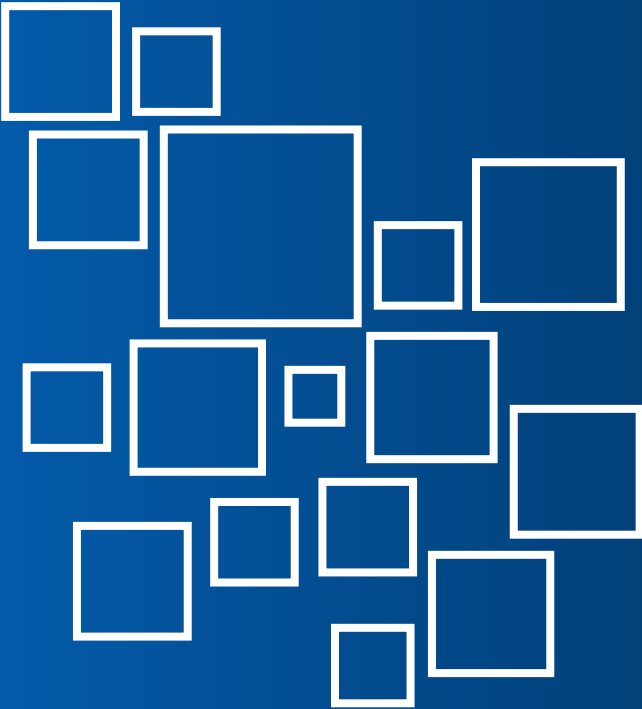


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The Real Relation between Microcredit and Development: a critical analysis of the international regulation of financial services

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RESUMO

A principal atividade deste estudo é identificar as implicações do microcrédito no sistema regulatório formal e, a partir disso, elencar os principais problemas associados ao foco demasiado em evocar os lucros obtidos em programas baseados na microfinança ao invés de atentar para o efetivo resultado do acesso ao crédito para a camada mais fragilizada da sociedade – os supostos beneficiários dessa modalidade de serviço. Nesta busca pelo desenvolvimento, imperioso perceber a insuficiência de uma fórmula regulatória padrão que sirva irrestritamente a todos os países em relação ao microcrédito, sob pena de afrontar os princípios basilares nos quais a microfinança e, especificamente, o microcrédito foram fundados.

Palavras-chave: Microcrédito, Regulação, Desenvolvimento, Redução da Pobreza
JEL: G18; G21; K29

ABSTRACT

The current task is to identify the implications of introducing microcredit into the formal regulatory system. The present analysis outlines the problems associated with focusing entirely on a business model approach to microfinance rather than striving to achieve capital access for the poor - the supposed beneficiaries of such services. In order to remain loyal to the original principles of microfinance, and specifically microcredit, it is crucial to note the limitations of implementing a one-size-fits-all regulatory framework in the process of development.

Key words: Microcredit, Regulation, Development, Poverty Alleviation
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Bangladesh had a terrible famine in 1974. I was teaching economics in a Bangladesh university at that time. You can guess how difficult is to teach the elegant theories of economics when people are dying of hunger all around you. Those theories appeared like cruel jokes. I became a drop-out from formal economics. I wanted to learn economics from the poor in the village next door to university campus. (Yunus, 2005, p. 322)

1. Introduction

The role of regulation in promoting access to financial services is one of the most significant contemporary discussions facing the international financial world. The desire to determine the causes of development and establish a propitious framework for it to occur has been the primary goal of many academics and practitioners from different disciplines. But, while the pursuit of and need for development might be agreed upon, the same cannot be said for the methods set out to achieve it. The objective of the present article is to understand the meaning of and possibilities for microfinance. It focuses specifically on microcredit as a vehicle to promote development through poverty alleviation.

Since the 1990s, the primary goal of theories of development has been to find the proper balance between government intervention and the use of markets in stimulating growth.² Most theories reinforce the importance of both the macro and microeconomic environment in enabling the emergence of efficient economic activity. These theorists stress the need for an “appropriate” institutional infrastructure (Thorbecke, 2006, p. 21) that is able to encourage both long-term investments and the satisfaction of basic human needs. However, exogenously given package reforms that take the shape of standardized regulation, such as those proposed by the World Bank, have been criticized by many observers as a result of their failure to effectively reduce levels of poverty.³ On the other hand, constant and unavoidable market failures undermine the role of the state in promoting development policies. The role of the state is especially important in microcredit because of its ability to mitigate unfair power relations between creditors and debtors.⁴ As such, the main

² Even though it has been argued that neoliberal ideas added to the definition of development during the period (lead particularly by market shocks in Russia and Latin American countries, as well as the Asian financial crisis) many criticisms have been raised regarding the adoption of these new approaches in the pragmatic field. For instance, taking the ambiguous definition of “market failure” as a rationale for intervention can be very dangerous as the reasoning can be construed very broadly or very narrowly. The dilemma between market driven and interventionist policies seems to be reformulated under new headings but any resolution is still a long way off. (Santos, 2006).

³ In an era of “aid fatigue” and conditionality, a number of econometric studies assessed aid’s effectiveness and pointed out that it could only be a powerful tool for promoting growth and reducing poverty if granted to countries that are already helping themselves by following well-known “growth-enhancing policies”. (Dollar, 2000, p. 847). Conversely, other studies challenged this assumption by saying that the effectiveness would be dependent on exogenous environmental factors, such as external trade, exports and climatic shocks. See further (Chavet, 2001).

⁴ To give an example of the miscomprehension of economic growth and development, one need only look to the celebration of Brazilian policies. However, too little has been said about its increasing growth in human welfare. As noted by Gillis et al more than a decade ago, the criticisms are still valid. Brazilian economic growth has been uneven both in time and space. While sections of the country such as the poor in the northeast have been largely excluded from development, even big modern cities in the South (Rio de Janeiro, São Paulo, Belo Horizonte) have “appalling urban slums.” Among the problems still persistent there are the highly concentrated ownership of assets, the uneven access to education and very high levels of inequality. (Gillis, 1992, p. 90).

difficulty at present is that there is no simple formula that all states could easily implement that would necessarily result in development (Santos, 2006, p. 18). Broadly speaking, contemporary studies of law and development “*seem to share a mid-level conception of ‘development policy’ – neither a narrow matter of technical economic detail nor a broad vocabulary for political struggle, but something in between.*” (Kennedy, 2003, p. 17).

