Increasing Microlending Potential in the United States Through a Strategic Approach to Regulatory Reform

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I. INTRODUCTION

After 30 years of lending money to poor people in developing countries to encourage entrepreneurship, microfinance institutions (MFIs) have become generally accepted in the international community. The United Nations named 2005 the International Year of Microcredit. President Bill Clinton sang its praises. Microlending has appealed to both liberals and conservatives in U.S. government. Muhammad Yunus, and the Grameen Bank he founded, were recently given a Nobel Peace Prize, and Business Week named Yunus one of “The Greatest Entrepreneurs of All Time.” Many international MFIs have become self-sufficient and enjoy repayment rates in the high 90 percentages. Microloans have supplied billions of dollars in small loans to millions of people struggling to start and expand businesses. Despite this international success,
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microcredit efforts in the United States are nowhere near self-sufficient, face high default rates, and are not meeting microentrepreneurs’ needs.

This Note explains microlending in general, and then examines its implementation in the United States. It then analyzes why U.S. MFIs have not reached self-sufficiency at the same levels as international MFIs. Next, this Note examines the various proposals different scholars and practitioners have offered to address the limitations of microcredit in the United States. This Note next recommends the most promising solutions, which center on regulatory reform. The proposed regulatory reforms aim to strengthen the sustainability of microlending in the United States. The Note then offers a practical political strategy to implement these reforms—something largely missing from academic literature on microlending in the United States.

II. BACKGROUND

This Part explores the history of microcredit, both abroad and in the United States. It then explains U.S. microlending in more detail, and outlines the demand for more sustainable microlending practices in the United States. Finally, this Part explores the U.S. regulations that most directly affect microlending practices.

A. A Brief History of Microcredit and Its Success in Developing Countries

Since their inception in the 1970s, MFIs have offered economic opportunities to poor people, in part by lending small amounts of capital to borrowers who use it to fund their small businesses.8 MFIs generally lend to microbusinesses, which are businesses with five or fewer employees.9 MFIs offer many different services,10 but this Note focuses specifically on the microlending function of MFIs. This Part will briefly explain the process and history of international microlending.

1. Functions and Effects of International Microlending

Commercial banks in developing countries generally serve less than 20% of the population.11 Microcredit institutions step in to fill the void in the lending market by offering small loans, ranging from roughly $10–$1000, to poor people attempting to start businesses.12 The borrowers are people to whom traditional financial institutions will not lend because of the high transaction costs and high risks associated with lending to microentrepreneurs.13 Borrowers’ incomes and quality of living often increase as a result

8. Jaffer, supra note 6, at 183–84.
10. Other microfinance services in addition to microlending include savings and checking accounts, and pension and insurance services. CGAP, What is Microfinance?, http://www.cgap.org/p/site/c/template.rc/1.26.1302 (last visited Jan. 20, 2009).
13. Id.
of receiving these loans. The duration of the loan is typically less than two years, and microlenders usually require that the loan be used for productive capital purposes rather than consumption. Acceptable uses include purchasing raw materials and supplies like food ingredients, sewing machines, or more recently, cell phones—materials necessary to start and expand the business operation.

Microlending institutions typically do not require borrowers to give collateral or undergo credit checks, but instead rely on alternative methods to reduce risks associated with lending. For example, the Grameen Bank relies on peer lending circles. These lending circles use social pressure to encourage borrowers to repay, since, in some cases, the group has joint responsibility for the loan or cannot obtain another loan until one borrower has repaid. Other methods include information gathering about a potential borrower, joint liability contracts, short term contracts, or “loan ladders,” which increase subsequent loan amounts after each repayment.

2. Microlending’s History and Successes

In its relatively short history, microcredit has reached a vast number of poor people in over 100 developing countries throughout South and Central America, Africa, and Asia. Between 1997 and 2006, ACCION International (ACCIION), a premier microfinance organization, lent $12.3 billion to 4.94 million people, with a repayment rate of 97%. Similarly, the Grameen Bank loaned more than $750 million in a two-year period, with a 97% rate of repayment. Such high repayment rates show that many international MFI’s have reached self-sufficiency.

ACCIION and Muhammad Yunus, founder of the Grameen Bank, claim to have both independently pioneered the concept of microcredit. In the early 1970s, ACCION

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15. Jaffer, supra note 6, at 184.
17. See O’Rourke, supra note 12, at 183.
18. The Grameen Bank was one of the original microfinance institutions and was founded by Muhammad Yunus in the 1970s and 80s. The bank now has over three million members and over 2400 branches internationally and has disbursed $6.5 billion in loans since its inception. Grameen Bank Historical Data Series 2003, http://www.grameen-info.org/index.php?option=com_content+task=view+id=314+Itemid=301 (last visited Jan. 20, 2009); Grameen Bank at a Glance, http://www.grameen-info.org/bank/GBGlance.htm (last visited Jan. 20, 2009).
19. Anderson, supra note 1, at 106.
20. See id. (describing lending circles generally).
24. Jaffer, supra note 6, at 185.
25. Id. at 184.
volunteers struggled to address the high unemployment rates in South American cities.\textsuperscript{27} Unemployed urban poor in these cities started their own enterprises selling hand-woven belts, handmade pots, or vegetables.\textsuperscript{28} ACCION staff observed that local loan sharks charged the entrepreneurs outrageous interest rates, which usually left borrowers broke.\textsuperscript{29} In response, ACCION offered small loans with lower interest rates to small business owners, thus “launch[ing] the field of microcredit.”\textsuperscript{30}

