

BANKING FOR THE POOR: BUILDING A NEW INTERNATIONAL LEGAL ARCHITECTURE FOR MICROFINANCE

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Microfinance has defied traditional beliefs in proving that poor global citizens in Africa and other developing regions are “bankable” and that financial services extended to them can be scaled. Yet, increasingly, there is an awareness that certain microfinance institutions are engaging in harmful behavior - akin to the predatory behavior of lenders in the now-collapsed subprime-market. Common features of both markets include the express targeting of poor, minority persons and a growing presence of unfair lending practices, with an attendant high risk of irresponsible growth and great harm to borrowers. This article proposes a new international legal architecture for microfinance, one that promotes responsible growth and fair lending practices. It expands upon the principles outlined in the 2008 Campaign for Client Protection initiated by certain microfinance institutions. It proposes more granular guidelines for responsible and sustainable growth that is centered on: ensuring fair lending; ensuring a free and fair bargaining process; protecting the dignity of clients; and closely monitoring microfinance institutions' growth and interactions with global capital markets. By adopting such a legal framework, the microfinance industry has the potential to build a double-bottom line, where social and economic well-being are reinforced in concert.

KEYWORDS

Microfinance, MFI, Predatory Lending, Subprime, Loan Banking, Client Protection

BIOGRAPHICAL STATEMENT

Margaux J. Hall received a J.D. *cum laude* from Harvard Law School and is currently a Fulbright Scholar in South Africa affiliated with the University of Cape Town Law School and Stellenbosch University Law School. After graduating from law school, she worked with One Acre Fund – a microcredit non-profit in East Africa – while supported by a Sheldon Fellowship from Harvard University. Her work with One Acre Fund and its exemplary staff revealed microfinance’s great potential to help persons uplift themselves from poverty if microfinance institutions operate in a responsible and client-focused manner.

Introduction

“Whatever banks did, I did the opposite.”¹ With that radical approach to financial services, Muhammad Yunus – a young economics professor at Chittagong University in Bangladesh – revolutionized the world’s approach to providing financial services for poor global citizens in 1976. Yunus developed the concept of microfinance – the extension of small amounts of credit and other financial services to poor community members.² In becoming a “banker for the poor,” Yunus sparked a microfinance blaze that has spread rapidly through developing countries including many on the African continent. It has spanned non-profit and for-profit groups, now extending to commercial banks such as Citigroup.

Today, *microfinance* is far from *micro* in scale. It has grown to extend to over 100 million clients across Africa and the world a range of financial services³, including savings, insurance, and pension services.⁴ It is present in the developing and developed world alike, offering services to marginalized community members like Roma persons in Europe and disabled persons in rural Bangladesh.⁵

Microfinance has significantly expanded to include a wider set of financial players than non-profits like Yunus’ Grameen Bank. Commercial banks are now at the forefront of microfinance’s rapid expansion to as yet un-served persons across the globe. They are doing so in a highly unregulated and unstructured landscape through the use of international capital markets. What began with Yunus’ design of the “opposite” of a bank now is closely intertwined with top global banks that are in fierce competition with one another. As former United Nations’ Secretary-General Kofi Annan noted, “[m]icrofinance is not charity. ... [T]oday it is a real business.”⁶ Commercial financial

¹ Muhammad Yunus, *Creating a World Without Poverty: Social Business and the Future of Capitalism* (2008).

² *Nobel Winner Yunus: Microcredit Missionary Economics professor Muhammad Yunus wasn't afraid to turn the rules of banking upside down*, Business Week (Dec. 26, 2005), available at http://www.businessweek.com/magazine/content/05_52/b3965024.htm.

³ See Sam Daley-Harris, *State of the Microcredit Summit Campaign Report 1* (2005).

⁴ See MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS: A READER’S GUIDE TO THE MILLENNIUM PROJECT REPORTS AND OTHER UN DOCUMENTS 5-6 (Oct. 2005); *About Microfinance*, The Consultative Group to Assist the Poor (CGAP), available at <http://www.cgap.org/about/faq01.html> (discussing the range of financial services available from microfinance institutions).

⁵ See *Call for EU Legislation to Encourage Microcredit Schemes*, Monday, News Wire (Jan. 26, 2009), available at <http://www.microcapital.org/press-release-call-for-eu-legislation-to-encourage-microcredit-schemes/> (noting the Economic and Monetary Affairs Committee’s formal call for the European Commission to form a legislative proposal to extend microcredit to women, immigrants and Roma community members); *Microcredit Empowers Disabled Bangladeshis*, One World.Net (Aug. 29, 2008) (noting that the Blind Education and Rehabilitation Development Organization has been giving loans to many physical disabled persons in Bangladesh since 1991).

⁶ See Ximena Escobar de Nogales, *Microfinance Matters: Geneva Symposium Addresses Investing Private Capital in Microfinance: Attracts Broad Private Sector Participation* (Oct. 2005), at 33, available at http://www.uncdf.org/english/microfinance/pubs/newsletter/pages/2005_10/update_geneva.php. Then-United Nations

institutions view microfinance as an unexploited opportunity for private sector profit, perhaps even one that can withstand the global economic downturn.⁷

Yet certain voices have been less audible, yet highly worthy of consideration, in the microfinance conversation. Eva Yanet Hernández Caballero's is one of these voices.⁸ The daughter of a small Mexican farmer, Eva took out a loan from Compartamos (meaning "let's share" in Spanish) in order to buy yarn and knitting machines to sew socks. Over four years, she borrowed money ranging from \$200 to \$1,800 at an annual percentage rate of 105%. Eva was a microfinance poster child, producing 1,500 pairs of socks a week and bringing in \$800 in revenue a week. But when her wholesale customers fell behind in payments, her business and life "unraveled." She missed several \$130 repayment installments, and the other 22 members of her borrowing circle had to pay on her behalf. She encountered resentment and eventual expulsion from the group. "It's been a huge effort," she says, "and we're barely afloat now."⁹

Eva's story has similar threads with those of recipients of subprime loans in the U.S. during the 1980's, 1990's, and early 2000's. The subprime market that collapsed this past year, adversely affecting many American families and financial institutions in the process, has striking similarities to the burgeoning microfinance industry. The issuance of subprime loans to a community of families with otherwise-limited access to financial services was celebrated as a means to extend the American dream of homeownership to more lower-class and minority families. The banking industry led the way in designing and implementing financial products to serve these community members. The government played a minimal role, allowing free market agents to design an increasingly complex range of financial products.

The casualties of the rapid and largely unsupervised growth that followed are now evident. The country confronts a great crisis among lower and middle class borrowers and institutional lenders, with estimated losses of \$164 billion in wealth during 2008 alone.¹⁰ A recent study concluded that the subprime mortgage crisis has caused the largest loss of wealth for black and Latino homeowners in modern U.S. history.¹¹ The

Secretary-General Kofi Annan made this statement at the open of a Geneva Private Capital Symposium in October 2005 that emphasized the importance of generating private capital for microfinance. *See id.*

⁷ See Elisabeth Rhyne, *Viewpoint: Standards for Microfinance Growth*, American Banker (Dec. 17, 2008).

⁸ See *Compartamos: From Nonprofit to Profit, Behind its gentle image is a tough, highly lucrative bank*, Business Week (Dec. 13, 2007). Business Week ran a series of articles that closely investigated microlender practices and provided a range of important coverage of the human stories that underlie the objective statistics on default and repayment rates. Their story on Eva Yanet Hernández Caballero is just one of these.

⁹ *Id.*

¹⁰ SIF Predatory Lending Fact Sheet, Community Investing Center (2008), available at <http://www.communityinvest.org/documents/SIFPredatoryLendingFactSheet-2008.pdf>; Ken Sweet, *Analysis: American Dream On Standby*, Fox Business News (Oct. 16, 2008) available at <http://www.foxbusiness.com/story/markets/american-dream-standby/>.

¹¹ FORECLOSED: STATE OF THE DREAM 2008, UNITED FOR A FAIR ECONOMY (2008). Minority subprime borrowers will lose \$164 billion to \$213 billion for loans taken out in the past eight years. Black borrowers will lose \$72 billion to \$93 billion, and Latino borrowers will lose \$76 billion to \$98 billion. *Id.* See also Michelle Singletary, *King's Dream Deferred, One More Victim of the Subprime Mortgage Crisis*, The Washington Post, F01 (Feb. 10, 2008) ("The dream

country is increasingly aware of the risks that overabundant funding and irrational, unregulated growth pose to all stakeholders.

The global economic crisis of 2008 offers a window into the harms that can result from overzealous growth, coupled with inadequate regulation and supervision.¹² Without adequate constraints and principles guiding their expansion, financial institutions can compete to the death. Importantly, without a fair and accurate understanding of the terms of the transactions into which they enter, families in the lower and middle classes stand to lose their homes and fall into financial depression. They also face threats to their dignity and their entitlement to the American mantra of a fair and equal chance at success.

A powerful lesson emerging from this subprime mortgage crisis and economic crisis is the need for careful deliberation, principles and oversight when creating financial services for disadvantaged community members, particularly those living below the poverty line on the African continent.¹³ The law has an important role to play in this endeavor. One must ask if the same attributes that spurred this market and contributed to the subprime market's fast-paced and deleterious decline are also present in the commercial microfinance market. Commercial microfinance stands at the precipice of global capital markets.¹⁴ It enjoys a steady influx of funding, minimal regulatory constraints, and a wide audience of supporters.¹⁵ Certainly, access to credit is essentially important for poor persons. For many, the success of a small business can help uplift them from poverty and help them realize human rights like the right to health, the right to housing, the right to education and the right to work.¹⁶ Grameen Bank has framed its microfinance services as realizing another human right, the right to credit.¹⁷

This article acknowledges the successes of many microfinance institutions to-date, but seeks to elucidate the less frequently heard, and more pernicious, stories underlying certain microfinance initiatives. It highlights the commonalities between the subprime market and the commercial microfinance market. It demonstrates how the harms currently being confronted in the collapsed subprime market are already evident on a small scale within the microfinance sector and, left unfettered and unregulated, can expand to the serious detriment of poor borrowers as well as lenders. The article argues that there are important reasons for the legal community to play a role in shaping global

of economic stability and opportunity for everyone living in the U.S., so eloquently described by Martin Luther King Jr., is bound up with homeownership, the most significant source of wealth for most people," said Dedrick Muhammad, senior organizer and research associate at the Institute for Policy Studies and co-author of the UFE report."')

¹² See Rhyne, *supra* note 8.

¹³ See *id.*

¹⁴ See Cecelia Beirne, Subprime Lending: Lessons for the Microfinance Industry, MicroVest Capital Management LLC 4 (April 2008).

¹⁵ See *id.* at 3-4; MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 4; Michael S. Barr, *Microfinance and Financial Development*, 26 MICH. J. INTL. L. 271, 274, 284.

¹⁶ See MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 8, 9, 19.

¹⁷ Muhammad Yunus, *Letter to the Ed., Credit as a Human Right*, Wall St. J., A19 (Dec. 12, 2001).

microfinance, and it offers a potential framework to steer microfinance institutions towards rational growth and responsible lending practices.

Roadmap

The paper proceeds as follows. Part I defines microfinance and describes its historical evolution. It describes the features of microfinance that have won it large praise, as well as the stories that raise concerns about the ethics of certain lenders operating in this space, including those in Africa and Latin America. Part II defines the subprime market that flourished in the developed world in the past few decades and recently faltered. It highlights the rapid growth that precipitated the subprime market's sudden crash. Part III identifies a series of similarities between the microfinance market and subprime market, namely the emphasis on providing financial services to disadvantaged community members; a series of unique terms and bargaining relationships that approached and sometimes squarely fell within predatory lending; the development of increasingly complex financial instruments; and the deregulation of the markets and their integration into global capital markets. Part IV outlines the causes and effects of the collapse of the subprime market, including the dramatic effect that the collapse had on the financial well-being of minority families in the United States. Part V proposes a new legal architecture to guide microfinance institutions, an architecture that expands upon the principles outlined in the 2008 Campaign for Client Protection initiated by certain microfinance institutions. It proposes more granular guidelines for responsible and sustainable microfinance growth that is centered on: ensuring fair lending; ensuring a free and fair bargaining process; protecting the dignity of clients; and closely monitoring microfinance institutions' growth and interactions with global capital markets. Part VI concludes by highlighting the potential to build a double-bottom line for the microfinance industry, where social and economic well-being are reinforced in concert.

