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Nudging Inclusive Banking and Micro Finance towards Self-Sustainability

(The Ethical Role of Regulation and Self-Regulation)

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1.- A brief introduction on values and on an institutional design committing to values.

As the societal tide moves towards social and environmental sustainability, the legal framework, historically focused on profit-maximising corporations has needed adjustment. An example is offered by Benefit Corporations in the US, now available in more than 30 States, following the Benefit Corporation Model,[1] and Benefit Companies ("società benefit")[2] in Italy, reportedly the first two jurisdictions to have used regulation to nudge businesses towards a re-balanced calibration of profit-seeking and social involvement.

The financial sector has not been exempt from a rising trend that seeks to re-balance profit and social involvement. Financial institutions across the world have started to incorporate, albeit with a wide array of variations, social and environmental sustainability principles into their business models and product offerings[3] and customers have responded positively.[4] Socially responsible investment law[5] and microfinance have become popular subjects on their own right. Some banks and credit unions have long been targeting

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[*] Griffith University, University of Bologna and Universitad Carlos III Madrid respectively.

[1] Compare, for an updated state of the art, Winston, E. (2017), 'Benefit Corporation and the Separation between Benefit and Control', forthcoming in (2017) *Cardozo Law Review* (working paper available on ssrn).

[2] ESELA (2016), *The first European benefit corporation: blurring the lines between "social" and "business"*, available at http://esela.eu/news/the-first-e; De Ricco, G., Mazzeschi, M. (2017), *The Italian benefit corporation: to profit and .... beyond!*, available at http://www.lawyerissue.com/italian-benefit-corporation-profit-beyond/; The ECCLBlog (2017), *The Legacy of B Lab: Italy's Società Benefit*, available at http://www.ecclblog.law.ed.ac.uk/2017/03/31/the-legacy-of-b-lab-italys-societa-benefit/.

[3] Loorbach, D., Avelino, F., Haxeltine, A., Wittmayer, J., O'Riordan, T., Weaver, P., & Kemp, R. (2016), 'The economic crisis as a game changer? Exploring the role of social', *Ecology and Society*, 21, p. 5-7.

[4] Pérez, A., & Rodríguez del Bosque, I. (2014) 'Customer CSR expectations in the banking industry' *International Journal of Bank Marketing, 32*(3), 223-244 (p. 235-240). See also: Yusof, J. M., Manan, H. A., Karim, N. A., & Kassim, N. A. M. (2015) 'Customer's Loyalty effects of CSR Initiatives', *Procedia-Social and Behavioral Sciences, 170*, 109-119 (p. 117-118).

[5] Richardson, B.J. (2008), *Socially Responsible Investment Law: Regulating the Unseen Polluters*, Oxford University Press, Oxford and New York (p. 73 ff. for an overview of SRI growing since the eighteenth century)

community financing and socially or environmentally responsible lending; some entrench this as a core mission. UmweltBank in Germany, Triodos Bank[6] in the Netherland, Banca Etica and Banca Prossima in Italy, Co-operative Banks in the United Kingdom, and some large 'conventional' banks, like CaixaBank in Spain, although not being 'ethical banks' *per se*, have inserted ethical investment as part of their group strategy, with specialized subsidiaries.[7]These individual examples stand alongside the other members of FEBEA, the European Federation of Ethical and Alternative Banks[8], which exemplify this trend.[9] Thus, Socially Responsible Investment (SRI) gains traction in Europe and the developing world.[10]

Furthermore, according to FEBEA ethical banks are a new generation of social banks, originated through a bottom-up process, which reclaims the traditional idea that banks should contribute to the development of their territory.[11]The 29 ethical financial institutions which are members of FEBEA are present in 14 European countries. Despite they represent a very small segment of the overall European banking and financial system they are quite heterogeneous among themselves. More important aspire to act, in their own words, as a "prophetical minority". Their numbers are encouraging so far:

> "29 members in 17 countries (13 banks and 16 financial institutions); more than 3,300 employees, more than 250 branches, more than 200,000 shareholders, more than 240,000 depositors; total assets: 30.5 billion euros, more than 670,000 clients, more than 18 billion euros in loans, more than 9.8 billion euros in TBL (people, planet, prosperity) assets; more than 33 million euros obtained in EU funding; members implementing practices to assess non-economic benefits of loans' requests: 70%, members offering convenient conditions to socio-environmental projects: 75% , bank members offering social financial products: 82%; members implementing practices to verify the origin of funds, beyond the mandatory standard (2014): 81%, bank members disclosing information on allocation of assets (2014): 87.5%; average highest wage/lowest wage ratio (2014): 3.75, members having ethical principles included in articles of association or internal regulations: 95%"

They, together with many other initiatives worldwide in microfinance and microcredit, are part of a wider movement towards what has rightly been described as "a new age of responsibility in banking and finance".[12]

Ethics and culture are key in rebuilding people's trust in the financial sector,[13] something that, according to some, may take a generation.[14] However, this requires

[6] www.triodos.co.uk

[7] A model to be taken as an example: MicroBank - Banco Social La Caixa from 2007 to end 2012 granted 169,282 microcredits for a value of 1,045,000,000 Euro (only in 2012, 11,185 microloans productive type for a value of € 116.5 million and 29,599 social microloans for a value of 119 million euro). See http://www.microbanklacaixa.com/informacioncorporativa/datosbasicos_es.html

[8] www.febea.org

[9] Compare again Richardson B.J., *Socially Responsible Investment Law*, p. 75-76

[10] "with its traditions of stakeholders capitalism and relatively high awareness of environmental challenges, Europe will likely lead such changes in the social responsible investment". (...) [In turn] "SRI is gaining traction [also] in emerging and rapidly industrializing economies. Microcredit institutions for community development and poverty reduction are the strongest element of SRI in the developing world, epitomized by the successful Grameen Bank in Bangladesh". Richardson B.J., *Socially Responsible Investment Law*, p. 80-8

[11] "These have the objective of achieving a positive impact on the collection and use of money. They invest in new activities such as organic farming, renewable energies, the Third sector (or nonprofit sector), Fair Trade. They respond more and more to the needs of those who are excluded from the banking system, and to the needs of savers and investors who are increasingly interested in the way their savings are used. Thanks to ethical banks, the "banking institution" returns to a path interrupted at the beginning of the twentieth century, and it becomes again an instrument of development for the territory and for new social and environmental initiatives." Compare www.febea.org/

[12] Kenadjian P.S., Dombret A. (eds.) (2016), *Getting the culture and the ethics right. Towards a new age of responsibility in banking and finance*, Institute for Law and Finance Series, de Gruyter, Berlin, Boston (in particolar at p. 32 the acknowledgment that this expression is borrowed from Mark Carney)

redirecting financial activity to better target the underprivileged, address poverty challenges and self-employment in the transition from unemployment, and sustainable development in local communities.[15] In other words, 'values' need to be credible and operational, and this requires them to be *institutionalized*. A change in culture, in other words, is transient and not enduring absent a change in institutional arrangements.[16]These help to bridge the gap between values and goals[17] and warrant that, once a specific code of values is adopted, these values are respected at all times and not traded off against more profitable goals when convenient.

We intend to explore some of these institutional arrangements looking at the sub-cluster of financial institutions represented by ethical niche banks and microfinance institutions. Although these offer case-specific peculiarities, there are some useful broader lessons to be drawn from their experience, which may prove interesting for all banks and for policy makers in this process of adaptation to the "new age of responsibility".

After the financial and social crisis originated by sub-prime mortgages unfolded all its dramatic feedback effects, an avant-garde of financial institutions turned its attention at the market segment which traditionally had been considered financially unsustainable and was historically left –at very high and ethically disturbing social costs - to shadow or informal financiers.[18] Our query is whether *inclusive niche ethical banks and MFIs which build business models around serving the previously financially excluded can be helped, or 'nudged' into building business models that are also financially robust*. We posit that they can, and that once this is achieved, the sector can tap resources that may dwarf corporate social responsibility (CSR) programs in terms of social impact. Today, these financial institutions are still marginal, but they *clearly represent one of the greatest opportunities of our times: to achieve financial inclusion (also) via the private sector*. In fact, their still diminished role may be partly due to a regulatory environment that has been tardy to respond to their challenges.

In the present essay we argue that regulation and self-regulation in this sector could and should bolster this shift, and that rules should be designed to help achieve this purpose. This, in turns, means, first, 'nudging'[19] ethical niche banks and MFIs towards self-

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[13] Group of Thirty, *Banking Conduct and Culture (2015): A Call for Sustained and Comprehensive Reform,* at http://group30.org; FSB (2014), *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* (at http:/www.fsb.org/2014/04/140407; compare Raaijmakers, M. (ed) (2015), *Supervision of Behavior and Culture:Foundations, Practice & Future Developments,* De Nederlandsche Bank, Amsterdam.

[14] Kenadjian P.S., 'We ignore Culture at our Peril', in Kenadjian P.S., Dombret A. (eds.), *Getting the culture and the ethics right. Towards a new age of responsibility in banking and finance,* p. 23

[15] For the impressive number of US citizens in need of better financial inclusion in the face of weak social and health protection schemes, compare recently Servon L. (2017), *The Unbanking of America. How the New Middle Class Survives,* Houghton Mifflin Harcour, Boston-New York, in particular p. 166 ("in a study of US financial health, CFSI [The Center for Financial Services Innovation] found that 57% of Americans – 138 million people – are struggling financially, more than double the number of adults the FDIC categorized as unbanked or underbanked in its most recent survey").

[16] "First, recognize that culture exists and it matters. Second, explicitly define the ideal culture for your institution. Here I would add that it needs to conform both to your business strategy and to society's expectation of how people in your position should behave. To the extent your business strategy calls for activities which go beyond what society understands or finds appropriate, that strategy may have to be altered to suit the expectations of the people on whose sufferance you are allowed the substantial privileges you enjoy, including deposit insurance and access to the lender of last resort, both of which allow you to operate with a degree of leverage unheard in other sectors. Third, institutionalize mechanisms for shaping culture, including instilling clear values (...)" Kenadjian P.S., 'We ignore Culture at our Peril', p. 41

[17] On values and goals in ethical finance, Guiso, L., Sapienza, P., & Zingales, L. (2013) 'The Determinants of Attitudes toward Strategic Default on Mortgages' *The Journal of Finace,* vol. LXVIII, No. 4, 1473- 1515.

[18] Islam, A., Nguyen, C., & Smyth, R. (2015) 'Does microfinance change informal lending in village economies? Evidence from Bangladesh', *Journal of Banking & Finance, 50,* 141-156 (p. 153).

[19] Compare Thaler, R.H., Sustein, C.R., (2008), *Nudge, Improving Decisions About Health, Wealth and Happiness,* Yale University Press, New Haven and London, p. 4; for the same conceptual reference to nudging in SRI, recently, Herwig, P. (2017), 'The Choice Architecture of Sustainable and Responsible Investment: Nudging Investors Towards Ethical Decision-Making', in *Journal of Business Ethics,* Vol. 140,issue 4, p. 743-753

sustainability choices, and, second, helping *all* other banks to pilot a transition towards more socially responsible and inclusive banking. We consider herein two aspects of the problem:

(a) organizationally, a special prudential and transparency rule-set (at a minimum, in the form of an ethical bank and MFI regulatory sandbox) under the aegis of 'proportionality';

(b) functionally, the institutionalisation of a fair coexistence of profit-seeking and financial inclusion as an ethical choice available for opt-in.