Around the same time, economist Muhammad Yunus was exploring the potential for small loans to ease poverty in developing countries.\textsuperscript{31} In 1976, Yunus was a professor and head of the Rural Economics Program at the University of Chittagong.\textsuperscript{32} As part of his research with the program, he initiated a project to study the “possibility of designing a credit delivery system to provide banking services targeted at the rural poor.”\textsuperscript{33} After seeing the effects unemployment and poverty had in Bangladesh, he loaned $27 to a group of women who made bamboo furniture.\textsuperscript{34} Based on their success and subsequent repayment, he expanded this concept of microlending and eventually formed the Grameen Bank, a nongovernmental organization (NGO).\textsuperscript{35} In 1983, Bangladeshi legislation made the Grameen Bank Project an independent bank.\textsuperscript{36} Currently, 90% of the bank’s shares are owned by borrowers, and 10% are owned by the government.\textsuperscript{37} Today, the Grameen Bank extends loans to nearly two million borrowers in Bangladesh.\textsuperscript{38}

During the 1970s, NGOs and donor groups began to offer microcredit in developing countries.\textsuperscript{39} NGOs and donor groups still make up the majority of microlenders, but the number of commercial microcredit providers is increasing.\textsuperscript{40} Commercial suppliers range from commercial banks that modify their traditional lending practices, to credit unions, to commercialized NGOs that become licensed as financial institutions.\textsuperscript{41} For example, the Postal Savings Banks represent a typical MFI—they reach poor rural areas by locating offices in rural postal offices.\textsuperscript{42} Postal Savings Banks operate similarly to traditional commercial banks, except that they offer more flexible loan terms.\textsuperscript{43} Most MFIs seek grants from international development banks and the government, and many are starting to solicit private investors in an effort to reach self-sufficiency.\textsuperscript{44}

\begin{itemize}
\item \textsuperscript{27} ACCION History, supra note 22.
\item \textsuperscript{28} Id.
\item \textsuperscript{29} Id.
\item \textsuperscript{30} Id.
\item \textsuperscript{31} Short History of Grameen, supra note 26.
\item \textsuperscript{32} Id.
\item \textsuperscript{33} Id.
\item \textsuperscript{34} Making the Dollar Go Further, the Yunus Way, http://muhammadyunus.org/content/view/157/128/lang,en/ (last visited Jan. 20, 2009).
\item \textsuperscript{35} Id.
\item \textsuperscript{36} Short History of Grameen, supra note 26.
\item \textsuperscript{37} Id.
\item \textsuperscript{39} See Jones, supra note 11, at 193 (explaining how NGOs pioneered microfinance).
\item \textsuperscript{40} Id. at 193–94.
\item \textsuperscript{41} Id. at 194.
\item \textsuperscript{42} See O’Rourke, supra note 12, at 183 (describing how the Postal Savings Banks operate).
\item \textsuperscript{43} Id.
\item \textsuperscript{44} Id.
\end{itemize}
3. Microlending and the Market

Some scholars and practitioners have debated whether microlending occurs within or outside the market—whether the practice of microlending has “embraced market mechanisms or has . . . elaborated other disciplinary mechanisms.”45 Some see MFIs as working within the existing global market, while others see MFIs as creating their own “faux markets for the poor.”46 Some have questioned whether MFIs would be necessary at all if traditional lending institutions found lending to the poor to be profitable.47 Since microlending processes—supplying capital and requiring repayment—involves market principles, however, and not government subsidies, this Note examines microlending within the market framework. Under this perspective, microlending occurs in a capitalistic, efficient system and not in a vacuum. Further, many MFIs have found microlending to be a profitable enterprise. For example, the microlending division of Bank Rakyat Indonesia reported $200 million in profits,48 and the Grameen Bank reported $20 million in profits for 2006.49

Within this market context, microloans seem to be a hybrid of both banking and venture capital principles.50 MFIs utilize banking terms like credit, interest rates, and rates of return.51 Like banks, MFIs require fixed interest rates and do not take any portion of the borrower’s profits.52 But in practice, microlending often resembles venture capital lending, in which lenders make riskier loans and more closely monitor and manage the borrower’s use of the loan.53 As this Note explores in Part IV, consciously identifying where MFIs fit within this divide could help MFIs become more sustainable, to the extent they can select successful practices in both banking and venture capital.54

Some critics argue that microlending’s success has been exaggerated, noting that microcredit does not reach all poor people who need loans.55 Studies on MFI sustainability vary: one study showed that only about 70 MFIs, or one percent of MFIs worldwide, are sustainable,56 while other studies indicate that roughly 30% of MFIs are sustainable.57 Some studies have questioned the statistics indicating high repayment rates and argue that lenders are justified in requiring traditional collateral because such loans are risky.58 Despite these concerns, microloans have given millions of struggling

45. Anderson, supra note 1, at 87.
46. Id. at 88.
47. Id. at 97.
50. Anderson, supra note 1, at 104–05.
51. Id. at 105.
52. Id.
53. Id.
54. Id.
56. See O’Rourke, supra note 12, at 179.
57. Berkman, supra note 48, at 336.
58. Anderson, supra note 1, at 98.
entrepreneurs the funds to start or expand successful businesses, and many lending institutions are self-sustaining. Even if the current majority of MFIs are not self-sustaining, many of the strongest MFIs are moving toward that goal. One reason MFIs are not self-sufficient is that the commercialization of MFIs is a relatively recent trend. Microcredit programs are not a cure-all, but few critics can point to programs that have done more to alleviate poverty and generate capital in developing countries.

