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Microfinance in the context of international economic development

Note by the Secretariat

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* This document is submitted later than the required ten weeks prior to the start of the meeting because of the need to complete consultations.

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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. The Commission may wish to recall that, by the Resolution 53/197 of 15 December 1998, the General Assembly has recognized the importance of scaling up microcredit and microfinance services. In 2005, the United Nations launched the International Year of Microcredit ("UN International Year"). Its overarching goal was to "secure a global commitment to develop inclusive financial sectors in which all people have access to the financial services they need to make the best possible use of their human potential". Specifically, an emphasis was placed on three goals. First, the UN International Year focused on increasing awareness of microfinance and the conditions in which it can develop. Second, it aimed at improving data availability on microcredit and filling the information gaps about who has access to financial services, their costs, the impacts on people's lives and eventually the reasons why access to them was limited. The third major concern was to secure the commitment of governments, namely to ensure that their fiscal, macroeconomic, regulatory and supervisory policies encouraged microfinance activities. Improvements to legal and regulatory frameworks were considered necessary for the attainment of these goals and for better governance of microfinance. Subsequently, the Advisors Group to the UN International Year expressly recommended that governments, assisted by the relevant multilateral organizations, urgently review their regulations to ensure that they encourage prudent and sound provision of financial services to poor people.[3]

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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] Statement of the Advisory Group to the United Nations Year of Microcredit, United Nations Forum to Build Inclusive Financial Sectors, United Nations Headquarters, New York, 8 November 2005.

3. While the UN International Year was vital in promoting microcredit, it was agreed that the international community's commitment should go beyond the 2005 UN International Year in order to produce long-term results. The following year, the United Nations published "Building Inclusive Financial Sectors for Development"[4] (widely known as the "Blue Book") with the aim of offering a vision of what financial inclusion could be. The Blue Book discussed policy options for the consideration of microfinance stakeholders at country level, though it expressly did not make specific recommendations. It noted that financial services in most developing countries were only available to a minority of the population, and that many potential clients among the poor, including small enterprises, were excluded from access to formal financial services such as loans, bank accounts, funds transfers and insurance. Financial inclusion aimed to remedy this inequality and could contribute to reaching the United Nations Millennium Development Goals such as halving the proportion of people in the world who live in extreme poverty by 2015.

4. By its Resolution 63/229 of 10 March 2009, the General Assembly invited "Member States to consider adopting policies to facilitate the expansion of microcredit and microfinance institutions in order to service the large unmet demand among poor people for financial services, including the identification and development of mechanisms to promote access to sustainable financial services, the removal of institutional and regulatory obstacles, the promotion of financial literacy and the provision of incentives to microfinance institutions that meet national standards for delivering sound financial services to the poor".

5. This note seeks to examine and provide an overview of the issues relating to the regulatory and legal framework of microfinance. In its preparation, the Secretariat has referred to research resources of the following bodies: the Basel Committee on Banking Supervision; Consultative Group to Assist the Poor (CGAP), an independent policy and research centre housed at the World Bank; the G-20 Financial Inclusion Experts Group/Access through Innovation Sub-Group; the Inter-American Development Bank (IDB); Alliance for Financial Inclusion (AFI); the International Development Law Organization (IDLO), the African Development Bank, the Asian development Bank and the International Monetary Fund (IMF).

II. Definitions and trends

A. Definitions

1. Defining aspects of microfinance

6. Microfinance was founded on the idea that the use of appropriate financial services, in particular savings and credit, could transform the lives of unserved people and create pathways out of poverty.[5] Muhammad Yunus, widely regarded as the originator of microfinance, considered that two-thirds of the world's population

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[4] United Nations publication, "Building Inclusive Financial Sectors for Development", May 2006, Sales No. E.06.IIA.3.

