for-profit or regulated entities to please investors or increase efficiency, standardization of products and procedures, IPOs and securitizations of microloans, etc.) that, coupled with higher interest rates, higher profits, and scandals about client abuses, has concerned many commentators. *See* Robert Peck Christen, *Commercialization and Mission Drift: The Transformation Experience in Latin America*, (2001), CGAP Occasional Paper No. 5, *available at* http://www.cgap.org/sites/default/files/CGAP-Occasional-Paper-Commercialization-and-Mission-Drift-The-Transformation-of-Microfinance-in-Latin-America-Jan-2001.pdf; Victoria White & Anita Campion, *Transformation – Journey from NGO to Regulated MFI*, in DEBORAH DRAKE & ELISABETH RHYNE, THE COMMERCIALIZATION OF MICROFINANCE: BALANCING BUSINESS AND DEVELOPMENT, (2002), Bloomfield; CHRISTINA FRANK, STEMMING THE TIDE OF MISSION DRIFT: MICROFINANCE TRANSFORMATIONS AND THE DOUBLE BOTTOM LINE, WWB Focus Note (2008), *available at* http://www.swwb.org/sites/default/files/pubs/en/stemming_the_tide_of_mission_drift_microfinance_transformations_and_the_double_bottom_line.pdf; Roy Mersland, *The Cost of Ownership in Microfinance Organizations*, 37 WORLD DEVELOPMENT 469 (2009), at 472; Robert Cull, Asli Demirgüç-Kunt & Jonathan Morduch, *Financial Performance and Outreach: a Global Analysis Leading Microbanks*, 117 THE ECONOMIC JOURNAL 107 (2007); Cécile Aubert, Alain de Janvry & Elisabeth Sadoule, *Designing credit agent incentives to prevent mission drift in pro-poor micro?nance institutions*, 90 J. OF DEV. ECON. 153 (2009). *See also* literature indicated at note 191. About recent scandals involving clients suicides and MFIs abuses in some regions (e.g., India and Nicaragua); *see* Sergio Guzmán, *Nicaraguan Microfinance in Crisis*, (10 Nov. 2009), *available at* www.microfinancegateway.org; CGAP, *Growth and Vulnerabilities in Microfinance*, CGAP Focus Note 61 (Febr. 2010), *available at* http://www.cgap.org/gm/document-1.9.42393/FN61.pdf; *see also* references to the Andhra Pradesh crisis and other scandals in the present work in notes 43,,148 and accompa-

The following sections briefly describe and discuss the main legal issues arising under each dimension (horizontal, vertical and authority nature) and then propose criteria to solve the regulatory dilemmas. As I will explain, I adopt a broad concept of regulation covering not only public regulation issued by a formal public authority according to certain procedural rules, but also private regulation, referring to the creation of norms by private organizations or groups without formal promulgating power aimed at affecting the behaviors of others. I will thus consider guidelines, standards, codes of conduct and standardized terms of private contract originated by groups of non-profit organizations, practitioners, professionals, industry participants, international organizations and development banks, in their private role of market participants, as well as network affiliation agreements and the criteria used by ratings and labeling agencies.

II.
MICROFINANCE: THE HORIZONTAL DIMENSION OF THE PROBLEM.

A. *Overview of the Horizontal Dimension*

As already mentioned, microfinance cuts across many different sectors, each often regulated by a specialized authority and governed by different principles and rules.[26] For example, in some countries, such as those in Western Europe, financial regulation may prohibit NGOs from conducting credit-related activities directly, but rules concerning not-for-profit organizations expanding their funding sources and activities allows them to partner with banks to offer capacity building services to microcredit.[27] In some cases, NGOs-MFIs can help banks in

nying text. From a different point of view, doubts have been raised about microfinance's ability to lift people out of poverty based on field and empirical studies. *See* references reported *supra* at note 14 and *infra* 183.

26. Donato Masciandaro & Marc Quintyn, *After the big-bang and after the next one? Reforming the financial supervision architecture and the role of the Central Bank. A Review of Worldwide Trends, Causes and Effects (1998 – 2008)* ("Paolo Baffi" Ctr. Research Paper Series No. 2009-37, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1336390.

27. For more information about bank-MFIs partnerships, see Alexandra O'Rourke, *Public-Private Partnerships: The Key to Sustainable Microfinancing*, 12 LAW & BUS. REV. AM. 1790 (2006); C. Fökehrer, *Gaining Scale in Microcredit. Can Banks Make it Happen?*, EMN BI-ANNUAL MAGAZINE (Dec. 2007), at 7,

selecting appropriate borrowers through their social network and can provide financial education and support services to such borrowers.[28] As an alternative, banking regulation can be reformed to allow NGOs to directly provide microcredit under certain conditions, like specific corporate governance, social missions or maximum loan size requirements,[29] while subjecting them to banking supervision or an *ad hoc* authority. This is beneficial since NGOs can better reach the poorest part of the population, which would otherwise be excluded from banking.[30]

From a different perspective, foreign investment treaties can affect microfinance activities when provided by foreign entities and may conflict with protective domestic financial regulation.

Microfinance might also be seen as a business activity and regulated by the WTO. With its hybrid nature, it is also "trapped" between the financial regulation and development aid spheres, as I will explain in the next subsection.

The prevalence given to one aspect over another has consequences from the point of view of authorities entitled to take

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available at http://ec.europa.eu/enterprise/policies/finance/files/gaining_scale_in_microcredit_en.pdf; Martin Jung, Stefanie Lahn and Michael Unterberg, *EIF Market Studies on Micro Lending in the European Union: Capacity Building and Policy Recommendations,* (March 2009), *available at* http://www.european-microfinance.org/data/file/EIF%20MF%20Studies%20-%20Capacity%20Building%20final.pdf.

28. *Id.*

29. NGOs would be required to adopt some internal control mechanisms, clear and specific missions (e.g., target primarily people without bank accounts and with an income below a certain threshold; provide coaching services) and loans not above certain levels in order to ensure, on the one hand, effective governance and, on the other, protection against frauds and predatory lending as well as a limited market share (so that problems do not have the potential to affect the whole market and the damages are limited to small amounts per person).

30. This has been introduced in France. L. 511-6 *Code monétaire et financier* and R. 518-59 as modified by *loi* No. 2001-420 (May 15 2001), No. 2005-32, No. 2008-420 (Aug. 4, 2008), No. 2010-737 (July 1 2010), *available at* http://www.legifrance.gouv.fr/affichCodeArticle.do;jsessionid=8758BDAEC3915030A5E10F00435C83CA.tpdjo07v_2?idArticle=LEGIARTI000022422888&cidTexte=LEGITEXT000006072026&dateTexte=20120509. As regards the new regulation of microcredit in Italy, see art. 111 of "Testo unico bancario" (legislative decree No. 385/1993), as modified by the legislative decree No. 141/2010 (Aug. 13, 2010), *available at* http://www.bancaditalia.it/vigilanza/normativa/norm_naz/TUB_gennaio_2011.pdf.

action, authorized types of action, types of regulation and so on.

B. *From Development Aid to Financial Inclusion to Financial Regulation*

Microfinance has been assigned very different roles and missions over time, ranging from private organizations' tools to alleviate the poor's difficulties, to transnational forces' instruments to lift people out of poverty, to, more recently, a financial inclusion instrument and, thus, listed among governments' new priorities.

In particular, for years microfinance has been seen either as an additional tool for alleviating poverty by providing immediate and efficient help to the poor or as an innovative form of business and financial activity. Since the 1990s, and especially since 2005, microfinance has been included among the development instruments at the disposal of the United States and international cooperators for attainment of the Millennium Development Goals ("MDGs").[31] The involvement of international organizations active in the fields of human rights, women's empowerment, social and economic development[32] and development banks has been impressive and includes commercial investments, grants,[33] technical assistance, lobbying

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31. United Nations International Conference on Financing for Development, Monterrey, Mex., Mar. 21-22, 2002, *Confronting the challenges of financing for development: a global response*, U.N. Doc. A/CONF.198/11 (2002), *available at* http://www.un.org/esa/ffd/monterrey/Monterrey-Consensus-excerpts-aconf198_11.pdf; Press Release, U.N. Department of Public Information, U.N. Launches International Year of Microcredit 2005, U.N. Press Release DEV/2492 (Nov. 18, 2004), *available at* http://www.un.org/News/Press/docs/2004/dev2492.doc.htm.

32. See the innumerable UN projects and other similar entities dedicated or involved somehow in microfinance projects, such as the United Nations Capital Development Fund (UNCDF) and United Nations Development Program (UNDP), United Nations Children's Fund (UNICEF), United Nations Development Fund for Women (UNIFEM), Convention on the Elimination of All Forms of Discrimination Against Women (CEDAW).

33. They have been accused of crowding out private investors through excessive grants and investments, with negative effects on the maturity and efficiency of the sector. *See* BRIGIT HELMS, ACCESS FOR ALL. BUILDING INCLUSIVE FINANCIAL SYSTEMS, CGAP, (2006), *available at* http://www.microfinancegateway.org/gm/document-1.9.24915/30667_file_Book_AccessforAll.pdf; Julie Abrams & Damian von Stauffenberg, *Are Public Development Institutions Crowding Out Private Investment in Microfinance?*, (Febr. 2007), *available at*

and elaboration of principles affecting microfinance.[34] In addition, the UN has cooperated in elaborating its "Principles for Investors in Inclusive Finance" ("PIIF") to guide investors on how to ensure that MFIs respect clients rights and treat them fairly, respond to principles of responsible investing, continuously adapt and innovate their services, and measure and report their social performance; the UN has advanced PIIF endorsement of major microfinance investors.[35]

The international arena has recently played a more pervasive role in the field through the involvement of International Financial Institutions ("IFIs") such as the World Bank and the IMF.[36] These institutions were originally conceived to provide immediate liquidity and stability to countries facing difficulties but have evolved into development aid organizations.[37] At first, microfinance appeared to be a perfect tool for IFIs, efficiently solving economic and social problems of the poor while contributing to the development of a country's financial market and thus the local economy in general.[38] Consequently, the World Bank, through its conditionality clauses on funded countries, has also imposed reforms in the microfinance framework.[39]

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http://www.microfinancegateway.org/gm/document-1.9.29192/38659_file_Are_Public_Developm.pdf.

34. *See generally* UNCDF, *Building Inclusive Financial Sectors for Development*, (2006), *available at* http://www.uncdf.org/sites/default/files/Download/bluebook_0.pdf.

35. UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT, 40 GLOBAL INVESTORS LAUNCH INCLUSIVE AND RESPONSIBLE FINANCE PRINCIPLES, http://www.unpri.org/files/2011_01_piif_press_release.pdf.

36. About the involvement of such organizations in the microfinance field, see http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20433592~menuPK:34480~pagePK:64257043~piPK:437376~theSitePK:4607,00.html; *see also* further references later on in the text and footnotes.

37. About the different roles covered by the IMF and the World Bank over time, see NGAIRE WOODS, THE GLOBALIZERS: THE IMF, THE WORLD BANK, AND THEIR BORROWERS, (2006), Ithaca, at 3 et seq.

38. *See* DEEPA NARAYAN ET AL., MOVING OUT OF POVERTY, VOLUME 2: SUCCESS FROM THE BOTTOM UP, 33, WORLD BANK, (2009); ASLI DEMIRGÜÇ-KUNT, T. BECK & P. HONOHAN, FINANCE FOR ALL? POLICIES AND PITFALLS IN EXPANDING ACCESS, (2007), World Bank Policy Research Report, at 13.

39. For references to the use by the World Bank of conditions regarding microcredit, see Heloise Weber, *The Imposition of a Global Development Architecture: The Example of Microcredit*, CSGR Working Paper No. 77/01, (July 2001), *available at* http://dspace.cigilibrary.org/jspui/bitstream/123456789/9454/

After the recent financial crisis, financial inclusion has been seen as a new objective of financial regulators at both the national and international level,[40] and thus the new wave of international and national standards aimed at global stability and financial inclusion might also affect microfinance. For example, the BCBS has recently issued a document on its international banking principles applied to microfinance, and there has been wide discussion about methods for applying anti-money laundering ("AMN") and combating the financing of terrorism ("CFT") rules to microfinance.[41] The G20 Financial Inclusion Experts Group plans to participate in elaborating global standards for financial inclusion.[42]

Consequently, the prevailing regulatory sphere is financial regulation. In fact, as mentioned, the global financial crisis has further focused the attention of regulators on this field. Furthermore, we have recently witnessed first failures of MFIs

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1/The%20Imposition%20of%20a%20Global%20Development%20Architecture%20The%20Example%20of%20Microcredit.pdf?1. For an example of the World Bank's criticized conditions regarding microcredit reforms in Croatia, see Milford Bateman & Dean Sinkovic, *Global financial crisis and related country-level financial sector disasters: The case of microfinance in Croatia,* (2009), *available at* http://bib.irb.hr/prikazi-rad?rad=463745;_aklina Marta Bogdanic & Hans Peter Schmitz *The Weakness of Strong Ties: Transnational Mobilization and the Failure of Microfinance Sector Reform in Croatia, 1999-2003,* (2006), *available at* http://faculty.maxwell.syr.edu/hpschmitz-dev/Papers/TransMicroCreditPaper2006.pdf; about the Armenian case, see Monica Harutyunyan, *The Regulatory Reform Process for Microfinance in Armenia,* (2005), *available at* http://www.iris.umd.edu.

40. G20, *The Pittsburgh Summit, supra* note 23; ALLIANCE FOR FINANCIAL INCLUSION (AFI), FINANCIAL INCLUSION MEASUREMENT FOR REGULATORS: SURVEY DESIGN AND IMPLEMENTATION (2010).

41. FINANCIAL ACTION TASK FORCE (FATF), THE FORTY RECOMMENDATIONS ON MONEY LAUNDERING AND THE SPECIAL RECOMMENDATIONS ON FINANCING OF TERRORISM (2003). More recently, FATF, INTERNATIONAL STANDARDS ON COMBATTING MONEY LAUNDERING AND THE FINANCING OF TERRORISM AND PROLIFERATION, (Febr. 2012); *id.*, DECLARATION OF THE MINISTERS AND REPRESENTATIVES OF THE FINANCIAL ACTION TASK ON APRIL 20, 2012, (2012), *available at* http://www.fatf-gafi.org/documents/repository/ministersrenewthemandateofthefinancialactiontaskforceuntil2020.html. On the adaptation to MFIs' organizations and business of AML/CFT regulation, see CGAP, AML/CFT REGULATION: IMPLICATIONS FOR FINANCIAL SERVICE PROVIDERS THAT SERVE LOW-INCOME PEOPLE (July 2005).

42. G20, *The Pittsburgh Summit, supra* note 23, at point 41; G20, *Principles for Innovative Financial Inclusion,* INTERNATIONAL MONETARY FUND FINANCIAL ACCESS SURVEY (June 27, 2010), http://fas.imf.org/misc/G20%20Toronto%20Principles%20for%20Innovative%20Financial%20Inclusion.pdf.

and some serious scandals related to predatory lending,[43] endangering the financial sectors of some DCs as well as casting doubts on the social and development missions of the whole sector. At the same time, financial regulation is one of the strongest instruments used by local and domestic governments to react to some perceived problems and to give the community a political message.[44]

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43. For a synthesis, see Microfinance Focus, *6 Microfinance Crises That the Sector Does Not Want to Remember* (Apr. 22, 2010), *available at* http://www.microfinancefocus.com/6-microfinance-crises-sector-does-not-want-remember.

44. As an example, in both India and Nicaragua, microfinance scandals about MFIs' client abuses have triggered an immediate and strict regulatory response by local governments in terms of financial regulation over MFIs in order to reassure the population and fight MFIs. In India, in addition, the national government advanced a general reform regarding supervision in the sector to reaffirm its power. *See* Sergio Guzmán, *Ley Moratoria (Moratorium Law) Passes in Nicaragua,* (23 March 2010), *available at* http://centerforfinancialinclusionblog.wordpress.com/2010/03/23/ley-moratoria-moratorium-law-passes-in-nicaragua/; Cristhian Marenco, *Asomif recurrirá contra Ley de Moratoria por inconstitucionalidad,* (5 Apr. 2010), *available at* http://archivo.elnuevodiario.com.ni/2010/04/06/economia/121918; David Roodman, *When Indian Elephants Fight,* (Nov. 24, 2010), *available at* http://blogs.cgdev.org/open_book/2010/11/when-indian-elephants-fight.php; Daniel Rozas, *Bring Microfinance into Politics,* (July 7, 2011), *available at* http://www.microfinancefocus.com/part-1-bring-microfinance-politics; *see also* note 148. Furthermore, considering the recognized link between finance, financial regulation and growth (although debated in some aspects), government has often used financial regulation reforms (either de-regulating or reinforcing financial rules) to show to investors, IFIs and citizens their commitment to change and innovation. About developing countries adopting Basel principles under the influence of economically advanced countries, see DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION, 206 (Washington 2008); JAMES R. BARTH, GERARD CAPRIO & ROSS LEVINE, RETHINKING BANKING REGULATION: TILL ANGELS GOVERN, 71 (New York 2008); Caroline Bradley, *Private International Lawmaking for the Financial Markets,* 29 FORDHAM INT'L L. J. 127 (2005), at 137. About the connections between finance and growth, Felix Eschenbach, *Finance and Growth: A Survey of the Theoretical and Empirical Literature,* (2004), Tinberg Institute Discussion Paper, *available at* http://ssrn.com/abstract=530123 or http://dx.doi.org/10.2139/ssrn.530123; Ross Levine, *Finance and Growth: Theory and Evidence,* (2004), National Bureau of Economic Research Working Paper, *available at* http://www.nber.org/papers/w10766.pdf?new_window=1; Asli Demirgüç Kunt & Ross Levine, *Finance, Financial Sector Policies, and Long-Run Growth,* (1 Jan. 2008), World Bank Policy Research Working Paper No. 446, *available at* http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2008/01/07/000158349_20080107115116/Rendered/PDF/wps4469.pdf;

For these reasons, I will focus this paper on the financial regulation perspective. In the next subsection I will explain why financial regulation appears so important nowadays, why it is able to attract microfinance in its sphere and what the consequences of financial regulation for microfinance are.

