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Selected legal issues impacting microfinance

Note by the Secretariat

Contents

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I. Introduction

1. At its forty-fourth session, in 2011, the Commission had before it a note by the Secretariat including a summary of the proceedings and the key issues identified at the international colloquium on microfinance, held in Vienna from 12 to 13 January 2011, pursuant to a request of the Commission (A/CN.9/727). After discussion, the Commission agreed to include microfinance as an item for the future work of UNCITRAL and to further consider that matter at its next session, in 2012. The Commission also agreed that the Secretariat should, resources permitting, undertake research for consideration by the Commission on the following items: (i) overcollateralization and the use of collateral with no economic value; (ii) e-money, including its status as savings; whether "issuers" of e-money were engaged in banking and hence what type of regulation they were subject to; and the coverage of such funds by deposit insurance schemes; (iii) provision for fair, rapid, transparent and inexpensive processes for the resolution of disputes arising from microfinance transactions; (iv) facilitating the use of, and ensuring transparency in, secured lending to microenterprises and small and medium-sized enterprises.

2. This note includes a short summary of the state of the matter in each of the four topics indicated above, as well as key legal and regulatory issues, relating thereto, for consideration by the Commission.

II. Secured lending in microfinance

A. An overview

3. Microfinance does not necessarily involve secured lending (in the sense of a security interest in a movable asset to secure outstanding amounts of a loan). It may be available without any security, with personal security (guarantees) or security in immovable property. However, microfinance may involve secured lending, in the context of which fragile borrowers in the microfinance sector may be utilizing essential household items to secure loans for micro trade as well as consumption purposes. The nature of the borrower and the collateral poses a number of challenges. First, there may be practices that are unfair for an individual borrower that offers assets such as household goods as collateral; second, valuation of collateral is not easy (valuation of collateral is a problem that arises in respect of any type of collateral, but in particular when the collateral's value is intangible or which may be difficult to ascertain, like household items); third, registration of security interests in a microfinance context creates particular difficulties; and fourth, enforcement and collection in the event of borrower default raises particular issues. All issues are linked and pose potential pitfalls for the availability of credit and financial inclusion of any borrower, and in particular borrowers in microfinance transactions.

4. Secured lending is an area in which UNCITRAL has a depth of experience which could be of great assistance to the microfinance sector. UNCITRAL prepared: (a) in 2001, the United Nations Convention on the Assignment of Receivables in International Trade (the "Convention"); (b) in 2007, the UNCITRAL Legislative Guide on Secured Transactions (the "Guide"); (c) in 2010, the Supplement on Security Rights in Intellectual Property (the "Supplement"). UNCITRAL is also

preparing a draft Technical Legislative Guide on the implementation of a Security Rights Registry, which is expected to be finalized in 2013. Like most national secured transactions laws, all these texts apply to secured transactions among businesses, including small and medium-sized enterprises (SMEs), as well as between a business and a consumer. However, the Convention and the Guide provide that they do not affect the rights of consumers under consumer protection law (see article 4.4 of the Convention and recommendation 2, subpara. (b), of the Guide; this recommendation applies also to the Supplement). The reason that these texts take this approach is that there is nothing therein that would be incompatible with the principles of good faith or fair dealing typically incorporated in consumer protection or similar law, and the exclusion of SMEs or consumers could inadvertently have a negative impact on the availability and the cost of credit to SMEs or consumers. This is the case with other texts of UNCITRAL (such as, for example, the Model Law on International Commercial Arbitration). Thus, consumer transactions are not excluded altogether from the Convention or the law recommended in the Guide, but appropriate deference is shown to consumer protection laws. In any case, UNCITRAL has not attempted to unify or harmonize consumer protection law, as it is generally considered to be an area of law that does not lend itself to unification or harmonization at the international level, because it raises fundamental policy issues that go to the core of each legal system.

5. In the last decade, the microfinance industry has attracted the interest of international investors and investment therein has surged. In fact, the Mix Market, an entity which monitors financial transparency of microfinance institutions (MFIs), reports that the sector grew 39 per cent each year on average over the last ten years, which represents more than 45 billion euros in volume of business globally.[1] Over the years, MFIs have also undergone a shift in methodology from the early years when lending relied heavily on the group enforcement mechanism. Groups were responsible both for ensuring that all members were creditworthy, and as a result, each group member subsequently became a guarantor through joint and several liability for other group member's loans. By contrast, modern microfinance in many countries prioritizes individual loans backed by pledges of the borrower's own assets, such as household goods, or mortgages of immovable property. Personal guarantees are also requested as additional assurances of repayment.

6. Like any other secured lender, MFIs should be complying with an array of laws, such as contract law, property law and in particular secured transactions law, civil procedure law, land law, insolvency, consumer protection law, and fair trade and competition laws. A reliable assessment of the risk of potential default is always a problem for any lender, including for MFIs in particular in many developing countries where there is insufficient information about borrowers and no credit bureau that could illustrate the past lending history of a particular potential borrower. Thus, obtaining other assurances of repayment, such as guarantees from friends and family, pledges of movable assets and mortgages of immovable property are an integral part of every microfinance transaction.

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[1] From the state of the MicroCredit Summit Campaign report 2011 based on a data sample of 3,300 MFIs from which it received annual data on client volume. Available at www.microcreditsummit.org/SOCR_2011_EN_web.pdf.