The new meaning of development includes a multiplicity of objectives that not only correspond to economic markers, but also consider indicators of human development. This consists in *n* dimensions of human welfare to the satisfaction of basic needs to the effective participation in society (Thorbecke, The Evolution of the Development Doctrine 1950-2005, 2006). In this sense, an institutional framework is still important, but the way it is presented and constructed has changed. When economic growth becomes dependent on the observance of other elements such as poverty alleviation, democracy implementation and income distribution, the content of the concept of ‘development’ becomes more complex and, importantly, more holistic.⁵

Indeed, microfinance initially emerged as a social policy designed to attend to the needs and aspirations of people from low-income backgrounds. It is defined as a system of “financial services targeting and catering to clients who are excluded from the traditional financial system on account of their lower economic status” (Alliance). Nowadays, the term also includes services such as microcredit, microsavings and microinsurance (McNew, 2009, p. 290). Of these, perhaps the most well-known service is “microcredit,” which is characterized as the “the extension of small loans to microentrepreneurs who lack collateral and do not qualify for traditional bank loans.” (McNew, 2009, p. 291) As already highlighted by McNew, the term microcredit has evolved throughout time and now includes a wide range of credit arrangements including money lender credit, loans from friends and relatives and even loan shark-type credit largely “recognized by its extremely high —if not usurious — interest rates.” (McNew, 2009, p. 291)

Microcredit is the focus of the present study. The expansion of microloans across the world in the last two decades has been based on a new motto delivered by the “Microfinance Revolution” (Kumar, 2004, p. 77). —use the market to combat misery. As already observed by Dyal-Chand, “the image of a market-based response to entrenched poverty has caught the excitement and imagination of many people around the world, including the popular press” (Dyal-Chand, 2005, p. 241). This is largely because a market-based approach would hypothetically conciliate the interests of private investors and the beneficiaries of the loans at the same time. As a result of this introduction of private actors guided by the logic of profit maximization, the original philanthropic character of the old microfinance institutions (MFIs) has largely disappeared (Harper, 2007, p. 33). Consequently, the goal of establishing an appropriate regulatory system has become increasingly crucial.

In order to devise an adequate regulatory scheme, the original informal method of financial accessibility provided by microcredit must be translated into the formal sector’s language. While many efforts have been made to expand the business-like aspect of the micro credit industry, far too little attention has been paid to granting capital access to the poor, the supposed beneficiaries of such services (Hulme, 2003, p. 155). This paper addresses this problem in three parts. The first part deals with the meaning and background of microfinance and microcredit. The second part describes

⁵ This reconceptualization of development decenters the focus on economic growth and adds the idea of human development. Under this reconceptualization, considerations are specifically paid to political, social, and legal development factors. It is argued that taken together, these multiple aspects of development “aim at promoting development as *freedom*: the goal is to enhance people’s capabilities and to enable individuals to lead the life they choose to live” and captured in the promotion of a so called “Comprehensive Development Framework”. (Santos, 2006, p. 7).

the design and evaluation of different types of MFIs in the operations related to microcredit. Finally, the third section lays out the theoretical and pragmatic dimensions of a desirable microcredit regulatory framework. It looks at how these perspectives can be conciliated with aspirations of sustainability, poverty alleviation and development.

2. Microfinance, Microcredit and Development: meaning and background

Microfinance can be defined as a vehicle designed to promote the inclusion of the poor into the formal market and, in this manner, into mainstream society (Alliance). Considering that the purpose of the present essay is to consider the role of development in poverty alleviation, the analysis will prioritize credit services offered to low-income populations and the attendant impact these services have on their livelihoods (Rauch, 2005, p. 327).

2.1. The History and Evolution of Microcredit

The essential idea of microcredit is not new, however, the meaning of the word has greatly expanded over the last two decades. Indeed, poor people in different countries have used informal methods of savings for hundreds of years. Some examples of these systems are the “susus” of Ghana, the “chit funds” in India, the “tandas” in Mexico, the West African “esusu”, the Jamaican “partner”, the Korean “kye”, among many others (McNew, 2009, p. 162). On the other hand, by the end of the late 19th century, a number of larger and more formal savings and credit organizations emerged in Europe, mainly amongst the rural and urban poor areas known variably as People’s Banks, Credit Unions and Savings and Credit Co-operatives (Cunningham, 2005). When previous savings were non-existent, moneylenders and informal market actors provided the poor with quick loans with very high interests rates that were justified by the high risk involved in the transactions (WWB W. W., 2002) (GrameenBank, 2011). Aware of this situation, a number of cooperatives, credit unions, and social policies (O’Rourke, 2006, p. 179) (CGAP C. G.) were created during the 1950s (Rauch, 2005, pp. 320-321) in order to provide cheaper credit to low-income people.⁶ However, many of these microcredit policies were dependent on government subsidies and, as such, were unsustainable on their own.

The “true emergence” (O’Rourke, 2006, p. 182) of the modern microcredit agency occurred during the 1970s and the 1980s with the birth of microenterprise lending. (O’Rourke, 2006, p. 179) (Cunningham, 2005). This form of lending was largely undertaken by non-governmental organizations (NGOs) such as the Grameen Bank in Bangladesh.⁷ At that time NGOs were considered to be “naturals to provide credit to the microenterprises” because they were both considered “ideologically motivated” and “appropriately positioned” (Dichter, 2007a, p. 3). The prejudice against corporate banks was considered justified because of the atypical features of the microloans they provided. For example, microloans from banks had no collateral and carried with them a high risk of “non-repayment” (Dichter, 2007a, p. 3).

The original idea of microcredit was the provision of small loans for the disadvantaged strata of society using alternative methods to assure repayment. One example is a “solidarity circle”, where

⁶ In the middle of the last century, cooperatives and credit unions in developing countries focused on savings mobilization and lending to rural households, many of which were poor. Before the so-called *boom* of the microfinance industry, governments created lending programs for poor entrepreneurs and producers. It is said that most of these programs suffered from subsidized interest rates and political patronage. (WWB - Women’s World Banking, 2002).

