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Selected legal issues impacting microfinance

Note by the Secretariat*

Observations by the New York State Bar Association (NYSBA) International Section**

The New York State Bar Association (NYSBA) International Section submitted to the Secretariat of the United Nations Commission on International Trade Law (UNCITRAL) observations concerning UNCITRAL's role in microfinance. The text of the observations is reproduced as an annex to this note in the form in which it was received by the Secretariat, with formatting changes.

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* The Secretariat received the NYSBA observations annexed to this Note on 30 April 2012.

** The opinions expressed in the Statement are those of the International Section and do not represent those of NYSBA unless and until they have been adopted by NYSBA's House of Delegates or Executive Committee. These observations are endorsed by Microfinance Transparency, and Advocates for International Development.

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Annex

I. Introduction

1. Microfinance and issues broadly relating to financial inclusion have come to the forefront of international standard setting bodies (SSBs) that provide guidance to Governments and regulators regarding the conduct, practices, and governance of microfinance institutions (MFIs) and their investors. As such, legal and regulatory issues respecting microfinance are ripe for consideration by UNCITRAL, whose mandate includes promoting the harmonization and modernization of commercial law by drafting international standards. Such work promotes the rule of law and advances progress toward the United Nations Millennium Development Goals. UNCITRAL has initiated information gathering processes in this area, such as the colloquium on microfinance held in January 2011 and distribution of the questionnaires that member States are currently completing with respect to microfinance practices in their respective jurisdictions.

2. UNCITRAL's success in providing guidance toward the creation of an effective and predictable legal framework will particularly benefit developing country economies where microfinance sector growth has advanced the need for legal structures tailored to the idiosyncrasies of MFIs; such legal developments will promote economic growth and trade. Recognizing the importance of microfinance in the national economy and poverty alleviation strategies of these countries, UNCITRAL's timely efforts can create an enabling environment for markets guided by sound legal principles and transparent regulatory systems.

3. In its 2011 report to the General Assembly, the 44th Commission identified four topics as substantive legal areas that other SSBs are not addressing.[1] The topics the Commission selected for further study (hereafter called "the Identified Issues") are: (1) Overcollateralization and the use of collateral with no economic value; (2) Electronic-money, including its status as savings; whether "issuers" of e-money were engaged in banking and hence what type of regulation govern them; and the coverage of such funds by deposit insurance schemes; (3) Provision for fair, rapid, transparent and inexpensive processes for the resolution of disputes arising from microfinance transactions; and (4) Facilitating the use of, and ensuring transparency in, secured lending to microenterprises and small and medium-sized enterprises.[2]

4. The Commission determined that UNCITRAL should not duplicate international efforts already in progress relating to financial inclusion. In fact, the work of other SSBs shows no particular focus on global harmonization of the Identified Issues. Therefore, UNCITRAL has an important role in covering these areas.

5. The Secretariat's April 1, 2011 Note[3] surveyed eight SSBs addressing issues of inclusive finance, and a White Paper prepared by the Consultative Group to Assist the Poor (CGAP) on behalf of the G-20's Global Partnership on Financial Inclusion

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[1] General Assembly, Official Records, *Sixty-sixth session, Supplement No. 17*: Report to UNCITRAL, *Forty-forth session* (27 June-8 July 2011) A/66/17, 246.

[2] Id.

[3] UNCITRAL, *Forty-fourth session*, Legal and Regulatory Issues Surrounding Microfinance, Note by Secretariat (Vienna, 27 June-8 July 2011) A/CN.9/727.

surveyed the work of five additional SSBs.[4] While this literature demonstrates convergence on matters of insurance, lending, and prudential regulation of deposit-taking institutions, the Identified Issues have not enjoyed the same level of scrutiny.[5] For example, the Financial Action Task Force (FATF) is an intergovernmental body that develops and promotes international policies to combat money-laundering and terrorism financing. MFIs have long confronted issues of the application of FATF standards to the microfinance scheme, often a poor fit that thwarts the growth of the industry. To these ends, FATF addresses issues of proportionality in the standard "know your customer" regime for monitoring potential money-laundering transactions. While FATF addresses the policy issues of formalizing informal commerce vis-à-vis these concerns, the central legal issues are less scrutinized.