To be clear from the very outset, we certainly acknowledge that ethical niche banks and MFIs also pose micro-prudential and transparency challenges that need to be duly addressed by appropriate rules: nudging towards ethical involvement should not come at a cost for the micro-soundness of institutions, or the macro-stability of the system. Yet we are also convinced that (i) tailor-made solutions are needed, and (ii) recalibration experiments between profit-seeking and financial inclusion may help self-sustainability, and offer useful lessons for the banking industry as a whole. Another fundamental point is that these solutions should 'nudge', rather than prescribe. The remainder of this section presents the main ideas that will structure the subsequent discussion and recommendations.

a) First, we argue that ethical niche banks and MFIs should be offered, *as a default regime unless they opt for the traditional banking or financial licences*, a special and proportionate set of prudential and transparency rules, at a minimum in the form of a EU regulatory sand-box. Two of us have more generally argued[20] that disproportionate regulation can undermine banks' basic function as financial intermediaries,[21] "induce arbitrage within the banking system if, for any reason, regulation impacts disproportionably on some types of banks" by making it harder for instance for small players "to compete with more established players"[22] and prevent newcomers from entering the market.[23] This general idea also applies to niche ethical banks and MFIs, for which non-proportionate requirements carry a "knock on effect".[24] The problem is particularly acute in Europe, where Basel prudential requirements[25] still pivot around the over-simplistic idea that EU implementation of these standards ought to be the same for *all* European banks and other regulated financial institutions to bolster safety, soundness and stability, whilst US, and especially Japan, see Basel rules as a blueprint only to

[20] BSG, *Proportionality in the Bank Regulation,* EBA, London, 2015, p. 9
[21] BSG, *Proportionality in the Bank Regulation,* EBA, London, 2015, p. 9
[22] BSG, *Proportionality in the Bank Regulation,* p. 15*;* European Commission*, Economic Review of the Financial Regulation Agenda,* SWD(2014) 158 final, at 260
[23] The UK debate on challenger banks vividly portrayed this. Compare CMA, *Retail Banking Market Investigation*, Summary of Challenger roundtable, 3 July 2015. In the U.K. it has been calculated that – due to the differences in the risk weights under the IRB and standardised models – "for every £ 1 of capital set aside to cover credit risk, a large bank can do 10 times more low LTV mortgage lending than a small bank or a building society. Put another way, for taking exactly the same credit risk, the smaller lenders have to set aside ten times more capital that the 6 biggest firms that [in the U.K.] control 80% of the mortgage market".[23] Since capital is a bank's most scarce and most expensive resource, this is not only a quite impressive competitive disadvantage. In reality the "one size fits all" approach hides – in the clothes of and under the false pretence of equal treatment – a fatal discrimination against small banks in two concomitant ways: (a) it denies the potential for a *reasonable* calibration of capital requirements for small banks, adjusted to take into account the relative simplicity of their business model, and (b) it requires small banks to set aside much more capital to take exactly the same risk that big banks are weighing in a different and more favourable way through IRB models. As it has been noted, this generates disturbing markets effects because small banks are pushed to write proportionally more higher LTV mortgages (since they have to charge more than large banks for low LTV mortgage lending), whereas the biggest bank write proportionately more lower LTV mortgages and their profitability is materially higher than that of the small banks. This is clearly paradoxical, because "the banks taking the lowest risks and setting aside the least capital to support these risks [appear to] generate the highest levels of profitability".
[24] BSG, *Proportionality in the Bank Regulation,* p. 28
[25] This includes the revisions under discussion. Compare Coen W. (2016), *The global policy reform agenda: completing the job*, Keynote speech at the Australian Financial Review's Banking and Wealth Summit, Sydney, 5 April 2016 (available on the BIS website), p. 2

the largest, internationally-active banks.[26] This approach, misguided as it is for all small banks with a simple business model, is truly damaging for ethical niche banks and MFIs, *unless a choice is given to these institutions*, among several possible approaches within the Banking Union.[27] First, a series of *special* exceptions and adjustments for individual rules of the Single Rule Book could be introduced. Second, a new regulatory package could be designed "from scratch". A third way, though, would in our view be at point here. Rather than providing for exceptions, exclusions and calibrations from the Single Rule Book, the special (and optional) regulatory framework for ethical niche banks and MFIs should pick from the Single Rule Book provisions that are *explicitly* made *applicable* to them, with the necessary adjustments and calibrations. This would counter the creeping and inertial expansion of the "one-size-fits-all" approach,[28] and, at a minimum, should amount to an "ethical banks and MFI's regulatory sandbox".

For this purpose, we develop a financial self-sustainability strategic matrix, relying on selected comparative experiences in microfinance. In most countries, regulation of inclusive banks and MFIs is identical to those of regular banks, meaning that they do not have enough capital to qualify for savings mobilisation, and are reliant on donations to fund expansion and working capital.[29] A tailored regulatory environment which is supportive and nudges towards self-sustainability ensures that inclusive banks and MFIs can innovate in the way they access capital, and in the products that they offer, such that they are financially self-sustainable. *This type of environment ensures that long term financial inclusion can be achieved without reliance on donors*. Within a supportive regulatory environment, MFIs can achieve profitability or operational self-sustainability (OSS) while providing financial services to those most vulnerable.[30] Hence, regulation has the power to provide an environment where financial institutions are able take the next step in reflecting the increasing societal focus on social good, while blending profit and impact.

b) Second, we claim that self-regulation, possibly assisted by a fiscal nudging, and, where needed, regulation inspired by Benefit Corporations, should help in re-orienting value creation towards financial inclusion, in a partial departure from profit maximisation. In our view, the key is to focus on the bottom line, in a way that targets profitability and social engagement through the institutionalisation of internal reinvestment policies in activities directed at those financially excluded, in a way that indirectly expands the company's client base. This type of institutionalised inclusive banking has been tested for example in Italy throughout the last decade and will be discussed in detail in section 3.

In order to explore the impact of regulation on the financial self-sustainability of inclusive banks and MFI's, both hard and soft regulation will be discussed with direct relevance to this sector. Further, a specific regulatory comparison will be made between India, Bangladesh, Pakistan, Italy and Spain to highlight the different paths that regulators take in pursuing their financial inclusion goals.

[26] Coen W. (2016), *Finalising Basle III*, Introductory remarks at the ECON Committee, Brussels, 12 October 2016 (available on the BIS website), p. 1

[27] Compare Dombret A. (2016), *Banking diversity and regulation – do we need more proportionality in banking regulation?*, speech at the Banking Industry Conference of the Peaople's Banks and Raiffeisen Banks, Berlin, 8 June 2016, p. 5

[28] Tarullo D.K. (2014), *Rethinking the Aims of Prudential Regulation*, Speech at the Federal Reserve Bank of Chicago, Chicago, 8 May 2014 (available online), p. 5

[29] Kiweu, J. M. (2011), 'Relaxing Financing Constraint In The Microfinance Industry: Is Commercialization The Answer?' *Journal of Business & Economics Research, 9*(10), 87-104 (p. 102).

[30] Kiweu, J. M. (2011),' Relaxing Financing Constraint In The Microfinance Industry: Is Commercialization The Answer?' p. 101-102; Kyereboah-Coleman, A., & Osei, K. A. (2008), 'Outreach and profitability of microfinance institutions: the role of governance', *Journal of Economic Studies, 35*(3), 236-248 (p. 246); Obamuyi, T. M. (2009), 'Credit delivery and sustainability of micro-credit schemes in Nigeria', *Journal of Enterprising Communities, 3*(1), 71-83 (p. 81).

2.- Nudging towards inclusive banking and finance through proportionate regulation.

Inclusive finance is about facilitating access to financial services to those without, and a large part of this typically concerns the extension of micro-loans to these people or socially-committed institutions.[31] Inclusion occurs when financial institutions make use of credit scorings and judgmental methodologies to supplement, and often override ordinary commercial banking standards, e.g. the Italian Banca Etica's social indicators, or resort to other corrective tools that expand the lending spectrum without impairing the institution's soundness and safety.

Inclusive finance has become a popular, albeit controversial[32], method of facilitating development, not only in poor countries but also in the poorer segments of the richest societies, by providing financial support to start ups, microenterprises, non-profit organizations and disadvantaged persons. Mainstream commercial banks have traditionally failed to adequately meet the demand for credit by those who cannot offer sufficient collateral and do not possess a regular income.[33] This significantly restrains entrepreneurial risk taking and self-employment, especially in the transition from unemployment to self-employment, and the financing of non-profit organizations. The means to bridge this gap are so far insufficient, but have rapidly grown in the past thirty years, with the expansion of targeted

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[31] European Commission, *A European initiative for the development of micro-credit in support of growth and employment*, COM (2007) 708 final, Brussels, 13 November 2007.

[32] For a critical assessment of micro-credit as a suitable development instrument for developing countries see for example Dyal Chand R. (2007), 'Reflection in a Distant Mirror: Why the West has Misperceived the Grameen Bank's Vision of Microcredit', Northeastern University School of Law, Working Papers Series no. 13, 2007 (available at http://ssrn/abstract=962374); on the failure of the Canadian Calmeadow Metrofund Williams T. (2001), 'Requiem for microcredit? The decline of a romantic ideal', available at http://ssrn/abstract=976211 (showing how peer lending does not work in the US and Canada and advocating for "the imposition on financial institutions of strictly regulated duties to serve disadvantaged communities"). See also: Al-Mamun, A., Malarvizhi, C. A., Hossain, S., & Tan, S.-H. (2012), 'Examining the Effect of Microcredit on Poverty in Malaysia', *ASEAN Economic Bulletin, 29*(1), 15-28 (p. 25-26); Block, W. E. (2010), 'A critique of Yunus and his micro-finance', *Economics, Management and Financial Markets, 5*(2), 57-75 (p. 73); Brett, J. A. (2006) "We Sacrifice and Eat Less": The Structural Complexities of Microfinance Participation', *Human Organization, 65*(1), 8-19 (p. 17); de Mel, S., McKenzie, D., & Woodruff, C. (2011). Getting Credit to High Return Microentrepreneurs: The Results of an Information Intervention. *The World Bank Economic Review, 25*(3), 456 (p. 461); Gloukoviezoff, G. (2016) 'Evaluating the impact of European microfinance: The foundations', *EIF Research & Market Analysis, Working Paper, 33* (p. 8); Hamdani, S. M. Q., & Naeem, H. (2012) 'The Impact of Microfinance on Social Mobility, an Empirical Evidence from Pakistan'. *Interdisciplinary Journal of Contemporary Research In Business, 3*(9), 81-89 (p. 87); Holvoet, N. (2004), 'Impact of Microfinance Programs on Children's Education' *Journal of Microfinance, 6*(2), 27-49 (p. 45); Hossain, M. K. (2012), 'Measuring the Impact of BRAC Microfinance Operations: A Case Study of a Village', *International Business Research, 5*(4), 112-123 (p. 119-121); Hunt, K. (2013), 'Microfinance: Dreams and Reality', *International Review on Transitions in Corporate Life, Law and Governance, 2*(1), 62-77 (p. 73); Karlan, D., & Goldberg, N. (2007), 'Impact Evaluation for Microfinance: Review of Methodological Issues', *Poverty Reduction and Economic Management: Thematic Group on Poverty Analysis, Monitoring and Impact Evaluation, November 2007*, 1-37 (p. 31); Kyereboah-Coleman, A., & Osei, K. A. (2008), 'Outreach and profitability of microfinance institutions: the role of governance', *Journal of Economic Studies, 35*(3), 236-248 (p. 243); Mallick, I. (2012), 'Major impacts of microfinance on the poor: snapshots from Bangladesh', *Munich Personal RePEc Archive, MPRA*(39038), 1-18 (p. 15); Mosley, P. (2001), 'Microfinance and poverty in Bolivia', *The Journal of Development Studies, 37*(4), 101-132 (p. 128); Pollinger, J. J., Outhwaite, J., & Cordero-Guzmán, H. (2007),'The Question of Sustainability for Microfinance Institutions', *Journal of Small Business Management, 45*(1), 1-23 (p. 19); Schrauwers, A. (2011)' "Money bound you--money shall loose you": Micro-Credit, Social Capital, and the Meaning of Money in Upper Canada', *Comparative Studies in Society and History, 53*(2), 314-343 (p. 339); Sharma, M. (2005), 'Emerging Contours of Micro Finance: Where Do We Go From Here?' *The Business Review, Cambridge, 4*(1), 288-295 (p. 294); Yoong, F. J., See, B. L., & Baronovich, D.-L. (2012), 'Financial Literacy Key to Retirement Planning in Malaysia', *Journal of Management and Sustainability, 2*(1), 75-86 (p. 84).