[5] Consultative Group to Assist the Poor (CGAP) and Department for International Development (DFID), "Scenarios for Branchless Banking in 2020", Focus Note, No. 57, October 2009, p. 25.

did not have access to financial services from the conventional financial institutions, and that exclusion of poor people from financial services was, in his words "tantamount to financial apartheid".[6]

7. A recent study observed that there is no internationally accepted definition of microfinance, but posited what would seem to be a useful working definition, namely "the provision of diverse financial services in limited amounts to lower income households and small, informal businesses in both urban and rural areas".[7] As outlined in a consultative document of the Basel Committee on Banking Supervision, microfinance can be broadly viewed as "a business line that can be carried out by a wide range of institutions providing a range of financial services, such as lending, deposit taking, insurance, payments and funds transfers".[8] Microentrepreneurs seek a variety of financial services — such as checking and savings accounts, drafts, transfers, international payments and remittances. Their most pressing need has to do with access to short- and medium-term loans to finance their productive and commercial activities.[9] Also, having a safe place to put savings is a very important aspect as it offers the chance to accumulate capital without necessarily becoming indebted. Operating costs in microfinance are relatively high when compared to mainstream commercial and consumer lending. Interest rates are therefore usually well above those for commercial and consumer loans, in order to cover the higher costs of this type of banking.

8. Loans are normally in small amounts and for short terms, requiring frequent turnover. They are made to large numbers of borrowers, who are often geographically widely dispersed. The decision to lend is generally not based on availability of collateral (of which borrowers have little or none) or a history of creditworthiness, but rather on the personal circumstances of the borrower and the perceived ability to repay. Loan administration costs are therefore significant, since the lending methodology requires numerous on-site visits by loan officers to assess clients and assist them in preparing the documentation, and later to closely monitor repayment of the resulting large portfolio of small loans.

9. The microfinance lending methodology requires strict enforcement of on-time repayment, both because the absence of realizable collateral raises the risks of default, and in order to discourage "contagion" effects, whereby a perceived non-pursuit of repayment by the microfinance institution ("MFI") could lead other borrowers to renege on their payments in the belief that the MFI will not be in a position to grant further loans in the future. This is important as the borrowers' main incentive for on-time repayment is the prospect of further loans in future, perhaps for greater amounts and/or on more favourable terms.

10. Another common feature of microfinance is group borrowing: "some MFIs use lending methodologies based on groups of borrowers who guarantee each other's

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[6] "Proceedings of the Euro-Mediterranean Conference on Microcredit", 2005, p. 122.

[7] Bank for International Settlements, Basel Committee on Banking Supervision. "Microfinance activities and the Core Principles for Effective Banking Supervision", February 2010, pp. 31-32.

[8] Ibid., p. 32.

[9] Inter-American Development Bank, "Principles and Practices for Regulating and Supervising Microfinance", 2004, p. 15.

loans" (sometimes known as "solidarity groups" or "village banking").[10] The Basel Committee observed, in its report on microfinance activities, that in group lending, "peer pressure also helps to ensure high repayment levels, as the default of one group member could adversely affect the availability of credit to others".[11]

11. Microfinance activities may be subject to either prudential or non-prudential regulations, and it may be helpful to define those terms.

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.[12]

13. 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, consumer protection, disclosure of interest rates, fraud and financial crimes prevention and credit information services.[13]

2. Persons served by microfinance

14. The poor who lack access to formal financial services are vast in number: estimates range between 2.5 and 4 billion people.[14] Research in this area is still incomplete and, despite recent efforts to measure financial inclusion, there do not seem to be consistent datasets that can provide an indication of how this proportion has evolved in recent years.[15]

15. However, there has been exponential growth worldwide in the number of persons served by, and entities offering, microfinance services. Microfinance institutions were "by some measures serving close to 100 million active loan customers at the end of 2008".[16] While the overall amount loaned by MFIs is still a small proportion of the total of funds loaned in the developing world, there is

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[10] Inter-American Development Bank, "Principles and Practices for Regulating and Supervising Microfinance", 2004, p. 26.

[11] Bank for International Settlements, Basel Committee on Banking Supervision, "Microfinance activities and the Core Principles for Effective Banking Supervision", February 2010, p. 11.