C. *Restricting the Focus: Microfinance and Financial Regulation*

In this subsection we should first analyze the rationales for the existence of a special regulation for banks and then assess whether such arguments apply also to MFIs, thus justifying prudential regulation over MFIs. Microfinance, in fact, resembles a form of "small banking" (also thanks to the current expansion of the range of services offered)[45] but conducted through unconventional models. The hybrid nature of its activities, structures and products can trigger different rules designed to protect important interests (e.g., stability, consumer protection, charity promotion, etc.), but, at the same time, it does not fit into the conventional categories and thus casts doubt on the applicability of such rules to it.

Banks typically receive special regulatory treatment. They must comply with stringent rules, called prudential regulation, and are subject to the public authority's oversight, known as supervision. The debate around the reasons for such special

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Katharina Pistor, Martin Raiser & Stanislaw Gelfer, *Law and Finance in Transition Economies*, 8 THE ECONOMICS OF TRANSITION 325 (2000); Rajan Rajan & Luigi Zingales, *Financial Development and Growth*, 88 AMERICAN ECONOMIC REVIEW 559 (1998); Kev in Davis & Michael Trebilcock, *The Relationship Between Law and Development: Optimists versus Skeptics*, 57(1) AMERICAN JOURNAL OF COMPARATIVE LAW 895 (2009).

45. Micro-deposits reached $23.5 billion from 95.8 million depositors compared to $44.2 billion in loans to 86.2 million borrowers at the end of 2009. *See* http://www.mixmarket.org (last visited Sept. 16th, 2010). The total number of deposits refers to the 1395 MFIs that reported to the MIX for 2008, *available at* http://www.themix.org/sites/default/files/Microfinance%20at%20a%20Glance%202009-12-31.pdf. At the end of 2003 the ratio between deposits and loans among 61 Latin American MFIs reached 76%. MAISCH, ET AL., INTER-AMERICAN DEVELOPMENT BANK, HOW SHOULD MICROFINANCE INSTITUTIONS BEST FUND THEMSELVES?, at i (2006), *available at* http://www.rrojasdatabank.info/iadbremit/howshould.pdf. In a recent study involving 166 MFIs, 27% of the MFIs offered savings services. Taea Calcut, *MFIs' Financial Products and Services: An Overview of SP Report Data*, SOCIAL PERFORMANCE INDICATORS BLOG, *available at* http://www.spblog.org/2010/02/mfis-financial-products-and-services-an-overview-of-sp-report-data.html.

regimes is varied and relates to banks' deposit-holding and payment-processing functions, including the need to control the ability of banks to create money while performing payment services, the risks of highly leveraged banks, the government guarantee implied in deposit insurance regimes and instability related to demand deposits. By protecting depositors, regulators seek to prevent runs and panics and so guarantee the stability of the whole banking system.[46]

Some of these rationales for regulation of banks would also apply to other non-bank financial intermediaries, blurring the appropriate boundaries of such regulation. Depending on the country, some rules apply only to banks, some to all financial institutions and credit providers and some to insurance companies. Some rules apply only to entity classes, but most apply to activities or products so that they potentially reach NGOs and other non-profit entities.[47] The recent financial turmoil has encouraged the extension of additional regulation to some or all financial intermediaries and markets.[48]

There are two main types of financial regulation: prudential and non-prudential. Prudential regulation manages systemic risk by focusing on the safety and soundness of the financial system as a whole, as well as idiosyncratic risks associated with single institutions. Its goal is the protection of the savings of depositors and the maintenance of stability using pervasive tools of regulation, control and enforcement.[49] Non-

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46. *See generally* BASEL COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION, *supra* note 21; RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 33, 53 et seq. (4th ed. 2009); ROSS CRANSTON, PRINCIPLES OF BANKING LAW, 65 et seq. (Oxford 2002); MATHIAS DEWATRIPONT & JEAN TIROLE, THE PRUDENTIAL REGULATION OF BANKS (Losanne 1993); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 198 (2008); Ferrarini & Ungureanu, *Economics, Politics and the International Principles for Sound Compensation Practices*, *supra* note 46.

47. DEWATRIPONT & TIROLE, *supra* note 46.

48. Schwarcz, *supra* note 46.

49. INT'L MONETARY FUND, MONETARY AND CAPITAL MARKETS DEPARTMENT, LESSONS OF THE FINANCIAL CRISIS FOR FUTURE REGULATION OF FINANCIAL INSTITUTIONS AND MARKETS AND FOR LIQUIDITY MANAGEMENT (Feb. 4, 2010), *available at* http://www.imf.org/external/np/pp/eng/2009/020409.pdf; Andrew Crockett, *Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability* (Sept. 21, 2000) (unpublished presentation at the Bank for International Settlements autumn meeting in 2000), *available at* http://www.bis.org/review/rr000921b.pdf.

prudential regulation pursues other varied objectives like consumer protection and prevention of fraud and usury, and relies on disclosure and non-banking authorities.

Microfinance complicates this distinction. As already mentioned, even restricting the discussion to credit and savings services, microfinance can be seen as a kind of banking activity or a separate and new sector conducted by for-profit, non-profit or public entities; different rules from different sectors of the law might apply at the same time, with conflicting important interests at stake.

Commentators agree on limiting the scope of existing prudential rules to those MFIs that choose to adopt the formal structure of a bank or take deposits from the public.[50] In fact, deposits represent both a cheap form of funding for the MFI (although the costs of staff training, management information system and adapting to other regulatory requirements can be surprisingly expensive) as well as a protection from foreign exchange risk and international market fluctuations.[51] It is also an additional and fundamental financial service to the poor who have alternative but less-reliable savings instruments.[52] However, concentration of deposits in MFIs will impact trust and stability in the system and the possible need of government intervention in times of crisis.[53]

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50. *See, e.g.*, Robert Peck Christen & Richard Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance*, *supra* note 18; CHRISTEN, LYMAN & ROSENBERG, CGAP, MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19, 13-14 and MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 19, at 16, 19 et seq.

51. Susan Featherston & Elisabeth Littlefield, *Foreign Exchange Rate Risk in Microfinance: What is it and How Can it be Managed?*, CGAP Focus Note No. 31, at 8 (Jan. 2006), *available at* http://www.cgap.org/gm/document-1.9.2522/FN31.pdf; RANI DESHPANDE, CAMILLA NESTOR & JULIE ABRAMS, CGAP, MFI CAPITAL STRUCTURE DECISION MAKING: A CALL FOR GREATER AWARENESS 3 (Aug. 2007) *available at* http://www.cgap.org/gm/document-1.9.2735/BR_MFI_Capital_Structure_Decision_Making.pdf.

52. UNCDF, WORLD BANK INSTITUTE, BUILDING INCLUSIVE FINANCIAL SECTORS FOR DEVELOPMENT: WIDENING ACCESS, ENHANCING GROWTH, ALLEVIATION POVERTY 8 (2005), *available at* http://www.un.org/esa/ffd/msc/bluebook/full%20report%20of%20e-conference.pdf; Thankom Arun, *Regulating for Development: The Case of Microfinance*, 45 Q. REV. ECON. & FIN. 346, 353 (2005).

53. The main guarantee of repayment for an MFI is its borrowers' expectation of a new and bigger loan after the repayment of the previous one. Consequently, when an MFI appears to be in trouble and some borrowers

As already mentioned, MFIs are beginning to offer other financial services along with credit products, but micro-deposits, payments and other more complex services are only offered in mature microfinance markets, especially where non-bank entities are allowed to conduct these kinds of businesses.[54] For example, Eastern Europe and Central Asia have a high savings penetration rate, and the growth rate of deposit mobilization in Latin America and the Caribbean has recently risen.[55]

Requiring so-called "mandatory" savings as a loan guarantee to be eligible to receive a microloan is generally excluded from prudential regulation; mandatory savings are a kind of bundled service, incentivizing, on the one hand, saving mentality in the borrower and, on the other hand, representing a form of collateral for the bank. The exclusion has been justified based on the fact that the balance is generally in favor of the bank in the sense that the savings kept by the MFIs represent only an extremely small part of the total amount due by the borrower so that, in the event of a MFI default, the borrowers are not really losing their money.[56] Nonetheless, some

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stop repaying their debt, the others consider a new loan unlikely and, thus, have incentives to stop repaying as well, especially when no credit bureau system is in place. This phenomenon is called the "contagion effect." *See, e.g.*, Philip Bond & Ashok S. Rai, *Borrower Runs*, 88 J. DEV. ECON. 185 (2009); DANIEL ROZAS, THROWING IN THE TOWEL: LESSONS FROM MFI LIQUIDATIONS (Sept. 20 2009), *available at* http://www.microfinancegateway.org/gm/document-1.9.38716/Throwing%20in%20the%20Towel_%20%20Lessons%20from%20MFI%20Liquidations.pdf.

54. About MFIs' funding evolution, see MAISCH ET AL., HOW SHOULD MICROFINANCE INSTITUTIONS BEST FUND THEMSELVES?, *supra* note 45; about MFIs' product offering, http://www.microrate.com/research/about-microfinance.

55. In Eastern Europe and Central Asia, the savings penetration rate is 14.5%. Sapundzhieva & Tomilova, *supra* note 10, at 1. Since the end of 2009 Latin America has seen a clear trend towards deposit mobilization by MFIs with an increase of deposit accounts and balances of 28% in the top MFIs. Furthermore, for MFIs mobilizing deposits, these represent 80% of their total sources financing their loan portfolio. *Deposit Mobilization on Rise in LAC Microfinance Sector: Report*, MICROFINANCE FOCUS (Oct. 22, 2010 5:12 PM), *available at* http://www.microfinancefocus.com/news/2010/10/22/deposit-mobilization-on-rise-in-lac-microfinance-sector-report/.

56. *See, e.g.*, MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19, at 10 and MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 17; PATRICK MEAGHER, IRIS CENTER, MICROFINANCE REGULATION IN DEVELOPING COUNTRIES: A COMPARATIVE REVIEW OF CURRENT PRACTICE 6 (2002), *available*

countries, like Zambia, have applied different rules.[57] Furthermore, some kinds of regulation concerning risk containment and stability might be required for MFIs occupying certain parts of a country or region's economy or financial sector. Such MFIs would, in case of negative events, have a dramatic impact on a significant vulnerable part of the population, thus calling for government intervention.[58] Finally, many MFIs receive a considerable amount of financing from domestic financial institutions with which they are consequently interconnected.

While regulation is necessary, it is also important to avoid excessive regulation that might restrain economic activities. Excessive regulation may be especially detrimental to MFIs considering the characteristics of the microfinance business, the need to maintain continuous relationships with borrowers often living in remote areas and the need to deal with many small transactions. Some studies draw a correlation between prudential regulation of MFIs and reductions in the number of female or impoverished clients.[59] However, based on these studies, the entities subject to supervision appear mature, as-

at http://www.microfinancegateway.org/gm/document-1.9.25004/14077_14077.pdf; BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 46, at 15 (considering a possible exclusion depending on the weight of risks and costs).

57. In 2006 the Bank of Zambia classified compulsory savings as "deposits" and the MFIs involved subject to banking regulation. Chiara Chiumya, *The Regulation of Microfinance in Zambia*, CGAP MICROFINANCE GATEWAY 8 (2010), *available at* http://www.microfinancegateway.org/gm/document-1.9.44531/The%20regulation%20of%20microfinance.pdf.

58. *See* section VI.A.d *infra* for the "too sensible to fail" argument.

59. *See, e.g.*, Robert Cull, Asli Demirgüç-Kunt & Jonathan Morduch, *Does Regulatory Supervision Curtail Microfinance Profitability and Outreach?* 26-27 (World Bank Policy Research Working Paper Series, Paper No. 4948, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1414710## (finding that regulation is correlated with larger average loan size and a reduced proportion of loans to women, which is consistent with the hypothesis that "profit-oriented MFIs that have to comply with prudential supervision respond by curtailing their outreach to segments of the population that are more costly to serve"). *But see, e.g.*, Valentina Hartarska & Denis Nadolnyak, *Do Regulated Microfinance Institutions Achieve Better Sustainability and Outreach? Cross-Country Evidence*, 39 APPLIED ECONOMICS 1207, 1220 (2007) (finding that "regulatory involvement does not affect sustainability or outreach but that better capitalized MFIs have better sustainability"); Roy Mersland & R. Øysten Strøm, *Performance and Corporate Governance in Microfinance Institutions* 18 (MPRA Working Paper No. 3888, 2007), *available at* http://www.micro

set-rich, profit-seeking and self-sustainable.[60] Sometimes the regulation adopted has been aimed at promoting microfinance, introducing favorable "special window" exemptions to general regulation or just adjusting existing requirements to the nature and limits of the sector.[61] This perspective is also partially consistent with the idea of microfinance as something different from mere banking because it shares aspects with social work and development aid.

The prevailing idea in the literature is to adapt the existing prudential and non-prudential regulatory frameworks to the characteristics and specific risks of the microfinance business by looking mainly at activities rather than at institutional forms for the creation of a level playing field and flexibility for innovation, exempting in some cases small businesses.[62] This avoids special windows for microfinance or special legal statuses unless the existing applicable requirements would impede the activity itself.[63] The trade-off is between promoting a business providing access to the poor—thus pursuing a public interest—and preventing the existence of unsound, unsafe and abusive entities taking advantage of the favorable treatment reserved to microfinance (regulatory arbitrage).[64] Such

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financegateway.org/gm/document-1.9.25086/12.pdf (finding regulation to be insignificant in predicting MFI performance).

60. *See supra* note 59.

61. *See* Robert Peck Christen & Richard Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance, supra* note 18, at 13 et seq.; MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19 and MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 9 et seq.; BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11 at 6-7, 37-42.

62. Chaves & Gonzalez-Vega, *Principles of Regulation and Prudential Supervision and Their Relevance for Microenterprise Finance Organizations, supra* note 19; Christen & Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance, supra* note 18; MICROFINANCE CONSENSUS GUIDELINES, *supra* note 19; Microcapital, *Microfinance 101. Regulation and Supervision, supra* note 19.

63. MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19, at 5, 18 and MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 15, 23; JANSSON, ROSALES & WESTLEY, *supra* note 11, at 6.

64. *See* MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19, at 5-6 (arguing poorly fashioned regulation will result in regulatory arbitrage where financial institutions disguise themselves as MFIs to avoid regulation) and MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 11; Seth McNew, *Regulation and Supervision of Microfinance Institutions: A Proposal for a Balanced Approach*, 15 L. & BUS. REV. AM. 287, 302 (2009) ("[T]oo much prudential regulation will lead to the demise of MFIs.").

a trade-off is particularly acute in the microfinance field where flexibility and customization have often led to innovation and better fulfillment of the poor's needs.[65] Obviously legal uncertainty, although coming from a reform effort, is also detrimental to financial inclusion and microfinance. For example, Bolivia has recently created a new supervisory authority (Autoridad de Supervisión del Sistema Financiero - ASFI) under whose supervision cooperative and NGO-MFIs now fall, but the licenses of such entities are still pending since the new authority needs additional regulation to become operative.[66]

As already mentioned, in this paper I will focus on prudential regulation, which is central to the current debate on microfinance, considering and highlighting the related significant costs to the MFIs, their clients and the system in general, as well other important aspects and interests to be balanced (e.g., stability, access to finance and competition) (section VI.B) and the relevant policy implications involved (and attached to different regulators; see in particular section VI.B.b.).

This topic not only entails specific discussions related to the particular regulatory and institutional framework of each country, but also a major distinction between DCs and EACs (section VI.C). In fact, for DCs the goal might be either to permit microfinance activity in the absence of an advanced financial and legal framework or to eliminate burdensome requirements or restrictions for a new kind of commercial activity. In many EACs, on the contrary, where microfinance is limited to microcredit and social initiatives, the focus would be on

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65. *See generally* IGNACIO MAS & DAN RADCLIFFE, BILL AND MELINDA GATES FOUNDATION, MOBILE PAYMENTS GO VIRAL: M-PESA IN KENYA (2010), *available at* http://www.microfinancegateway.org/gm/document-1.9.43376/mobile%20payments%20go%20viral_m-pesa%20in%20kenya.pdf; CGAP, REGULATING TRANSFORMATIONAL BRANCHLESS BANKING: MOBILE PHONES AND OTHER TECHNOLOGY TO INCREASE ACCESS TO FINANCE (2008), *available at* http://www.cgap.org/gm/document-1.9.2583/fn43.pdf (explaining and evaluating potential approaches to branchless banking technology); SUSANA BARTON ET AL., USAID, CLIENT-FOCUSED MFI TECHNOLOGIES CASE STUDY (2007), *available at* http://pdf.usaid.gov/pdf_docs/pnadn418.pdf (examining the use of client-focused technologies to improve outreach and performance of MFIs).

66. *See* Economist Intelligence Unit, *Global microscope on the microfinance business environment 2012*, (2012), at 39, *available at* https://www.eiu.com/public/topical_report.aspx?campaignid=microscope2012.

adjusting existing financial regulation in order to facilitate microfinance while preventing its abuse.