Part I: The Microfinance Industry

What is Microfinance?

Microcredit is the extension of credit, or small loans, to individuals who often are not able to access traditional forms of credit. Its origins extend back to 1979, when Muhammad Yunus launched an innovative lending program. Yunus lent \$27 from his

pocket to a group of poor craftsmen in the town of Jobra, Bangladesh.¹⁸ To boost the potential impact of the \$27, he volunteered to be a guarantor on a larger loan from a traditional bank. He thereby inspired the concept of a financial enterprise called the Grameen Project.¹⁹ Beginning with this gesture, Yunus became a new model of “banker” far different from those in the large-scale commercial banks. He became a “banker for the poor.” Yunus breathed life into a global micro-development and micro-prosperity campaign that won him the Nobel Prize for Peace in 2006.²⁰

Microcredit has expanded over the years to include a range of other financial services for borrowers, such as savings, insurance, pension funds and remittances.²¹ Microfinance is the provision of small loans and these other services to individuals who are often not served by traditional financial institutions. Loans are often given to poor, rural entrepreneurs and people working in the informal sector who wish to pursue a business endeavor.²² “Up to 80% of people in developing countries derive their incomes from the informal sector, thus the need for good financial mechanisms to support wealth creation and financial services in this sector.”²³ Microfinance can help smooth fluctuations in farm income in natural disasters such as drought.²⁴

Microcredit providers generally give a borrower a small loan that can be increased over time if the borrower meets his or her repayment obligations.²⁵ Often, the lender will issue a loan or several loans to a group, each member of which is jointly and severally liable for the loans of the other group members.²⁶ If one person fails to repay, the other group members must account for the loss or else all group members lose the opportunity to further participate with the program. Lenders charge high interest rates, ranging from 20 percent to over 100 percent, in part because small loans are costly to service.²⁷ Loan officers must make regular visits to the individual or group to collect repayment. For commercial banks, the high interest rates also reflect a desire to make a profit.²⁸ The banks contend that despite the high interest rates they charge, their loans are still far

¹⁸ Nobel Winner Yunus, *supra* note 3.

¹⁹ *Id.*

²⁰ *Id.*

²¹ See MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 5-6. See also About Microfinance, The Consultative Group to Assist the Poor (CGAP) <http://www.cgap.org/about/faq01.html> (discussing the range of financial services available from microfinance institutions).

²² See Eduardo Kaplan, *Background: Microlending, Initiative for Policy Dialogue*, http://www2.gsb.columbia.edu/ipd/j_microlending.html.

²³ See MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 6.

²⁴ See *id.*

²⁵ See Zern-shun Adam Chen, *Securitizing Microcredit: The Implications of Securitization for Microcredit Institutions' Human Rights Missions*, 39 COLUM. HUM. RTS. L. REV. 757, 762-63 (2008).

²⁶ Kenneth Anderson, *Microcredit: Fulfilling or Belying the Universalist Morality of Globalizing Markets?*, 5 YALE HUM. RTS. & DEV. L.J. 85, 108 (2002).

²⁷ Many microfinance institutions have felt compelled to become financially sustainability in order to advance their human rights goals. See, e.g., Chen, *supra* note 25, at 759.

²⁸ See Anderson, *supra* note 26, at 100 (noting the desire for a reasonable profit at Standard Bank in South Africa).

preferable to those offered by loan sharks or moneylenders, who can charge 10 to 20 percent interest per day, which over an annual period amounts to 4000 percent interest.²⁹

The Rapid Expansion of Microfinance

Microfinance institutions have expanded dramatically in size, and more institutions have joined the industry. In 1996, less than one thousand microfinance institutions existed, providing financial services to 13 million persons.³⁰ Less than ten years later in 2005, over ten thousand microfinance institutions existed, providing small loans to 100 million clients.³¹

Among the new lenders are large commercial banking entities such as HSBC and Citibank.³² These commercial players are assuming an ever-more dominant role in the microfinance industry. Indeed, Carlos Labarthe of Compartamos, the largest microfinance institution in Latin America, has estimated that in a matter of years, around 80 to 90 percent of microfinance institutions will be commercial lenders.³³ At the same time, the industry is increasingly being run according to commercial principles dictated by investors. The rapid growth in microfinance is not only experienced in the developing world. Developed countries are seeing microfinance institutions as a powerful mechanism to serve marginalized and minority community members.³⁴

Growing Popularity and Praise of Microfinance

Microfinance has grown tremendously in popularity, with the United Nations viewing it as a critical strategy to assist in the attainment of the Millennium Development Goals.³⁵ The year 2005 was designated by the United Nations as the “International year of

²⁹ See CONSULTATIVE GROUP TO ASSIST THE POOR, MICROFINANCE IN CENTRAL AMERICA AND MEXICO: PROFILE AND CHALLENGES 3 (2001), available at <http://www.microfinancegateway.org/content/article/detail/3518> [hereinafter CGAP CENTRAL AMERICA AND MEXICO].

³⁰ See SUSTAINABLE BANKING WITH THE POOR, WORLD BANK i (1996), available at http://microfinancegateway.com/files/28364_file_10.pdf.

³¹ Michael Phillips et al., 'Microloan' Father Yunus Is Awarded Nobel Peace Prize--Bank Spurred Global Movement Through Aid to Women, Poor; Major Insurers Following Suit, Wall St. J., B1 (Oct. 14, 2006). The Consultative Group to Assist the Poor reports that investment in microfinance funds grew at a compound annual rate of 80% from 2004-2007, and currently investments amount to \$5.4 billion. Rhyne, *supra* note 8.

³² Eric Bellman, *Invisible Hand: Entrepreneur Gets Big Banks to Back Very Small Loans--Microlending-for-Profit Effort In India Draws Business From Citigroup, HSBC--Ms. Dobbala's Baby Buffalo*, Wall St. J. (Eastern Edition), A1 (May 15, 2006).

³³ See Connie Bruck, *Millions for Millions*, New Yorker, 62 (Oct. 30, 2006).

³⁴ See *Call for EU Legislation*, *supra* note 6.

³⁵ See MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 4; Michael S. Barr, *Microfinance and Financial Development*, 26 MICH. J. INTL. L. 271, 274 (advocating the use of microfinance as a way to attain the United Nations Millennium Development Goals).

Microcredit.”³⁶ Attendees at the 2005 United Nations World Summit concluded: “We recognize the need for access to financial services, in particular for the poor, including through microfinance and microcredit.”³⁷ Microfinance has been lauded as an effective means to achieve numerous UN MDG targets, including the following:

- Eradicating extreme poverty and hunger;³⁸
- Promoting gender equality and empowering women;³⁹
- Combating HIV/AIDS, malaria and other diseases;⁴⁰ and
- Ensuring environmental sustainability.⁴¹

Microfinance has been unique in receiving praise from a wide spectrum of individuals and entities – spanning the political and ideological spectrum. Former President Bill Clinton has championed it as a key way to target the poor and provide them with an equal opportunity at financial success.⁴² Socially oriented nonprofits have appreciated the attention to marginalized and otherwise-unserved community members such as women, minorities, and those in remote, rural areas. They have applauded the industry’s empowerment of women and marginalized community members like slum dwellers that are otherwise restricted from easily accessing the formal financial sector.⁴³

Commercial banks and financial institutions have joined in the praise, finding great promise in the high reported repayment rates and rates of return on investments – with studies showing that most MFIs achieve at least 98 percent repayment, and some offer at least 15 percent return on investments.⁴⁴ Many lenders have been successful across a variety of contexts and settings.⁴⁵ Some microfinance institutions are more profitable than traditional banks.⁴⁶ For example, Compartamos, a Mexican microfinance institution, reported a 47.7% return-on-equity between 2001 and 2003.⁴⁷

³⁶ MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 4-5.

³⁷ *Id.* (referencing the United Nations World Summit Outcome Document, at para 23(i)).

³⁸ MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 17 (stating that microfinance provides not only loans to start businesses but also offers a range of financial services like savings and insurance products).

³⁹ *Id.* (reporting that microfinance creates wealth and financial products for women and allows many women to enter self employment or start their own business).

⁴⁰ *Id.* (noting that the financial services help individuals protect their health by saving and insuring, and that healthier borrowers in turn pose less of a credit risk, comprising a positive feedback loop).

⁴¹ *Id.* at 18 (stating that certain financial institutions offer microfinance services that promote environmentally sustainable businesses and that certain slum dwellers are able to access microfinance for home improvements).

⁴² See Diane Ainsworth, *Clinton: education, economic development key to building a peaceful, global village* (Jan. 29, 2002), transcript available at <http://berkeley.edu/news/features/2002/clinton/>.

⁴³ See MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 8.

⁴⁴ See *Focus on MFI Performance by Region*, 12 MICROBANKING BULLETIN 1, 47 (2006) (offering statistics on microfinance institutions’ achievements). The MicroBanking Bulletin compiles financial information on microfinance institutions semi-annually and segments institutions according to size, region of operation, and maturity. In this report, the most mature mature (8+ years) institutions report a Return On Equity of 11.5 percent and Return On Assets of 2.8 percent, while younger institutions (5-8 years) report a Return on Equity of 5.1 percent and a Return on Assets of 1.6 percent. *Id.*

⁴⁵ See generally Tom Easton, *A Survey on Microfinance: Micro No More*, Economist, (Nov. 5, 2005).

⁴⁶ Chen, *supra* note 25, at 760 (citing Jennifer Isern, CONSULTATIVE GROUP TO ASSIST THE POOR (CGAP) COMMERCIAL BANKS AND MICROFINANCE: EVOLVING MODELS OF SUCCESS 2 (2005)). A study was performed that compared the

Even international development institutions such as the International Monetary Fund (IMF), the United Nations and the G8 have made declarations for the rapid expansion of microfinance and its integration into long-term country financial planning. Then-United Nations' Secretary General Kofi Annan stated in October 2005, "[m]icrofinance is not charity. In some cases it might have started out as philanthropy. But today it is a real business."⁴⁸ The IMF stated that "[t]o achieve its full potential, microfinance must become a fully integrated part of a developing country's mainstream financial system rather than being confined to a niche of the development community."⁴⁹ And in 2004, the G8 made a formal declaration on expanding access to microfinance for entrepreneurs. The declaration called for G8 countries to:

- Focus on best practices for expanding and mainstreaming sustainable microfinance;
- Reduce barriers to access to domestic and international capital markets;
- Encourage, where needed, the establishment and expansion of self-sustaining microfinance investment funds;
- Assist developing countries to improve their legal and institutional frameworks for microfinance so it can become sustainable and more widely available; and
- Enable growing microenterprises to access capital by reducing barriers for bank lending, promoting innovative bank-microfinance institution linkages, and removing disincentives to business formalization.⁵⁰

Cause for Concern? Lender Practices Deserve Closer Inspection

Microfinance appears as a blazing train towards poverty alleviation. Why put on the brakes? With a more critical look at microfinance, tensions and questions emerge. The first questions industry participants' adherence to the nonprofit mission statements that originally accompanied microfinance when individuals like Yunus introduced it to the world. As microfinance has grown to include not only small nonprofits but also publicly traded financial institutions, individuals have begun to question the appropriate balance of the two missions: the mission of increasing access to financial services to everyone

profitability of top microfinance institutions and top ten global commercial banks. It found that 51 microfinance institutions had reported profits that exceeded the weighted average of profits among the top ten global commercial banks. See Julie Abrams, *The Microfinance Profitability Index*, MicroBanking Bull., 19-20 (Aug. 2005), available at http://www.mixmbb.org/Publications/001-IND/01-IND.ANLS/01-IND.ANLS.MBB/MIX_2005_08_MBB11.pdf.

⁴⁷ Chen, *supra* note 25, at 760 (citing Julie Abrams, *supra* note 47, at 21). See also Jay Lee, *Equity and Innovation: Using Traditional Islamic Banking to Reinvigorate Microlending in Urban America*, 16 IND. INT'L & COMP. L. REV. 523, 534 (2006) (showing that microfinance institution investments were safer than investments in the market).

⁴⁸ See Escobar de Nogales, *supra* note 7, at 33.

⁴⁹ MICROFINANCE AND THE POOR: FINANCE & DEVELOPMENT, INTERNATIONAL MONETARY FUND (June 2004).