[12] United Nations publication, "Building Inclusive Financial Sectors for Development", May 2006, Sales No. E.06.IIA.3, p. 120.

[13] Ibid.

[14] These indications can be found in G-20 Financial Inclusion Experts Group: Access through Innovation Sub-Group, "Draft work plan for discussion", p. 2; Consultative Group to Assist the Poor and Department for International Development, "Scenarios for Branchless Banking in 2020", Focus Note, No. 57, October 2009, p. 3.

[15] See for instance, Consultative Group to Assist the Poor (CGAP) and Department for International Development (DFID), "Scenarios for Branchless Banking in 2020", Focus Note, No. 57, October 2009, p. 3.

[16] These indications can be found in "Proceedings of the Euro-Mediterranean Conference on Microcredit", 2005, p. 125.

evidence to suggest that in many countries the number of loans granted by, and customers served by, MFIs exceeds that of banks.[17]

3. Microfinance institutions (MFIs)

16. International governmental organizations such as the United Nations Development Programme (UNDP) or the United Nations Capital Development Fund (UNCDF) are involved in microfinance activities and in providing support to MFIs. It may be noted that there is a range of institutions which offer microfinance services. These include entities whose sole purpose is microfinance; banks and finance companies offering microfinance services as part of their larger business; and credit unions and cooperatives. The services which they can offer largely depend on their size, their organizational form, the laws and regulations governing them, and their sources of capital.

17. "A significant proportion of […] MFIs in developing countries operate either as non-governmental organizations ("NGOs") or as projects of international NGOs."[18] These are by and large non-profit bodies set up with the objective of providing financial services to the poor. However, there are limits to the services such entities can offer. Not being banks, they normally are not permitted to accept deposits from the public, which can restrict the loan capital available to them. These entities may have different legal forms, for example: association, foundation, not-for-profit corporation, company limited by guarantee, public benefit company. "Such entities cannot distribute profits, are not state-owned, and have voluntary membership."[19] A major trend in microfinance has been the move by many such NGOs to "transform" themselves into profit-making bodies, including becoming regulated financial institutions. These transformations normally have two main objectives: "(i) to provide clients with a range of financial services beyond credit, including savings and transfer services, and (ii) to increase access to capital, whether through commercial borrowings (which still remain inaccessible for many NGO MFIs), deposits, raising equity, or all three."[20] (see below, paras. 18 to 24).

B. Some trends in the evolution of microfinance

1. Transformation

18. Traditional lenders are banks. They are able to access the deposits of account-holders to provide capital for their lending operations. However, in most countries, non-bank entities are barred from accepting deposits from the public. Most MFIs are not licensed as banks. Reasons for this include size and capitalization requirements for banks, stricter governance standards and a higher degree of regulation, and the level of management expertise required. All these factors are seen as necessary to protect the savings of citizens and the integrity of the financial system in general.

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[17] Bank for International Settlements, Basel Committee on Banking Supervision, "Microfinance activities and the Core Principles for Effective Banking Supervision", February 2010, p. 9.

[18] Consultative Group to Assist the Poor (CGAP), "Transforming NGO MFIs: Critical Ownership Issues to Consider", Occasional Paper, No. 13, June 2008, p. 17.

[19] Ibid., p. 3.

[20] Ibid., p. 1.

19. NGO MFIs that provide microcredit must either borrow their capital in the commercial markets or rely on funding from donors, which limits their ability to grow. For this reason many have transformed, or are seeking to transform, into licensed and regulated deposit-taking financial institutions in the jurisdictions where they operate. A leading review of this subject has identified some 84 such transformations in 35 countries in the period 1992-2007.[21] Transformation presents several legal and regulatory issues.

20. The nature of each transformation will depend heavily on local law and practice. A number of questions can arise, which may or may not have been contemplated by regulators in the jurisdiction where the transformation is occurring, such as whether the originating NGO can be the sole owner of the new entity or whether it must have outside investors. Concerns here include the capacity of the owners to provide the capital necessary for the MFI to thrive, as well the experience and competence of NGO management, and employees to run a deposit-taking financial institution.