III.
THE VERTICAL DIMENSION OF THE PROBLEM: AN INTERNATIONAL REGULATION OF MICROFINANCE

The vertical dimension concerns different allocations of power and function across authorities at the international, regional, national and local levels. In the mainstream financial sector there is extensive debate as to whether certain powers should be allocated to an international level or a national one, and whether to centralize these powers or allow competition among regulators. As a sign of the expansion of international law beyond its traditional bounds, this paper discusses allocation to supranational institutions of either full regulatory powers or of the ability to adopt principles, standards or guidelines.[67]

The banking and financial sector has recently facilitated increased regulation and monitoring at an international and regional level. The deeper integration of financial markets, increasing cross-border activities and foreign investments and the general globalization of the financial sector have been used to justify the creation of structures for monitoring systemic risks, adopting common standards of supervision and regulation and supporting coordination among countries.[68] In particular, the financial crisis has evidenced the need to monitor systemic risks[69] involving the financial world as a whole, to

67. *See* JOSÉ ALVAREZ, INTERNATIONAL ORGANIZATIONS AS LAW-MAKERS (2005); Ramses A. Wessel & Jan Wouters, *The Phenomenon of Multilevel Regulation*, 4 INT'L ORG. L. REV. 257 (2007) (discussing the rise of supra-national organizations with both legal and non-legal power and jurisdiction).

68. *See generally* the work of the Basel Committee on Banking Supervision of the Bank for international settlements, the International Organization of Securities Commission (IOSCO), the International Association of Insurance Supervisors (IAIS), the Organization for Economic Co-operation and Development (OECD).

69. Schwarcz defines systemic risk as the "risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial- market price volatility." Schwarcz, *supra* note 46, at 204. The FSB identifies the same as the "risk of disruption to financial services

improve cooperation among regulators of different countries and to manage and prevent crises, especially in the case of cross-border banks or internationally active banking groups.[70]

Like the global financial system as a whole, microfinance might appear to require an international approach because it is so widespread and involves participants from many different countries. However, it presents many country-specific aspects and is generally unrelated to international systemic risk and the global economy, warranting primarily domestic regulation.

No single MFI has the size to manage systemic risk,[71] and they rarely engage in trans-border activities. Before the financial crisis, studies even suggested the resilience of the microfinance sector in the face of big economic challenges.[72]

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that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy" and it is evaluated based on the size, substitutability, interconnectedness of institutions or markets. INTERNATIONAL MONETARY FUND, BANK FOR INTERNATIONAL SETTLEMENTS & FINANCIAL STABILITY BOARD, GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS 2 (2009), *available at* http://www.bis.org/publ/othp07.pdf.

70. *See* THE LAROSIÈRE GROUP, THE HIGH LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU - REPORT 6, 59-60 (2009), *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf; FINANCIAL STABILITY BOARD, IMPROVING FINANCIAL REGULATION. REPORT OF THE FINANCIAL STABILITY BOARD TO G20 LEADERS 10 (2009), *available at* http://www.financialstabilityboard.org/publications/r_090925b.pdf; FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR CROSS-BORDER COOPERATION ON CRISIS MANAGEMENT (2009), *available at* http://www.financialstabilityboard.org/publications/r_0904c.pdf; BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 34-35 (2010), *available at* http://www.bis.org/publ/bcbs169.pdf; Vanessa Blackmore & Esther Jeapes, *The Global Financial Crisis: One Global Financial Regulator or Multiple Regulators?*, 4 CAPITAL MARKETS L. J. S112, S118-S120 (2009); Jean-Claude Trichet, President, European Central Bank, *Speech at the Eurofi Financial Forum* (Sept. 30, 2009), *available at* http://www.bis.org/review/r110920b.pdf.

71. *See* Arun, *supra* note 52, at 350; GRAHAM WRIGHT, MICROFINANCE SYSTEMS: DESIGNING QUALITY FINANCIAL SERVICES FOR THE POOR (2000).

72. The factors leading to the resilience of microfinance are generally listed as the following: non-public ownership, little international exposure, loans with short average maturities, lower financial and operating leverage, and ties with and knowledge of borrowers. Nicolas Krauss & Ingo Walter, *Can Microfinance Reduce Portfolio Volatility?*, (Dec. 30, 2008), *available at* http://ssrn.com/abstract=943786; Adrian Gonzalez, *Resilience of Microfinance Institutions to National Macroeconomic Events: An Econometric Analysis of MFI Asset*

Instead, MFIs' operations might be tightly connected to the economy and events of the region (or even the town) where it operates and less with the international economy. Thus, attention should focus on local prudential standards including risk management, capital requirements, reserves and liquidity issues and supervision rather than macro-prudential supervision. Furthermore, because the microfinance market is relatively small, and because deposits received by MFIs are often smaller than their loan portfolios, national or regional regulators might be more interested in assuring the soundness of MFIs not for the purpose of protecting depositors, but to protect the poorest part of the population from the failure of the financial sector and the exclusion from the financial sector of "too sensitive to fail" institutions.[73]

However, considering the growth rate and commercialization trend of the sector,[74] problems related to cross-border ac-

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Quality, (Microfinance Information Exchange Research Series No. 1, 2010), *available at*. http://ssrn.com/abstract=1004568; Nicolas Krauss & Ingo Walter, *Can Microfinance (Still) Reduce Portfolio Volatility?* in *ALFI Microfinance Conference slides*, (March 25, 2010), *available at* http://www.alfi.lu/conference/microfinance/microfinance-2010.pdf, at 20 et seq., and Nicolas Krauss & Ingo Walter, *Can Microfinance Reduce Portfolio Volatility?*, 58(1) ECONOMIC DEVELOPMENT AND CULTURAL CHANGE 85 (2009) (referencing updated data taking into account the effects the current financial crisis and the changed microfinance, which suggests that many of the above mentioned factors are weaker now—because of the increased number of IPOs, international level transactions, financial leverage of MFIs, fewer ties with borrowers and, in general, risk of mission drift—but that the sector appears still resilient).

73. *See* Savita Shankar & Mukul G. Asher, *Regulating Microfinance: A Suggested Framework*, 45 ECONOMIC & POLITICAL WEEKLY 15 (2010), *available at* http://ssrn.com/abstract=1607704.

74. *See e.g.* ELIZABETH RHYNE, CENTER FOR FINANCIAL INCLUSION, MICROFINANCE FOR BANKERS & INVESTORS: UNDERSTANDING THE OPPORTUNITIES AT THE BOTTOM OF THE PYRAMID (2009), *available at* http://www.accion.org/Document.Doc?id=405; Jennifer Isern & David Porteous, *Commercial Banks and Microfinance: Evolving Models of Success*, CGAP FocusNote No. 28 (June 2005), *available at* http://www.cgap.org/p/site/c/template.rc/1.9.2572/; Richard Rosenber, *CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits*, CGAP Focus Note No. 42 (June 2007), *available at* http://www.cgap.org/p/site/c/template.rc/1.9.2440/; MFI Solutions & La Colmena Milenaria, *The Implications of Increased Commercialization of the Microfinance Industry: What Can We Learn from the Discussion that Followed the Compartamos IPO?*, (July 2008), *available at* http://www.microfin.com/files/Implications%20of%20Increased%20Commercialization.pdf (discussing the criticized IPOs by Compartamos and its commercialization).

tivities and systemic risk at least for a particular country or a region should not be ignored. In particular, we can now observe new phenomena in the market: signs of a growing sector. As an example, some big MFIs are currently exporting their model to close countries, thus expanding their activities cross-border; in addition, foreign banks or other international entities (also based in an EAC) have been creating subsidiaries or branches in DCs with a low level of access to financial services.[75] This would involve classical home-host country problems[76] in supervision as well as the risk of a supervisory hole.[77] Protective measures adopted by domestic regulators in DCs limiting foreign investment rights might trigger the provisions of some treaties (e.g., the "non discrimination" and "national treatment" clauses in Bilateral Investment Treaties – BITs or GATS)[78].

75. *See, e.g.*, references to Compartamos expansion in note 166 and Wal-Mart's experience in Mexico. Anna Gelpern, *Wal-Mart Bank in Mexico: Money to the Masses and the Home-Host Hole*, 39 CONN. L. REV. 1513 (2007) (addressing the rare case of a unregulated entity in the home country, the U.S., operating through a subsidiary in the host country, Mexico, and consequently under the supervision of the latter only, instead of a consolidated supervision of the home country).

76. This would also include phenomena like the deficiency in supervision in some DCs and the consequent domination of EAC home countries' supervisors, as well as possible protective responses by DCs such as the imposition of a subsidiary organization instead of branches, territorial liquidity requirements or limitations on the transfer of capital. THE WARWICK COMMISSION, THE WARWICK COMMISSION ON INTERNATIONAL FINANCIAL REFORM: IN PRAISE OF UNLEVEL PLAYING FIELDS 26 (2009), *available at* http://www2.warwick.ac.uk/research/warwickcommission/financialreform/report/uw_warcomm_intfinreform_09.pdf; Katharina Pistor, *Into the Void: Governing Finance in Central & Eastern Europe*, (Columbia Law and Econ. Working Paper Group, Paper No. 356), *available at* http://ssrn.com/abstract=1476889 (exploring home-host country frictions in supervision between DCs and EACs).

77. *See* Gelpern, *supra* note 75.

78. As regards GATS, however, protective prudential measures might be acceptable since GATS recognizes a "prudential carve-out", allowing restrictive measures targeting foreign entities when introduced "for prudential reasons, including the protection of depositors, policy holders or person to whom a fiduciary duty is owned by a financial service supplier, or to ensure the integrity or stability of the financial system." *See* BARTH, CAPRIO & LEVINE, RETHINKING BANKING REGULATION. TILL ANGELS GOVERN, *supra* note 44, at 170–71; CRANSTON, PRINCIPLES OF BANKING LAW, *supra* note 46, at 428. *See also infra* note 155 and accompanying text.

In general, international standards such as Basel III in the financial field have increased and have been implemented worldwide, and the challenge for MFIs is to convince local governments to adjust the principles to the distinct characteristics of their business.[79] In any case, as we have seen, a rationale for international regulation in microfinance might come, not from systemic risk monitoring, but from a development aid perspective, which is closely tied with financial regulation. A high number of international organizations, including the UN, World Bank, IMF, G20, BCBS and WTO, are currently—or may soon be—involved in regulating microfinance.

IV. NATURE OF THE AUTHORITY AND OF REGULATION

This dimension refers to the different types of authorities: public, self-regulatory, private or hybrid. Private regulation refers to various forms of private entities' involvement in the creation of norms, including contractual or organizational norms, consultation during the co-regulation decision process, delegation by the public regulator or *ex post* adoption of private rules by the public regulator.[80] The role of private bodies might also be limited to supervision and monitoring compliance of government-issued rules.

There are various rationales for the existence and development of private regulation. Market failures such as access to information and inefficiency of the public regulator in solving problems can justify private regulation with the objective of entrusting the rules with legitimacy, improving compliance with them and assigning rulemaking power to a body with possibly better understanding and access to information.[81] Other reasons include historic or traditional structures or the politi-

79. *See* Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems,* (June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

80. *See* Fabrizio Cafaggi, *Rethinking Private Regulation in the European Regulatory Space* (EUI Law Working Paper, Paper No. 2006/13), *available at* http://ssrn.com/abstract=910870; Julia Black, *Constructing and contesting legitimacy and accountability in polycentric regulatory regimes,* 2 REGULATION & GOVERNANCE, 137, 139 (2008).

81. *See* Fabrizio Cafaggi, *Private Regulation in European Private Law,* in ARTHUR HARTKAMP, MARTJIN W. HESSELINK, EWOUD HONDIUS, C. MAK, EDGARD DU PERRON (eds.), TOWARDS A EUROPEAN CIVIL CODE 91 (4th ed. 2010, The

cal or economic power of some actors.[82] Rules would be applied voluntarily by the members of the association operating in the sector or even by non-members adopting the same standards because of competition forces or other reasons. This can be observed at all vertical levels of government (national, local or transnational level).[83]

The private regulatory process can include the regulated entities, affected constituencies or independent experts.[84] We can also have forms of hybrid bodies with participation of both public and private actors to different degrees and at different stages depending on the case. In consequence, issues regarding risks of self-interest[85] or lack of adequate structures and procedures for accountability and legitimacy[86] as well as toothless enforcement might come to mind.[87] For instance, the reliability of the rules issued by a self-regulatory organization setting standards for its members but affecting other subjects without contemplating the participation of other stakeholders, and without an adequate monitoring system or correct alignment of interests, have been often questioned. Also, forms of public-private regulation can lead to regulatory capture, preferential treatments or unbalanced regulation instead of in-

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Netherlands, Wolters Kluwer), *available at* http://ssrn.com/abstract=1443948.

82. *Id.*

83. *See* Geoffrey P. Miller, *Financial Private Regulation and Enforcement', Presentation at the Conference on Enforcement of Transnational Private Regulation*, EUI, Florence, (14 – 15 May 2010); Joanna Benjamin, Paul Bowden & David Rouch, *Law and Regulation for Global Financial Markets: Markets as Rule-Makers - Enforcement, Dispute Resolution and Risk*, 2 LAW AND FINANCIAL MARKETS REVIEW 321 (2008); Fabrizio Cafaggi, *The architecture of transnational private regulation*, (May 1, 2011), EUI Law Working Paper, *available at* http://ssrn.com/abstract=1899555.

84. *See* Celia Taylor, *Microcredit as Model: A Critique of State/NGO Relations*, 29 SYRACUSE J. INT'L L. & COM. 303, 316 (2002) (exploring the shift in the international development field from development state-led approach and the separation between state and NGOs to a growing role of NGOs).

85. *See* David Snyder, *Private Lawmaking*, 64 OHIO ST. L.J. 371, 434 (2003).

86. *See* Julia Black & David Rouch, *The Development of the Global Markets as Rule-makers: Engagement and Legitimacy*, 2 LAW AND FIN. MARKETS REV. 218, 223 (2008).

87. *See* Dan Awrey, *The Dynamics of OTC Derivatives Regulation: Bridging The Public-Private Divide*, 11 EUR. BUS. ORG. L. REV. 155, 184 (2010).

creased legitimacy and democracy.[88] Along the same lines, issues related to the incentives of private regulators or supervisors in the financial sector have been raised.[89]

However, some studies show that close-knit groups tend to cooperate in a socially beneficial way, highlighting the limits of public regulation such as capture, incompetence and bureaucratic failures.[90] In addition, when the behaviors are observable, and when the observance of rules is price- and investment-sensitive, the organization has an interest in enforcing the rules, and the members have an interest in compliance. As we will see later on, this is why transparency and investor monitoring is of special importance in microfinance.

Another problem with private regulation absent state enforcement is that if the exclusion of the member violating the standards does not drive such member out of the market, no other sanctions are left to enforce the rules.[91] With regard to microfinance, the topic is particularly relevant since, in some countries, microfinance is too small a sector for the government to invest substantial economic, human and time resources. Thus, it can be led to delegate its regulatory and su-

88. Geoffrey R.D. Underhill, *Financial Markets, Institutions, and Transaction Costs: the Endogeneity of Financial Governance* (draft Sept. 2009), APSA Toronto Meeting Paper, at 53–54, *available at* http://ssrn.com/abstract=1449921; Bradley, *Private International Law-Making for the Financial Markets, supra* note 44; Black & Rouch, *The Development of the Global Markets as Rule-makers: Engagement and Legitimacy, supra* note 86. *See supra* notes 80-83 and accompanying text.

89. Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation,* 2 THEORETICAL INQUIRIES IN LAW 649 (2001), at 671 n. 58; Larisa Dragomir, *Private parties' involvement in prudential banking regulation – some thoughts on the underlying accountability mechanisms,* (June 2007), *available at* http://www.iilj.org/GAL/documents/DragomirPrivateBankReg.pdf; TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION, *supra* note 44, at 152 et seq.

90. Jonathan R. Macey, *Public and Private Ordering and the Production of Legitimate and Illegitimate Legal Rules,* (1997). Faculty Scholarship Series. Paper 144, at 1131-32, *available at* http://digitalcommons.law.yale.edu/fss_papers/1449.

91. *See* Daniel Rozas & Sanjay Sinha, *Avoiding a Microfinance Bubble in India: Is Self-Regulation the Answer?,* MICROFINANCE FOCUS (Jan. 10, 2010), http://www.microfinancefocus.com/news/2010/01/10/avoiding-a-microfinance-bubble-in-india-is-self-regulation-the-answer/; Macey, *Public and Private Ordering, supra* note 90, at 1133 (quoting Professor Cooter about the advantages of public enforcement).

pervisory powers to some associations or networks in the sector. In the absence of any intervention by the government, in order to improve trust in the field and attract investments, the gap can be filled by various actors including the MFIs, donors and investors through the implementation of guidelines, best practices or even conditions on funding.[92] Private regulation might be able to ensure not only expertise in the sector, but also competence about local conditions as well as flexibility permitting innovation and meeting clients' needs.

In the microfinance field we can observe many active domestic self-regulatory organizations ("SROs"). For example, in India, after numerous criticisms of the lending methodologies of some MFIs and a perceived worsening of the financial conditions of the microfinance business, a network of MFIs decided to implement client protection legislation through the adoption of a code of conduct and a concomitant enforcement committee.[93] It has been suggested that the Reserve Bank of India ("RBI" – the national banking supervisor) promulgate general objectives, delegate to self-regulation and support self-regulation through a consultative process involving microfinance clients for the adoption of specific rules.[94] This would allow innovation, prompt responses, official imprimatur of the private authority and legitimacy.[95]

However, self-regulation in India is also seen as a response to the tendency by regulatory agencies to impose burdensome regulations that do not take account of the specific needs of the microfinance sector, as well as a way to enact more ac-

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92. For an overview and discussion of such forms of private regulation in microfinance, see Eugenia Macchiavello, *Private regulation and enforcement in microfinance: a multi-layered and polycentric puzzle*, in GEOFFREY P. MILLER & FABRIZIO CAFAGGI (with Tiago Andreotti e Silva, Maciej Konrad Borowicz, Agnieszka Janczuk-Gorywoda, Eugenia Macchiavello, and Paolo Saguato), THE GOVERNANCE OF INTERNATIONAL BANKING, Cheltenham, Edward Elgar Publishing Ltd, forthcoming 2012.

