

FocusNote

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PROTECTING MICROFINANCE BORROWERS



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CGAP, the Consultative Group to Assist the Poor, is a consortium of 29 development agencies that support microfinance. More information is available on the CGAP web site: www.cgap.org.

Around the world, the microfinance community is paying more attention to consumer protection. Controversial topics, such as high interest rates and the over-indebtedness of borrowers, have raised public concern for poor consumers in countries far and wide, from Bolivia to Bangladesh to South Africa and beyond. Yet relatively little is known about how consumer protection might apply to financial services for the poor.

The very success of microfinance in demonstrating that poor people can and do repay loans has encouraged commercial lenders to enter some markets, and more commercialization is expected in the future. Increasing commercialization has heightened awareness of consumer issues. While greater competition is likely to expand access to financial services to more and more people, it may also open the market to lenders who are less concerned with socially-responsible lending principles than are specialized microfinance institutions (MFIs). As a consequence, vulnerable borrowers are being more exposed to potentially abusive lenders. This is attracting the attention of regulators and politicians.

Moral arguments for consumer protection in microfinance focus on the imbalance of power between lenders and borrowers. Individuals who are functionally illiterate, first-time consumers, or different in language or ethnicity from the staff of financial institutions are particularly vulnerable. Even middle-income, relatively educated borrowers may be insufficiently informed about their rights and can be pressured into making poor borrowing decisions.

In addition to the moral arguments, there may also be strategic reasons for promoting or supporting consumer protection. A number of countries have imposed or are considering imposing interest rate ceilings in the name of protecting clients.¹ Unfortunately these ceilings end up hurting the poorest and most vulnerable customers by shrinking their access to credit. Enhanced consumer protection measures can be a more constructive alternative to new or lowered interest rate ceilings. Lenders and policy makers alike may prefer this alternative if it avoids undermining the viability of the sector as a whole with artificially imposed rate ceilings.

¹ For more information on the impact of interest rate ceilings on poor borrowers, see Brigit Helms and Xavier Reille, *Interest Rate Ceilings and Microfinance: The Story So Far*, CGAP Occasional Paper, no. 9 (Washington, DC: CGAP 2004).



Most developing countries do not have the elaborate legal or regulatory frameworks for consumer protection found in developed countries. Thus the growing interest in applying consumer protection to microfinance has little grounding in concrete experience. The purpose of this note is to shed some light on what is known so far and raise some issues for the debate moving forward. The note defines and discusses the elements that make up consumer protection. It assesses the two primary approaches to enforcement of such measures—voluntary codes and state regulation—in the context of developing countries.

What Is Consumer Protection?

Consumer protection encompasses all the means necessary to safeguard the interests of consumers (in the case of microcredit, usually poor borrowers in developing countries) and empower them to

know their rights and make wise, educated decisions. The main categories of consumer protection measures are disclosure requirements, lender practice prohibitions and requirements, mechanisms for handling complaints and disputes, and consumer education.

These measures may be applied in different ways throughout the lending cycle. (See examples in box 1.)

Disclosure Requirements

The basis for all consumer protection measures is adequate disclosure of lending terms and conditions. Disclosure, or “truth-in-lending,” laws exist in many countries. They typically require that lenders clearly state interest rates and loan terms in contracts and other publicly accessible documents, as these examples show:

- In Central Africa, the 2002 microfinance law requires MFIs to disclose annual percentage