⁷ See further in Grameen Bank example. (GrameenBank, A Short History of the Grameen Bank, 2012)

small groups of borrowers guarantee each other's loans as a substitute for physical collateral (Dyal-Chand, 2005, p. 254). Some authors point out that the power of the solidarity circle is precisely in the ability of members to enforce repayment by means of informal pressure. However, as borrowers have the power to screen their peers for participation in such a circle, the poorest members of villages are often excluded due to doubts about their repayment capabilities (Dyal-Chand, 2005, p. 284). Another form of alternative financing is the often-overlooked method of microsavings (McNew, 2009, p. 291). Under this arrangement, deposits of small sums of money by clients enable organizations to achieve self-sufficiency and consolidate their independence from donor and governmental support (CGAP C. G.). However, the persistence of poverty seems to be a result of the *lack of capital* amongst low-income classes, which results in the lack of access to basic goods and services. Consequently, as already mentioned, the focus of the present study is on microcredit and not microsavings.

2.2. Microfinance Revolution, Development and Poverty Alleviation

The “Microfinance Revolution” was launched by the prosperity achieved by a set of unusual financial institutions in different parts of the world, especially Bangladesh (Matin, 2005), Bolivia (Keyes, 2006, p. 556), and Indonesia (Rauch, 2005, p. 323). The logic of the campaigns was straightforward: poverty could be alleviated by providing financial access through microcredit. Nonetheless, it was only in the 1990s that excitement grew among traditional financial institutions, forcing the credit operators to become more professional. In 1995, a group of major donors created the *Consultative Group to Assist the Poorest* (CGAP) as a secretariat housed at the World Bank building (CGAP). After a series of exhaustive manuals and “best practices” were produced, microcredit became considerably more relevant in the academic field (Dichter, 2007a). During this time the focus of the industry began to shift away from the interests of the beneficiaries and became more focused on lender expansion. Yet, in 2005, the United Nations declared the “International Year of Microcredit” highlighting its importance and inciting its expansion:

Invites Governments, the United Nations system, all concerned non-governmental organizations, other actors of civil society, the private sector and the media to highlight and give enhanced recognition to the role of microcredit in the eradication of poverty, its contribution to social development and its positive impact on the lives of people living in poverty.⁸

While efforts to overcome poverty are of course important, overestimating the role of private actors in this project is harmful. Firstly, the overreliance on the microcredit industry emphasizes the profitability of selling to people at the “bottom of the pyramid” and neglects the critical role of the state in poverty reduction (Karnani, 2008).⁹ The business-model approach views the poor as “resilient and creative entrepreneurs and value-conscious consumers” even though there

⁸“*Noting further* that the international community is observing the period 1997–2006 as the first United Nations Decade for the Eradication of Poverty, the General Assembly *proclaims* the year 2005 as the International Year of Microcredit.” UNGA Res 53 (22 February 1999) GAOR 53rd Session.

⁹There is a debate regarding whether or not credit should be considered a right. That is because in order for these rights to be enforced there would have to be a formal relationship between financial institutions and governments. In other words, to hinder completely the exclusion of the poor by financial institutions, there would be the need for subsidized credit for those clients who are not likely to be reached by commercial players. In this scenario, the role of government becomes crucial to the success of microcredit and poverty alleviation. (Hudon, 2009, p. 25).

is considerable lack of empirical evidence to support this assumption (Hudon, 2009). For instance, the Grameen Bank, one of the most well-known and admired contemporary MFIs, evaluates its success by the number of loans it extends, the increase in nutritional levels and health of its clients, and the amount of personal physical assets of the borrower.

These criteria are compared both before and after the microcredit provision is extended and are important proxies of human development. Despite that, they do not necessarily imply that the poor are getting richer due to their engagement in economic activity. That is because the bank does not count the real number of start-up microenterprises they successfully fund or the number of projects that last long enough to lift their proprietors out of poverty for an extended period of time (Dyal-Chand, 2005, p. 244).

Misleading representations of the power and potential of microcredit circulate in other places as well. For example, Kumar gives an overly optimistic description of a microcredit paradigm in his recent work (2004, p. 77):

Loans are made available, in very small amounts, [...] unsubsidized lending at market rates, typically with low levels of formality and limited requirements of collateral, often to particularly vulnerable groups, such as village women. Repayment is undertaken frequently, and rates of repayment in many microfinance ventures are cited to be high. Many microfinance ventures also offer deposit-taking services.¹⁰

A similar characterization is found on the official website of the World Bank (2012):

These providers have increased their product offerings and improved their methodologies and services over time, as poor people proved their ability to repay loans and their desire to save. Banking through mobile phones (mobile banking) makes financial services even more convenient and safer, and enables greater outreach to more people living in isolated areas.

In order to achieve long term and genuine success for borrowers the overall environmental architecture must be taken into consideration. In this manner, financial sustainability is dependent on the ability of a country to organize its own institutions in order to create an “enabling environment”, one that builds a propitious regulatory framework for the World Bank and its affiliates.¹¹ The success of this environment is a direct reflection of the authorities’ ability to regulate and support financial institutions at a national or wholesale level (WorldBank, 2012).

In order to provide equitable local financial trading in developing markets, the World Bank Group relies on different institutions to play complementary roles in making prognostics in various countries. This strategy is ostensibly used to assist in the process of universal access to finance. For instance, the International Finance Corporation (IFC) is the World Bank Group’s lead investor in microfinance and the number one multilateral investor in terms of outreach to microfinance institutions. The IFC works with more than 100 institutions in over 60 countries, including 21 Sub-Saharan African countries:

¹⁰ Even though the findings, interpretations, and conclusions expressed in Kumar’s book do not necessarily reflect the views of the Board of Executive Directors of the World Bank, there are notable similarities between Kumar’s visions and the recommendations made by the World Bank. See further in the following footnotes.

¹¹ According to Rittich, the “foundational aspect of neoliberal development policy has been the claim that markets can and should be designed in accordance with one architectural style, and organized around a set of ‘best practice’ rules and institutions which have been derived from model market economies. This claim has dominated the economic discourse in recent years and has become intimately associated if not inseparable from current debates about development” (Rittich, 2000).

IFC's focus is on creating and supporting commercially-viable microfinance institutions that can attract the private capital needed. IFC plays a catalytic role by demonstrating the business case for commercial microfinance, enhancing the sector with innovative financial products, and promoting it as an asset class.¹²

Nevertheless, some have serious reservations about the concept of “commercially-viable institutions” developed by the World Bank and their researchers.¹³ First of all, the World Bank and many financial institutions argue for more policies to stimulate doing business with the poor, as well as for a regulatory framework that will allow them to grow and expand. However, the main concern should be the *effectiveness* of the service provided instead of the profitability of the activity (Hudon, 2009, p. 22).

