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Microfinance: Importing Regulations in Reforms for the Real Small Businesses

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MICROFINANCE: IMPORTING REGULATIONS IN REFORMS FOR THE REAL
SMALL BUSINESSES

Triet Leminh

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I. INTRODUCTION

In the Jackson Heights neighborhood of Queens, New York, Guadalupe Perez and her husband are entrepreneurs.¹ The couple owns a party decoration store in which they invested their life savings, and where they have worked every day to earn about \$29,000 a year, considered “very low” income in New York.² When the business suffered during the recent recession, the couple had difficulty paying rent, but they were afraid of going to a bank.³

¹ Shaila Dewan, *Microcredit for Americans*, N.Y. TIMES (Oct. 28, 2013), available at <http://www.nytimes.com/2013/10/29/business/microcredit-for-americans.html>.

² *Id.*

³ *Id.*

Instead, they turned to Grameen America, the stateside sister company of Grameen Bank in Bangladesh.⁴ Grameen provided an initial loan that helped them remain open, and additional loans enabled them to expand.⁵

Tigist Reda owns Demera Ethiopian Restaurant in Uptown, Chicago.⁶ She recently hosted Chicago mayor Rahm Emanuel to speak about the city's Microloan Institute in order to help introduce small business owners to a pool of \$700,000 for microloans.⁷ Even with substantial equity in the restaurant, she struggled to secure enough additional loan capital for renovations.⁸ The restaurant's "good food and good location" were apparently not enough.⁹ Through loans provided by the Institute, Reda was able not only to renovate the restaurant, but also to hire twelve new employees and begin considering a second location.¹⁰

Kiva Microfunds is a non-profit organization with a mission "to connect people through lending to alleviate poverty."¹¹ Its loan model exploits a recent surge in the popularity of crowdfunding. Through a web-based platform, anyone can lend a minimum of twenty-five dollars to be packaged as a loan to individual entrepreneurs and collectives around the world "without access to traditional banking systems."¹² More recently, however, Kiva has diverted some of its attention to credit needs in different metropolitan areas in the United States. For example, Kiva City Louisville, one of nine other Kiva platforms in various U.S. cities, lists local businesses requesting loans of up to \$5,000 with no interest.¹³

⁴ *Id.*

⁵ *Id.*

⁶ Gregory Karp, *Chicago has \$700,000 Ready to Lend to Small Businesses*, CHI. TRIB. (Nov. 13, 2014), available at <http://www.chicagotribune.com/business/ct-microloans-chicago-1114-biz-20141113-story.html>.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *About Us*, KIVA, <http://www.kiva.org/about> (last visited Nov. 26, 2014).

¹² *Id.*

¹³ Branden Lammers, *Louisville Officially a Kiva City*, LOUISVILLE BUSINESS FIRST (Nov. 24, 2014), <http://www.bizjournals.com/louisville/news/2014/11/24/louisville-is-officially-a-kiva-city.html>.

Premal Shah, co-founder and president of Kiva, calls it “a movement of lending local,” just like “buying local and eating local.”¹⁴

These examples emphasize the potential for positive social impact from the adoption of alternative credit sources, sources that include microfinance. This article considers the lack of legal certainty in the United States’ regulation of microfinance and suggests that it is well advised for certain reforms to be implemented both to promote microfinance and to ensure credit safety for these products. Alongside a proliferation of for-profit entities engaged in an inherently contradictory “humanitarian banking” business, it appears that this uncertainty could be addressed via select conventions employed abroad. Part II of this article provides an overview of microfinance and its ambitions and Part III details certain provisions of United States law that apply to, or serve as a basis for thinking about microfinance. Finally, Part IV discusses select strategies employed around the world in regulating the field and evaluates both their potential for success and possible shortcomings if implemented in the United States.

II. MICROFINANCE

Microfinance refers to the financial services industry that has principally served communities and individuals in developing nations that lack access to more mainstream financial services.¹⁵ The Basel Committee on Banking Supervision (BCBS) understands the term to mean “the provision of financial services in limited amounts to low-income persons and small, informal businesses.”¹⁶ These services typically include credit and deposit accounts. The BCBS also notes that borrowers of these funds are “typically concentrated in a limited geographic area, social segment or entrepreneurial undertaking.”¹⁷ These loans often come with high interest rates to

¹⁴ *Id.*

¹⁵ See Aaron Jones, *Promotion of a Commercially-Viable Microfinance Sector in Emerging Markets*, 13 GEO. J. ON POVERTY L. & POL’Y 187 (2006).

¹⁶ BASEL COMM. ON BANKING SUPERVISION, MICROFINANCE ACTIVITIES AND THE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION I (Bank For Int’l Settlements 2010) [hereinafter BASEL], available at <http://www.bis.org/publ/bcbs175.pdf>.

¹⁷ *Id.* at 9.

offset high administrative costs and to make up for the risk derived from borrowers' questionable creditworthiness and lack of collateral.¹⁸ Microfinance institutions (MFIs) in developing regions issue these loans with the understanding that borrowers should use them to fund income-producing activities or small businesses. Many of these MFI products are considered drivers of economic growth that foster the development of a country's financial sector.¹⁹ Often, they are the only way for certain communities (where formal financial instruments are otherwise unavailable, inaccessible, or prohibitively expensive) to acquire working capital for projects. Of course, the intent is that individuals will use such credit for productive endeavors rather than for personal consumption.²⁰ Access to credit means access to capital, in theory jumpstarting a community, creating jobs, and increasing the community's economic productivity. A number of studies show that economic growth is not only correlated with financial intermediary development, but might be caused by such development.²¹ Most of these studies look to the development in the macro economies of developing nations, but economically-neglected communities and populations without access to traditional financial intermediaries in the United States benefit as well. Alternative financial intermediaries such as MFIs provide the starting point, whereas legal reforms that "strengthen creditor rights, contract enforcement, and accounting practices, can boost financial intermediary development and accelerate economic growth."²² On the debtor side, however, regulation is needed to ensure continued growth and to prevent problems.

