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ORIGINAL ARTICLE

Intended and unintended effects of specialized regulation on microfinance institutions' double-bottom line management

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Abstract

Taking advantage of the passage of a microfinance law in Italy (2014), we explore the rationales for introducing microfinance-specific regulation in high-income welfare states and the potential effects that this process may have on MFIs' social and financial performances (i.e. double bottom line). Our findings suggest that the institutional transformation of MFIs, in addition to product design and target group required by the new regulation, has unintendedly shifted their balance in favor of financial over social performance. This mainly applies to nonprofit organizations and cooperatives. Microfinance-specific regulation in high-income welfare states may reflect the emerging trends of market-based rationality of public policy. When regulatory arrangements for MFIs are stipulated irrespectively of MFIs' original mission the structural causes of financial exclusion may be reinforced. The underlying rationales for this trade-off should be considered to prevent and mitigate the unintended effects of microfinance-specific regulation.

KEYWORDS

microfinance regulation, welfare state, financial performance, social performance, institutional transformation

1 INTRODUCTION

Microfinance institutions (MFIs) supply small loans to people who are underserved by, or excluded from, formal financial systems. Microfinance was historically conceived as a sustainable policy tool to promote poverty alleviation (Olsen, 2017). However, a series of non-payment crises worldwide, linked to the aggressive commercialization of the sector (Bastiaensen et al., 2013), have put the ethical conduct of MFIs into question (Hudon & Sandberg, 2013). As a consequence, many voices have argued for tighter, more effective regulatory policies able to address the so-called microfinance ethical crisis (Lauer & Staschen, 2013).

Regulating what is by nature an innovative financial approach may present multiple challenges. MFIs are part of the financial ecosystem and, thus, their regulation needs to be integrated into existing legal frameworks and policy environments. Microfinance is highly context-specific (Antonio Bittencourt Marconatto *et al.*, 2013), and MFIs can adopt multiple institutional forms (e.g. banks, cooperatives, non-bank financial institutions (NBFIs), government-owned organizations providing microloans and non-profit organizations (NPOs)). These particularities of the microfinance sector, paired with its evolution towards commercialization in the last decades, have broadened the traditional definition of microfinance. In this regard, some microfinance products have, for example, been designed using collaterals and guarantees. As such, MFIs are often subject to different regulatory standards, operate according to diverse organizational cultures, and can be non-profit or follow more commercial approaches (Tchakoute-Tchuigoua, 2010). Therefore, no consensus exists on whether the introduction of microfinance-specific laws that address, directly, some or all of the MFIs' operations is better than embedding microfinance under existing financial regulatory frameworks (Ledgerwood & White, 2006).

Western European MFIs are, compared to those operating in low-income countries, small-scale and particularly socially oriented, and they operate mostly as NPOs or cooperatives (Blakenhol, 2015; Botti et al., 2017). These characteristics make them well-suited to high-income welfare states, where the theoretical potential of MFIs to support existing public services in tackling the structural and socially graded roots of financial exclusion has been discussed in the academic literature (Barinaga, 2014). However, most Western European MFIs are challenged by legal vacua. Some provide financial products by navigating the lack of specific financial rules and others adapt to the mainstream ones, which the academic literature suggests may negatively affect their social objectives (Cozarenco & Szafarz, 2018).

The rationales for introducing microfinance-specific regulation in low-income countries and the potential effects that this process may have on MFIs' social and financial performances (i.e. double bottom line) have been substantially researched in the literature (Hermes & Hudon, 2018; Olsen, 2017). However, these issues remain unexplored in high-income contexts such as the European Union (Cozarenco & Szafarz, 2019), where MFIs have "emerged as one response to financial exclusion in the modern welfare states" (McHugh et al., 2019, p. 80).

Our article aims to contribute to this gap in the literature by analyzing the perceptions of a range of key stakeholders operating in the Italian microfinance sector where a sector-specific law was enacted in 2014. We locate our study in Political Stakeholder Theory (PST) (Olsen, 2017). We employ the constructs of double-bottom line management and mission complexity in hybrid organizations (Battilana & Dorado, 2010; Grimes et al., 2020; Varendh-Mansson et al., 2020) to explore, through qualitative interviews and documentary analysis, the "tensions, competing demands, and ethical dilemmas" (Smith et al., 2013) that can arise when MFIs' prospects of social and financial achievements meet a unique stakeholder state-regulator (Olsen, 2017).

We found that microfinance-specific regulation in Italy is intended to legitimize MFIs as win-win vehicles for social inclusion and entrepreneurship. The regulatory mechanisms to achieve this aim included capital adequacy for NPOs and cooperatives, product standardization, specification of target groups, compulsory credit-plus services and interest rate ceilings. These mechanisms have been designed to assure an effective balance between MFIs' social and financial performance. However, our findings also suggest that such regulatory mechanisms have unintended consequences for MFIs. Abiding by the new regulation, especially in terms of product standardization, specification of target groups and interest rate ceilings, requires an institutional transformation which may be detrimental to the social objectives of pre-regulation NPOs and cooperatives.

Our findings contribute to the literature on the effects of regulation on MFIs' double bottom line by highlighting that microfinance regulation in high-income welfare states may reflect the emerging trends of market-based rationality for public service provision. This may represent a challenge for Western European MFIs because they lack, compared to most MFIs operating in low-income contexts, well institutionalized capacity building instruments to adapt to regulatory tenets that promote a successful balance between financial and social performances. As such, if regulatory arrangements for MFIs are stipulated irrespectively of MFIs' original missions and capacity, there is a risk that the structural causes of financial exclusion can be reinforced.

The remainder of this article proceeds as follows. Section 2 presents our theoretical background. Section 3 introduces the Italian microfinance sector and describes, in detail, its sector-specific regulation. Section 4 describes our methods and analysis. Section 5 presents our findings, which are critically discussed in Section 6. Section 7 concludes.