7. In any secured transaction, including a microfinance transaction, the appropriate use of collateral could be a benefit to both lenders and borrowers. Borrowers who have household goods (to the extent they may be pledged, which is a matter of general property law), business inventory and receivables and other assets can potentially obtain larger amounts of credit, or (if borrowing from commercial banks) possibly lower interest rates and longer repayment periods. Lenders who appropriately value and effectively obtain security interests in collateral are less likely to experience loss in the event of a borrower default, and can expand their business. Borrowers that are able to offer as collateral particular types of asset, such as household goods, can be included in the financial system and obtain access to affordable credit. Of course, whether an asset is transferable and thus can be offered as collateral for credit is typically an issue of property law. In order to protect the minimum living standard of borrowers, many legal systems do not permit the creation of security interests in essential household goods and employment benefits necessary for the essential needs of a person or family that can be used as a collateral. For the same reason, in many legal systems, even where the creation of a security interest in such a type of asset is permitted, the enforcement of such a security interest is made subject to special rules. In recognition of the social policies pursued by such laws, the law recommended in the Guide does not override provisions of such other law that limits the creation or the enforcement of a security interest or the transferability of certain types of asset (see recommendation 18).

8. In many countries, however, in the absence of a modern secured transactions law, unfair practices have developed, in particular in the microfinance sector. It is, therefore, important to promote the global adoption of effective and efficient secured transactions laws, such as the texts prepared by UNCITRAL and other organizations such as the International Institute for the Unification of Private Law ("Unidroit") and the Hague Conference on Private International Law (the "Hague Conference").[2] It may also be important to examine how those texts may apply in particular to the microfinance sector.[3]

B. Unfair practices in microfinance transactions

9. To determine the usage patterns of collateral in the microfinance industry, the Secretariat surveyed a random sampling of MFIs that report financial data including information on their financial products and lending methodology to the Mix Market. It analysed the types of loans offered and collateral requirements of 33 institutions from 11 countries. Results of the survey illustrate that 26 of the 33 surveyed MFIs require collateral such as: (a) compulsory savings retained by the MFI; (b) household assets; (c) movable goods; (d) receivables; (e) immovable property; (f) personal guarantees; and (g) blocked portions of the microloan itself.[4]

10. MFIs, like many commercial lenders require multiple collateral, combining compulsory savings and household goods with personal guarantees. The most

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[2] For a comparative analysis of major features of international instruments relating to secured transactions, see A/CN.9/720.

[3] Of particular relevance in this regard is the work of Unidroit on a new Protocol to the Cape Town Convention on matters specific to agricultural, mining and construction equipment.

[4] MFI data was taken from www.MixMarket.org and cross checked with information contained on the MFIs' websites.

complex collateral requirements appear to be set by Eastern European and Latin American MFIs, where immovable property is used as collateral, and even receivables are pledged (and upon payment are directed to a reserve account paid for by the borrower).[5] The most commonly required collateral per the survey is the compulsory savings requirement. Thirteen of the MFIs surveyed required savings retained by the MFI; three of which also required an additional form of collateral, like chattels.

11. MFI practices vary greatly within countries as well as from region to region regarding the compulsory savings issue. There are examples of MFIs requesting a seemingly modest 25 cents per week in savings,[6] whereas another MFI requires 20 per cent obligatory savings (which has the effect of raising its effective interest rate to 125.9 per cent).[7] In some countries MFIs combine the group methodology, with compulsory savings and household goods as collateral.[8]

12. The practice of compulsory savings tied to a loan product raises several concerns. First, a significant number of MFIs requiring compulsory savings are not licensed deposit taking financial institutions. Therefore, interest is not likely to be paid on these savings accounts by the MFI and the accounts are not protected by deposit insurance schemes. In addition, this practice has the effect of increasing the cost of funds for borrowers, while simultaneously making it very difficult for borrowers to calculate the effective interest rate for the loan or the total cost of funds for comparison purposes. Moreover, obligatory bundling or tying financial services such that the customer must purchase two services, when they may only want one raises fair trade and competition issues. MFIs most commonly bundle compulsory savings and insurance products. The former do not pay the client any interest, and the latter are frequently provided without an explanatory policy, but rather presented as an additional cost in the loan agreement. Therefore, in substance, these products appear to be no more than additional insurance against borrower default, or another type of collateral.

C. Valuation of collateral in a microfinance transaction

13. Like any other secured lender, MFIs must maintain a delicate balance with regard to collateral. On the one hand, they need to cover the possible risk of default, but, on the other, they cannot demand too much collateral, because their potential

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[5] At Fundacion Mujer in Costa Rica, an individual borrower pays 200 colones for the accounts receivable reserve account; from 2-3000 colones for a credit inspection as well as legal fees to register the pledge of collateral or mortgage for the microloan. Individual credit terms can be found at www.fundacionmujer.org/servicios/credito-individual.

[6] See for instance the Dariu Foundation in Viet Nam: the average loans balance is $133 per client and average deposit balance is $13 per data submitted by the Foundation to MixMarket available at www.mixmarket.org/mfi/dariu/report. Thus, although the compulsory savings requirement seems modest, it does in fact result in an additional and significant cost to the borrower.

[7] See for instance, LAPO-Nigeria, loan details can be found at www.lapo-nigeria.org/web/what-are-the-benefitsadvantages-of-becoming-a-lapo-customer-.html. Further pricing clarifications can be found online at www.kiva.org/partners/20.