⁵⁰ See MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 12-13.

who needs them by using rigorous business principles and the mission of maintaining a concerted focus on the well-being of poor, rural, often marginalized clients.⁵¹

The other tension is how to respond to the small, yet ever present, evidence of financial lender abuses towards clients taking out small loans or otherwise transacting with microfinance institutions. A number of microfinance institutions have been charging borrowers interest rates so high that they have led to enormous indebtedness, even to the point of de facto servitude.⁵² Some MFIs in India resemble loan sharks, charging interest rates on the full loan amount rather than on the declining balance of the loan, and intimidating and embarrassing borrowers.⁵³

Further, even if a microlender itself upholds principled and non-exploitative lending practices, there is always the risk that borrowers – falling just short of their repayment installment – will resort to the feared loan sharks in order to obtain a bridge loan.⁵⁴ Many borrowers, no matter how diligent, could fall into this same predicament. Since many live on the cusp of poverty, the necessary payment for a child's emergency malaria treatment or for a family member's urgently needed loan for food can be enough to make the borrower fall short of his or her installment payment. In institutions such as Grameen Bank, these borrowers' loans can merely become "rescheduled" – a new payment schedule is established to account for this new hardship.⁵⁵ But many other MFIs are much stricter in their repayment requirements.

Even Muhammad Yunus has expressed concerns about the reports of lender abuses, noting "[m]icrofinance emerged as a struggle against loan sharks, so we don't want to see new loan sharks created in the name of microcredit."⁵⁶ And the Consultative Group to Assist the Poor has acknowledged the risk that these practices pose, stating that "predatory lending and consumer abuses are legitimate policy concerns."⁵⁷ These voices are adding fuel to the argument that the global community needs a new legal paradigm to guide microfinance institutions' operations. Otherwise, commercial microfinance risks failure like that in the subprime market, with an attendant loss to borrowers and lenders alike.

⁵¹ See Rhyne, *supra* note 8.

⁵² See 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, at 565-66 (2008) (citing *Microsharks*, Economist, Aug. 17, 2006).

⁵³ *Id.*

⁵⁴ *Microfinance - The Dark Side?*, A Personal Journey into the World of Microfinance (Nov. 14, 2006), <http://www.microfinancenow.org/2006/11/microfinance-dark-side.html>.

⁵⁵ GRAMEEN BANK ANNUAL REPORT, GRAMEEN BANK (2001) ("Flexible Loan is actually a rescheduled loan and a borrower can negotiate the repayment schedule according to her capacity to pay.") *available at* <http://www.grameen-info.org/annualreport/annualreport2001/gbYear.htm>. Indeed, this practice of rescheduling loans makes the reported repayment rates slightly misleading since they do not always report how many loans are repaid on time under their original terms.

⁵⁶ *MicroFinance Transparency to Publicize Microfinance Institution Rates & Fees*, Business Week News Wire (Aug. 6, 2008), *available at* <http://muhammadyunus.org/content/view/158/128/lang,en/>.

⁵⁷ Whittaker, *supra* note 53, at 566 (citing CONSULTATIVE GROUP TO ASSIST THE POOR, OCCASIONAL PAPER NO. 9: INTEREST RATE CEILINGS AND MICROFINANCE: THE STORY SO FAR 10 (Sept. 2004)).

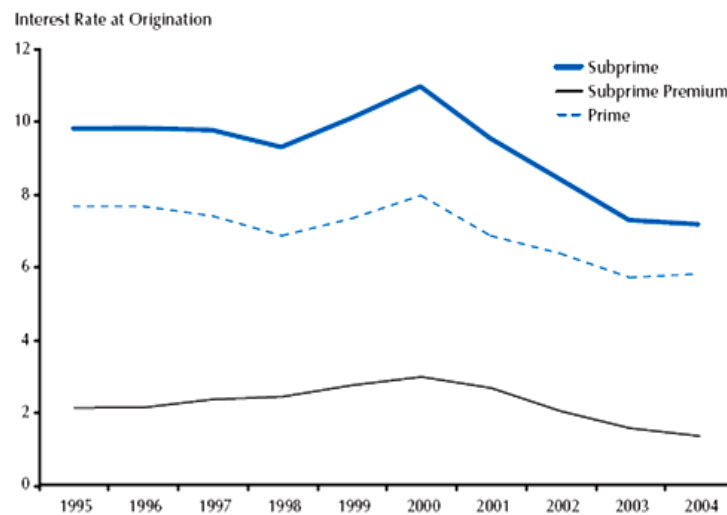
Part II: The Subprime Lending Industry

What are Subprime Loans?

Subprime loans are loans made to borrowers with a perceived high credit risk, often due to their weak credit history or other characteristics suggesting a higher chance of default.⁵⁸ Subprime loans operate outside prime lending markets.⁵⁹ A simplified definition of subprime lending is “high-cost lending.”⁶⁰ Despite the loans’ designation as *subprime*, borrowers pay *higher* interest rates than those charged for prime loans to compensate for the increased credit risk.⁶¹ As Chart A below shows, subprime loans often have interest rates about 2 percentage points higher than those of prime loans.

*Chart A – Subprime and Prime Interest Rates*⁶²

Interest Rates



NOTE: Prime is the 30-year fixed interest rate reported by the Freddie Mac Primary Mortgage Market Survey. Subprime is the average 30-year fixed interest rate at origination as calculated from the LoanPerformance data set. The Subprime Premium is the difference between the prime and subprime rates.

Historical Evolution of the Subprime Market

⁵⁸ Ben S. Bernanke, The Subprime Mortgage, Speech At the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition (May 17, 2007), <http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm>

⁵⁹ See SIF Predatory Lending Fact Sheet, *supra* note 11.

⁶⁰ See Souphala Chomsisengphet and Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, FEDERAL RESERVE BANK OF ST. LOUIS REVIEW 31, 31 (Jan. – Feb. 2006).

⁶¹ See Beirne, *supra* note 15, at 2.

⁶² See Chomsisengphet, *supra* note 61, at 33.

Subprime loans have extended financial services to a broader market of previously unserved individuals.⁶³ In particular, subprime home mortgage loans have allowed American citizens lacking significant assets or solid credit histories to obtain a home mortgage loan.⁶⁴ They have provided a means through which to attain the American dream: subprime borrowers have received loans allowing them to become homeowners and thereby embark upon the traditional path to the middle class.⁶⁵ At the same time, borrowers' neighborhoods have held the promise of becoming more stable, and their community as a whole may be improved and uplifted.⁶⁶

During the 1970s and 1980s, home mortgage loans were restricted to those borrowers with sizeable assets and well-established credit histories.⁶⁷ This changed in the 1980s, when subprime lending allowed other groups of borrowers to obtain home mortgage loans.⁶⁸ Subprime lending continued to rapidly expand during the mid-1990s⁶⁹ due to these factors: deregulation of the mortgage market,⁷⁰ tax reform,⁷¹ and technological improvements that reduced the costs for lenders to assess and price borrowers' risks.⁷² According to Federal Reserve Bank Chairman Ben Bernanke, lenders developed new strategies for using enhanced information about borrowers to manage risks, set interest rates, and create standards for underwriting the loans.⁷³ Individuals lacking sizeable assets or extensive credit histories could now qualify for subprime loans.⁷⁴

Rapid Subprime Market Growth

The growth in the subprime residential mortgage market was dramatic in the years after the mid-1990s. The subprime residential mortgage market stood at \$332 billion in 2003, around five-times the size of the \$65 billion market that existed in 1995.⁷⁵ As of 2007,

⁶³ *See id.*

⁶⁴ *See* Beirne, *supra* note 15, at 2.

⁶⁵ *See generally* FORECLOSED, *supra* note 12.

⁶⁶ *See* Beirne, *supra* note 15, at 2. Empirical studies have shown that homeowners are more likely than renters to maintain their properties and to participate in civic organizations. *See* Bernanke, *supra* note 59.

⁶⁷ *See* Beirne, *supra* note 15, at 2.

⁶⁸ *See id.*

⁶⁹ Bernanke, *supra* note 59.

⁷⁰ *Id.* Two pieces of legislation played a powerful role: the Depository Institutions Deregulation and Monetary Control Act of 1980, which preempted state caps on mortgage interest rates, and the Alternative Mortgage Transaction Parity Act of 1982, which permitted the use of variable interest rates. *See* Chomsisengphet, *supra* note 61, at 38.

⁷¹ Bernanke, *supra* note 59. The Tax Reform Act of 1986 played a significant role in the growth of the industry. It increased the demand for mortgage debt because it allowed interest deductions on mortgages for a primary residence and one additional home, while prohibiting interest deductions on other consumer loans. As a result, high-cost mortgage debt became a cheaper type of debt for homeowners. *See id.*

⁷² Bernanke, *supra* note 59.

⁷³ *Id.*

⁷⁴ *See* Beirne, *supra* note 15, at 2.

⁷⁵ Chomsisengphet, *supra* note 61, at 37.

around 7.5 million first-lien subprime mortgages were outstanding, representing around 14 percent of all first-lien mortgages.⁷⁶

The domestic homeownership rate rose dramatically as well. In 2006, 69 percent of all households owned their homes, an increase from the 65 percent of households that owned their homes in 1995.⁷⁷ While the increase in homeownership rates spanned most demographics, minority and lower-income households had some of the largest percentage gains.⁷⁸

Failure of the Subprime Market

In hindsight, it is evident that “continued strong performance was uncertain, as the loan products and deal structures were new and relatively untested. Furthermore, everyone knew the real estate bubble could not last forever.”⁷⁹ In 2006 and 2007, investors confronted increasing rates of default on home mortgage loans, and many subprime borrowers began losing homes now worth a fraction of their original price through foreclosure.⁸⁰

The causes precipitating this downfall will be explored in part IV, but it is of note that an estimated 2.2 million borrowers may have lost their homes in 2008 alone, with an accompanying loss of wealth of \$164 billion.⁸¹ The losses have been borne most profoundly by the same minority communities that originally benefited from this range of innovative financial products.⁸² The losses have been described as a deferral of Martin Luther King Jr.’s “dream” of economic stability and opportunity for everyone in the U.S., whether part of a minority or majority race.⁸³

The subprime market was a business model that, if developed and expanded deliberately and thoughtfully, held the potential to benefit society by extending financial services to a previously under-served population.⁸⁴ “Had the emphasis been on sustainable growth, balancing the interests of all stakeholders (borrowers, lenders, other third party businesses and investors), the outcome may have been different.”⁸⁵ Nonetheless, there are powerful lessons to be gleaned from the subprime mortgage collapse. Microfinance initiatives must take into account these lessons and grow in a responsible manner in order to avoid a similar fate.

⁷⁶ Bernanke, *supra* note 59.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ Beirne, *supra* note 15, at 2.

⁸⁰ *Id.* at 3.

⁸¹ See SIF Predatory Lending Fact Sheet, *supra* note 11.

⁸² See FORECLOSED, *supra* note 12.

⁸³ See *id.*

⁸⁴ See Beirne, *supra* note 15, at 3.

⁸⁵ *Id.*

Part III: Similarities Between Subprime and Commercial Microfinance Markets

This section explores similarities between the subprime market and the burgeoning microfinance market. Both markets are driven by intense market protection, and both suffer from key failures in adequate consumer protection. The following key features are shared by both of these markets: the extension of financial services to under-served minority and marginalized community members; strong competitive pressures among large commercial financial service providers; non-traditional terms including high interest rates and -‘buried’ or -‘hidden’ clauses; the creation of new, sophisticated financial products that are sold on a secondary market; and increased deregulation and integration into global capital markets. The comparison proceeds by first examining the characteristic as evident in the microfinance market, and then examining how the characteristic as manifested in the now-failed subprime market.

The Extension of Financial Services to Under-Served Minority and Marginalized Community Members

Microfinance Market

Beginning with Muhammad Yunus’ extension of a small loan to the ‘unbankable’ in Bangladesh, microcredit has typically targeted marginalized, poor and rural community members who would otherwise have difficulty accessing formal credit or financial services from banking institutions.⁸⁶ Microfinance institutions have responded to poor persons’ lack of financial services and capital to invest in business, recognizing these as primary reasons for social and economic immobility.⁸⁷

Microfinance institutions have targeted individuals marginalized by race, ethnicity, gender, geography, disability, and other status. In the United States, over 75 percent of microentrepreneurs are women and over 60 percent are minorities.⁸⁸ Among the disparate groups microfinance programs have assisted are immigrants and refugees, disabled persons, ex-criminal offenders reentering society, survivors of domestic

⁸⁶ See Kaplan, *supra* note 22.