2 | THEORETICAL BACKGROUND

MFIs attempt to pursue a complex mission by operating, ideally, through three principles: (1) fair interest rates, (2) balance between efficiency and lending to the poor, and (3) protection of poor people from over-indebtedness (Hudon, 2011; Hudon & Ashta, 2013). For this reason, MFIs can be broadly defined as hybrid models of financial inclusion with a double-bottom line—that is, they attempt to combine social and financial objectives in one mission (Battilana & Dorado, 2010).

To pursue their mission, hybrid organizations must generally negotiate their operations with different stakeholders, because they need different audiences willing to support their multiple and diverse goals (Battilana et al., 2014). These negotiations, often underpinned by divergent values, can be productive for hybrid organizations such as MFIs, providing them with legitimacy to compromise between different objectives and, thus, integrate them successfully into a whole mission (Varendh-Mansson et al., 2020). However, albeit intentional, these negotiations may lead to unexpected results (Grimes et al., 2020). The literature suggests that organizations might depart (or be perceived to depart) from their mission (i.e. mission drift) when actions are taken to cater to or deviate from specific negotiation terms. This is especially the case when these negotiations involve institutional actors or mechanisms that are exogenous to the organizational setting (Grimes et al., 2020). For example, scholars suggest that MFIs may choose to target wealthier clients to cope with the uncertainty caused by volatile subsidization (D'Espallier et al., 2017) or to charge higher interest rates to remunerate their shareholders, thus drifting from their mission-related principles (Hudon et al., 2018).

Among several exogenous factors that can affect whether MFIs can balance their double bottom line and adhere to their complex mission, regulation has been recognized as a particularly crucial one (Hermes & Hudon, 2018). In contexts of lack of specific microfinance regulation, some MFIs have been found to increase their profits at the expense of customer protection (Chen et al., 2010). Driven by uncontrolled competition and need for private investments, particular MFIs worldwide have used exploitative practices, contributed to the overindebtedness of borrowers and fuelled non-payment crises (Ashta & Hudon, 2012; Bastiaensen et al., 2013). For this reason, scholars and policy makers have argued that microfinance has lost its moral compass and its potential to be profitable while serving a social mission (Beisland et al., 2017; D'Espallier et al., 2013; Hulme & Maitrot, 2014). As such, microfinance-specific regulation has been promoted as a means to support MFIs with their double bottom line management and the fulfilment of their complex mission (Lauer & Staschen, 2013).

Experiences of microfinance regulation worldwide are diverse, but the literature divides them between prudential and non-prudential (McNew, 2009). Prudential regulation involves centralized supervision and introduces norms of capital adequacy and liquidity compliance for MFIs. This type of regulation has been advocated for situations in which MFIs may create systemic risks and market distortions. In this case, regulation is mainly justified by market imperfections and is particularly envisaged for MFIs that collect deposits from the public (Arun, 2005; Cull et al., 2011). In contrast to stringent prudential practices, non-prudential regulation is "concerned with transparency, disclosure, control of ownership, consumer protection, fees, rates and financial performance" (Jobim, 2012, p. 12). Such measures are usually self-implemented, not supervised by financial authorities and intended to prevent potential misconduct while preserving the institutional differences and innovation in the sector (Keyes, 2006).

Despite its protective aims, microfinance-specific regulation is a context-responsive process (Macchiavello, 2017). PST posits that governments can impose specific political wills over MFIs, and they do this by controlling, through microfinance-specific rules, the breadth and depth of negotiations that MFIs can carry out with other sector stakeholders (Olsen, 2017). Depending on the level of involvement that a state aims to have in the microfinance sector, regulation can influence the type of legitimacy MFIs can pursue and, as a consequence, whether the actions needed to pursue such legitimacy cater to or drift from their original mission (Olsen, 2017). For this reason, microfinance-specific regulation frequently comes with trade-offs for MFIs (Dato et al., 2020).

Empirical studies on the effects of regulation on microfinance have focused mostly on low-income countries, and have examined the regulation effects against MFIs' indicators of social and financial performance (i.e. breadth and depth of outreach, percentage of female borrowers, average loan balance size/GNI per capita, operational self-sustainability, financial self-sustainability, return on assets and equity, among others). Regulation has been considered a potential indirect instrument to boost the sustainability and efficiency of the microfinance sector, enabling MFIs to collect savings from the public and increase the numbers of clients reached (Hartarska & Nadolnyak, 2007). Regulation can also lead to MFIs cutting their operating expenses and lowering their interest rates (D'Espallier et al., 2017). However, expanding the banking functions of MFIs through regulation has also been argued to undermine their social orientation towards more financially-excluded and worse-off clients. A positive association has been found between regulation and MFIs' inability to pursue their original organizational objectives—that is, mission drift (Cull et al., 2011; D'Espallier et al., 2017; Mia & Lee, 2017).

However, evidence is mixed and there is a body of work suggesting that regulation does not affect MFIs' performance. Exploring regulation effects on MFIs' sustainability and outreach, Hartarska (2009) found that the social and financial indicators of 108 MFIs worldwide did not improve when specific regulatory frameworks were in place. Mersland and Strøm (2009) corroborate that no causal links exist between regulation and the social and financial performance of MFIs. Other scholars, mostly through qualitative analysis, have argued that regulation might have detrimental effects on MFIs' efficiency, sustainability and outreach in Ghana (Anku-Tsede, 2014), Nigeria and Zambia (Okoye & Siwale, 2017; Siwale & Okoye, 2017). Similarly, the evidence on the effects of non-prudential regulatory mechanisms on microfinance suggests that specific regulatory frameworks can control market penetration and competition, and ultimately damage MFIs' social outreach (Afonso et al., 2017).

In Western Europe, well-developed mainstream financial systems have led to most governments leaving microfinance unregulated (EMN, 2020). Whilst some authors argue that specific regulation would improve the financial viability of the sector (Pedrini et al., 2016) and enhance financial inclusion (Estapé-Dubreuil & Torreguitart-Mirada, 2013), others question the effects of specialized laws on the social performance of MFIs (Dayson & Vik, 2014). Cozarenco and Szafarz (2018) quantitatively explore how the impact of a regulatory change affects the social performance of a French MFI. In this case, the introduction of a loan ceiling for MFIs triggers mechanisms that contribute to female credit rationing. The authors argue that post-regulation co-funding schemes between MFIs and commercial banks are detrimental for women as MFIs embed banks' screening biases.