[8] International Development Law Organization (IDLO), *Consumer Protection and Microfinance Country Reports*, 2011, pages 81-83 available at www.idlo.int/DOCCalendar/FINAL%20Microfinance%20Reports.pdf.

clients may not own items of sufficient value. Thus, by requesting too much collateral, the MFI would risk eliminating a significant share of its market, because poor populations may not own assets such as a car or house. The MFI's valuation must fairly assess the present, *actual* market value of collateral in the event of a future default. And, collateral pledged by borrowers, which may be used household appliances or aging animals, is likely to have a higher value to the borrower than to the MFI. Requiring very high collateral-to-loan ratios, however, can put borrowers in a precarious position whereby, if they default on their microfinance loan, they could also lose the family's sole source of income, or even home.[9] Finding the appropriate collateral-to-loan ratio is an important issue for any secured lender, including MFIs, and any borrower, including an SME or a consumer. Yet, there does not appear to be a consensus within the microfinance community on what ratio is fair and appropriate. Further, there does not appear to be much discussion of the issue in recent years among microfinance practitioners, nor among international organizations concerned with client protection issues. In addition, collateral-to-loan ratios required by MFIs appear to be much higher than those required by commercial banks. Certainly, every lending situation is unique, but many MFIs have a poverty alleviation mandate, thus best practices for secured lending are certainly relevant to the discussion. Collateral valuation, however, is an economic, not a legal issue. Thus, the Guide discusses collateral valuation in several places to highlight the relevant issues but makes no recommendation.[10]

D. Registration of a security interest in a microfinance transaction

14. Like any other secured lender, an MFI is also challenged to register a notice of and protect its security interest in the types of collateral used by borrowers in microfinance transactions, so as to make a security interest effective against third parties and ensure its priority over competing interests. Priority is particularly important where the same types of asset (for example, the same TV, pots and pans or chickens) are being used for multiple loans with different MFIs, and the total value of the loans exceeds the total value of the collateral, with the result that creditors without priority may not be paid at all or at least not in full. This affords a significant challenge because many countries, whether developed or developing, do not have registries for security interests in movable goods. Of the eleven developing countries surveyed, per the World Bank's *Doing Business Reports*, only four countries have collateral registries and laws that allow a business to use movable goods as collateral while maintaining possession of the goods.[11] It is not evident, however, whether the collateral registries in these four countries allow the registration of a notice of a security interest in collateral used in microfinance transactions with a view to making a security interest effective against third parties. In addition, it is not clear how simple, quick and inexpensive the registration process is, which is crucial given that the duration of a microfinance loan may be

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[9] Borrowers surveyed in Cameroon were frequently asked for title to their homes to secure a microloan. Collateral values to loan values were on average 356 per cent.

[10] See the UNCITRAL Legislative Guide, pages 217, 297, 431, 435, 451, 452 and 534.

[11] One of the issues assessed in the World Bank Doing Business Reports is access to credit and secured lending. Individual country reports can be viewed at www.doingbusiness.org and by clicking on "explore economy data".

quite short.[12] Thus, even if technically available to the MFI, the type of collateral registry in those four countries may be ill-suited for short-term microfinance loans.

15. In the absence of an effective and efficient security interests registry, such as the one recommended in the Guide and in the draft Technical Legislative Guide on the Implementation of a Security Rights Registry, MFIs develop mechanisms that may or may not be legal or fair and probably do not protect sufficiently their security interests. For example, as already mentioned, in some countries MFIs are simply requiring a transfer of title to the borrower's immovable property and keeping the title documents in their safes. Borrowers subsequently found out that it was quite easy to obtain a new deed of title, stating that the old one had been "lost."[13] Thus, the lack of an effective and efficient collateral registry led MFIs to follow approaches that may leave them without security. This result is bound to have an impact on the availability and the cost of credit, which in turn is likely to perpetuate the financial exclusion of the SMEs and consumers.

16. In order to address the above-mentioned problems, security interests registries may need to be established or reorganized in accordance with the recommendations of the Guide and the draft Technical Legislative Guide on the Implementation of a Security Rights Registry. In particular, the security interests registry recommended in the Guide is so designed to permit the registration of notices of security interests in all types of secured transaction, including microfinance transactions (that is, assets of SMEs or consumers), to the extent that under the relevant property law a particular asset may be transferred or encumbered (see recommendations 32 and 34). Such registration does not create a security interest, nor is registration a requirement for the creation of a security interest (see recommendation 33). In addition, the registration process is quick, easy and inexpensive, and thus may accommodate any type of secured transaction, including microfinance transactions of a short length, or where the amount of credit or the value of the collateral is small (see recommendation 54).

E. Fair and transparent enforcement of a security interest in a microfinance transaction

17. MFIs also struggle with the fair and transparent practices in relation to the enforcement of their security interests and collection of debts. When constrained to seize and sell a borrower's pledged assets, in countries where the group lending mechanism is still widely used, MFIs rely on the group members to seize and sell the collateral. For instance, in one country MFIs groups have a designated person

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[12] While there is no specific data on the Doing Business site related to time and costs of the registration of collaterals, we can use the time and number of steps to register property as an indicator. In one country examined, which has a collateral registry, there are 13 steps required to register property which takes on average 82 days per the World Bank. This seems not compatible with the short loan cycles of microfinance borrowers. The Nigerian access to credit report is published at www.doingbusiness.org/data/exploreeconomies/nigeria#registering-property.

[13] International Development Law Organization (IDLO), *Consumer Protection and Microfinance Country Reports*, 2011 available at www.idlo.int/DOCCalendar/FINAL%20Microfinance%20Reports.pdf.

for this purpose, called "discipline master."[14] However, this does not seem consistent with the law of the country which specifies that only licensed auctioneers may seize and sell collateral in a very precise manner, with strict notification rules to ensure transparency of the entire enforcement process.[15] In another country, bank regulators concluded that coercive and aggressive enforcement and collection practices may have been a contributing factor in a recent over-indebtedness crisis in the region.[16]

18. To address the specific problems mentioned above, the implementation of the recommendations of the Guide with respect to enforcement should be recommended. Of particular importance in this context are the following recommendations:

(a) Recommendation 131, which requires the secured creditor to enforce its security interest under the law in good faith and in accordance to reasonable commercial standards;

(b) Recommendations 132-135, which provide that these standards may not be waived by agreement before default;

(c) Recommendation 136, which provides that any person that violates the enforcement provisions of the law is liable for any damage caused by such failure;

(d) Recommendation 142, which provides for enforcement through judicial proceedings or extrajudicial enforcement;

(e) Recommendation 145, which provides that the higher ranking secured creditor may take over enforcement proceedings from the enforcing secured creditor; and

(f) Recommendations 147-151, which provide for the protection of the borrower and other persons with rights in the collateral in the case of extrajudicial enforcement.