In addition, there are several concerns regarding the World Bank's repayment rates and the methods employed to achieve these rates.¹⁴ For example, in places like Bangladesh unreasonable conditions have forced some borrowers to commit suicide.¹⁵ The volatility of having a low-income makes those clients more vulnerable to environmental and economic shocks, such as sickness, flood, drought, theft and so on — conditions that are beyond their control (Hulme, 2003, p. 156). Additionally, lack of skills amongst disadvantaged groups often deepens difficulties in achieving loan repayment. While “microcredit providers have been myopic about debt, the poor of the developing world have not” (Dichter, 2007a, p. 9). A more comprehensive definition of the meaning of debt — one that includes a consideration of social deprivation — results in a less reductionist conception of microcredit. A widening out of the definition is imperative if poverty alleviation is indeed the final objective (Dichter, 2007b).

On the other hand, it is possible that the high rates of repayment mentioned above may have not been the result of liberalizing policies but, rather, accumulated through the administration of affordable loans to the poor through aid or government intervention (Rauch, 2005, p. 321). There is no consensus on the desirability of governmental or non-governmental subsidies in microfinance. Indeed, the debate over whether microcredit should be seen as “sustainable and therefore market driven” or as an “instrument to distribute interest rate subsidies to the poor” (Kumar, 2004, p. 112) raises complex issues. However, considering that the present meaning of development is tied to the need to conciliate economic efficiency with human development (Thorbecke, *The Evolution of the Development Doctrine 1950-2005*, 2006, p. 30), it seems unreasonable to see subsidy policies as necessarily harmful.

¹² According to the official data, IFC is considered a leading global investor in terms of volume. As of June/2010, IFC has committed a total of \$1.7 billion to microfinance, with \$416 million in fiscal year 2010. See further: (WorldBank).

¹³ In the present study, the World Bank's ideas are represented by the World Bank Group, considered a key investor, advisor, innovator, and researcher. The database involves premises made by the International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), as well as its researchers, authors and representative authorities. When appropriate, there are mentions of their independent researchers that do not necessarily involve the formal WB concordance.

¹⁴ Based on CGAP data, Burand points out that five large funders of microfinance estimated that in 2009 the microfinance providers within their respective portfolios would have refinanced approximately \$1.8 billion dollars. (Burand, 2008-2009, pp. 198, fns 25, 26).

¹⁵ For instance, in Bangladesh, one of the most successful examples of microfinance achievements, MFI debtors have been already arrested by the police and threatened with physical violence. Moreover, the press regularly reports female suicides resulting from problems of repaying loans. (Hulme, 2003, p. 156). See also (Dyal-Chand, 2005, p. 256).

3. Different Forms of Microfinance Institutions (MFIS)

MFIs include a wide range of formal and informal organizations, ranging from credit unions, public funds and community initiatives to cooperative organizations and traditional lending institutions. The boundaries between these different categories of MFIs are based on the varying degrees of governmental intervention and independency they are subject to. Considering the limited scope and extension of the present essay, the analysis is restricted to the general features of formal non-profit organizations (i.e., NGOs and governmental organizations) and profitable institutions (i.e., commercial banks).

3.1. Non-Profit Organizations

Non-profit MFIs take diverse forms but are united in their basic provision of (micro)credit services. Usually, organizations that provide only lending services are known as microlending institutions (MLIs)¹⁶ and receive support from the government or aid of international organizations in order to provide affordable services to the poor. Despite the increasing concern with deposit-taking restrictions on many MFIs (i.e., restrictions that would require minimal capital requirements for them to function), it should be noted that there are examples of “non-profit organizations”¹⁷ such as the Grameen Bank¹⁸ that deal both with lending and deposit-taking activities.

Some other basic features of non-profit MFIs include: the small size of their loans,¹⁹ their provision of short-term loan contracts (Barr, 2004-2005), their ability to provide superior information regarding borrowers’ behavior (WWB W. W., 2003), their use of “peer lending”²⁰ and their commitment to joint liability. All of these features are imagined to enhance the so-called “social capital” (Rauch, 2005, p. 320) element of lending, which means dealing with social outcomes as well as financial affairs (Pischke, 2007, p. 139).

The general idea that most MLI beneficiaries are entrepreneurs (Kaplan) has been challenged by recent studies that show that, in fact, mass credit to the poor has been used to smooth consumption (i.e., to acquire goods or services needed for their survival that they could not have

¹⁶ Many practitioners have criticized the aim of non-profit organizations to highlight the “bottom up” aspects of microcredit, such as attention to community and helping those excluded from the social strata. Alternative solutions such as public-private partnerships are increasingly, but not consensually, viewed as a useful tool to conciliate those economic and social goals within MFIs. (O’Rourke, 2006).

¹⁷ Greeman Bank has always been known for its philanthropic features. However, recent data shows it has been achieving profitability as well. Its classification as a non-profit institution is then controversial, but serves as an example of an institution that can work with negative financial outcomes. According to some authors, the bank’s sustainability should be no surprise since the loan portfolios of the bank could “easily” be supported by member savings, “reducing dependence on money markets and donor funds, especially when saving products allow for easy, constrained withdraw”. Further considerations of this issue are made in the section 2.2 of the present essay regarding nonprudential regulation and the discussion about interest rate caps. (Allen, 2007, p. 53).

¹⁸ According to Harper, group methodologies are not ideal due to their heavy burdens on members in terms of time, risk and privacy. The author believes that collective lending should be a stop-gap financial service seen as a regrettable short-term second-rate expedient; the suggestion then points towards the offering of individual services as rapidly as possible. (Harper, 2007, p. 35).

¹⁹ The loan size usually ranges from “single-digit dollar amounts to approximately US \$1,000 and often do not require collateral or credit checks”. (O’Rourke, 2006, p. 182).