6. UNCITRAL has the opportunity to develop consensus among member States regarding model laws accompanied by standardized contract terms for microfinance-related transactions, while it also deals with various legal issues of a technical nature, such as new payment methods. Related concerns include the relative applicability of the laws of sending and receiving countries for international money transfers; the legal constitution of savings; and establishment of standard legal norms that balance the conflicting interests of protection of international investors, MFIs, and microborrowers and their local communities. The Commission can also develop relevant special choice of law rules in coordination with the Hague Conference on Private International Law (HCCH) and UNIDROIT, as necessary. Microfinance would benefit from UNCITRAL leadership in the area of mobile money, since, in the event of default, such alternative payment systems simplify the transfer of accounts for servicing of outstanding loans, which correspondingly encourages investment.[6] This effort could include development of standard e-transaction provisions that build on existing UNCITRAL e-commerce work. UNCITRAL guidance in this context would both assist countries struggling with these types of paradigms and increase investor confidence, thereby facilitating trade.

II. Transparency as integral to financial inclusion

7. Among the Identified Issues, transparency in lending is particularly apt for consideration by UNCITRAL. Legislation to regulate financial institutions that primarily serve small borrowers is not well developed in many jurisdictions. The economically vulnerable communities served by microfinance present a moral imperative for fair lending standards. Given the increase in microfinance activities

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[4] Global Standard-Setting Bodies and Financial Inclusion for the Poor: Toward Proportionate Standards and Guidance, A White Paper Prepared by CGAP on Behalf of the G-20's Global Partnership for Financial Inclusion.

[5] Non-governmental organizations have been advocating for best practices relating to similar topics, the outcomes of which can inform the Commission. For example, see MFTransparency (www.mftransparency.org); see also The Smart Campaign, Client Protection Principles (www.smartcampaign.org); see also The Microcredit Summit Seal of Excellence (www.microcreditsummit.org/about/the_seal_of_excellence).

[6] See, Throwing in the Towel: Lessons from MFI liquidations, Daniel Rozas (September 20, 2009) at www.microfinancefocus.com/news/wp-content/uploads/2009/09/Throwing-in-the-Towel.pdf.

worldwide,[7] a model law or legislative guide drafted by the Commission would provide a valuable resource to developing economies. As observed by the Secretariat, "pragmatic guidance on microfinance regulation from an institution such as UNCITRAL which is legitimated by considering the input from its Commission's member State delegates and creating consensus-oriented legal instruments could prove highly valuable for countries with less developed regulatory regimes and fewer resources to allocate to consideration of the issues involved in enacting microfinance."[8]

8. Regarding the transparency of financial products and services:

(i) *Mandatory Savings Accounts*.[9] Some MFIs require that borrowers deposit a portion of their loan into a mandatory savings account with the lending MFI. These accounts are often locked (i.e., borrowers cannot access them at their discretion) rather than being available "on demand" to the borrower. Most MFIs do not calculate the amount that is in the savings account as part of the costs that they disclose to the borrower. In addition, some MFIs charge maintenance fees on these savings accounts, which fees are also not consistently disclosed. Local law treatment of whether these savings accounts serve as collateral for a loan varies; even where they are considered collateral, many states do not have effective registries making such collateralization less useful to investors.[10] These weaknesses are notable as, in the event of an MFI failure or bankruptcy, collateral is an influential factor in borrower repayment.[11] Thus, the issue of savings accounts cuts across several of the Identified Issues. An UNCITRAL-led set of guidelines for disclosure standards under a model law accompanied by standard contract terms can solve problems in the use of mandatory savings accounts and achieve consistent treatment of savings accounts as collateral by MFIs. Such solutions would benefit all parties and nurture responsible growth of the industry.

(ii) *Pricing Transparency and Standardized Disclosure Forms*. For competition to increase among MFIs, borrowers need to have access to information to adequately assess products the MFIs offer. For microcredit, Annual Percentage Rates (APRs) can provide a valuable method for borrowers to compare loan

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[7] "While the overall amount loaned by MFIs is still a small proportion of the total of funds loaned in the developing world, there is evidence to suggest that in many countries the number of loans granted by, and customers served by, MFIs exceed that of banks." UNCITRAL, *Forty-third session*, Microfinance in the context of international economic development, Note by Secretariat (NY, 21 June-9 July, 2010) A/CN.9/698 at paragraph 15.