¹⁸ *Id.*

¹⁹ See Jones, *supra* note 15, at 192.

²⁰ See Partha Ghosh et al., IMPACT OF POLICIES AND REGULATIONS ON THE MICRO FINANCE SECTOR 21 (MicroSave 2015), available at http://www.microsave.net/files/pdf/Impact_of_Policies_and_Regulations_on_the_Micro_finance_Sector.pdf.

²¹ See Ross Levine et al., *Financial Intermediation and Growth: Causality and Causes*, 46 J. MONETARY ECON. 31, 63 (2000); see also John P. Caskey et al., *The Urban Unbanked in Mexico and the United States* 3 (World Bank, Working Paper No. 3835, 2006).

²² Levine et al., *supra* note 21, at 63.

III. LEGAL REGIMES IN THE UNITED STATES

Microfinance is intended to address the population, which not only includes those in developing nations, but also people like Guadalupe and countless others in the United States who are financially crippled from unequal access to credit. However, due to its connotation of a tiny loan, many still label microfinance as an exotic humanitarian instrument reserved for the third world.²³ In light of this, there is still a mere patchwork of law and regulation surrounding this type of small loan lending, and the non-profit organizations that mostly participate do not fall under the umbrella of any specific regulatory agency.²⁴ Beyond small business lending requirements implemented by individual states and requirements for non-profit tax accounting, it is largely unregulated.²⁵

A. Funding the Everyday Hustler: The Community Reinvestment Act and Subsequent Measures

Since 1977, several laws enacted in the United States have recognized disparate access to credit and supported community entrepreneurs. Together, they act as a foundation for the idea of small loans in the United States. A series of legislation shows signs of Congress's principled intentions, but poor execution. In passing the Community Reinvestment Act of 1977 (CRA), Congress aimed to require regulated financial institutions to demonstrate that they "serve the convenience and needs of the communities in which they are chartered to do business."²⁶ This included "the need for credit services as well as deposit services,"²⁷ and "regulated financial institutions" are defined as those with FDIC-insured deposits.²⁸ But

²³ Tanya Mannes, *Federal Microloans Big With Small Businesses*, SAN DIEGO UNION-TRIB., Sept. 21, 2010, at C1.

²⁴ Bill Burrus, LESSONS AND TRENDS OF MICROCREDIT IN THE UNITED STATES 14 (Accion 2005), available at <http://www.microfinancegateway.org/sites/default/files/mfg-en-paper-lessons-and-trends-of-microcredit-in-the-united-states-2005.pdf>.

²⁵ *Id.*

²⁶ 12 U.S.C. § 2901 (2013).

²⁷ *Id.*

²⁸ Richard D. Marsico, *Enforcing the Community Reinvestment Act: An Advocate's*

the CRA has been criticized as lacking teeth with its “scant directives” of encouragement.²⁹ Critics also point out a practical deficiency in that it lacked a basis for determining the particular institutions selected to carry out its mandate of meeting credit needs.³⁰

Subsequent regulations passed during the Clinton administration in 1995 reconciled some of the CRA’s statutory ambiguities.³¹ The regulations allowed for a particular bank to choose between evaluations under a standard compliance test or developing their own strategic tests as well as the criteria of activities to satisfy the tests.³² Most importantly, the regulations not only incentivized but required banks to invest in, lend to, and assist local organizations called community development financial institutions (CDFIs).³³

CDFIs remained outside of legislative attention until roughly two decades after the CRA, when the Community Development Banking and Financial Institutions Act of 1994 was passed to “promote economic revitalization and community development” by providing “[government] investment in and assistance to community development financial institutions.”³⁴ Under this Act, funds were earmarked for CDFIs to distribute to “underserved communities.” Around the same time, Congress passed the Equal Credit Opportunity Act (ECOA), acknowledging that the target population for smaller loans to the “community” was mostly comprised of minority borrowers.³⁵ Implemented by the Board of Governors of the Federal Reserve in Regulation B,³⁶ the ECOA makes it “unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction” for reasons including race, color,

Guide to Making the CRA Work for Communities, 17 N.Y.L. SCH. J. HUM. RTS. 129, 131 (2000).

²⁹ Brooke Overby, *The Community Reinvestment Act Reconsidered*, 143 U. PA. L. REV. 1431, 1432 (1994-1995).

³⁰ *Id.* at 1442.

³¹ See Nellie R. Santiago et al., *Turning David and Goliath into the Odd Couple: How the New Community Reinvestment Act Promotes Community Development Financial Institutions*, 6 J.L. & POL’Y 571, 590-92 (1998).

³² *Id.*

³³ *Id.*

³⁴ 12 U.S.C. § 4701 (2013).

³⁵ 15 U.S.C. §§ 1691-1691f (2013 & Supp. IV 1998).

³⁶ 12 C.F.R. § 202 (2014).

religion, national origin, sex, marital status, age, or an applicant's receipt of public assistance.³⁷ But funds and their availability were only a part of what borrowers required. A few years later, the Program for Investment in Microentrepreneurs (PRIME) Act of 1999 allocated federal funds for programs offering training, technical assistance, and capacity-building to microenterprises.³⁸

The foregoing legislative initiatives came alongside other reforms designed to expand the scope of authorized bank powers, reforms culminating in the Gramm-Leach-Bliley Act (GLBA) of 1999.³⁹ The GLBA removed the division between commercial and investment banking activities.⁴⁰ In doing so, it opened the door for banks to engage in numerous securities, insurance, and merchant banking activities through affiliation, consolidation, and the use of subsidiaries.⁴¹

B. Post-Crisis

Between 1990 and the early 2000s, small business owners relied heavily on home equity lines of credit and business credit cards to finance capital expenditures.⁴² But in the wake of the financial crisis, the availability of both experienced a drastic decline, due in part to tightened lending standards.⁴³ Economic recovery following the crisis yielded a substantial increase in credit extended to small businesses in the United States between 2007 and 2014. According to the Thomson Reuters/PayNet Small Business Lending Index (SBLI), financing in amounts under \$1 million experienced an

³⁷ 15 U.S.C. § 1691 (2013).