B. Background on Microcredit in the United States

Despite microcredit’s prevalence and success in many developing countries, efforts to promote entrepreneurship through microcredit among poor people in the United States have been less successful. Less than one percent of microentrepreneurs in the United States have received microloans to date. U.S. MFIs have failed to reach the level of self-sufficiency that many international MFIs have attained. Default rates are higher on U.S. microloans. U.S. markets are more saturated than those in developing countries and provide fewer opportunities for entrepreneurs to pursue. This Part provides a brief history and explanation of microcredit in the United States.

1. History and Overview of Microlending in the United States

Microcreditors began lending in the United States in the 1980s and modeled their lending, in part, after programs used by ACCION and the Grameen Bank. MFIs in the United States expanded during the 1990s, leading to a presence of nonprofit lenders in all 50 states, as well as state associations and a national trade association. U.S. MFIs are generally nonprofit organizations rather than commercial institutions. Microloans are usually made in amounts under $25,000, and the average microloan is for $10,000.

59. See Barr, supra note 2, at 282 (citing the Microfinance Exchange study, which found that roughly 40% of the MFIs it tracks were financially self-sufficient).
60. See id. at 282 n.59 (explaining that data on MFIs that showed about 40% of MFIs were self-sustaining does not show “that the industry as a whole is moving towards financial self-sustainability, but rather that a significant part of the best institutions are doing so”).
61. EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, SUSTAINABILITY OF MICROFINANCE BANKS: THE ULTIMATE GOAL, (2003); Francesca Pissarides et al., Sustainability of Microfinance Banks: The Ultimate Goal, Lit ONLINE (European Bank for Reconstruction & Dev., London, Eng.), Autumn 2003, at 7, available at http://www.ebrd.com/pubs/legal/lit032c.pdf (arguing that the commercialization of microfinance is a relatively new focus in microfinance, since the past focus had mostly been on providing financial services to the poor, and so lower numbers of self-sustaining MFIs will likely increase due to this new focus).
62. BURRUS, supra note 9, at 6.
63. Id.
64. See id. at 13 (claiming that “specific methodological innovations” made “efficiency and scale possible” in the international scene and that the microenterprise field in the United States “should consider how to better utilize technology to create greater efficiency and scale”).
65. See Lee, supra note 38, at 530 (explaining why U.S. microloans have higher default rates).
66. See Berkman, supra note 48, at 349 (explaining the saturated U.S. mortgage market).
67. See id. at 337 (explaining that “[m]icrocredit was in its infancy in the U.S. . . . [and] had been modeled on efforts abroad spearheaded in the 1970s”).
68. BURRUS, supra note 9, at 4.
69. Id.
Unlike efforts in developing countries, U.S. microlending typically does not involve peer lending groups, a method that has contributed to microlending successes internationally. A 2002 report identified 650 microfinance organizations in the United States, comprised of MFI-focused groups like ACCION USA, credit unions, and centers at universities. ACCION USA has loaned over $100 million to 10,000 borrowers in the last 14 years. The average loan is roughly $4500, with a five percent cumulative loss rate. The average cost recovery (the cost of covering all expenses associated with the loan) for the MFI-focused organizations is 49%. Currently, the U.S. microcredit field faces numerous challenges. Recessions have resulted in job losses, which in turn result in more people becoming self-employed. This presents an opportunity for microlenders. But at the same time, financial assistance to microlenders has dropped, due to the Bush Administration’s lack of interest in microlending, limited federal funds, and donors who have started limiting their contributions to microcredit institutions.

2. Microentrepreneurs and the Need for Microcredit in the United States

Though MFIs have not reached large portions of the U.S. population, the need for their services is great. Many microentrepreneurs cannot successfully obtain loans through traditional banking institutions, in part because they lack the credit history most banks require. Although microbusinesses are difficult to track, one study claims that there are around 13.1 million microentrepreneurs in the United States. Of those 13.1 million microentrepreneurs, 10.8 million have never received a loan for their business. Most traditional commercial banks do not lend to people without sufficient credit history or collateral, which many microentrepreneurs do not have.

Though the need for microloans is great, MFIs in the United States fall short of filling this void. This is true, in part, because MFIs are not self-sufficient. While ACCION USA, one of the most prominent U.S. microlenders, has been lending in the United States for over ten years, its “goal of creating programs that are financially self-sufficient is still illusory.” ACCION defines “self-sufficiency” as the ability to generate

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71. BURRUS, supra note 9, at 4. Borrowers in lending circles exert pressure on one another to repay loans. Anderson, supra note 1, at 106.
72. BURRUS, supra note 9, at 4.
73. Id. at 9.
75. BURRUS, supra note 9, at 6.
76. Id. at 15.
77. See id. at 2–3 (describing how 10.8 million of the 13.1 million microentrepreneurs had never received a bank loan for their microenterprise).
78. Id. at 1.
79. Id. at 3.
80. BURRUS, supra note 9, at 3.
81. See Jones, supra note 11, at 208 (explaining how many potential borrowers have not established a credit history).
82. BURRUS, supra note 9, at 11.
83. Id.
enough revenue from lending to cover operation costs.\textsuperscript{84} In the United States, ACCION is just 25\%–63\% self-sustaining, where 100\% represents fully self-sustaining lending.\textsuperscript{85}

3. Regulation of Microcredit in the United States

Nonprofit microlenders in the United States are largely unregulated.\textsuperscript{86} Beyond general IRS regulations for nonprofits and state small business and consumer laws, U.S. nonprofit microlenders face no regulations.\textsuperscript{87} Congress and lending organizations have started to establish some accreditation standards, and MFIs have to undergo a certification process and become a Community Development Financial Institution in order to receive federal funds.\textsuperscript{88} For microcreditors to meet the needs of microentrepreneurs, Congress must promulgate regulations focused on reducing transaction costs, as this Note explores in Part III.