⁸⁷ See Rachel Errett Figura, *An End to Poverty through Microlending: An Examination of the Need for Credit by Poor, Rural Women and the Success of Microlending Programs*, 8 NEW ENG. INT’L & COMP. L. 157, 163 (2002).

⁸⁸ R.H. Tipton III, *Microenterprise Through Microfinance and Microlending: The Missing Piece In the Overall Tribal Economic Development Puzzle*, 29 AM. INDIAN L. REV. 173, 178 (2004) (citing Ass’n for Economic Opportunity & Microenterprise Fund for Innovation, Effectiveness, Learning & Dissemination at the Aspen Inst., Microenterprise Fact Sheet Series No. 1, Microenterprise Development in the United States: An Overview 3 (2000)).

violence, and homeless individuals.⁸⁹ In Europe, there is increasing pressure to extend microfinance to minorities. For example, the European Economic and Monetary Affairs Committee recently made a formal call to the European Commission, asking the Commission to draft a legislative proposal to encourage microfinance's extension to marginalized European citizens like women, immigrants and the Roma community.⁹⁰ Women have been a target community for microfinance institutions.⁹¹ As the majority of the poorest global citizens and those highly likely to have constrained access to financial services, women are a prime target for poverty alleviation programs, and microfinance has been viewed as a key such program.⁹² The 2005 UN World Summit Outcome Document adopted by the member states reinforces the importance of banking targeted towards the poor.⁹³ The Asian Development Bank has called for the extension of microfinance to "the poorest, women in poor households, the poor in resource-poor and remote areas, and ethnic minorities."⁹⁴

Subprime Market

Subprime loans opened up a new path to homeownership for certain minority communities that historically had limited access to lending institutions.⁹⁵ The federal government had contributed to minority communities' restricted access to loans. In the 1930s the Federal Housing Authority expressly referred to African Americans and other minority groups as adverse influences on mortgage lenders.⁹⁶ Yet, in the decade leading

⁸⁹ See Lee, *supra* note 48, at 539 (2006) (citing Susan R. Jones, *Legal Guide to Microenterprise Development* 50-61 (2004)).

⁹⁰ See *Call for EU Legislation to Encourage Microcredit Schemes*, *supra* note 6.

⁹¹ See Toni Williams, *Requiem for Microcredit? The Demise of a Romantic Ideal*, 19 BFLR 145, 158. See also Michael Kevane and Bruce Wydick, *Microenterprise Lending to Female Entrepreneurs: Sacrificing Economic Growth for Poverty Alleviation?*, 29 WORLD DEVELOPMENT 1225 (2001); Mark M. Pitt and Shahidur R. Khandker, *The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of the Participants Matter?*, 106 J. POL. ECON. 958 (1998).

⁹² See Isobel Coleman, *Defending Microfinance*, 29 WTR FLETCHER F. WORLD AFFAIRS 181, 185 (2005). Extending credit and financial services empowers women and may help alleviate gender inequities and oppressive or harmful social relationships. *Id.* Further, women have proven to be a great social investment. "Early experience cast women as disciplined, responsible borrowers and successful microentrepreneurs, who use the credit to produce household income with which to feed, clothe, and educate their children." Williams, *supra* note 94, at 159. Lenders have been enthusiastic about women's solid repayment rates, which to-date have generally been higher than men's. *Id.* at 185. They have noted that women are especially likely to repay when they are involved in group-based lending, and the social pressures in the group strongly encourage on-time repayment. *Id.*

⁹³ MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 4 (referencing the United Nations World Summit Outcome Document, at para 23(i)) ("We recognize the need for access to financial services, in particular for the poor, including through microfinance and microcredit.").

⁹⁴ Ashok Sharma, V. DEVELOPING SUSTAINABLE MICROFINANCE SYSTEMS, ASIAN DEVELOPMENT BANK, at 138, available at http://www.unescap.org/drrpad/publication/fin_2206/part5.pdf

⁹⁵ See Chomsisengphet, *supra* note 61, at 31.

⁹⁶ See *id.* By the 1940s, the Department of Justice had filed civil and criminal actions to help stop these discriminatory practices by lenders. *Id.*

up to 2007, the number of subprime loans issued to low- and moderate-income minorities dramatically increased.⁹⁷

While the increase in homeownership rates in the U.S. was broadly based, the most profound increases were in minority communities.⁹⁸ A research study in 2008 reported that “[h]igh-cost subprime loans account for 55 percent of loans to blacks but only 17 percent of loans to whites....”⁹⁹ Another study found that black borrowers were 3.8 times more likely than whites to receive a higher-cost home loan.¹⁰⁰ This was the case even though the majority of subprime borrowers would have qualified for conventional prime rate loans at a lower interest rate.¹⁰¹ Minority community members were disproportionately targeted by lenders.¹⁰²

The increase in minority home ownership rates in the U.S. was celebrated. In 2007, Federal Reserve Chairman Bernanke highlighted that the dramatic increases in homeownership rates among minorities had positive spill-over effects into the community.

Not only the new homeowners but also their communities have benefited from these trends [of greater minority homeownership]. Studies point to various ways in which homeownership helps strengthen neighborhoods. For example, homeowners are more likely than renters to maintain their properties and to participate in civic organizations. Homeownership has also helped many families build wealth, and accumulated home equity may serve as a financial reserve that can be tapped as needed at a lower cost than most other forms of credit.¹⁰³

Increased minority homeownership was seen by many as the fulfillment of the American dream, a dream espoused by the federal government. Congress signed the American Dream Downpayment Initiative (ADDI) into law in 2003 in order to increase the homeownership rate, especially among low income and minority households.¹⁰⁴ President Bush noted in a 2004 speech that “[t]he more people who own their home, the

⁹⁷ Richard K. Green and Susan M. Wachter, *The Housing Finance Revolution*, prepared for the 31st economic policy symposium: Housing, Housing Finance and Monetary Policy, Federal Reserve Bank of Kansas City (Aug. 31, 2007).

⁹⁸ See Bernanke, *supra* note 59.

⁹⁹ See FORECLOSED, *supra* note 12; Singletary, *supra* note 12.

¹⁰⁰ *Mortgage Meltdown Threatens the American Dream, Some Say*, Fox news, <http://www.foxnews.com/story/0,2933,263583,00.html>.

¹⁰¹ Michelle J. Nealy, *On the losing end: from the subprime mortgage crisis to the subsequent credit crunch, minorities are feeling the heat*, BNet Business Net (May 1, 2008), available at http://findarticles.com/p/articles/mi_m0WMX/is_6_25/ai_n25490928 (citing a research study by the Center for Responsible Lending).

¹⁰² *Id.*

¹⁰³ Bernanke, *supra* note 59.

¹⁰⁴ See Department of Housing and Urban Development, <http://www.hud.gov/offices/cpd/affordablehousing/programs/home/addi/> (explaining that ADDI aimed to help first-time home buyers with their downpayment and closing costs).

better off America is... See, we want more people owning something because when somebody owns something, they have a vital stake in the future of the country."¹⁰⁵

The Presence of Strong Competitive Pressures Among Large Commercial Financial Players

Microfinance Market

Banks have increasingly seen the strong economic potential of “banking on the poor.” Even as mainstream credit markets have frozen in the recent economic downturn, microfinance institutions have not slowed significantly in their growth. As Elizabeth Rhyne, the Managing Director of the Center for Financial Inclusion at ACCION International, noted:

If anything, the crisis in confidence has highlighted what a good credit risk most microfinance clients have proved to be. Isolated in most cases from their countries’ formal economies, the self-employed poor are also resilient during downturns. Indeed, microfinance may represent a bright spot in the banking industry’s future – a huge market of hundreds of millions, whom pioneering microfinance specialists are learning to serve in a sustainable way.¹⁰⁶

Large banks and companies across the U.S. and Europe have entered the industry, including: Banamex (Mexico’s second largest bank that is wholly owned by Citigroup), HSBC Holdings, Zurich Financial Services (underwriting life insurance policies sold with loans in Mexico), Compartamos (the non-profit turned for-profit bank), and Wal-Mart Stores (offering goods on credit at interest rates that can exceed 80 percent, and a range of other financial services).¹⁰⁷ The entry of large commercial banks into the microfinance arena has allowed for a rapid influx of financing and funding. However, the attendant competitive pressures generate concern even among members of the lending community.¹⁰⁸ Increasingly, individuals see parallels between the tremendous competitive pressures in the subprime market and those seen now in microfinance.¹⁰⁹

¹⁰⁵ See *Mortgage Meltdown*, *supra* note 105.

¹⁰⁶ Rhyne, *supra* note 8.

¹⁰⁷ See Keith Epstein and Geri Smith, *The Ugly Side of Microlending*, *Business Week* (Dec. 13, 2007).

¹⁰⁸ Rhyne, *supra* note 8 (“Though [lenders’ abusive] practices are not widespread in microfinance, competitive conditions in some markets could tempt providers to engage in some of them.”).

¹⁰⁹ See *id.*

Subprime Market

At its height, the subprime market was characterized by tremendous competition. Lenders flocked to the lucrative subprime market, where pools of subprime loans enjoyed attractive yields.¹¹⁰ Large, mainstream financial institutions fueled the competition and rapid growth in subprime lending. These institutions included Wells Fargo & Co., U.S. Bancorp, Bank of America, and Merrill Lynch & Co.¹¹¹ Commercial banks owned subprime mortgage companies; banks accounted for five of the top ten subprime lenders in the country.¹¹² With the competition came the design of innovative subprime products that allowed upwardly mobile borrowers to stretch and buy a car or house that previously would have been out of reach.¹¹³

Non-Traditional Terms Including High Interest Rates and ‘Buried’ Terms

The loans that the microfinance market and subprime industry have offered clients have been unique. The loans have featured terms unlike those found in standard market transactions – terms which often cater to the unique needs of poorer community members who lack substantial collateral to secure their loans and readily available information to show their credit worthiness. The transactions between borrower and lender have also been unique in that they sometimes include high interest rates and hidden or misleading terms. In certain circumstances, the transactions feature a lack of clear and candid communication between the bargaining parties, as well as unequal bargaining power in deciding upon the specific terms. Taken as a whole, certain transactions may indeed fit squarely within the definition of “predatory lending.”

Microfinance Market: Loan terms

Microcredit providers generally issue the borrower a small loan, limited in amount to the amount that the borrower can repay from savings, and not from business profits.¹¹⁴ The goal of this practice is to minimize the risk that borrowers “overextend” themselves. Repayment is often extended over a period ranging from several months to a year, and it is not unusual for borrowers to make small, incremental payments as often as every-week.¹¹⁵

Micro lenders charge high interest rates on the loans, in part because of the high cost of servicing these loans¹¹⁶ and, at times, also because of the profit-making motive of

¹¹⁰ See Beirne, *supra* note 15, at 2.

¹¹¹ See Brian Grow & Keith Epstein, *The Poverty Business*, Business Week (May 21, 2007).

¹¹² See SIF Predatory Lending Fact Sheet, *supra* note 11.

¹¹³ See Beirne, *supra* note 15, at 2.

¹¹⁴ See Chen, *supra* note 25, at 762-63.

¹¹⁵ *Id.*

¹¹⁶ Many microfinance institutions have felt compelled to become financially sustainability in order to advance their

the lending agencies.¹¹⁷ For example, the Grameen Bank charges interest rates around 20%.¹¹⁸ Non-profit microlenders charge 31% interest on average.¹¹⁹ Commercial bank lenders in search of a reasonable profit typically charge rates higher than this. Compartamos, a Mexican microlender, switched from a non-profit to a for-profit model, had a successful initial public offering, and now charges an estimated 100 percent interest on its loans.¹²⁰ Several microfinance institutions in India charge annual real interest rates of 50% or higher.¹²¹ And in South Africa, Standard Bank officials reported that they would need to charge annual interest rates between 50 and 100 percent in order to make a reasonable return.¹²² While these interest rates appear to be quite high, they are still significantly lower than those that borrowers can attain from traditional money lenders, who can charge interest rates of 10 to 20 percent interest per day, which amounts to 4000 percent per year.¹²³

Muhammad Yunus has recently focused a lens on lenders' interest rates and has recommended a regulatory cap on the interest rates that banks can charge. Rejecting a bright-line absolute maximum interest rate, Yunus has argued that microfinance institutions should not charge interest rates that are more than 15 percent above their cost of funds, or else they should be subject to penalties.¹²⁴ Yet, many commercial lenders continue to charge rates that are well above this recommended 15 percent mark.

