

The Protection of the Borrower in the Microfinance Environment

I. Introduction

In the Microfinance environment attention is normally paid to the lenders, investors and governments. However, not much attention is paid to the borrowers. Sometimes, they are just seen as the source of income for the Microfinance Institutions (hereinafter “MFIs”) and in some cases they are just exploited by institutions whose only purpose is to make money.

In this document we will analyze the purpose of the microfinance and its real meaning. We will see that microfinance has two purposes which are intimately united. So united, that if we forget one of those purposes, the microfinance jeopardizes.

We will mainly study the rights of the consumers in the microfinance environment. We will analyze how those rights should be implemented and how consumers should be protected in the aggressive world of microfinance.

Finally, we will notice that the regulators hand should not be disregarded. Regulators hand is necessary to promote competence, to protect the basic borrowers’ rights and ultimately to protect the financial system.

II. Concept and Purpose of Microfinance

Microfinance means the provision of banking services to lower-income people, especially the poor and the very poor.¹ The institutions providing those services are the MFIs. In this paper, we will understand the word “consumers” or “clients” not just as the microentrepreneurs seeking to finance their business, but the whole range of poor clients who also use financial services to manage emergencies, acquire household assets, improve their homes, smooth consumption, and fund social obligations.

All MFIs should have two purposes: (i) profitability; and (ii) positive social impact. As we will see trough this paper both purposes are linked, and if one of them is absent the success of the MFI is at risk.

In the microfinance environment, profitability means the ability of the MIF to be financially sustainable. That is, the ability to make a profit after costs, overheads or expenses.

The social impact that a MFI should have is translated into the provision of loans to poor families and individuals to help them engage in productive activities for the development of their society. The microfinance services enable poor people to start their own business, generate or sustain an income and often begin to build up wealth and exit poverty. In summary, the microfinance has been recognized as an important tool for the foundation of a new economic middle-class. Evidence of understanding and commitment to institutional mission should be present at all levels of staff and in all aspect of the MFIs work. Fulfillment social mission of the MFI should be evaluated regularly².

¹ Peck Robert, Lyman Timothy, Rosenberg Richard “Microfinance Consensus Guidelines”, July 2003.

² Accion In Sight, “Guidelines to Evaluate Social Performance”, Number 24, November 2007.

On one hand, the profitability allows the MFIs to roll back poverty in certain areas or regions. Without profitability the MFIs do not fulfill the four basic conditions necessary to alleviate poverty. Those conditions are: scale (when there are so much people surviving on \$2 dollars or less, reaching a few thousand is like aspirin in the face of a raging cancer), permanence (an assurance that the intervention will be present not only for today's poor but for the children and their children's children), continuous efficacy (the ability of the intervention to become better and better through time), and continuous efficiency (the capability of the intervention to become cheaper and cheaper with each passing day).³ On the other hand, without a positive social impact, the consumers or clients of the MIFs would be unable to repay the loans and the MIFs would be severely affected, especially in the long term and in those areas where no social impact was pursued as a purpose.

III. Borrowers' Rights in the Microfinance Environment

As in any other contract, both parties, the one who provides the product or the services and the one who receives the product or the services have rights and obligations. MFIs shall have the right to promote and offer their services, to decide the appropriate clients to lend them money, to charge interest rates over the amount lent, to request collateral, to collect principal and interests, among others. However, MFIs have also obligations which sometimes are translated into their clients' rights. If those obligations would not exist, then the contract would be unfair, inequitable and most probably invalid.

Some people classify the borrowers' rights or the MFIs' obligations as non-prudential regulatory issues. This classification seems to be as relative as the phrase "it all depends on the color of the glass you are looking through". These rights might not be prudent for some opportunist institutions but they are prudent for the institutions practicing real microfinance and more importantly, they are prudent regulatory issues for the consumers.

The most important rights of the borrowers in the microfinance environment are the following:

III.1 Truth in lending practices

Truth-in-lending practices means to provide borrowers with accurate, comparable and transparent information about the cost of loans.⁴

This borrowers' right requires from the MFIs to disclose their fees, commissions and effective interest rates to loan applicants, so that they can evaluate the loan cost. It is important to mention that quantity of information is no substitute for quality of information.

As we know, in any jurisdiction for a contract to be valid is necessary to have an offering and an acceptance. When there is not truth in lending practice there is not a real acceptance from the client. Therefore, it is important for the MFIs to disclose all

³ Chu Michael, "Profit and Poverty: Why It Matters", Forbes, December 20, 2007.

