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Legal and regulatory issues surrounding microfinance

Note by the Secretariat

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I. Introduction

1. At its forty-second session (Vienna, 29 June-17 July 2009), the Commission heard a suggestion that it would be timely for it to carry out a study on microfinance in the context of international economic development, in close coordination with the main organizations already active in that field. The purpose of the study would be to identify the need for a regulatory and legal framework aimed at protecting and developing the microfinance sector so as to allow its continuous development, consistent with its purpose, which was to build inclusive financial sectors for development.[1] At that session, the Commission requested the Secretariat, subject to the availability of resources, to prepare a detailed study including an assessment of the legal and regulatory issues at stake in the field of microfinance as well as proposals as to the form and nature of a reference document discussing the various elements required to establish a favourable legal framework for microfinance, which the Commission might in the future consider preparing with a view to assisting legislators and policymakers around the world. It was said that developing countries and countries with economies in transition were considering whether and how to regulate microfinance; thus, the creation of consensus-oriented legal instruments could prove highly valuable for countries at this stage of development of the microfinance industry. The Commission requested the Secretariat to work in conjunction with experts and to seek possible cooperation with other interested organizations for the preparation of such a study, as appropriate.[2]

2. At its forty-third session, the Commission had before it a note by the Secretariat containing a study and proposals as requested (A/CN.9/698). The note sought to examine and provide an overview of the issues relating to the regulatory and legal framework of microfinance.[3] It was recognized that, in facilitating access to financial services to the many poor who were not currently served by the formal financial system, microfinance could play an important role as a tool for the alleviation of poverty and achievement of the Millennium Development Goals. It was also noted that an appropriate regulatory environment would contribute to the development of the microfinance sector.[4]

3. After discussion, the Commission agreed that the Secretariat should convene a colloquium, with the possible participation of experts from other organizations working actively in that field, to explore the legal and regulatory issues surrounding microfinance that fell within the mandate of UNCITRAL. The colloquium should result in a report to the Commission at its next session, outlining the issues at stake and containing recommendations on work that UNCITRAL might usefully undertake in the field.[5]

4. Pursuant to that request, the Secretariat organized a colloquium on 12-13 January 2011 in Vienna, consisting of presentations and panel discussions on

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[1] *Official Records of the General Assembly, Sixty-fourth Session, Supplement No. 17* (A/64/17), para. 432.

[2] Ibid., para. 433.

[3] *Official Records of the General Assembly Sixty-fifth session, Supplement No. 17* (A/65/17), para. 275.

[4] Ibid., para. 276.

[5] Ibid., para. 280.

key issues surrounding microfinance. Speakers, panellists and participants included microfinance specialists from various governments, international organizations, non-governmental organizations, the private sector and academia from all parts of the world.[6]

5. This note contains a summary of the Colloquium proceedings and of the key issues that were identified. The first part contains a summary of various initiatives that were developed at international, regional and domestic level to deal with the promotion and regulation of microfinance. The second part outlines legal and regulatory issues raised, for consideration by the Commission.

II. Policy, legal and regulatory initiatives on financial inclusion

6. At the Colloquium participants noted that microfinance had rapidly become a globally recognized form of finance evolving from a donor-driven NGO system.[7] According to the available data,[8] in 2009 there were 92.4 million microborrowers, and a gross loan portfolio of $65 billion in credit (compared to $24 billion in 2006). Commitments to support microfinance reached about $21.3 billion,[9] and cross-border investment in microfinance represented about $12 billion. In the same period, microfinance investment vehicles were estimated to manage foreign capital investment of about $6.2 billion.[10]

7. Microfinance is also entering a new and more dynamic phase. It keeps growing worldwide and expanding into new and more sophisticated financial products. However, legal, regulatory and market gaps keep the industry from operating as well as it should.[11] This fact, together with the increasing role of investors in funding microfinance enterprises and the advent of direct contacts between lenders and borrowers in cross-border microlending indicates a role for international legal and regulatory standard-setting in order to establish common practices and principles across the industry.[12]

8. At the Colloquium the difference between microfinance and financial inclusion was also noted. It was highlighted that financial inclusion is a broader concept than microfinance, based upon the recognition that access to credit alone is insufficient for poverty eradication. A set of useful, flexible services and reliable

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[6] The agenda and the papers of the Colloquium can be found at www.uncitral.org/uncitral/en/commission/colloquia/microfinance-2011.html.

[7] See also Deutsche Bank, “Microfinance: An Emerging Investment Opportunity”, December 2007, www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000219174.pdf.

[8] Microfinance Information Exchange, available at www.mixmarket.org.

[9] www.cgap.org/p/site/c/template.rc/1.11.45737/.

[10] Consultative Group to Assist the Poor (CGAP), “Microfinance Investors Adjust Strategy in Tougher Market Conditions”, October 2010, available at www.cgap.org/gm/document-1.9.47946/MIVBrief.pdf.

[11] See also Economist Intelligence Unit, “Global Microscope on the Microfinance Business Environment 2010”, available at http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=35379430.

[12] See also the Consultative Group to Assist the Poor (CGAP), “G20 Identifies nine principles for innovative financial inclusion, action plan expected in November”, June 2010, available at www.cgap.org/p/site/c/template.rc/1.26.13722/.

delivery mechanisms are required to meet a range of changing economic and social needs. Financial inclusion thus aims not only at microbusiness but also at increasing outreach to households, through a continuum of financial institutions offering appropriate products and services to all segments of the population and through various types of service providers.[13] As a market-based approach to fighting poverty, microfinance is focused on developing entrepreneurship and expanding self-employment.[14] At the Colloquium it was recognized that microfinance is characterized by close relationships with clients, simplified procedures and specialized credit methodology. The focus of A/CN.9/698 (see paras. 1 and 2 above) was on microfinance.