[33] Chakravarty, S., & Scott, James S. (1999), 'Relationships and Rationing in Consumer Loans,' *The Journal of Business, 72*(4), 523-544 (p. 535-542); Stiglitz, J. E., & Weiss, A. (1981), 'Credit Rationing in Markets with Imperfect Information', *The American Economic Review, 71*(3), 393-410 (p. 406-409); Williamson, S. D. (1987), 'Costly monitoring, loan contracts, and equilibrium credit rationing' *Quarterly Journal of Economics, 102*(1), 135-145 (p. 143).

financing through niche ethical banks and MFIs,[34] often encouraged by public support mechanisms, including the EU supranational level, with EU PHARE, European Investment Fund and European Bank for Reconstruction and Development programmes, and the European Regional Development Fund (ERDF) and European Social Fund (ESF).

Basel II and III force microfinance institutions, along with other credit providers, to hedge against credit risks via insurance, guarantee funds, or securitisation, and these instruments are supported by various institutions within the European governance and funding environment.[35] However, the nature, size, operational features and economic and financial outcomes of these ethical niche banks and MFIs are extremely heterogeneous. This is not new in Europe, which has witnessed the birth of early English lending charities, Irish Loan funds, saving banks and credit cooperatives.[36] History shows two points of particular interest. First, financial exclusion is back, and large in developed economies due to the financial crisis and the rise of a middle class. Lisa Servon's look at the US financial system, notes that banks have been gradually turning away from consumers, while the gap has been filled by other types of institutions with no incentive to increase social inclusion: ordinary people lack access to finance when they need it most, and the picture is even more sombre for African Americans or Latino households.[37] Second, financial institutions relying on donors

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[34] Literature is extremely rich: compare for instance *Microfinance for Poverty Reduction: Building Inclusive Financial Sectors in Asia and the Pacific*, UN ESCAP, Development Paper no. 27, New York, 2006; ABI – Fondazione Giordano Dell'Amore (2006), *Banche e microfinanza*, Bancaria Editrice, Roma; Novak M. (2005), *Non si presta solo ai ricchi – la rivoluzione del microcredito*, Einaudi, Torino; Schreiner M., (2004), *Rural Microfinance in Argentina After the Tequila Crisis*, Edwin Mellen Press, Lewiston, NY; Uddin N. (2003), *Regional Rural Banks and Development*, Mittal Publications, New Dehli; Midgley J. (2008), 'Microenterprise, global poverty and social development', *International Social Work*, p. 467-479; Mendoza R., Thelen N. (2008), 'Innovations to Make Markets More Inclusive for the Poor', *Development Policy Review*, 2008, p. 427-458, especially at 444-448. See also: Al-Mamun, A., Malarvizhi, C. A., Hossain, S., & Tan, S.-H. (2012), 'Examining the Effect of Microcredit on Poverty in Malaysia', *ASEAN Economic Bulletin, 29*(1), 15-28 (p. 25-26); Amoako-Kwakye, F. Y. (2012), 'Background Characteristics and Determinants of Performance of Women's Business Operations in Agona and Asikuma-Odoben-Brakwa Districts, Ghana', *Journal of Management Policy and Practice, 13*(3), 129-148 (p. 145); Arora, S. (2012), 'Microfinance interventions and customer perceptions: a study of rural poor in Punjab', *Decision, 39*(1), 62-76 (p. 74); Das, S. K. (2012), 'Entrepreneurship through Micro Finance in North East India: A Comprehensive Review of Existing Literature', *Information Management and Business Review, 4*(3), 168-184 (p. 181); Gloukoviezoff, G. (2016), 'Evaluating the impact of European microfinance: The foundations', *EIF Research & Market Analysis, Working Paper, 33* (p. 8); Hamdani, S. M. Q., & Naeem, H. (2012), 'The Impact of Microfinance on Social Mobility, an Empirical Evidence from Pakistan', *Interdisciplinary Journal of Contemporary Research In Business, 3*(9), 81-89 (p. 87); Hossain, M. K. (2012), 'Measuring the Impact of BRAC Microfinance Operations: A Case Study of a Village' *International Business Research, 5*(4), 112-123 (p. 119-121); Mallick, I. (2012), 'Major impacts of microfinance on the poor: snapshots from Bangladesh' *Munich Personal RePEc Archive, MPRA*(39038), 1-18 (p. 15); Nwaokoro, A. N. (2012), 'Sources, Stigmatization, And Alleviation Of Poverty In Albany/Dougherty, Georgia'. *Journal of Applied Business Research, 28*(2), 155-170 (p. 167); Oncioiu, I. (2012), 'Small and Medium Enterprises' Access to Financing - A European Concern: Evidence from Romanian SME'. *International Business Research, 5*(8), 47-58 (p. 54); Parvin, L., Rahman, M. W., & Jia, J. (2012), 'Determinates of Women Micro-entrepreneurship Development: An Empirical Investigation in Rural Bangladesh', *International Journal of Economics and Finance, 4*(5), 254-260 (p. 252); Randøy, T., Strøm, R. Ø., & Mersland, R. (2015), 'The impact of entrepreneur-CEOs in microfinance institutions: A global survey' *Entrepreneurship Theory and Practice, 39*(4), 927-953 (p. 948); Wilson, T. A. (2012), 'Supporting Social Enterprises to Support Vulnerable Consumers: The Example of Community Development Finance Institutions and Financial Exclusion', *Journal of Consumer Policy, 35*(2), 197-213 (p. 210); Yoong, F. J., See, B. L., & Baronovich, D.-L. (2012), 'Financial Literacy Key to Retirement Planning in Malaysia', *Journal of Management and Sustainability, 2*(1), 75-86 (p. 80).

[35] For an overview in Europe, Viganò L. (2004), *Microfinanza in Europa*, Fondazione Giordano dell'Amore, Milano, Giuffré Editore; Leone, P., & Porretta, P. (2014). Introduction. In *Micro Credit Guarantee Funds in the Mediterranean* (pp. 1-21): Palgrave Macmillan, Basingstoke, UK.

[36] Hollin A., Sweetman A. (1998), 'Microcredit: What Can we Learn from the Past', 26 *World Development* (1998), p. 1875. As opposed to the US experience of credit unions, European credit cooperatives are generally subject to general banking law and supervision: see however, for an exception, the historical legacy of 163 "casse peote" (informal credit associations) still existing in the Italian Veneto and Friuli Venezia Giulia.

[37] Servon L., *The Unbanking of America. How the New Middle Class Survives*, p. XIII and XVII.

were more fragile than deposit-taking institutions,[38] which stresses the importance of self-sustainability for inclusive banking.

Significant differences in the patterns of inclusive banking and micro-finance caution against any unwarranted generalisation, however. The literature on micro-credit in Europe illuminates several aspects of this difference: in Europe (i) the average number of clients of each institution is often much lower; (ii) group lending and other peer lending practices based on community control are hardly effective; (iii) loans are usually of a significant amount (up to Euro 25.000,00); (iv) average interest rates are much lower than the usual 20-60% range in developing countries[39]; (iv) operating and transaction costs are high.[40] *Under these conditions, only a small fraction of institutions are self-sustainable, and thus most of them are associated with NGOs and/or rely on support from public or private donors*.

Against this factual background, proportionate regulation of inclusive banking has potential to help correcting some vulnerabilities in the *current scenario, where most of the potential of ethical niche banks and MFIs is strangled in the cradle by regulatory costs, while profit-seeking banks are not nudged towards financial inclusion*. In the past, government initiatives have not been matched by regulation that fosters self-sustainability, which has made donations necessary, and crippled levels of outreach growth.

We turn first to the reasons why the regulation that is appropriate for traditional banks is inappropriate for inclusive banks and microfinance institutions, and how a special set of rules can nudge towards financial self-sustainability, while preserving financial stability and promoting financial inclusion.

(a) Why general regulation does not fit.

Regulation for banks and MFIs are like shoes: one size does not, and cannot, fit all. There vast differences in size, ethical banks and MFIs are typically smaller in loan and deposit size, individually or as a cluster. Yet, and more significantly, the goals are different. For example, while a large bank such as Standard Chartered may have the motivation of being the world's best bank and operating at the highest standards,[41] MFIs have goals of meeting social objectives and operating efficiently.[42]Their mission is to fight poverty, and they often operate as non-profit entities without private owners,[43] are often promoted by international Non-Government Organisations (NGO's), despite the concern this raises about

[38] Hollin A., Sweetman A,'Microcredit: What Can we Learn from the Past', at p. 1877; Al-Azzam, M. d., Mimouni, K., & Ali, M. A. (2012), 'The Impact of Socioeconomic Factors and Financial Access on Microfinance Institutions', *International Journal of Economics and Finance, 4*(4), 61-71 (p. 68); Hamdani, S. M. Q., & Naeem, H. (2012), 'The Impact of Microfinance on Social Mobility, an Empirical Evidence from Pakistan'. *Interdisciplinary Journal of Contemporary Research In Business, 3*(9), 81-89 (p. 87); Kiweu, J. M. (2011), 'Relaxing Financing Constraint In The Microfinance Industry: Is Commercialization The Answer?' *Journal of Business & Economics Research, 9*(10), 87-104 (p. 100); Mbogo, M., & Ashika, C. (2011), *Factors Influencing Product Innovation in Micro Finance Institutions in Kenya: A Case Study of MFIs Registered With the Association of Microfinance Institutions*, Washington, United States, Washington (p. 8).

[39] See: Block, W. E. (2010), 'A critique of Yunus and his micro-finance'. *Economics, Management and Financial Markets, 5*(2), 57-75 (p. 70); de Mel, S., McKenzie, D., & Woodruff, C. (2011), 'Getting Credit to High Return Microentrepreneurs: The Results of an Information Intervention' *The World Bank Economic Review, 25*(3), (p. 456); Mayer, R. (2012), 'Loan Sharks, Interest-Rate Caps, and Deregulation', *Washington & Lee Law Review, 69*(2), 807-849 (p. 844).

[40] Hunt, K. (2014), 'The Law and Economics of Microfinance'. *Journal of Law and Commerce, 33*(1), 1-79 (p. 72-73).

[41] Standard-Chartered. (2017). Our Brand and Values. Retrieved from https://www.sc.com/en/about-us/our-brand-and-values/

[42] See, e.g. KIVA, a large MFI. Kiva. (2017). About Us: Mission Statement. Retrieved from http://www.kiva.org/about

[43] Spahr, R. W., Ashraf, M., Scannell, N., & Korobov, Y. I. (2011), 'The governance of non-profit micro finance institutions: lessons from history', *Journal of Management & Governance, 15*(3), 327-348 (p. 344).

their sustainability,[44] but their goals do not change when MFIs are established as a regulated Microfinance Bank: empowerment, education, health care and other goals are poles apart from those of profit-seeking banks. Thus, one can surmise that rules based on assumptions of risk-taking driven by short-term profit maximization will prove inadequate for institutions with a different set of goals, and thereby incentives.

Consider, first, capital requirements. These try to ensure the soundness of banks, which are deposit-taking and deposit-mobilising institutions. Banks guaranteeing access to liquidity are intrinsically risky, because they are subject to 'runs', which makes deposit insurance necessary, which in turn, increases the banks' incentive to increase risk, since profits will stay at the bank, while losses will be 'socialized' through the Deposit Guarantee Scheme. Now consider MFIs. They sometimes take micro-deposits, and mobilise those deposits to deliver loans, but many of them do not, or do so in low amounts, which means that an insolvency priority for depositors and the Deposit Guarantee Scheme, and the corresponding subordination of other investors, would be easy to achieve with lower levels of capital. This without mentioning the fact that the same type of management risk-taking cannot be simply taken for granted in institutions that do not only seek to maximize profit. Changes in capital requirements impact lending programs across the board,[45] and although, in principle, increasing capital requirements positively impacts welfare over the long term[46] and simultaneously decreases consumption,[47] this only applies when those requirements are needed to correct a defined set of incentives, not in case those incentives are different.