Box 1 Consumer Protection across the Lending Cycle		
Stage in Cycle	Risk(s) of Lending Abuse	Examples of Protective Measures
Before sale	<p>Incorrect or misleading advertising (e.g., of interest rates on loans)</p> <p>Inappropriate sales techniques (e.g., hard selling through home visitation)</p> <p>Kickback requests</p>	<p>Require that all fees be declared and interest rates stated in a standardized format</p> <p>Prohibit certain types of marketing</p> <p>Monitor lending behavior to eliminate kickbacks</p>
At time of sale	<p>Inappropriate contract wording</p> <p>Reckless lending (e.g., without due reference to the borrower's ability to repay)</p> <p>Unfair discrimination in lending decision</p> <p>Penalties imposed for loan cancellation within a few days of the sale</p>	<p>Require (or prefer) standardized contracts with full disclosure of costs and other terms</p> <p>Set laws that criminalize reckless lending</p> <p>Require that reasons be given for rejection</p> <p>Require a mandatory “cooling-off” period during which the borrower can cancel the loan without penalty</p>
After sale	<p>Inaccurate recording of borrower payments</p> <p>Illegal payment collection methods</p> <p>Actions against a borrower who has no legal recourse or defense</p> <p>Abusive behavior in the collection process</p> <p>Sharing of borrower information with another entity</p>	<p>Require lenders to provide regular statements of account</p> <p>Require lenders to follow legal process for collections</p> <p>Implement dispute-resolution procedures outside of court</p> <p>Prohibit certain collection practices</p> <p>Require borrower's signature before sharing information with another entity</p>

rates (APRs) by publishing them in loan contracts and posting them on the premises. A clear and precise formula for APR calculation is determined by the Central Bank governor, by decree. Bank supervisors have already fined several MFIs for breaching this truth-in-lending provision.²

- In 2000, Panama's superintendency of banks issued a resolution that requires banks to provide customers with the effective interest rate and the nature of the product, along with other information.³
- The European Commission has proposed a 2005 draft directive for consumer credit in EU countries that will affect microfinance in the new member countries of Eastern Europe. The directive includes substantial disclosure requirements (e.g., all credit agreements must include the total cost of the loan expressed as an APR, and all creditors must use the same formula for calculating APR).⁴
- In the United States, lenders are required to display a "Schumer Box" (named after the US senator who shepherded the related bill through Congress), in all credit agreements which presents all required disclosures (e.g., terms and rates) in table format. Including this box is a statutory requirement in the United States under the Truth in Lending Act.⁵

Disclosure offers a level of consumer protection because comparable and widely available information on true loan costs allows borrowers to comparison shop for loans. It might also have the effect of stimulating pricing competition that could bring their costs and interest rates down, benefiting consumers over time. Also, in countries that have credit bureaus, certain disclosure requirements might allow customers access to their credit records at any time and/or restrict lenders' ability to disclose information about borrower performance to other entities.

Lender Practice Prohibitions and Requirements

Norms, rules, and laws related to lending practice prohibit and restrict certain types of undesirable behavior. They may apply to any stage of the borrowing cycle, but tend to focus on origination and collection of overdue loans. These tend to be the stages where consumers are most vulnerable. Rules may seek to limit the pressure that lending agents can apply on potential borrowers to take a loan. For collections, protective measures may define which techniques are considered inappropriate or coercive. These measures may go even farther and declare these techniques illegal and give consumers the right to redress if they are victims of such techniques.

In developed countries, regulator concerns about predatory lending practices have grown in recent years. Predatory lending includes a broad range of lending behavior, e.g., unnecessarily consolidating debts at a higher rate or charging inappropriate fees. The effect is to leave the consumer with an unsustainable or unnecessary debt burden. To counter this practice, rules may define maximum acceptable debt burdens relative to borrower's income, and charge lenders that breach such rules with predation. For these rules to be enforceable, a central credit registry is required, where all lenders register new loans so

² Interview with Henry Madrenes, technical assistant to the Central Bank of the Central African States (BEAC), April 2004.

³ Superintendencia de Bancos, Republica de Panama, General Resolution No. 3-2000, www.superbancos.gob.pa.

⁴ Julie Robie, "EU Consumer Protection Laws Requiring MFI Compliance" (internal memorandum, April 1, 2004). Also, see the original "Consumer Credit Directive" [official title: "Council Directive 87/102/EEC of 22 December 1986 for the Approximation of the Laws, Regulations, and Administrative Provisions of the Member States Concerning Consumer Credit"] (Brussels, Belgium: European Commission, December 22, 1986), europa.eu.int/comm/consumers/cons_int/fin_serv/cons_directive/index_en.htm.