³⁸ See 15 U.S.C. § 6902 (2013); SBA Administrator's authority created by 15 U.S.C. § 634(b)(6) (2013); see also 13 C.F.R. § 119 (2014) (implementing regulation for the PRIME Act of 1999).

³⁹ Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-02, 113 Stat. 1338 (1999) (codified in 12 and 15 U.S.C. (2013)).

⁴⁰ See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J. L. BUS. & FIN. 151, 170 (2008-2009).

⁴¹ Gramm-Leach-Bliley, *supra* note 39 at § 103.

⁴² Luz Gomez & Elaine L. Edgcomb, *A Newly Crowded Marketplace: How For-Profit Lenders Are Serving Microentrepreneurs*, FIELD AT THE ASPEN INSTITUTE 2 (2011), available at <http://fieldus.org/publications/ForProfitLenders.pdf>.

⁴³ *Id.*

eleven percent jump in July 2014 alone.⁴⁴ Part of this increase was likely attributed to the current administration's impressive list of bailout commitments, although its actual investments thankfully came up short of the original figures. These amounts were as follows: \$700 billion to "systemically important institutions" under the Trouble Asset Relief Program (TARP), \$6.4 trillion from the Federal Reserve to restore liquidity in the financial markets, and \$1.2 trillion to various federal stimulus programs designed to "save or create jobs" and "jumpstart the economy."⁴⁵ Most relevant to the purposes of this article, the central legislation that enabled this \$1.2 trillion allocation was the American Recovery and Reinvestment Act (ARRA, or the "stimulus"), which promised \$400 million over two years to CDFIs.⁴⁶

However, the sub-\$1 million category of small business financings examined by the SBLI fails to consider the backbone of the American economy, the smallest of small businesses. The category is overly inclusive. The Census Bureau's latest report crams 97.7 percent of all private businesses in the United States under the "small business" moniker.⁴⁷ Eighty-five percent of all United States businesses employ five or fewer employees.⁴⁸ The "small," or more appropriately, "micro," businesses receiving Grameen America's unsecured loans borrowed modest amounts of \$1,500 to \$8,000,⁴⁹ rather than amounts between \$10,000 and \$1 million. Though their desired loans are small, borrowers' insufficient credit histories and lack of collateral equates to presumably low lender confidence. This means that many of these businesses fall outside of the scope of

⁴⁴ Thomson Reuters/PayNet Small Business Lending Index (September 2014), <http://www.paynetonline.com/SmallBusinessInsights/ThomsonReutersPayNetSmallBusinessLendingIndex.aspx>.

⁴⁵ David Goldman, *CNNMoney.com's bailout tracker*, CNN MONEY (Nov. 16, 2009), <http://money.cnn.com/news/storysupplement/economy/bailouttracker/>.

⁴⁶ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

⁴⁷ G. Scott Thomas, *Almost 98% of all businesses are classified as small businesses*, THE BUSINESS JOURNALS (November 2, 2011), <http://www.bizjournals.com/bizjournals/on-numbers/scott-thomas/2011/11/98-of-all-businesses-are-small.html>.

⁴⁸ *Where We Work: United States*, ACCION, <http://www.accion.org/page.aspx?pid=580> (last visited Nov. 23, 2014).

⁴⁹ Dewan, *supra* note 1.

consideration for traditional lenders, especially commercial banks, and possibly even retail banks. These lenders look to be those contributing to the data accounted for by the SBLI. Microenterprises continue to be an afterthought to banks, and part of ARRA intended to close this gap accordingly.

C. Protecting Borrowers

While most MFIs fall outside of the formal statutory regime governing banks and other for-profit (including “predatory”) lenders, these regulations in the United States are a starting point in evaluating effective frameworks for microfinance activities. The problem is categorizing MFIs. Commercial bank investments in CDFIs fall under the term, as do a myriad of tax-exempt nonprofit institutions. The infant sector of independent (from commercial banks) for-profit MFIs is also to be considered. This section will discuss both the statutory and regulatory controls that have been placed on banks and other financial institutions. If MFIs continue to expand as they have, there should either be reforms treating them as distinct classes of organizations, or changes to allow more clarity and safety under the current structure of bureaucratic oversight.

The recent financial crisis forced the world, and especially the United States, to evaluate shortcomings in the regulatory environment. To address them, the Wall Street Reform and Consumer Protection Act, or Dodd-Frank Act, reconsidered the past few decades’ trend of deregulation, and addressed both ends of the wealth spectrum in the United States.⁵⁰ Especially considering the criticized GLBA expansion of authorized bank activities,⁵¹ it tackled dormant problems in the powerful, interconnected banking and financial services industries. Included among legislative concerns was the inadequacy of loan regulations, something crucial to microfinance if it wishes to progress. Former head of the Consumer Financial Protection Bureau (CFPB), Elizabeth Warren, asked why financial products (specifically mortgages) that “catch fire” causing

⁵⁰ Anita Bernstein, *The Trouble with Regulating Microfinance*, 35 HAWAII L. REV. 1, 20 (2013).

⁵¹ See Damian Paletta & Kara Scannell, *Ten Questions for Those Fixing the Financial Mess*, WALL ST. J. (Mar. 10, 2009), <http://www.wsj.com/articles/SB123665023774979341>.

financial ruin one out of twenty times are allowed to be sold whereas toasters that only do so one out of a hundred times are not.⁵² Microcredit should be subject to at least some "safety" measures and precautions especially because it targets such a financially vulnerable demographic.

1. *Interest Rates and Abuses*

Microfinance, although much less controversial, involves issues related to payday and fringe lending.⁵³ Considering the significant overlap in the targeted low- to moderate-income population, existing experiences in regulation of this field could assist to find a reasonable way to protect borrowers. In the 1900s, wage assignments were used to secure payday loans, entitling the lender to collect payment due from the payroll office of the borrower's employer.⁵⁴ Today, a typical situation in a payday loan is where the consumer writes a \$300 check payable in two weeks (postdated) and in return receives \$255 in cash at the time he or she needs it.⁵⁵ As its fee, the lender retains the remaining \$45.