Commercial banks that partner with MFIs are still subject to traditional banking regulations. Under these regulations, two of the major impediments to U.S. MFIs reaching sustainability or profitability are interest rate ceilings and the possibility of excessive interest rates without interest rate caps.\textsuperscript{89} Interest rate ceilings limit banks’ ability to raise revenue, which obviously limits a MFI’s ability to be self-sustaining.\textsuperscript{90} However, to completely abolish ceilings and charge excessive interest rates to the poor not only looks unseemly,\textsuperscript{91} but also risks breaking usury laws. In the United States, each state has usury laws that limit the interest rates lenders can charge on certain types of loans.\textsuperscript{92} These laws apply to lending in various areas, but in the area of small business loans, states enact usury laws to protect borrowers from interest rates that put too great a burden on borrowers.\textsuperscript{93} To fall within most states’ legal requirements, a lender can charge up to a ten percent interest rate.\textsuperscript{94} Higher interest rates would help microlenders cover all the costs associated with smaller loans that are considered more risky, and thereby reach profitability.\textsuperscript{95}

Some MFIs, like ACCION, have had success partnering with banks, in part because of the Community Reinvestment Act (CRA) of 1977.\textsuperscript{96} When banking industry regulators rank banks, the CRA requires them to consider whether the banks offer

\textsuperscript{84} Id.
\textsuperscript{85} Id.
\textsuperscript{86} Id. at 14.
\textsuperscript{87} BURRUS, supra note 9, at 14.
\textsuperscript{88} Id.
\textsuperscript{89} See Berkman, supra note 48, at 341.
\textsuperscript{90} Id.
\textsuperscript{91} See id. (arguing that high interest rates on loans for poor people “look bad”).
\textsuperscript{93} Id.
\textsuperscript{94} Id.
\textsuperscript{95} See infra Part IV (describing increased interest rates).
\textsuperscript{96} BURRUS, supra note 9, at 10. Congress enacted the CRA to encourage “depository institutions to help meet the credit needs of the communities in which they operate . . . consistent with safe and sound banking operations.” Community Reinvestment Act Background and Purpose, http://www.ffiec.gov/cra/history.htm (last visited Jan. 20, 2009).
services in low-income communities. Congress passed the CRA, in part, because the government could not maintain certain community programs without help from the private sector. The CRA encourages banks to serve “the credit needs of its community.” The CRA has resulted in more lending to “traditionally un-banked groups,” but it also faces significant limitations in lending to low-income borrowers. The CRA and microlending share common goals of meeting financial needs of poor people, and these CRA provisions could be addressed through microcredit institutions and the services they offer to low income communities.

Capital holding requirements, which require banks to hold a certain amount of capital against each loan they distribute, directly affect commercial banks’ involvement with microlending. Generally, the more risky the loan, the greater the amount of capital a bank must hold. The Basel Capital Accord (Basel I), promulgated by a group of central banks and supervisory authorities in different countries, known collectively as the Basel Committee on Banking Supervision, sets standards for banks internationally, as well as in the United States. Basel I requires that banks have available as regulatory capital at least eight percent of their risk-weighted assets (loans, for example) and “asset-equivalent off-balance-sheet exposures” (loan commitments, for example). Assets in this case are determined by assessing the type of risk the loan presents; the higher the risk, the greater the bank’s minimum capital requirement. Such requirements serve as an impediment to banks making loans they might consider high-risk. Many in the banking industry are pushing for reforms to Basel I, and banking agencies in the United States will most likely adopt the proposed New Basel Capital Accord, or Basel II.

C. Differences Between U.S. and International Microcredit Markets

Microlending’s success in developing countries and relative lack of success in the United States can, in many ways, be attributed to differences between the markets in developed and developing nations. Rashmi Dyal-Chand, assistant professor of law at Northeastern University School of Law, argues that microlenders in developing countries

97. BURRUS, supra note 9, at 10.
98. Berkman, supra note 48, at 342–43; see also infra Part III.A.1 (discussing the CRA).
99. Jones, supra note 11, at 196; see also 12 U.S.C. § 2901 (1977) (stating that regulated financial institutions have a continuing and affirmative obligation to meet the credit needs of the local community).
100. Jones, supra note 11, at 197–98.
103. Id. at 396.
104. Id. at 395 n.1.
105. Id. at 396.
106. Id.
107. Capital Standards for Banks, supra note 102, at 397.
108. Id. at 396.
109. Id. at 397. This Note analyzes possible solutions to the limitations presented by capital requirements in Part III infra.
110. Dyal-Chand, supra note 4, at 248.
have been more successful because their markets are much less formal than U.S. markets.\textsuperscript{111} This informality allows “quicker, easier, and deeper penetration of the market by new entrants.”\textsuperscript{112} Since business structures are generally less formal in developing countries, entrepreneurs often do not have to invest as much into formal transaction instruments like written contracts.\textsuperscript{113} These market differences suggest that U.S. microentrepreneurs need more market-specific information, including whether a business idea would be financially viable given the current market, in order for their business endeavor to be successful.\textsuperscript{114} In contrast, developing countries have a greater need for many different types of enterprises, causing microentrepreneurs to worry less about market saturation.\textsuperscript{115}

1. Logistical Limitations

Several logistical limitations increase the transaction costs of microlending in the United States. First, the high costs required to collect qualifying information on potential borrowers and to enforce repayment once a borrower qualifies impede sustainability.\textsuperscript{116} Microlenders have high financial investments because most borrowers do not have traditional collateral.\textsuperscript{117} Second, because borrowers have so few assets, microlenders cannot enforce repayment through asset foreclosure, which otherwise provides a relatively efficient means of enforcing repayment.\textsuperscript{118} Finally, U.S. usury laws prevent banks from charging interest rates similar to international MFIs.\textsuperscript{119} For example, the Grameen Bank charges higher interest rates in Bangladesh than MFIs can charge in the United States.\textsuperscript{120}