Second, capital requirements encompass two relevant components: 'micro' risks, e.g. credit risk, market risk and operational risk, and 'macro' systemic risk. Credit risk is higher in inclusive banks, and the Basel accords already require hedging via insurance, guarantee funds, or securitisation.[48] The result of hedging for inclusive banks is a long term reduction in the price of microcredit, increased sustainability, and increased outreach.[49] The factors relevant to the capital requirements of microfinance are as different as the borrowers are – microfinance borrowers are small scale, and have limited financial collateral.[50] Microfinance banks are similarly different in that they generally serve clients through small scale loans, and charge higher interest rates to recover the cost of servicing such an expensive population.[51] In turn, as pointed out in the literature *inappropriate regulatory caps on interest rates likely result in the withdrawal of MFI funding, reduced MFI scale, increased loan sizes, and at the end of day increases in effective interest rates for the poor*[52] *(as there will be a shift towards informal lenders who charge higher interest rates than MFIs).*

[44] Spahr, R. W., Ashraf, M., Scannell, N., & Korobov, Y. I. (2011),' The governance of non-profit micro finance institutions: lessons from history, *Journal of Management & Governance, 15*(3), 327-348 (p. 345).

[45] Bridges, J., Gregory, D., Nielsen, M., Pezzini, S., Radia, A., & Spaltro, M. (2014) 'The impact of capital requirements on bank lending', Working Paper No. 486, Bank of England, London, (p. 12).

[46] Nguyen, T. T. (2014), 'Bank capital requirements: A quantitative analysis' at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2356043 (p. 12).

[47] Van den Heuvel, S. J. (2008), 'The welfare cost of bank capital requirements' *Journal of Monetary Economics, 55*(2), 298-320 (p. 317).

[48] Leone, P., & Porretta, P. (2014). Introduction. In *Microcredit Guarantee Funds in the Mediterranean*, in particular p. 15-19.

[49] Leone, P., Mango, F. M., Panetta, I. C., & Porretta, P. (2014). Regulatory Framework and Supervisory Authorities in Microcredit Sector: A Comparative Analysis. In *Microcredit Guarantee Funds in the Mediterranean*, in particular pp. 22-62.

[50] Agyapong, D., Agyapong, G. K. Q., & Darfor, K. N. (2011), 'Criteria for Assessing Small and Medium Enterprises' Borrowers in Ghana', *International Business Research, 4*(4), 132-138 (p. 134)

[51] de Mel, S., McKenzie, D. J., & Woodruff, C. (2009), 'Measuring microenterprise profits: Must we ask how the sausage is made?', *Journal of Development Economics, 88*(1), p. 17.

[52] Di Bella, G. (2011) The Impact of the Global Financial Crisis on Microfinance and Policy Implications, Western Hemisphere Department, IMF Working Paper 11/75, (p. 37)

Yet with regard to 'macro' risk, inclusive banks pose no systemic problem, which suggests that it is not appropriate for the regulation to be the same. Studies addressing MFI regulation in Tanzania[53] recommend internal rules for board governance and auditing for non-deposit taking MFIs, rather than stringent requirements to ensure financial stability, as the law would for a deposit-taking MFI.

Another example is reporting. One way that regulation ensures financial stability is by monitoring financial institutions through mandated reporting of financial indicators in a comparable format. This ensures the regulator is in control of understanding the benchmarks and trends for each financial institution and for the industry as a whole. This reporting requirement is as suitable for inclusive banks and MFIs as it is for traditional banks, *but in different forms*. Calibrations are appropriately available in some jurisdictions but not across the board. The reporting requirements of MFI's range from the usual one for financial institutions in Italy to an annual balance sheet in India, to an internal audit and annual report and a weekly financial summary in Pakistan, to a list of requirements to be provided half-yearly in Bangladesh. There are very significant operating costs associated to reporting: when reporting regulation is overly demanding, this will add another cost to MFIs' operational structure and stand in the way of self-sustainability. One way to achieve the desirable level of information in a way which allows MFIs to have long term financial self-sustainability could be to follow the lead of Pakistan: the State Bank of Pakistan (SBP) requires weekly reporting from Microfinance Banks (MFBs), but only of key indicators. This provides a nudge to the MFBs to keep their financial records up to date while staying within benchmarks of financial soundness, and allows timely monitoring of trends by the regulator.

(b) How self-regulation could help.

Self-regulation can remove part of the burden of rule-making from the government, while still ensuring a high level of industry quality. In order to explore in detail how self-regulation has helped and not helped inclusive banks, interviews were conducted by one of us with MFIs, Inclusive Banks, regulators, and self-regulators in Italy, Pakistan, Bangladesh, and India in 2013 and 2015. *The interviews in countries with self-regulatory institutions (namely MFIN in India and PMN in Pakistan) revealed that the role of these bodies is much more important than research previously considered.* The interviews revealed that the self-regulatory body not only ensures MFIs are able to set their own industry standards and keep each other in line, but it also serves as a forum for sharing ideas, and a powerful lobbying body to get changes in the legislation that would have otherwise been impossible. Indeed, these institutions have indicated many particular changes in the law have been a direct result of their negotiations with the government, which are uncomplicated because the government has overlapping goals with the MFIs. Even more importantly, *in instances where the self-regulatory body has power because it is a funder of MFIs, such as PKSF in Bangladesh and PPAF in Pakistan, it is a very efficient regulatory system for the smaller MFIs – which are the ones that seek funding from these bodies.* This is especially the case in Bangladesh where the regulator has opted for paper-based reporting (and manual entry into an electronic system to monitor MFIs), and thus does not have the resources to monitor all of the MFIs in a detailed manner. *Government organisations which simultaneously fund and oversee to keep MFIs accountable to reporting and operational standards is an effective soft regulation*

[53] Satta, T. A. (2004), 'Microfinance regulation influence on small firms' financing in Tanzania', *Journal of Financial Regulation and Compliance*, *12*(1), 64-75 (in particular at p. 72-73)

which shows that 'money talks' in 'nudging' MFIs to operate in a way which can be financially self-sustainable in the long term.

An additional aspect which illustrates the positive effect of self-regulation is found in credit bureaus. The establishment of a Credit Information Bureau (CIB) which MFIs are required to report to is an example of soft regulation that works. Some initiatives such as a credit database and disclosure regulation has the potential to promote microfinance in a '*softly, softly'* manner which does not have many potential disadvantages, but has many potential benefits.[54] A study[55] focussed on "second wave" Indian financial reforms suggested that the government can do things to reduce the risk of over-borrowing other than caps on interest rates, such as a credit database.[56] In a sense, credit bureaus are institutions built also for consumer protection.[57] These institutions compile borrower data from all of the different MFIs in order to make sure that borrowers do not become over-indebted by obtaining loans from different companies and ensure there are inherent incentives for loan repayments in that borrowers who default cannot obtain loans from any MFI in the future. In this way, the credit bureaus enforce the rules about the maximum number, or value of microfinance loans per borrower. Regulation which requires reporting to a CIB is a very low cost way of ensuring country-wide portfolio quality and consumer protection. From the perspective of MFIs, credit bureaus play a dual role. Not only do the credit bureaus ensure that clients self-select into microfinance only if they take the loans seriously enough to repay them; the credit bureau also serves as an industry apex of information sharing to make sure that borrowers are given incentives to repay their loan, because if they do not repay they will not be able to access any loans from other MFIs. Hence the credit bureau plays a role throughout the loan process. *Discussions with MFIs in Pakistan and India revealed that their portfolio quality and repayment rate has increased since the credit bureaus have been active. This lends some support for the 'law matters' principle where regulation nudges versus market solutions are capable not only to support MFIs in increasing portfolio quality, but also in protecting consumers from over-indebtedness.* Research has commented in the past on the ability for microfinance borrowers to take multiple loans, with each loan being used to repay the previous one, being responsible, for example, for the crisis in Andhra Pradesh.[58] Obviously, portfolio quality has the potential to impact MFI operating sustainability. A question

[54] Research on CIB's in the less developed context can be found in papers by: Bumacov, V., Ashta, A., & Singh, P. (2014), 'The use of credit scoring in microfinance institutions and their outreach', *Strategic Change, 23*(7-8), 401-413 (p. 411); McIntosh, C., Sadoulet, E., Buck, S., & Rosada, T. (2013), 'Reputation in a public goods game: Taking the design of credit bureaus to the lab', *Journal of Economic Behavior & Organization, 95*, 270-285 (p. 282); Pandit, A. (2013), 'The Role of Credit Bureaus in the Commercialized Indian Microfinance Sector: A Catalyst or An Obstacle to Financial Inclusion?' (p. 6); Serrano-Cinca, C., Gutiérrez-Nieto, B., & Reyes, N. M. (2016), 'A social and environmental approach to microfinance credit scoring', *Journal of Cleaner Production, 112*, 3504-3513 (p. 3511).

[55] Herd, R., Koen, V., Patnaik, I., & Shah, A. (2011), 'Financial Sector Reform in India: Time for a Second Wave?', *Economics Department Working Papers No. 879*, 1-37 (p. 32-35)

[56] Research on CIB's has often considered general areas, such as the work by Herd, Koen, Patnaik, and Shah (2011) in an OECD working paper who analyse the financial reforms of India and develop recommendations for microfinance regulation to promote microfinance. The authors based an analysis on the law of microfinance in India with the aim of avoiding the consequences such as were seen in Andhra Pradesh in 2010 with interest rate caps introduced by the state parliament. The paper established the situation of microfinance in India in 2010, and theoretically discussed the effect of financial sector reforms on financial sector efficiency and the spill-over effects on the rest of the economy. In particular it was found that 13 out of 14 of India's largest MFIs were regulated as non-bank financial companies and were not allowed to take deposits. The result of this is understandably that there is lower microfinance penetration (as found by: Hartarska, V., & Nadolnyak, D. (2007), 'Do regulated microfinance institutions achieve better sustainability and outreach? Cross-country evidence', *Applied Economics, 39*(10), 1207-1222 (p. 1219)).

[57] This is the case in Pakistan, India, and Italy. However, in Bangladesh there are a variety of credit bureaus, which compete for data from MFI's, who are reluctant to pass on information as a result of competition fears. Interviews in Bangladesh revealed that MFIs would prefer lower portfolio quality rather than the perceived risk of increased competition if they report borrower data to a CIB.

[58] Das, S. K. (2012), 'Entrepreneurship through Micro Finance in North East India: A Comprehensive Review of Existing Literature'. *Information Management and Business Review, 4*(3), 168-184 (p. 181-182).

particular to Europe is whether niche ethical banks and MFIs should rely on sector specific CIBs duly linked with traditional banking ones or with the latter, duly expanded to encompass also this segment of the market.

(c) A matrix for strategic decision-making in regulating MFIs nudging towards self-sustainability

In this essay we are not putting forward a specific proposal for rules of one kind or another on niche ethical banks and MFIs in Europe but rather we start laying down the conceptual foundations for a tiered approach to their co-regulation. Regulation shall follow an in depth impact assessment and a much wider debate; here we simply claim that a European experiment of a regulatory sandbox would appear quite at point to nudge European ethical niche banks and MFIs towards self-sustainability.

To support this, we considered that a strategic decision making matrix could prove useful and we started to develop it looking at the comparative experiences of MFIs in selected countries. Identifying countries to compare on this topic can take one of two main perspectives. Some authors have indicated that the most beneficial legal comparison can be made between countries which have large contextual differences.[59] On the other hand, authors have attempted to compare similar countries. Both perspectives are important for establishing a sound empirical methodology. A key consideration is also the availability of data, as although microfinance is present in many countries, the availability of data on microfinance laws differ widely.