21. There may be legal limits on the percentage of ownership by an individual or entity in the transformed MFI, or restrictions on foreign ownership of financial institutions (many NGOs are based, and funded from donors and financial institutions, outside the countries where they operate).

22. Concerns raised in relation to the transformation process relate to determination of the fair market value of the entity for acquisition purposes, given that there is little in the way of accepted method for valuation of MFIs.[22]

23. Governance of the transformed MFI, including the size and composition of its board of directors, may be an issue for local law. A transformation can create "particularly serious conflict-of-interest issues if the NGO principals who are negotiating the price of the NGO's assets stand to gain personally from the transformation".[23] Concerns have also been raised about "mission drift", i.e. whether the long-term mission of a transformed MFI will be diverted from helping the poor to maximizing profit for the owners.[24]

24. Against these concerns must be set the fact that transformations may offer benefits in the form of enhanced client services and better access to capital, thus increasing the funds available for lending. Here, the effect of outside owners can be beneficial, in bringing "… financial expertise, important connections to providers of capital, and the potential to contribute to effective governance".[25]

2. Branchless banking

25. In order to reach greater numbers of the poor who do not have access to banks, particularly in remote areas, as well as to increase the range and lower the cost of services offered, microfinance service providers in many countries are moving to

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[21] Consultative Group to Assist the Poor (CGAP), "Transforming NGO MFIs: Critical Ownership Issues to Consider", Occasional Paper, No. 13, June 2008.

[22] Consultative Group to Assist the Poor (CGAP), "Transforming NGO MFIs: Critical Ownership Issues to Consider", Occasional Paper, No. 13, June 2008, pp. 6-12.

[23] Ibid., p. 13.

[24] Ibid., pp. 15-16.

[25] Ibid., pp. 6.

branchless banking. This development includes offering payment and other banking services through the use of mobile phones, and the use of agents who are widely dispersed throughout the country and can provide services at the local level.

26. Branchless banking could be defined as the delivery of financial services outside conventional bank branches using information and communications technologies and non-bank retail agents, for example, over card-based networks or with mobile phones.[26] As noted in the G-20 draft workplan, it is said to have “the potential to radically reduce the cost of delivery and increase convenience for customers. Branchless banking can increase poor people’s access to financial services” including “transfers, payments, credit, savings, and insurance”.[27]

27. A recent scenario-building project by the Consultative Group to Assist the Poor (CGAP) and the Department for International Development (DFID) examined the role of government and the private sector in advancing the use of branchless banking over the coming decade.[28] One conclusion was that, although some reports may indicate otherwise, “branchless banking for the poor is at an early stage of development”.[29] Legislators and regulators will need to confront a number of issues in this area. Regulatory framework, which is enabling can encourage the expansion of branchless banking. Governments may consider mandating financial institutions to provide basic bank accounts to low-income individuals. They may allow, or prevent, the use of agents by banks: most countries do not allow banks to employ agents for opening of accounts or conducting other business, a situation which — if unchanged — would mean that “branchless banking that relies on agents cannot take off at all”.[30]

28. The government itself may be in a position to stimulate and provide content to the market for branchless services by making use of branchless channels to deliver payments to citizens under its various social programmes. Overall, the project concluded, “governments have several tools at hand to promote wider and broader usage of branchless channels for financial services”.[31]

29. E-money (also known as e-currency, electronic cash, digital money) refers to value which is exchanged only electronically. Typically, this involves the use of computer networks, the Internet and digital stored value systems. To use the mobile payment service, clients may convert actual money to electronic money or may receive electronic money as a loan. Clients then use the electronic money in participating merchant partners or make domestic or international P2P (person-to-person) transactions.

30. Some observers have indicated that mobile payments systems may aid accessibility as clients can be spared the cost of travel to a bank, dealing instead with nearby accredited intermediaries or making remote transactions, and that lower

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[26] Consultative Group to Assist the Poor (CGAP) and Department for International Development (DFID), “Scenarios for Branchless Banking in 2020”, Focus Note, No. 57, October 2009, note 1.