2. Theoretical Limitations

Beyond logistical limitations, microlenders and scholars point to other theoretical limitations on microlending in the United States. Generally, poor people without credit histories have limited knowledge about how the credit market works and how to most effectively participate in the market.\textsuperscript{121} Most microlenders in developing countries have addressed this issue\textsuperscript{122} while microlenders in the United States have not.\textsuperscript{123}

Given the relative differences in the formality of U.S. markets compared to developing countries’ markets, scholars suggest that U.S. microlending would be most successful if microlenders adopted methods consistent with U.S. markets rather than try

\textsuperscript{111} Id.
\textsuperscript{112} Id. at 248–49.
\textsuperscript{113} Id. at 249.
\textsuperscript{114} Id. at 249–50.
\textsuperscript{115} Dyal-Chand, supra note 4, at 248–50.
\textsuperscript{116} Id. at 267.
\textsuperscript{117} Id.
\textsuperscript{118} Id.
\textsuperscript{119} Id.
\textsuperscript{120} Dyal-Chand, supra note 4, at 267.
\textsuperscript{121} Id. at 277–78.
\textsuperscript{122} Id. at 268–70 (describing the success of solidarity circles in developing countries and the failure of solidarity circles in the United States).
\textsuperscript{123} However, some U.S. MFIs, like ACCION, offer significant training to borrowers.
to mimic methods used in developing countries. For example, some scholars have recommended the “formalization of credit transactions” so that the loan agreement consists of a “clear and unambiguous written contract.” Proponents of formalized microloan transactions argue that “the more objective and simple that document is, the easier it should be to enforce, and the more transparent and efficient the loan transaction should be.” To fully understand the impediments to U.S. MFI sustainability, and possible solutions, this Note provides further analysis below.

III. ANALYSIS

Many scholars and microcredit practitioners have analyzed microcredit’s limitations in the United States and offered potential solutions to increase microlenders’ ability to make more successful loans. Most proposals center on making MFIs self-sustaining through regulatory reforms encouraging commercial banks to partner with microlending organizations. This Part examines the various regulatory approaches to microlending and critiques the possible regulatory reforms that scholars suggest could help microlending institutions reach sustainability in the United States.

A. Current Regulations Affecting Microlending

Although the field of microlending is largely unregulated in the United States, community banking, usury, and capital regulations directly impact microcredit’s success. This Part analyzes the three major regulations affecting microlending. First, many practitioners and legal scholars have explored the relationship between the CRA and increasing microlending’s profitability. Second, laws capping interest rates directly impact microlending practices. The third and least explored regulations are minimum capital holding requirements.

1. The Community Reinvestment Act

Some observers have looked to the CRA to encourage more successful U.S. microlending. The CRA’s goals are similar to those of microlenders in that the CRA encourages banks to serve “the credit needs of its community,” as diverse as those needs may be. The CRA has resulted in some increased lending to “traditionally un-banked groups,” such as poor people, but it has not lifted all the limitations on lending to

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124. Dyal-Chand, supra note 4, at 281–84.
125. Id. at 281.
126. Id. This Note considers these market based approaches to lending in Part IV below.
127. See, e.g., BURRUS, supra note 9, at 12 (proposing multiple solutions to increase microlending).
128. Id.
129. See supra Part II.B.3 (explaining regulations on U.S. microlending).
130. See, e.g., Jones, supra note 11, at 196, 199 (describing the connection between the CRA and microcredit goals).
131. O’Rourke, supra note 12, at 185.
132. See id. at 184 (exploring minimum capital requirements as a major impediment to MFI sustainability).
133. See, e.g., Jones, supra note 11, at 196, 199 (discussing the relationship between the CRA and microlending).
134. Id. at 196; see also 12 U.S.C. § 2901 (2006) (detailing the CRA’s purpose and provisions).
low-income borrowers. The CRA and microlending also have common goals of meeting the financial needs of poor people, so CRA provisions, to that end, could be met through microcredit institutions. Because both the CRA and MFIs are empowered to serve low income people, microcredit “clearly fit[s] into an effective CRA compliance strategy.” Congress has empowered the CRA to maintain profitable community banking. U.S. MFIs are attempting to reach profitability and self-sufficiency. With these shared goals, partnerships between microlenders and community banks seem to be mutually reinforcing.

Legal scholars and practitioners have suggested that CRA regulators can take steps to encourage these partnerships, which would likely strengthen microlending’s sustainability. All FDIC-insured banks are covered by the CRA. Banks get “credit” for engaging in community banking activities that show they are complying with the CRA. CRA regulators can give credit toward compliance to banks that create microcredit programs. This would create incentives to commercialize microlending, and ideally allow these microlenders to remain profitable and self-sustaining after the initial institutional support from the CRA.