93. See Sa-Dhan, gathering together almost 300 community development financial institutions and MFIs of all types, and MFIN, a network of MFIs in the form of non-bank financial companies; Vikash Kumar, *MFIN was necessary for Indian Microfinance*, MICROFINANCE FOCUS (Apr. 2, 2010), http://www.microfinancefocus.com/news/2010/04/02/exclusive-interview-%E2%80%9Cmfin-was-necessary-for-indian-microfinance-vijay-mahajan%E2%80%9D/.

94. *See* Rozas & Sinha, *supra* note 91.

95. *Id.*

cepted and shared standards.[96] Recent regulatory reactions by the Andhra Pradesh government and RBI might involve less, instead of more, self-regulation.[97]

We might also recognize the possibility of a greater role in the sector of self-regulation played by a supra-governmental organization at an international level, like the fair trade sector with its Fairtrade Labeling Organizations International, to monitor and label MFIs and MIVs.[98] These include the MicroRate, PlanNet Rating, Microfinanza Rating and M-CRIL rating agencies and the Microfinance Information eXchange ("MIX"), created by the Consultative Group to Assist the Poor ("CGAP").[99] In addition, many international, regional or bilateral developmental organizations, such as the UN, UNDP, Inter-American Development Bank, IMF and USAID, as well as non-profit organizations such as the Ford, Rockefeller, Citi and Gates Foundations, and MFI networks such as MFN, SEEP, Acción, EMN, Women's World Banking and Pro Mujer, have addressed many challenging issues in the sector, suggesting or reporting best practices, guidelines and setting standards.[100] Particularly interesting is the growing role of CGAP and its hybrid nature gathering together many distant interests, as discussed in the following section.

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96. INTERNATIONAL NETWORK OF ALTERNATIVE FINANCIAL INSTITUTIONS (INAFI) – INDIA, *Self Regulation*, http://www.inafiindia.in/selfregulation.htm.

97. *See* MICROFINANCE FOCUS, *Will the Sector Survive the Microfinance Bill?* (Dec. 9, 2010), *available at* http://www.microfinancefocus.com/content/will-sector-survive-microfinance-bill.

98. On supra-governmental organizations and self-regulation, see Errol Meidinger, *Competitive Supragovernmental Regulation: How Could It Be Democratic?*, 8 CHI. J. OF INT'L L. 513 (2008).

99. CGAP is an independent organization specialized in microfinance, housed at World Bank and gathering together the main funders of the sector, both international organizations (IFIs and development aid) and private funders (see the discussion about this entity in the next paragraph). CGAP created the Mix in 2002 in partnership with for profit as well as not-for-profit entities (such as Open Society Institute, Citibank and Deutsche Bank). *See* CGAP, *Annual Report 2002*, at 27, *available at* http://www.cgap.org/gm/document-1.9.41930/CGAP_Annual_Report_2002NoSig.pdf.

100. On various forms of self-regulation and regulation by donors or commercial funders, see Michael Fiebig, *Prudential Regulation and Supervision for Agricultural Finance*, 75-87 (2001), *available at* http://www.redcamif.org/uploads/tx_rtgfiles/afr5_e.pdf.

V.
A SPECIAL FOCUS ON CGAP AND ITS ROLE IN THE MICROFINANCE SECTOR

CGAP is an organization created in 1995 that is independent but housed at the World Bank.[101] CGAP is particularly active in the production of guidelines for investors, funding sources, rating agencies, MFIs and local governments in every subsector of microfinance.[102] It is also active in collecting and disclosing data on MFIs and MIVs, facilitating a debate among all different sources on relevant topics for the industry, creating a network of knowledge, experience and technical assistance and responding to the concerns of critics of the sector.[103] The declared or implicit rationales for the regulatory intervention range from filling gaps left by local governments due to lack of resources or interest, to improving competition on a sound basis therefore encouraging investments and trust in the sector without burdensome or inadequate regulation from other authorities. CGAP participates in the G20 Expert Group on financial inclusion in charge of setting standards on financial access, financial literacy and consumer protection.[104] It is not clear if this dedication and activism should be attributed to the intent or *de facto* role of CGAP as an international regulator,[105] as an industry association with private self-regulat-

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101. *See* http://www.worldbank.org/ieg/gppp/case_studies/infrastructure/cgap.html; INDEP.EVALUATION GRP. (IEG), WORLD BANK GRP., THE CONSULTATIVE GROUP TO ASSIST THE POOR 26 (2008), at ix, *available at* http://siteresources.worldbank.org/extgloregparprog/resources/cgap.pdf.

102. *See, e.g.*, CGAP, GOOD PRACTICE GUIDELINES FOR FUNDERS OF MICROFINANCE: MICROFINANCE CONSENSUS GUIDELINES (2006); ROBERT PECK CHRISTEN AND MARK FLAMING, CGAP, DUE DILIGENCE GUIDELINES FOR THE REVIEW OF MICROCREDIT PORTFOLIOS: A TIERED APPROACH (2009); SARAH FOSTER, ESTELLE LAHAYE & KATE MCKEE, CGAP, IMPLEMENTING THE CLIENT PROTECTION PRINCIPLES: A TECHNICAL GUIDE FOR INVESTORS, (2009 and 2010); CGAP, MICROFINANCE INVESTMENT VEHICLES (MIV) DISCLOSURE GUIDELINES FOR REPORTING ON PERFORMANCE INDICATORS (2007); CGAP, MICROFINANCE INVESTMENT VEHICLES DISCLOSURE GUIDELINES (2010), *supra* note 17. All documents are available at www.cgap.org.

103. On CGAP's role as stated by this body itself, see *CGAP IV Strategy Building Local Financial Systems*, CGAP (last visited Apr. 23, 2012), http://www.cgap.org/p/site/c/template.rc/1.9.40791/.

104. G-20, *The Pittsburgh Summit*, *supra* note 23, at point 41.

105. As an example, CGAP sometimes appears to play the role of a supranational body assigning different roles to investors, donors, regulators and others involved in the industry as regards the development of the

ing powers or even just as an interest group.[106] The hybrid character of this entity is not limited to public-private participation in terms of members, but can also be seen in the interests defended and represented by the members and the types of missions and activities.

As regards its composition and functioning, CGAP comprises public (development agencies and regional, bilateral and multilateral IFIs) and private (foundations) developmental organizations. Since 2008, the voting membership has been limited to those funding organizations that support public goods and commit to core funding.[107] In fact, CGAP's only concern in creating its governance structure has been to create incentives for providing enough resources; its recent reform provided that only members funding the core budget are eligible to elect the Executive Committee ("Excom") and therefore vote both on the work plan that deploys their funds and on revisions to CGAP's charter.[108] The majority of the members, particularly those with voting power, are from EACs.[109] Its principal governing body, Excom, is composed of eleven member representatives, including independent experts, a representative of the World Bank and representatives of CGAP members' constituencies.[110] It currently includes representatives from foundations, Development Finance Institutions ("DFIs"), multilateral and bilateral entities and two

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microfinance industry, building countries' infrastructures and promoting financial inclusion, at the micro, meso and macro levels. CGAP, GOOD PRACTICE GUIDELINES FOR FUNDERS OF MICROFINANCE (2006) http://www.cgap.org/gm/document-1.9.2746/donorguidelines.pdf.

106. CGAP also depicts itself as an "informed, credible and objective industry organization." CGAP, STRATEGY BUILDING LOCAL FINANCIAL SYSTEMS THAT WORK FOR THE POOR: EQUITY AND EFFICIENCY 9 (2008), http://www.cgap.org/p/site/c/template.rc/1.9.40791/.

107. CGAP, *Strategy Building*, *supra* note 106, at 17.

108. *Id.* at 18.

109. For a list of all current members. see *The Council of Governors*, CGAP (last visited Apr. 23, 2012), http://www.cgap.org/p/site/c/template.rc/1.26.1380/.

110. Of the 11 Excom members, four are elected by the four constituencies of CGAP members, and one is elected by the World Bank Group. *See* INDEP. EVALUATION GRP. (IEG), WORLD BANK GRP., THE CONSULTATIVE GROUP TO ASSIST THE POOR, CORPORATE AND GLOBAL EVALUATIONS AND METHODS, (Oct. 26, 2008), at 26, *available at* http://siteresources.worldbank.org/extgloregparprog/resources/cgap.pdf.

MFIs.[111] No procedures for decisions or consultations are disclosed on Excom's website.[112]

Consequently, most CGAP members are funders of MFIs rather than MFIs themselves, and the representation of DCs is diluted relative to their high involvement and potential role in the microfinance world. The World Bank's Independent Evaluation Group ("IEG") believes otherwise in its evaluation of CGAP:

> [CGAP's] governance structure has a strong *legitimacy* arising from the effective participation of almost all major stakeholders, the service providers, MFIs, networks, donors, other financiers, etc.[113]

In addition, the IEG highlights as substantial achievements in the legitimacy of the governance structure the decision both to treat the World Bank on par with other members in terms of representation on Excom and to invite the Development Bank of China ("CDB") to join CGAP as the first bilateral member from a developing country.[114]

Thus, participation by the first non-EAC bilateral member and the reduction of the World Bank's "domination" are presented as great achievements,[115] though they should be considered basic and unavoidable elements of an institution that is supposed to be independent from the World Bank to operate as a leader in the microfinance field.

Looking at CGAP as a possible future international organization responsible for regulation and supervision in the field, its unbalanced composition is problematic. Its public-private hybrid nature responds to the recent demand for broader and more democratic participation, especially from the private sector,[116] but it represents a restricted and unequal model.[117] Its

111. *The Executive Committee,* CGAP (last visited November 13, 2012), http://www.cgap.org/executive-committee.

112. IEG evaluation considers adequate CGAP's transparency but suggests some improvements including the publication of its charter on its website. IEG, THE CONSULTATIVE GROUP TO ASSIST THE POOR, *supra* note 110, at 27.

113. *Id.* at xvi (emphasis added).

114. *Id.*

115. IEG itself refers to the World Bank's domination at CGAP before the proposed reforms in the Excom's election process: "This development further enhances CGAP's legitimacy as a representative of the industry without the domination of the World Bank." *Id.* at 26-27.

116. *See* Taylor, *supra* notes 84, 126 and accompanying text.

composition is unusual for an industry association since it represents neither the MFIs nor the sector as a whole and excludes professionals, NGOs, DFIs, EAC Governments and other constituencies. At most, it might be seen as an investor association that views private development organizations as mere funders of the sector rather than public entities or civil society advocates.[118] Consequently, the legitimacy of its rules can be challenged depending on the scope adopted and the people affected as well as the force and enforcement of the rules.[119] For instance, the fact that an investor association issues rules affecting MIVs, standards of governance for MFIs or prudential requirements affecting the internal functioning of MFIs and DCs' would be unacceptable unless such power and authority derive from a delegation from the public authority of the affected entities.[120] Furthermore, other "compensatory" measures such as independence, accountability, transparency, quality of norms and efficiency might make it more acceptable.[121]

Up to now, CGAP's guidelines and standards have been presented as strong recommendations, but never formally imposed with an official authoritative effect.[122] However, in the

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117. On the risk that a hybrid composition of an international organization diverts the attention from the problem of accountability or favours only few constituencies, see Kingsbury & Casini, *Global Administrative Law Dimensions of International Organizations Law*, *supra* note 20, at 21.

118. This is consistent with the current criteria for the membership. *See supra* note 107-109 and accompanying text.

119. *See* Cafaggi, *Rethinking Private Regulation*, *supra* note 80, at 6, 7 (discussing the legitimacy of rules when coming from all people affected by the regulation and the need for procedures and organizational structures assuring active participation of all private actors in order to fulfil the objective of increasing compliance with standards).

120. *See id.* at 20-21.

121. *See* Gráinne De Búrca, *Developing Democracy Beyond the State*, 46 COLUM. J. TRANSNAT'L L. 221 (2008) (discussing the compensatory approach and the democracy of transnational governance, criticizing this and other approaches that somehow accept the lack of the traditional democratic principle at transnational level, and proposing the "democratic-striving approach").

122. De Búrca argues that "where the norms generated by an international or transnational institution, entity, [sic] or set of processes have a clearly public quality in terms of their impact and scope, and where they enjoy or have acquired authoritative effect equivalent to that of national laws and policies, the question of their democratic legitimacy is raised in terms of their normative acceptability to those who are governed by them." *Id.* at 235.

next years, we can expect some discussions similar to the ones surrounding the adoptions of the Basel principles[123] whenever CGAP gained more authoritative power and whenever the rules could be considered inadequate to a DC's conditions or interests. Like the Basel Committee, however, CGAP has adopted processes for consultations and debate involving subjects carrying varied interests while maintaining its informal organization. This allows more flexibility and the formation of a consensus on many different topics in a relatively short time.[124]

In addition, this new authority would represent a new form of hybrid regulator, embodying an evolution of the NGO-led development model[125] in response to strong participation of public and private actors as well as a continuous blurring of the line separating public and private sectors in the developmental field.[126] In such a case, governments and representatives of civil society, encouraged by a willingness to avoid leaving the control of this sector to NGOs, would regulate and maybe even supervise the sector. However, in order to assure proper regulation based on principles and basic minimum requirements, there would be a need to include DCs' representa-

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Thus, the argument regarding the legitimacy of CGAP's rules, although having public quality, might appear weak until such rules acquire authoritative effect.

123. *See* Michael Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT'L L. 15 (2006); TARULLO, *supra* note 44, at 182; Eric Y. Wu, Note, *Basel II: A Revised Framework*, 24 ANN. REV. BANKING & FIN. L. 150 (2005); Kern Alexander, *Global Financial Standard Setting, the G-10 Committees, and International Economic Law*, 34 BROOK. J. INT'L L. 861 (2009); Bradley, *Private International Law-Making for the Financial Markets*, *supra* note 44, at 136-55.

124. Consultations in theory allow the participation of many stakeholders without the downsides of complex procedures (e.g., proposal from an entity representing certain interests, opinion by another carrying different interest and final decision by a third with the possibility of starting over in case of disagreement among different bodies) or organizational structures (e.g., bodies with composition reflecting different constituencies with equal or weighted vote) that slow down the decision process and make more rigid the functioning of the entity.

125. *See* Taylor, *supra* note 84.

126. *See* Kevin E. Davis, *Financing Development as a Field of Practice, Study and Innovation* (NYU Institute for International Law & Justice, Working Paper No. 2008/10, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstractid=1341291. *See also* Kingsbury et al., *The Emergence of Global Administrative Law*, *supra* note 20 (addressing new forms of hybrid standard setting).

tives in membership. Otherwise, a possibly counterproductive, dangerous and destabilizing delegation by DCs of their financial governance to an unrepresentative and unbalanced body would result.[127] Furthermore, it might be desirable to reorganize membership or structure the consultation process to include MFIs, MIVs, NGOs and other interest groups in order to avoid adopting a participatory model based on preferences for only certain groups. However, it is easy to cast doubt on the efficiency of the resulting regulation, which is inevitably extremely generic, to take into account all differences among countries. These problems include difficulties reconciling different positions among members, lack of real enforcement instruments and lack of supervisory capacity at an international level.

Consequently, it may be ideal to design differentiated responses, allocating the powers at different levels depending on the sector: as an example, we might accept a greater role of CGAP and transnational private regulators in the consumer protection and transparency fields, while giving priority to domestic rulemaking power in the prudential sector (see section VI.A and B).

On the other side of the spectrum, if CGAP assumed the role of a private regulator appointed by DCs and EACs to fill regulatory gaps with its experience, there would not be any guarantee that the predominant interests of investors represented at CGAP would not actually prevail in designing rules. In any case, delegation in the prudential field is questionable, being too broad an expansion of private regulation's scope. However, it may be possible to rely more on reputational factors since they play a particularly important role in microfinance, as all public and private contributions and investments in MFIs rely on reputation and thus help investors keep a closer eye on efficient management and respect for financial best practices and principles, rather than simple short-term profitability.[128] For instance, in Latin America some net-

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127. *See* Pistor, *supra* note 76, at 25, 35 (commenting on the delegation of powers to the EU and more developed and leading countries in the financial sector's negative consequences to the stability and functioning of CEE's financial markets). *See also* Gelpern, *Wal-Mart Bank*, *supra* note 75, at 1535; The Warwick Commission, *supra* note 76.