Considering this, and without any pretention of being exhaustive, five key countries have been identified hereunder for consideration – Bangladesh, India, and Pakistan, and Italy, as leading jurisdictions in ethical banking and investment, to which we add another, Spain, where such type of investments is still low. Indeed, from a historical perspective, these first three countries were administered by Britain as one country until less than 70 years ago. India, Pakistan and Bangladesh have been chosen as comparable countries for a number of key reasons. In particular, these countries have a similarity in history and culture, despite different dominant religions. There is also relative similarity across geography, language and established microfinance presence. Although the countries have distinctly different cultures, religions, and regulatory conditions now, it can be argued that these differences are smaller than would exist between a geographically diverse set of countries. Italy and Spain have been included to compare how two developed countries where nonetheless ethical banking is in different stages of development, have reacted to microfinance by trying to adapt their banking regulatory framework to include also MFIs. They are also included to illustrate ghow they can learn, in this process of adaptation, from the developing countries when it comes to the regulation of inclusive banks. The Italian experience is also useful to discuss existing European strategies and the most desirable future course of events. In a nutshell, the 2010 Italian reform on microfinance has identified MFIs as a new class of financial intermediaries ("microcredit operators") which, provided that certain minimum requirements are met, are licensed and can operate as non-deposit-taking microfinance providers. Under Article 111 of the Italian Banking Act, as introduced in 2010, they are listed in a register, provisionally held by the Bank of Italy until there are enough of them present in the market to warrant the establishment of a specialized supervisory office responsible this class of intermediaries only.

[59] Marr, A., & Tubaro, P. (2013), 'The microfinance wholesale lending market: a comparative study of India, Peru and Tanzania', *International Journal of Economics and Business Research, 5*(1), 33-54 (p. 49-52) (p. 45-48).

Microcredit operators can provide financing for the purpose of promoting "the taking up or pursuit of autonomous work activities or of micro-enterprises" ("entrepreneurial microcredit") or of supporting "individuals in conditions of particular economic and social vulnerability" ("social microcredit"). [60] The granting of loans must be accompanied by the provision of ancillary mentoring services. Ministerial Decree No. 176/2014[61] implemented Article 111 and detailed all technical aspects related to lending in microfinance. In turn, Bank of Italy issued on 3 June 2015 rules[62] governing the register and MFIs' reporting, including also reports on ancillary services. However, Bank of Italy has limited supervisory powers over microcredit operators; these powers are listed in Article 113 of the Banking Act, which confers upon the supervisory authority the power to request information and documents, carry out inspections, prohibit new operations, impose a reduction in assets and order cancelation from the register in extreme circumstances.

The Spanish case sits in contrast with the Italian one, and even more with that of development countries, due to the almost non-existent regulation, and the preponderance of self-regulation. INVERCO (the association of fund management institutions) issued a circular in November 1999, which was approved by the Spanish securities Commission (CNMV) but only applied to mutual funds, differentiating between ethical funds, green funds, and sharing funds. This was supplemented by the Standard on launched by the Spanish Association for Standardization and Certification (AENOR) on Socially Responsible Financial Products.[63] These standards have been updated to account for the developments at an international level, e.g. UN Principles and procedures, and European level, e.g. the Regulation on Social Entrepreneurship Funds, and thus a new Circular was adopted by INVERCO in 2014, and a new Standard was adopted in 2012 (UNE 165001). The legislature, however, has been reluctant to adopt mandatory regulation. The extreme case is that of MFIs, which lack any specific rules. The Spanish Association of Microloans has tried to bridge the vast gap by adopting a Code of Good Practices, which can operate as a sort of framework principles,[64] but these are very broad, and focus on the bank-customer relationship.[65]

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[60] In this way, micro-finance is normatively bifurcated in Italy: when it takes the form of "entrepreneurial microcredit", micro-financing must be (i) for amounts not exceeding 25,000 Euros and without collateral; (ii) aimed at the establishment or development of entrepreneurial initiatives or inclusion in the labour market; (iii) accompanied by the provision of ancillary assistance and monitoring services. When it takes the form of "social microcredit", i.e. social welfare loans that can cover the costs of health care, education and job placement, or expenses arising from a situation of sudden and temporary vulnerabilities, financing must be (i) up to 10,000 Euros (ii) unsecured (iii) accompanied by the provision of ancillary services to family budgeting, (iv) on terms more favourable than those prevailing in the market. Note that some micro finance can still be exercised, but at "rates adjusted to merely allow the recovery of the costs incurred by the creditor", by certain non licensed non profit organizations, recorded in a separate section of the register referred to in paragraph 1 of art. 111. However, they can offer only "social" microcredit. Compare Pellegrini, F., 'Microcredit in Italy: Searching for a Model', in (2015) ESD 9th Conference, *Book of Proceedings*, eds. Vrankic, I., Kozina, G. E Kovsca V., Istanbul, p. 329, noting also that since 2012 the European Microfinance Network (EMN) adopted a similar differentiation "as a first step towards a more focused discussion on institutional blueprints and lending models for microfinance in Europe": See *Overview of the microcredit sector in the European Union*, (2012), p. 14 and p. 39 ss. The EU recognises this distinction, for example in the report of the European Commission COM (2012) 769 final, 18 December 2012, p. 4

[61] Legislative Decree 17 October 2014, no. 176, *Disciplina del microcredito, in attuazione dell'articolo 111, comma 5, del decreto legislativo 1° settembre 1993, n. 385.*

[62] Banca d'Italia, *Disposizioni per l'iscrizione e la gestione dell'elenco degli operatori di microcredito*, 3 June 2015, available at http://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/disposizioni/disposizioni-microcredito/Disposizioni.pdf

[63] UNE 165001:2002 (AENOR).

[64] AEMIP *Código de buenas prácticas para la concesión de micropréstamos* 10 December 2015.

[65] One of the most specific contributions is the access to a mediator in case of overindebtedness. See Code no. 6.7, and the framework agreement available at https://www.aemip.es/agentes-mediadores/

The picture has only worsened after the financial crisis. In Spain the banking market was traditionally divided between ordinary banks and *cajas,* or saving banks. The latter originated as partly 'social' institutions, and had to dedicate a percentage of their annual profits to social works.[66] Spanish *cajas* experienced an extraordinary expansion, in pre-crisis years, which led them to accumulate around half of the loans originated in the country,[67] and, despite this may have come at the price of a gradual 'bankarization' of their model and practices, they still had more social roots than pure banks. The most damning side effect of the expansion, however, was the reckless accumulation of risky loans, which eventually led to restructuring the whole banking sector.[68] Despite the lack of prudent management can be traced back to deficiencies in the *cajas'* governance model, which had led to rampant political meddling,[69] subsequent reforms have tended to paint the whole model with the broad brush of suspicion, and to separate savings 'banks', turning them into ordinary banks, and non-bank activities, which can be exercised through foundations, still socially active, but with more constrains to access the bank's financial muscle.[70] Some institutions continue to see social lending as part of their company purpose due to institutional path-dependence, like Caixabank, which was originally a (solvent and sound) *caja,* and now accumulates a large volume of microcredit in Spain. However, it is telling that Caixabank turned into an ordinary years before the crisis, and runs its microcredit operations through Microbank, which is also registered as an ordinary bank, and is also a fully-owned subsidiary,[71] which poses no issues with minority shareholders seeking to maximize profits.

The field of SRIs, on the other hand, has seen some timid developments, after a larger Social Security reform introduced (i) a requirement for managers of pension funds to make explicit their investment policies, a policy that, in the case of employment pension funds, must include a reference to extra-financial risks, including ethical, social, environmental or governance, and (ii) the obligation for the fund's manager, or control committee to include a reference to the implementation of such criteria for socially responsible investment.[72]The single text establishing specific rules is the EU Regulation 346/2013 on Social Entrepreneurship Funds.

There are therefore no controls on sound and prudent management tailored to the specific needs of these institutions, which makes a cross-country comparison more pertinent. The criteria for such comparison have been identified based on the aspects of regulation likely to have the largest impact on MFI financial sustainability, which relate to business activities, including provisions for capital requirements, corporate governance, reporting and consumer protection via credit bureaus. Table 1 offers the relevant data of the comparison and some of the results which in our view stand out are commented below.

[66] See, e.g. Fundación de Estudios Financieros 'Las Cajas de Ahorros: Modelo de Negocio, Estructura de la Propiedad y su Gobierno Corporativo' *Papeles de la Fundación* no. 218 (2007) p. 21.

[67] Manuel Illueca; Lars Norden; Gregory Udell 'Liberalization and risk-taking: evidence from government-controlled banks" *Review of Finance* Vol. 18 Issue 4 (2014) pp. 1217-1247.

[68] *Ibidem.*

[69] *Ibid.* See also Vicente Cuñat; Luis Garicano 'Did Good Cajas Extend Bad Loans? Governance, Human Capital and Loan Portfolios' *FEDEA* Working Paper (February 2010).

[70] See Royal Decree-Law 11/2010, and Act 26/2013, on Saving Banks and Bank Foundations.

[71] https://www.microbank.com/conocemicrobank/quienessomos/nuestramision_es.html

[72] New Article 14 (7) of the Royal Legislative Decree 1/2002, which establishes the Single Text on the Regulation of Pension Funds, introduced by the Final Provision Eleventh of Act 27/2011, of 1 August, on the Updating and Modernization of the Social Security System, and article 69 (5) of Royal Decree 304/2004, on the regulation of pension commitments, ad modified by Royal Decree 681/2011.

Table 1. Cross-Country Regulatory Comparison

Criteria	**India**	**Pakistan**	**Bangladesh**	**Italy**	**Spain**
Regulatory environment					
Relevant legislation	MFI Bill, 2012; RBI/2012-13/161; DNBS(PD)CC.No.300 /03.10.038/2012-13; Marr and Tubaro (2013); Nair, Sathye, Perumal, Applegate, and Sathye (2014).	Prudential Regulation for Microfinance Banks (2014); Microfinance Institutions Ordinance, 2001; AC&MFD Circular No. 02 0f 2015; AC&MFD Circular No. 05 0f 2015; the Societies Registration Act, 1860, The Voluntary Social Welfare Agencies Ordinance, 1961, The Trust Act, 1882, and the Companies' Ordinance, 1984 (for MFI's and Rural Support Programs (RSP's)).	Financial Reporting Act (2015); Grameen Bank Ordinance (1983); Microcredit Regulatory Authority Rules (2010) SRO No. 394-Law/2010; Microfinance Regulatory Act (2006)	Articles 111 and 113 Banking Act; Legislative Decree 176/2014 and Provisions of Bank of Italy 3 June 2015.	Article 14 (7) Royal Legislative Decree 1/2002 on Pension Funds, article 69 (5) Royal decree 304/2004 (SRI-specific), Act 10/2014 on Supervision of Credit Institutions, circulars 2/2016, 2/2014 (capital requirements, Act 16/2011 on Consumer Credit (not MFI-specific) self-regulation
Regulator	RBI (Reserve Bank of India) and Self-Regulatory Organisations (SRO's). Most MFIs are registered as non-bank financial companies (NBFCs) or under Acts for Societies, Cooperatives, and Trusts.	SBP (State Bank of Pakistan) with a Microfinance Division established in 2001. The Microfinance Consultative Group was also created in 2001 and is chaired by	Microcredit Regulatory Authority (MRA): 'Independent' body with Central Bank representation on board.	The Minister of Economy and Finance, after consulting with the Bank of Italy	Bank of Spain for banks, CNMV for funds. No differentiated treatment