A. Selected international initiatives

9. Reference was made to the activities of various governmental and non-governmental bodies involved in setting international and regional legal and regulatory standards. Discussions noted that some of those bodies do not focus exclusively or comprehensively on microfinance; and others are mostly concerned with regulation of prudential issues, not dealing with non-prudential regulation. It seemed evident that greater international clarity on several issues would encourage cross-border providers of microfinance.

1. The United Nations system

10. The United Nations has supported the evolution from microcredit to microfinance and now to financial inclusion, which is considered instrumental to accelerate the achievement of the Millennium Development Goals (MDGs). United Nations activities are not currently directed toward standard-setting, but they concern promotion of microfinance, i.e. assistance to the Secretary-General's Special Advocate for Inclusive Finance for Development to promote greater financial inclusion, and relevant technical assistance to member States. It was suggested that the wider United Nations system could play a greater role in enhancing financial inclusion, and four priorities for future action were indicated. Those priorities included (i) a greater coordination among policymakers and regulators from different countries and among the various international standard-setting bodies, in particular those dealing with financial inclusion, financial stability and financial integrity; (ii) the development of effective inclusive financial systems, serving a continuum of clients, from individuals to micro, small and medium-sized enterprises; (iii) the development of an enabling financial infrastructure at the national level, particularly in the area of payment services;[15] (iv) the protection of clients from potential abuses, which was said to be achievable through a combination of industry standards and self-regulation, together with appropriate client protection regulation and oversight. More transparency about products was

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[13] Role of microcredit and microfinance in the eradication of poverty, Report of the Secretary General (A/65/267), August 2010, paras. 38-39, page 12.

[14] Ibid., para. 7.

[15] Payment services include funds transfer between account holders, for example to transfer funds among family members dispersed geographically, to pay utility bills, to receive payments, for example, from government programmes or tobacco traders selling smallholder production on the auction floor.

advocated and the need to increase the capability of clients to make informed and sound choices about financial products and money management.

2. Other international bodies

11. At the Colloquium, discussion of selected initiatives of other international advisory bodies noted that any regulatory regime needed to balance the cost of regulation and supervision against the risks presented by non-regulation, and be commensurate with the type and size of the transactions at issue. The distinction between prudential and non-prudential regulation was also highlighted.

12. Prudential regulation aims at protecting the financial system as a whole, including the safety of funds on deposit in licensed financial institutions. Oversight of banks' loan portfolios has the aim of limiting the risks banks can take with depositors' money. Such regulations include capital adequacy norms and liquidity requirements, and are usually administered by a specialized financial regulator. With non-prudential regulation, the emphasis is not on protecting the financial system and funds on deposit per se, but rather on the conduct of the financial business, including such matters as registration; client protection; disclosure of interest rates; supporting secured transactions; setting limits on foreign ownership, management, and sources of capital; transformation from one institutional type to another; fraud and financial crimes prevention; and credit information services.

13. At the Colloquium, there was general agreement that prudential regulation was inappropriate or unnecessary for microfinance institutions which did not take deposits. However, it was pointed out that microlenders should be allowed to take deposits, in order for them to become less dependent on donors and the capital markets for obtaining their loan funding; this raises the question whether such lenders might be subject to some measure of prudential supervision.

Basel Committee on Banking Supervision ("BCBS")

14. The BCBS has recently provided guidance[16] on the application of the Basel Core Principles for Effective Banking Supervision[17] ("the Core Principles") to microfinance activities (since the Core Principles themselves were not originally designed to address microfinance). The guidance is not to be considered a summary of best practices or a revision of the Core Principles: it is intended to highlight the key differences between the application of each Core Principle to traditional retail banking and microfinance, pointing out areas that may require tailoring.[18]

15. The guidance aims at assisting States in developing a coherent approach to regulating and supervising the microfinance sector. It considers the need to allocate supervisory resources efficiently, develop specialized knowledge within supervisory bodies to effectively evaluate the risks of microfinance activities, and to recognize

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[16] Basel Committee on Banking Supervision, "Microfinance activities and the Core Principles for Effective Banking Supervision", August 2010, prepared by the Microfinance Workstream of the BCBS. Available at www.bis.org/publ/bcbs175.htm.

[17] The Core Principles for Effective Banking Supervision, originally published in 1997 and revised in 2006 by the "BCBS", are a benchmark against which countries can assess the quality of national banking supervisory systems. They are available at www.bis.org/publ/bcbs129.htm.

[18] Basel Committee on Banking Supervision, "Microfinance activities and the Core Principles for Effective Banking Supervision", August 2010, page 1.

proven control and managerial practices that may differ from traditional banking but may be appropriate for microfinance. The guidance considers that while some of the Core Principles apply equally to banks and other deposit taking institutions ("ODTIs") engaged in microfinance regardless of the nature of the activities (or the complexity and size of the ODTIs) most of the principles need to be adapted to the sector. However, the guidance addresses depository microfinance institutions ("MFIs") only and concerns the prudential regulation of their activities. It does not apply to non-deposit taking MFIs (which are the majority)[19] and does not deal with non-prudential regulation issues.