The rationales for regulating MFIs in high-income welfare states and the potential effects of microfinance-specific regulation on MFIs' double-bottom line management remain therefore open to debate. Our paper explores these issues in the Italian microfinance sector where a microfinance-specific law was recently approved.

3 | MICROFINANCE-SPECIFIC REGULATION: ITALY

The microfinance sector in Italy has experienced rapid growth between 2005 and 2014, with nearly 300 non-profit-led initiatives at a national level in 2014 (ENM, 2014). In the same year, the Italian Government enacted a new microcredit-specific legislation (Decree no. 176/2014) that introduced two fundamental changes in the sector: (a) a new legal entity for MFIs called microcredit operator (MO) and (b) a distinction between entrepreneurial and social microcredit.

The introduction of MOs, the new legal form of MFI operating under article no. 111 of the Italian Consolidated Banking Act, has strong implications for the NPOs engaged in microfinance activities before regulation. The law makes a distinction between entrepreneurial microcredit, defined as microloans of up to €25,000 (€35,000 in specific cases) for microentrepreneurs, and social microcredit which are personal loans with no collateral requirements of up to €10,000. NPOs that decide not to transform into MOs are restricted to exclusively disbursing social microcredit at a capped interest rate, in theory calculated to cover their operational expenses and costs of the legally required credit-plus services. Pre-regulation NPOs that aim to continue disbursing both entrepreneurial and social microcredit will have to do so in the form of MOs. This institutional transformation, as shown in Table 1, implies new requirements in terms of capital adequacy, legal status (e.g. public limited company, private limited company, cooperative limited-liability company), products offered (activity restricted to microcredit only and at least 51% of the portfolio should be entrepreneurial microloans), services offered (two compulsory credit-plus services required), governance, target groups and interest rate limits (MEF, 2014).

This regulatory process of microcredit was completed with the subsequent enactment, in 2015, of another financial intermediation law (Statutory provision no. 288/2015; Decree no. 53/2015) to regulate the operations of NBFIs, also known as financial intermediaries. These were included under the prudential supervision of the Bank of Italy under article no. 106 of the Italian Consolidated Banking Act (Bank of Italy, 2015; MEF, 2015). Prior to this regulatory intervention, the

TABLE 1 Overview of the Italian microcredit legislation and NBFIs legislation

Legal form	Products and beneficiaries	Requirements
MO: Plc; Ltd; Cooperative limited (liability) company; Publicly traded partnership company	**1. Entrepreneurial microcredit**: At least 51% of the total loan portfolio - Up to €25,000 (max. seven years). - Up to €35,000 (max 10 years; the borrower has paid off the last six instalments and the project development has achieved expected results). - Microenterprises (financial leverage < €100,000) and self-employed individuals within their first five years of activity and with less than five employees. - At least two credit-plus services limited to business development service, marketing, legal, fiscal and administrative support, training. **2. Social microcredit**: - Maximum 49% of the total loan portfolio - Up to €10,000 with no collaterals for max. five years. - Individuals who are experiencing economic or social vulnerability (e.g. unemployment; poor standard living conditions)	• Registration in the microcredit operators list. • Capital adequacy: €250,000. • Interest rates on an average basis of interests charged on loans by banks multiplied by 0.8. • At least two different credit-plus services. • Explicit social mission and business and microcredit project plans (including credit models, targets, monitoring processes and partnerships for credit-plus services provision). • Integrity requirements for shareholders owning more than 10% of the share capital. • Professional and integrity requirements for managers and directors of the MFIs.

(Continues)

TABLE 1 (Continued)

Legal form	Products and beneficiaries	Requirements
NPO (not regulated): Association; Foundation; Mutual aid society; Local and governmental agency; Social cooperative; Non-profit cooperative	**Social microcredit** • Up to €10,000 with no collaterals for max. five years. • Individuals who are experiencing economic or social vulnerability and: (i) are unemployed or in forced reduction of working hours and/or (ii) cannot provide standard living conditions to themselves and their households.	• Interest rates on an average basis of interests charged on loans by banks multiplied by 0.4. • Exclusive social mission. • Integrity requirements for shareholders owning more than 10% of the share capital. • Professional and integrity requirements for managers and directors of the MFIs.
NBFI: Plc; Ltd; Cooperative limited (liability) company;	Free to tailor financial product (entrepreneurial credit/microcredit; credit/microcredit for personal consumption) to any kinds of beneficiary (including microcredit and credit-plus services) excluding: **1. Entrepreneurial microcredit when accessing Government Microcredit Guarantees Scheme**: - Up to €25,000 (max. seven years). - Up to €35,000 (max 10 years; the borrower has paid off the last six instalments and the project development has achieved expected results). - Microenterprises (financial leverage < €100,000) and self-employed individuals within their first five years of activity.	• Prudential supervision. • Capital adequacy. • Risk Weighted Assets at 6%. • Exit strategies through crisis management procedures. • Adaptation of microcredit products and beneficiaries to new product and target as with microfinance law (2014) only when accessing Microcredit Guarantees Schemes.

supervision exercised by Bank of Italy on NBFIs was graded on the basis of their operational size. Whilst larger intermediaries were registered on a special list and subject to prudential supervision, smaller socially-oriented NBFIs were non-prudentially regulated.

After the changes in the law in 2014 and 2015, smaller NBFIs, especially those highly active in the microcredit sector, had to decide between transforming into MOs or into prudentially regulated NBFIs. The latter choice entailed complying with requirements on capital adequacy, ownership structures, and exit strategies, among others. The legal form, products, target beneficiaries and legal requirements for MOs, NPOs and NBFIs are described in detail in Table 1.