128. Microfinance providers appear sensible to reputational concerns as evidenced by a survey conducted in 2011, after the previously mentioned

works of MFIs have decided to organize themselves and impose on members the same kind of prudential regulation applied by the government and its agencies to regulated entities in order to gain trust and respect, access to favorable treatment and financing.[129] In addition, MFIs in some DCs are maintaining capital adequacy ratios significantly above what is required by public regulation to satisfy investors.[130]

Currently, regulators in the microfinance field are both numerous and horizontally and vertically differentiated. In fact, CGAP documents in a certain sense compete with reports, recommendations and analyses from NGOs, foundations, rating agencies, international organizations, investors associations, networks of MFIs and governments such that defects regarding CGAP's structures and procedures might be excused considering the absence of a regulatory monopoly.[131]

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scandals in the sector: CSFI, *Microfinance Banana Skins 2011. Losing its fairy dust,* (Feb. 2011), at. 6 et seq., *available at* http://www.citigroup.com/citi/microfinance/data/news110125b.pdf. Furthermore, microfinance funders are still mainly donors or socially responsible investors, so that MFIs social performance and reputation represent a form of return for them and, in consequence, an element to carefully consider and monitor; in fact, many efforts are currently directed towards social performance and impact measurement and standardization. *See* Dieckman, *Microfinance: An Emerging Investment Opportunity, supra* note 10; The SEEP Network, *Social Rating,* 4 *Social Performance Progress Brief,* (Nov. 2007); David Dewez, *Le rôle des investisseurs socialement responsables dans la performance sociale des IMF,* 1 E-MFP DIALOGUE EUROPÉEN, (Nov. 2008), at 45 et seq.; David Dewez & Luce Perez, *InCoFIn's experience in assessing MFIs Social performance,* 3 E-MFP EUROPEAN DIALOGUE, (Nov. 2010), at 73 et seq. Among social performance guidelines and investor instruments: Social Performance Task Force adopting *Social Performance Standards* (by CGAP and the MiX, http://www.microfinancegateway.org; http://www.sptf.info/page/background-1); *Social Performance Management Guidelines* (by Imp-Act and the Microfinance Centre for Central and Eastern Europe and the New Independent States - MFC, http://www2.ids.ac.uk/impact/), CERISE *Social Performance Indicators Initiative* (http://www.cerise-microfinance.org), Oxfam Novib Fund *Social Performance Questionnaire* (http://www.cgap.org), Acción *Social Performance Tool* 2009 (http://www.accion.org).

129. REYNOLD O. WALER P., MICROCREDIT SUMMIT CAMPAIGN, BEST PRACTICES FOR NATIONAL AND REGIONAL MICROFINANCE NETWORKS – THE EXPERIENCE OF LATIN AMERICA AND THE CARIBBEAN (2006), *available at* http://www.microfinancegateway.org/p/site/m//template.rc/1.9.26677.

130. PHILIP BROWN, SHANKAR ARORA & DERMOT TURING, CITI MICROFINANCE AND CLIFFORD CHANCE LLP, MICROFINANCE SECTOR TRANSFORMATION – MAKING SENSE OF THE BASEL II CAPITAL ACCORD 5 (2008).

131. Kingsbury et al., *supra* note 20, at 24; Meidinger, *supra* note 98, at 518.

The conclusion would be different if it was verified that the influence of CGAP on governments and international regulators is prevailing over the others. This might not seem to be the case, but it is worth mentioning that many initiatives directly or indirectly involves CGAP which, in addition, has been recently serving some official role as a microfinance leader.[132]

VI. SECTIONING THE PRISM: BASIC CRITERIA FOR THE ATTRIBUTION OF RULEMAKING POWER

A. *Principles for the Attribution of Rulemaking Power, and a Few Examples*

The aforementioned landscape can be seen as a very decentralized, multi-layered and confused form of global law in the microfinance field.[133] The unclear attribution of decision-making is also related to the hybrid nature of microfinance and its young age. Developmental goals, for-profit aspects and social objectives are all salient. Regulation must create a balanced and coherent set of rules for the banking and financial sector and take account of actors with different objectives and interests. An adequate answer to such a regulatory dilemma cannot be to simply pick one regulator over others for the entire microfinance field, but instead requires a diversified approach.

This section will attempt to simplify the structure of multifaceted problems by suggesting a certain distribution of rulemaking powers among different actors. Microfinance is a global phenomenon, and, with its development objectives, it suggests the need for a global regulation and coordination of efforts in the public and private sectors. This is true because experiences vary by country, region or even village regarding many relevant factors such as client needs, penetration, development, sophistication and commercialization of the industry.

132. For instance, CGAP was the co-chair of the Microfinance Workstream drafting the Basel Committee on Banking Supervision document on regulation and supervision of microfinance (BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11, at 57) and was mentioned in the G20 Pittsburg Summit along with G20 itself and IFC as coordinators of reforms targeting financial inclusion. *See* G20, *Leaders statement. The Pittsburgh Summit*, *supra* note 23, at point 41.

133. Kingsbury et al., *supra* note 20.

Consequently, when analyzing issues related to regulation and supervision, we need to make distinctions based on the type and purpose of regulation, interests, incentives, costs, benefits, timing, effectiveness, powers available, effects on different stakeholders and legitimate authority. In addition, reasons for centralization, competition and privatization need to be addressed.[134]

Regarding financial regulation, prudential regulation looks at the stability of the whole financial system or of the institutions to protect the confidence of the financial system and small depositors, while non-prudential regulation responds to other kinds of rationales, such as consumer protection, investor protection, competition, etc. The interests, stakeholders, risks, costs and motivations behind the rules are different for the two sectors. Thus, it is plausible to argue that the attribution of rulemaking at different levels should consider also such relevant differences and follow different patterns in different cases.

To clarify I will provide some examples.

1. *Consumer Protection Area*

Consumer protection regulation aims at protecting consumers from abuses and exploitations due to market failure or other reasons. Interests in regulating this field might come from the domestic government to defend a public interest, from private actors to promote social investments and avoid government intervention or from development agencies to ensure a positive and socially responsible impact of the agency's action and present the fulfillment of its missions to stakeholders. Especially if local governments do not adopt regulation to protect MFIs' clients, forms of self-regulation or international guidelines are more than welcome, are frequent in practice, and are likely to be even more efficient. In fact, self-regulation can work when all participants agree about the shared benefits coming from it and credible enforcement is implemented. Microfinance providers and their associations need to make investors and donors comfortable about their social perform-

134. *See generally* Jackson, *supra* note 89, at 650 (discussing academic reform proposals recommending centralization, competition or privatization as methods of regulating of corporate governance, securities regulation and financial institutions).

ance and the microfinance sector's reliability on this aspect in order to receive funds and assistance.[135] As a matter of fact, self-regulatory solutions have been often implemented by local microfinance networks not only because of government threats of intervention or pressure from international organizations, but also at the initiative of investors and lenders under typical market pressure. I have already mentioned Sa-Dhan and MFIN consumer protection codes in India. However, the RBI Malegam Committee, which was set up to study the opportunity of enhancing NBFC-MFIs rules, plans to restrict the self-regulation space.[136] In fact, RBI would adopt a mandatory client protection code for NBFC-MFIs drawn from international models by microfinance networks or organizations, leaving MFIs and their managements responsible, subject to sanctions, for the implementation of the code and internal control systems.[137] Associations of MFIs would discipline their members by monitoring and removing their membership in case of violation. In addition, an officer of a lead bank in the district would be nominated as Ombudsman and, in general, banks financing MFIs would have to supervise their functioning. However, there is no formal liability or accountability other than the risk of losing the priority-lending sector label for their loans to MFIs.[138]

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135. However, this works, in particular, under the threat of government intervention in case of failure. *See* ELINOR OSTROM, GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION. (1990, Cambridge): MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS. (1965 Cambridge); with particular reference to new sectors, Abraham L. Newman & David Bach, *Self-Regulatory Trajectories in the Shadow of Public Power: Resolving Digital Dilemmas in Europe and the U.S.*, 17(3) GOVERNANCE 387 (2004).

136. RESERVE BANK OF INDIA, REPORT OF THE SUB-COMMITTEE OF THE CENTRAL BOARD OF DIRECTORS OF RESERVE BANK OF INDIA TO STUDY ISSUES AND CONCERNS IN THE MFI SECTOR 23 (2011), *available at* http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/YHMR190111.pdf.

137. *Id.* at 21-23. *See also The Microfinance Institutions (Development and Regulation) Bill 2011 (draft)*, at 17-19, *available at* http://indiamicrofinance.com/wp-content/uploads/2011/07/microfinance_india_bill_2011.pdf (last accessed July 2011).

138. While this paper was under review process, RBI has adopted new guidelines subordinating priority-sector lending qualification as regards bank loans directed to MFIs to the respect of certain requirements (e.g. maximum loan amount, tenure, borrower's indebtedness, margin and interest caps, absence of collateral, etc.) by the latter. *See* RBI, *Master Circular -*

In addition, there are initiatives at the international level aimed at protecting microfinance borrowers from a humanitarian, social and development perspective, and efforts to distinguish the sector from other negative experiences such as subprime scandal and abusive collection practices have been undertaken. For example, the Client Protection Principles ("CPPs") campaign has been promoted by CGAP and many other organizations, especially Acción[139] and consists of six very general directives based on avoidance of over-indebtedness, transparent pricing, appropriate collection practices, ethical staff behavior, mechanisms for redress of grievances and privacy of client data.[140] The enforcement mechanisms of CPPs range from mere endorsement to inclusion as clauses in financing contracts or the due diligence process.[141] Furthermore, international networks of MFIs have adopted their own consumer protection codes and monitoring and enforcement

Lending to Priority Sector, (2011), *available at* http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6603.

139. Acción is a global non-profit association and network of MFIs, founded in 1961 and operating in 21 countries: http://www.accion.org/page.aspx?pid=254.

140. CPPs are currently undergoing a revision to keep up with microfinance evolution and new services. The CPPs initiative was launched by CGAP and Acción International in March 2009 and evolved in October 2009 in the "SMART Campaign" and whose adoption is recommended as possible condition to investments in MFIs. *See* Laura Brix & Katharine McKee, *Consumer Protection Regulation in Low-Access Environments,* CGAP Focus Note No. 60, 2 (Febr. 2010), *available at* http://www.cgap.org/gm/document-1.9.42343/FN60.pdf; David Porteous, *Consumer Protection in Credit Markets* 3 (2009), *available at* http://www.microfinancegateway.org/gm/document-1.9.41468/15.pdf; David Porteous & Brigit Helms, *Protecting Microfinance Borrowers,* CGAP Focus Note No. 27, 7 (May 2005), *available at* http://www.cgap.org/gm/document-1.9.2571/FN27.pdf; *The Client Protection Principles in Microfinance,* CGAP, http://www.cgap.org/p/site/c/template.rc/1.26.4943/; *The Client Protection Principles,* The Smart Campaign, http://smartcampaign.org/. *See also* MFTransparency (last visited April 6, 2012), http://www.mftransparency.org (focusing on transparency on interest rates and other expenses charged on clients).

141. *See* SARAH FOSTER ET AL., CGAP, IMPLEMENTING THE CLIENT PROTECTION PRINCIPLES: A TECHNICAL GUIDE FOR INVESTORS, 4, 12-16 (2d ed. 2010), *available at* http://www.cgap.org/gm/document-1.9.49367/CPP_TG.pdf; ESTELLE LAHAYE & KATE MCKEE, CGAP, INVESTORS IMPLEMENTING THE CLIENT PROTECTION PRINCIPLES IN MICROFINANCE 3 (2010), *available at* http://www.cgap.org/gm/document-1.9.42046/BR_Investors_Implementing_Client_Protection_Principles.pdf.

mechanisms,[142] while ratings agencies and social investors have developed their own social performance indicators sending messages to the MFIs regarding how to behave in order to obtain financing.[143]

The financial crisis has also revealed to EACs the importance of financial education and of borrowers' understanding of the real costs of a loan.[144] Self-regulatory or private methods would be more reliable if accompanied by enhanced financial education provided by MFIs. Financial education and understanding by the borrower of the loan's terms represent funda-

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142. Among the networks adopting consumer pledges (not necessarily the CPP) and disclosure requirements binding their members are SEEP (network of non-profit private development organizations' networks located in North America operating globally; it developed client principles since 2005 which then lead to CPP initiative); MicroFinance Network – MFN (network of MFIs with global focus, adopting a consumer pledge since 2004); European Microfinance Network – EMN (Europe); Acción (operating primarily in Latin America) and Women's World Banking – WWB (with global scope). Some of them, like Opportunity International, Pro-Mujer or Acción have equity stakes or governance roles in their member organizations. *See* Jennifer Isern & Tamara Cook, *What is a network? The diversity of networks in microfinance today*, (2004), at 3, 7, *available at* http://www.microfinancegateway.org/gm/document-1.9.26359/Focus%20Note%2026.pdf.

143. Some guarantor networks (e.g., MicroCredit Enterprises) provide coverage protection only if some conditions (e.g., women and rural focus, low interest rates, etc.) are met by MFIs. About social ratings, see Rating Initiative, *Microfinance Rating Market Review 2010*, (2010), *available at* http://www.ratinginitiative.org/fileadmin/media/publications/Rating_Market/RI_Market_Review_2010.pdf; The SEEP Network, *Social Rating*, 4 *Social Performance Progress Brief*, (Nov. 2007). Among the main rating agencies specialized in microfinance: M-CRIL, Microfinanza Rating, Planet Rating e MicroRate. On social performance indicators of MFIs adopted by social investors (directing their investment decisions) and examples of the same, see CERISE *Social Performance Indicators Initiative*, *available at* http://www.cerise-microfinance.org; *Social Performance Standards*, *available at* http://www.sptf.info/page/background-1; Oxfam Novib Fund *Social Performance Questionnaire*, *available at* http://cgap.org/gm/document-1.9.37832/Oxfam%20Novib%20Social%20Performance%20questionnaire%20definitief.pdf; Acción *Social Performance Tool* 2009, *available at* http://publications.accion.org/insight/. *See* also Deutsche Bank's investment decision memo, *available at* http://www.cgap.org/gm/document-1.9.37835/DB%20Credit%20Writeup%20Template%20v13.pdf.

144. *See generally* SENDHIL MULLAINATHAN & SUDHA KRISHNAN, PSYCHOLOGY AND ECONOMICS: WHAT IT MEANS FOR MICROFINANCE (2008), *available at* http://www.iamfi.com/documents/PsychologyandEconomics.pdf (discussing behavioural economics and microfinance); Porteous, *Consumer Protection in Credit Markets*, *supra* note 140, at 4, 5.

mental objectives for the repayment of microcredit in the absence of collateral and thus act as a sort of risk management system and a prudential measure aimed at stability. For both of these bottom-line and economic factors, microfinance market might be trusted more than the mainstream financial sector for implementing proper norms and controls. However, this assumption should be verified for all particular local circumstances[145] and some general conditions.

Furthermore, self-regulation can be more effective when it consists of delegated supervision backed by public enforcement or a prestigious association with an efficient governance system, such as a rotating president, and coherent systems of financing monitored by multiple and powerful stakeholders.[146] For example, self-regulation in the consumer protection field in Andhra Pradesh in India might appear ineffective for reasons related to the extreme commercialization of the sector, fragmentation, large size, hard competition and multiple borrowings (i.e., the same borrower receiving loans from different providers often without disclosing it to the latter and thus imperiling his/her repayment ability without the creditors' being aware of the risk) without a shared credit bureau system.[147] This is especially true if anecdotes about microbor-

145. *See* Porteous, *Consumer Protection in Credit Markets, supra* note 140, at 13 ("The evidence of the effectiveness of self-regulation in financial services is mixed: particularly when members suffer little or no effective loss as the result of breaking a code, self-regulation is unlikely to be effective. However, even if signatories do adhere to their own code, the presence of large numbers of non-members with poor lending practices raises the risk of a general backlash. This would affect compliant and non-compliant firms alike, reducing the incentives for costly participation in the first place.").

146. *See* Porteous, *Consumer Protection in Credit Markets, supra* note 140, at 13-15; USAID, *Regulating Egyptian MFIs: the SRO Option. A Comparative Study of Self Regulatory Organizations,* (2007), *available at* http://pdf.usaid.gov/pdf_docs/PNADK826.pdf; CAFAGGI, REFRAMING SELF-REGULATION IN EUROPEAN PRIVATE LAW, (The Netherlands, 2006); *Gouvernance et responsabilité des régulateurs privés,* (2005), EUI Working Paper Law, 2005/6, *available at* http://www.cadmus.eui.eu.

147. Credit bureaus (databases with fundamental information about borrowers profile and credit history) are not available in many countries or, at least, not to MFIs. Credit bureau systems shared by all financial sector providers would contribute to limit over-indebtedness and multiple borrowing, although only partially since they do not capture informal borrowing mechanisms. Vivien Kappel, Annette Krauss & Laura Lontzek, *Over-indebtedness and Microfinance: Constructing an Early Warning Index,* (2010), *available at* http://

rowers' suicides and predatory lending techniques by many MFIs are confirmed.[148]

Systems of private supervision and reporting—especially when coupled with monitoring by third parties, best practices, credit bureau scope expansion and involvement of labeling organizations—can fill a governmental regulatory gap better than a formal international public supervision mechanism or even one imposed on local governments through World Bank and IMF agreements. They allow flexibility, adherence to local needs and differentiation among investors' preferences and objectives.[149] However, when providing resources, international organizations and development agencies might reasona-

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www.triodos.com/downloads/overindebtednes-in-microfinance.pdf; Elio Vitucci, *Overindebtedness in Microfinance: Role of Credit Bureaus,* (2009), *available at* http://deutschland.planetfinancegroup.org/site/uploads/media/Newsletter_2_2009.pdf; Jessica Schicks & Richard Rosenberg, *Too Much Microcredit? A Survey of the Evidence on Over-Indebtedness,* (2011), CGAP Occasional paper No. 19, *available at* http://www.cgap.org/sites/default/files/CGAP-Occasional-Paper-Too-Much-Microcredit-A-Survey-of-the-Evidence-on-Overindebtedness-Sep-2011.pdf; CGAP, MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 60 et seq.