F. Legal Framework for secured transactions in a microfinance context

19. In many States, the national legal framework for secured transactions implicates an array of domestic laws. In those States, there is no comprehensive secured transactions law of the kind recommended in the Guide. To the contrary, the law is a composite drawn from various segments of the law of those States. For example, in a Financial Sector Deepening legal survey, some 25 laws were

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[14] See, International Development Law Organization (IDLO), *Consumer Protection and Microfinance Country Reports*, 2011, page 77 available at www.idlo.int/DOCCalendar/FINAL%20Microfinance%20Reports.pdf.

[15] Laws of Kenya, The Auctioneers Act, Chpt. 526, 2009 available at www.kenyalaw.org/klr/fileadmin/pdfdownloads/Acts/AuctioneersActCap526.pdf.

[16] Reserve Bank of India (RBI), *Report of the Sub-Committee of the Central Bank Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector*, January 2011, available at www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=608#L11.

identified in a country that impact the registration of security interests.[17] In another country, 21 different laws have implications for secured lending.[18] In addition, in many countries there is no security interests' registry or the existing registry cannot accommodate secured transactions, including microfinance transactions. For example, registration of notices of security interests may not be available with respect to collateral such as household goods, or the registration process may be simply too lengthy and add an additional cost for MFIs.

20. MFIs have thus tended to compensate for these challenges with strategies that can be unfair to clients and that do not actually protect the MFI from legal or credit risks. MFIs may have adopted these strategies because of problems relating, for example, to the lack of a functioning security interests registry for movable goods in general or for the type of collateral used in microfinance transactions. Thus, MFIs circumvent these problems by requiring compulsory savings or bundled insurance products.

G. Matters for consideration

21. In view of these problems, the Commission may wish to consider whether the secured transactions issues mentioned above are already adequately addressed in the Guide and recommend broad implementation of the recommendations of the Guide. Once a sufficient number of States has implemented the recommendations of the Guide, the Commission may also wish to consider whether any other secured transactions issues need to be addressed to specifically facilitate microfinance transactions.

22. Alternatively, the Commission, in conjunction with other organizations working on microfinance, such as the World Bank, may wish to consider the way in which the secured transactions law recommended in the Guide applies to secured transactions in a microfinance context and consider whether a supplement to the Guide could usefully discuss and clarify the application of the secured transactions law in a microfinance context and, if necessary, make additional recommendations.

III. Dispute Resolution Mechanisms

A. Brief assessment of the legal framework

Access to justice for the poor

23. Recognizing that access to justice is essential in the fight against poverty, the United Nations Development Programme (UNDP) hosted a Commission on Legal Empowerment of the Poor, a global initiative to focus on the link between exclusion, poverty and the law. A report prepared pursuant to General Assembly resolution 63/142, underlined that measures to improve access to justice should focus on developing low-cost justice delivery models, taking into account the

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[17] Financial Sector Deepening Kenya (FSD), *Costs of Collateral in Kenya, Opportunities for Reform*, September 2009.

[18] International Labour Organization (ILO), *Securing Small Loans: The Transaction Costs of Taking Collateral*, 2001.

capacity and willingness of the poor to pay for such services, congestion in the court system, and the efficacy of informal and alternative dispute resolution mechanisms.[19]

24. The gravity of the access to justice gap for the poor was underscored by the Commission's report titled "Making the Law Work for Everyone." It indicated that four billion persons lack access to well functioning judicial systems due to poverty. Affordable, efficient and fair dispute resolution systems are in short supply for the poor, particularly when low value disputes are at issue. Moreover, the adversarial system excludes the poor, because they cannot afford the costs related to lawyers, or paying court fees. Further, court procedures can be slow, and it is not uncommon for courts to have a large backlog of cases.[20]

25. Studies carried out by the International Development Law Organization (IDLO) highlighted that microfinance institutions enter into contractual agreements with the poor who often have low literacy levels, and who are not fully informed of the terms of the loan contract, in particular regarding all applicable fees and interest rates, including the type of interest rate, be it flat or on a declining balance.[21] Microfinance clients also have low financial literacy levels, and little knowledge of their legal rights.[22] Thus, clients may have a difficult time understanding their rights and obligations vis-à-vis a contract.[23] Furthermore, if a dispute arises, normally, the only recourse of the microfinance client is to revert to the loan officer or MFI itself for redress.[24] The microfinance industry refers to this situation as "asymmetries of information"; a technical term for a rather large imbalance of power.

Applicable regulation

26. An integral component of financial services client protection, the provision of effective, alternative dispute settlement mechanisms for micro entrepreneurs, is often unavailable.[25] Sometimes, there may also be several authorities with overlapping jurisdiction related to financial services complaints resolution, making

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[19] Ibid., Sixty-fourth session (A/64/133), para. 24.

[20] UNDP, Commission on Legal Empowerment of the Poor, *Making the Law work for Everyone*, available at www.undp.org/legalempowerment.

[21] Centre for Microfinance*, How do Microfinance Clients Understand their Loans?* Tiwari, A., Khandelwal, A. & Ramji, M. October 2008. Available at www.microfinancegateway.org/p/site/m/template.rc/1.9.31190/.

[22] Id. In the aforementioned CMF study, less than 50 per cent of Indian microfinance clients surveyed could cite their effective interest rate and had only been orally explained their contract terms; no written copy was supplied. Similarly, in a CGAP survey done in Kenya, 25 per cent of microfinance clients were surprised by interest rates and service fees and that there were limited avenues for recourse. On the importance to strengthen the financial literacy and capability of users of microfinance services see also Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group, *Innovative Financial Inclusion, Principles and Report on Innovative Financial Inclusion*, pages 27-28.