Bargaining and Power Relationships

The power relationships and bargaining processes that accompany many microlenders' transactions are also of note. Many borrowers are illiterate and speak local dialects. Despite the language and literacy barriers often present, these individuals enter into contracts with a range of sophisticated terms and complicated repayment conditions. The

human rights goals. *See, e.g., id.* at 759.

¹¹⁷ *See* Anderson, *supra* note 26, at 100 (noting the desire for reasonable profit at South Africa's Standard Bank).

¹¹⁸ *See* Shahidur R. Khandker, *Fighting Poverty with Microcredit: Experience in Bangladesh* 102-03 (1998).

¹¹⁹ Epstein, *supra* note 112. By comparison, Americans with bad credit histories pay from 22 to 29 percent interest on their credit card debt. *Id.*

¹²⁰ *MicroFinance Transparency to Publicize Microfinance Institution Rates & Fees*, Business Week News Wire (Aug. 6, 2008), available at <http://muhammadyunus.org/content/view/158/128/lang.en/>. Compartamos has defended its lending practices in a July 2007 "Letter to our Peers" that explains why the bank charges these high interest rates. Compartamos says it must charge high interest rates to account for high operational costs - \$152 per client each year on loans of around \$450 - or else it will not be able to offer poor people access to credit. It noted, "A plea for lower interest rates is in fact a plea to increase the size of our loans significantly. Doing that can only have two outcomes: the overindebtedness in our clients or moving to a different segment of the market, which amounts to mission drift." *Id.*

¹²¹ Yoko Miyashita, *Microfinance and Poverty Alleviation: Lessons from Indonesia's Village Banking System*, 10 PAC. RIM. L. & POL'Y 147, 159 (2000).

¹²² Peter Montagnon, CENTER FOR THE STUDY OF FINANCIAL INNOVATION, CREDIT WHERE CREDIT IS DUE: BRINGING MICROFINANCE INTO THE MAINSTREAM 10 (1998).

¹²³ *See* CGAP CENTRAL AMERICA AND MEXICO, *supra* note 29, at 3. Note that traditional moneylenders are seen as serving an important role in providing bridge loans for individuals who suffer from a sudden event like a family member's medical emergency. Since a micro-loan is intended for business use, it would not qualify for such use.

¹²⁴ *See Nobel Laureate Mohd Yunus's debt removal idea*, Symbiotics (Feb. 2, 2007), available at http://www.symbiotics.ch/en/microfinance_archives_2007.asp?id=b298.

head of the local legal department of Banco Azteca, a microfinance institution in Mexico, acknowledged that “[t]erms are explained to them, maybe not as clearly as they should be, but many clients don’t understand.... They [clients] take on financial commitments they can’t meet.”¹²⁵

A Compartamos representative also acknowledged that many clients do not understand the concept of interest rates; they focus on how much they must pay, when, and whether they must pay up front, instead of looking at the bigger picture of how much they must pay *overall* on the amount of the loan.¹²⁶ Banks in Mexico, unlike those in the U.S., are not even legally required to disclose the annual percentage rate (APR) on the loan, so clients may not even have the privilege or understanding the larger financial commitment into which they are entering.¹²⁷ For example, Banco Azteca does not generally disclose the interest rates on its loans, preferring instead to discuss the weekly repayment amounts with its potential customers.¹²⁸

Certain lenders are willing and indeed eager to offer clients loans for as much as they want to borrow.¹²⁹ Compartamos staff members encourage borrowers to take out more credit as soon as they pay off an existing loan; the staff are incentivized to do so as they earn bonuses based upon their number of clients and loans.¹³⁰ In fact, almost 9 out of 10 borrowers renew a loan with Compartamos as soon as they pay off a previous loan, often increasing the size of the loan in the process.¹³¹ In these situations, certain borrowers overextend themselves and take out loans that they will not likely be able to repay. Poor clients are sensitive to adverse weather, natural disasters, family illnesses and deaths.¹³² For example, a flood in a village can destroy a crop, eliminating the village’s primary source of food and income for the season.¹³³ With a single natural disaster or family medical emergency, the borrowers may fall short of their installment payment and be in default.¹³⁴

Further, clients typically have highly unequal bargaining power in the transaction. How is a poor, rural, illiterate farmer supposed to go head-to-head with a bank’s loan officer? Borrowers are generally presented with an adhesion contract - “take it or leave it” – without room to negotiate alternative, more favorable terms. The at-times coercive

¹²⁵ See Epstein, *supra* note 112.

¹²⁶ See *Compartamos: From Nonprofit to Profit: Behind its gentle image is a tough, highly lucrative bank*, Business Week (Dec. 13, 2007).

¹²⁷ See Epstein, *supra* note 112.

¹²⁸ See *id.*

¹²⁹ See, e.g., *id.* The Vice-Chairman of Azteca has said, “We lend to them as much as they can borrow... and they can borrow as much as they can pay.” *Id.*

¹³⁰ See *Compartamos*, *supra* note 131.

¹³¹ *Id.*

¹³² See Chen, *supra* note 25, at 767.

¹³³ See *id.*

¹³⁴ See, e.g., Epstein, *supra* note 112 (telling the story of a parsley farmer who borrowed money to purchase a motorcycle to scout out potential buyers and who ultimately fell just short of repayment due to a natural event that destroyed his crop).

tone raises legitimate questions as to whether certain contracts were entered into voluntarily and freely. At the very least, the economic pressures posed by incredible poverty, and the hope of securing a small loan and a path out of that poverty, raise questions of economic duress.

Once they have entered into the transaction, clients are regularly visited by loan officers. These officers can come in various forms, from friendly agents to those who intimidate and embarrass clients. In the case of Azteca, “[w]ith efficiency unusual in the Mexican marketplace, the bank deploys a cavalry of credit and collection agents on motorbikes. These *jefes de crédito y cobranza* visit borrowers within 24 hours of a purchase or loan application.”¹³⁵

Social pressures and a “shame factor” are exploited by many lenders in order to encourage minimal default.¹³⁶ Where group lending takes place, other group members may threaten or sanction borrowers who default on their loan obligations.¹³⁷ Microlenders like Azteca in Mexico capitalize on the pressure community members exert on one another to repay; they know that in communities where pride and honor are highly valued, this is an effective strategy to encourage borrowers to pay.¹³⁸

Is This Predatory Lending?

Predatory lending has been defined as follows: “Any number of fraudulent, deceptive or unfavorable lending practices. Many of these practices are illegal, while others are legal but not in the best interest of borrowers.”¹³⁹ Predatory lending is often associated with distinct characteristics, including the following:

- Poor analysis of the borrower’s ability to repay;
- Aggressive marketing of high-risk, high-interest loans;
- Promotion of complicated loan products that are not easily understood by borrowers; and
- Collection of undisclosed charges and expensive fees.¹⁴⁰

Under this definition of predatory lending, the loans being issued by many of these banks – like Banco Azteca and some visited in this article – are predatory. Even if the lending practices are legal in the Mexican deregulated landscape, they are unfavorable, and at

¹³⁵ Epstein, *supra* note 112.

¹³⁶ See Coleman, *supra* note 95, at 185; Bruce Wydick, *Can Social Cohesion be Harnessed to Repair Market Failures? Evidence from Group Lending in Guatemala*, 109 *ECON. J.* 463, 465 (1999).

¹³⁷ Wydick, *supra* note 141, at 474.

¹³⁸ Epstein, *supra* note 112 (also commenting on one reported incident where a man’s picture was publicly posted when he failed to repay, a practice that Elektra/Azteca says was punished and prohibited).

¹³⁹ Beirne, *supra* note 15, at 3 (citing InvestorWords, http://www.investorwords.com/5728/predatory_lending.html).

¹⁴⁰ See Cecelia Beirne, *Subprime Lending: Lessons for the Microfinance Industry*, Microfinance Gateway, available at <http://www.microfinancegateway.org/content/article/detail/49154>.

times deceptive and fraudulent. Where a client takes on an unreasonably high-interest and aggressively-marketed loan with complicated terms, little room for negotiation, and the inherent risk of overextending herself or himself, the lender appears more as a predatory lender than as a benevolent lender promoting social and economic development for the poor.

It is important to note that microfinance institutions are not *de facto* predatory lenders, even when they charge seemingly high interest rates.¹⁴¹ Many microfinance institutions are socially-minded organizations working within the constraint of high operating costs.¹⁴² Even Muhammad Yunus has rejected a bright line approach to defining predatory behavior. There seems to be no exact threshold interest rate at which a loan becomes predatory, as small institutions face higher operating costs than large institutions that enjoy economies of scale.

Also, when debating whether a microfinance institution is engaging in the behavior of a predatory lender, one must look beyond the individual transaction and terms established between borrower and lender. One must consider the broader economic behavior that a lender induces. For example, a borrower, so eager to have access to a small loan and confronted with a shortfall in money for a repayment installment, may turn to a loan shark to borrow money to meet his or her obligation under the original loan.¹⁴³ In the case of group loans, groups will often pressure a person into borrowing from a secondary lender or group member rather than defaulting in a payment.¹⁴⁴ A group of Kenyan women borrowers expressed this sentiment, admitting that they would rather ask a neighbor for a bridge loan than miss a payment.¹⁴⁵ And by definition moneylenders and loan sharks are also microfinance lenders.¹⁴⁶ The global community cannot properly guide the development and growth of microfinance institutions without considering the activities of moneylenders and loan sharks in this space.

Subprime Market Loan Terms

¹⁴¹ Beirne, *supra* note 15, at 3 (noting, however, that another author has said, “[i]n some respects, microfinance is the sub-prime market in most developing and emerging countries.”) (citing Kate McKee, *Meditations on the U.S. Sub-Prime Crisis*, *The Microfinance Gateway* (March 2008)).

¹⁴² See Chen, *supra* note 25, at 767.

¹⁴³ See, e.g., Epstein, *supra* note 112 (detailing the story of the Arana family that borrowed from Azteca and, confronted with the prospect of default, increasing interest charges, and regular visits from the collection agent, instead chose to borrow from a loan shark at 10% interest per month).

¹⁴⁴ See Chen, *supra* note 25, at 772.

¹⁴⁵ Susan Johnson, *Gender Norms in Financial Markets: Evidence from Kenya*, 32 *WORLD DEV.* 1355, 1367 (2004).

¹⁴⁶ See Joanna Ledgerwood, *MICROFINANCE HANDBOOK: AN INSTITUTIONAL AND FINANCIAL PERSPECTIVE 1* (World Bank ed., 1999), at 2 (“Moneylenders, pawnbrokers, and rotating savings and credit associations are informal microfinance providers and important sources of financial intermediation” to poor community members.). *But see* Robert Peck Christen, *What Microenterprise Credit Programs Can Learn from the Moneylenders* 11 (1989) (ACCION International Discussion Papers Series No. 4) (noting that microcredit programs could benefit from learning at some of the moneylenders’ practices). Other commentators have pointed out that moneylenders serve an important purpose in the community because they can provide loans for immediate medical emergencies, whereas a traditional microloan is not intended for such uses.