148. In Fall 2010, the government of Andhra Pradesh issued an ordinance requiring MFIs to stop lending activities until they registered with local authorities. The ordinance came in response to years of criticism about MFIs practices, interest rates and borrowers' suicides, as well as populist demands and the problems and competition of the local government with MFIs. This ordinance could have seriously hurt the microfinance sector in the region and the economic status of the numerous microfinance borrowers. *See Borrowers stranded as AP Microfinance Institutions freeze operations,* MICROFINANCE FOCUS (Oct. 20, 2010), http://www.microfinancefocus.com/content/borrowers-stranded-ap-microfinance-institutions-freeze-operations. The Andhra Pradesh High Court, however, allowed the MFIs to continue their activities while waiting for the registration so long as it was requested within seven days. *AP HC permits microfinance operations; orders registration,* MICROFINANCE FOCUS (Oct. 22, 2010), http://www.microfinancefocus.com/content/ap-hc-permits-microfinance-operations-orders-registration. In response to this episode, there have been calls for the central Indian government to issue a new regulatory framework for microfinance. *See* Vinod Kothari, *Microfinance: Choose schematic regulation now, or face sporadic regulation,* MICROFINANCE FOCUS (Oct. 23, 2010), http://www.microfinancefocus.com/content/microfinance-choose-schematic-regulation-now-or-face-sporadic-regulation.

149. *See, e.g.,* Fabrizio Cafaggi, *New Foundations of Transnational Private Regulation,* EUI Working paper, Private Regulation Series No. 04 at 25, 36, *available at* http://cadmus.eui.eu/bitstream/handle/1814/15284/RSCAS_2010_53.pdf?sequence=1 (then published in 38(1) JOURNAL OF LAW AND SOCIETY 20 (2011).

bly want to impose as a condition a minimum level of consumer protection principles (e.g., requiring that information and data provided to clients are complete, clear and simple; that collection practices employed by MFIs are fair and respectful; or that inexpensive complaint and redress mechanisms are available to clients),[150] especially in the areas of microfinance conducted as social projects rather than purely commercial activities.

The existing competition among regulators appears beneficial.[151] The combined efforts of NGOs, specialized rating agencies, CGAP, MFI networks, investors, and international agencies should be preferred to regulation only by international public law instruments. The interaction of different regulatory authorities can lead to both differentiated requirements depending on the local conditions and some minimum uniformity and comparability among MFIs for investments.

2. *Social Performance and Impact*

Going beyond traditional financial regulation and its requirements, social impact assessments are currently relevant for development agencies, NGOs and social investors, but they might not represent a priority for domestic governments. Such assessments are traditionally considered outside of financial regulation. Here it is especially important to counterbalance the need for accurate assessments from non-profit entities with the costs imposed on MFIs, MIVs and investor's profitability objectives. A broad discussion involving investors, development agencies, not-for-profit actors, MIVs, specialized ratings agencies, MFIs and consumer associations should be encouraged internationally but implemented domestically through the private sector taking into account all specificities.

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150. About implementing CPPs into investment contracts and financing agreements, SARAH FOSTER ET AL., CGAP, IMPLEMENTING THE CLIENT PROTECTION PRINCIPLES: A TECHNICAL GUIDE FOR INVESTORS, *supra* note 141.

151. On the beneficial effects of competition among private as well as public regulators, see Larry Catá Backer, *Economic Globalization and the Rise of Efficient Systems of Global Private Law Making: Wal-Mart as Global Legislator*, 39 CONN. L. REV. 1739, 1776-77 (2007).

3. *Narrowing Our Perspective: Financial Regulation*

On the contrary, moving to more classic financial regulation, local governments should retain control over the regulation of lending practices and legal forms of MFIs since such rules would promote the correct functioning, competition and balance within their financial markets.[152] Liberalization imposed internationally on these aspects in a DC's context might not be optimal towards maintaining control over the financial system and stable development.

Going forward, local governments should still be able to impose restrictions on foreign ownership,[153] transfers in foreign currency and usury since these decisions greatly affect

152. The legal form requirement could also be seen as a prudential rule since business structures, organization and management have great impact on the stability of a financial entity. Some governments allow NGOs to provide financial services (generally not deposits) while others require a shareholder-based form or at least cooperative form. The Basel Committee (*see* BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES 32, *supra* note 11 at 36) attests that the majority of the surveyed countries require the corporate form or the financial cooperative form to be authorized for deposits collection. Against the use of the NGO form in microfinance, see *id.* at 15; Richard A. Chavez & Claudio Gonzalez Vega, *Principles of Regulation and Prudential Supervision: should they be different for microenterprise finance organizations?*, (Sept. 1992), at 44, *available at* http://aede.ag.ohio-state.edu/programs/ruralfinance/pdf%20docs/Publications%20List/Papers/92P01.pdf; STEFAN STASCHEN, REGULATORY REQUIREMENTS FOR MICROFINANCE: A COMPARISON OF LEGAL FRAMEWORKS IN 11 COUNTRIES WORLDWIDE 21 (2003), *available at* http://www.izdihar-iraq.com/resources/mfsummit/ref_RegulatoryRequirementsInMicrofinance_GTZ.pdf. About the influence of the legal structure and governance on a bank's functioning and efficiency, see HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISES, (1996), London, at 246 et seq.; SHARON M. OSTER, STRATEGIC MANAGEMENT FOR NON-PROFIT ORGANIZATION. THEORY AND CASES, (1995), Oxford, at 77; Brian Branch, *Working with Savings & Credit Cooperatives*, CGAP Donor Brief N. 25 (2005), at 1, *available at* http://www.cgap.org/gm/document-1.9.4396/DB25.pdf; Giuliano Iannotta, Giacomo Nocera & Andrea Sironi, *Ownership structure, Risk and Performance in the European Banking Industry*, (March 2006), at 4, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020306; BASEL COMMITTEE ON BANKING SUPEVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS (1999; updated to 2006), *available at* http://www.bis.org/publ/bcbs122.pdf.

153. *But see* Ashley Hubka & Rida Zaidi, *Impact of Government Regulation on Microfinance*, WORLD DEVELOPMENT REPORT 2005 (recommending that foreign equity participation in microfinance be allowed), *available at* http://siteresources.worldbank.org/INTWDR2005/Resources/Hubka_Zaidi_Impact_of_Government_Regulation.pdf.

state and public objectives and have effects on competition among financial providers, capital controls and imbalances inside the country.[154] Sometimes, these measures are not motivated by protectionism, but by the desire to avoid dependence on international or foreign funds and to focus on domestic markets.[155] On the other hand, the role and involvement of the government in the economic field is a topic on which positions in the same country or among countries might differ considerably. For instance, public-private microfinance partnerships or government-sponsored programs can be seen as beneficial[156] or, on the contrary, as creating an unfair advantage over private competitors and thus reducing the potential of the sector.[157] However, the answer might depend not only on economic theories, but also on political ideas, local priorities, historical paths and financial conditions.

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154. *See* THE WARWICK COMMISSION, *supra* note 76, at 41-50; Pistor, *supra* note 76 (discussing the effects of choices in financial regulation in former Soviet states since the fall of the Soviet Union).

155. MEAGHER, *supra* note 56, at 15. *See also* General Agreement on Tariffs and Trade, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex on Financial Services, 33 I.L.M. 70 (1994) ("A member shall not be prevented from taking measures for prudential reasons, including the protection of depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity or stability of the financial system."); BARTH, CAPRIO & LEVINE, RETHINKING BANK REGULATION, *supra* note 44, at 170–73; CRANSTON, *Principles of Banking Law, supra* note 46, at 427-28.

156. *See* Souren Ghosal, *Emerging growth model for microfinance institutions – Banks or NBFC,* MICROFINANCE FOCUS (Apr. 20, 2010), http://www.microfinance.com/content.spl-article-emerging-growth-model-microfinance-institutions-%E2%80%93-banks-or-nbfc (suggesting that PPP is an effective instrument for development of villages because "the future of MFIs depend on either becoming a bank on their own or become a subsidiary of a public sector bank and come out of the groove of providing only consumption loan to supplement income of poor family but try to transform village economy through project financing on a cluster basis and become one of the stakeholders of business enterprise of village poor people for sometimes till these people could run on their own like venture capitalist").

157. *See* HUBKA & ZAIDI, *supra* note 153, at 8; JACQUES TRIGO LOUBIÈRE, PATRICIS LEE DEVANEY & ELIZABETH RHYNE, SUPERVISING & REGULATING MICROFINANCE IN THE CONTEXT OF FINANCIAL LIBERALIZATION. LESSONS FROM BOLIVIA, COLOMBIA AND MEXICO, 7 (AUG. 2004), *available at* http://centerfor financialinclusionblog.files.wordpress.com/2011/10/supervising-regulating-microfinance-in-the-context-of-financial-sector-liberalization-english.pdf.

In any case, the maintenance of such measures can discourage many actors in the industry due to the costs involved and can limit the development of microfinance.[158] As a result, international and local microfinance organizations might benefit from engaging in lobbying activities to obtain special windows for microfinance (allowing exceptions to the aforementioned limits) because of its public interest nature under certain conditions to be determined. Nonetheless, special windows and exemptions in favor of microfinance create the problem of how to define and delimit them while avoiding regulatory arbitrage and other unintended consequences.[159] In fact, missions, quantitative parameters based on volumes, amount of loans and geographic expansion—among other indicators—can be used, but they might not prevent abuses and might impede innovation and growth in the industry.[160] These restrictions might also raise foreign investment dispute claims under existing BITs, but up to now the small amounts of the investments and the prevailing nature of the funders as development agencies and NGOs[161] might have mostly excluded

158. Limits on foreign ownership and on money transfers can jeopardize an MFI ability to find sources of funding since investors might fear local governments' enforcement or impossibility to receive payments. Usury laws make more difficult for MFIs to cover their high operational expenses and, thus, to reach sustainability or to cover poorest clients.

159. On this topic, see MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 8 et seq., 95.

160. Definitions of microfinance adopted by some regulators refer to some or all these factors, suggesting either a difficult practical application or a system that is too easily subject to abuse: dedication to business or productive activity of the poor (Morocco), limited size (Colombia), services to microenterprise or microfinance service in a sustainable manner to poor persons, preferably women with a view to alleviating poverty (Pakistan), loan to persons/firms whose principal source is business activities, loans based on borrower's character rather than full documentation. *See* KATE DRUSCHEL, *The Ultimate Balancing Act: Investor Confidence and Regulatory Considerations for Microfinance*, USAID, 22-23 (July 2005), *available at* http://pdf.usaid.gov/pdf_docs/PNADF313.pdf; STASCHEN, REGULATORY REQUIREMENTS FOR MICROFINANCE, *supra* note 152; JANSSON ET AL., *supra* note 11, at 29. On the difficulty of defining microfinance, see also BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11, at 34 et seq.

161. Based on the CGAP *Microfinance Cross-borders Funding Survey 2010*, *available at* http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Cross-border-Funding-of-Microfinance-Apr-2011.pdf, the 68.5% ($14.6 billion) of MFIs cross-borders financing comes from public investors and donors (i.e., multilateral and bilateral agencies and DFIs), while the 31.4%

this path. On the opposite side, anti-laundering and anti-terrorist rules should be elaborated internationally in order to better control the phenomenon, but adaptation to local markets and business models is also required.

4. *More Specifically, Prudential Regulation (Anticipation)*

Looking now at prudential regulation, we need to consider that, generally, microfinance does not involve systemic risk at an international level (also considering the generally demonstrated resilience of microfinance to international markets), but it does locally where other rationales for prudential regulation or government intervention might primarily apply. The highly contagious nature of delinquency in microfinance is now clear; a few defaults can rapidly lead to runs of borrowers. Thus, a default by some borrowers matched with rumors about possible difficulties by the MFI in extending future loans can destroy an MFI (that relies on periodic interest rate payment to cover its high operative costs) and depress entire areas, hitting the most fragile and poorest part of the population, triggering a "too sensitive to fail" approach.[162] As an example, the Andhra Pradesh region in India is one of microfinance's most penetrated areas with 6.25 million borrowers in a country where microfinance is an important financial sector.[163] In fact, one out of every hundred Indians is a microfinance borrower, and one out of fifty rural Indians—or one out of every ten rural families—is a MFI borrower.[164] Problems in the sector may compromise a significant part of

($6.7 billion) from private investors and donors (NGOs, foundations, retail investors). Among the latter, foundations and NGOs account for the 16.4% ($1.1 billion) while institutional and private investors for the 83.4% ($5.59 billion) but the vast majority of these has social responsibility as goal. In addition, MFIs funding are equally distributed between grants (52%) and investments (48%). CGAP, *2009 Microfinance Funder Survey, available at* http://www.cgap.org.

162. *See* Kothari, *supra* note 148 ("[A]s the lender stops further lending, existing borrowers start defaulting.").

163. Microfinance Focus, *Borrowers stranded as AP Microfinance Institutions freeze operations,* (Oct. 21, 2010), *available at* http://www.microfinancefocus.com/content/borrowers-stranded-ap-microfinance-institutions-freeze-operations.

164. Kothari, *supra* note 148.

the economy or of the population.[165] Sometimes this situation is made worse by intense competition and the problem of multiple borrowing. Borrowers can easily escape a failing MFI by going to another one or by defaulting on multiple personal loans, which spreads the contagion. Domestic authorities have better information and experience on local conditions and can better supervise activities or make decisions aimed at expanding financial access through significant exemptions of MFIs from prudential regulation. Thus, as a general matter, domestic governments should retain the power to regulate and supervise in the prudential field.

B. *Prudential Regulation: A New View on all Dimensions and the Influence of the Rules' Source*

1. *The Vertical, Horizontal and "Nature of Authority" Dimensions Unified*

The main concern in banking and financial regulation is systemic risk at the domestic and international level. As a general matter, we have mentioned that microfinance tends to incur this risk only at a local or domestic level. Nonetheless, in the areas of wide expansion of microfinance and of the interconnectivity between economic activities in different countries, systemic risk can involve regions instead of states. The intensive growth in the sector in some countries and the increased use of technologies allowing services from remote locations can lead to a geographic expansion beyond countries' borders,[166] leading to the classical problems of regulatory arbitrage or competition,[167] cooperation between the home and

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165. *See supra* note 148, (discussing the possible consequences of the Andhra Pradesh ordinance on the region's economy).

166. Banco Compartamos SA, the largest Mexican lender to the working poor, has recently declared: "We're actively looking at possibilities to acquire some institution that allows us to expand rapidly to another country and take our strategy to another country." *See* Thomas Black & Andres R. Martinez, *Compartamos Draws Gartmore as UBS Projects 20% Rally*, BLOOMBERG (Apr. 20, 2010), *available at* http://www.bloomberg.com/news/2010-04-20/compartamos-draws-gartmore-on-mexico-s-rebound-as-ubs-projects-22-rally.html.

167. Edward J. Kane, *Financial Regulation and Market Forces*, 127 SWISS J. ECON. & STAT. 325, 334-336 (1991) (hereinafter *Financial Regulation*); Edward J. Kane, *Ethical Foundations of Financial Regulation*, 12 J. FIN. SERVICES RES. 51, 52, 61-68 (1997) (hereinafter *Ethical Foundations*). With geographical and business expansion, we can envisage regulatory competition among

the host country and efficient supervision by the home country. Consequently, forms of cooperation relying on some existing regional structure for regulation, supervision and sharing of information might be desirable. The continuous comparative research work conducted by international organizations and private research centers can be useful but should not be regarded as the final word.

Second, the main obstacle to local government regulation—and especially to supervision—is the lack of resources and structures to elaborate an optimal legal regime for microfinance and to effectively supervise many MFIs of small size and with very different organizational structures. The cost of supervision thus also affects the structure and substance of regulation. The government can decide to regulate only deposit-taking institutions and leave all the others unregulated and unsupervised (from the prudential point of view) or even to turn a blind eye to savings mobilization by non-bank MFIs, as was done in India, Bangladesh and Nigeria in the past.[168] The government can regulate the microfinance activity regardless of the legal forms used and then subject all MFIs to the same supervisory agency (i.e., functional supervision, by activity) or leave different entities supervised by their respective supervisor (i.e., institutional supervision approach based on the legal status) or something in the middle (e.g., some rules and consequent consolidated supervision applying to microfinance activities in general irrespective of the legal form used, while

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DCs to attract MFIs or their activities. In a race to the top scenario, governments would adopt the optimal regulation to balance attracting business and maintaining prudential standards, likely reducing the negative effects of protectionist measures mentioned above.

168. *See* Priya Basu, *Improving Access to Finance for India's Rural Poor*, (2006), *available at* http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan024234.pdf; Maren Duvendack, *Smoke and Mirrors: Evidence of Microfinance Impact from an Evaluation of SEWA Bank in India*, University of East Aglia Working Paper No. 24, (2010), at 16, *available at* http://mpra.ub.uni-muenchen.de/24511/1/WP24_MarenDuvendack.pdf; Stephanie Charitonenko, *The Nigerian Legal and Regulatory Framework for Microfinance: Strengths, Weaknesses and Recent Developments*, (2005) at 2, *available at* http://www.microfinancegateway.org/gm/document-1.9.25182/25979_file_Nigeria.pdf; Malcolm Harper & Mariè Kirsten, *ICICI Bank and its Partnership Linkages in India: A Case Study*, (2008), at 6, *available at* http://media.microfinancelessons.com/resources/ICICI_bank_case_study.pdf. *See* also referencesin note 178.

others referring only to specific legal forms; twin-peaks approach).[169] For example, it can be decided that all credit cooperatives, even if accepting deposits from members, be supervised by the credit union authority, and that non-profit entities are permitted to extend credit either without being subject to any governmental supervision or with monitoring only by the charity authority.[170] Regulated MFIs might also be assigned to the supervision of a delegated supervisor that can be another agency or a government-sponsored institution as in Ban-

169. For a description of different models of financial regulation and supervision, see GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE, 12-14, 23 et seq. (2008), *available at* http://www.group30.org/images/PDF/The%20Structure%20of%20Financial%20Supervision.pdf.