G-20 Financial Inclusion Experts Group/Access through Innovation Sub-Group

16. The G-20's nine "Principles for Innovative Financial Inclusion",[20] endorsed at the G-20 Summit held in Toronto, in June 2010, and presented at the Colloquium, aim to provide guidance for policy and regulatory approaches to innovative financial inclusion. Their goal is to (i) foster the safe and sound adoption of innovative, adequate, low-cost financial service delivery models; (ii) help define a framework of incentives for the various bank, insurance, and non-bank actors involved, while ensuring fair conditions of competition between all financial service providers; and (iii) foster affordable financial services that respond to customer's needs in both quality and range.

17. The Principles for Innovative Financial Inclusion are based upon recognition that innovations (e.g. branchless banking technologies) and the role of global investors and donors in financial access foster an increased relevance of international standard setting and advisory bodies to promote improved financial access across the globe, which has the potential to improve efficiency of the sector, and increase transparency. One of the Principles, for instance, suggests that regulatory frameworks should reflect international standards.

Global Partnership for Financial Inclusion ("GPFI")

18. The Global Partnership for Financial Inclusion ("GPFI") is the main implementing mechanism for the action plan on financial inclusion agreed at the G-20 Summit held in Seoul in November 2010. The GPFI has established a sub-group focusing on the G-20 Principles for Innovative Financial Inclusion and engagement with standard setting bodies. Among the GPFI priorities is the creation of a financial inclusion data and measurement task force to improve the quality and quantity of relevant data for individuals, households and micro-to-small enterprises; as well as to provide tools and methodologies for States to set financial inclusion targets.

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[19] Some of the largest microfinance institutions in the world, e.g. SKS in India, are non-deposit taking institutions.

[20] Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group, "Innovative Financial Inclusion, Principles and Report on Innovative Financial Inclusion", May 2010.

Consultative Group to Assist the Poor ("CGAP")

19. The Consultative Group to Assist the Poor (CGAP)[21] is an independent policy and research centre dedicated to advancing financial access for the world's poor, housed at the World Bank. In September 2002, CGAP's 29 member donor agencies adopted the "Microfinance Consensus Guidelines — Guiding Principles on Regulation and Supervision of Microfinance".[22] The Guidelines, authored by microfinance practitioners, are based on the information and experience from various commentators involved in regulation and supervision of microfinance in various parts of the world. The Guidelines outline several principles for the prudential and non-prudential regulation — and supervision — of the microfinance sector. They argue that, to reach its full potential, microfinance must eventually enter the arena of licensed, prudentially supervised financial intermediation, and that regulations will need to be crafted to allow this development.[23]

World Bank

20. The World Bank's work on microfinance has emphasized, inter alia, the importance of an efficient financial infrastructure in expanding access by the poor to financial services. Among the elements of such financial infrastructure, the crucial role of measures for the enforcement of collateral has been highlighted.[24] Collateral registries and secured transactions systems address the reluctance of financial institutions to accept movable property as collateral. A modernized secured transactions and collateral registries system therefore can contribute to financial inclusion by increasing the level of credit and decreasing its cost.

B. Selected regional initiatives

21. The increased involvement of regional and international bodies in the areas of microfinance and financial inclusion would seem to underscore again the importance of giving consideration to legal and regulatory standards at the global level.

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[21] CGAP has also served as a co-founder of the Smart Campaign, a global effort to provide MFIs with the tools and resources to deliver transparent, respectful, and prudent financial services to all clients. The Smart Campaign embodies a set of core principles for the treatment of microfinance clients — the minimum standards that clients should expect to receive when doing business with a microfinance institution. The principles are: avoidance of over-indebtedness, transparent and responsible pricing, appropriate collections practices, ethical staff behaviour, mechanisms for redress of grievances, privacy of client data. Information is available at www.smartcampaign.org/.

[22] At the Colloquium it was mentioned that the Guidelines were being updated for release later in 2011.

[23] R. Christen, T. Lyman, R. Rosenberg, "Microfinance Consensus Guidelines — Guiding Principles on Regulation and Supervision of Microfinance", CGAP, June 2003, page 30.

[24] See, for instance, S. Fardoust, Y. Kim and C. Paz Sepulveda, eds. "Post crisis Growth and Development: A Development Agenda for the G-20" at chapter 10 "Toward Universal Access: Addressing the Global Challenge of Financial Inclusion" (by, P. Stein, B. Randhawa and N. Bilandzic),World Bank, October 2010, pages 457 ff.

European Union

22. The "European initiative for the development of microcredit in support of growth and employment"[25] was launched by the European Commission in 2007 with a view to improving access to finance to small enterprises and socially excluded people who wanted to set up their own business. The initiative, recognizing microcredit as a vehicle for economic growth and employment, was built upon four pillars which included, among others, the improvement of the legal and institutional environment for microfinance and the enhancement of a favourable climate for entrepreneurship.[26]

23. Pointing to the link between microcredit and the creation or expansion of income-generating activities, the Commission encouraged EU Member States to (i) facilitate the offering of microcredit services by both banks and non-banks through various means; (ii) relax interest rate caps for microcredit operations; (iii) adapt national regulation and supervision to the specificity of microfinance as well as (iv) improve the institutional framework for self-employment and micro-enterprises. Member States were urged to adopt measures enabling the unemployed and welfare recipients to make the transition into self-employment, and increasing chances of success of new micro-enterprises. The discussion at the Colloquium noted that microcredit concerns not only developing countries, but also developed ones and that for a meaningful development in the latter, where wage earners are prevalent, reform of the legislative and regulatory framework of microcredit and micro-enterprise is key.