To access Microcredit Guarantees Schemes, banks and NBFIs are required to comply with product and target requirements that are equivalent to those of MOs. These schemes, implemented within the context of mainstream Guarantees Schemes (Leone & Porretta, 2014), are public instruments to support micro, small and medium enterprises access credit. They provide insurance to MOs, NBFIs and banks against default risks of microentrepreneurs by covering up to 80% of the defaulted microloan.

4 METHODS AND ANALYSIS

Our case-study is focused on the Emilia Romagna region in North Italy, which represents an exemplary case of Italian microfinance for its relatively high number of microcredit initiatives and small-scale microloans disbursed by both commercial banks and other types of MFIs (Brunori et al., 2014; ENM, 2014).

A sample of eight individuals, including representatives of the leading MFIs operating in Emilia Romagna region, policy-makers at national level who voted for the approval of the law and one expert in the sector, was purposefully selected as a primary data source using maximum variation sampling (Patton, 2014). Participants were recruited through email and phone calls; their contact details were retrieved through institutional websites. We attempted to capture institutional variation in the type of stakeholder (including legal forms of MFIs potentially impacted by new regulation, and type of services offered by MFIs when applicable), role in the microcredit regulation process and years of involvement in microcredit activities in Italy.

Semi-structured interviews ($n = 8$) with open-ended questions tailored to the type of respondent (four topic guides were used) were undertaken in Italian either face-to-face in the stakeholders' premises ($n = 3$) or through Skype ($n = 5$) between June and October 2016. The interviews covered the following topics: (1) MFIs' mission and products; (2) target market; (3) factors relevant to MFIs' financial and social sustainability including geographical scope, governance structure, regulatory status, subsidies, characteristics of active borrowers and screening processes; (4) the new microfinance-specific regulatory framework and its relationship with each of the previous topics. Interviews ranged in length from 34 to 96 minutes. All interviews were digitally recorded and transcribed in full. The analysis was conducted in Italian and, subsequently, quotes from participants were translated into English.

Our sampling-for-meaning approach, based on institutional variation, and the use of extant evidence for data sense-making allowed for meaningful, although non-generalizable results (Boddy, 2016). More precisely, our sample includes the views of the major microfinance-specialized organizations in Italy (i.e. Per Micro—largest microcredit portfolio), especially in Emilia Romagna region, as well as the views of key representatives of the most popular typologies of microfinance providers in Italy: cooperative banks, NBFIs and cooperatives. This, coupled with the views of representatives of the state regulator and of an expert, allowed us to capture enough institutional variation to explore the underlying rationales for microfinance-specific regulation and the perceived consequences of the new legal requirements on MFIs' financial and social performance.

Secondary data collection was also undertaken to retrieve legislation and reports on institutional characteristics, internal performance, operations and policies of the sampled MFIs, as well as to contextualize our qualitative interviews. Table 2 shows our sampled MFIs and stakeholders' affiliation, secondary data, and the rationale for sample selection. Ethical approval for this study was obtained from the Glasgow School for Business and Society Research Ethics Committee, Glasgow Caledonian University. All research participants gave full written consent.

Primary and secondary data were analyzed following the principles of abductive thematic analysis (Rambaree & Faxelid, 2013)—that is, mixing deductive and inductive reasoning. Practically, we processed our analysis as follows. In a first stage, we used structural coding (Vaismoradi et al., 2013) to group data-driven, descriptive essential codes applied to portions of textual evidence from the interview transcripts and secondary data. Through this strategy we identified, deductively, first-order themes based on the topics covered during our interviews. In this stage of analysis we categorized the insights from respondents and documentary evidence and grouped them into theoretical themes relevant to MFIs' double bottom line management, including regulation. For example, we identified "institutional transformation" as a first-order theme. Institutional transformation of MFIs is theoretically supported by the literature as a mechanism explaining the impacts that the regulation can have on MFIs' double bottom line (Hermes & Hudon, 2018). In our data, this theme is supported by open codes such as, for instance, "organizational form", "business model", "legal status", "external supervision", and accounts for the institutional changes MFIs implemented to respond to the regulatory changes in the Italian microfinance sector.

In a second analytical stage, we applied causation coding (Saldana, 2015) to further explore the content of each first-order theme and infer, inductively, whether respondents perceived any causal connections between specific elements of MFIs' double bottom line and the introduction of the new regulatory framework. By searching for causal linguistic expressions such as "because", "therefore", "since", "if it wasn't for", "as a result of", "the reason is", etc. (Saldana, 2015, p. 163), we explored the rationales for a microfinance-specific regulation and the relating perceived changes and effects on MFIs' operations that respondents attributed to the introduction of the new microfinance law. For example, when exploring the perceived causal link between the new microfinance regulation and the theme "institutional transformation", we identified that changes in MFIs' business model as a response to the new law could lead to two scenarios, depending on the type of stakeholders interviewed. On the one hand, these changes encouraged by the new law were envisioned by policy makers as a necessary step towards a more efficient and socially oriented microfinance sector. On the other, the institutional changes required by the law were not part of the life-cycle plans of the MFIs interviewed, and thus they were perceived as adding complexity to their double bottom line management and creating tension in their dual mission.

Finally, to account for the emerging thematic split between policy makers' and practitioners' perceptions of the rationales for regulating microfinance and the associated effects on MFIs' double bottom line, we created two higher-level grouping codes. The first grouping code collates the views of microfinance stakeholders that are external to MFIs (i.e. policy makers and expert). Their perspectives were broader and abstract, at a more national level, as they were not affected by day-to-day management of a MFI. The second code accounts for the diverse perceptions coming from institutionally different MFIs (NPO/cooperative, NBFIs and a bank) and the reasoning behind the strategic decisions made by MFIs to manage a double bottom line in the context of the new legal requests. Our findings are presented below and reflect, thematically, this institutional split.