[27] G-20 Financial Inclusion Experts Group: Access through Innovation Sub-Group, “Draft work plan for discussion”, p. 2.

[28] Consultative Group to Assist the Poor (CGAP) and Department for International Development (DFID), “Scenarios for Branchless Banking in 2020”, Focus Note, No. 57, October 2009.

[29] Ibid., p. 1.

[30] Ibid., p. 13.

[31] Ibid., p. 24.

income MFI clients are given access to a system suited to the making of small payments. Mobile devices are relatively easy to use and do not demand high levels of education or literacy. From the point of view of providers of mobile payment services, mobile payment provides additional value to clients while expanding the provider's service distribution channels at a low cost. Among the numerous examples of the use of e-money in developing countries are those in the Philippines[32] and Kenya.[33]

3. Involvement of commercial banks

31. It may be noted that commercial banks have also entered the microfinance sector over the past ten years, mainly for reasons of diversification of activities, profitability and the prospect of rapid growth of the sector. The involvement of commercial banks is seen as important in terms of increasing the impact microfinance can have on global poverty, given that privately owned commercial banks dominate the financial markets in most countries. Commercial banks have potential competitive advantages in a number of areas vis-à-vis other players in the sector, including their existing infrastructure and systems, and of course access to capital.

32. Cases of pre-existing, privately owned commercial banks starting microfinance operations are still relatively few. Although there are success stories — examples include Hatton National Commercial Bank in Sri Lanka, and a number of private banks in India through a programme started by the National Bank of Agriculture and Rural Development (NABARD) — many of the commercial banks that have tried to develop microfinance activities have faced considerable problems, and have not achieved the needed levels of outreach. Nonetheless, this situation seems to be evolving. Many commercial banks in developing countries are beginning to examine the microfinance market. Although the initial resources for loans frequently came from donor-funded credit programmes, commercial banks began to draw on their own deposit sources for a growing share of their total funds for micro-loans.[34]

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[32] The Philippines' GCASH is a non-bank model which allows transactions with parties in other networks: as of August 2005, it has over 1.2 million subscribers and is accepted at thousands of retail partners and intermediaries in the Philippines and abroad, (Globe Telecom, "The Mobile Phone Revolution: Opportunities to Scale up Microfinance" presented at the World Bank and CGAP Conference on "Microfinance in South Asia, Today and Tomorrow, in 2005).

[33] M-PESA is a mobile telephone banking service in use in Kenya since 2007, with over 4.5 million active customers and served by 4,230 agents throughout the country as of 2008 (Alliance for Financial Inclusion (AFI), "Enabling mobile money transfer: The Central Bank of Kenya's treatment of M-Pesa", Case Study, February 2010, p. 1). For updated diagnostics on Kenya, the Philippines and other jurisdictions, see http://www.cgap.org/p/site/c/template.rc/1/11/1772/.

[34] Consultative Group to Assist the Poor (CGAP), Focus note No. 26, Commercial Banks and Microfinance: Evolving Models of Success.

III. Issues in legislating and regulating in the area of microfinance

A. General remarks

33. Countries around the world have adopted different approaches to microfinance. For instance, the principal objective of the Microfinance Act (2006) of Kenya is to provide the legal, regulatory and supervisory framework for the entire microfinance industry both deposit-taking and non-deposit taking MFIs. This Act enables deposit-taking microfinance institutions licensed by the Central Bank of Kenya to mobilize savings from the general public. Under a different approach, Peru has built a legal and regulatory framework for consumer protection in the financial industry. The General Law of the Financial and Insurance Systems, last modified in 2008, established the rules and regulations for all banks and financial institutions and seeks to protect public interest by ensuring the stability and solvency of the firms that form the financial system of Peru. Peru's most comprehensive effort to protect its financial services clients is the 2005 addition to the Consumer Protection Law for Financial Service Clients.