²⁰ The term has been used by academics both to designate the pre-screening devices to reduce information asymmetry and the assumption of responsibilities by individuals for the repayment of all loans. See Barr (2004-2005, p. 279) e Williams (2004, p. 150).

beforehand) rather than start up business (Dichter, 2007a, p. 10). For instance, Karnani questions the myth of the entrepreneurial poor by arguing that their businesses, when they do exist, operate in areas with low entry barriers and high competition. As such, these businesses result in low productivity that cannot lift the owners out of poverty (Karnani, 2008, p. 182). While smoothing consumption is absolutely necessary for social development, the fact that loans are not being used as working capital for income generation reveals potential barriers to the achievement of economic growth (Dichter, 2007c, p. 180). In this sense, the introduction of subsidies to MFIs and NGOs for the provision of credit might be justified and even encouraged.²¹

However, there has been a noticeable trend in the last few years concerning institutions' long-term sustainability. Grants from governments and donors have given rise to MFIs dependency on these funding sources, thereby defeating their ability to achieve their own self-sufficiency (Kumar, 2004, p. 112). As a result, organizations such as Bolivia's *Banco Sol* and Mexico's *Compartamos* have begun to seek private investors so that they can become more "independent" (Kaplan). Indeed, the challenge of self-sufficiency has become the recent focus of the microcredit movement. However, the shift towards commercial investment raises many questions about the role of the private sector and, in particular, commercial banks in the microcredit industry.

3.2. Commercial Banks

As a consequence of the "Microfinance Revolution", traditional financial institutions advocate for greater influence and are generally suspicious of long-term government subsidization plans (Rauch, 2005, p. 320). For instance, the World Bank suggests that the strategic position of banks – and not of NGOs – coupled with their government-granted authorization to provide guaranteed deposit insurance renders them more socially responsible than ordinary lenders (Kumar, 2004). This assumption, however, unfairly compares the advantages of savings and securities of large corporations with those of informal organizations. It is an unconvincing comparison because market-driven microfinance is based mainly on individual loans, credit-scoring support and expectations about the fulfillment of contractual terms (Pischke, 2007, p. 142). This is in stark contrast to the collective lending practices employed by grassroots microfinance institutions. Whereas traditional practices of microfinance relied on peer lending and forms of security based on relationships, commercial lending is concerned with risk-management and personal guarantees.²² The limits of even a "minimalist" (Pischke, 2007, p. 142) role of profit-driven MFIs becomes clear when compared to the original intentions of microcredit.

As Kumar states, there are obvious tensions between the logic of profit-maximization and social responsibilities (Kumar, 2004). For this reason, the participation of banks in this scenario should not be applauded without raising critical concerns about their real intentions. In 1997, ventures among policymakers, charitable foundations and practitioners raised over twenty billion US dollars (Rauch, 2005, p. 321). Currently, the amount is over thirty billion US dollars for MFIs (Burand, 2008-2009, p. 194), indicating a substantial shift from traditional poverty alleviation programs towards a profit-making microcredit industry. Moreover, these transformations are taking place incredibly quickly.²³ High repayment rates have been used as an argument in favor of the

²¹ See (Mahajan, 2007); (Rauch, 2005, pp. 328-329).

²² According to Williams, this shift has occurred due to the challenges of implementing group lending features among the mobile populations of rich urbanized societies. (Williams, 2004, p. 163).

²³ The financing of MFIs has been quickly changing in recent years as the sector becomes less reliant on donor grants and subsidies. "International (as opposed to domestic) investors also have become a significant source of this new funding EALR, V. 3, n° 1, p. 1-19, Jan-Jun, 2012

potential profitability of the activity. However, the affordability of these rates in the past was made possible by programs largely maintained by direct or indirect subsidies (Rauch, 2005, p. 321). As a result, concerns about repayment and refinancing have begun to emerge.²⁴

It is clear that it would not be possible to assist many low-income people who are economically excluded from society without private actors. The present article does not intend to entirely condemn their role in the overall picture. Moreover, it is unclear what the exact extent of the government's role should be in exercising its authority over the banking system. However, it is clear that there is a role for the state to play by introducing some forms of regulation on an activity that is invested in achieving both economic and social development.²⁵

4. Regulatory Framework Analysis and Microcredit Prospects

Microfinance has to be embraced by a regulatory framework that conciliates the aspirations of the financial industry with concerns about social equality. Due to the diversity of services provided by MFIs, policymakers face the dilemma of either adopting regulation focused on institutions' activities or on the institutions themselves. As a one-size-fits-all solution is not feasible, the present section highlights the main points that should be covered by a regulatory framework and outlines the major constraints facing such a system.

4.1. Institutional x Functional Perspective

The distinction between the regulation of the institutional versus the activity of the institution depends on whether MFIs are considered to be a specific type of entity regulated: (i) by a separate microfinance law (institutional) or (ii) "according to the economic function they perform, regardless of their institutional structure" (Staschen, 2003, p. 15). One of the main characteristics of many Latin American MFIs, for example, is the lack of a specific framework to accommodate commercial microfinance activities that are still regulated under the scope of general banking law (Keyes, *Protecting the Peace While Profiting the Poor: Microfinance and Terrorist Financing Regulation*, 2006).

For instance, the Brazilian system has been criticized for its excessive complexity and a discrete prejudice against profitable MFIs (Kumar, 2004, p. 128). As an exception, regulatory structures in Bolivia, Mexico (Keyes, 2006, p. 556) and South Africa (Staschen, 2003, p. 8) have been cited as simplified models that would help to expand business and promote investment. This comparison between different countries is particularly important because it demonstrates how regulation can result in microfinance success and, in turn, alleviate poverty. The following passage is illustrative (McNew, 2009, p. 291):

[...] A commonly held view was that "the flood of international capital, coupled with new domestic sources in many markets, means capital availability isn't the problem. In fact over abundance presents a much bigger risk". (Burand, 2008-2009, pp. 195-196).

²⁴ See further (Burand, 2008-2009).

²⁵ As a result of a bargaining problem, private and sometimes even public institutions do not have sufficient motivation to provide services to the economically disadvantaged population. Therefore, the attractiveness of the investment in the sector depends on a combination of efforts between public and private actors. Both creditors' and debtors' interests need to be considered if the private sector is expected to assist in the process of poverty alleviation. The role of the government is also essential. This is becoming increasingly obvious in contemporary theories of development that try to conciliate economic growth with human welfare. The proper balance between the public and the private still needs to be found. (Santos, 2006, p. 15); (Hudon, 2009, p. 21).

Regardless of the form that these institutions take, their goal is the same: to reach the “poor sectors of the economy and provide financial services to those individuals on a ‘sustainable basis’”. In the future, the fulfillment of that goal may have much less to do with how these entities are organized and much more to do with the regulatory structure in which they operate.