TABLE 2 Respondents, data typology and source

Primary data – Interviews (codes)		Secondary data	Sampling justification
PerMicro Prudentially regulated financial intermediary (NBFI) after 2015. Before 2015, it operated as non-prudentially regulated NBFI.	One interviewee (50 minutes interview)Code: PerMicro	Social and financial report retrieved from the NBFI's website. Rating report retrieved from Microfinanza Rating.	The largest prudentially regulated financial intermediary in Italy specialized in microcredit and operating at national level since 2007. Part of the European Commission program EaSI, this NBFI offers mainly individual microloans to immigrants, but also entrepreneurial microcredit to a wide range of clients.
CxIT Prudentially regulated social enterprise operating as NBFI after 2015. Before 2015, it operated as non-prudentially regulated NBFI.	One interviewee (59 minutes interview)Code: CxIT	Social report retrieved from the NBFI's website.	Operating since 2011 in earthquake-hit regions of Italy this NBFI is mainly specialized in providing microcredit guarantees and credit plus services in partnership with cooperative banks and third sector organizations. This NBFI has recently started to operate as direct provider of microfinance.
Emil Banca Prudentially regulated financial institution - bank	Two interviewees: one social microcredit specialist; one entrepreneurial microcredit specialist (82 minutes interview) Codes: Emil Banca 1 (social microcredit); Emil Banca 2 (entrepreneurial microcredit)	Service information and social report from the bank's website.	The first bank to have applied for social rating. It offers both social and entrepreneurial microcredit. This bank has a high territory coverage in Emilia Romagna (46 branches). It is also a partner in the European program Progress Microfinance.

(Continues)

TABLE 2 (Continued)

Primary data – Interviews (codes)		**Secondary data**	**Sampling justification**
Mag6 Financial cooperative operating and regulated as MO since 2016.	One interviewee (96 minutes interview)Code: Mag6	Service and institutional information from website and respondent.	Operating as cooperative and engaged in financial activities based on the principle of ethics and solidarity. Cooperative members' savings are collected as shares of capital and used to disburse loans to other members. Loans are intended for business activities of social cooperatives and social enterprises, but also for members with financial problems and women who experienced domestic violence. This financial cooperative is now operating a newly-regulated MO.
Expert (Grameen Italia Research Foundation)	One interviewee (57 minutes interview)Code: Expert	-	Extensive experience on microfinance projects and research both in developing and developed countries.
Politician (Italian Government)	Two interviews with two policy makers (42 and 34 minutes interviews Codes • Politician 1 • Politician 2	Microcredit legislation texts (2010–14).	Voted for the new microcredit legislation.

Our analytical approach led us to saturate our data because our emerging theoretical explanations made sense when located in extant literature (Bowen, 2008). We conducted our analysis using QSR International's NVivo 10 Software for qualitative research (Bazeley & Jackson, 2013).

5 | FINDINGS

5.1 | The intended effects of regulation: MFIs as win-win vehicles for inclusion and entrepreneurship

In the views of the policy makers and the expert, the pre-regulation microfinance sector was ineffective, especially due to the poor balance between social and financial performances of the MFIs, including banks. Regulation was described as desirable to strengthen the sector and contribute to preserve its social mission as, in their view, larger financial institutions such as banks should have played a more responsible role. This issue was attributed to the absence of a proper formal definition and operationalization of microcredit, but it was also linked to the increasing presence of banks in the Italian microcredit sector over the decade before the new law was enacted in 2014 (ENM, 2014).

In the view of our respondents, the pre-regulation microfinance sector was not formulated as a social policy tool and this was perceived to have affected the sector's social performance, especially in terms of depth of outreach. For example, banks involved in microcredit operations before regulation were perceived as simple "money dispensers". They used personal characteristics of clients to apply market segmentation and increase their supply of new and profitable financial products that still excluded underserved individuals. These practices were regarded as potential barriers for microcredit to become a real financial inclusion mechanism and were also seen as enablers of the exploitative conduct of sub-prime lenders in the country:

> Small loans are those in which loan sharks can intervene more easily by applying usury interest rates to desperate people, who are desperate just for small loans that they cannot repay (Politician 2).

In this context, the new law emerged as important to prevent financial and social exclusion. More specifically, the requirements for MOs (i.e. loan ceilings, interest rate caps, capital adequacy, product design and product delivery) were designed to strengthen the social mission of the sector by encouraging MFIs to become more socially oriented, whilst preserving their financial sustainability. Therefore, regulation was necessary to make microfinance an effective instrument to tackle exclusion through employment:

> Microfinance is not only aimed at income support or, even worse, at replacing an income that is not in place. It should incentivize and support forms of self-employment. As with all sectors, even with microcredit it is necessary to invest in knowledge and research to make these institutions (MFIs) not only minor ATMs, but also actors that orient and support sustainable development projects (Politician 1).

The new law introduced four requirements designed to change the way in which MFIs were operating. Firstly, loan ceilings were devised to enhance the depth of outreach of the sector by encouraging MFIs to focus only on vulnerable microborrowers looking for small loans for primary needs. Secondly, alongside the 2014 law, Microcredit Guarantees Schemes were extended by the Italian Government to all new MOs, NBFIs and banks. Respondents argued that public intervention provided an indirect pathway to help larger financial institutions such as banks achieve their social aspirations and reach more vulnerable consumers. Thirdly, capital adequacy requirements imposed by the law on MOs were seen as a way to promote the financial viability of MFIs, improve their products quality and capacity to serve and assist microentrepreneurs, as well as to protect their borrowers. Finally, the requirement of providing non-financial services to microcredit borrowers, particularly for business loans, had been introduced to help borrowers increase the return from their investments, and also create and preserve a direct relationship between the MFIs and their clients, which in turn would allow for better and responsible screening as well as for improving clients' financial behavior:

> According to 2014 data from the National Authority of Microcredit [Ente Nazionale per il Microcredito], what is called accompaniment [credit-plus services] only reflects in the screening process [...] Offering technical and personal training courses is also important because the businesses must survive and be competitive [...] This would ensure repayment but also the good evolution of the businesses. We talk about utopia, I know, but the legislation speaks of accompaniment [credit-plus services] in these terms (Expert).