Early on, upon the realization that dissatisfaction with low usury caps drove a substantial amount of lending activity to loan sharks, the model Uniform Small Loan Law (USLL) was drafted in 1916 as the brainchild of the Russell Sage Foundation.⁵⁶ The law was the result of an effort by regulators, consumer advocates, and lenders to facilitate "small-loan lending at the lowest practicably profitable

⁵² See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 3-4 (2008) (asking why consumers are "protected from dangerous products and sharp business practices when they purchase tangible consumer products, but left at the mercy of their creditors when they sign up for routine financial products like mortgages and credit cards").

⁵³ See Alan M. White, *Credit and Human Welfare: Lessons from Microcredit in Developing Nations*, 69 WASH. & LEE L. REV. 1093, 1096 (2012).

⁵⁴ Robert Mayer, *Loan Sharks, Interest-Rate Caps, and Deregulation*, 69 WASH. & LEE L. REV. 807 (2012).

⁵⁵ See, e.g., Michael A. Stegman, *Payday Lending*, 21 J. ECON. PERSP. 169, 169 (2007) ("Thus, a typical example [of a payday loan] would be that in exchange for a \$300 advance until the next payday, the borrower writes a postdated check for \$300 and receives \$255 in cash—the lender taking a \$45 fee off the top.").

⁵⁶ See ROBERT MAYER, *QUICK CASH: THE STORY OF THE LOAN SHARK*, 73-74 (2010) (discussing the drafting efforts that resulted in the USLL).

rates by licensed and transparent lenders.”⁵⁷ The USLL was adopted in three-quarters of the states in various forms by the 1950s.⁵⁸ Some states in the 1930s attempted to reduce the ceiling, only to experience the return of illegal loan sharking.⁵⁹ These laws would have the most teeth in cases where banks, bank subsidiaries, “affiliates,” and other large for-profit entities issue microloans through CDFIs.

At the state level, usury laws force interest rate caps. However, payday lenders have developed tactics to sustain high interest rates. Early lenders took the position that state usury laws did not apply to them because their loans were not loans per se and borrowers were incurring fees rather than interest.⁶⁰ In light of federal law, more modern maneuvers to charge interest over state caps have included affiliations with out-of-state banks.⁶¹ These affiliations took advantage of the National Bank Act’s provision allowing nationally chartered banks to charge “interest at the rate allowed by the laws of the State . . . where the bank is located,”⁶² and the Federal Deposit Insurance Act’s allowance of the same for state-chartered banks.⁶³ However, in 2005, the FDIC promulgated regulations to counter these affiliations through increased capital requirements and added scrutiny for banks and thrifts affiliated with payday lenders.

Finally, laws including the Federal Trade Commission Act (FTC Act) and the Consumer Credit Protection Act (CCPA) address collections practices on the ground. The FTC Act created the Federal

⁵⁷ Ronald J. Mann, *Regulating Financial Services for Low & Middle Income Communities*, 69 WASH. & LEE L. REV. 729, 749 (2012) (discussing the problems faced by low and middle income communities with financial services and credit products, and where an overly paternalistic regulatory approach might come up short).

⁵⁸ Mayer, *supra* note 54, at 822.

⁵⁹ See Rolf Nugent, *Three Experiments in Small-Loan Interest Rates*, 11 HARV. BUS. REV. 35, 37–46 (1933) (describing effects of state decisions lowering maximum interest rates for small-loans, in 1929 and through the 1930s).

⁶⁰ See Jean Ann Fox, *Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury*, CONSUMERS FED’N OF AM. 7 (Mar. 30, 2004), www.consumerfed.org/pdfs/pdlrentabankreport.pdf (“Early payday lenders used inventive schemes to hide the true nature of their loans.”).

⁶¹ *Id.*

⁶² See National Bank Act of 1864, 12 U.S.C. § 85 (2013).

⁶³ See Federal Deposit Insurance Act, 12 U.S.C. §§ 1811–1831aa (2013).

Trade Commission (FTC).⁶⁴ In relevant part, the FTC Act grants the FTC commissioner general authority to hear and seek redress for consumer grievances for alleged incidents of “unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce,”⁶⁵ It also allows the FTC commissioner to promulgate rules, especially in “defin[ing] with specificity acts or practices which are unfair or deceptive”⁶⁶ Primarily in the mortgage context, one of the CCPA’s central provisions requires calculation of “finance charges . . . as the sum of all charges payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit.”⁶⁷ But the calculation excludes “charges of a type payable in a comparable cash transaction,” and in the mortgage context, those “imposed by third party closing agents.”⁶⁸

2. *Transparency*

To facilitate positive economic impact, ensure debtor repayment, and prevent the overextension of credit, regulation of microfinance should take transparency needs into account. In addition to the usury concerns addressed above, credit contracts have been widely criticized throughout the twentieth century for being ambiguous.⁶⁹ The post-World War II explosion in widespread consumer credit use exposed serious deficiencies in consumers’ understanding of these contracts.⁷⁰ Varying methods of computing interest and the complexity of quoted credit prices were primarily to blame, especially with the growth of the consumer borrowing population.⁷¹ Furthermore, statutory terms and classifications

⁶⁴ 15 U.S.C. § 41 (2013).

⁶⁵ 15 U.S.C. § 45(a)(1) (2013).

⁶⁶ 15 U.S.C. § 57a(a)(1)(B) (2013).

⁶⁷ 15 U.S.C. § 1605(a) (2013).

⁶⁸ *Id.*

⁶⁹ Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 876 (2003).