⁵ For more information, see Comptroller of the Currency, Administrator of National Banks, *Truth in Lending Act: Comptrollers Handbook* (Washington, DC: US Department of the Treasury, December 1996), www.occ.treas.gov/handbook/til.pdf.

that prospective lenders could determine a consumer's exposure.

Simpler approaches include giving borrowers the right to cancel loan agreements without penalty during a defined period immediately after signing a contract (known as a "cooling-off" period) and allowing early repayment of loans with limited or no penalty. Yet another strategy will soon be employed in South Africa. The draft Consumer Credit Bill in South Africa, due to become law in 2005, requires that lenders take "reasonable steps" to establish a borrower's ability to repay before granting a loan.⁶ It also empowers the credit regulator to publish guidelines for assessing potential borrowers' capacity for debt.

An especially controversial aspect of lender practices has to do with pricing. An important goal of consumer protection is to protect consumers from exorbitant fees and interest rates. Some governments try to control this risk through usury laws that set interest rate ceilings.⁷ However, defining what constitutes usury is often difficult.

The ACCIÓN International–Micro Finance Network (MFN) Pro-Consumer Pledge (box 2) takes a voluntary, rather than imposed, approach to protecting consumers from exorbitant interest rates. It includes a clear commitment to "fair rates ... [that] will not provide excessive profits, but will ensure that the business can survive and grow to reach more people." By comparison, MicroFinance South Africa (the commercial microfinance lenders' association in South Africa) addresses the issue in broader terms in its Code of Conduct for members: "The Association subscribes to the view that free-market forces should determine interest rates. Members should therefore charge interest rates which are market related. Where called upon to do so, the Association may at its sole discretion issue an opinion as to what constitutes an interest rate that is excessive in terms of market forces."⁸

Determining what is fair and what is excessive is difficult, particularly as local conditions differ

and market conditions change. Countries with liberalized interest rates rely on the combination of interest rate disclosure and lender competition to promote fair rates over time.

Mechanisms for Handling Complaints and Disputes

Individual lenders may employ staff that specializes in handling customer complaints, and industry bodies may establish ombuds offices or other agents to resolve issues that consumers cannot solve directly with member institutions. This kind of complaint-driven enforcement is a rather inexpensive way to enforce rules, but many cases and patterns of abuse go unreported or unnoticed. In South Africa, the Micro Finance Regulatory Council (MFRC) has set up a toll-free call center to connect consumers with complaints officers who investigate complaints and alleged abuses.⁹ For lenders found to be in violation of MFRC rules, disciplinary action ranges from sanctions to expulsion from the Council (which is tantamount to shutting down a microlending business). The South African credit law also provides consumers with relatively quick, low-cost access to the legal system through special consumer courts.¹⁰

Consumer Education

Promoting consumer education is usually considered a vital strategy of consumer protection. Consumer vulnerability is most often characterized by an inability to make informed choices and exercise contractual or statutory rights. To be effective, consumer protection measures, such as disclosure requirements, lender practice rules, and complaint

⁶ "Consumer Credit Bill," *Government Gazette* 26678 (August 17, 2004), www.dti.gov.za/ccrdlawreview/consumercredit/gaz26678.pdf.

⁷ See Helms and Reille, *Interest Rate Ceilings and Microfinance*, for a full description of this issue.

⁸ MicroFinance South Africa, *Code of Conduct* (Lynnwoodrif, South Africa: MFSA, 2004), www.mla.org.za/code_of_conduct.php.

⁹ The Micro Finance Regulatory Council web site is www.mfrc.co.za.

¹⁰ For example, South Africa's draft Consumer Credit Bill.

mechanisms, require consumers to be educated about products and rights. Educated consumers are not only less susceptible to lender abuse in the first place, but they are also better able to seek solutions and compensation if they have been mistreated. Consumer education teaches borrowers how to acquire the right information at different stages of the lending cycle so they can make wise borrowing choices.

Consumer education should be distinguished from the pre-marketing stage in the sale of a product or service. For example, with housing finance, consumer education would not start with the different types of home loans on offer. The starting point should be the tenure options—from rental to ownership—and then the range of financial instruments (including savings) available to support each option.