[23] On this point see also Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group, *Innovative Financial Inclusion, Principles and Report on Innovative Financial Inclusion*, pages 25-26.

[24] *Supra*, IDLO, page 34, where it is mentioned that one-hundred per cent of Indian microfinance clients surveyed indicated that in the event of a complaint, their sole recourse was to the MFI management, or an internal MFI customer helpline.

[25] Economist Intelligence Unit (EIU*), Global Microscope on the Microfinance Business Environment*, EIU, Ltd. 2011.

it more difficult for the microfinance client to discern which authority is competent to hear the claim.[26]

Use of court system by MFIs

27. It is not clear how frequently MFIs resort to the court system for debt collection purposes. Courts in many developing countries are not automated, thus it is difficult to obtain data. Anecdotal evidence suggests the courts are being utilized more as a potential threat to inspire recalcitrant debtors to pay, versus an actual debt collection mechanism.[27]

Existence of alternative systems for dispute resolution

28. The Economist Intelligence Unit noted in its assessment of the business climates for microfinance in 55 countries that the lack of well-functioning dispute resolution systems was a common denominator in most countries surveyed. The report found that "where an established mechanism of dispute resolution does exist and can be accessed by microfinance clients, in many cases it does not work in practice — often because it is too costly, time-consuming, or is only available to a limited number of users."[28] Similarly, the Consultative Group to Assist the Poor (CGAP) assessed 140 countries as part of a survey on "Financial Access" in 2010, and noted that while more than half of the countries do have a third-party recourse mechanism for consumer dispute resolution; such as an ombudsman or mediation, the effective implementation of same may be limited.[29]

29. While stakeholders directly engaged in microfinance recognize that providing clients with efficient and fair dispute resolution mechanisms is essential for the proper functioning of the entire microfinance industry, their efforts to strengthen dispute resolution systems and improve access for clients are uniquely focused on in-house dispute resolution. Accion International, for example is a prominent microfinance industry actor that established a voluntary code of conduct for MFIs consisting of seven integral principles for client protection, including provision of an internal grievance resolution procedure.[30] More than 2,300 microfinance industry actors, including 714 financial services providers have signed this code of conduct, called the "Smart Campaign".[31] To date, however, there has not been a detailed analysis of the dispute resolution procedures put in place by MFIs taking part in the Smart Campaign. Nor has information been collected and compared on volumes and types of microfinance client complaints throughout the industry.

30. Also, the informal nature of microfinance, and the fact that a substantial number of MFIs remain unregulated by a prudential regulator in itself often limits

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[26] Such authorities could be for instance a consumer protection authority, the Central Bank, administrative agencies, local courts.

[27] *Supra*, IDLO, pages 65 and 110.

[28] Id.

[29] CGAP World Bank Group, *Financial Access 2010: The State of Financial Inclusion through the Crisis*, 2010 available at www.cgap.org/gm/document-1.9.46570/FA_2010_Financial_Access_2010_Rev.pdf.

[30] See www.smartcampaign.org/about-the-campaign/smart-microfinance-and-the-client-protection-principles.

[31] See http://centerforfinancialinclusionblog.files.wordpress.com/2011/11/20111115_certification_proposal-for-public-comment_final1.pdf.

recourse to the only existing redress mechanism for financial services disputes. Thus, even if the regulator provides a complaints window, an ombudsman or other mechanism for grievance redress, these facilities are generally not available to clients of unregulated MFIs. In India for example, those with a complaint against a commercial bank can have recourse to one of the 15 Ombudsmen of the Reserve Bank of India.[32] This service, however is not available for clients of non-regulated MFIs. Likewise, in Colombia there is a Financial Consumer Defender whose mediation services are available to clients of regulated MFIs, but only when the MFI has elected to use the Defender of the Financial Consumer, and further agrees to be bound by its decision.[33] In Peru, there has been an attempt to connect microfinance clients with arbitration services.[34]

31. Within the European Union, financial services ombudsmen have been established in most member States, and the UK ombudsman in particular publishes data annually on the volume and types of complaints received,[35] which has illustrated the intrinsic value of the ombudsman as a law and policymaking aid, in addition to a dispute resolution tool. Therefore, it would seem that a necessary precursor to developing new dispute resolution law and policy for microfinance would be to aggregate data which individual MFIs may already collect on the types of client complaints and how they are resolved, such as the UK Ombudsman does.

B. Types of disputes

32. Just as there is a scarcity of published research on the volume and types of complaints specific to the microfinance industry, there has also been little attention paid to the disputes of small businesses in developing countries, including how often they avail themselves of the courts or utilize out-of-court dispute resolution.[36]

33. Studies by prominent international organizations, such as Microfinance Pricing Transparency, suggest that within the microfinance sector, a significant number of disputes may be caused by the industry's opaque pricing and unfair contracting policies.[37] IDLO also conducted an assessment of *de jure* vs. *de facto* microfinance consumer protection in place, which revealed that borrowers often had complaints related to incomplete and inaccurate disclosure of the terms of the agreement, and the MFIs' refusal to restructure debts during repayment difficulty.[38] Other studies of

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[32] The Reserve Bank of India Ombudsman offices can be found at www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=164.

[33] *Supra*, IDLO, pages 68-69; Colombia, Law 1328 of 2009.

[34] This ADR initiative ("Huancayo initiative") was presented at the UNCITRAL Colloquium on Microfinance held in Vienna on 12-13 January 2011. It was indicated that there are 250,000 financial services disputes per year in Peru which are dealt with by the courts, estimating that each of the 60 regulated MFIs in Peru have 2,000 disputes annually.

[35] See www.financial-ombudsman.org.uk.