Nevertheless, there are good reasons to have serious reservations about the overreliance on regulation. This is because such a one-dimensional approach to microfinance is injurious to the goal of matching low-income people’s needs with their aspirations. Microfinance must be concerned not only with the service it provides, but also with the quality of the service and its ability to improve the welfare of the poor. Indeed, an examination of the different types of MFIs reveals the inappropriateness of a strategy that focuses on the output component of microfinance (i.e., financial services provision), and not on their effects (i.e., social,²⁶ network²⁷ or institutional²⁸). The understanding of these different dimensions and dynamics is imperative for a holistic impression of debt and, in turn, the role of MFIs in the provision of microfinance. Such an understanding of both capital and debt is crucial for developing a “bolder and more comprehensive attack on poverty” (I Matin, 2007, p. 24). In other words, it is necessary to analyze both the intentions and aspirations of the poor (what will they do with the money) and the way lenders interpret this provision of capital in their business programs.

Contrary to what some others have claimed (McNew, 2009, p. 106), the main reason why many non-profit MFIs are not sustainable or self-sufficient is not only due to “legal barriers” (O’Rourke, 2006), but also due to the ruling principles under which they operate. For instance, many NGOs have been granted regulatory exceptions such as flexible minimum capital and loss prevention requirements (O’Rourke, 2006, p. 304) that make them unable to receive deposits from the public. Such a scheme compromises their ability to become self-sufficient. In addition, many consider MFIs unsustainable because they only provide temporary aid to increase people’s income and re-insert them into the general financial system. Skeptics assert that this piece-meal arrangement keeps MFIs dependent on political bargains that compromise their long-term survival. It is a result of this precarious situation that a number of MFIs are seeking opportunities to widen their scope by acting as deposit institutions (i.e., by demanding transformations in the regulatory window in which they operate). However, this shift does not necessarily undermine their main philanthropic characteristics (Rosenberg, 2003, p. 87).

While there are obstacles to many microfinance NGOs accepting deposits from borrowers, the same cannot be said regarding commercial banks. The key problem is that, to increase microfinance accessibility, banks are now advocating for benefits that were initially created by non-profit organizations, arguing that their final aim is the same: to increase financial service accessibility to low-income populations. As has been argued above, equal treatment between NGOs and commercial banks is not possible, let alone desirable.

²⁶ Social capital is said to be based on a trust-based contract between formal institutions and individuals in their group. (I Matin, 2007, p. 24).

²⁷ Network capital serves to designate the reflecting relationship among producers, consumers and citizens with similar background and expectations resulting in a new culture of responsibilities and reciprocities. (I Matin, 2007) 24.

²⁸ The idea of institutional capital is connected to the ability of microfinance institutions to manage large scale delivering systems. (I Matin, 2007, p. 24).

4.2. Prudential and Non-prudential Regulation

Traditionally, the international microfinance regulatory framework has been distinguished by its reasoning and scope in two main areas: prudential and non-prudential regulation (McNew, 2009) (CGAP C. G., 2003, p. 7). While the former type is used to protect the financial system as a whole and the safety of small deposits in individual institutions (CGAP C. G., 2003, p. 7), the latter is used to prevent potential industrial abuses. Non-prudential regulation is thereby concerned with transparency, disclosure, control of ownership, consumer protection, fees, rates and financial performance (CGAP C. G., 2003, p. 7) (Kumar, 2004, p. 126). In order to conciliate the different types of MFIs operating in the microfinance sector while maintaining the importance of social and economic goals, a combination of these two approaches to regulation is necessary. Meanwhile, care must always be taken to ensure different countries' ability to enact regulations according to their specific needs and resources (McNew, 2009) (CGAP C. G., 2003, p. 8). In the global sphere, the entrance of commercial activity in microfinance has usually been subject to the same regulations that have been applied to traditional banks. This, according to the financial industry, has hindered MFIs' expansion across the globe (Keyes, 2006). In his recent study, Kumar (2004, p. 127) points out the pervasiveness of state intervention in microfinance regulation:

The emerging consensus points out that credit-only MFIs need not in general to be subject to prudential regulation, because the limited resources of a bank authority would be distracted regulating and supervising and institutions which public interest is not at stake. However, this does not preclude nonprudential or enabling regulations, which are aiming at preventing abuses in the industry and also at promotion through greater transparency... the debate focuses on whether there should be a special regulatory window for microfinance activities, or for MFIs, or whether this should be under the code applied to other financial institutions. As discussed, the risk profile is unique, and regulations may do well to require distinct treatment for microloans or institutions specialized in microfinance. Such windows may, for example, lower entry requirements or establish a higher capital ratio.

In order to address all of the potential modifications advocated by the private sector, a number of MFIs' features and aims should be considered. As previously mentioned, when MFIs work as deposit-taking institutions, their regulatory framework should be stricter than the ones constructed for the MLIs. However, this is not to say that a prudential regulatory framework is absolutely unnecessary for MLIs. Certainly, the claim that their downscale size would not pose "a significant risk to the banking system as a whole" (McNew, 2009, p. 307) is open to debate. That is because, as already outlined, the main reason for the establishment of prudential regulation is not restricted to the protection of deposits. It is also aimed at guaranteeing confidence in the financial system as a whole – in this case, the microsystem of microfinance.

For example, countries that suffered significant banking crises in the past might be more concerned with the solidity of the sector and its conformity with overall regulations. It is therefore difficult to criticize the Brazilian system of fragmentary regulations without evoking the reasons — such as the cultural, legal and economic — that result in the distinct treatment of civil society organizations (OSCIPs), microcredit societies *and* other types of finance (Kumar, 2004, p. 126). Additionally, prudent regulation is necessary to avoid misuse of MFIs²⁹ and to comply with specific requirements demanded by donors and government.

²⁹ For instance, preventing the use of MFIs and banks for criminal purposes is mentioned by Keyes. (Keyes, 2006).

On the other hand, there is a consensus that profitable institutions and deposit-taking institutions *should* be subject to prudential regulation (CGAP C. G., 2003, p. 10). The banking industry claims that this should be done with the least interference possible.³⁰ This is due to the complexity, high cost and administrative difficulties associated with regulations that not all developing countries can afford to construct or maintain (Kumar, 2004, p. 128). At the same time, some practitioners concerned about regulatory constraints call for high capital ratio requirements in order to avoid the “proliferation of different specialized regulatory windows” (Kumar, 2004). Such an unrestrained proliferation could inadvertently increase the number of regulated MFIs and reduce the effectiveness of prudential supervision in less wealthy countries (Kumar, 2004).