Consumer education on lending (including microcredit) aims to promote financial literacy as “the ability to make informed decisions and take appropriate actions on matters affecting one’s financial health and well-being.”¹¹ It includes basic financial management skills, such as household budgeting, as well as specific concepts, such as understanding interest rates and inflation. These topics are successfully taught in high schools in some countries and also can be taught in adult education programs. Most consumer education programs are offered in specific localities by non-governmental organizations (NGOs) and financed by philanthropic foundations. For example, the Citigroup Foundation is stepping up its activity in this area by funding NGOs around the world with close to US \$10 million annually.¹²

Consumer education has not received much attention in the microfinance community to date. A recent working paper from the Financial Literacy Project concluded that “there are very few examples of efforts to build financial literacy skills among microfinance clients or other groups of clients targeted by these programs.”¹³ These conclusions stemmed from research on three con-

tinents, which focused on the broad themes of money management, debt management, savings management, financial negotiations, and use of bank services. The examples in developing countries are few; the Financial Literacy Project working paper highlights only three programs: the Self Employed Women’s Association (SEWA) Bank in India, World Education in Nepal, and the Food and Agriculture Organization of the United Nations (FAO) in Zambia.

Enforcement Issues

Whereas many people would agree on pro-consumer or consumer-protection measures in principle, they may disagree strongly on the preferred enforcement method. In general, there are two distinct approaches:

- **Industry self-regulation**—Institutions within an industry form an association that subscribes to a voluntary code of conduct, agree on mechanisms of surveillance and monitoring for adherence to the code, and decide on consequences of violating the code, e.g., expulsion from the association.
- **Government agency enforcement**—A state regulatory body, such as a consumer protection agency, is authorized to enforce the relevant law.

Self-regulation is often more flexible and pragmatic than government agency enforcement because it more closely reflects industry views. In the case of microfinance, it is less likely to result in excessive measures that reduce access to financial services and more likely to promote expanded access over time. However, one major drawback is

¹¹ See ECI Africa, “Financial Literacy Scoping Study and Strategy Project Report” (paper commissioned by FinMark Trust, Vorna Valley, South Africa, 2004), i and section 7.

¹² For more information, visit the Citigroup Foundation web site, www.citigroup.com/citigroup/corporate/foundation.

¹³ Jennefer Sebstad, and Monique Cohen, “Financial Education for the Poor,” Financial Literacy Project, Working Paper No. 1 (Washington, DC: Microfinance Opportunities, April 2003), 11. www.microfinanceopportunities.org/publications/.

that once an institution is expelled from the association for non-adherence, the association has no further authority over it. That institution may continue its abusive practices without risk of retribution. Bad practice by nonmember institutions may undermine the reputation of the industry, despite good practice by members. This risk is particularly high if a substantial number of non-subscribing or expelled institutions operate freely, without incurring the costs of compliance. Only when voluntary industry associations develop a visible, trusted, and recognized public brand name are the incentives strong enough to influence nonmembers and encourage institutions to remain members.

Box 2 is an example of self-regulation: the Pro-Consumer Pledge, adopted in late 2004 by ACCIÓN International and MFN member institutions. MFN's active working group on pro-consumer policies developed the pledge and now seeks to document best practice as members implement it.¹⁴ The pledge principles address all the main categories of consumer protection highlighted in this note.

State enforcement of consumer protection laws can become cumbersome and bureaucratic. Substantial human and financial resources are required to monitor compliance and run effective complaint investigation operations. Because of their mandate, regulators may pursue consumer protection goals single-mindedly, possibly at the expense of expanding access to those who presently lack services. However, the advantage of state regulation over voluntary self-regulation is that it applies to all institutions—regardless of whether they are members of an industry association.

Each of these two approaches offers its own advantages and disadvantages, and neither is a one-size-fits-all solution. The appropriate enforcement approach for a particular country depends on the maturity and size of microfinance lending and the (perceived and actual) extent of lending

abuse. Even self-regulation may require and benefit from cooperation with government agencies (see the “Regulation and Enforcement” section of the Pro-Consumer Pledge in box 2). Indeed, self-regulation and government enforcement often go hand-in-hand. But when state enforcement is seen as an outright replacement for self-regulation, the balance tends to tip towards over-enforcement. The result may be to discourage competition and ultimately limit access to services for poor people.