2. Interest Rate Regulations

Current interest rate caps, known as usury laws, which most states establish, present significant obstacles to MFI sustainability. Most notably, interest rate caps limit the amount of interest an institution can charge a borrower. These interest rate caps were generally designed for traditional lending institutions like commercial banks, so they do not cover the unique transaction costs associated with microloans. Some microlending organizations have successfully partnered with commercial banks to increase their lending potential. Interest rate caps limit the amount of money banks can raise, and impede the microlending operations’ chances of reaching self-sufficiency. One bank indicated that it offered microcredit because the state eased interest rate caps. Another author noted that among the most important things the government can do to promote

135. Jones, supra note 11, at 197 n.3 (noting that community groups argue that the CRA has not led to enough lending to underbanked groups). “Un-banked groups” are groups that traditional commercial banks do not serve, in this case, because the people do not have the financial resources to participate in traditional financial transactions. See id. at 196 (noting that the CRA required banks to meet credit needs of low- and middle-income neighborhoods).
137. Id. at 347.
138. See id. at 343 (noting that the CRA aspires to “balance a bank’s benefits and burdens”).
139. Id.
140. Id. at 342.
141. Berkman, supra note 48, at 347–49.
142. Id. at 348.
143. Id. at 348.
144. O’Rourke, supra note 12, at 185.
145. Id.
146. Id.; see supra Part II.A (discussing microloan transactions).
147. See supra Part II.B.3 (discussing partnerships between microcredit lenders and commercial banks).
149. Id.
profitable microlending is “to avoid interest rate caps that prevent MFIs from covering their costs and operating sustainably.”\(^{150}\)

Further, some scholars have pointed out that interest rate caps, in general, “tend to have market-distorting, detrimental effects on financial sector development and therefore should be avoided.”\(^{151}\) Although this sentiment is not specific to microcredit, it supports the argument that, in some cases, interest rates should account for the field they are regulating. With the current microcredit market restrictions, lenders must choose between setting interest rates high enough to compensate for risky borrowers, or setting lower interest rates and rationing credit.\(^{152}\) This choice is not ideal for microlenders. One solution scholars have suggested involves increasing information gathering to assess the extent of the borrower’s risk, and then assign interest rates accordingly.\(^{153}\) Another solution is to exempt microlenders from interest rate caps, or set a higher rate for MFIs than traditional banks, accounting for MFIs’ unique transaction costs, which this Note considers further in Part IV.

Exempting microlenders from traditional usury laws that cap interest rates is a solution that raises its own set of problems. Indeed, one reason ACCION began offering small loans to poor entrepreneurs was because of the high interest rates loan sharks were charging.\(^{154}\) Predatory lending is a pervasive problem, and an exception for microlenders could allow predatory lenders to take advantage of first-time borrowers who do not know the difference. Charging higher interest rates to people who are often struggling financially also, quite simply, “looks bad.”\(^{155}\) However, regulators could find a middle ground where interest rates are not capped at a point that stifles profitability, but are also not so high that repayment is an impossibility. Further, microlenders could incorporate the slightly higher interest rates into loans in a way that would not deter poor borrowers or hinder their repayment.

3. Capital Holding Requirements

Capital holding requirements present another obstacle to U.S. microlenders reaching sustainability.\(^{156}\) As described above in Part II.B.3, the Basel Accord I governs U.S. capital holding requirements. High capital requirements often stabilize the market by ensuring institutions can withstand financial hardship,\(^{157}\) but high capital requirements also deter microlending.\(^{158}\) Because microlending is considered risky by traditional lending standards, capital requirements demand “disproportionately large investments for small-scale projects,” like MFIs.\(^{159}\) These requirements make it difficult for MFIs to

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\(^{150}\) Jones, supra note 11, at 200.

\(^{151}\) Id. at 203.

\(^{152}\) Id. at 207.

\(^{153}\) Id. at 208–09.


\(^{155}\) See supra note 91 and accompanying text.

\(^{156}\) See O’Rourke, supra note 12, at 184 (discussing minimum capital requirements as one of the major barriers to MFIs reaching sustainability).

\(^{157}\) Id.

\(^{158}\) Id.

\(^{159}\) Id.
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raise money because investors often require microlending institutions to put up ten percent of the capital required, an amount they cannot always produce. One scholar believes that when capital requirements reach five million dollars, most microlenders likely will not be able to make the necessary investment and will not be able to continue to lend.

To lessen the burden capital holding requirements place on MFIs, practitioners and legal scholars argue that regulators should exempt MFIs from high minimum capital requirements. The rationale for exempting MFIs from the requirements—or providing an alternate and more accommodating holding requirement—is based on MFIs’ ability to meet a market need that commercial banks largely ignore. Consequently, practitioners and scholars believe that rather than hold MFIs to standards identical to those of commercial banks, regulations should consider the fact that MFIs function differently than commercial banks in accommodating low-income borrowers.

These regulatory reforms offer a promising opportunity for U.S. MFIs to reach sustainability. However, for Congress or practitioners to enact these reforms, microlending advocates and practitioners need to strategically advocate for reform. To do this, reformers need to forge broad political coalitions with groups that have common goals. These groups can range from those in the banking community, to antipoverty activists. In Part IV, this Note considers the most promising reforms for the government and industry to enact, and the most realistic ways of enacting them.

IV. RECOMMENDATIONS

For microlending to become sustainable in the United States, practitioners and advocates need to enact reforms at both regulatory and theoretical levels. The two main regulation-based solutions are exempting MFIs from interest rate ceiling requirements and amending minimum capital requirements to accommodate the unique role microlenders fill in the market. At a more theoretical level, microcredit practitioners need to be conscious of the differences between the microcredit model in developing countries with less formal market structures, and in the more developed U.S. markets. Microcredit practitioners must then consider the most effective ways to configure microlending within the formal structures of U.S. markets. Further, practitioners need to approach legislative reform in a strategic way—in partnership with influential private and public bodies.