⁴ See http://www.microfinancegateway.org/resource_centers/reg_sup/consumer_protection

necessary information about the products and services offered, so that the customers can have a real and total acceptance of the services or products contracted.

III.2 Education

Sometimes the truth in lending practices is not enough if the borrowers do not even understand what they are asking for. Since most of the MFIs clients have received few opportunities in life, the majority of them are poorly educated; many of them are even illiterate. It is necessary to explain to each client the real cost of the loan in plain language, without complications and without thousands of documents. MFIs should understand that teaching clients about the products and services offered and teaching them how to calculate their loan repayment capacity would benefit both, the clients and the MIFs by reducing one of the biggest risks for the MFIs, the credit risk. For MFIs, improved ability of clients to manage debt can help keep repayment rates up and delinquency rates down.

The costs of the loan or the payment capacity are not the only issue which shall be discussed with the clients of the MFIs. As we already mentioned, MFIs have also a social dimension; they should also be able to discuss with their clients, the advantages and the possible return that a loan might have for them. It is important to explain to their customers why sometimes access to money is more important than the price of cost of such money. MFIs should be promoters of microentrepreneurs in the areas or regions where they offer services and products. MFIs should give advice and teach their clients how to invest or manage the money; so that the clients can benefit from the income they produce achieving a better wellbeing for them and for their families.

According to the above, MFIs should give financial education at two levels. The first level is the development of financial literacy teaching material and guides to train trainers and financial educators who will deliver financial education. The second level is financial literacy materials and guides for use by trainers to deliver financial education to different groups of people and at both the group and individual levels. These should incorporate adult learning techniques and include training modules and guides for group-based training complemented by workbooks, interactive games, stories, and exercises that focus on building individual financial literacy skills.⁵

III.3 Protection against abusive lending

One of the myths that some MIFs have mentioned is that microlending cannot be done sustainably unless the borrowers pay interest rates that are substantially higher than the rates banks charge to their traditional borrowers.

The truth is that, normally the MIFs have very low delinquency rates (an efficient MIF may achieve rates less than 1%) and their loan charges cover by far the cost of funds, the loan losses and the administrative costs, as we will see below. Also, in comparison to the commercial banks, most MFIs do not have minimum capital requirements, do not offer online banking services, do not have big buildings and fancy offices, offer less salaries to management and officers, are not subject to regular supervision and the

⁵ Jennefer Sebstad and Monique Cohen, "Financial Education for the Poor", Microfinance Opportunities, April 2003.

process for lending is much less formal. At the end we can realize that the loan costs in MIFs may be much lesser than the loan costs for commercial banks.

When we talk about abusive lending, distinction between high interest rates and usury should be made. The capping of interest rates has been long discussed in the microfinance environment and the majority of the conclusions have been that interest rate caps may limit the financial services to the poor. However, borrowers' should be protected from abusive lending practices, in particular from usury.

III. 3.1 A quick analysis of some called "MIFs" regarding lending practices.

Due to the conditions of the Mexican market, it is interesting to analyze some institutions in such market that charge high interest rates despite the fact that inflation in Mexico is very low⁶. One of those institutions is Banco Azteca⁷ which is classified for some people as a microfinance institution because provides financial services to the poor people. On the website of Banco Azteca⁸ we can see that for a personal loan of \$2,000 pesos they may charge an annual cost (interest rates plus banks' fees and commissions) up to 308.75%. Another not less remarkable institution is Banco Compartamos which, according to its website, may charge an annual cost up to 141.54% for a \$5000 pesos personal loan.⁹

Analyzing the financial statements of Banco Compartamos for the 2008 year¹⁰, we can realize that only 1.7% of the loans were not paid within 30 days following the payment date. This shows the low delinquency rate that a MFI can achieve.

In the financial statements of Banco Compartamos, we can further note that it had an income of 3,238 millions of pesos due to interests and fees charged to its clients and 1,776 millions of pesos of expenses (including administration and management expenses). The above means that the income (mainly due to interest rates charged to its clients) perceived by Banco Compartamos is 182% superior to the cost of the loans.

The foregoing analysis shows two main issues regarding the Mexican market: (i) the called "MIFs" are more profitable than commercial banks; and (ii) it is more expensive for a commercial bank to finance a loan than for a "MIF".

The questions in these particular cases are: What are the fair costs of a loan? Are these institutions providing microfinance services? Can we describe the loan costs as usury? Should the abuse of these institutions be limited by the corresponding authorities?