⁷⁰ *Id.*

⁷¹ *Id.*

defined by state governments in regulating consumer credit lacked consistency.⁷²

The Truth in Lending Act (TILA), part of the CCPA, sought economic stabilization and strengthening of competition among various lenders.⁷³ It requires a standard Annual Percentage Rate (APR) calculation for consumer loans,⁷⁴ as well as a “single, integrated disclosure for mortgage loan transactions.”⁷⁵ In doing so, as the House Committee on Banking and Currency reported (to the proposed legislation), “the American consumer will be given the information he needs to compare the cost of credit and to make the best informed decision on the use of credit.”⁷⁶

Regulation Z, promulgated by the Federal Reserve Board under color of TILA’s statutory delegation, implements the statute, providing it with specificity.⁷⁷ Regulation Z defines a “finance charge” as the “cost of consumer credit as a dollar amount.”⁷⁸ Finance charges include a substantial list of interest, premiums, fees, and various other charges.⁷⁹ It then goes further to define circumstances in which disclosures outlined in § 128 of TILA apply to extensions of credit, specifically that such disclosures are necessary whenever “a finance charge may be imposed or which pursuant to an agreement, is or may be payable in more than four installments.”⁸⁰

The scope of Regulation Z was contested in *Mourning v. Family Publications Svc., Inc.*, but the Supreme Court held that the rule was a valid exercise of the Federal Reserve Board’s rulemaking authority under TILA.⁸¹ Writing for the majority, Chief Justice Burger noted Congress’s policy transition “from a philosophy of ‘[l]et the buyer beware’ to one of ‘[l]et the seller disclose.’”⁸² In July 2011, following the passage of Dodd-Frank, general rulemaking authority under TILA was transferred from the Board of Governors of the

⁷² *Id.*

⁷³ 15 U.S.C. § 1601(a) (2013).

⁷⁴ 15 U.S.C. § 1606(a) (2013).

⁷⁵ 15 U.S.C. § 1604(b) (2013).

⁷⁶ H.R. Rep. No. 1040, at 10-13 (1967).

⁷⁷ 12 C.F.R. § 1026 (2014).

⁷⁸ 12 C.F.R. § 1026.4(a) (2014).

⁷⁹ 12 C.F.R. § 1026.4(b) (2014).

⁸⁰ 12 C.F.R. § 1026.1 (2014).

⁸¹ 411 U.S. 356, 377 (1973).

⁸² *Id.*

Federal Reserve System to the Consumer Financial Protection Bureau.⁸³

D. Banking Regulation

While many countries have explicit regulation for the microfinance sector,⁸⁴ laws in the United States largely omit similar specific treatment. In short, exposure to U.S. law depends heavily on how an MFI is categorized. One suggestion is to divide them between mutual-aid, nonprofit, and for-profit institutions.⁸⁵ Another looks to further divide nonprofit institutions into those primarily distributing federal funds (mostly CDFIs) and those operating independently from the government.⁸⁶

MFI activities in issuing loans and providing checking and savings accounts seem to align MFIs with banks, especially if the institution in question is for-profit. To clarify, this section focuses on smaller institutions that begin as mutual-aid or nonprofit and at some point transition to for-profit, rather than banks involved in small-dollar lending as part of the statutory “encouragement” discussed in Part III.A. On a global basis, there has been a trend toward MFIs licensed as banks or specialized finance companies.⁸⁷ These MFIs are able to access capital markets, take deposits from institutional investors, and participate in other commercial financing

⁸³ *Press Release*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Feb. 1, 2011), <http://www.federalreserve.gov/newsevents/press/bcreg/20110201a.htm>.

⁸⁴ Ian Davis, *Rural Banking: Designing an Effective Legal Framework for Microfinance*, 2 J. BUS. ENTREPRENEURSHIP & L. 394 (2008-2009); See generally Alfredo Ebentreich, *Microfinance Regulation in Peru: Current State, Lessons Learned and Prospects for the Future*, 4 ESSAYS ON REGULATION AND SUPERVISION 1, 1 (IRIS Center, University of Maryland, Apr. 2005) (discussing the different categories of MFIs in Peru and how they “are regulated with the same norms as banking and other financial institutions” but are subject to different capital requirements and restrictions on activities).

⁸⁵ Bernstein, *supra* note 50, at 25.

⁸⁶ Olivia L. Walker, Note, *The Future of Microlending in the United States: A Shift from Charity to Profits?*, 6 ENTREPREN. BUS. L.J. 383, 387 (2011).

⁸⁷ Elizabeth Littlefield & Richard Rosenberg, *Microfinance and the Poor: Breaking Down the Walls Between Microfinance and the Formal Financial System*, 39 FIN. & DEV. 38 (June 2004), <http://www.imf.org/external/pubs/ft/fandd/2004/06/pdf/littlefi.pdf>.

arrangements typically beyond the reach of nonprofits.⁸⁸ This, proponents argue, is how microfinance can really have an impact, by “becom[ing] a fully integrated party of a developing country’s mainstream financial system.”⁸⁹ But with the current state of credit in the United States, this statement should not be confined to “developing countries.”

This section will focus on the possible scope of banking law in the United States as it relates to for-profit MFIs and how U.S. law might consider such entities. The most similar (to banks) of this group would theoretically be subject to the gamut of federal banking regulation, including registration, licensing, capital adequacy, and prudential requirements. Some suggest that most MFIs are too small to involve systemic risk and hence do not require much if any regulation.⁹⁰ Others suggest that regulating these smaller, banking-related institutions “may be impracticable because proportionately more regulatory resources and costs are required to regulate them” and that private peer supervision might be more effective considering their “small size and community focus.”⁹¹

1. Federal Oversight of Banks

The Federal Depository Insurance Act of 1950 defines a bank as “any national bank and State bank, and any Federal branch and insured branch; and . . . includes any former savings association.” State banks under the Act are “any banking association, trust company, savings bank, industrial bank . . . or other depository institution which . . . receiv[es] deposits, other than trust funds . . . and is incorporated under the laws of any State . . .”⁹² The Act goes on to include in its definition of savings associations “any corporation (other than a bank) that the Board of Directors and the Comptroller of the Currency jointly determine to be operating in

⁸⁸ *Id.*

⁸⁹ *Id.* at 39.

⁹⁰ See Robert Peck Christen, et al., *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance*, CONSULTATIVE GROUP TO ASSIST THE POOR/THE WORLD BANK GROUP, 15 (2003).