Criteria	India	Pakistan	Bangladesh	Italy	Spain
		the SBP.			
Self-Regulation	All MFIs must be a member of an Self Regulatory Organisation (SRO) recognised by the RBI. MFIs must comply with the Code of Conduct of the SRO. Responsibility for compliance with the regulations lies with the NBFC-MFI's.	Various industry bodies have been created to provide a level of on-going self-regulation, the peak of which is the Pakistan Microfinance Network (PMN).	No relevant industry bodies established with the purpose of self-regulating MFIs have been established.	Not relevant	Most important source of criteria, but focused on transparency and investor protection
Tiered Approach to MFI Regulation	MFI's of different sizes (based on loans outstanding) are regulated differently in the stipulation regarding business activities. MFI's are either 'large' or 'small'.	MFB's are regulated differently to MFIs (NGO's) and informal microfinance providers. This table will consider MFB's only.	No. There is one set of regulation for MFIs and a separate legislation for the Grameen Bank under the previously stated Ordinance.	No	No
Tier thresholds	The benchmark is that a large MFI is one with more than Rs. 100 crore (1 crore = 10 million) loan portfolio. (Approx. €14million)	MFB's need €7.7mil in paid up capital to be regulated as such. Each MFI has the ability to decide under which regulatory code they are regulated. There is no clear tier structure with defined thresholds.	No thresholds.	No thresholds, just benchmarks for what microcredit is	No
Capital Requirements					
Initial Capital	All NBFC-MFI's need to	Rs. 1 billion (Approx.	No requirements from	Legislative Decree	Act 10/2014 on the

Criteria	India	Pakistan	Bangladesh	Italy	Spain
Requirements	have NOF (Net Owned Funds) of Rs. 5 crore (Approx. €700,000). There is an exception for the NE Region for Rs. 2 crore (Approx. €280,000). If they do not have the required capital they are restricted to lending only 10% of funds in microfinance loans, but can still be registered as a NBFC-MFI.	€7.7 million) in paid up capital to be regulated as a MFB. The RSP's and other regulatory tiers have other capital requirements, and they are not directly regulated by the SBP.	the MRA. Requirements are from the regulation under which NGO's were created (of which there are four).	176/2014 (Article 6.1.c)	Supervision of Credit Institutions, Bank of Spain circulars 2/2014 and 2/2016, hereafter Banking rules (not specific to MFIs)
On-going Capital Adequacy Requirements	Capital Adequacy of 15% of Risk Weighted Assets	Capital Adequacy of 15% of Risk Weighted Assets	All NGO-MFIs maintain CAR of above 10%	Banking Act – not specific to MFI's	Banking rules –not specific to MFIs
Risk Management Provisions	Must provide a percentage of profits as a reserve fund to the RBI each year (which will be used for MFI training etc)	Cash reserve requirement (5% of deposits); statutory liquidity requirement (10% of demand and time liabilities); statutory reserve (20% of annual profits); depositor's protection fund (5% of annual profit); provisioning requirements (100% loss declared on arrears of 180 days); exposure	10% of total income surplus (accumulated surplus or profits) must be maintained in a reserve fund (a separate bank account). The remaining profits can be used for operational activities or poverty alleviation activities (if approved by the MRA). Liquidity of 15% (previously 10%) required (5% in cash and 10% in term	Banking Act – not specific to MFI's	Banking rules –not specific to MFIs

Criteria	India	Pakistan	Bangladesh	Italy	Spain
		against contingent liabilities (<= 5 times equity). Standards for board composition are documented.	deposits) balanced half-yearly. MFI to classify loans as “Regular”, “Watchful”, “Sub-standard”, “Doubtful” and “Bad Loan” on an annual basis and provision based on the percentage indications provided in the rules. Bad debts are classified as an expenditure in accounting.		
Savings Mobilisation	Can mobilise deposits if the MFI has capitalisation of US$400,000 and a CAR 12-15%	MFB’s can mobilise deposits if the risk management guidelines are followed.	Grameen Bank is permitted to accept deposits from the general public. Under the MRA, MFIs are allowed to intermediate deposits from members (up to 80% of loan portfolio), but that is different to deposit mobilisation.	Banking Act – not specific to MFI’s	Banking rules –not specific to MFIs
Access to finance - debt	Can mobilise deposits if benchmarks above are met. Of the lenders to MFI’s, 21% are international (compared	Microfinance Credit Guarantee Fund (MCGF): GBP 10 million (USD 16.47 million) is available to	MFI’s can take loans from financial institutions. For loans from international institutions Government	Legislative Decree 176/2014 (Article 14.1)	Banking rules –not specific to MFIs

Criteria	India	Pakistan	Bangladesh	Italy	Spain
	with 55% in Peru and 75% in Tanzania (Marr & Tubaro, 2013).	the microfinance industry as guarantees to access commercial debt. This fund is also part of the Financial Inclusion Program (FIP).	authorisation must be obtained. Securitisation is allowed. Loans from people other than clients are allowed with a well-defined contract. Grameen Bank can sell bonds and debentures guaranteed by the Government.		
Access to finance - equity	Foreign investment in MFIs is automatically approved. Being a regulated NBFC allows them to attract commercial investment.	Investment in MFB's has no restrictions. Other providers of microfinance have investment restrictions, such as RSP's, thus giving incentives to move up the tiered regulation structure.	MFI's are structured as NGO's, therefore the ownership of the NGO is subject to the specific regulations under which it was founded.	Legislative Decree 176/2014 (Article 7); Provisions of Bank of Italy 3 June 2015 (Article 3)	Banking rules –not specific to MFIs
Governance					
Legal Form requirement	No requirement.	Legal form restrictions are placed on MFI's regulated by other supervisors than the SBP.	Depends on the regulation under which the NGO was formed.	Legislative Decree 176/2014 (Articles 6.2 and 11.1)	No requirement
Ownership	No restrictions. Can be NGO owned or private companies.	No restrictions. Can be companies which allocate profits to shareholders and receive investments.	Depends on the regulation under which the NGO was formed.	Legislative Decree 176/2014 (Article 7); Provisions of Bank of Italy 3 June 2015 (Article 3)	No requirement
Management board				Legislative Decree	No requirement

Criteria	India	Pakistan	Bangladesh	Italy	Spain
				176/2014 (Articles 6.2.e and 8);Provisions of Bank of Italy 3 June 2015 (Article 2)	
Asset (Loan Portfolio) Guidelines	85% of assets must be 'Qualifying Assets' (applies to post-2012 assets only) to receive eligible bank funding. In addition, 70% of loans must be for income generation purposes (as opposed to for housing repairs, education, medical emergencies).	The MFB must determine that the borrower has the ability to repay the loan. Hence, loans for business purposes are easier to verify, and many MFB's only provide loans for business purposes. MFB's can provide loans for any purpose that are backed by gold collateral up to 35% of the loan portfolio.	Loans for microenterprises must be less than 50% of the total loan portfolio. Regulatory guidelines from July 2011 ban unofficial deductions by lenders for so-called saving schemes (forced deposits from borrowers), limit charges for administration fees and set a 15-day mandatory grace period for repayment, and borrowers must pay back their loans in 46 instalments.	Legislative Decree 176/2014 (Article 5.7)	Banking rules –not specific to MFIs
Reporting					
Reporting	Must provide P&L and BS to RBI annually.	Weekly report of summary (one page of financial indicators). Annual audit to SPB. Need an internal audit department which reports to the board.	Abstract of results of internal audits must be published. MRA must be informed of the interest rate, duration, and repayment schedule of all loans on a half-	Article 113 Banking Act; Provisions of Bank of Italy 3 June 2015 (Articles 6 and 7)	Banking rules –not specific to MFIs

Criteria	India	Pakistan	Bangladesh	Italy	Spain
		Annual audit rating.	yearly basis. Send to the MRA annual reports of the BS, CF, Income-Expenditure, Change in Capital, Portfolio Statement.		
Accounting Standards	Interest rate calculation (monthly and annual) certified annually by Statutory Auditors and reported in the BS.	Different types of MFI regulation result in different accounting standards for each type. However, the legislation refers to 'international accounting standards'.	Standard accounting procedures must be followed Further, 'heads' of income and expenditure reports have been stipulated by the MRA for the financial management of accounts. Annual budget must be approved by the board.	Italian Accounting Standards – not specific to MFIs	Spanish Accounting Standards – not specific to MFIs
Interest rate caps	Loans under US$4,000 are subject to an interest rate cap. Interest rates are capped at 26%pa (with 4%pa +/- leeway). To calculate the cap, MFI's must use a calculation of the annual average borrowing cost plus the margin (max of 10% or 12% for 'small' MFI's. The aim of this is that in a low interest rate environment the borrower	No restrictions.	Microfinance interest rates are capped at 27%pa.	Legislative Decree 176/2014 (Articles 5.6 and 11.5)	Act of 23 July 1908, on Usury – not specific to MFIs

Criteria	**India**	**Pakistan**	**Bangladesh**	**Italy**	**Spain**
	will benefit and in a high interest rate environment the NBFC-MFI will have enough leeway to maintain sustainability.				
Legislated loans to microfinance	Domestic banks must lend 40% of lending portfolio to ‘weaker sectors’ (including microfinance)	No restrictions.	70% of clients must be borrowers	No	No
Deposit taking – Regulatory framework to allow (EIU)	Regulated MFI’s can take ‘thrift’, but not mobilise the savings for business activities	MFB’s can receive deposits as outlined in the regulations.	Grameen Bank can take deposits, and in 2009 had a ratio of 142% for client savings to loan portfolio. Total deposit balance will not exceed 80% of total loans outstanding at any time. There are conditions which need to be followed in order to receive voluntary deposits (including that they ca not exceed 25% of the total capitalisation of the organisation). Detail is given about how to administer deposits and the conditions to follow.	No allowance for MFI’s to take deposits. Banking Act – not specific to MFI’s	Banking rules – not specific to MFIs
Credit Bureaus					

Criteria	India	Pakistan	Bangladesh	Italy	Spain
Credit bureaus	Every MFI must be a member of a Credit Information Company (DiCicco-Bloom & Crabtree) created under the CIC Regulation Act 2005. Each MFI must share information with the CIC's about indebtedness and source of borrowing.	MF-CIB, a microfinance specific credit bureau was released in June 2012 to reduce the likelihood of microfinance defaults for over-indebtedness.	Luoto, McIntosh, and Wydick (2007) indicates that the World Bank planned to establish a credit bureau in Bangladesh, but no evidence has been found.	Banking Act – not specific to MFIs	Banking rules – not specific to MFIs
Deposit protection	In the case of MFI failure depositors are the first of the creditors to have access to assets.	Included in the strict risk management provisions is: depositor's protection fund (5% of annual profit)	If an MFI closes, depositors will have first access to assets.	Banking Act – not specific to MFIs	Banking rules – not specific to MFIs

Two findings, in our view, stand out from this matrix, for careful consideration for future developments.

First, the central role of suitable, but *ad hoc*, risk management provisions. Particularly of interest in this context is the finding that both internal funding via retained profits and external guarantee funds are present in the matrix and they appear effective, and complementary, tools to address risk, achieve inclusion and self-sustainability. MFIs offer loans without financial collateral. *An institutional framework supporting suitable forms of credit market guarantees*[73] *nudges towards inclusive banking because it allows inclusive banks to lend offering to the loan provider some security of the loan capital. Government-funded guarantee funds could also display useful market discipline in terms of better MFI governance*: as we noted above, commenting on PKSF in Bangladesh and PPAF in Pakistan, organisations which simultaneously fund and oversee to keep MFIs accountable to reporting and operational standards 'nudge' MFIs to operate in a way which can be financially self-sustainable in the long term. We will discuss this issue in some detail in the following sections.