However, the effects of the operational changes required by the new legislation were uncertain. Some of these institutional changes could also represent potential drivers of mission-drift among MFIs, especially among those with large loan portfolios and striving for particularly good financial performances:

> I don't know what the reaction of the overall sector will be. The need for [economic] sustainability could prevail over the mission [...] I cannot figure out what will remain of the experiences we have (Expert).

5.2 | Microfinance-specific regulation: A case for MFIs' mission drift

The legislation was considered fragmented and incomplete by sector professionals in that, from a practical and operational perspective, the new legal framework was perceived as not been designed to accommodate the challenges that MFIs face when operating in specific contexts. The tensions between a more high-level, national perspective, and a more localized and practical one were clear from our results. For example, the interviewed practitioners felt that the legislation had not accounted for the degree of innovation that characterized the sustainability of the microfinance model in Emilia Romagna before the new law was enacted. Respondents clarified that, prior to the regulatory changes, Emilia Romagna was characterized by socially innovative partnerships that involved banks, socially oriented NBFIs and NPOs working together to implement and sustain both entrepreneurial and social microcredit programs. In words of one of our interviewees: *"An issue with this regulation is that it assumes that MFIs are entities that directly provide microcredit, regardless of what they really are"* (Emil Banca 1).

After the new microfinance law was implemented, some of these partnerships had to be interrupted. Respondents expressed concerns around their ability to manage the double-bottom line of their MFIs during and after the transformation required to comply with the law, given that they had to give up some of these partnerships, fundamental to the success of their operations. The risk of mission drift emerged as the main concern for MFIs in terms of product development, outreach, legal structure, and financial sustainability.

The first issue raised by our respondents was that, contrarily to the regulators' view, specialized MOs cannot be considered as stand-alone economic actors, able to efficiently manage their double bottom line. MFIs were deemed effective when operating in collaborative business environments, where screening and monitoring of clients, credit disbursement and provision of extra-credit services were shared among multiple actors operating in different capacities. This contributed to limit the risks of microlending and ensured the sustainability of the whole microfinance supply chain.

Uncertainty was also expressed around the ability of newly regulated MOs to balance their dual mission, especially when operating independently. For instance, adapting entrepreneurial microcredit products to the new law required the compulsory supply of high-quality credit-plus services. This requirement, which seemed necessary from a policy perspective to guarantee client protection and business sustainability, represented a barrier for organizations transforming into MOs, which would focus much of their efforts on designing sustainable entrepreneurial products at the expense of social microcredit design and provision:

> We fulfilled all the legal requirements [...] but things came back with further requests [from the regulator] in relation to ordinary activities, which are entrepreneurial loans. We had to focus on this. So, now I know very well what is required for this [entrepreneurial microcredit], but we had to put credit for social inclusion aside (Mag6).

Concerns with this requirement emerged strongly from the data as it seemed to affect all types of microcredit providers. It also affected banks that had been operating as MFIs:

> We do not do additional services, we do not do tutoring services because they are very far from what the reality of a bank is, at least in the Italian banking model. And we don't do them because it's basically impossible to get paid for them *(Emil Banca 2)*.

There were other reasons for which the practitioners interviewed were worried that they would not be able to keep up their supply of social microcredit products to pre-regulation levels and preserve their depth of outreach. For example, the new microcredit law requires MOs to mainly focus on financial products for microentrepreneurs (51% minimum of the total loan portfolio). All the practitioners interviewed highlighted the importance that social microcredit programs had in the Emilia Romagna context, where specific social needs (e.g. supporting women economic independence or informal economic groups) emerged to be addressable only through forms of non-entrepreneurial financial inclusion. They questioned the balance required by the 2014 law between the two forms of credit:

> It [regulation] proposes a British formulation of microcredit that sees the importance of entrepreneurial microcredit over social microcredit, and therefore substantially extraneous from the Italian context, where microfinance institutions operate mainly through this social tool, and less through entrepreneurial microcredit (Emil Banca 1).

A barrier for MFIs to continue operating as social policy implementers, mainly in partnership with local authorities, was the requirement to target microcredit services only at population groups with specific demographic and socio-economic characteristics defined by the law. This requirement, introduced to ensure that microcredit focused on social groups in need, constrained MFIs to serving specific groups (unemployed, pre-defined income bracket, etc.) which implied that some of the traditional clients of social microcredit could no longer be served. The social and mutual aid products that were most affected were those that covered emergencies of vulnerable groups such as the "working-poor" or gender-violence victims, for example. Unforeseen expenditure shocks of microborrowers, such as broken-down cars or dental emergencies, had been traditionally funded through social microcredit products, but after regulation some vulnerable population groups had been left out of the population categories that MOs could target. This emerged particularly restrictive for organizations that were operating as mutual cooperatives (i.e. Mag6). Changes in the law imposed requirements for cooperative membership (also clients) which, as a result, needed to fit a particular socio-economic category. For cooperatives, this requirement not only had ownership and governance implications but, importantly, it limited the organizations' ability to diversify risks, cross-subsidize their activities, and pursue their social and financial goals.

Social microcredit for personal consumption was considered as a substantially less risky financial product, when compared to entrepreneurial microcredit. Practitioners claimed that it was difficult for them to assess the risk that business microcredit entailed (i.e. if businesses' liquidity problems were transitory or if they were due to the viability of the business model), and they underlined the importance of having the capacity and know-how to screen each operation very carefully. Interviewees mentioned that their organizations had traditionally cross-subsidized their lending operations towards microentrepreneurs using 'pre-regulation' social microcredit, considered as potentially profitable. Imposing a ratio between the volumes of social and entrepreneurial microcredit (at least 51% of the loan portfolio) was described as problematic and damaging for the operational sustainability of MFIs: "It is hard to balance this mix [social and entrepreneurial microcredit]" (Emil Banca 2). Furthermore, capping the interest rates on social microcredit products was perceived as a regulatory adjustment that would hamper the balance between MFIs' social and financial performances, because the supply of services to individuals in need of liquidity for personal purposes could be restricted: "The interest rate cap on private citizens' microloans implies that it is impossible to offer them in a financially sustainable way" (PerMicro).