Although many argue that competition would maintain the affordability of loans offered by MFIs in these countries, the required removal of interest rate caps raises serious doubt about this possibility. Certainly, the existence of institutional deficiencies in developing countries undermines the plausibility of this hypothesis. The result would be the monopoly of fewer and more-empowered private financial institutions offering credit. These corporations would then be able to charge soaring interest rates based on the high risk incurred by microlending operations. This scenario raises grave concerns when one remembers that the purpose of microfinance is to enable people to overcome poverty.

In addition to the question of whether or not to impose interest rate caps (Dichter, 2007a, p. 5) (Ramsay, 2010), some important considerations should be raised here. Firstly, the private sector has been arguing that usury limitations constrain the profitability, expansion and sustainability of microfinance. Moreover, they claim that these limitations prevent their ability to outreach to and access the spectrum of borrowers that could benefit from credit availability. Nevertheless, it should be noted that the central tenet of microfinance is to be an enabling structure rather than being an end in itself. Therefore, the expansion of the industry has to be monitored accordingly – not just for credit accessibility but also for its ability to provide enabling opportunities to low-income beneficiaries.³¹ Contrary to what has been said by the industry, there is no consensus about the liberalization of interest rates³² and microfinance should not be the most profitable industry for the private sector if developmental goals are to be meaningfully pursued.³³

As a case in point, and as mentioned above, one of the most successful programs of microfinance, the Grameen Bank in Bangladesh started its activities in the 1970s. It was begun by Muhammed Yunus and aimed to offer villagers credit at reasonable rates.³⁴ The bank has grown considerably over the years, and has never compromised its main philanthropic features – until now. Recent data shows that, in the last few years, Grameen Bank achieved sustainability through profit growth (GrameenBank), even though the affordability of loans has been maintained by subsidies for the past several years. Now, however, that is changing (Rauch, 2005, p. 323):

³⁰McNew addresses the “principle of avoiding the use of burdensome prudential regulation for non prudential purposes that is, purposes other than protecting depositors’ safety and the soundness of the financial sector as a whole.” (McNew, 2009).

³¹ “[...] Along the way Catholic Relief Services (CRS) learned that through microcredit the poor were poor twice, once from initial circumstances and twice from high interest rates.” (Wilson K. , 2007, p. 97).

³² Regarding the interest rate ceilings polemic, see (Ramsay, 2010).

³³ The assumption that “interest rate caps, where they are enforced, almost always hurt the poor by limiting services” should also give further consideration of others adverse effects that also *hurt* considerably the poor such as credit unaffordability, inability of repayment and their consequential financial exclusion. (CGAP C. G., 2003).

³⁴ See further (GrameenBank, A Short History of the Grameen Bank, 2012).

Most loans are for one year with a nominal interest of 20 percent [...] Calculations [...] suggest, however, that Grameen would have to charge a nominal rate of around thirty two percent in order to become fully financially sustainable (holding the current cost structure constant). The management argues that *such an increase would undermine the bank's social mission*, but there is little evidence that speaks to the issue [...] ³⁵ (emphasis added).

Notwithstanding that MFIs should not be restricted to non-profit organizations, and that business-like (Dichter, 2007a, p. 4) features may require critical reflection by regulators, the negotiability, extension and justification of limits on interest rates should be open to debate. Yet, the peculiarity of the microfinance scenario should not be forgotten, especially the circumstances surrounding borrowers' miserable economic conditions and vulnerability.³⁶ The main priority should be to decrease unsustainable levels of debt that hinder people's wellbeing (Allen, 2007, p. 49). Indeed, the focus on lenders' aspirations rather than on borrowers' conditions might result in over-inflated expectations (Dichter, 2007a, p. 2) that are unhelpful in achieving the intentions and aspirations of debtors and, as such, the ultimate goal of microfinance itself.

4.3. Constraints and Challenges: conciliating microcredit industry with social goals

The correlation between microcredit, the sustainability of MFIs and poverty alleviation is as of yet unclear.³⁷ Indeed, recent analyses have been reporting contradictory results.³⁸ It should be noted that the economic development of low-income populations and any consequent poverty reduction does not depend on microcredit being made more accessible but rather on the ability of people to repay their loans (including, of course, the conditions under which that is made possible). Low-income people's welfare is dependent on a number of social factors such as employment and other income generating activities that are facilitated and improved by financial access, but not a natural result of it. In other words, "to have capital is the result of economic achievement, not its precondition".³⁹

Studies show that financial access should begin with savings instead of loans (Allen, 2007, p. 49). However, until this situation can be achieved microcredit remains central in combating poverty. The challenge then is to turn microcredit into an effective instrument to overcome poverty rather than act as a temporary "antidote". Microcredit programs demand critical attention, not only because poverty is classified in terms of limits to services and goods, but also because of the emerging

³⁵ Accordingly to Allen, "it should be no surprise that Grameen and many others MFIs have recently discovered that their loan portfolios can easily be supported by member savings, reducing dependence on money markets and donor funds, especially when saving products allow for easy, constrained withdraw". Even though, the author recognizes the challenges of sustainability of the majority of MFIs. (Allen, 2007, p. 57).

³⁶ Allen addresses the straightforward relation between poverty and vulnerability: "the poorer you are the more affected you will be by social and economic shocks and stress, and the better you are the more you can cope". (Allen, 2007, p. 49).

³⁷ See (Rauch, 2005); (Dichter, 2007a, p. 4); (Harper, 2007); (Karnani, 2008).

³⁸ For instance, regarding refinancing and the rates of repayment of MFIs over the last years and based on CGAP data, Burand foresees an increasingly outstanding debt in 2009 and 2010. Considering the relation between CGAO and the World Bank, the contradictory results deserve attention. This fact indicates the need to reformulate the World Bank's paradigm of microfinance that is constructed on factors such as low defaults by borrowers and high repayment rates. (Burand, 2008-2009, p. 198), (Kumar, 2004, p. 77).