Second, innovation seems to be key for inclusive finance. Government support for innovation through regulation has direct flow-through effects on MFI operations and subsequently on financial inclusion in each country. Regulation has the ability to allow companies to form equity partnerships with international firms to share knowledge, to create innovative products, or to seek to leverage off technology in increasing outreach to the poorest. As Lisa Servon[74] put it recently

> "a confluence of forces has created a moment ripe for innovation and wholesale change in consumer financial-services industry, with a slew of innovators posed to seize the opportunities. Enormous advances in technology, significant changes in consumer behaviour and a radically revised regulatory environment are coming together in ways that offer hope for more efficient, effective and equitable provision of consumer financial services. This moment is notable for its rarity"

It is surprising thus that some governments – for instance those of India and Bangladesh – did not seem to support adequately innovation in microfinance, not to leverage off technology to come up with a more accurate credit-scoring model. The regulation of these countries reflects that MFIs are not encouraged to innovate in product design. In interviews with one of us, the Indian government explicitly communicated its willingness to avoid the use of mobile phones in banking, to avoid the creation of 'eMoney' outside of fiscal control. Yet, mobile phones have already revolutionized financial services in Kenya, where 19 million people (90% of the adults) manage their money through M-PESA. Furthermore, regulations can introduce specific licensing and reporting requirements which make e-money easier to track than cash, rather than the opposite. Furthermore, some studies, including by one of us, point that legal solutions do not need to simply 'bankarize' mobile e-money companies, e.g. rules that focus on the insulation of customer funds through a trust or

[73] In Pakistan, Microfinance Banks (MFB's) are well capitalised, but they need to prove to the market that they are able to operate as efficient businesses, and according to interviews with the Pakistan Institute of Management they are incompetent as they are just SME's themselves, learning to operate efficiently. The DIFID Guarantee fund has helped 27 loan contracts take place by guaranteeing the loans accessed by MFB's on the Pakistani capital markets. According to VIS Ratings Agency, this is effectively a 'credit enhancement'. It is critical that inclusive banks have diversified sources of credit. Although they cannot access the interbank overnight credit markets, they should be supported by regulation to access the capital markets. One effective mechanism to facilitate this is a guarantee fund, as exists in Pakistan.

[74] Servon L., *The Unbanking of America. How the New Middle Class Survives, p.* 143

fiduciary arrangement[75] can protect customers, while avoiding onerous prudential requirements, which are conceived more for entities that, unlike payment institutions, have an important recourse to leverage and maturity transformation. In turn, in Pakistan Telecommunications Companies (TelCo's) are investing in MFBs in a strategic way because with the innovations in branchless banking mean that the poor are now a potential market for financial services. These investments in MFI's are profit motivated, in terms of increasing the potential market for TelCo products and services.

Once the poor are treated as a promising market financial inclusion will increase through MFI growth. Interviews in Pakistan with leading MFI 'Tameer' illustrated how MFI regulation directly affects their business operations and model. Tameer's equity partner is TeleNor (a Norwegian Telecommunications Company) which allows the MFI to increase outreach using phone banking for certain services, as well as capital to invest in innovative infrastructure and market research. This equity partnership also provides TeleNor with an entry point into the Pakistani mobile phone sector, one of the most innovative and advanced in developing countries, and is This equity partnership is directly supported by enabling rules, unlike rules in India and Bangladesh, which explicitly deny equity partnerships of this nature. Tameer also benefits from a partial waiver on gold-backed loans,[76] which means that gold-backed loans do not require as large an amount of capital reserves as unsecured loans do.

Also Italy and Europe offer interesting examples of the necessary interplay between innovation and inclusive banking and on the difficulties that regulators face to keep abreast with technological and societal developments, if only one considers social lending on specialised on-line platforms (Terzo Valore, a peer-to-peer social lending platform developed in Italy by Banca Prossima being an excellent example).[77] EBA issued guidelines[78] and Bank of Italy adopted in November 2016 the relevant implementing provisions (covering soundness and stability concerns; the 'transparency leg' of such initiatives being governed by the Prospectus Regulation and its exemptions).[79] Although this was an endeavour to set out a comprehensive framework for such innovative initiatives granting also some leeway to deposit taking (limited to small amounts), the regulatory approach still does not give full justice to innovation and insufficiently 'nudges' towards social financing since an overhang of concerns of path-dependent nature (e.g. on yearly quantitative limits to public offerings and no clear exemptions for personalised social financing via platform), constrain innovative platforms from delivering the full potential of their social impact.

(d) What next for Europe? The path towards a regulatory sandbox nudging niche ethical banks and MFIs towards self-sustainability.

[75] David Ramos; Javier Solana; Ross P Buckley; Jonathan Greenacre 'Protecting Mobile Money Customer Funds in Civil Law Jurisdictions' *International and Comparative Law Quarterly* Vol. 65 Issue 3 (2016) pp. 705-739; Jonathan Greenacre; Ross P Buckley 'Using Trusts to Protect Mobile Money Customers' *Singapore Journal of Legal Studies* (2014) pp. 59-78.

[76] Tameer is well known in Pakistan for its 'gold-backed' microfinance loans, which, despite only serving those with some gold investments, increases the flexibility of collateral, and allows the firm to have 100% repayment of gold-backed loans. Interviews with both Tameer and the State Bank of Pakistan revealed that the gold-backed products are a direct result of the regulation which provides a partial waiver to the 'general conditions' for gold-backed loans. The State Bank of Pakistan has released instructions entitled: *Financing against Gold Backed Collateral-Instructions for MFBs* which can be found at: http://www.sbp.org.pk/acd/2015/C2-Annex.pdf

[77] https://www.terzovalore.com/terzovalore/)

[78] EBA, Opinion of the European Banking Authority on lending-based crowdfunding, EBA/Op/2015/03, 26 February 2015.

[79] Compare Consob, 10 December 2010, No 10101143

Europe has already devoted considerable attention and resources to microfinance and inclusive finance in the last decade. For instance, the European Commission, following its Staff Working Document of 2004 on "Microcredit for European small businesses"[80] and the works and recommendations of its Expert Group[81] issued in 2007 a Communication on "A European initiative for the development of micro-credit"[82] acknowledging that "micro-credit can play an important role in the realisation of the Lisbon strategy for growth and jobs and the promotion of social inclusion". It also recognized that "evidence suggests that banks engage in micro-credit activities (directly or more often in partnership with non bank institutions) where they are encouraged to do so by public support mechanisms" and that there is scope for EU action in the field, first of all, because "the institutional framework in the Member States appears to be often ill-suited to the development of micro-credit". The European Commission supported therefore (i) a wider provision of loan guarantees and, as portfolios develop, securitisation; (ii) relaxation of interest caps for micro-credit operations; (iii) access to banks' CBIs for MFIs and (iv) favourable tax schemes. The Commission also correctly underlined in its Staff Working Document of 2004 that inclusive banks are not just about funding, but also *implies "the provision of non-financial services, in particular mentoring, [which] is essential to increase the chance of survival of start-ups and small enterprises". Business support services help both sides of the loan agreement to reduce their transaction costs and information asymmetry*. In turn, it also implies[83], more appropriate credit scoring techniques for assessing the credit risk of microloans. [84]

As to prudential regulation, the EC approach was in favour of a bifurcation between deposit-taking institutions (for which general prudential requirements should apply) and non-deposit taking institutions, for which regulation could be simplified "so that it does not put a brake on the supply of micro-credit and the growth of specialist MFIs". It is also important to note that the Commission acknowledged that "methods developed for providing and recovering micro-credit differ from traditional banking techniques. This exchange of know-how would allow *inter alia* better integration of quantitative methods such as credit scoring, which are beginning to extend to micro-credit and trust-generating contacts, on which the micro-project and its reimbursement depends". To this purpose the Commission identified the need for a "central body with financial and social expertise and the ability to monitor and coordinate action in support of micro-credit and to act as a permanent discussion partner for those in the field". The tricky side, however, is how to implement those principles.

[80] SEC (2004) 1156 of 11 September 2004

[81] Expert Group Report, *The Regulation of Microcredit in Europe*, Brussels, April 2007.

[82] Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions A European initiative for the development of micro-credit in support of growth and employment , COM/2007/0708 final. Compare also A European initiative for the development of micro-credit in support of growth and employment, European, Parliament resolution of 24 March 2009 with recommendations to the Commission on a European initiative for the development of micro-credits in support of growth and employment (2008/2122(INI)).

[83] Bhatt N., Tang S. (2001), 'Making Microcredit Work in the United States: Social, Financial and Administrative Dimensions', 15 *Economic Development Quarterly*, p. 229, at p. 236

[84] Bhatt N., Tang S., 'Making Microcredit Work in the United States: Social, Financial and Administrative Dimensions', p. 236 ("such methods could include landlords references, savings records, and proofs of car payments or utility bill payments. Although it may somewhat increase program administrative costs to access such records, the strategy may help to identify low income individuals who lack a strong credit history but have demonstrated reasonable repayment discipline in the recent past. In addition, programs might secure their loans with items such as television sets, stereo units, furniture, pieces of equipment or cars. Although such non-traditional or creative collateral might not have significant market value compared to the loan amounts disbursed, they are often important to individual borrowers and have been known to serve as effective security against wilful default for some of the more prominent US programs").

The European approach is multi-faceted, and needs to combine measures directed at encouraging prudent management, with others to enhance capacity building.[85] The matrix developed in the previous section offers, in our view, some initial insights into the most desirable course of action for Europe on the best way to combine prudent management with a different mission.

However, in addition to those rules, a central feature to ensure the success of MFIs have been programs of financial support centred around guarantee funds. And for good reasons, for financial institutions regard microloans as risky if there is no financial collateral. The risk of having no collateral is mitigated by a guarantee consortium or a guarantee fund[86]. Therefore, the operating model in the provision of microcredit in Europe often includes three main actors: (1) a no profit organization, which identifies and assesses the needs and demands for microcredit, presents the potential beneficiary to the bank or financial intermediary that will provide the credit and follows the beneficiary through several *tutoring* activities, 2) the bank or lending financial institution, and 3) an (often publicly funded) guarantee fund. Authors have found that MFI guarantee funds contributed to lower financial exclusion, and that regulation to this aim is key.[87] These guarantee funds must operate, however, according to rules and practices and to be duly supervised which should be directed at minimizing moral hazard from the side of the borrowers. In our view, thus, one of the main challenges in supporting self-sustainable inclusive banking in Europe revolves around the role of guarantee funds. If appropriately designed, they could[88] help in fostering networking in inclusive banking, in the first place, and act as a central coordinator with financial and social expertise and the capacity and powers to monitor the decentralised action of a multiplicity of MFIs, in the second place. Two functions which in our view are key for long-term self-sustainability of microfinance. This is just an example, but one which illuminates how adapting the regulatory environment might prove effective in nudging towards inclusive banking.

3.- Nudging towards an internal guarantee fund: fair coexistence between profit seeking and social engagement as a path to self-sustainability

In the previous section we showed that guarantee funds are key for developing inclusive finance. In this section we discuss an experiment of an 'internally funded' guarantee fund, i.e. a fund set up through retained profits, as a suitable and complementary self-

[85] "At the European level the situation is also highly heterogeneous due to the differences between the legal and institutional frameworks of the Member States as well as the variety of entities operating in the microcredit field. The joint initiative of the European Commission, the European Central Bank and the European Investment Fund called JASMINE (Joint Action to Support Microfinance Institutions in Europe), in particular through the adoption of the European Code of Good Conduct for microcredit provision[85], attempted to establish principles of governance and prudent management consistent with best practices in the industry, with the aim of establishing a set of rules approved in the European Union and recognized as essential to the operations and financial reporting of entities operating in microcredit" (…) Despite support from the European Commission in recent years to the Microfinance sector through several programmes (CIP, EPPA, JEREMIE, JASMINE, EPMF, etc.) there is still a clear need to invest in the capacity building and refinancing of microfinance institutions in Europe over a sustained period of time, allowing them to improve their institutional capacities and providing them with access to sustainable funding sources. And this seems to be the way that European Commission wants to carry on"
[86] Leone, P., & Porretta, P. (2014). Introduction. In *Micro Credit Guarantee Funds in the Mediterranean* (pp. 1-21): Palgrave Macmillan, Basingstoke, UK, (p. 20).
[87] See Cozarenco, A. (2015). Microfinance Institutions and Banks in Europe: The story to date. *Working Papers CEB, 15* (p. 4)*;* Lorenzi, M. (2016). Microcredit in the European Union: A Feasible Means for Business Growth and Fair Access to Credit. *Innovation (EaSI), 2014*, (p.20); Marakkath, N., & Attuel-mendes, L. (2015). Can microfinance crowdfunding reduce financial exclusion? Regulatory issues. *International Journal of Bank Marketing, 33*(5), (p. 632).
[88] Lamandini, M., (2009), 'What Community Action for Microcredit?', *Rivista di Diritto Societario*, 4/2009, p. 903.

regulatory response to promote inclusive banking, to nudge ethical banks and MFIs towards self-sustainability and traditional banks towards more inclusive banking as part of their commitment to ethics and corporate social responsibility. This is in line with the movement which recently led to the regulatory recognition of Benefit Corporations and one which could do well to traditional banks to restore the bond of trust with society which seems currently broken.