34. The Commission may wish to note that the UNCITRAL Legislative Guide on Secured Transactions covers secured financing transactions irrespective of the amount of the loan provided or of the asset offered as security. As a result, it provides a modern legal framework that can facilitate a wide range of transactions, including micro-finance transactions.

35. A number of bodies[35] have considered the legal and regulatory issues surrounding microfinance. While it is clear — as the United Nations Publication "Building Inclusive Financial Sectors for Development"[36] has indicated — that the situation of each country is different and must be approached on its own terms, there would appear to be broad consensus on a range of such issues that policymakers need to address when legislating on microfinance, and in many cases as to what the preferred approaches or solutions might be in particular circumstances. A number of these considerations are outlined below.

B. Legal issues surrounding microfinance

1. Regulatory and supervisory aspects of microfinance activities

36. Consideration may be given to the question of the impact of the State's intervention in regulating certain aspects of microfinance — such as the forgiveness of loans and capping of interest rates — and its impact on microfinance development.[37] In this regard, it may be useful to consider whether regulatory

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[35] These include Consultative Group to Assist the Poor (CGAP), Basel Committee, Inter-American Development Bank; Information in this section comes from the Inter-American Development Bank, the CGAP Consensus Guidelines, and the Basel Report.

[36] United Nations publication, "Building Inclusive Financial Sectors for Development", May 2006, Sales No. E.06.IIA.3.

[37] See, for instance, Inter-American Development Bank, "Principles and Practices for Regulating and Supervising Microfinance", 2004, p. 16.

impact assessments could be helpful to countries in determining the extent to which laws and regulations that have been passed are having their intended effect of promoting financial inclusion.

37. Microfinance activities have, as highlighted in the preceding sections of this note, unique features, and consideration may be given as how to best identify those features to ensure effective regulation and supervision of that activity.

38. The issue of how best to apportion scarce supervisory resources should also be addressed, since effective supervision is crucial to a properly-functioning microfinance sector.

39. Consideration may also be given to recommending a tiered approach to regulation, which could be helpful in making the most efficient use of supervisory resources. A tiered approach to financial regulation may be appropriate, wherein the level and intensity of regulation can vary with the microfinance institution, taking into account the products and services it offers, the markets it serves, and hence the level of risk it presents.[38]

40. Credit bureaus — which collect and serve as a means of exchange of information on client financial histories — perform a crucial function as sources of information to microfinance lenders on creditworthiness of their potential clients, and can prove helpful to clients in building up a credit history that will assist them in securing future loans.[39] Enabling their development should be considered. Meanwhile, credit information sharing by agreement among MFIs in a given jurisdiction appears to be a growing phenomenon, particularly where formal credit bureaus may not exist or may be too expensive to establish.

41. Prevention of crime through the financial system is an important goal of non-prudential regulation. In the area of anti-money-laundering and countering the financing of terrorism (AML/CFT), international norms and national rules requiring financial institutions to “know their customers” could be difficult to implement at a reasonable cost among the poor and often widely dispersed clientele of microfinance; this may suggest a less stringent compliance standard for MFIs.

2. Protection of the borrower

42. As a matter of principle, it may be considered that the poor who are excluded from access to financial services should be guaranteed the basic right of access to deposit accounts.

43. Loan application requirements should be as simple and straightforward as possible, and loan documentation processes should not be overly formal (e.g. notarized signature requirements) as this would exclude many poor and uneducated clients and drive up loan administration costs.

44. In many countries, consumer protection legislation that is specific to financial services is not well developed. Amongst other requirements, borrowers need to be

[38] United Nations publication, “Building Inclusive Financial Sectors for Development”, May 2006, Sales No. E.06.IIA.3, pp. 127-8.

[39] Bank for International Settlements, Basel Committee on Banking Supervision, “Microfinance activities and the Core Principles for Effective Banking Supervision”, February 2010, p. 31.

provided with basic information to help them avoid multiple borrowing and the risk of over indebtedness.[40]

3. Regulation of MFIs

45. As discussed below in the section on transformation (see below, para. 57), the various aspects of facilitating and regulating the transformation of NGOs to incorporated and regulated MFIs should be given consideration.