Our secondary data analysis corroborates the insights from the interviews and suggests that even financially sustainable organizations such as banks may encounter difficulties in managing the costs of entrepreneurial microcredit and credit-plus services if specific subsidies were not in place. For instance, by looking at loan ceilings applied by Emil Banca (Table 3), microcredit under €25,000 is disbursed to entrepreneurs alongside credit-plus services only when the guarantees from the central government are available. More importantly, the combined restrictions described by respondents limited the ability of MFIs to continue innovating and exploring new services that would contribute to higher social impact but also increase profits to cross-subsidize other activities. In terms of microcredit services, practitioners gave examples of what they thought had been successful products that would no longer be feasible under the new microfinance regulation. For example, microcredit services to restructure debts of employees of large private companies (corporate welfare) or for entrepreneurs in specific disaster-hit areas in Italy with loan sizes slightly over the limit imposed by new microfinance regulation (€25,000) (see Table 3). Also, the more basic supply of microfinance products such as bank accounts for microborrowers and insurance products in collaboration with other financial institutions was at risk.

TABLE 3 Product characteristics of the sampled MFIs and average loan size (2014–15)

		Emil Banca	Credito per l'italia as guarantees provider[a]	- PerMicro- Credito per l'Italia as direct microcredit disburser	Mag6
Loan ceilings	Individual/Social microcredit	3,000 or 5,000	10,000	10,000	7,000
	Entrepreneurial microcredit	15,000 or 25,000 (over 25,000 with no Government Credit Guarantees and with no credit-plus services)	50,000	25,000	None
Average loan size (Euros)	Individual/Social microcredit	2,089	9,509	5,203 (PerMicro)	4,868
	Entrepreneurial microcredit	18,652	28,876	- 13,539 (PerMicro)- 19,504 (CxIT)	27,265
Fees (Euros)	Individual/Social microcredit	No	No	Yes (PerMicro)	No
	Entrepreneurial microcredit	Yes	No	Yes (PerMicro)Yes (CxIT)	No

(Continues)

TABLE 3 (Continued)

		Emil Banca	Credito per l'italia as guarantees provider[a]	- PerMicro- Credito per l'Italia as direct microcredit disburser	Mag6
Interest rate	Individual/Social microcredit	1.10 – 3.25%	3-month Euribor + 4.25	Commercial interest rates depending on sums borrowed but within the limits of anti-usury interest rates (PerMicro)	Up to 8.5%
	Entrepreneurial microcredit	Fixed at 3% or variable 6-months Euribor rounded to 0,10+2	3-month Euribor + 4.25	- Commercial interest rates depending on sums borrowed but within the limits of anti-usury interest rates (PerMicro) - 3-month Euribor + 5.50 (CxIT)	Up to 8.5%
Requirements to access credit	Individual/Social microcredit	Social network/Collaterals	Payslip	Social networks/social collaterals, income statements, payslip	Trust
	Entrepreneurial microcredit	Social network/Collaterals	Social network/collaterals	Social networks/ collaterals	Trust

[a]Data refer to 2014 and therefore do not take into account after-regulation adjustments.
[b]CxIT as direct disburser of microcredit.

Such concerns around restrictions that would compromise the sustainability of newly regulated MOs were weighted by respondents against the perceived advantages of becoming prudentially-regulated as NBFI instead. This strategy emerged as optimal to continue operating in the micro-credit sector in more flexible terms:

> Our choice [to be a NBFI] is evident, because the new legislation imposes a series of limitations [...] The register of MOs has remained empty until recently. Perhaps many microcredit institutions have been a bit discouraged by this new legislation (CxIT).

However, being regulated as NBFI also presented risks as it would require MFIs to focus on their financial performance, including reporting requirements for supervision purposes, with potential negative consequences for depth of outreach:

> If we talk about MOs [...], in my opinion there is no sustainability. There is no way. If we talk about NBFIs, I think we'll see. (PerMicro).

Nonetheless, secondary data analysis suggests that depth of outreach issues, especially for NBFIs, could be moderated by the Government Microcredit Guarantees Scheme. The findings on these are twofold depending on the type of MFI disbursing the loans. Firstly, the Guarantees Scheme may encourage financial institutions such as NBFIs and banks to focus on their social objectives through collaborative partnerships with third-sector organizations, resulting in lower sums of credit being offered and enhancing depth of outreach (see Table 3). Secondly, although the Microcredit Guarantees Scheme may encourage a NBFI to risk more by securing for free the bank's loans to entrepreneurs (CxIT), NBFI-Bank partnerships may have been used in the past to finance larger business projects, with higher sums of credit in specific disaster-hit areas (Table 3).

In summary, the new legal framework for microfinance was perceived as threatening the financial and, consequently, social performance of the sector from the perspective of all MFIs interviewed.

6 DISCUSSION

Our findings suggest that the Italian microfinance regulation has impacted the way in which some Italian MFIs manage the tension between their social and financial objectives. Such tension emerges reinforced by the newly introduced regulation that impacted NPOs and cooperatives already struggling to balance their double-bottom line before the regulatory changes. More precisely, the new legislation required a process of institutional transformation for most microfinance providers operating in the Italian sector. Pre-regulation NPOs with microcredit and related services as their main activity faced the choice of either transforming into MOs or, prudentially regulated and supervised, NBFIs. These transformation processes not only required important changes in the nature and business models of pre-regulation MFIs, but also contributed to the dismantling of those systems of partnerships and alliances that had enabled MFIs to flourish by balancing their financial and social objectives successfully. In particular, the benefits of these partnerships emerged from our findings as effective strategies for MFIs to identify needs, perform fair screening and assist microentrepreneurs through NPOs particularly focused on tackling systemic inequalities.