Association of Supervisors of Banks of the Americas/Inter-American Development Bank

24. The "Guidelines of principles for effective regulation and supervision of microfinance operations" were issued in 2010.[27] While recognizing the applicability of the Basel Core Principles to the microfinance sector, the Guidelines also advocate the need to broaden their application in order to create a complementary regulatory and legal framework that allows for the effective regulation and supervision of microfinance institutions.[28]

25. The principles in the Guidelines, that comprise best practices, apply to MFIs, including non-supervised institutions, and all financial institutions with microcredit portfolios, including banks. The main areas addressed are: (i) preconditions for

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[25] Commission of the European Communities, COM(2007) 708 final, "Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions — A European initiative for the development of microcredit in support of growth and employment", 13 November 2007.

[26] The third pillar concerned spreading best practices (including training); the fourth pillar was the provision of additional financial capital for non-bank microcredit institutions.

[27] The Guidelines, published by the Inter-American Development Bank (IDB) and the Association of Supervisors of Banks of the Americas (ASBA), were prepared by a Microfinance Working Group of Banking Supervisors, supported by consultants. The countries represented in the Working Group were Bolivia, Brazil, Colombia, El Salvador, USA (through the Federal Deposit Insurance Corporation), Mexico and Peru. The Guidelines were the result of a two-year process involving Latin America and the Caribbean.

[28] ASBA, "Guidelines of principles for effective regulation and supervision of microfinance operations", 2010, page 9.

effective regulation and supervision of MFIs; (ii) regulation and supervision of MFIs; (iii) regulation of microcredit operations. The Guidelines define microcredit as loans in small amounts granted to small business owners that will be paid back mainly from the cash flow of the business's sale of goods or services.

26. The Guidelines emphasize the need for a stable legal and regulatory framework for microfinance that supports, among others, the collection of debts and certainty in the settlement of guarantees and that includes a mechanism for rapid resolution of minor disputes between clients and MFIs. Policies concerning interest rates, availability of information for all users of microfinance services (and not just those of supervised MFIs), client protection, rights and obligations of microfinance users, product price transparency, and deposit insurance are other preconditions of the system highlighted by the Guidelines.

27. The Guidelines recommend that law or regulations clearly define the responsibilities of financial supervisors concerning MFIs. A legal framework should address licensing of MFIs (and the licensing process of new MFIs should be no less strict than for other financial institutions), and a regulatory framework should incorporate risk management concepts such as credit and operational risk management, strategic risk management, liquidity and market risk. Over-indebtedness limits, anti-money-laundering and counter terrorism financing should be topics for regulations as well. Finally, the Guidelines suggest defining microloans (or microcredit) explicitly in regulations, so that client characteristics and credit methodologies utilized are clearly defined.[29]

III. Legal and regulatory issues in microfinance

28. Presentations and discussions of countries' experiences helped to shed light on some of the crucial issues of the microfinance sector and of the challenges national legislators and regulators have to face. As noted, self-regulation by itself is no longer sufficient and there is an increasing consensus on the need to follow the principles of responsible finance. It was mentioned that consensus-oriented legal instruments discussing the various elements required to establish a favourable legal framework for microfinance would be highly valuable for legislators and policymakers around the world, particularly in developing countries and countries with economies in transition.

Nature and quality of the regulatory environment

29. The quality of the regulatory environment for MFIs was discussed. A challenge identified in several States is regulating the wide range of institutions that provide microfinance services. In India, for instance, several formal and informal entities — overseen by different regulators — currently provide such services, complicating policymaking and supervision. There is now a legislative proposal[30] for the establishment of a "single regulator" to oversee microfinance institutions and various aspects of their activities. In Peru, regulations cover issues such as loan-loss provisioning based on loan status (rather than institution type), on-site inspection

[29] Economist Intelligence Unit, "Global Microscope on the Microfinance Business Environment 2010", page 66.

[30] The Microfinance (Development & Regulation) Bill.

procedures, and stringent requirements for internal controls. The Philippines have a legislative and regulatory framework mostly applicable to those MFIs under the supervision of the central bank (Bangko Sentral ng Pilipinas (BSP)).[31] Microfinance NGOs which cannot accept deposits are not regulated by any government agency.[32]

30. As a result of legislative measures over the past decade, in Brazil there are currently two main microcredit streams with different regulations: (i) not-for-profit institutions, some of them subject to interest rate restrictions, others with unrestricted interest rates; (ii) for-profit institutions with no interest rate restrictions. In Kenya a Microfinance Act was enacted in 2006 with the view to reducing fragmentation in the number and type of institutions (formal, semi-formal and informal) providing microfinance services and improving the formality of operations. The Act addresses deposit-taking microfinance institutions (although some of its parts may be declared applicable to non-deposit taking institutions in the future);[33] some legislation and regulations have been issued to govern aspects of semi-formal institutions, while regulations on licensing and supervising of non-deposit taking financial institutions are under discussion.[34]

Interest rates

31. The extent and impact of the State's intervention, in particular in setting limits on the interest rate chargeable on microfinance loans ("interest rate capping") was identified as an issue of concern. While applied in some jurisdictions, for instance in Colombia, capping is not prescribed in others. France has specific legislation for small and medium enterprises, providing for the abolition of interest rate caps on the loans granted to individual enterprises.[35] It was observed that operating costs in microfinance are relatively high when compared to mainstream commercial and consumer lending (loans are normally in small amounts and for short terms, requiring frequent turnover; and are made to large numbers of borrowers, who are often geographically widely dispersed). For this reason interest rates well above those for commercial and consumer loans are usually required, in order to cover the higher costs of providing microcredit.