170. Peru has a quite complex but very interesting microfinance regulatory framework (it ranked first for best regulatory framework at the 2009 Microscope Index), recently reformed in 2008, that can be categorized under the model presented here in the text. A range of regulated forms are available for MFIs interested in providing varied services including savings, requiring prudential standards and disclosure similar to commercial banks as well as supervised by Supervisory Board of Banking and Insurance; cooperatives and NGOs (with limited permitted services) are unregulated but respectively supervised by the *Consejo de Vigilancia* and its *Asamblea General de Asociados* and the Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME). A previous attempt to delegate day-to-day oversight to a Federation of municipal savings and loan institutions turned unsatisfactory. *See* MCGUIRE – CONROY, THE ROLE OF CENTRAL BANKS, *supra* note 19, ch. 5-6; A. Ebentreich, *Microfinance Regulation in Peru: Current State, Lessons Learned and Prospects for the Future*, (Apr. 2005), *available at* http://www.sa-dhan.co.in/Adls/Dl1/RegSupr/MicrofinanceRegulationPeruCurrentState.pdf; Y. R. Chenet Carrasco, *Regulation of Microfinance: An Impact Assessment of the Regulatory Framework of Microfinance Institutions in Peru* (2006), *available at* http://www.microfinancegateway.org; articles 221 and 288 of the *Ley General del Sistema Financiero y del Sistema de Seguros y Orgánica de la Superintendencia de Banca y Seguros*, N. 26702; on the new regime after the *Decreto legislativo* No. 102812/2008, see Sara Sotelo, *Microfinanzas en Perú: desafíos y posibilitades*, IDLO Research Paper, at 7 (May 2009); Verónica Frisancho Robles, *Signaling Creditworthiness in Peruvian Micro?nance Markets: The Role of Information Sharing*, at 6, *available at* http://www.personal.psu.edu/vcf104/blogs/resume/3_Infosharing_paper.pdf; Sara Pait, *The microfinance sector in Peru: opportunities, challenges and empowerment with gender mainstreaming*, (March 2009), *available at* http://www.microfinancegateway.org/gm/document-1.9.38550/the%20microfinance%20sector%20in%20peru_%20opportunities,%20challenges%20and%20empowerment%20with%20gender%20mainstreaming.pdf.

gladesh;[171] alternatively, MFIs can be self-regulated as in the Philippines.[172]

The use of self-regulatory bodies in the prudential sector has been highly debated because of the risk that actors' incentives are not aligned with the public interest. For instance, the adoption through the Basel II Accord of capital adequacy rules based on internal assessment models (Internal-Ratings based approach - IRB) by more sophisticated banks has been criticized.[173] Supervisors recognized the existence of complex and effective risk management models used by large banks to allow them to reduce the required level of capital reserves. Proper investigation of these models by the supervisors would have required so many human and financial resources that the reform might eventually result, *de facto*, in a delegation of supervision to the regulated institutions.[174] Allowing an almost complete delegation of regulation and supervision to the microfinance industry can lead either to efficient solutions or disastrous consequences.[175] However, in the case of microfinance, a different kind of delegation to the private sec-

171. Palli Karma Sahayak Foundation (PKSF) in Bangladesh is a government-sponsored institution that provides most of the funding for NGO MFIs in the country and sets guidelines and requirements. It has received technical assistance in MFI supervision from the World Bank. *See* MEAGHER, *supra* note 56, at 48. For a negative evaluation of the role of PKSF regarding interest rate policy, see RAY RAHMAN & SAIF SHAH MOHAMMED, MF ANALYTICS LTD., BRAC MICRO CREDIT SECURITIZATION SERIES I: LESSONS FROM THE WORLD'S FIRST MICRO-CREDIT BACKED SECURITY (MCBS) 6 (2007), *available at* http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=646443.

172. On the regulatory role of the government-sponsored People's Credit and Finance Corporation (PCFC) in the Philippines, see MEAGHER, *supra* note 56, at 32.

173. *See* TARULLO, *supra* note 44, at 152 et seq.; Joseph J. Norton, *A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on a Public-Private Partnership*, 37 INT'L LAW. 43, 49 (2003). See also discussion in section VI.B.c.

174. *Id.*

175. In favor of a prudential regulatory agency and a non-prudential regulatory board comprised of managers and directors of the MFIs, see McNew, *supra* note 64, at 307–08. For intermediate solutions, see Rozas & Sinha, *supra* note 91. For openness to self-supervision, see BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11, at 28 et seq. For scepticism about self-regulation and supervision, see CHRISTEN ET AL., MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19, at 28 and MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 44 et seq.;

tor could be acceptable since it would not be motivated by reliance on the sophistication of elite banks.[176] Instead it would be based on a cost-benefit analysis, taking into account the resources available and presumably the less serious impact on the system of deficient supervision.

Under an alternative system, the supervisor monitors all institutions engaged in particular financial services without regard to their legal forms and with a differentiated intrusive power based on the complexity and types of services offered by each provider.[177]

These determinations about the architecture of the supervision, such as the number of supervisors or the choice between functional and institutional supervision, are undoubtedly domestic because they depend on available resources, effectiveness of other existing forms of self-regulation, recognized priorities[178] and existing structures and institutions.[179] The crisis and the failure of previously prevailing liberal models of development have increased the importance of local determination.[180] A common international position on these aspects has not been achieved even in an already harmo-

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Christen & Rosenberg, *The Rush to Regulate*, *supra* note 18, at 2, 20; *see also* Arun, *supra* note 52, at 350.

176. For a discussion on the influence elite banks have exerted on regulatory authorities, see Norton, *supra* note 173, at 47-51.

177. In Nepal, for instance, NGOs and cooperative MFIs are subject to some provisions of banking law and to supervision of the Central Bank. *See* Shankar Man Shrestha, *State of Microfinance in Nepal*, (2009), at 76 et seq., *available at* http://www.inm.org.bd/saarc/document/Nepal.pdf.

178. The Bangladeshi government has turned a blind-eye toward NGOs accepting deposits, perhaps due to the impact of this practice on financial inclusion and poverty relief. *See* Prabhu Ghate, *Linking Formal Finance with Micro and Informal Finance*, 26 *The Bangladesh Development Studies*, 201 (2/3), (2000); S.M. Rahman, *Regulating microfinance NGOs in Bangladesh*, 11 SMALL ENTERPRISE DEVELOPMENT 52 (2000).

179. With reference to the conventional financial system, see BARTH, CAPRIO & LEVINE, *supra* note 44, at 316 ("Given our findings regarding the connections between the operation of the political system and both the selection and influence of banking policies, our work sheds a sceptical light on attempts by international agencies to develop uniform best practice checklists for countries.").

180. *See* H.F. Rogers, *The Global Financial Crisis and Development Thinking*, (2010), World Bank Policy Research Working Paper No. 5353, *available at* http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-5353.

nized context and common market such as the EU.[181] Moreover, the interest of international development organizations in promoting their own microfinance projects through more liberalization or transformation of regulated entities might conflict with a developing country's interest in regulating the financial sector to serve domestic development.[182]

Furthermore, the link between microfinance and economic development is still uncertain.[183] This means reforms in the sector—particularly those that remove DCs' control of their financial sectors or perpetuate their dependence on development aid and supervision—might not be justified under the development aid scheme.[184] Thus, even in a capacity-building and development perspective, international authorities should limit their role to cooperation with domestic authorities to build strong infrastructures useful for the development of the financial and microfinance sector without imposing strict and specific parameters usually conceived for western systems.[185]

2. *Different Regulators with Different Perspectives and Missions: Implications*

Attribution of power and functions to one regulator instead of another can significantly affect the outcomes and effects of regulation and supervision because of differing priori-

181. *See* Donato Masciandaro, Maria J. Nieto & Marc Quintyn, *Will They Sing the Same Tune? Measuring Convergence in the new European System of Financial Supervisors* 9 (IMF Working Paper No. 9/142, 2009) (commenting on the low degree of convergence in the financial supervisory model among member states).

182. *See* MEAGHER, *supra* note 56, at 10.

183. DEEPA NARAYAN ET AL., MOVING OUT OF POVERTY, *supra* note 38, at 33 (2009) (reporting that "the tiny loans usually provided under microcredit schemes do not seem to lift large numbers of people out of poverty"). About such uncertainty, see also WORLD BANK INDEPENDENT EVALUATION GROUP, THE WORLD BANK'S COUNTRY POLICY AND INSTITUTIONAL ASSESSMENT 18, 110 (June 30, 2009).

184. *See* USAID, LEGAL AND REGULATORY REFORM FOR ACCESS TO FINANCE, A POLICY AND PROGRAMMING TOOL (Dec. 2005) (trying to design steps to assess the ability of local governments to design an adequate regulatory framework for microfinance and identify the best promoter of such reform).

185. On the conditions to the G20's action, see SHAHROKH FARDOUST ET AL. (eds.), POSTCRISIS GROWTH AND DEVELOPMENT: A DEVELOPMENT AGENDA FOR THE G-20, at 4, 31 (World Bank 2010), *available at* http://siteresources.worldbank.org/DEC/Resources/PCGD_1-62.pdf.

ties and perspectives among regulators. For instance, the small size of an MFI can be seen as a reason to allow it to provide useful services for its community such as deposits, but it can also be viewed as a reason to exclude it from prudential regulation and supervision[186] or to restrict the range of permissible activities available to it.[187] NGO MFIs might be allowed to accept deposits under certain conditions[188] or might always be considered unsuited.[189]

Minimum capital requirements are used as barriers to entry to reduce the number of institutions to be supervised and to reduce concomitant expenses.[190] Also, the costs of regulation on MFIs should be carefully considered since being regulated can yield many positive effects like more faith and deposits from the public, which can lead to more outreach. However, a trade-off between costs, actual profitability and outreach exists, and the current pressure in network affiliation agreements and guidelines towards MFIs' transformation into regulated entities might affect the equilibrium of DC's financial sectors and impose severe supervisory costs on domestic regulators.[191] When either a regulatory gap or excessive burden exists, it can divert potential investors and foreign actors

186. *See* MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19, at 17; *see also* MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 45, 47; Christen & Rosenberg, *The Rush to Regulate, supra* note 18, at 11.

187. BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11, at 2-3, 14-15; *see also* JANSSON, ROSALES & WESTLEY, *supra* note 11, at 68.

188. *See* Christen & Rosenberg, *The Rush to Regulate, supra* note 18, at 12 et seq.

189. *See* BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11, at 16-17.

190. *See* MICROFINANCE CONSENSUS GUIDELINES, *supra* note 19, at 16; *see also* MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 25.

191. About the advantages from transformation into regulated entities, see KATE LAUER, CGAP, TRANSFORMING NGO MFIS: CRITICAL OWNERSHIP ISSUES TO CONSIDER (June 2008), *available at* http://www.cgap.org/gm/document-1.9.4213/OP13.pdf; FRANK, STEMMING THE TIDE OF MISSION DRIFT, *supra* note 25. Some studies attest a higher number of clients but a smaller proportion of poor and female clients in transformed MFIs. Niels Hermes, Robert Lensink & Aljar Meesters, *Outreach and Efficiency of Microfinance Institutions* (2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1143925. For a recent study evidencing no significant positive correlation between being regulated and sustainability and outreach but finding such correlation between good capitalization or collection of savings and outreach, see Hartarska & Nadolnyak, *supra* note 59.

from investing in the sector and in those countries or, in exceptional cases, even lead to a supervisory hole.[192]

From the broader financial regulation point of view, some EACs are also concerned with the protection of investors using investment funds or peer-to-peer platforms, especially if they are unsophisticated and rely on the social value of the activity in the face of defective disclosure.[193] Up to now the response has been market-based through reputational concern from MFIs and the provision of technical support for conversion of NGOs into regulated entities.[194]

3. *An Example: Capital Adequacy and Microfinance*

The allocation of rule-making and supervision responsibility can strongly impact the possible outcomes because of the different perspectives characterizing different regulators. This is evident, as an example, comparing the various sources and comments about regulation and supervision from the first comments on Basel II and its impact on bank MFIs.[195] The studies elaborated by MFIs or their networks were pessimistic about the prospective implications for the industry and suggested either not applying the Basel framework to MFIs or adopting lower capital adequacy ratios for MFIs.[196] On the

192. A supervisory hole can arise when the home supervisor is not operative and the host supervisor becomes the only one responsible, though they have limited powers and resources coupled with considerable consequences for the entire financial system. On the other hand, preventing an unregulated US entity from owning offshore banks would result in a definitive cession of supervisory authority by developing countries. *See* Gelpern, *supra* note 75, at 1529-37.

193. Kevin E. Davis & Anna Gelpern, *Peer-to-Peer Lending for Development: Regulating the Intermediaries*, 42 NEW YORK UNIVERSITY JOURNAL OF INTERNATIONAL LAW AND POLITICS 1209 (2010), at 1224-29.

194. *See supra* note 170 about Peruvian experience and §§ IV and VI for references about the Indian case.

195. *See generally* BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS, (June 2004), *available at* http://www.bis.org/publ/bcbs128.pdf (hereinafter Basel II).

196. In particular, I am referring to Imboden, *supra* note 130, at 11-19. The author lists, among the possible negative consequences of the adoption of Basel II in developing countries, the risk of imposition by local regulators of high capital adequacy ratios or higher risk weights, the misperception of microfinance risks, the discretion allowed under the Accord, the reduced access to financing for MFIs, the implementation costs and the limitation of

other hand, following optimistic opinions, primarily coming from development agencies, some authors envisaged the idea of adopting an IRB approach, conceived under Basel II for large and sophisticated banks,[197] to adjust the Accord to microfinance activities.[198] The most popular current position, formed around a CGAP document, recommends capital adequacy ratios higher than mainstream banks for bank-MFIs in consideration of the contagion effect and the risk of rapid decapitalization, difficult capital calls for donors or investors (like socially responsible investors and development agencies), and a less geographically diversified portfolio.[199] It also supports a categorization of 75 percent of portfolios as "other retail loans"[200] and a possible exemption of small MFIs at the

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MFIs' ability to extend unsecured loans. Instead, Imboden justifies, based on criteria suggested in 2004 by the Basel Committee itself (such as MFIs' size, nature and complexity of operations, lack of international presence, and resource constraints with the supervisor) the exclusion of MFIs from the scope of Basel requirements. However, in case we have to apply Basel II to the MFIs or downscaling banks, in the author's opinion, the generally well capitalized and under-leveraged nature of MFIs would justify a lower capital level and the size and nature of micro-loans would permit a risk categorization of 75% instead of 100% (required instead for commercial loans or retail corporate loans when not meeting the retail small businesses test) under the standardized approach.

197. *See* BASEL COMMITTEE ON BANKING SUPERVISION, THE INTERNAL RATINGS-BASED APPROACH, (Jan. 2001), *available at* http://www.bis.org/publ/bcbsca05.pdf.

198. For an analysis justifying lower credit risk capitals for MFIs based on their resilience to systemic risk under the IRB approach, see Enrique Navarrete & Sergio Navajas, *Basel II and Microfinance*, MICROENTERPRISE DEVELOPMENT REVIEW 1 (Jul. 2006), *available at* http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=1442303.

199. *See, e.g.*, McNew, *supra* note 64, at 303; Hubka & Zaidi, *supra* note 153, at 13; *see also* Emilios Avgouelas, *Access to Finance, Microfinance, and International Capital Adequacy Standards for Banks: A New Approach to Development*, 4 MANCHESTER J. INT'L ECON. L. 1, 43-50 (2007) (suggesting the creation of new separate asset classes for microfinance under Basel II); MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 23 et seq.

200. For a definition of "other retail exposures" under Basel II, see paragraph 70 (standardized approach) using criteria such as orientation to individuals or small businesses, product type (such as personal term loans or small business loans), granularity (like diversification of the portfolio), low value of individual exposure; or paragraphs 231-232 (IRB approach): "Loans extended to small businesses and managed as retail exposures are eligible for retail treatment provided the total exposure of the banking group to a small business borrower (on a consolidated basis where applicable) is less

discretion of domestic supervisors.[201] Potential negative effects on MFIs' profitability and access to financing are weighed differently by MFIs, development agencies[202] and for-profit entities,[203] often recognizing that MFIs already have higher ratios for market reasons.[204] Similarly, many studies do not differentiate substantially between MFIs in general and credit union MFIs with regard to capital adequacy standards, while the Ba-

than _1 million. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold." Basel II, *supra* note 155.

201. *See* BROWN, ARORA & TURING, *supra* note 130, at 5. The authors refer to the same guiding principles of the Basel Committee as Imboden, *supra* note 103, but consider the exemption of smaller MFIs, not all MFIs.

202. *See* DRUSCHEL, *supra* note 160, at 26 ("For investors . . . it means that more capital is required to increase the level of business. For an increase in lending to occur, a larger increase in capital would be required than at a commercial bank, making profits more costly than they would be for comparable investments in a commercial bank.") and at n.17 ("Whether this would truly affect an investor's decision to work with an MFI versus a commercial bank would require further research about investor risk tolerance and other behaviors. Logic would suggest, however, that a more socially-oriented investor would be less affected by this difference, unless commercial banks in the region were also offering microfinance.").