⁹¹ See Jones, *supra* note 15, at 201.

⁹² 12 U.S.C. § 1813 (2013).

substantially the same manner as a savings association.”⁹³ It appears that at least some for-profit MFIs could at least be determined to be “operating in substantially the same manner as a savings association.”⁹⁴ With a more functional definition, the Bank Holding Company Act of 1956 includes “[a]n institution organized under the laws of the United States, [or] any State . . . which both accepts [sic] demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and . . . is engaged in the business of making commercial loans.”⁹⁵ Again, MFIs accepting deposits and making loans would fit. Many small loans might not be thought of as a commercial loan product, especially with the prevalent use of payday loans for personal expenses.⁹⁶ However, MFIs could easily condition loans on use for “entrepreneurial” purposes. “Commercial loan” is left undefined by the Act and the usual, though broad, understanding of this term is the business equivalent to consumer credit.⁹⁷ Regardless of this, many MFIs merely involve compulsory contributions to deposit or savings accounts elsewhere (at other institutions, usually banks) as a precondition to extensions of credit,⁹⁸ which might take such MFIs outside of the first requirement of the BHCA.

It is important to note that for better or for worse, many of the statutory terms governing banking, savings and loan, and financial institutions, as well as associated holding companies leave considerable room for regulatory interpretation. In 1986, the Supreme Court held in *FDIC v. Philadelphia Gear Corp.* that the FDIC’s interpretation of the FDIA’s scope of what a “deposit” was, even without implementing regulation, entitled to the “considerable weight [that] should be accorded to an executive department’s

⁹³ *Id.*

⁹⁴ *See id.*

⁹⁵ 12 U.S.C. § 1841 (2013).

⁹⁶ *See generally* Richard Hynes, *Payday Lending, Bankruptcy, and Insolvency*, 69 WASH. & LEE L. REV. 607, 613 (2012).

⁹⁷ *Commercial Loan*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/commercial-loan.asp> (last visited Apr. 1, 2015).

⁹⁸ Hennie van Greuning et al., *A Framework for Regulating Microfinance Institutions* 10 (World Bank, Working Paper No. 2061, 1998), available at <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-2061>.

construction of a statutory scheme it is entrusted to administer.”⁹⁹ A decade later, the Court similarly held that the Comptroller of the Currency’s interpretation of the “business of banking” term’s scope is subject to *Chevron* deference, as long as the Comptroller’s discretion is exercised within “reasonable bounds.”¹⁰⁰ In the event that the propriety of regulating MFIs became an issue in litigation, the Court under *Chevron* would likely defer to the agency’s interpretation absent extraordinary circumstances of the agency acting outside the constraints of its organic statute.¹⁰¹ It is easy to see that regulating at least some MFIs would be consistent with congressional intent.

The FDIA was enacted in 1950, and the BHCA in 1956. Without a lengthy discussion of other federal banking statutes, decades-old statutes as such seem to already lay the legislative groundwork for MFI regulation, whether full-fledged rulemaking is conducted or agency practice simply changes. The authority exists, but the question is whether agency initiative does. In light of the recent troubles with banks and financial institutions, maybe there is initiative for oversight. Especially considering the Basel Committee’s recent focus on deposit-taking institutions as related to microfinance activities, there is the added issue of what regulations are necessary in the event that individuals do, and continue to, deposit significant amounts of their earnings in MFIs. Many MFIs in the United States currently suggest partner banks or other depository institutions for borrowers to make checking or savings deposits. But some MFIs could choose to accept deposits themselves. They might be encouraged to do so for funds once initial donor investment money is spent and further growth is desired. In particular, those operating for profit and falling under the usual bank regulatory regimes are likely to be subject to more requirements. Some have argued that it is most appropriate for them to be supervised by whatever regulator supervises commercial banks, requiring specialized staff since both the risk characteristics of MFI loans and the supervisory techniques

⁹⁹ 476 U.S. 426 (1986).

¹⁰⁰ *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 257-259 (1995).

¹⁰¹ *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.* 467 U.S. 837, 842 (1984) (holding that legislative silence or ambiguity on an issue allows an agency’s treatment of such issue if it is based on a permissible reading of the statute).

most suited to MFIs differ from those involved with commercial banks.¹⁰²

IV. STRATEGIES TO IMPLEMENT

In order to consider possible solutions for ensuring the expansion of microfinance in the United States avoids the foregoing problems, it is worth examining how various players at the international level have addressed the issues of borrower protection and financial regulation. It may be that all the necessary parts of rulemaking power are already in place to ensure microfinance's long-term safety and viability, particularly to individual consumers, but also as a potential part of financial markets.¹⁰³

A. What Kind of Regulation?

Especially if the roots of MFIs in humanitarian aid are ignored, the type of credit they extend seems in theory to resemble the usurious payday loans and fringe products addressed in Part III.C. Regulation should attempt to quell this concern. There might be a range of parties with interests in the level and nature of regulation, namely the government in defending the public interest, for-profit institutions in encouraging investment (in what might be described as pseudo-social enterprises) while avoiding government constraints, and purely nonprofit organizations in presenting sustainability to stakeholders.¹⁰⁴

MFIs self-regulating through Self Regulatory Organizations (SROs) should be considered. In this context, self-regulation involves regulation by a body "effectively controlled by the regulated entities,

¹⁰² See Christen, *supra* note 90, at 27.

¹⁰³ Safety and viability in the second context would be evaluated from the perspective of securitizing MFI loans to be packaged and traded, which is beyond the scope of this article. For an in-depth guide through the process, see SECURITIZATION: A TECHNICAL GUIDE (Consultative Group to Assist the Poor/The World Bank and Grameen Foundation USA 2010) available at <http://www.cgap.org/sites/default/files/CGAP-Technical-Guide-Securitization-Oct-2010.pdf>.