Over-indebtedness

32. One emerging all-too-common phenomenon, and concern, was said to be clients' over-indebtedness. This is seen as the result of an over-supply of credit and a too intense competition in the sector, leading to customers' multiple borrowing from different microfinance sources.[36] Microfinance providers, for their part, would

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[31] Particularly relevant for the country's legislative framework is the General Banking Law No. 8791 (enacted in 2000) which attempts to establish a balance between prudential regulations and the need to ensure financial services to micro and small enterprises and poor households. See D. C. Valdemar, R. A. Encinas and M. D. Imperio, Microfinance activity in the Philippines, IDLO MF Working Paper No. 2, October 2007, page 11.

[32] Also see www.cgap.org/p/site/c/template.rc/1.26.13745/.

[33] See www.cgap.org/p/site/c/template.rc/1.9.44949/.

[34] See www.cgap.org/p/site/c/template.rc/1.26.13733/.

[35] Loi no. 2005-882 en faveur des petites et moyannes entreprises.

[36] See also Centre for the Study of Financial Innovation (CSFI), "Microfinance Banana Skins 2011", page 11, available at www.cgap.org/gm/document-1.9.49643/Microfinance_Banana_Skins_2011.pdf.

require processes to monitor/prevent over-indebtedness among their clients. Therefore, adequate legislation and regulation were said to be needed to support the development of, and properly regulate, credit bureaus, which play an important role in providing accurate financial information to lenders to help reduce imprudent lending, thus limiting losses and leading to cheaper credit for all.

33. A regulatory issue also seen as related to the pressure of competition was said to be the growing number of loan defaults, as the loan repayment incentives become weaker due to the high number of institutions offering services in the microfinance market.[37]

Use of collateral

34. The increased use of collateral, resulting in abusive collection practices by some MFIs (in the absence of an appropriate legislative framework), was noted as critical for regulation. In this regard it was mentioned that in one Indian State restrictions have been imposed on the operations of MFIs in the recovery of their loans by prohibiting the use of any security in microfinance lending.[38]

35. The phenomenon of abusive collection practices points to the need for borrowers of secured microloans to be aware of the consequences of potential default before entering into a transaction. Issues for consideration might also include limiting the use of collateral to those assets having some economic value in the marketplace;[39] and tailoring the law for microfinance loans in order to reduce costs and time.[40]

Foreign exchange risk and international capital markets

36. A need for legal and regulatory standards was identified in the area of foreign exchange risk, which can arise when an MFI borrows lending capital abroad in foreign currency, exposing it to the possibility of a loss or gain from variations in the exchange rates between the currency of the loan to the MFI and the local currency in which the MFI operates. This matter requires consideration in order to avoid the potential of large losses on the part of MFIs. While some authorities already prohibit currency mismatches in the portfolios of financial institutions, many countries do not possess an adequate legal framework to address such complex microfinance cross-border funding.

37. As noted, international capital markets are becoming the main source of funding for many MFIs. This is particularly true for those MFIs which are not allowed to take deposits and which are estimated to be the majority. In many countries compliance with the regulations applying to deposit-taking institutions is

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[37] Ibid., page 28.

[38] Andhra Pradesh Ordinance 7, available at www.cgap.org/gm/document-1.9.48097/Andhra-MFI-Ordinance.pdf, provides: "No MFI shall seek any security from a borrower by way of pawn, pledge or other security for the loan. Provided that any such security obtained from a borrower before the commencement of this Ordinance shall forthwith stand released in favour of the borrower."

[39] See also the OAS Model Inter-American Law on Secured Transactions.

[40] For instance permitting the description of encumbered microfinance asset in a manner that reasonably allows their identification to facilitate the transaction (see Recommendation 14(d) of the UNCITRAL Legislative Guide on Secured Transactions).

costly and complex and it is also difficult for microfinance institutions to turn themselves into deposit-taking institutions. Therefore, it would seem unlikely that in the future increased funding for MFIs will come from deposits.[41] Furthermore, it is not to be expected that commercial banks in developing countries and other institutional players would generate significant funds for microfinance as they are often averse to lending to MFIs or legally constrained from significant investment in microfinance.[42] A major source for leveraging funds of the required magnitude is thus the international capital market.[43] Collateralized debt obligations (CDO),[44] and securitizations of microloans have been among the instruments used to access international funds.[45] However, many countries do not have sophisticated legal frameworks for such complex transactions.[46]

Microfinance Institution Rating Agencies

38. Microfinance Institution Rating Agencies (MIRAs) have also emerged in some jurisdictions (for example there are now four in the Philippines) and their regulation may need to be taken account of in relevant legislation. The Bangko Sentral ng Pilipinas (BSP), for instance, has recently issued a circular on the recognition and de-recognition of such rating agencies.[47]

Remittances

39. A transnational financial service identified as crucial to the poor — and in particular, immigrants — was facilitation of the quick and inexpensive sending and receipt of remittances. Large numbers of low-income individuals work outside of their home countries and often use the services of international funds transfer businesses. Increasingly, MFIs are participating in the remittance market through their branch network as remittance payment points for money transfer operators. It may be appropriate to examine whether microfinance institutions can be licensed to handle international remittances of funds on a wider basis than is currently the case, so that they can provide this important service to clients.

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[41] B. Swanson, "The Role of International Capital Markets in Microfinance", 2007, page 2, available at www.dwmarkets.com/media/pdf-international-capital-markets.pdf.

[42] Ibid.

[43] Ibid., the author suggests that more than $200 billion should be raised to satisfy the potential demand.

[44] Collateralized debt obligations offer a range of asset-backed securities with different risk and return profiles to investors. They are primarily funded by private institutional investors and are characterized by high average investment size, long-term maturity of MFI debts and concentration in large MFIs. See Consultative Group to Assist the Poor (CGAP), Microfinance Investors adjust Strategy in Tougher Market Conditions, October 2010, page 4, available at www.cgap.org/gm/document-1.9.47946/MIVBrief.pdf.