As noted earlier, subprime loans are high-cost loans. From the perspective of the borrower, the primary distinguishing features of a subprime loan, as compared with a prime-rate loan, are higher upfront costs and higher continuing costs.¹⁴⁷ Upfront costs include the loan application fees, appraisal fees and other fees incurred with a mortgage.¹⁴⁸ Continuing costs include payments on principal, interest payments, mortgage insurance payments, late fees and fines for delinquent payments, and fees like property taxes levied by the locality.¹⁴⁹ During the 1980's through the early 2000's, subprime borrowers confronted continuing costs that were often significantly higher than those offered for prime rate loans. For borrowers obtaining a subprime home mortgage loan, higher continuing costs were evident in these common instruments.¹⁵⁰

- Adjustable-Rate Mortgages (ARMs)¹⁵¹

Subprime borrowers often received adjustable-rate mortgages (ARMs) from institutional lenders. ARMs have interest rates and payment schedules that adjust according to a specific formula. Oftentimes, a fixed interest rate is charged for the first few years, and then the interest rate is readjusted so that the loan's interest rate and required monthly payment rises. Some subprime lenders would offer borrowers a low "teaser" interest rate that would be readjusted to a much higher rate in subsequent years. In fact, some borrowers stood to pay readjusted interest rates that were more than double the initial "teaser" interest rate.¹⁵²

- Very Low Down-Payment Mortgages¹⁵³

As lenders rapidly expanded their customer base, they often competed with each other to attract borrowers. They were particularly competing for the business of borrowers who lacked sufficient savings and net worth to put down the five- to 20-percent down payment typically required in order to receive a home mortgage. Many subprime loans were

¹⁴⁷ *Id.* at 32.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ See Ronald D. Utt, *The Subprime Mortgage Collapse: A Primer on the Causes and Possible Solutions*, Heritage Foundation (April 22, 2008), available at <http://www.heritage.org/research/economy/bg2127.cfm>. For further discussion of the variety of mortgage terms available to subprime borrowers, see Edward Vincent Murphy, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, Congressional Research Service Report for Congress (Sept. 27, 2007).

¹⁵¹ See Utt, *supra* note 155.

¹⁵² David Cho and Dina ElBoghdady, *Mortgage Report Rattles Markets, Dow Down 2% On a Big Rise In Delinquencies*, Washington Post, A01 (March 14, 2007).

¹⁵³ Utt, *supra* note 155. Lenders also offered a similar instrument to very low down-payment mortgages in the form of interest-only mortgages. An interest-only mortgage allows a borrower to make lower initially monthly payments by only paying interest until a year or more into the loan, at which point the borrower begins to repay loan principal as well. *Id.* Interest-only mortgages are also similar to ARMs in that borrowers may pay very little in the beginning year(s), but their payments may dramatically increase after a few years. *Id.*

issued to borrowers with little or no down payments. At times, the borrowers received over 100 percent loan financing (greater than the home's actual cost) by also borrowing a portion of their settlement costs. When lenders offered these terms, they generally believed that the borrowers had sufficient income and credit worthiness to meet future repayment obligations. Further, they expected that as home prices continued to appreciate, the lender could be protected with an equity cushion. Nonetheless, they were assuming higher risk by not obtaining a greater down payment.¹⁵⁴

- Prepayment penalties¹⁵⁵

Many subprime loans included prepayment penalties, which provided a financial penalty for borrowers who repaid a loan ahead of schedule.¹⁵⁶ Penalties discouraging borrowers from paying off their loans at an early date were commonplace in many loans such as ARMs that had escalating interest rates over time.¹⁵⁷

Were the subprime terms fair? The interest rates for subprime loans have generally been lower than the interest rates charged for microfinance loans— with around 10% interest charged on a 30-year fixed interest subprime loan. Yet, the two lending practices share the common feature of charging poor borrowers considerably more in interest and fees than wealthier persons accessing traditional financial services.¹⁵⁸ Data from the Federal Reserve suggests that poor households were paying much higher interest rates than wealthier households. In 1989, households earning up to \$30,000 a year paid interest rates on car loans that were around 16.8% higher than wealthier families earning over \$90,000 a year.¹⁵⁹ Yet, by 2004, the disparity in auto loan interest payments between these poorer and wealthier families was 56.1 percent.¹⁶⁰ Similarly, for home mortgage loans, the interest discrepancy increased dramatically from 6.4% to 25.5% during the same time frame.¹⁶¹ Lenders claimed that the higher interest rates were necessary in order to offset the increased risk posed by these loans.¹⁶² Yet, the lenders were also making substantial profits on these loans in the booming subprime industry.

¹⁵⁴ No down-payment mortgages are risky because a lender without equity lacks a cushion for its losses in the event of a home foreclosure. Also, borrowers have reduced incentives to make regular payments since they do not stand to lose the initial down-payment that they made. *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ See Chomsisengphet, *supra* note 61, at 51-53.

¹⁵⁷ See *id.* at 53. Around 80 percent of ARMs had prepayment penalties in the years 2000-2001.

¹⁵⁸ See generally *id.* at 32-33 (discussing that it is difficult to quantify the difference in all the fees and terms but showing a comparative graph of interest rates charged on prime and sub-prime 30 year fixed interest loans).

¹⁵⁹ See Grow, *supra* note 116.

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² Beirne, *supra* note 15, at 3.

Bargaining and Power Relationships

Even if the subprime terms were fair, did borrowers adequately understand these instruments and the nature of the transactions into which they were entering? Many commentators have found that the terms were misleading. Borrowers were enticed by the low “teaser” interest rates, for example, without properly comprehending how their payments would increase dramatically over time. Some borrowers reasoned that the banks would not extend to them a loan that they would not be able to repay. Yet, many borrowers were making financial commitments that they would be unable to meet. As Yale political scientist Jacob S. Hacker commented, “[p]eople are being encouraged to live beyond their means by companies that are preying on low-income consumers.”¹⁶³

The terms that appeared so simple and straightforward were, in reality, quite complex, and borrowers needed shrewd wisdom in order to get an accurate picture of the transaction. “Unless inexperienced borrowers asked complex questions about loan terms covered only in the fine print, they received loans that they had little to no chance of repaying.”¹⁶⁴ These loans, like those from microlenders, were typically adhesion contracts. Borrowers had the choice of either accepting the terms contained within or else missing out on the opportunity. Borrowers were often reluctant to turn down an invitation to improve their lives. As Business Week noted:

Isn't that a bedrock definition of the American dream, the powerful idea that our children will enjoy a higher living standard than their parents? And that's the real tragedy of the subprime mortgage debacle. Subprime loan sharks dangled in front of low-income borrowers what seemed a genuine ladder into the U.S. mainstream, but it was nothing more than a hologram designed to hustle the poor out and dash their dreams.¹⁶⁵

Is This Predatory Lending?

This article does not argue that merely targeting poor persons with financial services is predatory behavior. Even if higher interest rates are charged to these communities, and a reasonable profit is earned, the lending practices are not necessarily predatory unless, under the definition provided earlier, they include “[a] number of fraudulent, deceptive or unfavorable lending practices. Many of these practices are illegal, while others are

¹⁶³ Grow, *supra* note 116.

¹⁶⁴ FORECLOSED, *supra* note 12.

¹⁶⁵ Chris Farrell, *The Shiny Side of Subprime, There may be an unintended positive consequence of the mortgage fiasco: an actual economic dialogue between the rich and poor*, Business Week (June 19, 2007).

legal but not in the best interest of borrowers.”¹⁶⁶ Some illegal activities took place during the subprime boom years;¹⁶⁷ but a range of other practices such as the “teaser rates” and prepayment penalties were legal yet unfavorable, if not deceptive or fraudulent. They fall within the definition of predatory lending.

The Creation of New, Sophisticated Financial Products

Microfinance Market

Microfinance has been marked by the presence of increasingly complex financial products.¹⁶⁸ Group lending and securitization have been two common features of many microfinance institutions’ loans.

Group lending

Many microlenders have made use of group lending strategies. In group lending, borrowers are divided into groups, and each group member must agree to be responsible for the entire debt of the group.¹⁶⁹ Group lending helps mitigate the risks of asymmetrical information. Borrowers with little or no formal credit history tend to have more information about their credit-risk than do the lenders. By lending to a group of individuals and making these individuals jointly and severally liable for each other’s debts, the lenders benefit from community members’ knowledge and assessment of one another’s creditworthiness.¹⁷⁰ Lenders can diversify their risk and capitalize on social pressures to help ensure repayment.¹⁷¹ The promise of joint and several liability helps poor persons overcome a chief barrier to accessing credit – little or no collateral for a loan – since a group is more likely to repay the loan by using peer pressure to encourage

¹⁶⁶ Beirne, *supra* note 15, at 3 (citing Investor Words http://www.investorwords.com/5728/predatory_lending.html).

¹⁶⁷ See Grow, *supra* note 116 (highlight activities that led to legal battles such as those of Jackson Hewitt Tax Service Inc., which was accused of pressuring customers under its “Money Now” program to take out expensive loans rather than encouraging them to wait a few weeks to receive their federal tax refunds for free).

¹⁶⁸ Beirne, *supra* note 15 at 3.

¹⁶⁹ See J. Wyatt Kendall, *Microfinance in Rural China: Government Initiatives to Encourage Participation by Foreign and Domestic Financial Institutions*, 12 N.C. BANKING INST. 375, 384 (2008).

¹⁷⁰ See Chen, *supra* note 25, at 771-72.

¹⁷¹ See Kendall, *supra* note 175, at 384.

individuals to repay or else looking to other group members to account for the amount due.¹⁷²

Securitization

In order to access more capital, many lenders have also begun to securitize their loans. Securitization is the packaging and resale of assets on capital markets in order to raise capital for the microfinance institution.¹⁷³ Microfinance institutions can package and resell their small loans, which are attractive investments given their historically high repayment rates.¹⁷⁴ Larger commercial lenders, which tend to make a higher profit on their loans and have lower default rates, have an easier time securitizing their loans and are more likely to do so.¹⁷⁵

The Bangladesh Rural Advance Commission was the first microfinance institution to securitize its loan portfolio in 2006.¹⁷⁶ Since that time, securitization has become an increasingly popular way to raise capital for rapid growth.¹⁷⁷ Securitization has been attractive because it provides access to capital to allow for growth and it minimizes the risk exposure by effectively allowing that lender to resell certain loans to a secondary financier.¹⁷⁸

At least one author has raised concerns about how the process of securitizing may interfere with microfinance institutions' human rights and development goals.¹⁷⁹ In securitizing, microfinance institutions often confront high transaction costs and pressure to securitize less-risky loans.¹⁸⁰ This often results in the microfinance institution being left with the riskier loans to often-poorer clients, which can lead to financial vulnerabilities for the microfinance institution.¹⁸¹ In the alternative, the microfinance institution may decide to not offer loans to this demographic and to focus instead on wealthier customers with higher returns and lower risk.¹⁸²

Subprime Market

¹⁷² See Anderson, *supra* note 26, at 107. For a more general discussion of the various types of group lending practices – from rotational lending practices where group members take turns receiving loans to lending practices where the group itself receives the loan – see Chen, *supra* note 25, at 771-72.

¹⁷³ Chen, *supra* note 25, at 761 (noting that the methods through which securitization raises capital are documented in Steven Schwarcz, *Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994)).

¹⁷⁴ *Id.* at 779.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* at 757.

¹⁷⁷ See Beirne, *supra* note 15, at 3; Chen, *supra* note 25, at 776. See also Joan Barmat, SECURITIZATION: AN OVERVIEW, THE HANDBOOK OF ASSET-BACKED SECURITIES 4 (Jess Lederman ed., 1990) (discussing the advantages of securitization).

¹⁷⁸ See Chen, *supra* note 25, at 781-86.

¹⁷⁹ See generally *id.*

¹⁸⁰ See *id.* at 786-87.

¹⁸¹ See *id.* at 787-90.

¹⁸² See *id.*

Securitization

Subprime loans have not typically been offered under a group lending model like that in the microfinance industry. But they have been marked by rapid securitization. After issuing individual subprime loans, lenders would “pool” their inventories of subprime loans and sell these pools on the secondary market to financial intermediaries.¹⁸³ As Federal Reserve Chairman Ben Bernanke noted in 2007, “[w]hereas once most lenders held mortgages on their books until the loans were repaid, regulatory changes and other developments have permitted lenders to more easily sell mortgages to financial intermediaries, who in turn pool mortgages and sell the cash flows as structured securities.”¹⁸⁴

Pools of loans were priced according to borrowers’ credit histories and relative risk of default.¹⁸⁵ Investors could choose from a variety of risk profiles and loan durations according to their investment preferences.¹⁸⁶ Those investors who were seeking a low amount of risk were reassured by the high diversification of certain pools across property types, geographic regions, interest rates, and other factors.¹⁸⁷

Primary lenders securitized an increasing number of loans in the late 1990’s and early 2000’s.¹⁸⁸ Competing lenders designed a range of new financial products to attract residential mortgage clients, some of the features of which included ARMs, very-low down payment mortgages and prepayment penalties, as described above.¹⁸⁹ In addition, new business owners with solid credit histories, albeit irregular income cash streams, could now receive loans with low- or no-income verification requirements.¹⁹⁰ With these new financial products available, many upwardly mobile borrowers could stretch themselves to buy a house that previously would have been out of reach.¹⁹¹

In turn, Wall Street began to structure increasingly complex subprime securitizations – or bundles of loans sold to secondary financiers – in order to adjust for the increased risk of the loans they were issuing.¹⁹² The growth of the secondary market was a boon for mortgage lenders.¹⁹³ By securitizing pools of mortgages, lenders were able to access long-term funds from investors and thereby expand their services more rapidly to as yet under-served communities.¹⁹⁴ Lenders also enjoyed lower transaction

¹⁸³ See Beirne, *supra* note 15, at 2.