III.4 Proper collection practices

Collection practices are those techniques utilized by the MFIs to recover the amount of money lent to their customers. The borrowers have the obligation to pay punctually to the MIFs the amount of money lent by the corresponding MFIs plus the commissions

⁶ The inflation rate in Mexico in 2007 was 3.76% and in 2008 was 6.53%.

⁷ Banco Azteca is a financial institution authorized to operate as a bank in Mexico.

⁸ See http://www.bancoazteca.com.mx/PortalBancoAzteca/publica/credito/prestamos/docs/simulador_ppersonales.xls

⁹ See <http://www.compartamos.com>

¹⁰ Available on the website <http://www.compartamos.com>.

and fees previously agreed. However, MIFs do not have the right to use abusive collection practices such as inappropriate coercion, humiliation, physical force, contact at inappropriate hours of the day, seizure of assets that are basic to the client's daily survival, among others, in order to collect the money lent to their customers.

One of the most common improper collection practices is over-indebtedness. The MFI should not refinance or disburse a new loan to the borrower when he is unable to pay. This kind of practice inevitably will worsen the situation for the borrower and the MFI.

Collateral is an important issue regarding collection practices in the microfinance environment. In developed economies or developed consumers, the use of collateral guarantees the repayment of a loan, because if the loan is not repaid, the lender can seize the collateral. Nevertheless, limited wealth, limited property rights and poorly functioning legal systems are factors that complicate the granting of collateral in the microfinance environment. Therefore, MFI normally enforce the repayment of the loans through psychological pressure.

Psychological pressure regularly means social sanction for the MFIs' clients. Some acceptable practices for the collection of the loans are the guarantee granted by a third party (the client does not want the MFI to bother the guarantor) or the denial of future credit (the client wants the opportunity of borrowing more money in the future).

If MFIs want to mitigate payment risk, collection shall be seen as an important service that helps to both maintain clients and free up money for lending again. It shall be understood as a strategic process to generate good habits and a payment culture among clients. It should also be seen as a business activity whose primary objective is to generate returns for the institution, converting losses into income.¹¹

To maintain a healthy balance between consumer protection and collections, the MFI must develop a culture of professional service and respect for the clients. This includes selecting staff with the right profile, offering regular training opportunities, and implementing clearly defined processes backed by accurate information and information systems.¹²

IV. Protection of the borrowers' rights

As we have seen throughout this paper, the protection to the consumers of microfinance services and products shall come principally from the MFIs, but also from the regulators. Governments and authorities have an important role to play in implementing the policies and strategies necessary for the protection of the borrowers. They should understand that in order to protect the soundness of the financial system, they should protect the borrowers first.

One of the first issues that regulators should address is competence. Government and authorities should facilitate the entry of financial institutions into microfinance; they should establish the appropriate laws and institutions to facilitate new entry of MIFs and to challenge entrenched monopolies. Competence brings big benefits for MIFs and for its clients. Among those benefits, we can mention: improvement of efficiency, lower

¹¹ Accion In Sight, "Best Practices in Collection Strategies", Number 26, November 2008.

¹² Idem.

costs of loans, production of new and better products for clients, better management, more appreciation for the client, exit of poor performers, lower interest rates, reduction of prices and increase of range and quality of products, better customer service, among others. On the other hand, as some people say, no competition creates incompetence.

In overseeing the MFIs, regulators shall comprehend that MFIs are not commercial banks. Regulators will not be able to monitor MFIs effectively unless their staff is trained and to some extent specialized due to the differing risk, characteristics and portfolios compared to any other financial institution.

Government and authorities shall require MFIs to disclose relevant information to the consumer and not just more information. In regulating the MFIs, regulators shall demand truth in lending practices, so that there can be a real market and real competence among MFIs.

Education needs to be understood by regulators as one of the main obligations of the MFIs. Regulation and supervision is necessary to enforce education. The aim of the regulators should be to require MFIs to teach basic skills related to earning, spending, budgeting, saving, borrowing, and investing money. Constant examination and a test system should be implemented by each government to assess the education aim of each MFI.

Regulators must understand the concept of usury as the charging of unreasonable high rates of interest to consumers. Although usury is normally regulated as a criminal offense in several countries, the concept is normally forgotten or not enforceable by regulators and authorities. Thus, usury should be regulated not only by the criminal laws but by the financial laws and regulations. Penalizations such as fines, revocation of licenses, social work, investment in the community, among others, are necessary for those institutions that practice usury.

Authorities shall oversee the collection practices of the MFIs. They must penalize improper collection practices by the MFIs. They must supervise the service granted by each MFIs along with the respect for the MFIs' clients.