203. *See* BROWN, ARORA & TURING, *supra* note 130, at 2 ("There will be a more accurate alignment of risk and return - Measurement of risk capital under Basel II is based on Risk-Weighted Assets (RWA) . . . . Commercial bank wholesale lending to the sector may be negatively impacted due to sub-investment grade ratings of MFI's and countries. This is based on the expected impact of wholesale lending to institutions in emerging markets in general, and not limited to MFI's. However, as noted above, in the determination of regulatory capital, Basel II allows for the use of credit risk mitigation to improve capital allocation. From a commercial bank's perspective, capital allocation is likely to be less if banks use the direct approach of taking on individual microloans on balance sheet as opposed to the indirect approach of providing wholesale loans to MFI's."), at 5 ("Microcredit by MFI's could be categorized as "other retail exposures" which falls under the "retail assets" category, as defined under Basel II . . . . This could translate into a more favourable capital treatment than under Basel I.") and at 6 ("Impact on other Non-Bank MFI's is expected to arise primarily from Pillar II. Whilst these MFI's may not be required to comply with Basel II from a regulatory basis, there is expected to be positive spillover impact in the form of improved a) Regulatory oversight and b) Risk management standards. The document also recognizes some possible negative indirect effects on MFIs in the form of increased cost of funding pertaining the loans to MFIs to risky categories (wholesale, unrated, lack of statistical data/default history), but it envisions a solution in increasing the use of collateral.").

204. BROWN, ARORA & TURING, *supra* note 130, at 5.

sel Committee, in its recent document on regulation and supervision of microfinance,[205] often shows distrust towards credit unions and suggests higher ratios. The industry and some regulators familiar with regulating and supervising financial cooperatives (from countries where credit unions and cooperatives are widespread and important participants of the financial sector, like in many European countries but also African ones) might reach a different evaluation, not seeing particular problems in dealing with financial cooperative models of organization.

Capital adequacy standards have gained more attention in the microfinance field because of the possible need for adjustments under Basel III, and the trend towards transformation into regulated entities experienced in recent years. It also represents an example of the difficulties in implementing a G-10 product in DCs' systems and diversified experiences. The recent attempt by the Basel Committee to help the industry and DCs' regulators deal with Basel principles with respect to microfinance—but in conjunction with the industry through a wide consultative process—is admirable. The Committee seems to absorb many suggestions from previous studies but fails to address some fundamental problems that could have been solved at least in part through its expertise and the microfinance industry's experience. These include a sample model of IRB for MFIs and a more tailored standardized approach balancing microfinance risks with existing systems to manage those risks—particularly liquidity reserve systems—while considering contagion risk and geographically undiversified portfolios,[206] loan loss provisioning requirements (taking into account different timing of microloans compared to the mainstream sector, but also based on other evaluating crite-

205. BIS, BASEL COMMITTEE ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES, *supra* note 11, at 3.

206. For existing initiatives, see Peter Bate, *In Case of Emergency: Break Glass: ELF, an innovative fund that helps MFIs respond to all kind of disasters*, INTER-AMERICAN DEVELOPMENT BANK, (December 19, 2007), *available at* http://www.iadb.org/micamericas/section/detail.cfm?id=4241&sectionid=spcal; *IFC to Provide Assistance to Crisis-Hit Microfinance Sector*, MICROFINANCE FOCUS, Jan. 1, 2011, *available at* http://www.microfinancefocus.com/content/ifc-provide-assistance-crisis-hit-microfinance-sector (discussing IFC's "Microfinance Enhancement Facility").

ria),[207] more frequent but less-burdensome reporting (due to the risk of quickly worsening scenarios in case of contagion effect), and suggestions for adequate supervisory powers and crisis management not hampering MFIs functioning.[208]

From a development aid perspective, rather than imposing international standards of capital adequacy and prudential rules derived from their own systems, international actors should focus on providing MFIs with technical assistance and suggesting voluntary instruments for them and their governments to manage risk and establish internal controls and assessments. In addition, the recent crisis has casted doubts on the effectiveness of capital-based requirements to prevent crises and ensure stability.[209]

4. *Conclusions*

As a general matter, a harmonized international regime[210] of detailed prudential rules for microfinance appears

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207. MEAGHER, *supra* note 56, at 12-13; Hubka & Zaidi, *supra* note 153, at 13; MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 26-27. In favor of relaxing provisions, see McNew, *supra* note 64, at 304.

208. *See* MICROFINANCE CONSENSUS GUIDELINES 2003, *supra* note 19, at 22 and MICROFINANCE CONSENSUS GUIDELINES 2012, *supra* note 13, at 31-32.

209. *See, e.g.*, TARULLO, *supra* note 44, at 231.

210. There are three possible forces towards a harmonized regime: regulatory cartelization, the regulatory policy lever phenomenon, and regulatory imperialism. Regulatory cartelization is harmonization as a response to increased regulatory competition and regulators' worries about losing their powers and role. Looking at the possible forces towards an harmonized regime, there are arguments to exclude regulatory cartelization due to limited regulatory competition since many MFIs choose where to incorporate based on the need for broader financial access. In practice, however, increased commercialization and the need for a reassuring political and regulatory framework for survival and profitable operation can create regulatory competition but presumably not enough to justify the costs for creating harmonized standards. The regulatory policy lever phenomenon, which is harmonization to overcome a domestic opposition to a reform, is also unlikely unless the government is willing to overcome political opposition to microfinance. Regarding government campaigns against repayment by microfinance clients, see Rahman & Mohammed, *supra* note 171. In conclusion, only regulatory imperialism is left. On the forms of and rationales for regulatory harmonization, see Jonathan R. Macey, *Regulatory Globalization as a Response to Regulatory Competition*, 52 EMORY L. J. 1353, 1376 (2003); Kane, *Financial Regulation*, *supra* note 167, at 338–40; Kane, *Ethical Foundations*, *supra* note 167, at 52, 61 (also looking at regulatory competition as the natural discipline as opposed to harmonization).

inadequate due to the multitude of differences in microfinance experiences, even as compared to the variety in the international mainstream financial sector and the lack of systemic risk at this level.[211] Guidelines and standards would be too detailed to be appropriate. Instead, only principles in the form of soft law without enforcement tools should be encouraged. However, initiatives to support policy makers from DCs with expertise and resources in a capacity building and development aid perspective[212] should be welcomed, and joint projects of CGAP and local governments focused on the specific country's framework are recommended in a non-mandatory regime to avoid repeating past World Bank and IMF problems with political reforms in DCs.[213]

A perspective worthy of attention is the possible role of CGAP under a reformed structure, perhaps in conjunction with the IMF, or another international body to help with MFIs' crisis management, assist with developing rating models and even act as a lender of last resort in case of unsatisfactory local infrastructure or instruments.

Indeed, in many recent crises of MFIs, a fundamental cause of inadequate management was the absence of resolution mechanisms in combination with the contagion effect. The lack of a prompt substitute for the failing MFIs in collecting loans and other instruments contributed to the rapid loss of asset value and the permanent failure of the MFI.[214] Local

211. On the relevant differences among countries even with respect to the mainstream sector and the opportunity of principles rather than rules, see THE WARWICK COMMISSION, *supra* note 76, at 41, 45-49.

212. *See About AFI*, ALLIANCE FOR FINANCIAL INCLUSION, http://www.afi-global.org/about-afi (providing DC's policymakers with resources and tools to develop, share and implement effective financial inclusion policies); *see also* Hio Kyeng Lee, *Who's Who in Microfinance: Supervisory Tools for Regulators and MFIs at the CGAP Reference Library*, MICROCAPITAL.ORG, Nov. 11, 2009, http://www.microcapital.org/whos-who-supervisory-tools-for-regulators-and-mfis-at-the-cgap-reference-library/.

213. On the IMF and the WB's legitimacy and accountability problems, see ROSS P. BUCKLEY, INTERNATIONAL FINANCIAL SYSTEM: POLICY AND REGULATION 166 (2008); Ngaire Woods, *Global Governance After the Financial Crisis: A New Multilateralism or the Last Gasp of the Great Powers?*, 1 GLOBAL POLICY 51, 52 (2010); *see also* Meidinger, *supra* note 98, at 524-26.

214. *See* ROZAS, *supra* note 53; Daniel Rozas, *Preparing for Failure: Strategies for Challenging Times in Microfinance*, MICROFINANCE FOCUS, Nov. 8, 2010, *available at* http://www.microfinancefocus.com/content/preparing-failure-strategies-challenging-times-microfinance.

or regional networks managing common funds and enforcing rescue procedures would also help increase self-supervision, competition, incentives for prompt intervention by other actors, and substitution of failing institutions. At present there are some interesting examples of regional liquidity facilities.[215]

Of course, the need to design a system that takes into account moral hazard[216] and risks, local government sovereignty, fair decisions, and links between liability and supervision and efficient supervision should characterize the additional research required on this topic. This should not be a way to let EACs indirectly control DCs' financial systems. Furthermore, balancing all these factors might prove impossible and, thus, the option of a local fund or just of an ex ante or ex post liquidation plan for each MFI should be considered that involves the local government, the investors and the international organization or one department of such organization specializing in microfinance.

In conclusion, international development organizations should refrain from playing a general regulatory role in microfinance regarding financial regulation, such as imposing the introduction of a special legal framework for microfinance or interest rate liberalization. They should instead focus on cooperation in building general and specific infrastructures, such as domestic credit bureaus and rating agencies, and promoting partnership with mainstream banks.[217]

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215. For example, a regional liquidity facility has been created in Latin America—providing emergency liquidity, technical assistance for management and risk management—that is funded by international organizations, foundations, NGOs, and socially responsible investment funds. The "Emergency Liquidity Facility" is an investment fund administered by IDB (Inter-American Development Bank - World Bank) and funded by many private investors designed to provide pre-qualified MFIs in Latin America and Caribbean with liquidity to face credit crises or shocks. *See* references *supra* note 206; Roberto Moro Visconti & Geoffrey Baluku Muzigiti, *Global Recession and Microfinance in Developing Countries: Threats And Opportunities*, (20 Dec. 2008), at 26–27, *available at* http://www.ssrn.com. Furthermore, the "Microfinance Enhancement Facility" was announced in late 2008 as an investment fund promoted by IFC and KfW and co-managed by BlueOrchard, with the aim to enhance liquidity support of MFIs to overcome the credit crisis. *See* http://www.ifc.org/ifcext/spiwebsite1.nsf/ProjectDisplay/SPI_DP27827 and http://www.mef-fund.com/

216. *See* Schwarcz, *supra* note 46, at 226.

217. *See* O'Rourke, *supra* note 27, at 195.

On the other hand, the combination of development and socially responsible investing perspectives can play an important role. There is room for international assistance and direct regulatory intervention in the forms of IMF and World Bank conditions (or other guidelines for microfinance activities conducted with the main objectives of development and social and human rights improvement) to protect the socially responsible part of their investments and efforts.

These conclusions are based on an assumption about the limited size of the sector and, consequently, its limited impact on the global financial sector. However, should microfinance in the future gain a substantial role in the financial sector from the point of view of systemic risk, more stringent and pervasive principles would be needed.[218]

C. *Economically Advanced Countries (EACs) and Developing Countries (DCs): Differences in Perspectives. In Particular, the EU Position.*

So far we have primarily referred to issues involving microfinance regulation and supervision in DCs. Different conclusions may be reached regarding microfinance regulation and supervision in EACs. In these countries, financial regulation is substantial and often burdensome. Especially after the financial crisis, microfinance has been regarded as a possible solution to social and financial disenfranchisement. For instance, in the European Union, although internally there are many differences due to the freedom in implementing European directives, quite a substantial system of rules regarding banking and financial systems exists.[219] Furthermore, the microfinance experience in the Western member states present similar patterns, consisting mainly of microcredit, perhaps due to the high costs in obtaining a banking license and complying with the regulation, relying on the non-profit sector

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218. Historically the regulation of the banking activity has increased in amount and pervasiveness with the incremental growth and interconnection of banks. *See* CARNELL, MACEY & MILLER, *supra* note 46; Gerard Hertig, Ruben Lee & Joseph A. McCahery, *Empowering the ECB to Supervise Banks: A Choice-Based Approach*, 5 (Eur. Corp. Governance Inst., Fin. Working Paper No. 262/2009, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327824.

219. *See, e.g.*, Council Directive 2006/48, 2006 O.J. (L 177) 1, 1 (EC); Council Directive 2006/49, 2006 O.J. (L 177) 201, 201 (EC).

or credit unions with special relevance of business development services and other collateral and supporting services for social inclusion. However, the Eastern member states have a developed and commercialized microfinance sector dominated by credit unions and a few specialized microfinance banks with a high level of foreign investments.[220] Many efforts in this context have been devoted to advocating for a more favorable regulation of MFIs compared to general financial regulation. EU institutions have been looking at microcredit more than microfinance as a tool for social inclusion, reduction of unemployment and support to small and medium enterprises ("SMEs")[221] in the context of the Lisbon Treaty.[222] The objective of such initiatives has been to provide the actors with financial resources as well as to promote a simpler regulatory framework. However, the 2007 Initiative simply recommends to Member States the creation of favorable regulatory and institutional conditions for microcredit, suggesting easier authorization processes, the creation of guarantee facilities, evaluation of securitization systems, more flexible usury laws for MFIs, access to credit bureau, tax breaks and the creation of a European database about defaults, loan losses and ratings. At the same time, the Commission confirms the requirement of a banking license (only) for taking deposits and extending loans simultaneously. To facilitate respect of accounting standards and the elaboration of an internal rating system under

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220. *See* MICROFINANCE INFO. EXCH. & CONSULTATIVE GRP. TO ASSIST THE POOR: EASTERN EUROPE AND CENTRAL ASIA MICROFINANCE ANALYSIS AND BENCHMARKING REPORT (2010), *available at* http://www.themix.org/sites/default/files/2009%20ECA%20Microfinance%20Analysis%20and%20Bench marking%20Report.pdf.

221. *See, e.g.,* Joint European Resources for Micro and Medium Enterprises (JEREMIE) (credit facility focusing on microfinance and SMEs, technical support); Joint Action to Support Microfinance Institutions in Europe (JASMINE) (to improve legal framework, promote SMEs and good practices and support the creation of non-bank MFIs).

222. *See, e.g.,* European Commission, *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions – A European Initiative for the Development of Micro-Credit in Support of Growth and Employment,* COM (2007) 708 (Dec. 20, 2007); *id., Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions – "Think Small First", A "Small Business Act" for Europe,* 10, COM (2008) 394, (June 25, 2008).

Basel II as well as the adoption of a European code of conduct for MFIs, the EU will provide resources and technical support.

Nonetheless, the integration of the financial system among European countries creates arguments for a regional elaboration of principles for microfinance regulation and supervision. They are not systemic risk concerns or joint development efforts to justify a partial harmonization but the recognition of existing similarities in the experiences and the need of a common response to regional social problems. The initiative of the Committee on Economic and Social Affairs of the European Parliament and the Parliament itself can be seen as efforts in this direction,[223] proposing the harmonization at the European level of a regulatory framework for microcredit applicable to all MFIs, but with a more agile prudential regulation and authorization process for non-bank MFIs, for which only microloan activities, not deposits, are permitted, in addition to lower interest rate ceilings, national or European guarantee funds and a European database about beneficiaries, collection of best practices and guidelines.[224] The attention towards a favorable treatment, thus, focuses more on non-bank MFIs. The problem, now more than before, is to find a balance between reduced requirements to encourage services to low income people and the risk of bad incentives and unsafe practices damaging the most needy as well as the entire financial system.

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223. *See* European Parliament, *Report with Recommendations to the Commission on a European Initiative for the Development of Micro-Credit in Support of Growth and Employment*, at 9, (Jan. 29, 2009), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//ep//nonsgml+report+a6-2009-0041+0+doc+pdf+v0//en; European Parliament, *A European Initiative for the Development of Micro-Credit in Support of Growth and Employment - European Parliament Resolution of 24 March 2009 with Recommendations to the Commission on a European Initiative for the Development of Micro-Credits in Support of Growth and Employment*, at 7-8, (Mar. 29, 2009), *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//ep//nonsgml+ta+p6-ta-2009-0166+0+doc+pdf+v0//en.

224. *See* European Parliament, *Report with Recommendations to the Commission on a European Initiative for the Development of Micro-Credit in Support of Growth and Employment*, *supra* note 223, at 9. Other proposed changes in the regulation pertain to competition, concession of public funds, anti-terrorism and anti-laundering legislation.

VII. CONCLUSIONS

In the previous sections I have highlighted some important issues to be considered in addressing allocation of rulemaking power to different levels and types of powers, and tried to propose principles for differentiated actions by existing regulators, considering interests and risks involved, scope and objectives of regulation and supervision, and limits in terms of resources, capacity and experience.

In particular, I have first, identified the reasons why financial regulation should not be ignored with respect to microfinance at a domestic level, leaving some room for the development aid perspective.

Second, I have drawn a fundamental distinction between prudential and non-prudential regulation and supervision, recognizing the former as more domestic and government-led and viewing the latter as more market- and regulatory competition- based with an important role played by transnational forces.

Then, with special reference to the prudential field, I have endorsed differentiated roles for international actors depending on the particular needs, characteristics and rationales of the sub-sector. I have proposed in some cases a more technical and development-based support for the creation of infrastructures while, in other cases, a more market-based approach for building know-how. I have generally excluded harmonized rules but suggested some possible evolution towards a transnational authority in the field.

Understanding the interaction among different levels of regulation is the first step toward designing an optimal regulatory framework. In any case, this topic requires further discussion and analysis in order to clarify the rationales for intervention of different actors and better define the borders of such action.[225]

Microfinance has a great potential in furthering financial inclusion but has recently showed also some downsides and risks for the financial system and financial consumers; consequently, the issues pertaining to its regulation deserve more attention. Furthermore, it is a sector in continuous evolution,

225. *See also* Macchiavello, *supra* note 92.

requiring constant updates in the balance of different interests and risks involved.

We should not forget that microfinance represents only one of the instruments to improve financial inclusion; regulators should consider implementing more comprehensive reforms addressing, more generally, financial services to low-income people that are tailored to the specific causes of financial exclusion in each country.