¹⁸⁴ Bernanke, *supra* note 59.

¹⁸⁵ Beirne, *supra* note 15, at 2.

¹⁸⁶ Bernanke, *supra* note 59.

¹⁸⁷ Beirne, *supra* note 15, at 2.

¹⁸⁸ A reported 58.7 percent of subprime loans originated in 2003 were sold into securitizations, an increase from the 28.4 percent that were sold into securitizations in 1995. Beirne, *supra* note 15, at 2.

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ Bernanke, *supra* note 59.

¹⁹⁴ Green, *supra* note 102, at 5.

costs, and risk-spreading and could thereby supply mortgage credit to a wider group of households.¹⁹⁵

Increased Deregulation and Integration into Global Capital Markets

The last characteristic of the microfinance market and subprime market is the increased deregulation of financial institutions and their integration into global capital markets. Operating without many regulatory constraints, the subprime and commercial microfinance industries have rapidly grown in a manner largely of their own design. The deregulation of the markets reflected a neoliberal approach to market activities. This approach has been described as follows:

Neoliberalism is a philosophy in which the existence and operation of a market are valued in themselves, separately from any previous relationship with the production of goods and services . . . and where the operation of a market or market-like structure is seen as an ethic in itself, capable of acting as a guide for all human action, and substituting for all previously existing ethical beliefs.¹⁹⁶

It is beyond the scope of this paper to provide a critique of the failures of neoliberal approaches to social and economic development. Decades of experience with these policies in developing countries have demonstrated that the free market alone cannot solve problems of poverty. The government has an important role to play in designing laws and policies that can guide all of civil society, including private entrepreneurs, in responsible economic and social growth. The need for some level of government regulation of markets is even more critical in light of these industries' integration into global capital markets via steps such as securitization.

Microfinance Market

To date, the microfinance industry has been able to operate largely independent of government regulations.¹⁹⁷ Indeed, microfinance has been viewed as an important tool for financial development in countries suffering from weak or corrupt governments.¹⁹⁸ Microfinancial institutions can still operate in these environments and, if they are responsible in their operations, can provide valuable services. Yet, the absence of

¹⁹⁵ Bernanke, *supra* note 59.

¹⁹⁶ Paul Treanor, *Neoliberalism: Origins, Theory, Definition*, Liberaux.org, <http://www.liberaux.org/lofiversion/index.php?t32765.html>.

¹⁹⁷ See Michael S. Barr, *Microfinance and Financial Development*, 26 MICH. J. INT'L LAW 271, 284 (2004).

¹⁹⁸ See *id.*

governance in this arena stands to not only hinder microfinance institutions' sustainable growth; it also has the potential to severely harm the persons microfinance was intended to empower. The United Nations commented that "[a]ccess to microfinance is stifled by a lack of fiscal, regulatory and supervisory policies to promote rather than stunt deep, broad and inclusive financial sectors."¹⁹⁹ A report to the United Nations Secretary General noted that legal and regulatory structures are necessary in order to allow small and medium businesses to be successful.²⁰⁰ These include commercial laws to create and protect contracts and enforce property rights.²⁰¹

Microfinance institutions contribute to the globalization of capital.²⁰² Through activities such as securitization, commercial banks that assume the risks for pools of loans are also the beneficiaries of financial gains if borrowers repay. Many of these commercial banks are located beyond the countries of the microentrepreneurs. Hence, all the gains of a successful microentrepreneurial endeavor are not necessarily reaped within the developing country. Rather, wealth and capital is transferred to another, often wealthy, country to be enjoyed therein.

Subprime Market

Prior to the 1980s, traditional housing finance was heavily regulated by the government, which implemented restrictive policies that segmented housing finance markets from the free market.²⁰³ Mortgage financing largely rested in the hands of institutions that were protected from free market pressures.²⁰⁴ In the 1980s, a series of legislations opened mortgages up to free market forces and allowed for competitive mortgage banking.²⁰⁵ Over time, the advent of deregulation led to the preeminence of commercial banks in the mortgage market.²⁰⁶ Like the microfinance industry, the subprime industry also benefited from broad access to capital markets. Securitization was commonplace in subprime lending practices.²⁰⁷ It allowed for broader access to capital to enable rapid, unfettered industry growth.

¹⁹⁹ MICROFINANCE AND THE MILLENNIUM DEVELOPMENT GOALS, *supra* note 5, at 10.

²⁰⁰ *Id.* at 12.

²⁰¹ *Id.*

²⁰² Beirne, *supra* note 15, at 4.

²⁰³ Green, *supra* note 102, at 4.

²⁰⁴ *Id.* at 5.

²⁰⁵ The Building Society Act of 1986 allowed mortgage-providing financial institutions to compete, operate as private profit-making firms, access capital markets by offering public stock, and offer mortgages to a variety of lenders with variable terms. *Id.* at 5.

²⁰⁶ *Id.* at 7 (noting that the deregulatory trend was a global one and commercial banks became preeminent in housing finance on a global scale). The article provides insightful analysis of the transition from public sector mortgage provisions in Bangladesh, Korea and Australia.

²⁰⁷ Beirne, *supra* note 15, at 2-3.

Part IV: Subprime Market Failure – Causes and Effects

In 2006 and 2007, many borrowers began defaulting on their subprime home mortgage loans, many of which were obtained without any verification of their household income.²⁰⁸ The “innovative” lending practices of many lenders increasingly became recognized as predatory ones that had taken advantage of a financially vulnerable market segment.²⁰⁹

Today, borrowers who entered into contracts for these high-cost loans continue to lose their homes through foreclosure.²¹⁰ As the real estate prices have fallen dramatically, lenders are acquiring foreclosed homes that are worth a fraction of their original price.²¹¹ The Center for Responsible Lending estimates that 2.2 million borrowers may have lost their homes in 2008, with an accompanying loss of wealth of \$164 billion.²¹²

The losses have been borne most profoundly by members of marginalized and minority communities. A report by United for a Fair Economy documented that black borrowers will lose between \$72 billion and \$93 billion in the subprime mortgage crisis, while Latino borrowers will lose between \$76 billion and \$98 billion.²¹³ A 2008 survey by the Pew Hispanic Center noted that almost one in ten Latin homeowners had reported missing, or being unable to make a full, mortgage payment in 2008.²¹⁴ Over one-third of the survey respondents said they feared foreclosure and loss of their home; and 53-percent of foreign-born Latinos feared foreclosure.²¹⁵

Subprime borrowers and their communities suffer severe consequences when they default on their loans. The individual costs include foreclosure, the loss of accumulated home equity, and reduced access to credit in the future. The community costs are harder to quantify, but are nevertheless present. Geographically concentrated foreclosures tend to reduce property values in the community and restrict community members’ future access to credit as these community members are viewed as higher risk borrowers.²¹⁶ Increasingly, the subprime crisis is being recognized as one that affects minority communities in a particularly pernicious manner. The Pew Hispanic Center noted that many Latinos had purchased or refinanced their homes right before the crash of the real estate market, oftentimes out of a misconception that “real-estate was an up-only

²⁰⁸ *Id.* at 3.

²⁰⁹ *Id.*, SIF Predatory Lending Fact Sheet, *supra* note 11.

²¹⁰ Beirne, *supra* note 15, at 3.

²¹¹ *Id.*

²¹² SIF Predatory Lending Fact Sheet, *supra* note 11.

²¹³ See FORECLOSED, *supra* note 12; Singletary, *supra* note 12.

²¹⁴ See Froma Harrop, *Latino-American Dream on Hold*, Real Clear Politics (Feb. 19, 2009), available at http://www.realclearpolitics.com/articles/2009/02/latinoamerican_dream_on_hold.html; Mark Hugo, et. al., *Hispanics and the Economic Downturn: Housing Woes and Remittance Cuts*, Pew Hispanic Center (Jan. 8, 2009), available at <http://pewhispanic.org/reports/report.php?ReportID=100>. A complete report on the impact of the economic downturn on sampled Hispanic community members is available on the Pew Hispanic Center website. *Id.*

²¹⁵ *Id.*

²¹⁶ See Bernanke, *supra* note 59.

escalator into the American Dream.”²¹⁷ One UFE report co-author described the current trends as a deferral of Martin Luther King Jr.’s dream.²¹⁸ “The dream of economic stability and opportunity for everyone living in the U.S., so eloquently described by Martin Luther King Jr., is bound up with homeownership, the most significant source of wealth for most people.”²¹⁹

The dramatic crash of the subprime market, contributing to a global economic recession, occurred rapidly and was largely unexpected. Investors are now asking if the same factors that led to the fall of the subprime market could also extend to microfinance and be a harbinger of its death.²²⁰ Elisabeth Rhyne from ACCION International believes that microfinance borrowers are more resilient than other market participants since they tend to engage in the informal economy and are often self-employed.²²¹ She believes that microfinance may be a “bright spot in the banking industry’s future – a huge market of hundreds of millions, whom pioneering microfinance specialists are learning to serve in a sustainable way.”²²² Yet, the similarities between the microfinance and subprime markets are many, and with only a bit of closer scrutiny, predatory practices are also evident in certain microfinance institutions. The abusive lending practices in the subprime market are evidence of the dangerous effects of financial services for poor persons done irresponsibly.²²³ There are important lessons to be gleaned from the subprime failure, a key one of which is the need for government to design laws and policies that guide sustainable and equitable growth and ensure consumer protection.

Part V: A New Legal Architecture for Microfinance

The time is ripe for the global community to design a new legal architecture for microfinance, one that halts abusive lending practices that allow poor borrowers to enter into contracts that they do not adequately understand and allows them to assume financial commitments that they cannot meet. This architecture should be centered upon the clients needs and should be rooted in the understanding that when microfinance institutions grow responsibly, they enhance their health and longevity, as well as that of the poor global citizens that they serve.

This paper presents an architecture to guide regulation and policy-making. It expands upon six general client protection principles that were developed by several

²¹⁷ See Harrop, *supra* note 222; Hugo, *supra* note 222.

²¹⁸ See FORECLOSED, *supra* note 12.

²¹⁹ See Singletary, *supra* note 12 (quoting Dedrick Muhammad, senior organizer and research associate at the Institute for Policy Studies and co-author of the United for a Fair Economy report).

²²⁰ Beirne, *supra* note 15, at 1.

²²¹ See Rhyne, *supra* note 8.

²²² See *id.*

²²³ See *id.*

leaders in the microfinance industry in 2008. The Campaign for Client Protection codified its six principles in a microbanker's oath.²²⁴

This article, like the Campaign for Client Protection, does not make a clear recommendation for government regulation. Regulations are appropriate in certain circumstances, but one needs to also consider the added costs that microfinance institutions confront in complying with rigid regulatory structures. These costs are ultimately passed on to the borrower, further increasing the continuing costs of small loans. Further, if the costs of operating a microfinance institution become too great, the small non-profits that often serve the poorest of the poor, may disappear from this space, finding it too expensive to operate. The net loss could be enormous if the very poorest community members, who often do not offer the highest rates of return on their loans, are not served by financial institutions. While excessive deregulation contributed to the problems in the subprime market, the answer is not a dramatic shift in the opposite direction to a rigid regulatory framework.

Rather, there are more creative options that should be explored, such as opt-in rating and certification devices. One such device – the Community Reinvestment Act (CRA) in the United States – has proven promising in encouraging banking institutions to serve poorer community members.²²⁵ The CRA operates as an evaluations and ratings model that awards banks various ratings based upon whether they have responsibly served disadvantaged community members.²²⁶ In practice, aside from the community pressure to achieve higher ratings, banks have little formal enforcement of ratings performance; but they have the incentive of an easier path to bank expansion if they have received higher ratings.²²⁷ Microfinance institutions can be encouraged to adhere to certain principles through a combination of mandatory regulations and certification and rating programs that offer strong incentives for compliance.