[45] B. Swanson, "The Role of International Capital Markets in Microfinance", 2007, page 3.

[46] See for instance S. L. Schwarcz, "Disintermediating Avarice: An Inquiry Into Commercially Sustainable Microfinance", pages 29-32; IFC, "Pakistan: microfinance and financial sector diagnostic study — final report", April 2008, page 28, available at www.ifc.org/ifcext/mifa.nsf/AttachmentsByTitle/Pakistan_Diagnostic_Studies_20090428.pdf/$FILE/Pakistan_Diagnostic_Studies_20090428.pdf ("Microfinance banks find it difficult to raise secured financing because they cannot pledge their loan portfolios or assets, and are therefore left with unsecured and expensive financing options.").

[47] Circular No. 685, enacted in 2010, available at www.cgap.org/p/site/c/template.rc/1.9.44803/.

Electronic money

40. The increasing use of mobile technology in financial services, a mode of branchless banking, was widely discussed. Particular attention was drawn to new regulatory issues and the gaps that are brought with it and that require standard-setting at the international level. Participants noted the rapid evolution of the sector and its potential to ensure financial inclusion. According to figures provided at the Colloquium, about 364 million low-income, unbanked people could be using mobile financial services in 2012; this means that the number of people without a bank account but with a mobile phone is estimated to grow from 1 to 1.7 billion in the same period (i.e. about 70 per cent of the unbanked population worldwide).[48] Mobile payment users have also been predicted to exceed 190 million in 2012[49] and transactions and money transfers via mobile devices will likely generate transactions worth more than $600 billion globally by 2013.[50]

41. Two models of mobile payment,[51] i.e. a bank based model and a non-bank based model, were presented at the Colloquium. An example of a bank based model is "Smart Money" in the Philippines, a partnership between a bank and a wireless service provider.[52] Partner banks in the network have a responsibility to ensure that "Smart Money" complies with anti-money-laundering and consumer protection regulations.

42. An example of a non-bank based model is the Philippines' GCASH. In this model a mobile network operator (MNO) issues GCASH as a form of pre-funding to its GCASH intermediaries, who transfer GCASH to the clients via mobile technology platforms or individually authorized agents.[53] Another example of a non-banking model is Kenya's MPesa,[54] which is based on a system of low-value accounts held by a MNO and accessible from the MNO's subscribers' mobile phones through SIM cards. Originally a domestic e-money system, more recently MPesa (partnering with selected agents in the United Kingdom) has started a service of international money transfers, active between the United Kingdom and Kenya, where funds are sent directly to the receiver's phone. The need for an international legal regime regarding such transfers was flagged as an item for attention.

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[48] See Consultative Group to Assist the Poor (CGAP), "Mobile Banking: From Concept to Reality (June 25 2009)", available at www.cgap.org/p/site/c/template.rc/1.26.10806/.

[49] See Gartner newsroom available at www.gartner.com/it/page.jsp?id=995812.

[50] http://juniperresearch.com/viewpressrelease.php?pr=106.

[51] Mobile payment has been defined as financial transactions undertaken using mobile devices such as mobile phones; mobile banking includes mobile payments but also involves access by mobile devices to the broader range of banking services.

[52] Through this partnership banks can issue e-money, i.e. "Smart Money", and use a mobile technology platform and distribution outlets as delivery channels, in addition to branches and an automatic teller machine (ATM) network.

[53] In order to use the GCASH system, clients first need to register by sending SMS (i.e. short message service), after which they convert (i.e. cash in) actual cash to electronic money through an accredited intermediary. Once clients have cashed in, they can use electronic money to pay bills and transfer funds by means of an SMS. If clients receive electronic money they can convert it into actual cash.

[54] MPesa, launched by a MNO, is used, inter alia, for bill payments, group salary payments, and school fee payments.

43. Unresolved legal issues surrounding the nature of e-money, as noted in the discussion, include whether e-money should be treated as savings, with the associated consideration of paying interest on those funds; whether "issuers" of e-money are engaged in banking and thus subject to banking regulation; and whether such funds should be covered by deposit insurance schemes to reduce risk. While some countries, like the Philippines, have issued regulations to govern the use of e-money applying to both bank led and non-bank led mobile services providers, in other countries providers and users of mobile financial services operate in an undefined regulatory space.[55] More generally, it was pointed out that at present there is no guidance as to the "gray zone" between pure payments, stored value instruments and deposits, thus presenting another potential area for setting of standards.

44. As noted, lack of common standards for developing an enabling legal environment in the context of mobile financial services has led to different regulatory approaches being adopted at country level, resulting in inconsistent operating environments for account providers and, in some cases, limitations on the services that can be provided.[56] At its forty-third session, in 2010, the Commission agreed that communication via mobile devices could be regarded as a subset of electronic communications as dealt with in the relevant legislative standards adopted by UNCITRAL. According to the Commission, the predictability of the legal status of transactions conducted with mobile devices would be greatly enhanced by the adoption of appropriate legislative standards. This is particularly relevant in the case of developing countries, where the broader use of mobile devices could make a significant contribution to widening access to electronic means of communication. The Commission noted that payment services are an area of special importance for mobile technology and that mobile payments could support financial inclusion, especially in rural areas.[57]

Agent Banking

45. Another aspect of branchless banking advocated as a means to make financial services more accessible to the poor as well as to increase the range and lower the cost of services offered, particularly in remote rural areas, was agent banking. This

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[55] For instance in Kenya there was no specific regulation on non-bank companies offering mobile financial services existing at the time of the Colloquium. The National Payment System Department of the Central bank of Kenya (CBK) was providing oversight to MPesa and other microfinance service providers (MFSPs), focusing on the integrity of information technology and the service delivery systems, with the aim of protecting customers from operational failures and financial failure of the providers. At the time of this report the CBK announced two sets of draft regulations on electronic retail transfers and on electronic money issuers which are intended inter alia to: facilitate the delivery of retail transfers and the provision of electronic payment services; govern e-money issuing; and define appropriate protection for clients of e-money issuers. See //www.centralbank.go.ke/downloads/speeches/2011/Launch%20of%20 Draft%20Electronic%20Payment%20Regulations.pdf.