These findings are aligned with the scholarly research on microfinance regulation and mission complexity in hybrid organizations. Regulation, in the form of loan ceilings, has been argued to have unintended detrimental consequences on the social performance of the sector (Cozarenco & Szafarz, 2018; Siwale & Okoye, 2017). Similarly, the academic literature on MFI transformations and microfinance commercialization worldwide suggests that these events are frequently associated with substantial increases in the average loan size supplied by MFIs, the preferred indicator for mission drift (D'Espallier et al., 2017). Finally, the state regulator has the power to affect the productive tensions that MFIs need to achieve their complex mission by establishing who the other sector stakeholders are and the types of transactions they are allowed to carry out with them (Olsen, 2017; Varendh-Mansson *et al.*, 2020). In the case of regulated standardization of MFI programs, the productive tensions needed for innovation in microfinance might be at risk (Keyes, 2006).

Our article suggests that the Italian microfinance legislation was designed and enacted to standardize microfinance activities and institutions and, by ensuring adequate financial performance, to strengthen the overall social mission of the sector. Control and supervision of microfinance activities were designed to enhance ethical behavior and consumer protection in the sector as a whole, including not only MFIs but also mainstream banks, public organizations and other financial intermediaries. However, whilst regulators and policymakers were aiming for a "virtuous" microcredit sector, the practitioners interviewed experienced operational difficulties. They found challenging to fulfill their double mission under the new legal requirements and questioned the economic viability of the model proposed by the regulators.

The ethical principles underlying the new legal framework were considered unquestionable and shared by all the stakeholders interviewed. However, their operationalization posed challenges to MFIs, especially when carried out in a particular context at a local level. In practice, the main challenges were the required changes of institutional form, capital adequacy, differentiation between entrepreneurial and social microloans, restrictions in the balance of entrepreneurial and social loans in the portfolio, loan ceilings, interest rate caps, compulsory credit-plus services, and a carefully stipulated group of target clients, among others. The standardization and restrictions imposed by the law had limited the ability of MFIs to take advantage of local opportunities. This suggests that the ethical norms underpinning Italian microcredit-specific regulation may have not been translated into appropriate rules and laws to allow for MFIs balancing their efficiency and lending to the poor.

Furthermore, adapting to these legal requirements had compromised MFIs' double bottom line management. More precisely, the organizations' depth of outreach was challenged because social products/programs that MFIs used to offer before the new law did not comply with new regulatory restrictions and had to be modified or abandoned. This supports the argument that regulation can hinder social performance, particularly by restricting target groups of users and increasing the lenders' costs (Hermes & Hudon, 2018). Reductions in the depth of outreach have been found in the literature to increase the incidence of trade-offs between the financial and social aims of MFIs (Hudon et al., 2018). For instance, this emerged relevant for Italian MOs' mission, since microcredit regulation impeded both cross-subsidization of products and strategic partnerships crucial for the survival of MFIs' social loans. Furthermore, the MFIs in our sample striving for financial sustainability were uncertain whether they could achieve this under the newly introduced institutional form, MO, and became regulated and supervised NBFIs instead. This could be the underlying reasoning behind the limited number of MFIs that transformed into MOs at a national level after regulation was enacted. According to PLTV Protection and Lending (2017), only 11 had MO status in May 2017 and were still waiting for a formal inclusion into a publicly-available national list of specialized MOs.

Finally, our study also suggests that the role of the new regulation in the context of the Government Guarantee Schemes can also be crucial, because the screening processes of clients before regulation could be initiated by banks' partners with clear social orientation: (1) pre-regulation NPOs (no longer permitted by the new law to supply this service using government schemes if not regulated) and (2) pre-regulation NBFIs, which were not constrained in their risk management strategies. This suggests that, after regulation, vulnerable entrepreneurs might only be able to access low-cost microcredit if microcredit guarantees will cover their default risks, directly assessed by banks and NBFIs, which are required to expose more of their assets to serve them.

Our article offers new theoretical insights into the complex relationship between the state regulator and MFIs. The reasons for high-income welfare states to introduce a microfinance-specific regulation may subtly lay in the emerging market-based rationality for delivering public services, at least in specific political contexts. More precisely, a microfinance-specific regulation in high-income welfare states may come with coercive legitimacy for MFIs (Olsen, 2017). This applies especially to NPOs and cooperatives, in that these organizations are called upon solving the problem of financial exclusion for both entrepreneurs and poor households efficiently by means of standardized products and operations. However, our article also suggests that the actions that hybrid organizations such as MFIs need to take to either cater to or deviate from specific exogenous factors such as regulation may lead to mission drift (Grimes *et al.*, 2020). In the case of Italian MFIs, a specialized microcredit regulation might have damaged the balance between MFIs' financial and social objectives by stipulating, too rigorously, who the borrowers should be, what the products should look like and how they should be delivered. According to our findings, the political will of the Italian state regulator was not aligned with the MFIs' original mission, and this mismatch may have affected MFIs' operational strategies. In this context, the role of Government Microcredit Guarantee Schemes may be crucial to prevent the mission drift of MFIs and enhance the potential of these organizations to support public services in tackling the structural inequalities that create financial exclusion.

7 | CONCLUSION

In this study we explored the perceptions of a group of Italian microfinance stakeholders on the reasons for and the effects of microfinance-specific regulation in high-income welfare states. Our paper contributes to the ongoing debate on the role of regulation for an effective microfinance sector, in which MFIs, with a range of legal forms, should be able to achieve the balance between social and financial performance and, thus, contribute to financial and social inclusion of vulnerable groups in society.

Our findings reveal concerns from microfinance providers about the effects that the new laws aiming for an effective sector have had in practice. Post-regulation institutional transformation of most MFIs, in addition to legal restrictions in product design and target beneficiary groups, may have shifted their balance in favor of financial performance over social objectives. Although our findings depict the initial stages of the regulatory process investing MFIs and are mainly restricted to a specific high-income context, they also suggest that providers of microfinance perceived that the new regulation has been detrimental to the financial inclusion of vulnerable groups. This was because the political will of the state regulator was not aligned with the original mission of the microfinance sector.

Future studies should pursue comparative mixed-method analyses of the rationales for a microfinance-specific regulation in high-income contexts and the potential effects that specific types of regulations can have on MFIs' double bottom line. This is important to further understand the role of MFIs in high-income welfare states and their potential to tackle the structural causes of financial exclusion.

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