46. The primary role of prudential regulation is to "protect the depositors and the integrity of the financial and payments systems".[41] Such regulation may only be necessary for those MFIs that take deposits from the public. Therefore, it should be considered whether only incorporated, shareholder-owned MFIs and cooperatives should be allowed to accept deposits. Non-deposit taking entities might be dealt with by encouraging "self-regulation or external oversight by creditors and donors".[42]

47. Capital adequacy requirements for MFIs should be adjusted according to the size and level of risk posed by the enterprise, so as to be neither so high as to impede the business nor so low that they fail to take due account of risk. In the case of credit unions and cooperatives, the shares of members may need to be regarded as capital of the entity only if there are limits on the withdrawal of such shares.

48. Foreign exchange risk can arise when an MFI borrows lending capital abroad in foreign currency. The risk is "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". Complex mechanisms for hedging such risks are available in developed countries, but are often inaccessible or too expensive for use by financial institutions in the developing world. Therefore this area may require consideration in order to avoid the potential of large losses on the part of MFIs in their jurisdiction. Some authorities have already gone so far as to prohibit "currency mismatches" in the portfolios of financial institutions.[43]

49. Tax treatment of microfinance lenders can also have an important effect on their viability. In some countries, banks and other formal financial institutions are granted favourable tax treatment, such as lower taxes on their earnings and the right to deduct loan loss provisions, advantages which may not be available to MFIs. There may be a need to consider whether to use tax laws to help level the playing field in the financial services industry, so as not to disadvantage those who lend primarily to the poor.[44]

50. To reach the sector of the public most in need of services, consideration should be given whether to allow banks and deposit-taking MFIs to employ agents to open accounts, which is an exception to normal banking practice. Similarly, large numbers of people work outside of their home countries and often use the services

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[40] Inter-American Development Bank, "Principles and Practices for Regulating and Supervising Microfinance", 2004, p. 16.

[41] Ibid., p. 62.

[42] Ibid., p. 22.

[43] United Nations publication, "Building Inclusive Financial Sectors for Development", May 2006, Sales No. E.06.IIA.3, p. 88.

[44] Ibid., pp. 113-114.

of international funds transfer businesses. It may be appropriate to examine whether licenses to handle international remittances of funds may be granted to MFIs on a wider basis than is currently the case, so that they can provide this important service to clients.

51. NGO managers, staff and board members who retain their association with a transformed MFI will require the appropriate knowledge and skills to operate such a financial institution.[45]

52. To ensure the long-term growth and viability of the sector, governments will need to consider how best to facilitate the involvement of private strategic investors in MFIs.[46]

4. Conditions of the loan

53. There is a common understanding that interest rates and their method of calculation must be clearly explained to borrowers and rates should not be subject to unilateral change[47] and there may be a need to consider remedies when practice differs.

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.

55. Consideration could be given to establishing a standard method of calculating the effective rate of interest, and making it public so that borrowers can have full disclosure and make comparison among providers.

56. Simplified customer due diligence (including in such matters as AML/CFT) incorporating a risk-based approach, may be appropriate for low value accounts.[48]

5. Transformation of NGOs

57. Among the legal and regulatory issues which demand the attention of legislators regarding transformations of NGOs (see above, paras. 18-24), the following could be noted:

– whether the loan portfolio of the NGO is transferable to the new financial institution in return for shares therein; if so, whether the loan portfolio

[45] Inter-American Development Bank, "Principles and Practices for Regulating and Supervising Microfinance", 2004, p. 58.

[46] Bank for International Settlements, Basel Committee on Banking Supervision, "Microfinance activities and the Core Principles for Effective Banking Supervision", February 2010, p. 32, United Nations publication, "Building Inclusive Financial Sectors for Development", May 2006, Sales No. E.06.IIA.3, p. 120.

[47] Inter-American Development Bank, "Principles and Practices for Regulating and Supervising Microfinance", 2004, p. 32.