- The Campaign for Client Protection codifies the following six principles as a minimum standard that clients should expect from microfinance institutions:²²⁸
- “*Avoidance of Over-Indebtedness*. Providers will take reasonable steps to ensure that credit will be extended only if borrowers have demonstrated an adequate ability to repay and loans will not put borrowers at significant risk of over-indebtedness. Similarly, providers will take adequate care that noncredit, financial products (such as insurance) extended to low-income clients are appropriate.

²²⁴ See The Client Protection Principles in Microfinance, Consultative Group to Assist the Poor, available at <http://www.cgap.org/p/site/c/template.rc/1.26.4943/>.

²²⁵ See Aaron Jones, *Promotion of a Commercially-Viable Microfinance Sector in Emerging Markets*, 13 GEO. J. ON POVERTY L. AND POLICY 187, 195-96 (2006) (discussing how developing countries can learn from certain promotional aspects of the Community Reinvestment Act).

²²⁶ *Id.* at 196-97.

²²⁷ *Id.*

²²⁸ The Client Protection Principles in Microfinance, *supra* note 232.

- *Transparent Pricing.* The pricing, terms, and conditions of financial products (including interest charges, insurance premiums, all fees, etc.) will be transparent and will be adequately disclosed in a form understandable to clients.
- *Appropriate Collections Practices.* Debt collection practices of providers will not be abusive or coercive.
- *Ethical Staff Behavior.* Staff of financial service providers will comply with high ethical standards in their interaction with microfinance clients and such providers will ensure that adequate safeguards are in place to detect and correct corruption or mistreatment of clients.
- *Mechanisms for Redress of Grievances.* Providers will have in place timely and responsive mechanisms for complaints and problem resolution for their clients.
- *Privacy of Client Data.* The privacy of individual client data will be respected, and such data cannot be used for other purposes without the express permission of the client (while recognizing that providers of financial services can play an important role in helping clients achieve the benefits of establishing credit histories).²²⁹

In endorsing these principles, institutions and individuals commit to realizing them in their own operations and institutional culture.²³⁰ They vouch to become an active member in an industry-wide process to translate the principles into concrete policies and practices to guide microfinance institutions' operations.²³¹ Donors and investors are also called upon to endorse these principles and, in so doing, to commit to support microfinance institutions that adequately protect clients and provide for due diligence, monitoring and governance of their protection mechanisms.²³² The Campaign has set an initial goal of having at least half of the 500 largest microfinance institutions in the world commit to the principles within the next three years.²³³ These 500 largest microfinance institutions currently serve an estimated 65 million poor clients, and around 70 percent of their clients are women.²³⁴

The Campaign, while a useful first step in generating momentum and commitment to client protection principles, currently lacks granularity in defining responsible industry practices. In Spring 2009, the Campaign began working towards developing certification standards that identify pro-consumer practices that institutions should follow.²³⁵ The Campaign is also working towards developing a tool kit that will assist in implementing these certification standards on the ground and monitoring and

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

²³² *Id.*

²³³ The Campaign for Client Protection in Microfinance, Accion International, *available at* <http://www.accion.org/Page.aspx?pid=1371>

²³⁴ *Id.*

²³⁵ *Id.*

assessing operations.²³⁶ It aims to have the whole community of providers, investors and donors contribute to drafting these certification standards.²³⁷

This article expands upon the six principles that have been identified by the Campaign and proposes particular guidelines that will help ensure consumer protection. The guidelines proffered, unlike the existing principles, make specific recommendations of benchmarks of fair lending and recognize the need to protect the longevity and health of financial institutions.

The following four building blocks comprise this new legal architecture for microfinance:

- Ensuring fair lending;
- Ensuring a free and fair bargaining process;
- Protecting the dignity of clients/borrowers; and
- Closely monitoring microfinance institutions' growth and interactions with global capital markets.

These building blocks are examined in detail below.

Ensuring Fair Lending

The mere activity of extending loans and financial services to low-income community members does not in and of itself constitute predatory lending. The extension of these services to under-served persons is an important component of uplifting individuals from poverty. Indeed, the non-lending financial services such as savings programs and insurance programs have helped many families enter upon a path to greater prosperity. Microfinance institutions' clients should be subjected to fair lending practices. One benchmark of fair lending would be the prohibition of predatory lending practices. That is, lending practices should not involve "fraudulent, deceptive or unfavorable lending practices" whether illegal or merely not in the best interest of borrowers.²³⁸

The benchmarks articulated earlier for predatory lending should be closely heeded. Lenders should closely analyze the borrower's ability to repay and should not collect undisclosed charges or fees. Complicated loan products should be closely

²³⁶ *Id.*

²³⁷ *Id.* The objectives of this stage of the Campaign are to: 1) Unite the microfinance industry around a clear statement of the core principles of client protection; 2) Gain the commitment of MFIs and their staff to operate under these principles, demonstrated through a "Microbanker's Oath," in the spirit of the Hippocratic Oath; 3) Establish a tool kit, based on research findings from the Beyond Codes action research project, to assist in the implementation of the principles into all aspects of institutional operations, including a self-assessment protocol and an institutional action plan; 4) Create a website community to unite financial service providers, microfinance professionals and supporting organizations (investors, microfinance associations, network organizations, etc.) and provide for an ongoing dialogue with colleagues as they implement the tool kit; 5) Work with the microfinance industry to create independent programs for institutional certification. *Id.*

²³⁸ Beirne, *supra* note 15, at 3 (citing Investor Words http://www.investorwords.com/5728/predatory_lending.html).

scrutinized, as should high-interest loans that are aggressively marketed. As the Consultative Group to Assist the Poor has emphasized, “[a]n important goal of consumer protection is to protect consumers from exorbitant fees and interest rates.”²³⁹ High fees and interest rates must be avoided.

Muhammad Yunus has provided a useful benchmark for setting appropriate interest rates – ones that allow for a reasonable profit but that do not exploit the poor community members subject to the loans. Yunus’ 15-percent floating cap on interest rates provides a window for reasonable profit, while also allowing microfinance institutions to serve a range of community members with their products. A ceiling imposed on interest rates could have deleterious effects. If a microfinance institution could not cover the costs of its operations while remaining within the ceiling interest rate, it would have to either restrict its loans to lower-risk and higher-profit clients, or else go out of business.²⁴⁰ Caps on interest rates could discourage non-profit NGOs from entering the microfinance arena and providing crucially needed financial services.²⁴¹ Hence, Yunus’ compromise approach of a floating cap on interest rates helps ensure consumer protection, as well as institutional viability. It is a useful standard.

Another advisable practice is to more closely evaluate the individual, human stories underlying reported statistics such as microfinance repayment rates. Reported repayment rates are often misleading since loans to certain microfinance institutions are rescheduled if they are not paid on time. One news article reported that even in the esteemed Grameen Bank, which claims to have loan repayment of over 95 percent, 19 percent of loans were one year overdue.²⁴²

Firstly, repayment rates must be dissected to uncover the full picture of what is taking place. If a sizeable group of clients are unable to repay their loans under the original terms, then perhaps the general terms governing these transactions should be modified. Secondly, the stories of those individuals who fall outside the “success rates” should be examined. By reviewing a cross section of delinquent loans, lenders, investors and regulators can understand how the former clients of microfinance institutions have been served and whether their lives have been improved, or worsened, on account of their financial interaction. Lastly, lenders must investigate and remain alert for the

²³⁹ See Consultative Group to Assist the Poor, Focus Note 27: Protecting Microfinance Borrowers 1 (May 2005), available at <http://www.microfinancegateway.org/content/article/detail/26287>.

²⁴⁰ See Whittaker, *supra* note 53, at 564-65 (discussing the harms of interest rate ceilings imposed on microfinance institutions).

²⁴¹ See *id.* at 565.

²⁴² Daniel Pearl & Michael M. Phillips, Small Change: Bank That Pioneered Loans for the Poor Hits Repayment Snag: ‘Microcredit’ Icon Grameen Faces Questions as Rate of Delinquencies Rises: Mrs. Begum’s Missing Cow, Wall St. J., A1 (Nov. 27, 2001).

aforementioned risk of clients resorting to predatory moneylenders as intermediaries that provide bridge loans when clients will otherwise miss repayment deadlines.

Ensuring a Free and Fair Bargaining Process

Microfinance institutions must also ensure that there is a free and fair bargaining process. The process must be free in that clients must enter into the transactions of their own volition – not due to deceptive and misleading marketing tactics that capitalize on situations of economic despair and duress. The process must be fair in that it should be transparent, with full disclosure of all relevant terms and translation of these terms into a language and context that clients can fully understand. Illiterate borrowers and those speaking local dialects should be approached with translators that take the time to discuss the various conditions and terms of the loans.

Again, lenders, investors and regulators can and should look at a cross section of delinquent loans in order to better understand the conditions surrounding that financial transaction. Was the bargaining process free and fair, or were there material omissions or other situations suggesting that there was not a meeting of the parties' minds?

The microfinance institution Accion has outlined several factors that contribute to appropriate microfinance regulation and supervision. It has rejected one-size-fits-all models, advocating instead that “a successful system will be tailored to the needs of the microfinance industry in each specific country.”²⁴³ Indeed, in designing bargaining processes that are free and fair, microfinance institutions must carefully consider the social, economic and cultural context within which they are operating.

Protecting the Dignity and Well-Being of Clients

Microfinance institutions must protect the dignity and well-being of clients. As the Campaign for Client Protection principles advocate, customer should be treated with dignity even during debt collection. Loan officers must not resort to practices that socially ostracize borrowers such as posting flyers with the names of debtors or embarrassing borrowers in front of their communities. They must recognize that, especially in group lending, there is already tremendous social pressure to repay loans, as group members are jointly and severally liable for each others' debts. Individual pride, honor and community reputation all create powerful social pressures to repay. And the economic pressures posed by incredible poverty, coupled with the prospect of loans to

²⁴³ Whittaker, *supra* note 53, at 568 (citing Jacques Trigo Loubière et al., *Supervising and Regulating Microfinance in the Context of Financial Sector Liberalization: Lessons from Bolivia, Colombia and Mexico* 10 (Aug. 2004)).

provide a window out of poverty, can be substantial. The Campaign's principles also emphasize the importance of keeping client data secure and extending consumer privacy protection devices to loans issued by microfinance institutions.

Closely Monitoring Microfinance Institutions' Growth and Interactions With Global Capital Markets

Lastly, lenders, investors and regulators should keep close watch over institutions' growth – to make sure it is responsible – and over how institutions engage with global capital markets. The microfinance industry must scale responsibly.²⁴⁴ As discussed, the subprime market's collapse has demonstrated the dangers of irresponsible growth to clients and lenders.

Attention must be paid to the larger picture of global capital markets and how they are transferring wealth. Undoubtedly large commercial microfinance institutions can scale much more quickly, extending services to under-served communities. They assume the risk of financial losses, yet they also assume the upside of financial gains of microfinance. The globalization and transfer of capital and wealth away from poorer countries should be closely considered. International lending institutions like the International Monetary Fund and the African Development Bank can play an increasing role in funding microfinance institutions and, in turn, helping return profits to developing countries.

Part VI: Conclusion

Microfinance has defied traditional beliefs in proving that poor global citizens are indeed “bankable” and that financial services extended to them can be scaled.²⁴⁵ Yet, with the collapse of the subprime market, lenders, investors and regulators must consider whether the same harmful characteristics of the subprime market are also present in the microfinance market. This article has identified several key commonalities, including a growing presence of unfair lending practices. Although microfinance institutions have generally been lauded for their work, without a close consideration of the harmful practices already present in the industry, it risks irresponsible growth and great harm to borrowers and lenders.

The rapid and largely unregulated growth taking place in microfinance must be checked in order to ensure that microfinance operates in a responsible and viable manner.

²⁴⁴ See Rhyne, *supra* note 8.

²⁴⁵ See *id.*

As the global community launches a Campaign summoning large microfinance institutions to be disciplined and principled in their growth, the time is ripe for a close consideration of what responsible growth would look like. The law has an important role to play in creating an architecture for microfinance that considers not just the bottom line, but also the bottom person. If constructed properly, this legal architecture can support a sturdy double bottom line – where economic and social wealth are increased simultaneously.