[56] See USAID, Kenya School of Monetary Studies and Booz Allen Hamilton, "Mobile Financial Services Risk Matrix", July 2010, available at http://bizclir.com/galleries/publications/Mobile%20Financial%20Services%20Risk%20Matrix%20July%202010.pdf.

[57] *Official Records of the General Assembly, Sixty-fifth Session, Supplement No. 17* (A/65/17), para. 249.

implies the use of agents who are widely dispersed throughout the country and can provide services at the local level. Agent banking involves consideration of whether banks should be permitted to employ non-bank retail agents to open accounts, accept deposits and carry out other banking business with clients (a practice on which some States have embarked, although at present most States do not allow banks to employ agents for such purposes). In Brazil there is a wide network of banking agents (also referred to as correspondents).[58] The Central Bank of Brazil has authorized financial and non-financial institutions to recruit such agents in order to facilitate account opening, bank transfers, and disbursement of loans. In Colombia, the Banca de las Oportunidades has promoted the establishment of non-bank agents[59] as a low cost distribution channel for financial services (in order to facilitate microfinance clients' access to bank services, transactions and payments closer to their location). Reference was made to the recent guidance of the Basel Committee on Banking Supervision according to which the use of new delivery channels requires tailored operational risk standards that do not curb innovative models while ensuring safety and soundness of institutions and customer funds. Aligning standards with industry trends requires supervisory personnel to develop a deep understanding of how new business models function and design specific tools and procedures to identify signs of increased operational risk in microfinance operations.[60]

Client protection and financial literacy

46. Credit to micro-entrepreneurs is different from consumer credit and has specific requirements.[61] A recurring theme was the need for measures to ensure client protection, including the prevention of unscrupulous practices and the building of financial literacy in the community generally. The practice of "bundling" financial services (for example requiring clients to take — and pay for — other financial products, such as insurance, when they are taking out a loan) can entail clients becoming involved in commitments and costs they don't fully understand. There was said to be a need to curtail other negative practices, such as over-collateralisation of loans, including forcing borrowers to deposit with the lender a percentage of the loan they obtain. More generally the need for transparency (e.g. interest rate disclosure, complaint procedures) in the microfinance sector was flagged. It was noted that according to a recent survey a very large number of economies do not have legal provisions restricting unfair and high-pressure selling practices and abusive collection practices (see also para. 44).[62]

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[58] See Resolution 3.110 of 31 July 2003 and Resolution 3.156 of 17 December 2003.

[59] See: Decree 2233 of July 2006; External Circular 26 of 2006 of the Financial Superintendence, Decree No. 3965 of November 10 of 2006; Decree 086 of January 17 of 2008; External Circular 053 of November 2009 of the Financial Superintendence.

[60] Basel Committee on Banking Supervision, "Microfinance activities and the Core Principles for Effective Banking Supervision", page 23.

[61] Association of Supervisors of Banks of the Americas, "Guidelines of principles for effective regulation and supervision of microfinance operations", para. 2.4.1, page 28.

[62] Consultative Group to Assist the Poor (CGAP)/World Bank, "Financial Access 2010", page 2. The Report found that in 118 out of 142 economies responding to the survey, some form of financial consumer protection legislation was in place. However only half of the economies had legal provisions restricting unfair and high-pressure selling practices and abusive collection practices.

Examples of countries with a system of client protection were mentioned. Peru has an extensive regulatory and supervisory framework for financial client protection, emphasizing transparency and fair treatment. Financial institutions are free to set interest rates, charges and fees, but abusive terms and conditions, and sales and marketing practices, are regulated. There is a similar focus on financial client protection in the Philippines, again emphasizing transparency of transactions, fair lending practices and the establishment of mechanisms to provide clients with avenues for redress. In Kenya national legislation is under consideration which would establish tribunals where complaints against credit providers could be addressed. Overall it was noted that potential clients need to be informed in a transparent manner about interest rates and the true cost of borrowing, the nature and cost of the other financial products they are being offered, and their rights at the time when loan repayments are being enforced.

47. Due to high levels of illiteracy among microfinance clients, it was felt that financial institutions that serve them should be held to higher standards of accountability (than commercial banks), and States should consider integrating financial literacy into their development agendas. The example of South Africa was mentioned: pursuant to its National Credit Act (2006), debt counselling courses for the over-indebted have been implemented.