[48] Bank for International Settlements, Basel Committee on Banking Supervision, "Microfinance activities and the Core Principles for Effective Banking Supervision", February 2010, p. 33.

qualifies as regulatory capital, essentially the net worth of the entity according to local bank regulatory standards;[49]

– whether those associated with the former NGO (management, employees, board members, etc.) are granted shares in the new entity (or are given a discounted price by the NGO), and that may be problematic because it involves a non-profit organization giving assets to private individuals;

– whether grant funds, which likely were given on the understanding that they were destined for a non-profit institution and to aid the poor, can continue to be used in the business when the result may be a benefit conferred upon private owners in the form of profit. This issue may turn on whether the shares of the transformed institution were sold at fair market value.

6. E-banking

58. Issues here include the concern that the services offered by mobile network operators (MNOs) involve them in the banking/financial sector without necessarily subjecting them to the same regulation as other players. Also, AML/CFT standards require compliance with "know-your-customer" rules, which may be more difficult to apply in the case of clients of mobile services. "[T]he ability of banks to intermediate deposits is almost universally denied to e-money issuers for example, denying them the credit margin."[50] Legal issues surrounding issuance by non-banks of e-money accounts, "electronic wallets" and the making of person-to-person transactions using a mobile phone may need consideration.[51]

7. Dispute settlement mechanism

59. The use of legal action in the courts to recover delinquent loans is often costly and time-consuming, particularly in relation to the amount of the indebtedness; other means to settle disputes, including alternative dispute resolution, could be considered.[52]

IV. Concluding remarks

60. The Blue Book[53] makes clear that there is a wide variety of circumstances and experience across different countries as regards financial inclusion. No one solution will be applicable to all and responses must be tailored to fit national realities, while drawing on the experience of other countries.

61. The Second United Nations Decade for the Eradication of Poverty (2008-2017), proclaimed by the General Assembly in December 2007, aims at

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[49] For a full definition of regulatory capital, see Basel Committee on Banking Supervision, (***).

[50] Ibid., p. 14.

[51] Ibid., p. 19. For additional consideration on that matter, see document A/CN.9/692, *Present and possible future work on electronic commerce*, paras. 67-74 on the use of mobile devices in electronic commerce.

[52] Inter-American Development Bank, "Principles and Practices for Regulating and Supervising Microfinance", 2004, p. 42.

[53] United Nations publication, "Building Inclusive Financial Sectors for Development", May 2006, Sales No. E.06.IIA.3.

supporting a broad framework for poverty reduction through international cooperation for development.

62. Microfinance is a poverty-alleviation tool that has proven to have a transformative effect on the lives of the poor. Access to credit and other financial services is a driving force of economic development and poverty reduction. Nevertheless, it remains the case that financial services worldwide are available only to a small percentage of the population.

63. The weighing of costs and benefits in the regulation of microfinance institutions is a difficult task for legislators and requires analysis and policy choices regarding the complex issues outlined above. Yet, the benefits of creating a stable microfinance industry may well prove worth the attendant costs, to the extent that microfinance has the potential to raise the standard of living, promote more widespread education, and help alleviate poverty. 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 legislation.

64. This paper has sought to identify characteristics of and challenges for microfinance that permeate systems worldwide, including the pressing need to provide financial services to small businesses. Issues are thus highlighted for microfinance legislation and regulation which may be common to all States, and on which further guidance may be needed. A reference document by the Commission setting out the issues and offering guidance could prove a useful tool for governments as they consider how to proceed in the regulation of this important activity.

65. It is necessary to acknowledge the considerable amount of research and analytical work and technical assistance that has been done in this field, together with ongoing initiatives, and the need to avoid duplication of effort. The Commission may wish to consider that any work contemplated by UNCITRAL in the area of microfinance should be undertaken in close cooperation with the key international bodies active in the field, including those set out in paragraph 5 of the introduction to this paper. The Commission may wish to consider whether an expert group meeting should be convened to further explore — with the assistance of specialists in the subject — how the legal and regulatory issues surrounding microfinance should be addressed at an international level.