[8] Id. at paragraph 63.

[9] See Id. at paragraph 54: "It appears that many MFIs are now demanding collateral for loans by means of "forced deposits," whereby a percentage of the loan is held back by the lender, often without interest being paid by the lender on the amount held back. This affects the overall effective rate of interest, although borrowers are often not in a position to fully appreciate it".

[10] UNCITRAL should mobilize the current work of Working Group VI (security interest) on legislative guidance on security interest registry systems if it proceeds with the microfinance agenda. See also, Disintermediating Avarice: A Legal Framework for Commercially Sustainable Microfinance, Steve L. Schwarcz, University of Illinois Law Review (Vol. 2011, p. 1165).

[11] See, Rozas, supra footnote 6. Despite the fact that the cornerstone of microcredit is non-collateralized loans, Rozas' research on MFI liquidations indicates that collateralization does incentivize loan repayment even among micro-borrowers. He states "… in this study, effective collateral has proved to be the most reliable predictor of client repayment after their MFI ceased making new loans".

products. Mandated truth in lending laws can require that MFIs calculate APRs to include not only the interest paid on the loan, but also all fees, the price of obligatory insurance (where such insurance is required), and the cost of compulsory savings accounts, which may effectively act as security deposits. Furthermore, to facilitate comparisons across various MFI products, local laws can require MFIs to provide standardized disclosure and repayment schedule forms and contracts. UNCITRAL can foster greater and more consistent transparency in lending by harmonizing lending contract terms and related legal norms under a model law. Such work promotes domestic and international investment in MFIs as legal predictability reduces risks, which in turn should bring economic benefit to the microborrowers.

(iii) *Flat Balance vs. Declining Balance Interest Rate Calculation Methods*. The flat balance interest rate calculation method is one in which a lender charges the borrower interest on the original amount of the loan for its entire term, irrespective of amounts the borrower has already repaid. The declining interest rate method takes into consideration the repayment amounts and charges interest on the declining principal amount of the loan. For borrowers to compare prices among MFIs, all MFIs need to use the same interest rate calculation method. From a borrower's perspective, the flat balance interest rate calculation method means that borrowers pay more for a loan than the amount originally advertised. For instance, a loan promoted at "2 per cent a month" would have an annualized true price of 24 per cent if calculated on a declining balance but an annualized true price in the range of 40-48 per cent — nearly double — if calculated "flat". UNCITRAL work concerning microfinance can consider methods for encouraging consistent use of the declining interest rate calculation method, or at least clear disclosure, so as to avoid predatory practice.[12]

9. UNCITRAL has a variety of ways to nurture inclusive finance through model laws, legislative guidance, and other methods focusing on specific industry transactions and contracts that accommodate and promote financial services and products to underserved parties.

III. The implementation of future opportunities

10. The cross-disciplinary nature of microfinance lends itself to a variety of opportunities within UNCITRAL. Assignment of the microfinance agenda to a specific working group to develop such legislative texts, guides, standards, and contractual terms, as appropriate, is a desired next step when UNCITRAL member States reach a consensus on the related legal issues. However, if UNCITRAL deems the formation of a new working group premature, the Commission should consider the best alternative methods for moving the subject matter forward, including using the resources of external organizations and seeking special funding outside the standard budgetary mechanisms. As yet further options, the Commission may consider separating some of the Identified Issues for consideration by separate working groups; commencing another colloquium or expert group; or collaborating

[12] Some jurisdictions have already outlawed the use of flat interest. See: www.mftransparency.org/pages/wp-content/uploads/2011/10/Case-Study_Cambodia_Regulation-Outlawing-Flat-Interest.pdf.

with other standard-setting bodies in developing model rules and contracts promoting microfinance.

11. Numerous stakeholders can contribute to this process, including professional organizations of lawyers, academia, and advocacy. UNCITRAL should leverage the knowledge and expertise of these parties, together with its questionnaire results and the relevant Commission decisions, to boost its efforts to develop legal tools that promote microfinance.