¹⁰⁴ Eugenia Macchiavello, *Microfinance Regulation and Supervision: A Multi-Faced Prism of Structures, Levels and Issues*, 9 N.Y.U. J. L. & BUS. 125 (2012-2013).

and thus not *effectively* controlled by the government supervisor.”¹⁰⁵ The Financial Industry Regulatory Agency (FINRA) is an example, but it is subject to the “active and direct oversight of the SEC.”¹⁰⁶ For this reason, one author argues FINRA is technically not a government entity, but should still be subject to administrative law and constitutional restrictions.¹⁰⁷ Regardless of how an SRO governing MFIs is classified, the government would be less involved than with direct agency oversight, but more involved than allowing regulation through market forces.¹⁰⁸ This might make it much more desirable than creation of yet another regulatory agency or expanding of the scope of a particular agency’s oversight. The government would encourage self-regulation through rules that “threaten costly litigation should [the] industry fail to deliver socially desired outcomes.”¹⁰⁹ As a result, MFIs might comply with the applicable SRO’s rules even if just to avoid government intervention.¹¹⁰ To the consumer, a successful SRO would inspire confidence through the related function of hearing and addressing consumer concerns.¹¹¹ An effective arrangement could involve the SRO enjoying immunity from lawsuits, like securities industry SROs,¹¹² to isolate it from industry influence. At the same time, the SRO would provide grievance redress, specifically for MFI borrowers.¹¹³

In developing countries, however, self-regulation has seen its failure in maintaining the soundness of financial intermediaries, leading critics to calling it a gamble.¹¹⁴ To some extent, self-regulation

¹⁰⁵ See Christen, *supra* note 90, at 28 (emphasis added/repeated).

¹⁰⁶ Karmel, *supra* note 40, at 152.

¹⁰⁷ *Id.* at 155.

¹⁰⁸ Abraham L. Newman & David Bach, *Self-Regulatory Trajectories in the Shadow of Public Power: Resolving Digital Dilemmas in Europe and the U.S.*, 17(3) GOVERNANCE 387, 390 (2004) (discussing self-regulation of relatively “new” areas such as e-commerce, and characterizing the U.S. model of self-regulation as *legalistic self-regulation*).

¹⁰⁹ *Id.* at 388.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 390.

¹¹² See Karmel, *supra* note 40, at 173.

¹¹³ See Brigit Helms & David Porteous, *Focus Note 27: Protecting Microfinance Borrowers*, CONSULTATIVE GROUP TO ASSIST THE POOR, 4 (May 2005), available at <http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Protecting-Microfinance-Borrowers-May-2005.pdf>.

¹¹⁴ See Christen et al., *supra* note 90, at 28.

is nothing more than a meaningless political concession to no regulation.¹¹⁵ Further criticism suggests that successful regulation through an SRO depends on whether “the majority of institutions are under its jurisdiction and if sanctions for non-compliance can be enforced,” conditions that are seldom met.¹¹⁶

Nevertheless, a regime of self-regulation might be an inexpensive measure to precede full-scale regulatory involvement and test its self-regulation’s effectiveness. At the very least, it could encourage reporting and articulation of “best practices.”¹¹⁷ For guidance on borrower protection, the Consultative Group to Assist the Poor (CGAP) and organizations such as Accion have promoted a campaign for Client Protection Principles (“CPPs”) to address avoidance of over-indebtedness, transparent pricing, appropriate collection practices, ethical staff behavior, mechanisms for grievance redress, and client data privacy.¹¹⁸ As far as financial and prudential regulations, the Basel Committee has done the same, as referenced in Part II.¹¹⁹ International best practices are available from many different sources and could be adopted by the applicable SRO, making compliance a requirement for membership. Membership would then act as a quality-screening device for prospective borrowers.

B. The Dilemma of Capping MFI Interest Rates

Usury laws applied to MFIs present a complex problem. With respect to for-profit lenders, regulators likely would not think twice to apply them. But from the business perspective, high interest rates are necessary. MFIs issue loans of small principal amounts. The loan cycles for MFI loans, designed to help borrowers stay current and avoid substantial individual payments, are shorter than those of traditional commercial loans, usually at six months to a year with some amount due every week.¹²⁰ Because this means more collection activities and transactions for a given account, overall costs are

¹¹⁵ *Id.*

¹¹⁶ Greuning et al., *supra* note 98, at 16.

¹¹⁷ *Id.*

¹¹⁸ Macchiavello, *supra* note 104, at 170.

¹¹⁹ Basel, *supra* note 16.

¹²⁰ Davis, *supra* note 84, at 417.

substantially higher than those for traditional portfolios of fewer but larger (and longer-term) loans.¹²¹ Many MFIs are forced to charge “obscene” interest rates, much higher than commercial bank rates and outside of most regulators’ comfort zones, to cover these costs and remain financially sound.¹²² Without alternatives, poor borrowers around the world have had little objection to these high rates.¹²³

On the one hand, countries with monopoly players dominating their microcredit markets have been thought to achieve better results with caps, because they increase market entry, encouraging competition with established players and consequently driving loan prices down.¹²⁴ However, caps might fall short of lawmakers’ good intentions when considering the high administrative costs previously discussed. For example, Bolivia caps loan interest at three percent per month.¹²⁵ By American standards, the equivalent compounded maximum annual rate of 42.58 percent, if charged, is criminally high. As a point of reference, Florida law, which is already generous among its peers, declares usurious annual rates higher than eighteen percent for loans under \$500,000.¹²⁶ For loans over \$500,000, it is a second-degree misdemeanor for a lender to charge annual rates between twenty-five and forty-five percent and a third-degree felony to charge more than forty-five percent.¹²⁷ As generous as the Bolivian cap is, it could fail as a consumer protection device if the rates charged are still too harsh for borrowers and if MFIs are unable to operate efficiently. Where pre-determined rates are imposed on lenders they usually prevent lenders from covering their costs, barring them from “operat[ing] efficiently and competitively.”¹²⁸ If enough sanctioned MFIs withdraw in a certain market, borrowers would be forced to rely on informal lenders due to

¹²¹ *Id.* at 416.

¹²² *Id.* at 417.