[36] In a survey of 30 Peruvian small business owners, entrepreneurs indicated that their impression of the judiciary lead them to modify their business conduct so as to avoid the need for judicial intervention to enforce contracts. See Herrero, Alvaro, and Henderson, Keith *The cost of resolving small-business conflicts: the case of Peru*, Inter-American Development Bank, 2004.

[37] Microfinance Transparency has developed a pricing calculator at www.MFTransparency.org so that the poor can insert all the costs, including insurance and withheld, or blocked portions of the loan used as collateral in order to determine the effective APR, or true cost of the loan.

[38] *Supra*, IDLO, pages 32-33; 62; 77; 79-80; 96-97 and 101.

microfinance industry abuses focus almost entirely on inappropriate collection practices and theft from clients.[39] Also, in the event of a borrower default, it would appear to be in the interest of the MFI to mediate and attempt to restructure client loans by extending payment periods, or lowering instalment amounts during times of reduced cash flow from microbusinesses. In an analysis of that issue, however, IDLO found that MFIs did not appear to be interested in restructuring, despite expressed interest on the part of the client.[40] The act of restructuring would most likely salvage a client relationship (once a borrower has defaulted, new loans are not normally granted, and the client is effectively lost to the MFI). Mediation therefore would appear to be in both the MFI and the client's best interest versus a seizure and sale of the debtor's assets used as loan collateral, which was discussed in the initial segment of this paper.

C. Matters for consideration

34. The access to justice gap for the poor is so large that new, innovative and more efficient dispute resolution systems should be developed which are tailored to the low incomes, literacy levels, geographical and cultural constraints of the poor. When parties to a contract have unequal bargaining positions, misunderstandings and disputes are likely to arise. In developing countries, however, with low access to financial services for the poor, regulators rarely have the resources to allocate to financial services complaint resolution systems.[41] Thus, the lack of third-party redress mechanisms appears to be an obstacle for both clients seeking resolution of complaints against MFIs, as well as for the financial institutions seeking to enforce and collect on valid debts.

35. At its forty-fourth session, the Commission[42] noted that a favourable legal and regulatory framework for microfinance included the provision of fair, efficient, transparent and inexpensive procedures for resolution of disputes arising from microfinance transactions, and that the lack of such procedures for microfinance clients was an issue to be further considered. Therefore, the Commission may want to consider the following matters:

(a) Whether alternative dispute resolution systems like arbitration, mediation and conciliation may provide viable solutions for the economic resolution of the low-value disputes of the poor; and in particular, if such a system is developed, the questions of how it would be financed in order to remain independent, and how it would be accessed by MFI clients living in remote locations are all crucial aspects;

(b) Whether the microfinance industry needs to better understand the types of client complaints, and how they impact industry growth as a whole, and to

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[39] Zeija, Flavian, *The Legal Requirements of Profitability, Sustainability, and Loan Recovery by Arrest and Imprisonment: A Dichotomy between Concern for the Poor and Concern for the Rich in Uganda*, IDLO Voices of Development Jurists, 2009. Available at www.idlo.int/MF/Documents/Publications/60E.PDF.

[40] *Supra*, IDLO, pages 33 and 64-65.

[41] See Brix, Laura and McKee, Katharine, *Consumer Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance*, CGAP Focus Note No. 60, February 2010.

[42] *Official records of the General Assembly, Sixty-Sixth Session, Supplement No. 17* (A/66/17), paras. 242 and 246.

engage the legal sector to assist in the development of redress mechanisms appropriate to the industry's needs. In that respect, a detailed assessment of the types and volumes of complaints in the industry is a prerequisite to determine whether alternative dispute resolution could be an effective means to resolve the disputes, and if so which form is best suited to the needs and lifestyles of the poor. Such a study could be done by UNCITRAL in conjunction with United Nations agencies such as UNDP and UNCDF, the World Bank's Consultative Group to Assist the Poor, Accion International or a prominent research institution or civil society actor interested in these matters; and

(c) Given the technological advances in the mobile banking and e-money sectors which are already used by MFIs in several countries to distribute loans, whether an online dispute resolution facility should also be studied to determine the feasibility of online dispute resolution (ODR) for microfinance related disputes. An ODR system has the potential to reach the poor residing in rural areas, though there may be a need for an extensive awareness raising campaign to accompany any such dispute resolution system.

IV. Electronic currency (E-money)

A. Prospects for financial inclusion

36. E-money can be a valuable bridge between the poor and financial services. E-money refers to value exchanged only electronically, using computer networks, the Internet and stored value systems (see A/C.9/698). To use e-money, a client converts actual currency to electronic money, usually at an agent of the service provider. The client may also access other financial services, such as linked savings accounts, and credit in the form of e-money. Growth in this sector has been very rapid in developing countries, where large percentages of the population are unbanked. According to figures presented at the UNCITRAL Colloquium, 364 million low-income, unbanked persons could be using mobile financial services by 2012.[43]

B. State of the industry

37. There are approximately 130 mobile money initiatives in existence worldwide.[44] In developing countries, the cell phone has demonstrated its remarkable ability to reach remote, rural villages, where banks and even MFIs are not present due to high infrastructure costs.[45] Cell phone services providers have existing agent relationships with thousands of cash-in, cash-out shops throughout the country, which translates into the telecom-led e-money initiatives having a

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[43] See UNCITRAL A/CN.9/727.

[44] Dolan, Jonathan, *Accelerating the Development of Mobile Money Ecosystems*, Washington, D.C.: IFC and the Harvard Kennedy School, 2009.

[45] See also Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group, *Innovative Financial Inclusion, Principles and Report on Innovative Financial Inclusion*, 3 May 2010, page 3 and pages 30-31.

significant market advantage. Telecom agents are also accustomed to dealing with high volumes of low-value cash transactions.