A. Promising Regulatory Reforms to U.S. Microlending

The sections below consider the two possible legislative reforms discussed above in more detail. Usury laws and minimum capital requirements serve important purposes in the financial sector. Although reforms in these areas would be complicated, enacting

160. Id.
161. O’Rourke, supra note 12, at 184.
162. See id. at 187 (arguing that MFIs should be able to operate with lower minimum capital requirements).
163. Id.
164. Id.
165. Jones, supra note 11, at 200.
166. O’Rourke, supra note 12, at 187.
exceptions to these regulations is practically possible. Certainly reforms would have to address a number of exceptions. Were microlenders to receive exemptions, other lenders, lacking microlenders’ good intentions, could turn these exceptions into loopholes that exploit first-time lenders. Therefore, reforms should center on providing legal and regulatory incentives for microlenders to focus efforts on building sustainable microenterprise, and regulators should carefully evaluate each lending institution applying for exemption based on the requirements below.

1. Exempt Microlenders from Interest Rate Caps

Charging higher interest rates would help microlenders cover all the costs associated with smaller loans and reach profitability. Banks’ partnership with microlenders is one of the most promising ways for MFIs to reach sustainability and profitability. To accommodate this partnership, states should allow exceptions for commercial banks partnering with microlending institutions, and should permit these institutions to charge slightly higher interest rates to cover the higher costs associated with microloans.

States set the statutory maximum interest rates most lending institutions can charge on loans.\textsuperscript{167} National legislation preempts state usury laws, and allows a national bank to set interest rates slightly above the Federal Reserve rate.\textsuperscript{168} State’s interest rates are generally capped around 5\%-12\%.\textsuperscript{169} The Grameen Bank charges 20\% interest for income-generating microloans.\textsuperscript{170} State usury laws should allow banks partnered with certified MFIs to charge interest rates closer to 20\%, or a number that practitioners collectively agree would cover the microloan’s transactional costs. The legislation should require qualifying banks to undergo a rigorous screening process to ensure they are legitimate microlenders who make loans to low-income people who otherwise would not qualify. Further, regulators should have to ensure that these microlending institutions have a business plan in which the higher interest rates directly lead them to become self-sufficient and profitable.

2. Amend Minimum Capital Holding Requirements to Accommodate the Higher Risks Involved in Microlending

Minimum capital holding requirements, as described above in Part III, are another impediment to commercial banks partnering with MFIs or offering microloans, because they require banks to hold more capital against riskier loans. Reform in this area looks promising,\textsuperscript{171} but regulators should ensure that the changes they enact most favorably accommodate U.S. microlenders by allowing flexibility in holding requirements. MFIs


\textsuperscript{169} Iowa’s legal interest rate, for example, is ten percent. In Delaware, the legal interest rate is five percent over the Federal Reserve interest rate. State Interest Rates and Usury Laws, http://www.lectlaw.com/files/ban02.htm (last visited Jan. 19, 2009).

\textsuperscript{170} Lee, \textit{supra} note 38, at 529.

\textsuperscript{171} \textit{Capital Standards for Banks, supra} note 102, at 397.
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serve a sector of the market that traditional commercial lending cannot. Therefore, loosening minimum capital holding requirements for MFIs is a common-sense approach. Further, as international statistics indicate, many MFIs abroad enjoy high repayment rates and are not always as risky as many people perceive.

The proposed Basel II, which is likely to become the new governing body for minimum capital requirements, appears to be more accommodating to nontraditional lending. Some of the proposed reforms in Basel II include linking the actual risk a bank takes more closely to the amount of required capital. While microlending in the United States is still relatively immature and in the process of becoming more sustainable, lenders cannot accurately determine the actual risk level of the microloan. Capital holding requirements should be sensitive to this situation.

MFIs and commercial banks that partner with MFIs should undergo a stringent certification process to ensure the legitimacy of their microlending operations. Once they are determined to be actual microlenders, Basel II should allow U.S. microlenders to hold smaller amounts of capital than usually required for such “higher risk” loans. This makes sense because (1) the loans might not be as risky as anticipated, and (2) the high (ten percent) capital requirements prevent banks from partnering with MFIs and therefore prevent MFI self-sufficiency. This self-sufficiency is imperative if microlending is to be a viable method of offering capital to poor people in the United States.

3. Adopt Microlending Methods Consistent with the Realities of the U.S. Market

First, from a theoretical approach, microlenders should think critically about the differences between markets in developing countries and in the mature, post industrial U.S. market. Microlending practices should conform to the U.S. market where possible, and not simply mimic methods used in developing countries. In the more formalized U.S. market, the informal approaches used in developing countries might not be what microlenders need to reach self-sufficiency and successfully collect loan repayments. For example, the social pressure to repay loans in rural areas of developing countries does not have the same effect in large, more anonymous, urban centers. Further, informal repayment practices contradict U.S. enterprise law. Pursuing formal legal proceedings to collect repayment is inefficient because of the relatively small dollar amount of each loan. Instead, MFIs can encourage repayment through the threat of denying future loans to borrowers.

172. Supra Part II.B.2.
173. See, e.g., Jaffer, supra note 6, at 185 (explaining that the Grameen Bank enjoys loan repayment rates in the high 90 percentages).
174. See Capital Standards for Banks, supra note 102, at 397 (addressing risk and capital requirements of Basel II).
175. Anderson, supra note 1, at 106–07.
176. Id. at 107.
177. Id.
178. Id. at 107.
179. Id.
simply mimic methods used by the Grameen Bank and other lending organizations in developing countries. Rather, U.S. MFIs have to pick and choose microcredit practices that will work in the United States, and reconfigure those that will not, even if those methods have proved successful in international microlending.

**B. How Microlending Reformers Can Most Effectively Enact the Desired Reforms**

Microcredit as a concept and practice has attracted wide appeal. Microlending is appealing as a private market concept because it generates economic activity in otherwise stagnant low-income sectors. It is appealing to social activists because it decreases poverty and gives poor people meaningful economic opportunities. Although many scholars and practitioners have written about possible reforms and means by which U.S. microlenders can become self-sustaining, Congress has not implemented any meaningful reforms. Advocates can convince Congress to implement the microlending reforms explored above if advocates are strategic in their approach and establish a political plan involving lobbying and coalition-building efforts.