¹²³ *Id.*

¹²⁴ Bernstein, *supra* note 50, at 22.

¹²⁵ Heywood W. Fleisig & Nuria De La Peña, Legal and Regulatory Requirements For Effective Rural Financial Markets, CTR. FOR THE ECON. ANALYSIS OF LAW, 27 (2003).

¹²⁶ FLA. STAT. § 687.02(1) (2014)

¹²⁷ FLA. STAT. § 687.071(2), (3) (2014)

¹²⁸ See Joanna Ledgerwood, *Microfinance Handbook: An Institutional and Financial Perspective*, WORLD BANK 18 (1999).

the reduction in regulated lenders.¹²⁹ In addition to usurious rates, the use of abusive collections tactics might manifest as a problem. In theory, it could be a matter of laws allowing different rates for different financial subsectors. Such a policy is found in South Africa, where legislation authorizes the Minister of Trade and Finance to set rates based on market data and in consultation with the National Credit Regulators, an independent body of economic experts.¹³⁰ Regulation in the United States could seek to adjust rates or rate caps on a more specific basis to balance the burden on borrowers and the financial viability of MFIs.

C. Consumer Protection: Abuses and Transparency

Regardless of the type or amount of regulation imposed on MFIs, much of it will fail without some degree of fairness to borrowers. Regulations should prevent coercion and confusion. For a new regulatory body, policies and data could be borrowed from the CFPB's playbook on credit products, or CGAP guidelines.¹³¹ Microloan terms should be barred from containing the "tricks and traps" of credit card (or mortgage) terms.¹³² The full range of an MFI's loan offerings should be marketed as "vanilla" or standardized products without provisions like balloon payments.¹³³

Best practices or regulation should also take a paternalistic stance against exploitative practices. Some scholars have explored how welfare effects of consumer credit are skewed by lender manipulation of consumer preferences.¹³⁴ These scholars suggest that lenders exploit borrower optimism and insufficient reasoning.¹³⁵ The lenders leverage this behavior to persuade borrowers to "enter credit transactions that reduce their consumption in the present and future,

¹²⁹ See *id.*; see also Heywood & De La Peña, *supra* note 125.

¹³⁰ Megan Whittaker, *South Africa's National Credit Act: A Possible Model for the Proper Role of Interest Rate Ceilings for Microfinance*, 28 NW. J. INT'L L. & BUS. 561, 573 (2008) (discussing South Africa's arguably successful implementation of rate ceilings).

¹³¹ See Helms & Porteous, *supra* note 113, at 4.

¹³² Mann, *supra* note 57, at 735.

¹³³ *Id.* (different scholars' approaches to the best types and terms for mortgages)

¹³⁴ See White, *supra* note 53, at 1104.

¹³⁵ *Id.*

do not result in investment or other gains, and simply transfer their limited resources to lenders and investors.”¹³⁶

Standardized loans go hand in hand with standardized terms, particularly statements of cost. Loans made by different types of lenders routinely state the cost of the loan according to different standards. For example “[a]nnual percentage rate and total cost of credit count the cost of borrowing differently and are used among other calculations.”¹³⁷ The gap between the requisite literacy to fully understand financial products and actual borrower literacy¹³⁸ is a problem that can be addressed uniform and easily understood standards. Select CCPA and TILA provisions should be applied to microloans, especially those mandating the standard APR calculation, the disclosure of the appropriate “finance charge” and uniformity of disclosure.¹³⁹ In addition, notwithstanding how high or low rates are set at a certain time of underwriting, payments by borrowers should be fully amortizing and interest rates should be fixed.¹⁴⁰ This would lead to less of the surprises endured by consumers in the mortgage crisis, with loans transforming from low (teaser) rate opportunities into “explosive” subprime financial products.¹⁴¹

Another lesson from the crisis is the undesirability of individual borrowers with multiple loans outstanding.¹⁴² Borrowers with multiple loans, or loans in frequent succession, are a criticism levied against payday lenders as potentially “ensnar[ing] consumers in a debt trap.”¹⁴³ MFIs should therefore be barred from issuing multiple concurrent loans to individual borrowers, and a mechanism should be implemented to limit an individual borrower’s ability to obtain loans from different lenders. Rules, as either a supplement or an alternative, could cap the amount of debt relative to a borrower’s income and incorporate penalties as appropriate for exceeding the

¹³⁶ *Id.*; see also Bar-Gill & Warren, *supra* note 52, at 46.

¹³⁷ Bernstein, *supra* note 50, at 21.

¹³⁸ *Id.*

¹³⁹ See section III.C.2 *infra* for a discussion of the Truth in Lending Act.

¹⁴⁰ Mann, *supra* note 57, at 734.

¹⁴¹ See Bar-Gill & Warren, *supra* note 52, at 10.

¹⁴² Bernstein, *supra* note 50, at 23.

¹⁴³ Hynes, *supra* note 96, at 615-16.

cap.¹⁴⁴ Specific guidance to address some of these issues is available to regulators and to the MFI industry in model principles such as the CPPs discussed above.¹⁴⁵

V. CONCLUSION

The potential for small loans to have a positive impact on credit access in the United States seems to be undermined by this lack of legal certainty. Nonprofit institutions in the United States are organized in ways that escape the brunt of regulation and so are their products. However, the foray of MFIs around the world into for-profit operations suggests that U.S. based organizations are not far behind. As they move into the role of an alternate source of financing, these lenders' missions would benefit greatly if new laws could address safety both on the consumer and institutional levels. Increasing access to credit is meaningless if reforms are not proactively implemented to address the problems previously experienced with predatory and payday lending. While the purposes of microcredit might stymy some of these concerns, continuing to treat microfinance as an exception to rules seems contrary to policies that purport to put consumers first. A legal and regulatory framework for this field must exist beyond carving out exceptions. Finally, such a framework should reflect commitments to the consumer and serve to promote efficiency and safety rather than acting as a burden on the industry.

¹⁴⁴ Helms & Porteous, *supra* note 113, at 3.

¹⁴⁵ Macchiavello, *supra* note 104, at 170.