E-money encourages telecom and financial sector collaborations

38. The relationship between telecoms and banks, however, as well as microfinance institutions is continually evolving. There have been several recent joint initiatives to provide a broader array of financial services via cell phones. For example, the international NGO CARE has partnered with Orange/Telkom Kenya and Equity Bank to provide savings accounts to village savings and loan associations (VSLA). Both deposit and withdrawal services are available through the use of Equity/Orange agents.[46]

39. Recent events on the global financial scene have shown that self-regulation by financial institutions is often insufficient to protect and sustain the confidence of consumers. Thus it is critical that regulators pay close attention to the developments in e-money.

Central banks in developing countries are actively monitoring and engaging with non-bank e-money initiatives to develop proportional regulation

40. In both Kenya and the Philippines, where e-money initiatives are flourishing, regulators first *observed, engaged in dialogue with the industry, and learned*,[47] which allowed the regulators to gauge the potential impact and risks of e-money prior to determining how to regulate. Based on their observations, the Central Banks of both countries determined the appropriate level of supervision for e-money actors based on their activities, rather than the type of institution.

41. The Philippines subsequently published its e-money circular No. 649 of 2009[48] and Kenya's Central Bank issued a no-action letter regarding M-Pesa operations. To date, Kenya does not yet have regulation on e-money (but has published draft regulations).[49] Both Central Banks are widely credited for their regulatory prowess, not only with respect to e-money, but also for their commitment to financial inclusion.[50] As a result, both countries have a positive experience from the regulatory, market and consumer perspectives on e-money.

42. In the Philippines, Smart Money and Globe G-Cash (a bank linked and a telecom e-money product respectively),[51] launched in 2003 and 2004 and have over 9 million subscribers cumulatively. Kenya's Safaricom, a mobile services company, had 14.91 million clients for its M-Pesa service as of June 2011, and it effected

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[46] CARE, Equity Bank and Orange Launch Partnership to Connect Community Savings Groups to Banks Using Mobile Phones, Press Release, March 16, 2012 available at www.care.org/newsroom/articles/2012/03/care-mobile-banking-services-kenya-20120316.asp

[47] The G20 Principles for Innovative Financial Inclusion make explicit reference to a *test and learn* approach as an effective approach to managing innovation. See Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group, *Innovative Financial Inclusion, Principles and Report on Innovative Financial Inclusion*, 3 May 2010, pages 24-25.

[48] Available at www.cgap.org/gm/document-1.9.44821/Circular%20649.pdf.

[49] www.centralbank.go.ke/downloads/nps/Electronic%20%20Retail%20and%20E-regulations.pdf.

[50] See UNCITRAL A/CN.9/727.

[51] See also Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group, *Innovative Financial Inclusion, Principles and Report on Innovative Financial Inclusion*, page 31.

$3.15 billion worth of transactions in a six-month period.[52] Safaricom has subsequently partnered with Equity Bank Kenya to offer M-Pesa clients: an interest-bearing savings account and an international remittance service for the Kenyan diaspora to send money home (in partnership with Western Union), in addition to insurance products.

Credit card company acquisitions in the e-money market

43. The large credit card companies are also establishing e-money services. One global credit card company is making acquisitions of existing e-money platforms. For example, in June of 2011, Visa purchased a South African e-money platform provider, *Fundamo*, which had a subscriber base of five million and predicted growth to be more than 180 million customers.[53] In December 2011, Visa also contracted with the Government of Rwanda to provide financial services to the government and to simultaneously roll out financial services as well as literacy programmes to Rwandan citizens.[54] If the acquisitions and (possibly exclusive) agreements with governments continue, there may very well be a negative impact on competition among e-money providers before the sector has had a chance to mature. Thus, competition authorities should be closely monitoring the sector's development. Consideration should also be given to the requirement of interoperability of networks so as to allow new players to enter the market. Effectively, this would allow the consumer to send money from any service provider to a user of another service provider, without using multiple SIM cards or e-money accounts.

Potential risks of e-money to the consumer

44. Potential risks to e-money clients include the possibility that:

(a) A significant portion of a client's income stored on a cell phone or a prepaid card could be lost through hacking and fraud;

(b) A provider's (or agent's) liquidity problems, insolvency or bankruptcy could disrupt the client's ability to access funds, temporarily, or perhaps even permanently;

(c) Increased access to credit products could also lead to increased levels of over-indebtedness for those who may already be living at or near the poverty line; and

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[52] *Safaricom Half-Year Results Presentation, November, 2011*, available at www.safaricom.co.ke/fileadmin/About_Us/Documents/Half%20Year%20Results%20September%202011.pdf.

[53] *Visa acquires Fundamo, signs new agreement with Monitise*, Visa Press Release, 9 June 2011 available at http://corporate.visa.com/media-center/press-releases/press1128.jsp.

[54] *Visa-Rwanda partnership to drive electronic financial services*, Visa Press Release, 5 December 2011 available at http://pressreleases.visa.com/phoenix.zhtml?c=215693&p=irol-newsarticlePR&ID=1635856&highlight=. Visa aspires to earn 50 per cent of its revenue outside of the US market by 2015. Visa Press Release, 5 December 2011. The Rwandan market is interesting to e-money and other financial services providers like Visa because GDP per capita in Rwanda is expected to rise to $1,000 in 2020 from $220 in 2000. The financial inclusion concern, however, relates to the blurring the line between payment services providers and credit providers. The (over) extension of credit to fairly modest earners can have serious implications on a nation's economy and culture.

(d) Personal, financial data and spending histories are increasingly being shared with merchants, which raises privacy concerns.[55]

C. Emerging regulatory issues in a dynamic industry

45. Non-bank e-money service providers seem to be evolving into full-fledged financial services providers including through partnerships with prudentially regulated financial services institutions.[56] However, how should a regulator approach the complex task of dealing with non-bank e-money providers, like telecoms and credit card companies, which do not partner with regulated financial institutions, but still provide bank-like services? And, could stored value ever become a savings deposit account?