Banca Prossima s.p.a. was established in Italy in 2007 by Intesa San Paolo (ISP) as a fully owned bank called to operate as a niche ethical bank for inclusive banking, mainly servicing non profit organizations; it offers, in our view, an interesting case study.[89] This bank, despite its strong social focus on inclusive banking, was designed as self-sustainable. After 10 years of operations, the experiment looks successful. Its specialty is reflected in special provisions of its articles of association. Under Italian company law, whilst profit seeking is a mandatory requirement, profit *maximisation* is not. The articles of association can therefore calibrate. Such calibration, in the case of Banca Prossima, was (mostly) made with a special provision concerning the allocation of yearly profits,[90] by which yearly disposable profits are used in part for *the accumulation of a specific reserve working as an internal guarantee fund.* The fund is without segregation and remains under the management of the bank's board of directors. It *is to be used, however, specifically to "face the risks and cover the losses" stemming from inclusive banking*.

In particular, as specified by implementing the internal rules, when the bank lends to borrowers whose credit scoring is below the minimum (classes "R4" and "R5", together constituting the so called "portfolio Gamma") under usual eligibility standards of the ISP group, specific provisioning is made against the fund in a percentage of 2,5% of the gross value of the loan, as long as the loan is performing, and 40% if it is defaulted. This is meant to ensure that the fund can make good those realised losses derived from loans extended to borrowers which, under normal credit scoring standard, would not be eligible to the loan, but which are nonetheless financed by the bank based upon a complementary 'social assessment', using different methodologies for inclusive banking (and which are also often receiving mentoring assistance by a specialised task force set up by the bank as part of the loan monitoring exercise). The provisioning against the fund is statistically calculated to prevent a misalignment between the fund's resources and the stock of insured portfolio Gamma loans. The functioning of the fund is such that it insures the additional risk for the bank associated with the difference in performance between the portfolio Gamma (credit scoring classes R4

[89] Lamandini, M., Steiner, I. (2007) 'Social Banking in Practice: an Italian Case for Corporate Social Responsibility in Banking', *Rivista di Diritto Societario*, 4, 174-194.

[90] "The net profits shown in the accounts, net of the legal reserve and of any other provisions which the Company is required to set aside under the applicable laws in force at the time, shall be distributed as follows: a) a share equal to the cost of capital invested by the Bank shall be allocated to a non-distributable statutory reserve to be calculated in accordance with the accounting methods generally employed by the market; b) the net yearly dividend allocated to shareholders shall not exceed 50% of the profits approved by the shareholders' meeting, net of the provisions set out under letter a) above; c) *all remaining profit shall be set aside for solidarity and development initiatives and allocated to a specific Fund for Development and the Social Enterprise. This risk and contingency Fund shall be employed – according to the procedure described here below – to cover losses arising from solidarity and development loans granted by the Company at below-market rates or to persons who do not have, or have only limited access to traditional credit facilities. If at the end of the financial year the Company should record losses attributable, in full or in part, to solidarity and development programmes, any such losses shall be fully covered by the Fund for Development and the Social Enterprise*. If the above losses, being too great to be covered by the above Fund, the net profit generated by the Company in the following financial years shall be set aside, after the mandatory legal reserve provision, to bring the shareholders' equity back to its previous level, net of the above Fund. If, conversely, the operating losses are due to other causes and do not arise from solidarity and development initiatives the Fund under point c) above may be used to cover such losses only after all other voluntary and statutory reserves have been used to this end, including the reserve under point a) above. If the Fund under point c) above is used to cover losses which do not arise from solidarity and development programmes, the net profit of the next two financial years, net of any legal reserve provisions, shall be used to bring the above Fund back to its previous level." (article 28 of the articles of association).

and R5) and the last class (R3) of eligible borrowers under usual credit scoring standards applied within the ISP group. In so doing, once such additional risk is covered by the fund, R4 and R5 borrowers can be treated, for any other aspect, as if they were eligible borrowers. The increased risk associated to the portfolio Gamma is neutralised by the fund (on a rotated basis, with yearly computations) once the loss is realised, making good such loss (ideally, in net terms and to the extent it is attributable to the differential risk of portfolio Gamma), but at the same time the group reaches a much wider client base and delivers a measurable social output in terms of inclusive banking.

This example, in our view, is quite illustrative of the virtues of nudging towards self-sustainability in inclusive banking. It offers a functional self-regulatory model of profit distribution (inspired by an ethics of moderation) which draws a balance and satisfies both profits and social expectations, is optional but could be further nudged through fiscal incentives (if for instance realised profits allocated to the solidarity fund were totally or partially exempted from taxation). At the same time, it adopts a long-term view of value creation, whereby the present use of part of the short-term profits is justified to internally subsidize social engagement and enlargement of the client base in view of the mid-to-long term returns associated, both in economical and reputational terms, to these investments.

We are aware that this experiment may invite all sort of arguments usually adopted against multi-stakeholders' governance. Sacrificing (part of the annual) profits in the social interest is extremely controversial. It raises important questions, normative as well as positive. On a normative level, there is disagreement over the question whether corporations *should* and/or *could* sacrifice parts of their profits in the social interest to begin with, and under what conditions they may do so. Yet, as nicely put, recently, by Robert Bartlett and Eric Talley[91], even in the US the issue is much less white and black than we usually care to admit:

> "notwithstanding longstanding judicial equivocation about corporate purpose, courts (especially Delaware courts) have been far less hesitant in indicating that, *absent special provisions in a company's charter*, the corporate maximand should at least involve some form of profit maximization. This vision appears clearly in the Delaware Chancery Court's 2010 opinion in *eBay v. Craigslist* (eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 : Del. Ch. 2010). There, the Chancery Court was asked to determine whether the founders of Craigslist could dilute eBay's ownership interest in the company in the name of preserving a corporate culture that explicitly avoided maximizing corporate profits. According to Chancellor Chandler: Having chosen a for-profit corporate form, the Craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. . . . Thus, I cannot accept as valid … a corporate policy that specifically, clearly, and admittedly seeks *not* to maximize the economic value of a forprofit Delaware corporation for the benefit of its stockholders".

This means that, in principle, "individuals who wish to subordinate profit maximization to other goals should accordingly look to non corporate forms of organization that are more accommodating of these objectives such as the non-profit corporation and, more recently, the Benefit Corporation". At the same time, however, several states outside Delaware have promulgated statutes that grant boards the immutable right to account for a variety of non-shareholder interests -- such as employees', debt holders, and even surrounding communities -- in discharging their fiduciary obligations. And even in Delaware,

[91] Corporate Governance Law 2017.

a more recent Delaware Chancery decision *In re* Trados, Inc., 73 A.3d 17, 41 n.16 (Del. Ch. 2013) found that:

> "W]hile tolerably clear in the abstract and sometimes in real-world settings, the enterprise value standard ultimately complicates rather than simplifies the difficult judgments faced by directors acting under conditions of uncertainty. . . . The enterprise value standard compounds the number of valuation alternatives that must be solved simultaneously and the resulting multivariate fiduciary calculus quickly devolves into the equitable equivalent of a constituency statute with a concomitant decline in accountability".

As one of us already discussed in a different paper[92] several years ago together with Ilan Steiner[93], from a social welfare perspective, how could we determine whether the social benefits compensate for the forgone profits? In our view, the problem lies in the methodology used to cope with the abovementioned questions: it cannot be confined to the framework of corporate governance, law, finance or economics. The context of the normative debate over the inclusion of social benefits within the scope of corporate action and the role of business corporations in society is by far broader. Today, however, so much water passed under the bridge from the time when this issue could be reduced to two seemingly conflicting poles:

a) On one side of the spectrum Nobel laureate Milton Friedman and his followers who claimed that the social responsibility of corporations is to increase their profits and maximize shareholders' value.[94] According to this view, under the assumptions of a perfect market, shareholders' value maximization would result in an increase in social welfare, since shareholders are the residual claimants. Put simply, corporations ought to focus on what they do best, which is maximizing shareholder value rather than attempting to satisfy the interests of multiple stakeholders. Consistent with this view, social concerns are best left for the government or the non-profit sector to deal with. This belief is based on the assumption that managers cannot be held accountable if they are told to pursue multiple objectives, rather than simply maximize shareholder value. In the context of inclusive banks this would encourage separate institutions, versus banks expanding operations to achieve financial inclusion.

b) On the other side of the spectrum were the proponents of the stakeholder theory.[95] This approach rejected the neo-classical assumptions about perfect markets and zero externalities and further suggested that value maximization is not a value in itself. In line with this approach, corporations ought to have a moral commitment towards society in return for their so called "license to operate" which allows shareholders to enjoy corporate profits.

In the last decade or so, many steps have been taken to converge some of the conflicting approaches.[96] And many European member states, as well as several US states, reflected this approach in their regulation. This is no surprise. In reality, as Ilan Steiner and one of us wrote in the past, more and more people have come to realize that the price

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[92] Lamandini, M., Steiner, I. (2007) 'Social Banking in Practice: an Italian Case for Corporate Social Responsibility in Banking', *Rivista di Diritto Societario*, 4, 174-194.

[93] Steiner, I. (2014), Law and Economics of Corporate Social Responsibility in Israel: Towards a Social Norms Theory, Thesis submitted for the degree "Doctor of Philosophy", University of Haifa, Faculty of Law.

[94] Friedman M., 'The Social Responsibility of Business Is to Increase Its Profits', *The New York Times Magazine*, September 13, 1970.

[95] For an overview of the fundamentals of stakeholder theory see Freeman R.E. (1984), *Strategic Management: A Stakeholder Perspective,* Pitman, Boston; Blair M. M. (1995), *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century,* Brookings Institution, Washington; Blair M. M and Stout L., (1999) 'A Team Production Theory of Corporate Law', *Virginia Law Review,* Vol. 85, No. 2.

[96] Jensen M., (2001) 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function*', European Financial Management Review,* No. 7.

associated with various corporate externalities has become too high; financial exclusion is for sure one of these, and it is exacting a very big toll on society. Using state authority, such as command and control regulation is only partially effective, due to information asymmetries, regulatory capture, enforcement problems and high transaction costs. The challenge is to find further ways to make also market actors voluntarily bind themselves, through self-regulation, to this principal effort. Nudging has the potential to deliver some good results, helping corporate insiders (such as dominant shareholders and senior managers), in internalising the right social norm. Indeed, "in the minds of millions of people all over the world the image of the corporation is shifting and more emphasis is given to corporate citizenship as well as social and environmental performance. There is extensive evidence that shows how powerful social norms could be in this context. (...) The rationale behind this argument is straightforward - the human beings who navigate the corporate entity are not immune to social norms by which they are surrounded. *Therefore, the road to change the way corporations act passes in the minds and hearts of those who run them"*[97].

[97] Lamandini, M., Steiner, I. (2007) 'Social Banking in Practice: an Italian Case for Corporate Social Responsibility in Banking', p. 194