In order for members of Congress or state legislators to introduce and enact usury reforms and minimum capital requirement exemptions, they have to be convinced that microlending is worth improving. For elected officials from both parties to understand the value of microlending, they have to consider it in both broader market and poverty-alleviation contexts. The best way to approach political and community leaders is to present microlending reforms both in the context of the market, emphasizing that microlending makes good business sense, and in the light of microlending decreasing poor people’s reliance on government assistance. For politicians to view microlending in those frameworks, advocates of microlending have to forge a broad coalition of groups with a stake in microlending. To maximize the success of both approaches, the coalition presenting these reforms should be broad and include members from the traditional banking sector, the nonprofit MFI sector, antipoverty activists, and prominent community leaders who support microlending.

1. Presenting Microlending in a Market Context

As explored above, MFIs offer economic opportunities to people who the traditional market does not and simply cannot serve. Therefore, MFIs fill a necessary void in the market. Microcredit is not just a charitable concept; it effectively generates economic activity in low income sectors of the market that would otherwise be stagnant. Some U.S. corporations understand these benefits. For example, IBM is partnering with the Grameen Foundation to help MFIs expand their open source software programs.\(^\text{180}\) Commercial banks have financial incentives to promote sustainable microlending. Some banking strategists have argued:

Retail banks can’t assume that the growth and returns of the recent past will continue. Amid a throng of banking competitors—including new market entrants, forward-thinking incumbents and non-banks—banks need to

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differentiate themselves in ways that are not easily duplicated. To restore confidence and realize strong future returns, banks must set the stage now. It will require uncommon innovation to stand out from the crowd and adapt successfully to marketplace demands.\textsuperscript{181}

Banks that expand their traditional lending will have increased access to previously unavailable markets.\textsuperscript{182} Further incentive for commercial banks is the alternative to simply rejecting people who do not qualify for loans at their institution. Currently, banks often refer rejected loan applicants to groups like ACCION. Direct participation or partnerships with MFIs would allow these banks to offer applicants an immediate alternative when they are rejected from traditional lending mechanisms.

Corporate and commercial banking incentives to participate in microlending provide political strength to a microlending reform campaign. Microcredit reformers can enlist these corporations and commercial banks, which have significant political clout, and combine forces in a lobbying campaign of state legislators and members of Congress. These corporate partners give advocates a greater amount of legitimacy in the eyes of elected officials and increase the chance that Congress and state legislatures will actually adopt the above proposed reforms.

2. Presenting Microlending as a Way to Lessen Reliance on Governmental Assistance

As stated above in Part I, both Republican and Democratic members of Congress support microlending.\textsuperscript{183} The concept behind microlending is generally appealing, especially in a post-welfare reform period, because it offers people a way out of poverty by means other than government assistance. Microlending offers real economic and entrepreneurial opportunities to people who would not otherwise have them. Finding support for this concept at a theoretical level is not difficult. Tapping into this support and enacting real reforms involves showing politicians microlending’s practical poverty-reducing effects.

Much of the academic writing concerning microlending presents it in a light that would appeal to political efforts to lessen poverty and improve poor people’s economic state. For example, Lewis Solomon, professor of law at the George Washington University Law School, argues that “microenterprises can potentially break the cycle of dependency and hopelessness by restoring initiative, responsibility, and dignity.”\textsuperscript{184} Further, he argues that microcredit offers capital to poor people, “while reducing their reliance on redistributive government programs.”\textsuperscript{185} This language is remarkably similar to the national debate over welfare reform. For example, during the 1992 presidential campaign, Bill Clinton stated that “government has failed us, and one of its worst failures


\textsuperscript{182} See B. WAMPFLER \& C. BARON, \textit{MICROFINANCE, AGRICULTURAL BANKS, COMMERCIAL BANKS: WHAT POTENTIAL PARTNERSHIPS COULD FINANCE FAMILY AGRICULTURE?} 10 (2002), available at http://microfinancement.cirad.fr/fr/news/bim/workshop3.pdf (arguing that a bank partnership with an MFI can increase the bank’s access to remote rural areas, where banks usually are not viable).

\textsuperscript{183} Polakow-Suransky, \textit{supra} note 4.


\textsuperscript{185} Id. at 192.
had been welfare. I have a plan to end welfare as we know it—to break the cycle of dependency. We’ll provide education, job training... those who are able to work must go to work.” Microlending goals and politicians’ goals are consistent when it comes to decreasing poverty, and this common ground is where regulatory reform is possible. Microlending advocates need to tap into this aspect of microlending to enact the regulatory reforms explored above. This involves appealing to Republicans, who largely favor reducing welfare reliance, and appealing to more liberal Democrats, who want to offer meaningful economic opportunities to poor people.

V. CONCLUSION

Microlending gives economic enterprise opportunities to people who would not otherwise have access to such resources. Many international MFIs have reached financial self-sufficiency. MFIs in the United States have not been as successful. Because microenterprise is a powerful private market tool to combat poverty, practitioners and reformers should strive to reach sustainable microlending in the United States. Regulatory reforms centered on usury laws and minimum capital requirements are likely to create an environment in which U.S. MFIs can become more profitable. Given the current political climate, these reforms are possible if approached in a strategic way, focused on private market incentives and decreasing reliance on government assistance. For microcredit to reach its true potential in the United States, microcredit practitioners and advocates must take these practical steps.

187. Jaffer, supra note 6, at 184.