Conclusions

The issue of consumer protection in microfinance is a challenge that is here to stay. Few lenders or policy makers would disagree with the principles supporting consumer protection. However, there exists no clear consensus about the scope and intensity of appropriate measures or the mechanisms to enforce them, especially in developing countries. As a result, developing countries may inappropriately apply mechanisms and approaches from developed countries without a proper evaluation of their costs and benefits, and often with unintended consequences.

In countries where political pressure to implement new protection measures is strong, regulators and policy makers should carefully consider the full impact such measures may have, both immediately and over time. Excessive protection could well lead to results that directly contradict what is intended. Rather than promoting the formalization and integration of microfinance into the mainstream of the financial sector, MFIs could be forced outside of any legal framework. Such cases would likely result in no protection at all for borrowers.

Even in countries where consumer abuse is not yet a problem, promoting consumer education and industry good practice holds considerable merit and could reduce, if not completely eliminate, future

¹⁴ For more information, visit the MFN home page, www.bellanet.org/partners/mfn.

pressure to over-regulate. Microfinance lenders should consider adhering to voluntary pledges or codes that promote effective consumer protection and a consumer-oriented culture. Proper adherence to codes of principles and good practice will demand

organizational commitment at all levels. Regardless of the regulatory environment for consumer protection, a truly consumer-friendly approach may indeed be the only long-term survival strategy for microfinance providers in competitive markets.

Box 2 ACCIÓN International-MicroFinance Network (MFN) Pro-Consumer Pledge

By adopting this pledge, the members of the MicroFinance Network agree to do the following:

- To apply these principles in their own organizations.
- To promote the widespread application of these principles among microfinance institutions in their countries.
- To engage with regulatory authorities in their countries where needed to promote effective yet non-burdensome policies or rules.
- To raise awareness in the global microfinance industry about the importance of pro-consumer principles.

Principles

1. *Quality of Service.* MFN members will treat every customer with dignity and respect. Members will provide services in as convenient and timely a manner as possible.
2. *Transparent Pricing.* MFN members will give clients complete and understandable information about the true costs they are paying for loans and transaction services and how much they are receiving for savings.
3. *Fair Pricing.* MFN members will price their services at a fair rates. Their rates will not provide excessive profits, but will be sufficient to ensure that the business can survive and grow to reach more people.
4. *Avoiding Overindebtedness.* In order to avoid customer over-indebtedness, MFN members will not lend any customer more than the customer can afford to repay.
5. *Appropriate Debt Collection Practices.* While debt collection practices must include energetic pursuit of defaulters, MFN members will treat customers with dignity and will not deprive customers of their basic survival capacity as a result of loan repayment.
6. *Privacy of Customer Information.* MFN members will protect the private information of customers from reaching others who are not legally authorized to see it.
7. *Ethical Behavior of Staff.* MFN members will hold their employees to a high standard with respect to conflicts of interest and unethical behavior, especially behavior that harms customers (such as taking kickbacks). Employees who breach these standards will be sanctioned.
8. *Feedback Mechanisms.* MFN members will provide formal channels of communication with customers through which customers can give feedback on service quality. These channels will include mechanisms for responding to specific customers regarding their personal complaints.
9. *Integrating Pro-Consumer Policies into Operations.* MFN members will make pro-consumer orientation a hallmark of the way they conduct business, through efforts such as staff training and incentives, financial education for customers, customer satisfaction programs and the like.

Regulation and Enforcement

The Network acknowledges that although in an ideal world, all microfinance institutions would adhere to these principles voluntarily, reality often differs. Microfinance institutions should not be put at a competitive disadvantage by adhering to these principles when less conscientious organizations ignore them. In such cases, collective action, either by the industry or by regulatory authorities, may be required to enforce application of these principles.

Source: www.bellanet.org/partners/mfn.



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