Alternative Dispute resolution

48. An important aspect of client protection was said to be the need for clients to have access to a fair, rapid, transparent and inexpensive process for the resolution of disputes (including legal advice where necessary) arising from microfinance transactions, whether regarding repayment of loans or other matters. Traditional court processes were generally felt to be inappropriate for this, being too lengthy and expensive. Furthermore, micro borrowers were said to often lack knowledge of their rights and how to protect them, as a contract with a microfinance provider was often the first formal agreement they had ever entered into. The example was offered of an initiative launched in Peru, where the use of alternative dispute resolution methods is being promoted. Difficulty in accessing the formal justice system due to high costs as well as geographic, linguistic and cultural barriers, poses a particular challenge to both microfinance providers and clients in the country. High rates of delinquency, coupled with the impossibility of effective recovery through judicial means, serve as a barrier to the lowering of interest rates and thus to wider access to credit. A project to promote the use of arbitration to resolve conflicts between microfinance providers and their clients has thus been developed in one of the regions of the country. The project, a collaboration of a local Chamber of Commerce and leading microfinance institutions, aims to facilitate access to justice, contain transaction costs and institutionalise the use of arbitration for low value cases.

49. A transparent regulatory framework for microfinance users would thus require regulators to ensure both recourse mechanisms under the financial institution's internal procedures and dispute resolution through a third-party dispute resolution mechanism (e.g. ombudsman, mediation etc.).[63]

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[63] Ibid., page 31.

Secured financing

50. As micro-enterprises grow and acquire assets, the possibilities made available by secured financing become of increasing importance to their progress as small and medium enterprises (SMEs). However, SMEs and micro-enterprises have little of the property often required as collateral in low/middle income countries in order to obtain credit. They do have, however, an array of productive assets that could easily be harnessed to serve as collateral. It is only the domestic legislation that often prevents firms from using these assets to secure loans.[64] A reform of the legal framework for secured transactions that allows the use of movable property and fixtures would thus support their access to credit. Loans secured by collateral generally have more favourable terms than unsecured loans, for any given borrower or size of loan.

51. The World Bank has noted that although MFIs rely on substitutes for collateral (e.g. peer pressure, access to repeat loans, collection mechanisms), the reform of collateral laws may bring a greater benefit to them than to conventional banks, in particular if legislation allows the use of moveable property and fixtures as collateral.[65] "In some countries that have undertaken secured transaction reform the initial uptake in using the system for registering security interests was bigger among microfinance institutions than among commercial banks."[66]

52. Developing a regulatory framework that ensures transparency in secured lending in microfinance should recognize that most economies have only basic legal and regulatory frameworks[67] for financial client protection. In addition to issues already mentioned in previous paragraphs (see for instance paras. 34 and 47), those systems usually do not consider protection against deceptive advertisement, breach of client confidentiality, transparency[68] in information on prices, terms, and conditions of financial products and services.

IV. Concluding remarks

53. Although there have been initiatives, often successful, in a number of States to address some of the issues identified at the Colloquium, it was highlighted that there is no coherent set of global legal and regulatory measures that can serve as a standard for States wishing to legislate in accordance with international best practice. As noted by some participants, many States are now struggling to find an appropriate regulatory framework to promote financial inclusion through microfinance institutions. The global and regional standards referred to earlier in this paper may provide useful guidance to the Commission in this regard.

54. UNCITRAL legislative texts were mentioned as instrumental in strengthening a legislative and regulatory framework that could accommodate the needs of the

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[64] Available at http://elibrary.worldbank.org/content/book/9780821364901.

[65] H. Fleisig, M. Safavian, N. de la Peña, "Reforming Collateral Laws to Expand Access to Finance", World Bank, 2006, page 20, available at http://elibrary.worldbank.org/content/book/9780821364901.

[66] Ibid.

[67] Consultative Group to Assist the Poor (CGAP)/World Bank, "Financial Access 2010", pages 24-26.

[68] See also Centre for Study of Financial Innovation, "Microfinance Banana Skins 2011", page 11.

microfinance industry. Subjects indicated included cross-border funding; secured transactions in microfinance, in order to enhance the availability of credit in particular to SMEs or clients that do not have sufficient capital or access to other kinds of credit; use of e-money; and dispute resolution mechanisms to address microfinance users' complaints. The Commission may wish to consider the appropriateness and relevance of UNCITRAL standards in those areas.

55. Mindful that some key microfinance legal and regulatory issues are being addressed by other organizations (for instance, prudential regulation, as discussed in the Basel Core Principles); and that any work undertaken by UNCITRAL should avoid duplication of effort in this field, the Commission may wish to consider whether further work in the area of microfinance should be carried out.

56. Conceiving a favourable legal and regulatory framework for microfinance raises various issues for consideration, a number of which have been referred to in the foregoing paper. The Commission may wish to consider further work in relation to the following matters:

(a) The nature and quality of the regulatory environment, including which institutions are regulated, by which regulator(s), and whether regulation should be according to activity type (e.g. microcredit) or according to the type of entity regulated;

(b) The appropriateness of setting limits on interest rates chargeable on microfinance loans;

(c) Measures to address the problem of over-indebtedness;

(d) The establishment and regulation of credit bureaus;

(e) Over-collateralisation and use of collateral with no economic value;

(f) Abusive collection practices;

(g) Foreign exchange risk where MFIs obtain loan capital from abroad;

(h) Facilitating the handling of international remittances of funds by microfinance institutions on a cheaper and more efficient basis;

(i) Electronic money, including its status as savings; whether "issuers" of e-money are engaged in banking and hence what type of regulation they are subject to; and the coverage of such funds by deposit insurance schemes;

(j) Enhancing predictability of the legal status of transactions conducted with mobile devices (for example in the area of payment services);

(k) Facilitating the use of agent banking and other forms of branchless banking as a means to make financial services more accessible;

(l) Measures to promote financial literacy and increase protection of clients against abusive or unscrupulous lending practices;

(m) Provision for fair, rapid, transparent and inexpensive processes for the resolution of disputes arising from microfinance transactions;

(n) Facilitating the use of, and ensuring transparency in, secured lending, in particular to micro-enterprises and SMEs.