³⁹ Dichter citing Peter Bauer has highlighted: "to have capital is the result of economic achievement, not is precondition. Capital, especially the lending of it is after all what most of microfinance is about. And we in the microfinance movement have indeed assumed that it is a precondition of development". (Dichter, 2007c, p. 191).

aspirations to turn the microcredit industry into a highly profitable sector.⁴⁰ The limitations of the conventional banking system in this arena are clear and, as argued above, are contrary to the original aims of microfinance.⁴¹ As such, the anticipated outcomes of microcredit programs must be reconsidered, as they alone cannot achieve development goals.⁴²

Microcredit should aim to reduce the financial exclusion of low-income populations.⁴³ However, microfinance should also minimize the potentially costly effects that this inclusion might generate (Wilson T., 2008). Surveillance, supervision and regulation should ensure that mainstream financial institutions lend to low-income populations on fair and reasonable terms. As already stated by Harper (2007, pp. 258-259):

Less pervasive, but more serious, than exaggerated expectations is the damage that microfinance can do. At a national level it may distort a whole economy, and at the individual level it can destroy a person's self-respect and even life. [...] but it is surely unacceptable that an intervention that is intended to help the poor should injure any of them.

The main challenge is then to harmonize profit and non-profitable organizations within MFIs. However, the establishment of a set of rules should not be adopted before discussions about what a desirable framework might look like. These discussions should also highlight the benefits and drawbacks incurred by the introduction of financial services to low-income populations. Certainly, it is crucial to realize that lending money to the poor can potentially generate more harm than good (Rauch, 2005, p. 327). For example, if poor clients cannot repay their debt, they will find themselves in a more miserable condition than when they originally asked for credit. They will face more difficulties in their efforts to get out of this debt and be restricted from accessing further financial help. Consequently, although microcredit often brings about positive results, the path to poverty alleviation must also go beyond microcredit. If development is indeed the goal, the outcomes of microcredit programs should be measured by their ability to minimize poverty rather than merely maximizing profitability.⁴⁴

⁴⁰ Nowadays it is publicly stated that "the microfinance industry, with over \$60 billion in assets, has unquestionably outgrown its charitable roots". (MacFarquhar, 2010).

⁴¹ In a critique of the structure of the westernization of institutions and concepts, lessons taken from Pollard and Samerson on Islamic finance adoption are useful. The idea is to untie biased minds that look at microfinance (analogically to what they refer to Islamic finance) as a "waiting room" to reach capitalist modernity based only on profit maximization. Looking at the results of an entire industry built of tiny loans without being aware of microfinance logic and justifications can be extremely harmful to the achievements of the ends it is supposed to serve. "Instead of assuming that these practices are fads, or will either fade or become co-opted into the 'mainstream', perhaps we should explore their diversity, the ends they serve and how, and in what circumstances, they proliferate". (Samers, 2007, p. 325).

⁴² Ditcher recommends: "If it is not we need radically to reduce our expectations about microcredit, and thus better align ourselves with reality". (Ditcher, 2007c, p. 191).

⁴³ There are constant criticisms regarding how well MFIs address poverty alleviation. As it is up to members to select their own group members, a field study in Malawi revealed that certain women were being systematically excluded from groups: namely women living with HIV or AIDS. (Farrer, 2008, p. 459).

⁴⁴ The impact of loans and repayment requirements on low-income populations are immense. For instance, "minimizing poverty as measured by the commonly used 'squared poverty gap' suggest that raising the poor's borrower's income by one dollar has five times greater impact than doing the same for less poor borrower [...]. The comparison is too simple, but it amply illustrates how social weights and depth outreach can outweigh concerns with scale [...]. The third issue is the key to efficiency is the maintenance of hard budget constraints, but not necessarily profits [...]. The lessons can be applied more widely and used to promote efficiency and improve targeting in a broader range of subsidized programs". (Rauch, 2005, p. 327).

5. Conclusion

Microcredit has emerged as a new hope in delivering one of the most challenging and ambitious promises of the twenty first century: poverty alleviation. In an era where finance rules the economy, it is not surprising to find that aid, assistance and support have been financialized as well. There are several advantages brought about by microfinance expansion. For example, it assists individuals who lack assets by offering innovative methods of obtaining access to financial services. However, within microfinance, microcredit is certainly the most enigmatic tool because it has the potential to both improve and erode low-income people's welfare. Indeed, the perpetuation of debt will result in more than financial exclusion – it will also mean social segregation and the undermining of the livelihood of the vulnerable individuals who opt for credit. The challenge is to conciliate different socioeconomic functions of MFIs in the international regulatory system so as to avoid perpetuating increasing rates of debt among poor borrowers.

For this reason, it is crucial that a discussion about the desirable regulatory framework of microfinance be started anew. This discussion must prioritize the pursuit of social goals in the microcredit industry. Therefore, as the debate about interest rate caps has returned, more than ever, their effectiveness should be judged in terms of the affordability of financial services offered to the poor. In the same vein, although government subsidies are considered controversial, they have helped produce many of the achievements already made by microcredit and their value should not be wholly discounted. Finally, the entrance of private actors in the field brings about new challenges. However, the question is whether independence from government would not simply mean substituting it with dependency on private capital and, furthermore, whether the price to be paid for this new scheme is not too high to be paid by low-income people. The conciliation between private and public interests is only as effective as its ability to maintain microcredit services to the poor; regulation must also be developed in pursuit of this goal.

The present study recognizes the importance of microcredit in its various forms and the insufficiency of one over-arching formula to achieve the best system of microfinance regulation. For instance, it is not feasible to equally regulate both NGOs and commercial banks. The former often functions under a regulatory window with flexible minimum capital and loss prevention requirements that are directly linked to their philanthropic features. The latter, on the other hand, often working as deposit-taking institutions, demands more severe regulations under which they can safely operate. At the same time, it remains crucial for the survival of the *homo economicus* that more people have access to credit. Therefore, the role of commercial banks and policy strategies can be justified if financial inclusion *and* poverty alleviation are achieved. As of yet, however, concrete results in this area are yet to be seen. Hence, microcredit programs should not be mindlessly applauded, but, rather, critically analyzed. As stated above, prudential and non-prudential regulation should be used according to MFIs' features. This reflective, multi-pronged approach will present different frameworks so as to account for various countries' needs, capabilities and infrastructure. Moreover, the circulation of these different frameworks will in turn promote innovative ideas and efficient practices. However, it is clear that economic growth does not begin with debt, and unrealistic expectations about the potentials of microcredit have to be curbed by recognizing that there are limits to what MFIs can do. Microcredit is certainly not an end in itself. Rather, it is an enabling structure to help to alleviate poverty by reinserting low-income people back into the formal financial market. This is the real relation between microcredit and development.

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