46. To date, all countries with existing mobile financial services initiatives require 100 per cent of the customers' electronic value to be backed by deposits in a regulated bank.[57] And, thus far, those countries with more mature e-money initiatives like the Philippines, Kenya and Malaysia have determined that e-money is not a deposit, per se, but rather transactional funds remaining on an account awaiting transfer. No State, however has specifically stated that a telecom which maintains e-float on deposit in a regulated bank *could not elect* to pay interest on the stored value. Permitting the payment of interest on stored value accounts backed 100 per cent by deposits in regulated financial institutions may be an additional tool towards financial inclusion for the poor.

47. Prominent financial inclusion proponents from CGAP have also spoken out in favour of allowing non-bank e-money providers to pay interest, provided the funds are protected by insurance schemes.

Financial sector integrity and financial crimes concerns

48. On the issue of the integrity of the financial system, there are certainly anti-money-laundering and terrorism financing concerns to be addressed. E-money, though, unlike cash transactions does allow for monitoring of suspicious activity, which is not possible with cash payments. Again, Kenya has handled this issue initially through a voluntary reporting agreement, whereby the telecoms submit reports, including on suspicious transactions and patterns to the Central Bank. There is also a limit to how much money can be held and sent via Safaricom.[58] Further,

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[55] As evidenced already by the Internet and advances in smartphone technology, companies will not only track consumer search patterns, e-mail content (Gmail and Hotmail) and purchasing patterns, sending targeted advertisements based on the consumers' past purchases, but they may also track a consumer's physical movements.

[56] Colombia, for example has passed several decrees to stimulate microsavings through the offering of simplified opening procedure for traditional savings accounts for small savings account holders (Circular Externa 053/09) and even decrees on e-savings accounts (decrees 4590/08 and 1349/09). Permanent Mission of Colombia Office to the United Nations Communication EMD-096, 30 January 2012.

[57] *The Mobile Financial Services Development Report 2011*, World Economic Forum USA, Inc. 2011 available at www.weforum.org/reports/mobile-financial-services-development-report-2011.

[58] Mutegi, M., *Kenya: Safaricom in Talks to Raise M-Pesa Limit*, AllAfrica.com, 4 October 2010, available at http://allafrica.com/stories/201010080127.html.

Kenya also handled the "know your customer" requirements retroactively by mandating that each SIM card be registered to one user; those who did not provide adequate identification to the issuing company would have their account invalidated (as a large percentage of the cards were sold prior to the existence of M-Pesa when no documentation was required).[59] South Africa, Tanzania and Ethiopia also require the mandatory registration of SIM numbers to combat financial crimes and terrorism.[60]

Security of the e-money platform for the client

49. Integrity of the software at use by telecom e-money providers is also a priority. In Kenya this was addressed by Safaricom submitting to an intensive system audit by a third-party consulting company per the Central Bank's request.[61] This issue could certainly be addressed as credit card companies have in the past done with fraud protection, as well as insurance schemes. Further, having a fair and clearly communicated dispute resolution system for clients should be a prerequisite.

Legal status of e-money and transactions therein

50. Similarly, as microenterprises begin to conduct more of their business transactions with e-money, what is the legal status of the payments concluded uniquely with e-money? Is the client required to accept e-money as opposed to cash for refunds?[62] This is also an emerging topic, on which few countries have applicable legislation.

D. Matters for consideration

51. The critical e-money issue for financial inclusion may be whether non-bank e-money providers can pay interest on stored value. Because leading e-money sector actors are telecoms and credit card companies, UNCITRAL could explore with regulators how to safely allow these institutions to offer interest bearing savings accounts and insurance, perhaps regulating according to the types of financial services being provided. Likewise, non-bank e-money providers desiring to offer credit products should have measures in place to assess the suitability of the proffered financial service for the clients' needs and ability to repay.[63]

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[59] *It's now Mandatory to register your SIM Card*, Communications Commission of Kenya, Press Release, 21 June 2010, available at www.cck.go.ke/news/2010/news_21june2010.html.

[60] Id.

[61] Alliance for Financial Inclusion, *Enabling mobile money transfer: The Central Bank of Kenya's treatment of M-Pesa*, 2010, page 5.

[62] In Singapore, the regulator expressed intent that merchants would be obliged to accept e-money payments by 2008. Electronic Money: the new legal tender, ZDnet.com, 21 December 2000 available at http://m.zdnet.com.au/electronic-money-the-new-legal-tender-120107819.htm. Nigeria is also making efforts to become a cashless society. Therefore, presumably e-money will become legal tender by default.

[63] See the National Credit Act in South Africa mandates. Thus far, South Africa appears to be the only country which mandates that financial institutions are responsible for ensuring the financial service provided is appropriate to the client's needs. Republic of South Africa, No. 34 of 2005; National Credit Act, 2005 available at www.ncr.org.za/pdfs/NATIONAL_CREDIT_ACT.pdf.

52. The selling of inappropriate financial services can lead to over-indebtedness which has caused repayment crises in quite a few developing countries' microfinance sectors. Thus, it would seem timely for the international community to develop best practices regarding responsible lending of e-credit products. UNCITRAL could be instrumental in initiating this dialogue among nations.

53. Further, because e-money is the result of an emerging technology, time may reveal security weaknesses. Regular audits of the security of the software platform, including client data privacy protocols, should be undertaken by external security experts. UNCITRAL could be instrumental in creating guidelines on the integrity of e-money platforms and determining the frequency and focus of systems audits.

54. The Commission may wish to consider a study of the above-mentioned issues to determine appropriate legislative guidelines, or recommendations with regard to a harmonized approach to regulation of non-bank financial institutions which offer e-money services beyond mere transfers of money and which balances: (a) financial inclusion needs with (b) the need to protect vulnerable client populations in a globally interconnected, and still fragile economy.